POST & SCHELL, P.C.
ATTORNEYS AT LAW

17 North Second Street
12th Floor
Harrisburg, PA 17101-1601
717-731-1970 Main
717-731-1985 Main Fax
www.postschell.com

John H. Isom

jisom@postschell.com
717-612-6032 Direct
717-731-1985 Direct Fax
File #: 150736

August 29, 2012

BY E-FILE

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor North
P.O. Box 3265
Harrisburg, PA 17105-3265

RE: Pennsylvania Public Utility Commission v. PPL Electric Utilities Corporation
Docket No. R-2012-2290597

Dear Secretary Chiavetta:

Enclosed is the Initial Brief of PPL Electric Utilities Corporation in the above-referenced proceeding.

Copies have been provided to the persons in the manner indicated on the certificate of service.

Respectfully Submitted,

John H. Isom

JHI/jl
Enclosure
cc: Certificate of Service
Honorable Susan D. Colwell

CERTIFICATE OF SERVICE

I hereby certify that true and correct copies of the foregoing **Initial Brief** have been served upon the following persons, in the manner indicated, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

Via E-Mail & First Class Mail

Tanya J. McCloskey, Esquire
Candis A. Tunilo, Esquire
Darryl Lawrence, Esquire
Office of Consumer Advocate
555 Walnut Street
5th Floor, Forum Place
Harrisburg, PA 17101-1923

Steven C. Gray, Esquire
Daniel G. Asmus, Esquire
Sharon E. Webb, Esquire
Office of Small Business Advocate
300 North Second Street
Harrisburg, PA 17101

Regina L. Matz, Esquire
Bureau of Investigation & Enforcement
PO Box 3265
Commonwealth Keystone Building
400 North Street, 2nd Floor West
Harrisburg, PA 17105-3265

Joseph L. Vullo, Esquire
Burke Vullo Reilly Roberts
1460 Wyoming Avenue
Forty Fort, PA 18704
Commission on Economic Opportunity

Adeolu A. Bakare, Esquire
Pamela C. Polacek, Esquire
McNees Wallace & Nurick LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
PP&L Industrial Customer Alliance

Todd S. Stewart, Esquire
Hawke McKeon & Sniscak LLP
100 N. 10th Street
PO Box 1778
Harrisburg, PA 17101
Dominion Retail, Inc.
d/b/a Dominion Energy Solutions

Scott J. Rubin, Esquire
Public Utility Consulting
333 Oak Lane
Bloomsburg, PA 17815
International Brotherhood of Electrical Workers, Local 1500

Kenneth L. Mickens, Esquire
The Sustainable Energy Fund of Central Eastern Pennsylvania
316 Yorkshire Drive
Harrisburg, PA 17111
Sustainable Energy Fund of Central Eastern Pennsylvania

Daniel Clearfield, Esquire
Carl R. Shultz, Esquire
Eckert Seamans Cherin & Mellott, LLC
213 Market Street, 8th Floor
PO Box 1248
Harrisburg, PA 17108
Granger Energy of Honey Brook LLC &
Granger Energy of Morgantown LLC

Deanne M. O'Dell, Esquire
Eckert Seamans Cherin & Mellott, LLC
213 Market Street, 8th Floor
Harrisburg, PA 17101
Direct Energy Services LLC

Eric Joseph Epstein
4100 Hillsdale Road
Harrisburg, PA 17112

Edmund J. Berger, Esquire
Berger Law Firm PC
2104 Market Street
Camp Hill, PA 17011
Richards Energy Group, Inc.

Robert D. Knecht
Consultant for OSBA
Industrial Economics Incorporated
2067 Massachusetts Avenue
Cambridge, MA 02140

Glenn Watkins
Technical Associates, Inc.
9030 Stony Point Parkway
Suite 580
Richmond, VA 23235

Stephen G. Hill
Hill Associates
4000 Benedict Road
Hurricane, WV 25526

Richard Koda
Koda Consulting
409 Main Street
Ridgefield, CT 06877

Roger D. Colton
Fisher, Sheehan and Colton
34 Warwick Road
Belmont, MA 02478

Via First Class Mail

John Lucas
112 Jessup Avenue
Jessup, PA 18434

Helen Schwika
1163 Lakeview Drive
White Haven, PA 18661

Dave A. Kenney
577 Shane Drive
Effort, PA 18330

William Andrews
40 Gordon Avenue
Carbondale, PA 18407

Roberta A. Kurrell
591 Little Mnt. Road
Sunbury, PA 17801

Date: August 29, 2012

John H. Isom

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-2012-2290597
	:	
PPL Electric Utilities Corporation	:	
	:	

INITIAL BRIEF OF PPL ELECTRIC UTILITIES CORPORATION

Paul E. Russell (ID # 21643)
Associate General Counsel
PPL Services Corporation
Office of General Counsel
Two North Ninth Street
Allentown, PA 18106
Phone: 610-774-4254
Fax: 610-774-6726
E-mail: perussell@pplweb.com

David B. MacGregor (ID # 28804)
Post & Schell, P.C.
Four Penn Center
1600 John F. Kennedy Boulevard
Philadelphia, PA 19103-2808
Phone: 215-587-1197
Fax: 215-320-4879
E-mail: dmacgregor@postschell.com

Michael W. Gang (ID # 25670)
John H. Isom (ID # 16569)
Christopher T. Wright (ID # 203412)
Post & Schell, P.C.
17 North Second Street
12th Floor
Harrisburg, PA 17101-1601
Phone: 717-731-1970
Fax: 717-731-1985
E-mail: mgang@postschell.com
E-mail: jisom@postschell.com
E-mail: cwright@postschell.com

Of Counsel:

Post & Schell, P.C.

Date: August 29, 2012

Attorneys for PPL Electric Utilities Corporation

9818533v1

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page

United States Court Decisions

Pennsylvania Court Decisions

TABLE OF AUTHORITIES

<u>Pennsylvania Administrative Agency Decisions</u>

TABLE OF AUTHORITIES

Page

TABLE OF AUTHORITIES

Page

TABLE OF AUTHORITIES

Page

Pennsylvania Statutes

TABLE OF AUTHORITIES

Page

Pennsylvania Regulations

I. INTRODUCTION

A. PPL ELECTRIC

PPL Electric Utilities Corporation ("PPL Electric" or the "Company") provides electric distribution services to approximately 1.4 million customers in a certificated service territory that spans approximately 10,000 square miles in all or portions of 29 counties in eastern and central Pennsylvania. PPL Electric Ex. 1, Exhibit Regs. § 53.53, I-B-1. PPL Electric is a "public utility" and an "electric distribution company" ("EDC") as those terms are defined under the Public Utility Code, 66 Pa.C.S. §§ 102 and 2803.

In this proceeding, PPL Electric requests Pennsylvania Public Utility Commission ("Commission") approval of a $104.6 million distribution rate increase, with an anticipated effective date of January 1, 2013. The rate relief is designed to provide the Company with an opportunity to earn an 8.46% overall rate of return on rate base, including an 11.25% return on common equity, on a claimed rate base of $2.422 billion. The distribution rate increase reflects PPL Electric's status as a distribution only electric utility and is based on financial and operating data for that single business line. The requested rate increase reflects the business environment the Company currently faces, including: reduced revenue resulting from lower customer usage and stagnant economic climate; the need to make significant capital investments to ensure that it is able to continue to provide safe and reliable service to its customers; support for the development and expansion of the competitive retail electricity market; and major storm damage in PPL Electric's service area during 2011. PPL Electric St. 1, pp. 2-3, 5.

Based on the results of a class cost allocation study and the requirements of the Commonwealth Court's decision in *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006) *appeal denied*, 591 Pa. 676, 916 A.2d 1104 (2007) ("*Lloyd*"), the Company proposes to allocate the requested increase to rate classes that are below the proposed system average rate of return. The affected classes include the residential customers, small single-phase commercial and industrial customers, street-lighting customers, and transmission service voltage customers. The Company also is proposing a rate decrease to one general service rate schedule with an overall return well above the system average rate of return. The proposed rate design also reflects PPL Electric's continued commitment to recover fixed costs through demand and customer charges rather than through kWh usage charges. Consistent therewith, PPL Electric is proposing to increase the residential customer charge from $8.75 to $16.00 per month to more closely reflect the costs that are incurred in providing service to these customers. The proposed rates are designed to reflect cost of service for each rate class and to reduce cross subsidization of rate classes. PPL Electric St. 1, pp. 3-4.

If approved, the requested distribution rate increase will move PPL Electric's inadequate return on equity from an estimated 6.7% in 2012 to an allowed 11.25%. This return is the minimum required for the Company to attract capital on reasonable terms, provide safe and reliable service to its customers, and fully fund the various innovative programs described in its filing. The return on equity proposed in this proceeding is particularly appropriate in view of PPL Electric's management effectiveness and award-winning customer service in the face of challenging economic and capital market conditions. PPL Electric St. 1, *passim*; PPL Electric Ex. No. 1, Statement of Reasons. For all these reasons, as explained below and in the filing, PPL Electric's proposed distribution rate increase is just and reasonable, and should be approved by the Commission.

B. HISTORY OF THE PROCEEDINGS

On March 30, 2012, PPL Electric filed with the Commission Supplement No. 118 to its Tariff-Electric Pa. P.U.C. No. 201 ("Supplement No. 118"), to become effective on June 1, 2012, together with supporting data, written testimony, and exhibits. In Supplement No. 118, PPL

Electric proposed a general increase in distribution base rates designed to produce approximately $104.6 million in additional annual base rate operating revenues based upon a future test year ending December 31, 2012, as adjusted for ratemaking purposes.

Supplement No. 118 was suspended by operation of law pursuant to Section 1308(d) of the Public Utility Code, 66 Pa.C.S. § 1308(d), for up to seven months, or until January 1, 2013, unless permitted by Commission Order to become effective at an earlier date. By Order entered May 24, 2012, the Commission initiated an investigation of PPL Electric's proposed general rate increase. The matter was assigned to the Office of Administrative Law Judge, and Administrative Law Judge Susan D. Colwell ("ALJ") was assigned to preside over the proceeding.

The Commission's Bureau of Investigation and Enforcement ("I&E") filed a Notice of Appearance. Complaints against the proposed rate increase were filed: the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), PP&L Industrial Customer Alliance ("PPLICA"), William Andrews, Eric Joseph Epstein, Dave A. Kenney, Roberta Kurrell, Donald Leventry, John G. Lucas, and Helen Schwika. Petitions to intervene were filed by the Commission on Economic Opportunity ("CEO"), Direct Energy Services LLC ("Direct Energy"), Dominion Retail, Inc. d/b/a Dominion Energy Solutions ("Dominion"), Granger Energy of Honey Brook LLC and Granger Energy of Morgantown LLC (collectively, "Granger"), the International Brotherhood of Electrical Workers, Local 1600 ("IBEW"), the Sustainable Energy Fund ("SEF"), and Richards Energy Group, Inc. ("REG"). In addition, various customers filed Protests to the requested distribution rate increase.

An initial Prehearing Conference was held as scheduled on May 31, 2012. Parties participating in the Prehearing Conference filed Prehearing Memoranda identifying potential issues and their expected witnesses. At the Prehearing Conference, the parties proposed a procedural schedule, which was adopted by the ALJ. In addition, the parties agreed to, and the ALJ approved, modified discovery rules for the above-captioned proceeding, which included shorter response times than those provided for in the Commission's regulations at 52 Pa. Code §§ 5.321 *et seq*.

In the Second Prehearing Order, dated June 1, 2012, the ALJ set forth the litigation schedule for the proceeding and the revised periods for responding to discovery requests. In addition, the ALJ listed the parties who had filed notices of intervention, petitions to intervene and complaints. The ALJ also granted the Petitions to Intervene of CEO, Direct Energy, Dominion, Granger, IBEW, and SEF.[1] Further, the ALJ indicated that the parties had agreed that there should be five public input hearings, which were held on: June 18, 2012, in Scranton and Wilkes-Barre; June 20, 2012, in Bethlehem and Allentown; and June 21, 2012, in Harrisburg.

The parties engaged in substantial formal and informal discovery in support of their respective positions. PPL Electric responded to more than 630 discovery requests, many of which had multiple subparts. In addition, substantial discovery requests were propounded to other parties.

On June 22, 2012, parties other than PPL Electric served their direct evidence, including testimony and exhibits. On July 16, 2012, PPL Electric, OCA, OSBA, and PPLICA served rebuttal testimony and exhibits. The I&E, OCA, OSBA, PPLICA, SEF, Dominion, Direct Energy, and Granger served surrebuttal testimony and exhibits on August 1, 2012. On August 6 and 8, 2012, PPL Electric served rejoinder testimony and exhibits.

[1] The Late-Filed Petition to Intervene of REG was granted in a separate Order issued by the ALJ on July 26, 2012.

Evidentiary hearings were held before the ALJ on August 6, 7, and 9, 2012. At the hearing, the parties' respective testimony and exhibits were admitted into the evidentiary record. Certain parties' witness were cross-examined and presented rejoinder testimony. The evidentiary record was closed on August 10, 2012.

A briefing schedule has been established by the ALJ. Pursuant to the Scheduling Order and Sections 5.501 and 5.502 of the Commission's regulations, 52 Pa. Code §§ 5.501, 5.205, PPL Electric herein submits this Initial Brief in support of the requested distribution rate increase. PPL Electric's Supplement No. 118, requesting a distribution base rate increase, is ripe for disposition.

C. LEGAL STANDARDS AND BURDEN OF PROOF

Under the Public Utility Code, a public utilities' rate must be just and reasonable and cannot result in unreasonable rate discrimination. 66 Pa.C.S. §§ 1301 and 1304. A public utility seeking a general rate increase has the burden of proof to establish the justness and reasonableness of every element of the rate increase request. 66 Pa.C.S. § 315(a); *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 236 PUR 4th 218, 2004 Pa. PUC LEXIS 39 (August 5, 2004). However, a public utility, in proving that its proposed rates are just and reasonable, does not have the burden to affirmatively defend claims made in its filing that no other party has questioned. As the Commonwealth Court has explained:

> 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. P.U.C., 570 A.2d 149, 153 (Pa. Cmwlth. 1990).

Although the ultimate burden of proof does not shift from the utility seeking a rate increase, a party proposing an adjustment to a ratemaking claim of a utility bears the burden of presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment. *See, e.g., Pa. P.U.C. v. PECO*, Docket No. R-891364, *et al.*, 1990 Pa. PUC LEXIS 155 (May 16, 1990); *Pa. P.U.C. v. Breezewood Telephone Company*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45 (January 31, 1991). In addition, tariff provisions previously approved by the Commission are deemed just and reasonable and, therefore, a party challenging a previously-approved tariff provision bears the burden to demonstrate that the Commission's prior approval is no longer justified. *See, e.g., Pa. P.U.C. v. Philadelphia Gas Works*, Docket Nos. R-00061931, *et al.*, 2007 Pa. PUC LEXIS 45 at *165-68 (September 28, 2007) (adopting the ALJ's discussion on burden of proof).

Further, a party that raises an issue that is not included in a public utility's general rate case filing bears the burden of proof. For example, in *Pa. P.U.C. v. Metropolitan Edison Company, et al.*, Docket Nos. R-00061366, *et al.*, 2007 Pa. PUC LEXIS 5 (January 11, 2007), a party offered proposals to have the companies incur expenses not included in their filings. The ALJ held that, as the proponent of a Commission order with respect to its proposals, the party bears the burden of proof as to proposals that are not included in the companies' filings. The Commission agreed and adopted the ALJ's conclusion that Section 315(a) of the Public Utility Code 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. *Id.* at *111-12.

II. <u>SUMMARY OF ARGUMENT</u>

As explained in the Company's Statement of Reasons and in the Direct Testimony of its President, Gregory N. Dudkin, the need for rate relief in this proceeding is based on four primary factors: (1) declining sales due to government-mandated conservation programs and poor economic conditions in the Company's service territory; (2) major plant investments required to replace aging infrastructure to ensure continued safe and reliable service to customers; (3) the need to achieve and maintain a strong financial profile necessary to raise the capital required to replace aging infrastructure; and (4) the need to recover the costs associated with major and unprecedented storm damage in 2011. The rate increase requested by the Company is fully supported by the record and is the minimum required to address these important issues.

PPL Electric's proposed rate increase is fully supported by well-established ratemaking principles and long-standing Commission practice and precedent. The requested increase also is fully supported by PPL Electric's demonstrated management effectiveness and outstanding service to its customers. As set forth in Section VI.E.1.g., the Company has undertaken an extensive series of efforts to control costs and improve the reliability and quality of service. PPL Electric has stepped forward to undertake a major capital investment program to replace aging infrastructure and proactively improve the safety and reliability of service. The Company has the highest level of shopping of any major Electric Distribution Company in the Commonwealth. The Company is the only EDC that has installed smart meters for all of its customers and is the only EDC that has installed an Interactive Voice Recognition program at its customer contact center. The Company, for the past 30 years, has been and remains a leader in developing and implementing cost effective universal service programs for its customers. As a result of these collective efforts, on July 12, 2012, the company received its 18th J.D. Power and Associates award, ranking first in customer satisfaction among electric utilities in the eastern United States.

At the same time, PPL Electric's rates remain fair and reasonable. The requested increase in this proceeding, if granted in full, will increase the average residential customer's bill by approximately $7 per month. Even with this increase, the average residential customer's total bill will be less than it was when PPL Electric's generation rate cap expired on January 1, 2010, and PPL Electric's rates will still be below comparable rates for both average Pennsylvania and Mid-Atlantic electric utilities. PPL Electric respectfully requests that the Commission consider these accomplishments in establishing just and reasonable rates in this proceeding.

The opposing parties have proposed a series of adjustments and disallowances, which if collectively adopted, would deny the Company any rate relief and destroy its financial integrity. The OCA proposes an increase of only $21.0 million, about one-fifth of the Company's claim. I&E goes much farther and proposes a $12.0 million rate decrease. The OCA proposal, if adopted, would substantially weaken the Company's financial profile at the worst possible time; when it is in the middle of a major capital construction program. The I&E proposal, if adopted, would seriously damage the Company's financial integrity, risking a further downgrade of PPL Electric's credit ratings and undermining its ability to raise capital on reasonable terms to provide safe and reliable service to customers.

These results are disturbing in their own right, but are particularly troubling because they are based almost entirely on proposed adjustments which are not only clearly without merit, but also are fundamentally inconsistent with many, many years of Commission and judicial precedent. The Company was very careful in this proceeding to file its case in accordance with fundamental ratemaking principles and established Commission precedent. The opposing parties have simply ignored these precedents and proposed adjustments which violate fundamental and long-standing ratemaking principles and controlling Court and Commission decisions. The ALJ and the Commission, by simply applying long-standing precedent, can and should reject virtually every adjustment proposed in this proceeding. Examples of opposing party adjustments which are inconsistent with Commission precedent, include the following:

Capital Structure. The Company's proposed capital structure (51.03% common equity and 48.97% long-term debt) reflects the replacement of $500 million preferred stock with 50% long-term debt and 50% common equity and the addition of a small amount of common equity designed to strengthen the Company's financial profile so that it can attract capital on reasonable terms to finance its major infrastructure improvement program and provide continued safe and reliable service to customers. This proposed capital structure is the Company's actual projected capital structure at the end of the future test year, December 31, 2012, and is within the range of capital structures for the Barometer Group of companies used by all witnesses in this proceeding.

I&E and OCA each propose hypothetical capital structures relying on the historic average capital structures for PPL Electric and on historic average capital structures of their respective barometer groups. These proposals should be rejected for several reasons. First, the Commission has consistently declined to adopt a hypothetical capital structures when the capital structure proposed by the utility is within the range of capital structures employed by other similarly situated utilities. PPL Electric's proposed capital structure clearly meets this precedent. Second, in this particular case, the use of historic averages miscalculates the capital structure because it fails to account for PPL Electric's elimination of preferred stock in 2012. The Company has proposed to replace its preferred stock with 50% common equity and 50% long-term debt, and no party has opposed this proposal. Third, and most importantly, the proposals of I&E and OCA do not reflect the need for a stronger financial profile if the Company is to be able finance its infrastructure improvement program on reasonable terms. The Company's proposed capital structure is reasonable, consistent with Commission precedent and should be approved.

Return on Common Equity. The cost of common equity is almost always the most hotly contested issue in base rate proceedings. In this case, it is also the most important issue. PPL

Electric is in the midst of a major infrastructure improvement program during which it will spend over $2.9 billion in new capital needed to continue to provide safe and reliable service to customers. Much of the Company's current distribution infrastructure was installed in the 1960's to address major growth in its service territory. These facilities are now nearing the end of their useful lives and must be replaced. No party has challenged any aspect of this program. Nor has any party contested PPL Electric's need to access capital markets on reasonable terms in order to fund this construction program. However, in order to implement this program and attract capital on reasonable terms, it is critical that the Company maintain a strong financial profile. The rate increase requested in this proceeding and in particular the proposed 11.25% return on common equity, is critically important to the Company's ability to maintain a financial profile which will allow it to attract the capital needed to complete the infrastructure improvement program.

The determination of the cost of common equity in this case is important for another reason. Pennsylvania recently adopted legislation, which authorizes fixed utilities to apply for a distribution system improvement charge ("DSIC") to recover the capital cost of qualifying distribution system investments. The cost of common equity determined by the Commission for PPL Electric in this proceeding also will be used in establishing PPL Electric's DSIC. A very important part of DSIC implementation is the determination by the Commission of the cost of common equity to be used in the DSIC formula. The investment community will be watching this case closely for guidance as to how the Commission plans to implement the DSIC and whether it will permit a reasonable return on DSIC-eligible investments. A fair and reasonable cost of common equity determination in this proceeding will send a positive signal to the investment community that the Commission is serious about implementing a DSIC mechanism which encourages all utilities to make the necessary investments to improve infrastructure critical to providing safe and reliable service to customers.

I&E (8.38%) and OCA (9.0%) propose costs of common equity far below that proposed by the Company. The many flaws and errors in the development of these figures and their devastating impact on the Company's financial condition are addressed in detail below. Fundamentally, these proposals are completely out of line with all applicable precedent. The Commission has not awarded a single digit rate of return since the adoption of original cost rate ratemaking (as opposed to fair value ratemaking) in the early 1980s,[2] and it certainly should not do so here. The Commission's most recent determination of the cost of equity for PPL Electric was in its 2004 base rate proceeding, where the Commission adopted a 10.7% allowance. In its 2008 *Aqua* Order, the Commission adopted a cost of common equity of 11.0%. In the 2006 *PPL Gas* decision, the Commission adopted a cost of common equity of 10.4. Indeed, Ms. Cannell demonstrated that the central tendency of allowed ROEs across the country from January 1, 2009 through June 30, 2012, ranged between 9.75% and 10.99% with several Commission's authorizing allowed ROEs between 11.0% and 11.25% Clearly, I&E and OCA proposals are out of line with applicable precedent.

Storm Damage Expense. The Company's operating expense claim for storm damage is comprised of three parts: (1) a budgeted level of expense for ongoing normal storm damage costs for non-Commission reportable storms and Commission reportable storms; (2) a storm damage insurance premium, which insures for Commission reportable storm damage expense in excess of the policy deductible up to an $18,250,000 policy limit; and (3) a claimed five-year amortization of 2011 storm damage expense for extraordinary storm damage expense in excess of the maximum insurance coverage. The Company's claim is opposed only by I&E, who

[2] *Pa. P.U.C. v. Pa. Gas & Water Co.*, 492 Pa. 326, 424 A.2d 1213 (1980).

proposes to end the Company's Commission-approved storm damage insurance program and provide a rate allowance based on a five-year average of both ordinary and extraordinary storm damage expense. I&E's proposal should be rejected for many reasons.

First, I&E's analysis is based almost entirely on its conclusion that over the five-year period 2007-2011 ratepayers paid more in rates for storm damage costs than the Company's total storm damage expense for the same period. This analysis, however, contained a fundamental and fatal error: It double counted the insurance deductible and budget amount for normal Commission-reportable storm damage expense. Correcting for this obvious error reverses the result of I&E's analysis and demonstrates the reasonableness of the Company's claim. Second, I&E claims that, on a 20/20 hindsight basis, the storm insurance premium paid by customers has exceeded payouts under the policy. Again, I&E is factually wrong; insurance payouts have exceeded the insurance premium, but more importantly, I&E's analysis reflects a serious and fundamental misunderstanding of insurance. One cannot judge the reasonableness of insurance based on whether the payout under the policy exceeded the premium. This is the equivalent of saying that purchasing a ten-year term life insurance policy was unreasonable because the policyholder did not die within the ten-year period. Third, I&E continues its 20/20 hindsight by contending that PPL Insurance, the affiliate company who provides storm damage insurance for PPL Electric, has operated at a "profit." Again, I&E fundamentally misunderstands the insurance business. The "profit" identified by I&E is in fact simply a reserve to pay future claims and is a fundamental and legally required element of insurance company operations. And, in any event, I&E is again factually wrong. PPL Insurance actually operated at a loss during the time period examined by I&E. For these reasons, I&E's attack on PPL Electric's Commission-approved storm damage insurance program should be rejected.

In addition, if the ALJ and the Commission for some reason were to adopt I&E's erroneous arguments, the alternative ratemaking allowance proposed by I&E, a five-year average of all storm damage expense, both ordinary and extraordinary, must be rejected. First, it is premised on I&E's flawed, double counting conclusion, discussed above, that customers have paid more in rates than PPL Electric's total storm damage costs. This is simply not true and adoption of I&E's proposal would assure that PPL Electric has no chance of recovering its reasonable storm damage costs. Second, I&E's proposal is fundamentally and completely inconsistent with 40 years of uniform Commission precedent on the treatment of storm damage costs in rates. In Pennsylvania, utilities include in rates a normal level of storm damage expense for normal ongoing storm damage expense. Extraordinary, non-recurring, storm damage costs are excluded from test year rates because they are not a recurring cost. Utilities are then permitted to recover the cost of extraordinary storms through an amortization allowance. I&E's proposal ignores all of this precedent and proposes a new and completely untested alternative method of recovering storm damage costs, which on its face would prevent PPL Electric from recovering its full storm damage expenses in rates. Finally, if I&E's proposal were adopted, it should apply prospectively only, and PPL Electric should be allowed full recovery through a five-year amortization allowance of the cost of 2011 storms, which were incurred under traditional and long-standing Commission practice and precedent. I&E's proposal should be recognized for what it is: A poorly disguised effort to disallow recovery of reasonable and prudent storm damage expense. This adjustment should be rejected.

Incentive Compensation. PPL Electric's wage expense claim in this proceeding consists of three components: base pay, benefits and incentive compensation. No party has challenged the reasonableness of PPL Electric's total wage expense claim, and indeed, no party has challenged the reasonableness of the amount of any of the three components of wage expense. Rather, I&E and OCA contend that incentive compensation benefits both ratepayers and shareholders and therefore should be shared on a 50/50 basis, thereby disallowing one-half of incentive compensation from rates. These proposals are unlawful and inconsistent with Commission and judicial precedent. The Commission has approved 100% recovery of incentive compensation in rates on several occasions, and in fact, recently held that Philadelphia Gas Works was imprudent for not having an incentive compensation program. In addition, the Commonwealth Court has held that 50/50 sharing of expenses on the theory of joint ratepayer/shareholder benefits is unlawful as it does not allow the utility the opportunity to recover reasonable operating costs in rates. A utility's operating expense is either reasonable or unreasonable in amount. If it is reasonable, it is fully recoverable in rates, not just one-half or some other fraction. If it is unreasonable, it is disallowed. No one has claimed that PPL Electric's incentive compensation expense is unreasonable in amount, and it therefore should be fully recovered in rates.

I&E and OCA also point out that PPL Electric's incentive compensation plans have both operating and financial goals and that financial goals benefit shareholders and therefore should not be recoverable in rates. Again, this position is inconsistent with long-standing Commission precedent. It also proves too much. All utility expenditures benefit both ratepayers and shareholders, but this is not and cannot be the basis for disallowing otherwise reasonable costs. PPL Electric's claim for incentive compensation expense is reasonable and should be approved.

Adjustments Based on Historic Averages. In several areas, *e.g.*, uncollectible accounts expense, capital structure, and PPL Services costs, I&E proposes the use of historic averages to set future test year expense. This appears to be based on I&E's belief that utility rates should be based on actual expenditures. While a comparison with historical results is one means of testing the reasonableness of future test expense claims, it is clear that utility rates in Pennsylvania are not, and have not been for over 30 years, based on historic results. Rates are set based on budgeted, not actual, expenses for a future test year. I&E's failure to acknowledge this fundamental ratemaking principle has caused it to rely on historic averages in setting rates even where these historic results do not reasonably reflect future conditions. Ratemaking is prospective and should reflect conditions expected during the future test year and the initial period new rates will be in effect. Where facts and conditions have changed, rates should not be based on historic results.

Rate Structure. The parties continue their departure from precedent in the rate structure area. The Company's cost allocation study was fully litigated and approved by the Commission in the Company's 2010 base rate proceeding, decided only two years ago. The OCA, inexplicably, simply reargues all of the positions it presented in the 2010 case in this proceeding, asks the Commission to reject the same cost allocation study it specifically approved only two years ago, and then proposes a revised revenue allocation based entirely on its flawed and previously rejected cost allocation study. For the reasons given by the ALJ and the Commission in the 2010 base rate case, OCA's alternative cost allocation study and its related revenue allocation should be rejected.

PPL Electric has proposed to recover the revenue increase requested in this proceeding through the residential customer charge, resulting in a proposed charge of $16.00 per month as compared to the current charge of $8.75. The Company's proposal is fully supported on the record and should be approved. However, the Company recognized that its proposal to recover the entire increase through the customer charge has created substantial opposition in this proceeding, and in its rebuttal testimony, proposed an alternative of $14.09. The $14.09 customer charge, in the Company's view, should not be controversial. The Company applied exactly the same approach in developing this charge that the Commission approved in a recent *Aqua* rate proceeding. Both OCA and I&E witnesses agree that the same principles should apply for electric, gas and water companies in developing customer charges. There is no reasonable basis for rejecting this alternative.

Purchase of Receivables Program. Marketers propose several changes to the purchase of receivables program. These are addressed in detail below. Direct Energy, however, goes beyond these proposals and recommends "rebundling" uncollectible accounts into distribution rates. This exact same proposal was just rejected in PPL Electric's 2010 base rate case, is fundamentally inconsistent with Commission precedent supporting the unbundling of costs, is at odds with the Competition Act, which requires rate unbundling, and is inconsistent with the Commonwealth's Court's *Lloyd* decision on unbundling. This proposal should be rejected out of hand.

Other Issues. On several other issues, *e.g.*, consolidated tax savings, depreciation reserve, cash working capital and prepayments opposing party adjustments also are completely inconsistent with long-standing Commission practice and precedent and should be rejected. Details regarding these claims are provided below.

Perhaps recognizing the lack of merit and support for their individual adjustments, certain parties seek to focus attention on the frequency and amount of Company distribution rate filings in recent years and their impact on residential customers, particularly in the current economic environment. These arguments should be rejected for several reasons. First, the issue in this case is what level of prospective rate relief, if any, the Company should receive. The fact that the Company has filed for several distribution rate increases over the past eight years is not relevant to this proceeding, which must determine a prospective level of just and reasonable rates. The increase requested in this proceeding, if granted in full, would result in a $7 per month increase in residential customers' bills. This, in the Company's view, is a reasonable price to pay to support implementation of a major infrastructure program to ensure continued safe and reliable electric service to customers.

Second, any fair examination of the Company's rate history should focus on a much longer time frame. Many utilities go through cycles of rate filings associated with major construction programs, and the Company is no exception. The Company completed its last major construction cycle in 1985 with the completion of its Susquehanna nuclear power plant. Since that time (27 years) the Company has filed six base rate cases, or an average of one every four and one-half years.

Third, the Company has explained the several reasons necessitating these filings, including "catch up" filings after the expiration of a nine-year distribution rate cap, compliance with the *Lloyd* decision which required the gradual elimination of substantial subsidies to residential customers which were implemented by Commission orders in the 1980s, and most importantly, the need to replace aging infrastructure and attract capital on reasonable terms to finance these improvements.

Finally, the rate analyses presented focus solely on distribution rates and not on the actual bills paid by customers. As noted above, the impact of increasing distribution rates has been fully offset by declining generation rates, such that even if the distribution rate increase requested in this proceeding were granted in full, the total bill for an average residential non-shopping customer will be lower than it was after generation rate caps expired on January 1,

2010. Shopping customers are presumably paying even lower rates. This is a remarkable result, which should be recognized by the Commission in its final determination of just and reasonable rates in this proceeding.

III. RATE BASE

A. PLANT IN SERVICE

1. OCA's Proposed Adjustments To Plant Additions Should Be Rejected

PPL Electric's original cost of jurisdictional plant in service, as of December 31, 2012, is projected to be $4,904,470,000. PPL Electric Ex. Future 1-Revised, Sch. C-1. Only OCA challenged any portion of PPL Electric's claimed plant in service.

Originally, OCA recommended that $5,458,000 of PPL Electric's proposed plant in service as of the end of future test year be disallowed because OCA believed that the expected in-service dates were beyond the end of the future test year, December 31, 2012. OCA Ex. KC-1-Revised, Sch. 2, p. 2; OCA St. 1-Revised, pp. 8-9. The OCA's adjustment was based upon PPL Electric's response to Interrogatory I&E-RB-14-D. A copy of this interrogatory response was provided as PPL Electric Ex. GLB-7.

In rebuttal, PPL Electric explained that OCA's proposed adjustment was based upon a misunderstanding of PPL Electric's interrogatory response. Specifically, the interrogatory asked for the **original** anticipated in-service dates, not the expected in-service date when the rate filing was prepared. When the rate case was prepared, primarily in March 2012, the originally anticipated in-service dates were reviewed and updated, and all of the projects shown on the interrogatory response had in-service dates on or before December 31, 2012. PPL Electric St. 2-R, pp. 5-6.

Based on this explanation, OCA withdrew its proposed adjustment to plant is service. OCA St. 1-SR, p. 3. No issues remain regarding the completion of plant projects before the end of the future test year.

2. OCA's Proposed Adjustment To Plant In Service Based Upon Proposed Adjustments To Incentive Compensation Expense Should Be Rejected

As explained in Section V.A., below, OCA proposed an adjustment to PPL Electric's claim to recover incentive compensation expense for employees of PPL Electric and employees of PPL Services. OCA also asserted that, because a portion of PPL Electric's payroll costs is capitalized, its proposed incentive compensation adjustment would also affect the level of payroll being capitalized and thereby reduce plant in service. OCA St. 1-Revised, pp. 8-9. As explained below, in Section V.A, the OCA's adjustment is without merit and should be rejected. The related OCA rate base adjustment should be rejected for the same reasons.

As shown on OCA Ex. KC-1-Revised, Sch. 4, p. 4, OCA also recommended that plant in service be reduced by $4,204,000 based on OCA's calculation of the capitalized portion of incentive compensation expense for employees of PPL Electric. In addition, OCA recommends that PPL Electric's plant in service be reduced by the additional amount of $4,612,000 based on OCA's calculation of the capitalized portion of the reduction in incentive compensation payroll expense to be paid to employees of PPL Services. OCA's original calculation capitalized not only a portion of payroll but also a portion of payroll taxes and benefits. PPL Electric St. 3-R, pp. 21,25; OCA Ex. KC-1 Revised, Sch. 4, p. 4.

In rebuttal, PPL Electric explained that OCA's calculations of the effects of its proposed payroll adjustments for incentive compensation were not calculated correctly because benefits and payroll taxes are not applied to incentive compensation. PPL Electric St. 3-R, pp. 21-25.

In surrebuttal, OCA accepted PPL Electric's explanation and withdrew its proposed adjustments to rate base related to payroll taxes and benefits for incentive compensation. OCA St. 1-SR, p. 8. The OCA adjustment to rate base for the capitalized portions of incentive compensation should be rejected for the reasons explained in Section V.A., below.

3. OCA's Adjustment To Rate Base For Vacant Positions Should Be Rejected.

OCA's proposed adjustment to plant in service related to vacant positions in the amount of $1,883,000 as shown on OCA Ex. KC-1-Revised, Sch. 1, p. 2. Like incentive compensation, OCA proposed an adjustment to rate base related to the capitalized portion of its proposed adjustment to payroll for vacant positions. OCA St. 1-Revised, pp. 17-18, OCA Ex. KKC-1, Sch. 4, p. 3, line 16. OCA' proposed adjustment should be rejected for the reasons explained in Section V.D. of this Brief, below.

B. DEPRECIATION RESERVE

1. OCA's Proposed Adjustment To The Accumulated Reserve For Depreciation Should Be Rejected

PPL Electric's claim for plant in service is comprised of two parts: The original cost of plant in service less accumulated depreciation. Both elements of this claim are based on projected levels of plant and accumulated depreciation at the end of the future test year, December 31, 2012. To project these balances, PPL Electric started with the plant and depreciation reserve balances at December 31, 2011, the end of the historic test year, and brought them forward to December 31, 2012 by adding or subtracting, as appropriate, all plant and depreciation-related transactions (such as plant additions, retirements and net salvage) projected to be recorded on the books and records of the Company during the future test year. PPL Electric's expert, Mr. Spanos, who sponsored the depreciation studies in this proceeding, has prepared depreciation studies for numerous public utilities throughout Pennsylvania and the rest of the United States, and has testified in numerous rate proceedings here and in other states. PPL Electric St. 13, pp. 2-7. Regarding PPL Electric's approach, Mr. Spanos explained that: "This methodology was utilized and approved in the last proceeding for PPL Electric Utilities. It has been universally accepted by this Commission for all major electric, gas and water companies." PPL Electric St. 13-R, p. 4. Mr. Spanos has used the same methodology in this proceeding that he has used in numerous prior proceedings, which has been universally accepted by the Commission.

OCA's witness, Mr. Coda, did not object to the manner in which Mr. Spanos developed its plant in service balance, but he proposed a different, and in PPL Electric's view, inconsistent method for developing the accumulated reserve for depreciation. Instead of using the projected depreciation expense for the calendar future test year used by Mr. Spanos ($155,248,000), Mr. Coda used the <u>annualized</u> level of expense based on the level of plant projected to be in service at the end of the future test year ($168,920,000). This is the same level of depreciation expense that PPL Electric has reflected in its revenue requirement in this proceeding. OCA St. 1 (Revised), pp. 10-12. The difference ($10,417,000) is the amount of OCA's proposed adjustment to the depreciation reserve. OCA's adjustment, if adopted, would overstate the depreciation reserve and understate rate base and therefore should be rejected.

OCA's witness, Mr. Coda, is not from Pennsylvania and apparently is not familiar with long-standing Pennsylvania depreciation practices. Nor does he, unlike Mr. Spanos, specialize in depreciation. As a result, he has proposed an inconsistent and completely unprecedented method for calculating the depreciation reserve. His proposed adjustment should be rejected for this reason alone.

Second, Mr. Coda's adjustment confuses the determination of rate base and the determination of revenues and expenses in a base rate proceeding. Rate base is determined at a point in time, *e.g.,* the end of the future test years, by adding together the various components of rate base at their projected levels as of the end of the test year. For plant in service and the depreciation reserve, these are the balances projected to appear on the public utility's balance sheet at the specified point in time, *i.e.,* the end of the future test year. Rate base components that are based on projected year-end levels include plant in service, deferred taxes and customer advances for construction. Rate base items are not "annualized" to reflect a full twelve months of end of future year condition. Revenues and expenses, in contrast, are not set at a single pint in time; rather, they are "annualized" to reflect year end levels, as though the level of expense being incurred at the test year end were to continue for the next twelve months. For example, a utility may have varying levels of employees and wage rates in effect during the course of the future test year. For ratemaking purposes, wage expense is not set based on the average number of employees or the averge wage rates in effect during the future test year; rather, it is based on the number of employees and wage rates projected to be in effect at the end of the future test year. Mr. Coda seeks to apply annualized depreciation expense to determine the rate base claim for accumulated depreciation. Annualization applies only to revenue and expense items, and not to rate base items. This mixing of ratemaking principles should be rejected.

The error of OCA's proposed adjustment can be demonstrated by its application to plant in service. Plant in service is the level of plant in service at the end of the historic test year plus plant added during the future year less retirements made during the future test year. There is no annualization of future test year level of plant additions. The same approach should be used for accumulated depreciation reserve, *i.e.,* it should be based on the level of reserve and the end of historic test year plus depreciation on plant additions made during the future test year less depreciation on retirements made during the future test year. Mr. Coda's approach of using a non-annualized level of plant in service with an annualized level of depreciation rserve would create a mismatch between plant in service and the accumulated reserve for depreciation. The mismatch would result in an overstatement of the accumulated depreciation reserve and a resulting understatement of rate base.

Finally, as the name suggests, the "accumulated" reserve for depreciation is the sum of all depreciation transactions projected to be recorded per books as of the end of the future test year. By including annualized depreciation expense in the calculation of the accumulated depreciation reserve OCA's proposed adjustment would add depreciation expense to the reserve that has not and will not be accrued or "accumulated" at the end of the future test year. His adjustment improperly reaches out beyond the end of the future test year to reflect depreciation that will not be accrued until after the test year is over. This clearly is inconsistent with fundamentals of test eyar ratemaking and should be rejected. PPL Electric St. 13-R.

C. ADDITIONS TO RATE BASE

1. Working Capital

PPL Electric's working capital requirement has five principal components. They are: (1) cashworking capital required for operation and maintenance expenses which is determined through a lead-lag study, (2) investments in prepayments, (3) an adjustment for accrued taxes; (4) adjustment for interest payments and (5) an adjustment for preferred dividend payments.[3] PPL Electric St. 7, p. 3. I&E has proposed adjustments to the lead-lag study, prepayments and

[3] PPL Electric, I&E and OCA all agree that the final calculation of working capital should reflect the final determinations regarding levels of expenses, preferred stock dividends and interest expense that will be recovered through rates. PPL Electric, I&E and OCA disagree about the level of expenses, preferred stock dividends and that PPL Electric should recover through rates, but although those disagreements affect the cash working capital requirement, they are disagreements regarding the underlying elements that affect the working capital calculation and are not working capital issues. These underlying elements are addressed below.

made certain comments regarding PPL Electric's working capital claim. These issues are addressed next.

a. OCA's Adjustments To PPL Electric's Cash Working Capital Requirement Should Be Rejected

PPL Electric's working capital calculation is explained in PPL Electric Statement 7 and PPL Electric Ex. Future 1-Revised, Schedules C-4 and C-5. PPL Electric's total working capital requirement is $65,303,000. PPL Electric Ex. Future 1-Revised, Sch. C-1.

b. I&E's Proposed Adjustment To Cash Working Capital For Lag Days For Affiliate Support Expense Should Be Rejected

PPL Electric cash working capital requirement is based on a lead/lag study. A lead/lad study measures revenue lag and the expense lag. The revenue lag is the delay between when service is provided to customers and when money is received in cash from customers for that service. The expense lag is the delay between when a service is provided to the utility and when the utility pays for that service. The difference between these two lags is the cash working capital requirement. PPL Electric St. 7, p. 4. No party has objected to the revenue lag (although I&E expresses concern but no adjustment[4]). As to expense lag I&E objects to the use of a 35 day lag for services from affiliates.

Specifically, I&E proposes to increase the expense lag days for payments to affiliates for support services to from 35 days to 75 days. PPL Electric's lead/lag study payment lag for operating expenses is based on the time between when services on average are received and when payments are actually made. The 35 days is the sum of 15 days, which is the midpoint of the monthly service period and 20 days, which is when PPL Electric pays monthly bills a standard accounting transaction for the preceding month. PPL Electric St. 7-R, p. 2.

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[4] I&E St. 2, pp. 59-60.

The basis for I&E's adjustment is that PPL Electric's shared services agreement with affiliates states that services are payable **within** 60 days after receipt of the invoice. I&E contends that PPL Electric should wait the full 60 days before paying its affiliates. I&E St. 2, p. 56; I&E Ex. 2, Sch. 35. I&E's proposed adjustment should be rejected.

PPL Electric treats its payments for affiliate support services exactly the same as it treats payments to non-affiliated vendors. PPL Electric should not discriminate in favor of its affiliates, nor should it discriminate against its affiliates.

A payment lag of thirty days of service is commercially reasonable and typical of terms required by PPL Electric's vendors. It would not be reasonable for PPL Electric to pay its affiliated service providers more slowly than it pays its non-affiliated vendors. In addition, the terms of the service agreement state that payment is due **within** 60 days; it does not mandate a 60-day delay in payment. PPL Electric St. 7-R, pp. 2-3. PPL Electric's use of a 35-day payment lag in its cash working capital is consistent with its past practices in many prior rate cases.

It must be emphasized also that PPL Electric has consistently incorporated a 35-day payment lag for affiliates in its prior rate cases. In all such prior rate cases, the Commission and other parties have accepted PPL Electric's actual 35 day payment lag for affiliated services in calculating cash working capital requirements. PPL Electric St. 7-R, p. 3. It also should be approved in this proceeding.

c. PPL Electric Has Addressed I&E's Comments Concerning PPL Electric's Cash Working Capital Calculation

I&E raised four additional comments regarding PPL Electric's cash working capital calculation. I&E St. 2, pp. 59-60. PPL Electric addressed each of these comments, as explained below. PPL Electric St. 7-R, pp. 4-7.

The first comment was an observation that the revenue lag specific to the 20-day due date has increased significantly since PPL Electric's 2010 base rate case filing. I&E St. 2, pp. 58-59. I&E is correct that the revenue lag for residential customers has increased from 43 days to 63 days since PPL Electric's 2010 base rate case. The increase results from a higher accounts receivable balance in proportion to revenue for 2011. The higher accounts receivable balance is due to customers' economic stress resulting from the sluggish economic recovery coupled with higher prices for generation in the 2010-2011 period. PPL Electric St. 7-R, pp. 4-5. The revenue lag for residential customers has grown because residential customers have a longer termination and collection cycle, longer pay back periods and other payment delays resulting from medical emergencies, Commission complaints, *etc.* Such delays arise more often during periods of economic stress. PPL Electric St. 7-R, pp. 4-5.

I&E's second comment relates to accrued taxes. I&E St. 2, p. 60. Through the discovery process, PPL Electric identified, and informed other parties about, certain incorrect accrued tax factors used in Sch. C-4, p. 4 of PPL Electric Ex. Future 1. The correct factors have been utilized to make calculations on Sch. C-4, p. 4 of PPL Electric's final accounting exhibit, Ex. Future 1-Revised. PPL Electric St. 7-R, p. 5.

I&E's third comment related to postage expense. I&E St. 2, p. 60. I&E opined that postage should not be reflected in both the pre-payment and operation and maintenance expense components of the working capital requirement. I&E's comments reflect a misunderstanding of PPL Electric's treatment of postage expense for ratemaking purposes. I&E fails to recognize that it is proper for postage expense to be reflected in both the operation and maintenance component of working capital and prepayments because each component addresses postage expense during two separate and distinct periods of time.

PPL Electric, like many corporations that make large mailings, uses a postage meter system to pay postage. Periodically, PPL Electric pays the United States Postal Service ("USPS") for postage to be used by the postage meter. The postage available in the meter decreases as PPL Electric uses it to add postage to envelopes. When the postage meter has been substantially depleted, PPL Electric remits additional payment to the USPS, and the process repeats.

For ratemaking purposes, the first time period related to postage expense is the prepayment. This period begins when PPL Electric makes prepayments to the USPS and ends when the postage meter adds postage to an envelope. Thus, the time when the postage has been purchased but not yet used appears on PPL Electric's balance sheet as a prepayment and is reflected in PPL Electric's working capital requirement as such. Thereafter, when PPL Electric adds postage to an envelope, the postage is recorded as an expense. In the second time period, which commences when the postage is used on an envelope, the expense appears in the working capital requirement as an operation and maintenance expense to reflect the period between when PPL Electric's postage meter adds postage to an envelope and the time that customers pay PPL Electric. That is, the second period is the payment lag. Because the inclusion of postage expense as a prepayment is completely separate from its treatment as an operation and maintenance expense in the working capital calculation, there is no double recovery on postage. PPL Electric St. 7-R, pp. 6-7.

I&E's fourth comment is that it has not adjusted PPL Electric's cash working capital requirement based on its proposed adjustments to operation and maintenance expenses. I&E St. 2, p. 60. As explained previously, PPL Electric agrees that it is appropriate for working capital calculations to reflect levels of operation and maintenance expenses allowed by the Commission for ratemaking purposes. It must be noted, however, that PPL Electric explains below reasons why most of I&E's proposed adjustments to operation and maintenance expenses should be rejected.

d. I&E's Proposed Elimination Of Assessments For The Commission, OCA And OSBA From Prepayments Should Be Rejected.

The second principal component of working capital is prepayments. This component of working capital reflects the fact that PPL Electric must pay certain costs before they are properly charged to expense for accounting and ratemaking purposes. The categories of prepayments include the Commission assessment (which includes the assessments for the OCA and OSBA as well as for the Commission itself), insurance, postage and other. The amounts of prepayments is determined by use of a 13-month average. PPL Electric St. 7, p. 5; PPL Electric Ex. Future 1-Revised, Sch. C-4, p. 3.

OCA proposes also to adjust PPL Electric's prepayments by eliminating Commission assessments. I&E St. 2, pp. 57-59. I&E, recommended that the assessment component of the working capital requirement be eliminated because, in I&E's view, the assessment is for the previous calendar year and is not a prepayment at all. I&E St. 2, pp. 57.59. I&E's recommendation should be rejected.

Consistent with long standing Commission precedent, PPL Electric included Commission assessment in the prepayment component of its working capital requirement. For many years, public utilities have included Commission assessments as prepayments in their working capital calculation without controversy. *See, e.g., Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, Docket No. R-00942991, 1994 Pa. PUC LEXIS 134 (Dec. 6, 1994). Despite decades of practice and despite the absence of any change in legislation or other circumstance, I&E proposes to disallow working capital on the theory that the assessment is for the prior calendar year and not for the Commission's fiscal year. I&E's proposed adjustment should be rejected.

Although the Commission assessment is **calculated** using, among other things, a utility's jurisdictional revenue for the prior calendar year, the assessment is applicable for the **forthcoming** Commission fiscal year, July 1, through June 30, as stated in the Commission's invoice that was dated June 21, 2012:

> The Commission is submitting a request for **pre-payment** of PPL Electric's estimated Public Utility Commission assessment for the fiscal year 2012-2013. The requested pre-payments amount is an estimate based on the revenues shown on your Company's GAO-11 submission and the Commission's **fiscal year 2012-2013 budget** request. When the assessment invoices are issued in August for the **fiscal year 2012-2013** your invoice will be adjusted to reflect the payment made in response to this letter.

PPL Electric Ex. BLJ-1 (emphasis added).

That the assessment is for the fiscal year starting on the following July 1 is made clear also in Section 510 of the Public Utility Code, 66 Pa.C.S. § 510 under which the Commission imposes assessments on public utilities subject to its jurisdiction. Under the statute, the chronology is clear. The Commission budget is proposed to the Governor and the General Assembly by the preceding November 1; the General Assembly is expected to approve a Commission budget for the forthcoming fiscal year by the preceding March 30. Acting on the approved budget, the Commission allocates the assessment among public utilities based upon, among other things, each public utility's jurisdictional revenues for the preceding calendar year. After the Commission makes the calculations, it prepares payment requests which the utilities receive in June prior to the fiscal year for which the assessment is made. PPL Electric pays its assessment in full in accordance with the Commission's invoice. The Commission does not offer payment plans for public utilities.

Contrary to I&E's unsupported contentions, PPL Electric properly included the 13-month average of its Commission assessment prepayments as a component of working capital.

D. DEDUCTIONS FROM RATE BASE

1. OCA's Proposed Reduction to Rate Base for Deferred Income Taxes Related to Incentive Compensation Should Be Rejected

In conjunction with its proposed adjustment to incentive compensation, OCA proposed to adjust rate base for deferred income taxes in the amount of $1,744,000. OCA Ex. KC-1 Revised, Sch. 4, p.4, line 20.

In rebuttal, PPL Electric explained that there are no deferred income taxes related to incentive compensation because such compensation is paid by March 15 after the year for which the compensation is granted. Therefore, PPL Electric is allowed to and does deduct incentive compensation from taxable income for the year in which the compensation is awarded, *i.e.*, the compensation is not deferred. PPL Electric St. 3-R, p. 21.

In surrebuttal, OCA accepted PPL Electric's explanation that there are no deferred incomes taxes related to incentive compensation and agreed to withdraw that proposed adjustment to rate base. OCA St. 1-SR, pp. 7-8.

Despite the fact that OCA agreed to withdraw the portion of its incentive compensation adjustment related to deferred income taxes, the adjustment is still in its revenue requirement calculations. OCA Ex. 1-SR, Sch. 4, page 4, line 20. PPL Electric believes that the inclusion of this adjustment is OCA's exhibit was an oversight.

2. OCA's Proposed Reduction To Rate Base For Accumulated Deferred Income Taxes From Deferred Storm Cost Deductions Should Be Rejected

OCA originally proposed that PPL Electric's rate base be reduced by approximately $10,744,000 by increasing accumulated deferred income taxes pertaining to reflect deferred storm costs. OCA St. 1-Revised, p. 14; OCA Ex. KC-1-Revised, Sch. 2, p. 8. In rebuttal, PPL Electric explained that reflecting deferred income taxes on deferred storm balances would be contrary to long standing Commission practice and Pennsylvania law. The Commission does not permit jurisdictional utilities to earn a return on deferred operating costs. *See, e.g., Pa. P.U.C. v. PPL Gas Utilities Corp.*, Docket No. R-00061398, pp. 10-13 9 (Feb. 9, 2007). Because PPL Electric is not permitted to earn a return on the deferred balance, it would not be appropriate to reduce rate base by any related deferred income taxes. Further, Pennsylvania is a "flow through" state with regard to the calculation of federal and state income taxes. That is, deferred taxes are reflected in a jurisdictional utility's rate base only when doing so is mandated by state or federal requirements such as ACRS/MACRS depreciation. *Barasch v. Pa. P.U.C.*, 507 Pa. 496, 491 A.2d 94 (1985). Consistent with these Pennsylvania ratemaking principles, PPL Electric reflected tax deductions for storm restoration expenses related to Hurricanes Irene and Lee and the Halloween Snow Storm for ratemaking purposes, as well as for tax purposes, in the year in which they were incurred – 2011. There are no deferred taxes. In surrebuttal, OCA accepted PPL Electric's explanation and withdrew its proposed adjustment. OCA St. 1-SR, p. 5.

E. CONCLUSION AS TO RATE BASE

For all the foregoing reasons, PPL Electric's proposed jurisdictional rate base of $2,420,963,000, as shown on PPL Electric Exhibit Future 1-Revised, Sch. C-1, should be approved.

IV. REVENUES

A. I&E'S ADJUSTMENT TO MISCELLANEOUS REVENUES FOR RECONNECTION FEES SHOULD BE ACCEPTED

PPL Electric proposes to increase the fee it charges customers for the reconnection of service under Rule 10 of its Tariff from $15 to $30 during normal business hours and from $21 to $50 during non-business hours. PPL Electric's current reconnection fees have been in place for over 30 years, and its proposed increase is at the low-end of the estimated costs to reconnect customers during and after normal business hours. PPL Electric St. 5, p. 21. Further, PPL Electric's proposed reconnection fees are at or below all but one Pennsylvania EDC. OCA St. 3, pp. 47-48. For these reasons, PPL Electric's proposal to increase its reconnection fees is just and reasonable and, therefore, should be approved.

OCA accepted PPL Electric's proposal, but recommended that the Company be directed to monitor the costs of reconnection and provide a detailed cost analysis, with and without smart metering, in its next general rate case. OCA St. 3, p 48. In response, PPL Electric explained that it has included in its Commission-approved Smart Meter Technology Procurement and Installation Plan, Docket No. M-2009-2123945, a pilot program intended to assess the feasibility and cost-effectiveness for using smart meter technology for remote disconnection and reconnection, which would eliminate the need to manually reconnect customers. Therefore, this effort, which already is being conducted in the context of a Commission proceeding, makes it unnecessary to require PPL Electric to provide the same information in its next base rate proceeding. PPL Electric St. 5-R, p. 19. For this reason, OCA's recommendation should be denied.

I&E also accepted PPL Electric's proposal to increase its reconnection fee, but recommends that the Company's miscellaneous revenues be increased by $355,000 to reflect the additional revenue that would result from the higher fees. I&E St. 3, pp. 19-20. PPL Electric agreed that the higher reconnection fees will bring in additional revenue. However, the Company explained that I&E overestimated the amount of additional revenue because only about 50% of these billings actually result in revenue. Notwithstanding, PPL Electric accepted I&E's

recommended revenue adjustment of $355,000 with the knowledge that the actual payment experience will be reflected in the next base rate filing. PPL Electric St. 5-R, pp. 19-20; PPL Electric St. 8-R, p. 41; PPL Electric Ex. 1, Future 1-Revised. With this adjustment, PPL Electric's unopposed proposal to increase its reconnection fee should be approved.

V. EXPENSES

A. ADJUSTMENTS TO PPL ELECTRIC'S INCENTIVE COMPENSATION SHOULD BE REJECTED

PPL Electric provides three types of compensation to its employees: base pay, benefits and eligibility for incentive compensation. PPL Electric makes incentive compensation payments to its own employees and reimburses PPL Services for its share of PPL Services' incentive compensation which enables PPL Services to make incentive payments to its eligible employees. PPL Electric St. 3-R, pp. 15-26. Significantly, no party has challenged total compensation, base pay or benefits or the incentive compensation program as to structure or as to amount. The only challenges are based solely on the argument that incentive compensation benefits both shareholders and ratepayers and therefore should be shared.

Both I&E and OCA have proposed adjustments to PPL Electric's incentive compensation. I&E proposes to disallow one-half of PPL Electric's incentive compensation payments to its employees. I&E St. 2, pp. 16-17. OCA originally proposed to disallow two-thirds of incentive compensation for PPL Electric's employees and for employees of PPL Services. In addition, OCA proposed related adjustments to benefits, payroll taxes and rate base. OCA St. 2, 18-21. After reviewing PPL Electric's rebuttal testimony on the subject, PPL Electric St. 3-R, pp. 15-26, OCA revised its proposed adjustment to propose disallowance of half, instead of two-thirds, of the incentive compensation expense and eliminated the proposed adjustment to benefits, payroll taxes and rate base. OCA St. 1-SR, pp. 7-8. OCA St. 2-SR, pp.

6-8. After reviewing PPL Electric's rebuttal testimony, I&E reaffirmed its original proposed disallowance. I&E St. 2-SR, p. 10. I&E's and OCA's proposed adjustments should be rejected because PPL Electric's incentive compensation expense is reasonable, is part of PPL Electric's market-driven, competitive compensation package for employees and is a necessary and proper cost of providing service to customers.

Incentive compensation payments are a normal practice for both employers generally and public utilities specifically. Approximately 80 percent of large employers make incentive compensation part of their total compensation package. More than 81 percent of large public utilities have incentive compensation programs for their employees. PPL Electric St. 3-R, p. 17. No party disputed these facts.

PPL Electric's incentive compensation payments are part of PPL Electric's total compensation package for its employees. PPL Electric's total compensation package is market-driven, reasonable and appropriate. No party disputed these assertions of PPL Electric.

In order to make certain that PPL Corporation's total compensation package remains reasonable and appropriate, PPL Corporation compares its total compensation packages with those of other employers for comparable positions, using surveys provided by large, reputable firms such as Towers Watson, Aon Hewitt and Mercer. That is, if PPL Electric were to eliminate incentive compensation payments to employees, it would have to raise the fixed compensation to remain competitive with other employers. There would be no savings to ratepayers. PPL Electric St. 3-R, pp. 16-17. Similarly, no party has challenged the reasonableness of PPL Electric's total compensation expense for its employees. Therefore, if PPL Electric converted incentive compensation to guaranteed salary without changing the total expense, no party would have proposed an adjustment.

The incentive compensation benefits ratepayers as well as shareholders. By making a portion of employees' total compensation variable and dependent on their performance, PPL Electric achieves benefits for ratepayers. Specifically, incentive compensation helps drive organizational performance. More specifically, incentive compensation provides direction for employees by articulating operational and tactical objectives, setting priorities and establishing measures to create clarity and priorities. Incentive compensation also permits an understanding of the connection between individual performance and organizational success, thereby aligning individual efforts and performance to organizational goals. Incentive compensation also fosters engagement and feedback, making employees understand how their efforts impact organizational results in a tangible way. PPL Electric St. 3-R, p. 16.

It is clear and indeed uncontested that PPL Electric's incentive compensation programs for its own employees and for employees of PPL Services are based on achievement of both operational and financial goals. These goals are set forth in Ex. DAC-2, which is a copy of PPL Corporation's strategic goals framework, which is the foundation for the goals of all of PPL Corporation's subsidiaries including PPL Electric and PPL Services. PPL Electric St. 3-R, p. 18. As shown there, the PPL Electric incentive compensation plan has three principal goals. The first is increased shareholder value which includes meeting expectations for earnings per share, achieving targeted credit metrics and utilizing multi-year planning to achieve safe and reliable operations. The second goal is to achieve operational excellence, which includes maintaining and improving reliable and safe operations, meeting stakeholder expectations and assuring public and employee safety by maintaining company compliance and optimizing risk management. The third goal is optimizing work force readiness and engagement, which includes preparation for leadership succession, development of plans to close anticipated talent gaps with a diversity focus and values driven performance excellence. PPL Electric also has reliability goals related to the duration and frequency of customer outages as well as goals related to optimizing the capabilities of its workforce. These goals further directly benefit customers through the furnishing of high quality, reliable service. PPL Electric St. 3-R, pp. 23-24.

Of these goals and objectives, only two objectives are financially driven. These relate to earnings per share and credit metrics. Even the financial objectives, however, provide value to customers. Clearly, achieving targeted credit metrics is critical to both PPL Corporation and PPL Electric's credit ratings. PPL Electric St. 3-R, p. 18. Maintaining appropriate credit ratings allows PPL Electric and PPL Corporation access to the debt capital market and allows PPL Corporation access to the equity capital market at reasonable rates. Access to financial markets over the next few years is especially critical as PPL Electric continues a major construction program to replace aging infrastructure. In addition, good financial performance provides an internal source of capital which reduces the need to go to the financial markets for additional capital. It also defers the need to file rate increases and/or reduces the amount of any future requested rate increase. PPL Electric St. 3-R, pp. 18-19. Clearly these corporate objectives also benefit customers.

The Commission has reviewed and approved incentive compensation programs in numerous prior rate cases. *See, e.g., Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, 2008 Pa. PUC LEXIS 50, Docket No. R-00072711 (July 31, 2008); *Pa. P.U.C. v. Duquesne Light Co.*, 63 Pa. PUC 337, 1987 Pa. PUC LEXIS 342 (March 10, 1987). In fact, the Commission approved the PPL Corporation incentive compensation payment program for ratemaking purposes in *Pa. P.U.C. v. PPL Gas Utilities Corporation*, R-00061398, p. 40 (Feb. 9, 2007). More recently, the Commission even required Philadelphia Gas Works to propose an incentive compensation plan as a condition to the Commission's approval of an extraordinary rate increase in order to address management inefficiencies. *Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-2008-2073938, 2008 Pa. PUC LEXIS 32 (December 19, 2008).

Although the PPL Electric and PPL Corporation incentive compensation plans include both operational and financial objectives, it is clear that they are not skewed toward achieving financial objectives at the expense of operational objectives. On July 12, 2012, J.D. Power & Associates ranked PPL Electric first in residential customer satisfaction among electric utilities in the eastern United States. This award is the Company's eighteenth overall J.D. Power award since JD Power began studying electric utilities.

As explained previously, both I&E and OCA propose that incentive compensation expense be shared between shareholders and ratepayers on the theory that both benefit from the incentive compensation program. Both would require a 50-50 sharing, between ratepayers and shareholders, of incentive compensation payments to PPL Electric employees, and OCA proposes to have shareholders bear one half of the cost of incentive compensation payments by PPL Electric for both its own employees and to employees of PPL Services.

The concept of sharing of expenses between ratepayers and shareholders, on the theory that expenses were incurred for the mutual benefit of both, has previously been considered and rejected by the Pennsylvania appellate courts. At one time, the Commission applied this rationale to deny one-half of rate case expenses on the theory that such expenses were incurred for the mutual benefit of shareholders and ratepayers. The Commonwealth Court of Pennsylvania, however, rejected that approach. In *Butler Township Water Co. v. Pa. P.U.C.*, 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984) ("*Butler Township*"), the Commonwealth Court concluded:

> Butler [Township Water Company] claimed an estimated current rate case expense of $37,989. The PUC allowed Butler one-half of the amount claimed, $19,996, because it believed that the utility's shareholders should bear the burden of the other half.
>
> The PUC advances two theories for this action: the first is that of shared benefits, that is, the rate increase benefits both the shareholder and the ratepayer, and both should bear a portion of the cost incurred in securing the rate increase. The PUC cites as authority its own decision in *Pa. P.U.C. v. Pennsylvania Power Co.*, R-811510 (Jan. 22, 1982), where it wrote:
>
>> Our conclusion, that a 50-50 sharing between the stockholders and ratepayers, of the prudently incurred current rate case expense is an appropriate balance of the respective interests.
>
> The general rule is that a public utility is entitled to recover in rates those expenses reasonably necessary to provide service to its customers and to earn a fair rate of return on the investment and plant used and useful in providing service. *Western Pennsylvania Water Co. v. Pennsylvania Public Utility Commission*, 54 Pa. Cmwlth. Ct. 187, 422 A.2d 906 (1980). Operating expenses include prudently incurred rate case expenses. *Driscoll v. Edison Light and Power Company*, 307 U.S. 104 (1939); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935). Obviously, the refusal to allow the recovery of a proper expense diminishes to the same extent the utility's return on investment. There is no evidence in the record that the rate case expenses claimed here were unreasonable, imprudently incurred or excessive in amount.[[5]]

See also T.W. Phillips Gas and Oil Co. v. Pa. P.U.C., 81 Pa. Cmwlth. 205, 474 A.2d 355 (1984).

The rationale for Commonwealth Court's decision in *Butler Township*, that public utilities are entitled to recover all reasonable expenses, is applicable to incentive compensation. A utility such as PPL Electric is entitled to recover in rates all expenses reasonably necessary to provide service to customers. Neither I&E nor OCA have made claims that the total compensation expenses were unreasonable, imprudent or excessive. Nor did they challenge the

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[5] The second theory was that disallowing recovery of one half of rate case expense would discourage public utilities from filing an excessive number of rate cases. This theory does not apply to incentive compensation in this proceeding because no party has contended that PPL Electric pays excessive compensation, in total, for its employees or employees of PPL Services.

amount of incentive compensation or the structure of the program. As OCA stated: "I am not saying that the one-half of incentive compensation expense should not be incurred, but that it should be funded by shareholders." OCA St. 1-SR, p. 7. The adjustment to the incentive compensation expense proposed by I&E and OCA should be rejected.

Indeed, the rationale of sharing of expenses between shareholders and ratepayers that benefit both is simply unreasonable. Almost all expenses by public utilities benefit both shareholders and ratepayers. For example, a utility's expenditures to add or replace plant to improve service or to serve new customers both enable it to serve customers and increase the investment on which shareholders are allowed to earn a return. When PPL Electric incurs expenses to restore service after a storm, customers benefit through the restored service, while PPL Electric can resume producing revenue through the delivery of electricity to those customers. If every expense that benefits both ratepayers and shareholders were apportioned between them, utilities would soon experience financial stress. Thus, the relevant question is not whether a certain expense benefits shareholders as well as ratepayers. Rather, as the Commonwealth Court determined in *Butler Township*, the relevant question is whether the expense is reasonable and appropriate for the furnishing of service to customers. If so, the expense should be recovered in full.

I&E, in surrebuttal, mischaracterized PPL Electric's position regarding sharing of incentive compensation costs between ratepayers and shareholders. It stated that PPL Electric could not support its position that all incentive compensation benefitted exclusively ratepayers. I&E St. 2-SR, pp. 10-12. Such a statement, however, is nowhere to be found in any of PPL Electric's testimony or exhibits. Instead, as explained above, it is PPL Electric's position that many expenses, including employee incentive compensation expenses, benefit both shareholders and ratepayers, and PPL Electric is entitled to recover all expenses reasonably incurred in order to provide service, even if such expenditures benefit shareholders as well. I&E has simply rebutted an argument that PPL Electric never made and does not support. I&E's surrebuttal, that PPL Electric did not support a contention that all incentive compensation benefits ratepayers exclusively, should be disregarded.[6]

B. PPL ELECTRIC SHOULD BE PERMITTED TO RECOVER ALL EXPENSES FOR SUPPORT PROVIDED BY PPL SERVICES.

PPL Electric is a member of a larger corporate system which includes PPL Corporation and its various direct and indirect subsidiaries. In order to reduce duplication of functions within the PPL Corporate System, various administrative and general services are provided to PPL Electric and its affiliates from a central source, PPL Services. PPL Electric St. 3-R, p. 2. These services are provided pursuant to a services agreement, dated April 27, 1995. A copy of the services agreement is provided as Ex. 1, Attachment II-D-8a.

Services provided by PPL Services are either direct or indirect in nature. Direct services are performed specifically for the affiliate charged. Indirect services, in contrast, benefit more than one affiliate. As a result, indirect costs are allocated among the various affiliates. The indirect cost allocation methodology and procedures are explained in Ex. 1, Attachment II-D-8b to the filing.

I&E has recommended adjustments to expenses for PPL Services for environmental management, external affairs, facilities management, Office of General Counsel, and Office of the Chairman. I&E St. 2, pp. 19-30. Below, PPL Electric explains that each of these

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[6] I&E, in surrebuttal testimony, also complains that PPL Electric did not provide sufficient detail regarding specific goals by employee and the weighting of goals in determining individual incentive compensation. I&E St. 2-SR, p. 11. Their argument is simply a subargument to I&E's proposed sharing of incentive compensation expense and its desire to establish a more specific sharing mechanism. As noted above, sharing of incentive compensation expense is not appropriate and the detailed analysis desired by I&E is not necessary.

adjustments recommended by I&E should be rejected. These adjustments are based almost exclusively on historic averages. History may be useful as a guide or a check on expenditures, but it should not be the basis for setting prospective rates. In each instance, PPL has shown that the historic average does not reasonably reflect future conditions and does not produce an appropriate expense allowance. I&E's use of historic averages is a further example of I&E's mistaken belief that rates should be set based on actual expenses. I&E St. 2-SR, p. 3. I&E's belief has not been correct since the legislature authorized public utilities to submit rate cases using future test years in 1978. 66 Pa.C.S. § 315(e), Act of July 1, 1978, P.L. 598, No. 116, § 1.

1. Environmental Management

I&E recommends that environmental management expenses from PPL Services be levelized using a four-year average of actual annual jurisdictional direct support fees for the years 2009 through 2011 and the 2012 budget for such fees. I&E St. 2, pp. 20-21. The result of I&E's methodology is a ratemaking allowance of $364,000, which is a reduction of $103,000 from PPL Electric's 2012 budget.

In proposing its adjustment, I&E makes three observations. First, environmental management fees vary from year to year. Second, the future test year budget includes costs for the implementation of the environmental management system which will not occur every year. Third, PPL Electric does not expect its future test year expenditure levels to be sustained in subsequent years. PPL Electric St. 3-R, p. 3. As explained below, each of these observations is either incorrect or irrelevant or both.

Although environmental management charges to PPL Electric from PPL Services have varied from year to year, historic levels of charges should not be used to set rates for the future because new regulations have been adopted that require PPL Electric to undertake greater levels of environmental management activities. More specifically, federal and state environmental rules mandate routine inspection of storm water and erosion, and sedimentation control measures continue to be inspected after the project has been completed. PPL Electric St. 3-R, pp. 4-5. In addition to new environmental rules, another indicator that PPL Electric will incur greater costs for environmental management than in the past is the level of construction activity. Construction activity has increased from $298 million in 2009 to $671 million in 2012 and is expected to increase to $870 million in 2013. PPL Electric St. 10-R, p. 2. This increased level of construction activity carries with it an increased need for environmental management services. For these reasons, the fact that the level of environmental management costs has varied in the past does not support use of a historic average because, in this instance, the past clearly is not representative of the future.

Moreover, the fact that not all specific expenditures reflected in the budget for 2012 will continue every year in the future does not indicate that environmental management expenses will decrease. For example, PPL Electric's 2012 budget for environmental management costs includes costs to support the development of Enviance software, which will be used to manage environmental permits and obligations, which costs will not extend beyond the future test year. Nevertheless, no reduction in environmental management expenses is expected thereafter. The budgeted costs for 2012 include the costs of one and one-half additional full-time employees to work on the Enviance software system for PPL Electric and licenses for existing PPL Electric employees who will use the Enviance software. In 2013 and beyond, these additional employees will be on the job for the entire year and thereafter. PPL Electric will require additional licenses for employees using the Enviance software and additional environmental management support as more PPL Electric employees need to utilize the software and labor costs to support construction projects, as well as increased labor costs. The fact that not all of the exact same activities in the

2012 environmental management budget will continue into the future does not mean that such expenses will not increase.

I&E's third observation, that PPL Electric does not expect its environmental management expenses to increase in the future is not correct. Jurisdictional environmental management expenses for the years 2013 through 2017 are all projected to be higher than the future test year level of environmental expenditures of $467,000 (PPL Electric Exhibit DAC-1, Sch. 2) and are expected to rise each year through 2016. The projected levels of jurisdictional environmental management expenses, taken from PPL Electric's 2012 Business Plan are $485,000 for 2013, $494,000 for 2014, $508,000 for 2015, $549,000 for 2016 and $549,000 for 2017. PPL Electric Ex. DAC-1, Sch. 2, p. 2; PPL Electric St. 3-R, p. 5; PPL Electric Ex. DAC-1, Sch. 3, page 2. Therefore, I&E is simply incorrect that PPL Electric does not expect its jurisdictional environmental management expenses to be sustained in future years. To the contrary, PPL Electric expects that environmental management expenses will rise substantially. The claimed future test year level of expense therefore is reasonable and should be approved.

2. External Affairs

PPL Electric's budget for 2012 includes $2,602,000 for direct services from the External Affairs department of PPL Services. PPL Electric St. 3-R, p. 6; PPL Electric Ex. DAC-1, Sch. 5, p.2. I&E originally proposed to reduce these expenses from $2,602,000 to $1,432,000, a proposed adjustment of $1,170,000. I&E proposal would hold **direct** charges for external affairs at the historic test year level. In I&E's opinion, PPL Electric did not adequately support the substantial increase in direct external affairs expense from the historic to the future test year. I&E St. 2, p. 22.

I&E's proposed adjustment should be rejected. The increase to costs from the External Affairs Department to PPL Electric was caused primarily by a change in the manner in which charges have been distributed to PPL Corporation's affiliates, including PPL Electric. Beginning in 2012, far more of PPL Electric's external affairs costs are budgeted as **direct** support rather than allocated **indirect** support. PPL Electric St. 3-R, p. 6.

The shift from allocated **indirect** costs to **directly** charged costs resulted from a review of the day-to-day activities of Regional Community Relations Directors, who are part of the External Affairs Department. The day-to-day activities of the Regional Community Relations Directors focus on reliability, connections and disconnections, billing and payment, street lighting and economic development. In the past, the expenses for these activities have been allocated. All of these activities, however, are specifically for PPL Electric, and not any other affiliates. Therefore, starting in 2012, these external affairs expenses are being budgeted directly to PPL Electric. As a result, a much greater portion of costs related to the Regional Community Relations Directors is directly assigned to PPL Electric. In addition, in recent years, increased work related to line upgrading, tree trimming, and enhanced storm communication protocols have significantly added to the ongoing responsibilities of the Regional Community Relations Directors and Corporate Communications, another group within the External Affairs Department. These expenses also are no longer allocated among PPL Electric's affiliates. Instead, they are directly charged to PPL Electric. PPL Electric St. 3-R, p. 7.

In surrebuttal, in response to PPL Electric's rebuttal, I&E revised its position and reduced its proposed adjustment to $620,000. Although I&E recognized that the total external affairs expense had not changed materially, it argues that there was an increase in the percentage charged to PPL Electric of the total external affairs expense of the PPL Corporate System from the historic to the future test years. The increase was from about 25 percent to 36 percent. I&E contended that this percentage increase was "too much." I&E St. 2-SR, p. 17. I&E's revised recommendation was based on the "sluggish economy" and "encouraging cost containment." I&E St. 2-SR, p. 18.

I&E's revised recommendation also should be rejected. As PPL Electric has explained, the External Affairs department responds to the concerns of the community. It provides information to local governments and the public regarding reliability of service, connections and terminations, billing and payment, street lighting, economic development, siting and upgrade work, tree trimming and enhanced storm communication protocols. PPL Electric St. 3-R, p. 7. Certainly, the Commission would want PPL Electric to be responsive to its customers and the public in its service territory. The External Affairs Department handles that responsibility for PPL Electric. There has been a shift from **indirect**, allocated charges to more precise **direct** charges, which more accurately reflect the identity of the affiliate for which such activities are undertaken and the affiliate which benefits from them. The I&E's recommended adjustment to the budget for External Affairs should be rejected.

3. Facilities Management

I&E originally proposed to disallow $5,148,000 of PPL Electric's budgeted facilities management expenses directly charged from PPL Services for 2012. I&E's adjustment is based upon a three-year average of such expenses through 2011 and adding to that amount a normalization of the Facilities Management 2012 budget for Jobs Planned/Tenants Requests in the amount of $306,000. I&E St. 2, pp. 23-26. I&E's proposed adjustments for facilities management should be rejected for two principal reasons.

First, use of a three-year average, 2009 through 2011, is inappropriate due to a change in accounting for company-use electricity. In years prior to 2011, the cost of electricity used in PPL Electric buildings was recovered through rates for generation supplies and not through base rates. This method of recovering company-use electricity changed in the 2010 rate case, in which the Commission specifically approved recovery of such costs through distribution rates that went into effect on January 1, 2011. PPL Electric St. 3-R, p.10.

In proposing its adjustment, I&E relied on the following comparison to support its adjustment:

	2009	2010	2011
Facilities Management Expense	$13,577,000	$14,581,000	$20,825,000

When expenses for company-use electricity are removed to make the data comparable, the comparison is as follows:

	2009	2010	2011
Facilities Management Expense	$13,577,000	$14,581,000	$14,567,000

PPL Electric St. 3-R, p. 10, PPL Electric Ex. DAC-1, Sch. 1, p. 2. No adjustment is appropriate.

Second, I&E's proposed adjustment based on Jobs Planned/Tenant Requests is based on a misunderstanding of the manner in which such expenses are handled within the PPL Corporate System. No adjustment is necessary or appropriate. Although PPL Services initially charges PPL Electric for all operating costs including improvements to PPL Electric's buildings, these costs are billed to the affiliates occupying portions of the building. Therefore, to the extent that such improvements are made to benefit, or at the request of, affiliates who occupy portions of those buildings, the affiliates reimburse PPL Electric through rental charges. Therefore, the level of Jobs Planned/Tenant Requests in any particular year is irrelevant to PPL Electric's total revenue requirement because such costs are directly offset by rental payments from the affiliated tenants. I&E's proposed adjustment would eliminate a substantial portion of the expense for Jobs Planned/Tenant Requests but not the offsetting revenue. The result would be that PPL Electric's revenue requirement would be understated. PPL Electric St. 3-R, pp. 8-12.

In surrebuttal, I&E accepted the explanations provided by PPL Electric and withdrew its proposed adjustment to facilities management expense. I&E St, 2-SR, p. 19.

4. Office Of General Counsel

I&E proposed to reduce directly charged support fees from PPL Services for the Office of General Counsel. I&E's proposed adjustment related to current rate case expense. It will be addressed more fully below in the Section V.F., of this Initial Brief on rate case expenses. As explained there, as a result of an oversight, PPL Electric included certain rate case expenses both in its operation and maintenance budget and in charges from the Office of General Counsel of PPL Services. An adjustment to eliminate the duplicate expense is appropriate. Although the same result could be reached by either eliminating the expense from the rate allowance for operation and maintenance expense or the charges from the Office of General Counsel, it is more appropriate to eliminate the duplication from operation and maintenance expense because the expense in question will be incurred by the Office of General Counsel and then charged directly to PPL Electric. PPL Electric St. 8-R, pp 41-42.

5. Office Of Chairman

I&E recommends that indirect support fees from the Office of the Chairman be reduced from $1,010,000 to $626,000, which reflects the actual indirect support expense from the Office of the Chairman that was allocated to PPL Electric in 2011. I&E attempted to justify its adjustment by noting that the increase was contrary to recent experience and by observing that the PPL Corporate System had acquired several new subsidiaries which would permit spreading costs over a large base, thereby reducing costs to PPL Electric. I&E St. 2, pp. 28-30.

I&E's proposed adjustment should be rejected. I&E correctly notes that PPL Corporation recently made certain acquisitions and that a portion of the expenses of the Office of the Chairman is allocated to these newly-acquired entities. All else equal, this would result in a decrease in amount of Office of the Chairman expenses allocated to PPL Electric. However, in this case, all else is not equal. Specifically, in 2011, PPL Services undertook an extensive review of the allocation of PPL Services support group fees, including the Office of the Chairman. This review resulted in an adjustment to the allocation of related expenses to better match the benefits they provide to affiliates. This initiative resulted in a greater allocation of certain PPL Services support group fees to PPL Electric. PPL Electric St. 3-R, p. 14.

In addition, as explained previously, indirect support fees are allocated using a three-factor formula recommended by the Commission. As explained in Exhibit 1, Attachment II-B-8b, page 1, the three-factor indirect cost allocation formula reflects invested capital, operation and maintenance expenses and the number of employees. PPL Electric's portion of these factors in the Corporate System increased in 2012, which resulted in a greater allocation of certain indirect costs to PPL Electric. These factors, taken together, resulted in an increase in the allocation of indirect support fees from the Office of the Chairman from 2011 to 2012.

For the reasons stated above, however, I&E's proposed adjustment should be rejected.

C. PPL ELECTRIC'S STORM DAMAGE EXPENSE SHOULD BE APPROVED

PPL Electric's claim for storm damage expense is composed of three components. First, PPL Electric has included its future test year budget for normal storm damage expenses ($12,625,000). Second, PPL Electric has included the premium for storm damage insurance ($8,750,000). Third, PPL Electric has proposed to amortize over five years the extraordinary storm expenses, in excess of insurance recoveries, incurred during major storms in August 2011, Hurricane Irene, and October 2011, the Halloween Snow Storm ($5.324 million per year for five years). PPL Electric St. 2-RJ, pp. 3-6; PPL Electric Ex. GLB-9.

PPL Electric's budget for normal storm damage expenses covers all storm damage caused by non-Commission reportable storms, which are not covered by insurance, and the portion of the damage caused by Commission reportable storms[7] that is subject to the insurance deductible. The future test year budget for normal storm damage expense is $12,625,000. Of this total, $3,175,000 is for non-reportable storms, and $9,450,000 is for reportable storms. PPL Electric St. 2-RJ, pp. 4-6; PPL Electric Ex. GLB-9; PPL Electric Ex. Future 1-Revised Sch. D-9.[8]

PPL Electric's insurance premium for 2012 is $8,750,000. This insurance covers reportable storm damage expense in excess of the deductible amount, which for 2012 is $15,750,000.[9] The insurance policy has a maximum annual coverage of $18,250,000. PPL Electric St. 9-RJ, p4; I&E Ex. 2-SR, attachment 1, p. 5. PPL Electric's total expense budget for storm damage for 2012 is $21,625,000 ($12,625,000 + $8,750,000). The normal storm budget expense contains no provision for storm damage expense in excess of the limits of the insurance coverage. These first two items, *i.e.*, the normal storm damage expense and the insurance premium, comprise PPL Electric's budget for 2012 storm damage expense.

The third component of PPL Electric's future test year storm damage expense is an adjustment to the budget to recover extraordinary losses, in excess of insurance coverage from Hurricane Irene in August, 2011 and the Halloween snowstorm in October, 2011. As explained below, the normal storm damage budget contains no provision for recovery of costs in excess of insurance coverage. A budget adjustment, therefore, is necessary and appropriate to address

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[7] A Commission reportable storms is a single event which causes an unscheduled service interruption of at least 2,500 customers for six or more hours. 52 Pa. Code § 67.1(b).

[8] The amount for reportable storms is based on the operating expense portion (60%) of the $15,750,000 deductible under the 2012 storm insurance policy. It is expected that the other 40 percent of the deductible will be capitalized.

[9] Although the deductible is $15,750,000, the 2012 operating expense budget contains only $9,450,000 for reportable storms subject to the deductible. The reason for the difference is that historically approximately 60 percent of the costs of storm damage repair and service restoration is expensed, and 40 percent is capitalized. The insurance policy does not distinguish between expensed and capitalized costs. It covers both subject to the deductible storm damage costs that are expensed and capitalized. PPL Electric St. 9-RJ, pp. 5-6.

recovery of these costs. The total amount of the losses in excess of the insurance coverage in 2011 was $26,622,000; the annual amortization (five years) is $5,324,000. PPL Electric Ex. Future 1-Revised, Sch. D-9.

As explained below, all three components of PPL Electric's storm damage expense are consistent with well-established Commission precedent and should be approved.

I&E proposes that PPL Electric's storm damage expense be completely disallowed as filed. It proposes instead a completely new and different ratemaking treatment of storm damage expense that is without precedent in Pennsylvania. Under the I&E proposal, the Commission would use a five-year average of all storm damage expense, both ordinary and extraordinary, for ratemaking purposes. As an alternative, I&E proposes that the five-year average expense be treated through a special reserve account in which all revenues from customers for storm damage expense and actual storm damage expenses would be recorded and that such amounts would be trued up over time through some unexplained means. I&E St. 2, pp. 35-36. As explained below, I&E's proposal is entirely premised on a fundamental factual error, reflects a misunderstanding of the purpose of insurance, is completely unprecedented and therefore should be rejected.

1. Budget for Normal Storm Damage

As explained above, PPL Electric's future test year budget for normal storm damage is $12,625,000. This amount includes $3,175,000 for non-Commission reportable storms that are not covered by insurance, and $9,450,000 for the portion of reportable storms that are subject to the expense portion of the insurance deductible and therefore not recoverable under the storm insurance policy. Although, I&E recommended an alternative ratemaking approach to storm damage expense, it made no criticism of PPL Electric's budget amount. It therefore should be approved.

2. Storm Damage Insurance Premium

PPL Electric included in its total storm damage expense claim for 2012 its annual storm damage insurance premium of $8,750,000. PPL Electric Ex. GLB-9. For this premium, PPL Electric received $18,250,000 of coverage, subject to an annual aggregate deductible of $15,750,000. I&E Ex. 2-SR, Sch. 2, p. 6.[10]

PPL Electric first purchased storm damage insurance for 2007. The insurance has been underwriten by PPL Power Insurance, LTD. ("PPL Insurance"), a Bermuda corporation. PPL Electric St. 14-R, p. 3. The insurance covers storm damage caused by Commission-reportable storms, (I&E Ex. 2-SR, Sch. 2, p. 10), which are storms which cause interruption of service to at least 2,500 customers for a least 6 hours. 52 Pa. Code §67.1(b). The insurance coverage is subject to a deductible amount that has varied from year to year and to a maximum limit of liability that also has varied from year to year.

I&E opposed recovery by PPL Electric of its storm insurance premium. I&E St. 2, pp. 31-36. I&E contends that the purchase of storm insurance by PPL Electric has not been economically prudent or beneficial to ratepayers. I&E St. 2, p. 32. In support of this conclusion, I&E makes six arguments. First, I&E relied on a comparison between actual storm damage losses in 2007 through 2011 and rate recovery for storm damage insurance for the same period. As explained below, I&E's analysis is flawed because it contains a double counting of the insurance deductible. When corrected, I&E's own analysis supports the prudence of PPL Electric's decision to purchase storm insurance. Second, I&E relies on information taken from PPL Electric's 2007 rate case at Docket No. R-00072155, to conclude that PPL Electric's storm

[10] For PUC-reportable storms. PPL Electric is responsible for the first $15,750,000 of covered storm damage and the next $18,250,000 is covered by the insurance policy. PPL Electric is also responsible for damage in excess of the insurance coverage.

insurance is imprudent. I&E fails to note, however, that the ALJ and the Commission specifically approved PPL Electric's storm insurance in its 2007 rate case. I&E's analysis is plainly 20/20 hindsight that is not appropriate and is inconsistent with long-standing Commission precedent. Third, I&E contends that premiums paid by PPL Electric have been too high because PPL Insurance has been profitable. As explained below, I&E is factually wrong and reflects a fundamental misunderstanding of insurance. Fourth, I&E claims that insurance was not prudent because it has not saved money for ratepayers. The purpose of insurance is not to save money; it is to manage risk. And, in any event, PPL Electric's customers have saved money under its storm insurance program. Fifth, I&E claims that the insurance has not benefited ratepayers because they bear the time value of money between the payment of the storm damage insurance premium and the payment of losses by PPL Insurance. As explained, this contention is simply wrong. Sixth, I&E relies on a report of the Edison Electric Institute published in February, 2005, entitled *After the Disaster: Utility Restoration Cost Recovery*. I&E Ex. 2, Sch. 20. As explained below, the Florida report is clearly irrelevant to this proceeding.

a. I&E's Comparison Of The Ratemaking Provision For Storm Damage And Actual Losses Double Counts The Insurance Deductible And When Corrected, Does Not Support Its Analysis

I&E's comparison between the ratemaking provision for storm damage and actual storm damage is incorrect. By including both the normal storm damage budget and the insurance deductible, I&E has double counted expenses because the insurance deductible is **included** in its analysis. At I&E St. 2, p. 38, it provided the following table:

	2007	2008	2009	2010	2011
Insurance Premium	$6,725,000	$7,260,000	$6,960,000	$10,850,000	$10,850,000
Insurance Deductible	$6,682,000	$7,500,000	$7,500,000	$$7,500,000	$7,500,000
Normal Storm Allowance	$7,500,000	$8,743,000	$8,161,000	$9,847,000	$11,057,000

Based on this table, I&E concluded that the ratemaking provision for storm damage expenses for the five years ended December 31, 2011, was $124,635,000, which is greater than the cumulative expenses for the same period of $118,925,000. I&E, St. 2, p. 38.

The I&E table is not correct because it should not include the insurance deductible. The "insurance deductible" is already included in the "normal storm allowance."

An insurance deductible merely identifies an amount of damages for which there is no insurance and for which the insured must pay. For example, if a policy holder incurs $25 million of storm damage expense in a year, policyholder pays the amount subject to the deductible and insurance covers the excess up to the maximum limit of the policy. The amount paid by the insured for storm damage repair and the deductible are one and the same. The same analysis applies to PPL Electric's budget for storm damage insurance. The "normal storm allowance" includes what PPL Electric must pay before storm damage insurance kicks in, *i.e.*, the deductible. Therefore, I&E's table counts the deductible twice. When this double counting is eliminated, budgets for storm damage and insurance premium for 2007 through 2011 total $87,953,000, which is significantly less than actual storm damage expenses incurred of $118,925,000. PPL Electric St. 2-R, pp. 2-3.[11]

[11] I&E's analysis also suffers from additional flaws. For example, I&E confuses PPL Electric's budget with the ratemaking provision for recovery of storm damage expenses. Under I&E's analysis, the ratemaking allowance for storm damage changes every year from 2007 through 2011. PPL Electric, however, had rate cases only in 2007 and 2010, so there could not have been any change in the ratemaking allowance for storm damage expense except for 2008 and 2011. I&E's analysis also ignores the facts that the 2007 rate case resulted in a "black box" settlement that contained no identified provision for recovery of normal storm damage expense, although it did specifically provide

Despite this explanation, I&E has persisted in including the double counted storm insurance deductible as a ratemaking provision for payment of such expenses (*see, e.g.*, I&E St. 2-SR, p. 39). It provided two explanations for doing so, both of which pointed to perceived inconsistencies between PPL Electric's rebuttal testimony (PPL Electric St. 2-R, pp. 2-3) and its responses to interrogatories. First, I&E contended that the storm insurance deductible of $15,750,000 for 2012 "cannot possibly" be included in the normal storm damage budget of $12,625,000. I&E St. 2-SR, p. 40. Second, I&E contended that there were differences between "claims paid" and "insurance reimbursements total." As explained next, neither contention has merit.

Contrary to I&E's contention, the normal insurance budget does include an amount equal to the portion of the deductible expected to be expensed. Of the total storm damage budget for 2012 of $12,625,000, $3,175,000 is for non-Commission reportable storms, and $9,450,000 is applicable to Commission reportable storms. The amount of $9,450,000 represents the portion of the storm damages that is subject to the insurance deductible that will be expensed, instead of capitalized. Historically, approximately 60 percent of storm costs have been charged to expense, and approximately 40 percent of storm costs have been charged to capital. PPL Electric first recognized this distinction in its budgeting process for 2012. PPL Electric St. 2-R, pp. 4-6; Tr. 186. I&E's contention that the deductible of $15,750,000 "cannot possibly be" in the budget of $12,625,000 is incorrect. I&E's use of a comparison between history storm damage expenses and revenues for recovery of such expenses is flawed, and therefore, it cannot support any conclusion that the storm losses incurred in 2011 were not extraordinary.

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for amortization of extraordinary 2005 storm damages and payment of the storm damage insurance premium. *Pa. P.U.C. v. PPL Electric*, Docket No. R-00072155, p. 21 (Dec. 6, 2007). Similarly, the 2010 rate case rate case resulted in a "black box" partial settlement which did not identify any amount for recovery of normal storm damage costs, although it did approved the proposed storm damage insurance premium. *Pa. P.U.C. v. PPL Electric*, Docket No. R-2010-216194, p. 9 (Dec. 21, 2010).

Nor is there any inconsistency between the "claims paid" amounts and the "insurance reimbursement total." At pages 30-31 of I&E St. 2-SR, I&E complains that PPL Electric's analysis is flawed because the "claims paid" information provided by PPL Electric does not equal "insurance reimbursement totals" as of December 31, 2011. I&E is correct that the two amounts are not equal, but otherwise, I&E is incorrect. The two amounts differ because the former represents claims paid during a specific period, while the latter amount reflects the value of claim made during a specific period. As PPL Electric has explained, it submits claims for storm losses for an entire year after the year has ended. Therefore, as of December 31, 2011, PPL Insurance had received all premiums for the year but had not paid any storm damage expenses for the year. In order to synchronize for this difference, PPL Insurance included in its financial statements, as required, its best estimate of claims that will be paid for storms which occurred during calendar year 2011 but will be paid during 2012. "Claims paid," in contrast includes only actual payments. Claims paid as of December 31,2011, included no amount for 2011 losses that will be paid in 2012. In essence, when I&E compares premiums paid with claims paid for the five years ended December 31, 2011, it is comparing five years of premium with four years of losses and excluding losses for 2011, the year in which the greatest losses occurred. PPL Electric St. 14-RJ, pp. 8-9. I&E's comparison between the ratemakaing provisions for storm damage and actual storm damage losses should be rejected.

b. I&E's Reliance On The 2007 PPL Electric Rate Case Is Improper 20/20 Hindsight And In Any Event, Does Not Support Its Position

I&E also relies on an analysis of PPL Electric's 2007 base rate case to support its position.. Specifically, I&E's contends in this case that the evidence from the 2007 rate case demonstrates that the initial decision for 2007 to purchase storm insurance was neither economically prudent nor beneficial to ratepayers. It stated:

> PPL witness Douglas A. Krall stated "The Commission should either approve PPL Electric's primary claim of $13.249 million for storm damage with related increase, or in the alternative, approve a revised claim of $12.8 million to reflect actual average storm damage costs (I&E Ex. No. 2, Sch. 22). Since insurance costs inherently increase, this 2007 statement by Douglas Krall itself demonstrates that the storm insurance proposal recommended in the 2007 rate case, comparative to average storm damage costs, was neither economically prudent nor to the benefit of the ratepayers.

I&E St. 2, p. 34. In reaching this conclusion, however, I&E inexplicably ignores the fact the ALJ and the Commission approved the Company's storm insurance proposal in that case and that OTS (the predecessor to I&E) supported that proposal in a settlement that was filed on August 30, 2007. The settlement generally was a "black box" settlement, but it resolved certain identified issues. Among these issues was the recovery of the "**distribution-related portion of the premium for storm damage insurance.**" The ALJ issued a Recommended Decision on October 19, 2007, in which she recommended approval of the settlement with two changes which are not germane to the storm damage insurance issue. In the Commission's Order in *Pa. P.U.C. v. PPL Electric*, Docket No. R-00072155, p. 8 (Dec. 6, 2007), the Commission approved the settlement including the insurance premium. It is difficult to understand I&E's reliance on PPL Electric's 2007 rate case to support its position that storm damage insurance is imprudent, where OTS never objected to PPL Electric's storm damage insurance, where the OCA, the only party that objected to the expense, joined in the settlement, and where the settlement was approved by the ALJ and by the Commission. I&E's reliance on PPL Electric's the 2007 rate case provides no support for its position and, in fact, demonstrates its lack of merit.

I&E's argument also reflects an obvious and improper use of 20/20 hindsight analysis to evaluate the prudence of a utility's decision making. PPL Electric's storm insurance policy was approved by the Commission in its 2007 rate proceeding. I&E now concludes in 2012, that the decision to purchase insurance in 2007 was wrong. Such 20/20 hindsight analysis is not proper. *Pa. P.U.C. v. Philadelphia Electric Co.*, 522 Pa. 338, 561 A.2d 1224 (1989); *Pittsburgh v. Pa. P.U.C.*, 370 Pa. 305, 88 A.2d 59 (1952); *National Fuel Gas Distribution Corp. v. Pa. P.U.C.*, 76 Pa. Cmwlth. 102, 464 A.2d 546 (1983).

c. PPL Insurance Has Not Been Profitable.

I&E next argues that PPL Electric should not continue to carry storm damage insurance because its affiliate PPL Insurance has made a "profit." I&E St. 2-SR, pp. 30-31. Later, in its Supplemental Surrebuttal Statement, I&E argues, in essence, that PPL Insurance is profitable but it is hiding its profitability in the growing value of its loss and loss expense account. I&E St. 2-SSR, p. 5. Both of I&E's contentions are incorrect, and both are based upon misunderstandings of insurance accounting and the treatment of the substantial storm losses incurred in 2011. Contrary to I&E's contentions, over the five years that the storm damage insurance has been in effect, PPL Insurance has lost money. During that period, PPL Electric's PPL Insurance's capital and surplus decreased from $12,378,416 as of December 31, 2006, to $6,533,494 as of December 31, 2011. I&E Ex. 2-SSR, Sch. 1, Att. 1, p. 4, Sch. 1, Att. 5, p. 4. In total for the period, PPL Insurance experienced a net loss, including investment income, of $5,480,896. PPL Electric Ex. TN-2. PPL Electric explained:

> To date, for the entire history of PPL Insurance for all lines of insurance, actual losses have been less than expected losses as calculated by actuarial studies. That is, combined with investment income has resulted in a positive Statutory Capital Surplus balance. There is a minimum statutory capital and surplus that PPL Insurance is required to maintain under Bermuda law in order to continue to write insurance. The losses incurrd in 2011 reduced PPL Insurance's statutory capital and surplus to a level that is less than $3 million above the required minimum. If PPL Insurance were to incur storm losses in 2012 similar to those incurred in 2011, it would not have sufficient remaining capital and surplus to retain its license to write insurance under Bermuda law.

PPL Electric, St. 14-RJ, pp. 12-13.

In apparent recognition of the fact that its contention, that PPL Electric is not profitable, is not supported by PPL Insurance's financial statements, I&E asserts that PPL Insurance's profit is concealed by an increase in the provision for losses and loss expenses. I&E St. 2-SSR, 5-6. Again, I&E is incorrect.

PPL Electric explained why its provision for loss and loss expense increased during 2011. Although it reflects all lines of insurance, the principal reason why it increased was the extreme amount of storm damage suffered by PPL Electric in 2011. Much of those losses were covered by insurance. PPL Electric St. 14-RJ, p. 11. I&E's observations regarding the increase in PPL Electric's provision for loss and loss expenses is misplaced. As PPL Electric explained: "A conclusion that the large storm damage expenses losses in 2011 somehow made PPL Insurance profitable is simply incorrect." PPL Electric St. 14-RJ, p. 12.

In this regard, it is important to understand that the provision for loss and loss expense cannot be manipulated to "hide" profit because it is subject to careful scrutiny by independent actuaries and because it reflects losses, most of which are known in amount. A large portion of the provision for loss and loss expense is related to workers' compensation coverage written by PPL Insurance. This provision is verified annually by an independent actuarial review. In addition, the provision for loss and loss expense is reviewed for accuracy annually by PPL Insurance's external auditor during its statutory audit review. PPL Electric St. 14-RJ, p. 12.

Most of the losses are known to a reasonable degree of certainty. The loss and loss expense provision as of December 31, 2011, as set forth in the 2011 annual statement includes obligations to pay two claims where it is certain that the policy limit will be paid. It also includes provision for payment of a claim involving a known jury verdict which is under appeal.

It is true that the provision for loss and loss expenses increased from December 31, 2010 to December 31, 2011. The principal reasons for such increase, however, was the storm damage losses incurred in 2011 that would be paid in 2012. The increase in the provision for loss and loss expenses does not in any way indicate that PPL Insurance has been profitable. PPL Electric St. 14-RJ, pp. 11-12.[12]

d. Contrary To I&E's Contention, The Purpose Of Insurance Is Not To Save Money.

I&E contends that no purchase of insurance is prudent unless it saves money for the insured. I&E St. 2, p. 32, 38. I&E's fundamental contention is incorrect. If insurance were prudent only if it saves money for the insured, no purchase of term life insurance would be prudent unless the insured died while the insurance was in effect. Further, if premiums were also set at a level below actual losses, all insurance companies would become insolvent. PPL Electric St. 14-R, p. 6.

PPL Electric's storm damage insurance from PPL Insurance is not designed to save money for PPL Electric. Instead, the premiums are calculated by the independent actuary to equal losses, over time, with no allowance for profit. Thus, under the policy, PPL Insurance assumes the risk that actual covered losses will be greater than the long term average of expected covered losses. PPL Electric St. 14-R, p. 3.

Instead of saving money, PPL Electric's purchase of storm damage insurance serves two important functions. First, it spreads losses over an extended period of time which reduces the impacts of the variability of losses from year-to-year on both PPL Electric's ratepayers and PPL Electric's financial statements. Second, it provides PPL Electric with access to the reinsurance market, which is the source of non-affiliated storm damage insurance available. PPL Electric St.

[12] It is important to note also that PPL Insurance has never paid a dividend. PPL Electric St. 14-RJ, p. 13.

14-RJ, p. 5. Clearly, PPL Electric's purchase of insurance was prudent because it has fulfilled its objectives that are explained above.

e. Ratepayers Do Not Pay For The Time Value Of The Money Between The Time When Storm Insurance Premiums Are Paid And When PPL Insurance Pays Losses.

I&E contends that storm damage insurance is not in ratepayers' interest because ratepayers bear the financing costs for the delay between the time that PPL Electric pays its storm damage insurance premiums and the time that PPL Insurance reimburses it for the covered portion of such losses. *See, e.g.*, I&E St. 2-SR, p. 28. In making these contentions, I&E does not even address the testimony of PPL Electric witness Bethany L. Johnson, PPL Electric St. 7-R, pp. 7-8, in which she explains that the financing costs for the period between the incurrence of storm damage costs and insurance reimbursement are not part of the revenue requirement in this proceeding. The delay in payment by PPL Insurance to PPL Electric has no impact on rates being established in this proceeding. I&E's contentions are without merit; they should be rejected.

f. The Edison Electric Institute Article Does Not Support I&E's Contention.

I&E contends that an article published by the Edison Electric Institute demonstrates that the premium paid by PPL Electric for storm insurance is too high. Contrary to I&E's contention, the Edison Electric Institute article does not support I&E's contention. Initially, I&E included the cover page and one page of text from the article in its Exhibit 2, Sch. 20. From this one page of text, I&E argued that, because Florida Power and Light Company ("FPL") saw its storm insurance premium, following Hurricane Andrew, rise to $23 million for an annual aggregate coverage of $100 million and because FPL decided not to continue its storm damage insurance, PPL Electric's proposal to pay premium equal to 48 percent of the coverage in 2012 is not prudent. I&E St. 2, pp. 33-34.

PPL Electric explained, however, that the comparison of the premium to coverage ratios was not meaningful. First, the levels of coverage are not comparable. If PPL Electric were to obtain insurance covering $100 million in losses in any year, the premium to coverage ratio would be much less that its current insurance because PPL Electric has never incurred that level of losses. As the level of coverage increases the frequency that maximum coverage will be reached decreases. PPL Electric St. 14-R, p. 5.

Comparisons of premium to coverage ratios are not useful for the additional reason that storm risks in Florida for FPL are different from storm risks in Pennsylvania for PPL Electric. Although Florida may have a greater risk of storm damage from hurricanes (although PPL Electric has incurred substantial storm damage from hurricanes), PPL Electric has a far greater risk of damage from snow and ice storms. Most importantly, however, PPL Electric's storm damage insurance premiums are based upon PPL Electric's actual historic level of covered losses and are appropriate for its risk of storm damage. PPL Electric's storm insurance premium is calculated by an independent actuarial consultant to equal covered losses over time and does not contain any provision for profit. PPL Electric St. 14-R, pp. 3-5.

In Surrebuttal, I&E provided a copy of the entire Edison Electric Institute report at I&E Ex. 2-SR, Sch. 5. I&E continued to argue that, based on the report, PPL Electric's storm damage insurance was too expensive and therefore imprudent. I&E St. 2-SR, pp. 31-35. Despite I&E's protestations, the Edison Electric Institute publication is fundamentally irrelevant to PPL Electric's storm damage insurance expense in this proceeding. PPL Electric's storm insurance premiums are based on actuarial studies of PPL Electric's actual storm loss history and have been calculated to equal, over time, covered storm losses. The premiums and losses over the five years in which storm damage insurance coverage has been in effect, have been approximately equal. Therefore, despite comparisons to FPL and other public utilities, the pricing of the insurance premium has been reasonably accurate and appropriate. PPL Electric St. 14-RJ, p. 10.

3. Amortization Of Extraordinary Storm Damage In 2011

PPL Electric's proposal to amortize extraordinary storm damage expenses incurred during 2011 was set forth initially in PPL Electric's Ex. Future 1. Sch. D-9. There, the amount of extraordinary storm damage deferred from the 2011 storm costs is shown as $24,183,000. This amount was later updated to $26,622,371 as of June 30, 2012 in PPL Electric's Rebuttal St. 2-R, p. 4. PPL Electric proposes to amortize this amount over five years, producing an annual amortization of $5,324,000. PPL Electric Ex. Future 1 (Revised), Sch. D-9. It is important to emphasize that the amortization covers only storm damages in excess of the insurance coverage, as shown on PPL Electric Ex. GLB-10. It is strictly a means of addressing storm losses excess of the insurance coverage for which no provision is made either in the normal storm damage budget or by way of insurance.

As indicated in PPL Electric Ex. Future 1, Sch. D-9, PPL Electric filed two petitions with the Commission for authority to defer, for accounting purposes, extraordinary storm damage expenses during 2011. The first petition related to the damage from Hurricane Irene. It was filed on November 1, 2011 and was approved by the Commission in an Order entered on December 15, 2011, at Docket No. P-2011-2270396. As set forth in the Commission's Order, in late August, 2011, Hurricane Irene struck the eastern portion of Pennsylvania including PPL Electric's service territory. The severe weather caused by the hurricane, including high winds and heavy rainfall, inflicted substantial damage to PPL Electric's transmission and distribution facilities, particularly in its Lehigh and Northeast Operating Regions, resulting in outages to approximately 428,503 customers. As shown on I&E Ex. 2-SR, Sch. 3, Hurricane Irene caused $21,542,000 in damages.

Subsequently, on November 18, 2011, PPL Electric filed a second petition for authority to defer, for accounting purposes, certain unanticipated expenses caused by the Halloween Snow Storm in October, 2011. The petition was docketed at P-2011-2274298. The Commission approved the petition in an Order entered on December 15, 2011. As explained in the Order, on October 29, 2011, an unusual autumn snow storm struck PPL Electric's service territory. Heavy snow accumulated on leaves of trees, as well as branches, which resulted in falling trees and branches which damaged transmission and distribution facilities. In addition, fallen trees hampered efforts to repair the system and restore power. This storm interrupted service to approximately 388,318 customers. As shown in I&E Ex. 2-SR, Sch. 3, the damage from the Halloween Snow Storm was $23,213,000. Both orders indicated that the ratemaking treatment of the deferred, extraordinary storm damage expenses would be determined in PPL Electric's next base rate case.

Details of the deferred amounts were provided in PPL Electric Ex. GLB-10. As shown there, total costs of repair and restoration caused by Commission-reportable storms[13] in 2011 were $85,916,000, the greatest annual amount in PPL Electric's history. PPL Electric St. 14-R, p. 5.

PPL Electric's proposal to amortize extraordinary storm damage expenses for ratemaking purposes is consistent with prior Commission practice and precedent that has been approved by the Pennsylvania appellate courts. As a general matter, retroactive, line-item ratemaking is not

[13] For PPL Electric, Commission-reportable storms are those affecting at least 2,500 customers who experience an unscheduled service interruption caused by a single event for six or more consecutive hours. 52 Pa. Code § 67.1(b). When non-recoverable costs, insurance deductible costs, costs recovered through insurance and the capital portion of total costs are removed, the result is $26,622,000, which is the amount PPL Electric proposes in this proceeding to amortize beginning January 1, 2013.

permitted. *National Fuel Gas Distribution Corp. v. Pa. P.U.C.*, 76 Pa. Cmwlth. 102, 464 A.2d 546 (1983). The Commission and the courts, however, have recognized an important exception to this rule. The exception is for extraordinary expenses for which no provision for recovery is made in normal ratemaking. In other words, if special provision were not made for recovery of extraordinary expenses, there would be no recovery of such legitimate and proper expenses. The general rule that ratemaking is prospective and the exception for extraordinary expenses not reflected in rates has been explained by the Commonwealth Court on numerous occasions, including *Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C.*, 149 Pa. Cmwlth. 247, 253, 613 A.2d 74, 76-77 (1992). After noting the general rule that ratemaking is prospective, the Commonwealth Court stated:

> However, "[a]n exception to this rule in the case of retroactive recovery of unanticipated expenses has been recognized where the expenses are extraordinary and non-recurring." One example is expenses caused by an act of God, such as damages from a serious storm. If the utility is not permitted to recover the costs of repair from such an event in its next rate case, on the grounds that rate recognition would be retroactive, then those perfectly legitimate operating expenses will never be recovered. Id. (footnotes and citations omitted).

See also Pike County Light and Power Co., v. Pa. P.U.C., 87 Pa. Cmwlth. 451, 487 A.2d 118 (1985).

The Commission also has provided an explanation of this exception to the general rule that ratemaking is prospective. As the Commission stated in *Bell*, 55 Pa. PUC, *supra*, at 109-10:

> We have, as a general practice, permitted utilities to amortize extraordinary storm or flood damages over a period of years. In our order at RID 57 (1973) 47 Pa. PUC 247, 279, 280, we did, in our review, allow the respondent to amortize these storm damages associated with Tropical Storm Agnes over a ten-year period. . . .

On the same basis, the Commission has permitted deferral for accounting purposes and later recovery of extraordinary, non-recurring items. For example, in *Pa. P.U.C. v. Pennsylvania*

Power & Light Co., 85 Pa. PUC 306, 334 (1995), the Commission allowed PPL Electric to recover in rates deferred "early window costs," incurred between the time when Susquehanna Unit Two was placed in service and the time when it was recognized in rates. The Commonwealth Court affirmed the amortization in *Popowsky v. Pa. P.U.C.*, 695 A.2d 448 (Pa. Cmwlth. 1997) ("*Popowsky*"). Similarly, the Commission approved, and the Commonwealth Court affirmed, recovery through rates of deferred transition costs under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 106. Under the Standard, PPL Electric and all other publically held United States corporations are required to record for financial reporting and accounting purposes post-retirement benefits other than pensions on an accrual basis, instead of on a cash basis. *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC, *supra,* 325; *Popowsky,* 695 Pa. Cmwlth., *supra,* 452-53. There, the Commonwealth Court reiterated the principle that extraordinary losses may be amortized for ratemaking purposes over a period of years:

> "The PUC may take into account extraordinary losses or gains that occurred in the past by amortizing them over a period of years. Pike County Light and Power Co. v. Pennsylvania Public Utility Commission, 87 Pa. Cmwlth. 451, 487 A.2d 118 (1985). Once a particular expense is recognized as falling within this exception, its recovery at a later time does not violate the rule against retroactive ratemaking."

The Commonwealth Court added that extraordinary expenses may be deferred and recovered in a later base rate proceeding so long as the utility claimed them at the first reasonable opportunity. *Popowsky*, 695 A.2d, *supra* at 453. *See also Blue Mountain Consolidated Water Co. v. Pa. P.U.C.,* 57 Pa. Cmwlth. Ct. 363, 426 A.2d 724 (1981); *UGI Corp. v. Pa. P.U.C.,* 49 Pa. Cmwlth. Ct. 69, 410 A.2d 923 (1980).

Although the exception to the general rule that ratemaking is prospective applies to several types of expenses, storm damage expenses are the prototype of the exception. *See, e.g.,* *Pa. P.U.C. v. The Bell Telephone Co.*, 55 Pa. PUC 97, 109-10 (1981) (hurricane); *Pa. P.U.C. v. Pennsylvania Gas & Water Co.,* 57 Pa. PUC 204, 229 (1983) (freezing); *Pa. P.U.C. v. Pennsylvania Gas & Water Co.,* 52 Pa. PUC 77, 102 (1978) (flooding from a hurricane).

PPL Electric's storm damage expenses meet these criteria because they were clearly extraordinary and because PPL Electric claimed recovery of these expenses at the first opportunity. The storm damage expenses were incurred in August and October, 2011, during the second half of the historic test year in this proceeding, and PPL Electric filed its base-rate case on March 30, 2012. PPL Electric's claim for recovery of deferred costs from Hurricane Irene and the Halloween Snow Storm is clearly timely.

Despite the fact that PPL Electric's proposed amortization of extraordinary storm damage expense clearly qualifies for amortization for ratemaking purposes based on the Commission and appellate court decisions explained above, I&E opposes PPL Electric's amortization for ratemaking purposes of extraordinary storm damage expenses incurred during 2011 for three principal reasons. First, I&E contends that PPL Electric's expenses were not extraordinary. Second, I&E argues that the purchase of insurance has made amortization of extraordinary losses unnecessary. As explained below, I&E's arguments are without merit.

a. The 2011 Storm Damage Expense Was Extraordinary

I&E's contends that during the five years ended December 31, 2011, the amount PPL Electric recovered in rates for storm damage expenses exceeded actual storm damage losses. I&E St. 2, pp. 36-39. Based on this comparison, I&E concluded that the 2011 storms were "within the bounds of yearly fluctuation" and therefore not extraordinary. I&E St. 2, p. 39. I&E's conclusion is derived by adding, for the years 2007 through 2011, the annual insurance premium paid by PPL Electric to PPL Power Insurance, Ltd. ("PPL Insurance"), the insurance deductible for each year and the normal storm allowance, *i.e.*, the storm damage budget. I&E St.

2, p. 38. I&E then compared its view of the ratemaking provisions for storm damage expenses with actual storm damage expenses for the same period.

This is exactly the same argument made by I&E in opposting continuation of storm damage insurance. As fully explained above, I&E's analysis double counted the insurance deductible which is already in the provision for "normal storm allowance." *See* Section V.C.2.a, *supra*. When corrected, the results are opposite of what I&E alleges. Specifically, for the period 2007 – 2011, rate recovery was $31 million less than actual sotrm damage expense.

b. Storm Insurance Did Not Make Amortization of Extraordinary Storm Damage Costs Unnecessary

I&E's second basis for opposing the amortization of extraordinary storm damage is a belief that storm damage insurance would make such amortizations unnecessary. I&E St. 2, p. 39. Clearly, I&E's contention cannot be correct because there is a specific limit on the amount of insurance provided by the storm damage insurance policy. For 2011, this limit was $26,500,000. I&E Ex. 2-SR, Sch.2, p. 4. Therefore, it could not have been intended that the budget for normal storm damage and the insurance would cover all possible future storm damage amounts. Indeed, if such a policy were in place, the premium would be much higher, if such a policy could be obtained at all.

In addition, and contrary to I&E's position, storm damage insurance was never intended to eliminate completely the need for amortizations of extraordinary storm damage expenses. In PPL Electric's 2007 base rate case, when the Commission first approved recovery of storm damage insurance premiums, PPL Electric's witness, Douglas Krall, made this precise point:

> In addition, customers will benefit because, with storm damage insurance, there is a significant reduction in the frequency of petitions of PPL Electric requesting amortization of extraordinary storm damage expenses. With the insurance coverage, PPL Electric would experience **extraordinary storm damage expenses that would be the subject of a petition for**

> **deferral and amortization only when total storm damage expenses substantially exceed the sum of the storm damage insurance annual aggregate deductible of $7.5 million and the annual aggregate coverage limits of $30 million.**

I&E Ex. 2, Sch. 22, p. 2 (emphasis added). Although the numbers have changed over time, the principle remains the same. In 2011, the deductible was $7.5 million, and the limit of liability was $26.5 million. I&E Ex. 2-SR, Sch. 2, Attachment 1, p. 4. Therefore, PPL Electric had no insurance coverage for losses in excess of $34 million ($7.5 million + $26.5 million). Storm costs for 2011, however, totaled $85,916,000. PPL Electric Ex. GLB-10. By any definition, storm damage costs in 2011 were extraordinary and greatly exceeded both losses in prior years and the sum of the insurance deductible and coverage limit for 2011. In other words, the situation that arose in 2011 was exactly the type of circumstance that Mr. Krall explained would be the subject of future amortizations. For 2011, storm insurance and the proposed amortization of a portion of the extraordinary losses have operated together exactly as contemplated in PPL Electric's 2007 base rate case in which the Commission first approved payment of the premium. Insurance would decrease the frequency of petitions for deferral and amortization of storm damage expense but would not eliminate the need for such petitions.

PPL Electric has demonstrated that its storm damage expenses in 2011 were extraordinary and qualify for deferral and amortization for ratemaking purposes. PPL Electric's proposed amortization for ratemaking purposes of the 2011 extraordinary storm damage expenses should be approved.

4. I&E's Proposed Five-Year Amortization For Storm Damage Expense Is Totally Unprecedented

For all of the reasons set forth above, I&E's arguments regarding PPL Electric's storm damage expense claims are in error and should be rejected. However, even if these arguments were accepted, and they should not be accepted, the adjustment proposed by I&E, future test year expense allowance based on 5-year average of all storm damage costs, should be rejected as it is completely inconsistent with almost 40 years of uniform Commission precedent.

As explained previously, Pennsylvania has a well-established ratemaking treatment of extraordinary expenses, including storm damage expenses. *See, e.g., Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C.*, 149 Pa. Cmwlth. 247, 253, 613 A.2d 74, 76-77 (1992) and other cases cited in Section V.C.3., above. Normal and extraordinary expenses are treated differently for ratemaking purposes. Although use of a multi-year average may be appropriate under some circumstances for normal expenses, there is no precedent in Pennsylvania for use of a multi-year average for recovering extraordinary expenses.

In Pennsylvania, utilities include in rates a normal level of storm damage expense for normal ongoing storm damage expense. Extraordinary, non-recurring, storm damage costs are excluded from test year rates because they are not a recurring cost. Utilities are then permitted to recover the cost of extraordinary storms through an amortization allowance. I&E's proposal ignores all of this precedent and proposes a new and completely untested alternative method of recovering storm damage costs, which on its face would prevent PPL Electric from recovering its full storm damages expenses in rates.

Use of a multi-year average would not be reasonable for practical reasons. One criteria for extraordinary expenses is that they cannot occur on a regular or predictable basis. Storms do not keep a regular schedule. Where and when they strike are not predictable, nor is the severity of storms predictable. A result of an improper use of a multi-year average is that it would unfairly disadvantage a utility that had the misfortune of incurring several major storms over a short period of time and benefit a utility that had the good fortune of not experiencing a major storm. I&E's approach would invariably result in major swings in the amount of storm damage reflected in rates depending on the timing of storms and the timing of rate cases, with customers either underpaying or overpaying actual storm damage costs. This would be extraordinarily poor ratemaking policy.

Finally, as I&E's proposal reflects a complete renewal of almost 40 years of uniform ratemaking practice, if it were adopted, it should apply prospectively only, and PPL Electric should be allowed full recovery through a five-year amortization allowance of the cost of 2011 storms, which were incurred under traditional and long-standing Commission practice and precedent.

5. I&E's Proposed Reconcilable Storm Reserve Account Should Not Be Approved At This Time

As explained previously, I&E proposed as an alternative that PPL Electric should be permitted to establish a reconcilable storm reserve account. I&E St. 2, pp. 32-33. The problem with I&E's alternative proposal is that it was made without any details whatsoever. I&E still has provided no details as to how the account would operate.

PPL Electric is not conceptually opposed to such a mechanism for recovery of storm damage costs. Indeed, PPL Electric proposed a similar mechanism in its 2007 base rate case, but did not pursue the issue in settlement in light of opposition by other parties. Based on the variability of PPL Electric's storm damage expense in recent years, however, it would make sense to revisit the issue.

The fact that I&E made its proposal without any details made the concept not viable in this proceeding. PPL Electric could have attempted to provide a complete proposal, but the earliest it could have done so was in rebuttal, which would not have given other parties a full opportunity to review it and express their views on the subject.

Among the details that would have to be worked out are provisions for interest on under and over collections, timing of reconciliation, reporting of storm damage expenses and revenues for their recovery, methods for adjusting the annual level of the expense in rates, exact categories of storm damage expense that would be subject to the reconcilable storm damage reserve account and whether PPL Electric would continue to purchase storm damage insurance. For the foregoing reasons, I&E's proposed reconcilable storm damage reserve account should not be implemented at this time. PPL Electric St. 8-R, p. 47-48.

D. PPL ELECTRIC'S PAYROLL EXPENSE SHOULD BE APPROVED; VACANT POSITIONS WILL BE FILLED.

PPL Electric based its future test year budget for payroll on an employee complement of 2,002. OCA St. 1, p. 16. The unrebutted record evidence demonstrates that this number of employees is required to manage and maintain PPL Electric's transmission and distribution systems in order to meet the needs of customers. PPL Electric St. 2-R, pp. 8-9.

OCA has proposed to reduce PPL Electric's wages, payroll taxes and benefits by the total amount of $3,740,000. OCA St. 1-Revised, p. 17. In computing the adjustment, OCA used the average number of employees of PPL Electric over a sixteen-month period ended March 2012 and assumed that this number of employees would be representative of the actual number of employees of PPL Electric at the end of the future test year and beyond. OCA Ex. KC-1-Revised, Sch. 4, p. 3. The average number of employees used by OCA to make the adjustment was 1,943 employees, which is 59 fewer than PPL Electric needs.

In proposing its adjustment, OCA fails to recognize current staffing level requirements and appropriate levels of staffing needed to maintain and manage PPL Electric's transmission and distribution systems. Although PPL Electric has experienced vacancies in the past as noted by OCA, PPL Electric is striving to bring staffing levels to the budgeted level. As of June 30, 2012, PPL Electric had 1,942 employees, just one short of the level used by OCA to compute its proposed adjustment. In addition, PPL Electric is in the process of filling 106 additional positions. PPL Electric St. 2-R, p. 8.

PPL Electric's current level of its employee complement and its activities to fill vacant positions will place the Company in a position to attain the staffing levels set forth in its 2012 budget and carry that level of employees forward beyond the future test year to complete the work necessary to continue to provide service to the public in 2013 and beyond. PPL Electric St. 2-R, pp. 8-9. PPL Electric's claimed wage expense there should be approved.

E. I&E'S PROPOSED ADJUSTMENT TO UNCOLLECTIBLE ACCOUNTS EXPENSE SHOULD BE REJECTED

PPL Electric's total uncollectible accounts expense includes an amount for expected write-offs plus any change in the reserve for doubtful accounts due to increased accounts receivable, which are subject to write-off. PPL Electric St. 8-R, p. 32. PPL Electric's total future test year uncollectible accounts expense is $42,098,806 as shown on PPL Electric Ex. JMK-4.

I&E opposes PPL Electric's uncollectible accounts expense. I&E, instead, would use a simple three-year average of total write-offs to total revenues for the years 2009 through 2011 to derive its average residential uncollectible accounts expense percentage of 1.70%. I&E would then apply this percentage to 2012 residential revenues to produce the future test year level of uncollectible accounts expense as shown on I&E Ex. 2, Sch. 1.

I&E's proposed adjustment to PPL Electric's uncollectible accounts expense should be rejected for four principal reasons. First, I&E's calculation of uncollectible accounts expense is incomplete. PPL Electric's total uncollectible accounts expense includes an amount for expected write-offs plus any changes in the reserve for doubtful accounts due to the increased accounts receivable which are subject to future write-off. PPL Electric St. 8-R, pp. 31-32. I&E has chosen to ignore this component of the uncollectible accounts expense.

Second, I&E's calculation of the average annual percentage write-off for the three years ended December 31, 2011 includes periods which are not representative of the future. I&E's three-year period includes 2009, when PPL Electric's generation supply rates were capped. Since then, PPL Electric's rates have increased significantly, when compared to periods when the generation supply rate cap was in effect, and, not surprisingly, PPL Electric has experienced an increase in the number and dollar amounts of uncollectible accounts since the generation rate cap was ended.. PPL Electric St. 8-R, p. 32.

Third, use of a three-year average by I&E masks the fact that PPL Electric has experienced very substantial increases in uncollectible accounts expense for residential customers during that period. For 2009, PPL Electric's uncollectible accounts expense for residential customers was $24.6 million, for 2010, it was $31.0 million, and for 2011, it was $38.7 million. PPL Electric St. 8-R, pp. 32-33. Use of a simple three-year average during the period of rising expenses will always produce an amount that is less than the amount expected in the future test year and beyond.

Fourth, a review of recent data demonstrates that PPL Electric's uncollectible accounts expense through June 30, 2012 is on track to produce at least the level of uncollectible accounts expense set forth in PPL Electric's revenue requirement of $42.1 million, in total. For the period January 1, 2012 through June 30, 2012, PPL Electric recorded total actual uncollectible accounts expense of $15.8 million. PPL Electric Ex. JMK-6. Monthly data from the same exhibit demonstrate that PPL Electric records approximately 35 percent of its total annual uncollectible accounts expense for each calendar year during the first half of the year. Uncollectible accounts expense from the first half of each calendar year are less than 50 percent of the total primarily due to the winter moratorium on residential customer terminations through March 31 of each year and the Chapter 56 notification requirements. As a result of these requirements, actual write-offs of uncollectible accounts each year occur several months after the end of the winter residential termination moratorium.

Based on current information, as summarized above, PPL Electric's total actual uncollectible accounts expense for 2012 is expected to be in excess of \$45.0 million (\$15.8 million ÷ 35%). This amount exceeds the rate case uncollectible accounts expense of \$42.1 million, which is shown on PPL Electric Ex. JMK-4. PPL Electric St. 8-RJ, p. 3.

Dominion Retail, Inc. ("Dominion") also has objected to PPL Electric's calculation of uncollectible accounts expense. Dominion St. 1 and Dominion Ex. TJB-1. Dominion's position is based upon a misinterpretation of information set forth at page 15 of PPL Electric's Annual Report to the Commission for the twelve months ended December 31, 2011. Based on this misinterpretation of the data provided, Dominion believes that PPL Electric's actual write-offs of uncollectible accounts for 2011 totaled \$33 million, and not the \$39.7 million indicated by PPL Electric in PPL Electric St. 8-RJ, p. 4.

Dominion's reliance upon information in the annual report to the Commission is misplaced because the data shown there are simply a summary in the changes of PPL Electric's reserve for doubtful accounts between 2010 and 2011. It is not PPL Electric's uncollectible accounts expense for the year. PPL Electric St. 8-RD (Part 1), p. 4. Dominion's proposed adjustment to PPL Electric's uncollectible accounts expense should be rejected.

F. PPL ELECTRIC'S REVISED RATE CASE EXPENSE SHOULD BE APPROVED.

PPL Electric's initial rate case expense calculation is shown on PPL Electric Ex. Future 1, Sch. D-6. There, the total estimated expense of $2,025,000 is normalized over a two year period, thereby producing an annual normalized rate case expense of $1,013,000. In addition, in its operation and maintenance expenses, PPL Electric included an amortization of its rate case expense from the 2010 base rate case at Docket No. R-2010-2161694 in the amount of $674,000. PPL Electric St. 8-R, p. 42.

In its Rebuttal Testimony, PPL Electric acknowledged two errors in the presentation of its rate case expense in this proceeding. First, PPL Electric acknowledged that, consistent with recent Commission policy regarding rate case expense, the inclusion in the revenue requirement of the amortization of rate case expense from the 2010 rate case is not appropriate because the Commission has been "normalizing," and not amortizing, rate case expenses for ratemaking purposes. Therefore, PPL Electric agreed to reduce its rate case expense by the annual amortization of the 2010 rate case expense, or by $674,000.

Second, it was determined that PPL Electric inadvertently included $1,200,000 of rate case expense twice – once in PPL Electric Ex. Future 1, Sch. D-6 and again as a charge from PPL Services. The amount was included in the budget for the Office of General Counsel for this proceeding. PPL Electric St. 8-R, p. 42. PPL Electric has removed the duplicative rate case expense from operation and maintenance expense.[14] The reduction for rate case expense in operation and maintenance is reflected in PPL Electric Ex. Future 1-Revised, Sch. D-6.

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[14] Despite PPL Electric's concession, I&E contends that the duplication in rate case expense should be eliminated by adjusting the budget of the Office of General Counsel and not to PPL Electric's operation and maintenance budget. I&E St. 2-SR, pp. 20-21. I&E's position is curious since the two approaches produce the same result. PPL Electric St. 8-RJ (Part 1), p. 5. PPL Electric's adjustment to its operation and maintenance expense is proper and consistent with long-standing rate making practice and precedent. PPL Electric St. 8-RJ (Part 1), page 5. PPL Electric's approach to eliminating the double count of rate case expense by reducing operation and maintenance expense, and

The remaining issue is over what period PPL Electric's rate case expense should be normalized. OCA argues that rate case expense should be normalized over 36 months. OCA St. 1-Revised, pp. 21-22. I&E proposes that rate case expense be normalized over 32 months. I&E St. 2, p. 15. In making their recommendations, both OCA and I&E rely on both the history of rate case filings commencing in 2004 and the possible future availability of a distribution system improvement charge ("DSIC").

Despite OCA's and I&E's contentions to the contrary, use of a two-year period for normalization is appropriate given the pressure that PPL Electric's capital spending program will place on earnings. In 2013, PPL Electric plans to spend $870,000,000 on capital projects, and for 2014, PPL Electric expects to spend $821,000,000 on capital projects. The total increase in plant added will be almost $1.7 billion. In contrast, PPL Electric's net measure of value, for total transmission and distribution operations, is approximately $3.3 billion. PPL Electric Ex. Future 1-Revised, Sch. C-1. In other words, plant additions during 2013 and 2014 will exceed 50 percent of PPL Electric's total projected net measure of value as of December 31, 2012. It is difficult to see how such a significant increase in rate base and plant in service would not drive a rate case during 2014 or before. The possibility that PPL Electric may be able to avail itself in the future of a distribution system improvement charge offers little comfort since the DSIC is capped at 5 percent of revenues. 66 Pa.C.S. § 1358(A)(1); *Implementation of Act 11 of 2012,* Docket No. M-2012-2293611, Final Implementation Order, pp. 40-41 (Aug. 2, 2012). The DSIC will do little to offset the revenue requirement associated with PPL Electric's substantial capital

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not charges from affiliates, is proper for the additional reason that legal services for PPL Electric are provided from PPL Services and not acquired directly by PPL Electric, itself. Legal services provided by PPL Services include the retaining services from third-party providers. PPL Electric Ex. 1, Attachment II-D-8a, p. 2. Therefore, the rate case expense for legal services is properly treated for ratemaking purposes as a charge from affiliates, and not an expense incurred directly by PPL Electric.

program. PPL Electric's proposed two-year period for normalization of rate case expense should be approved.

G. CEO'S PROPOSED INCREASE TO LOW INCOME USAGE REDUCTION PROGRAM FUNDING SHOULD BE REJECTED

In its filing, PPL Electric proposed no changes in its universal service programs nor did PPL Electric propose any changes in funding to universal service programs. PPL Electric's universal service programs include OnTrack, WRAP, Operation Help and CARES. PPL Electric St. 9, p. 3. OnTrack is PPL Electric's customer assistance program. Under this program, PPL Electric offers reduced payments for customers at or below 150 percent of the federal poverty level and references to other assistance programs. WRAP is PPL Electric's free weatherization or Low Income Usage Reduction Program ("LIURP"). Operation HELP a hardship fund for customers with household incomes at or below 200 percent of the federal poverty level. CARES is a special referral service for residential customers who have temporary hardships and need short-term help. PPL Electric St. 9, pp. 3-4.

All of PPL Electric's current universal service programs and their funding levels have been approved by the Commission. On May 5, 2011, the Commission entered an Order at Docket No. M-2010-2179796, approving PPL Electric's 2011-2013 Universal Service and Energy Conservation Plan ("Plan"). Pursuant to the Order, the programs in the Plan will remain in effect as approved through the end of 2013. Under this process, Plans are reviewed every three years. On June 1, 2013, PPL Electric will submit its plan for the years 2014-2016 to the Commission's for review and approval. There, PPL Electric will propose any necessary or appropriate changes to its current programs and services for low-income customers. The Plan review process is also an appropriate forum for participation by organizations that have a substantial interest in universal service issues but do not have substantial interest in rate case issues, such as the Commission's Bureau of Consumer Services. PPL Electric believes that the triennial Plan review process, and not a base rate case such as this one, is the proper forum for addressing changes to universal service programs, including funding levels. PPL Electric St. 9, p. 3.

Nevertheless, one party, CEO, recommended that funding for PPL Electric's WRAP or LIURP should be increased from its present annual funding level of $8 million to $9.5 million. CEO St. 1, pp. 7-8. In support of its proposal, CEO makes two observations. CEO first asserts that funds for PPL Electric's hardship program, Operation HELP, are typically exhausted in the first half of the program year. CEO St. 1, p. 8. CEO further observes that, based on 2010 census data, the number of low-income customers in PPL Electric's service territory has increased. CEO St. 1, p. 7. Upon analysis, however, neither rationale proffered by CEO is persuasive.

CEO assertion incorrect that Operation HELP's funding is typically exhausted in the first half of each program year is in error. To the contrary, PPL Electric distributes Operation HELP funds to community based organizations ("CBOs") in quarterly installments throughout each year. Over the past several years, many of the fifteen CBOs that administer Operation HELP have exhausted their funding for one calendar quarter before their next quarterly allocation is received. Funding is available, however, each year for all CBOs for all four calendar quarters. CEO's statement that there is no funding for Operation HELP during the second half of each program year is simply incorrect. PPL Electric St. 9-R, p. 5. Further, even if Operation HELP funds were exhausted each year, that would provide no basis for increasing funding for LIURP.

Regarding the number of low-income customers in PPL Electric's service territory, CEO is correct that the number of PPL Electric customers at or below 150 regarding of the federal poverty level has increased. That increase, however, should not be viewed in isolation. In considering the increase in the number of low-income residential customers, three additional factors should be considered. These factors include the cost impact on other residential customers, the ability of the CBOs, who administer the program, to deliver additional services, and the availability of funding from other sources. In order for all of these factors to be considered, the issues raised by CEO should be considered in the triennial filings for approval of Plans, where all appropriate entities, including the Commission's Bureau of Consumer Services, can and do participate in the deliberations. PPL Electric St. 9-R, p. 6.

It is also important to note that PPL Electric's funding for these programs has already increased to reflect the increase in the low-income customer population. For example, from 2008 through 2011, total expenditures for WRAP have increased by 128.4 percent, from $7.71 million to $17.61 million. This increase includes both the traditional LIURP, which CEO seeks to have increased and the effects of the implementation of Act 129 WRAP in 2010.

From the implementation of PPL Electric's LIURP in 1985 through 2011, PPL Electric has expended approximately $128.4 million to provide weatherization services to nearly 70,000 households. In addition, through Act 129 WRAP, PPL Electric will expend another $29.2 million by May 31, 2013 to assist about 13,000 additional households. PPL Electric also has proposed to continue the low-income weatherization into Phase II of Act 129, which will provide overall funding at about $16 million – $8 million for the WRAP Program and an additional $8 million for the Act 129 WRAP. PPL Electric St. 9-R, p. 7.

By ignoring the increases in funding of the LIURP and by ignoring the increases in funding of similar weatherization services provided under Act 129 WRAP, CEO has ignored the substantial expansions of funding for those related weatherization programs that have occurred in the past and will continue in the future. CEO's recommended increase to the funding of PPL Electric's LIURP should be rejected.

H. PPL ELECTRIC'S CONSUMER EDUCATION EXPENSE SHOULD BE APPROVED

Pursuant to the Commission's Final Order in *Policies to Mitigate Potential Electricity Price Increases* at Docket No. M-00061957, PPL Electric initiated a broad-based program of customer education designed to assist customers in understanding how and when they use electricity, how they can use electricity more efficiently and how they can shop for electric energy in Pennsylvania's competitive retail electricity supply market. The overall goal of this program was to educate consumers so that they will use energy wisely. The program was based on the premise that, given appropriate information and education, customers can exercise more control over their electric bills by using electric energy efficiently and shopping for the best price, thereby controlling their electric bills. PPL Electric's program has successfully targeted all customers including residential, commercial and industrial customers as well as low-income households and school age children. PPL Electric St. 6, p. 4. PPL Electric proposes to continue to provide customers with general information on efficient energy use and purchasing electric energy. PPL Electric's customer education programs are summarized in PPL Electric Ex. TSC-1.

Through the end of 2012, PPL Electric is recovering the cost of its consumer education program in base rates. In the Commission's Final Order in *PPL Electric Utilities Company Consumer Education Plan for 2008 – 2012*, Docket No. M-2008-2032279 (July 18, 2008), the Commission approved PPL Electric's Consumer Education Plan for the years 2008 through 2012. Pursuant to the Commission's Order, PPL Electric has included in its future test year expenses $5,482,220 for the final year of consumer education and consumer programs that PPL Electric is obligated to provide under the Commission-approved Consumer Education Plan.

PPL Electric proposes to recover, beginning in 2013, the amount of $5,482,220 for ongoing needs consistent with the Company's Consumer Education Plan. In addition, PPL Electric proposed to amortize $400,000 for the 2012 annual Retail Markets Investigation postcard over two years. Recovery should also include a two-year amortization of the amount to be spent on the Retail Markets Investigation Tri-Fold brochure anticipated to be mailed in November, 2012. In addition, PPL Electric proposes to recover all future amounts including but not limited to amounts related to the Retail Markets Investigation EDC letter and amounts that may arise from programs included in PPL Electric's default service program that are subject to separate and explicate approval. All of the expenses complying with mandates of the Commission, including the Retail Markets Investigation, should be recovered by PPL Electric because they are not currently reflected in rates. PPL Electric St. 5-R, pp. 29-30.

Both I&E and OCA oppose various components of PPL Electric's proposed consumer education programs. Such opposition to PPL Electric's proposals is without merit and should be rejected.

I&E recommends that all costs for PPL Electric's Consumer Education Plan, $5,482,220, be disallowed. I&E St. 2-SR, p. 46. I&E bases this recommendation on its contention that the goals of the Consumer Education Plan are duplicative of the goals of the Energy Efficiency and Conservation Plan and the Retail Markets Investigation mandates. I&E St. 2-SR, p. 46. I&E is incorrect.

Although the Consumer Education Plan complements the Energy Efficiency and Conservation Plan and the Retail Markets Investigation mandates, it is a separate and distinct

Plan with distinct goals. The Consumer Education Plan helps consumers understand issues associated with shopping for electricity, the importance of energy efficiency and conservation and the steps they can take to help control their electric bills. The Consumer Education Plan includes school-based programs like "Think! Energy" and "Bright Kids." In addition, the programs include teacher workshops, continuous energy improvement programs for school districts, a mobile efficiency and shopping exhibit and others. All of these programs raise awareness of the need for energy efficiency and customer choice and the positive impacts they can have on residences, businesses and institutions. These educational programs and activities build the case for energy efficiency and conservation and address the needs of current and future energy consumers. PPL Electric St. 6-R, p. 3.

The Act 129 EE&C Plan, in contrast, is not educational. Instead, it provides specified financial incentives including rebates for consumers to take approved actions such as installing energy efficient lighting, replacing inefficient HVAC systems and purchasing EnergyStar appliances in order to meet Act 129 consumption reduction targets established by the Commission for PPL Electric. The Consumer Education Plan and the Act 129 EE&C Plan are complementary, but their functions and activities are separate and distinct. One is purely educational; one is purely financial. PPL Electric St. 6-R, pp. 3-4.

Nor does the Consumer Education Plan duplicate the activities and programs mandated by the Commission in the Retail Markets Investigation at Docket No. I-2011-2237952 (July 28, 2011). There, the Commission established an intermediate work plan and recognized the importance of consumer education to support the development of the retail electricity market in Pennsylvania. The activities under the Retail Markets Investigation Order are separate from the Consumer Education Plan. These activities were mandated initially in a Secretarial Letter at

Docket No. I-2011-2237952, dated December 15, 2011, which directed EDCs, including PPL Electric, to print in accordance with the Commission's design and specifications and mail to customers a postcard on behalf of the Commission encouraging customers to visit the PaPowerSwitch.com website and to consider choosing a competitive electricity supplier. The Secretarial Letter also required two additional mailings to customers that EDCs are required to complete during 2012. Further, the Commission is expected to mandate additional measures for EDCs in the future at Docket No. M-2011-2270442 in the Orders on Accelerated Switching (Nov. 14, 2011) and the Intermediate Work Plan at Docket No. I-2011-2237952 (Dec. 16, 2011). Although these activities are complementary to PPL Electric's Consumer Education Plan, they are separate and distinct activities that have been specifically required by the Commission. Clearly, the Act 129 EE&C Plan and the activities under the Retail Markets Investigation do not supplant the need for a continuation of the Consumer Education Plan.

I&E also contends that PPL Electric's Consumer Education Plan is not necessary in the future because the goals of the Consumer Education Plan have been achieved. I&E St. 2, p. 45; I&E St. 1, p. 75. Again, I&E is incorrect. Although approximately 76 percent of PPL Electric's total generation supply is provided by EGSs and approximately 42 percent of PPL Electric's customers have chosen to purchase electric supply from an EGS, that does not mean that the need for the Consumer Education Plan has ended. More than 50 percent of PPL Electric's distribution customers, mostly small and residential customers, continue to take default supply service. Further, new customers continually enter into the marketplace by moving into PPL Electric's service territory or by becoming adults with their own households. Therefore, there is an ongoing opportunity to increase the percentage of customers who take competitive supply and, therefore, a continuing need for educational efforts to help customers understand the workings of the retail market. PPL Electric St. 6-R, pp. 5-6. The Commission's commitment to shopping for electric generation supplies is demonstrated by, among other things, its PAPowerSwitch website which encourages customers to shop and provides guidance on how to shop.

OCA's proposals regarding PPL Electric's Consumer Education Plan are without merit and should be rejected. OCA recommends that the total for all spending be limited to $5,400,000, although OCA provides no substantial basis for this adjustment. OCA St. 1-Revised, pp. 24-25. OCA's proposed level of recovery is clearly inadequate.

PPL Electric's proposal for the recovery of consumer education includes, for 2013, $5,482,222, the same amount as PPL Electric's budget for the future test year, 2012. PPL Electric believes that it is appropriate to continue its Consumer Education Plan for 2013 at the same level as in 2012 because the need for the Consumer Education Plan is continuing, as explained above.

PPL Electric's proposed future test year level of expenses should be approved in full. In addition, PPL Electric has proposed a Competitive Enhancement Rider in this proceeding to recover customer education costs. The merits of this proposal are addressed in Section IX.C., below.

VI. RATE OF RETURN

A. THE IMPORTANCE OF THE RATE OF RETURN DETERMINATION IN THIS PROCEEDING

PPL Electric has commenced a significant expansion of its construction activities to replace aging infrastructure across its entire distribution system. The expanded construction program was highlighted in the Statement of Reasons as one of the principal reasons for the proposed rate increase:

Much of the Company's electric distribution system was constructed and placed in service in the 1960s and 1970s. PPL Electric has been able to maintain this equipment in a way that has continued reliable customer service. However, much of that equipment has an expected useful life of approximately 40 years, and is nearing or past the end of that lifespan. The Company has begun to incur increasing maintenance expenses to deal with rising equipment failures, a solution that becomes expensive and does not adequately address long-term reliability. Investment in system replacements will reduce the rate of O&M cost increases, minimize the total cost of doing business and reduce the potential for eroding reliability performance.

In late 2008, the Company began a detailed, comprehensive study to assess the overall equipment age, condition and performance of its transmission and distribution assets. The purpose of the study was to develop a strategy for capital replacement and maintenance improvements that would allow the Company to avoid the anticipated cost and reliability effects of aging infrastructure and bolster its ability to maintain reliable electric service. Based on the results of the study, PPL Electric has embarked on a 10-year capital plan to replace, maintain and improve various distribution assets. In addition, the replacement of older technology with new systems and facilities will improve system reliability by reducing service outages and shortening outage response time.

Replacing and modernizing these delivery system facilities will require PPL Electric to make significant capital investments. Over the past five years, 2007 through 2011, the Company invested almost $1.3 billion in the delivery system, associated information technology and facilities infrastructure. PPL Electric intends to invest an additional $1.6 billion in the delivery system from 2012 to 2016. In 2011, PPL Electric invested a total of $326.6 million in distribution system improvements. The Company plans to make distribution system capital investments of $337 million during the future test year in this case (calendar year 2012). The Company will have to raise a significant amount of money in the capital markets to make those planned investments.

At the time of the last major utility-led infrastructure build-out period in the 1960s and 70s, utility corporate credit ratings were typically at the A to AA- levels. Today, the most common Standard & Poor's Rating Services corporate credit rating among electric utilities is BBB, which also tends to be about the average for the industry and is just two notches above speculative grade. This downward drift in utility credit ratings reflects the continued challenging business environment and slow economic recovery in the United States, including declining electric sales, increasing operating expenses and the need to fund significant capital investments. Clearly, access to capital at reasonable borrowing rates is extremely important to the Company and, ultimately, to its customers. For these

> reasons, it is critical that the financial community views PPL Electric as an attractive investment.
>
> Since its last distribution base rate case, Moody's has downgraded the Company's credit rating from Baa1 to Baa2. PPL Electric forecasts its return on equity for the distribution business will fall to approximately 6.7 percent in 2012 based on current rates. This return is inadequate by any standard. In this filing, the Company is requesting an allowed return on equity of 11.25 percent, along with a capital structure of approximately 51 percent common equity and 49 percent long-term debt, which PPL Electric believes are necessary ratios to successfully raise capital under today's financial market conditions.
>
> In light of the business environment described above, PPL Electric believes its requested return on equity is the minimum required to attract needed capital under reasonable terms. Such access to the capital markets will allow the Company to proceed with its proactive strategy to renew and strengthen the delivery system from a position of financial strength. Ultimately, it will enable the Company to execute its plan more efficiently, which will result in lower costs to customers over the long term, maintain reliable service, and create hundreds of jobs. Adequate rate relief also will permit the Company to pursue efforts to improve its bond ratings which, if achieved, would further lower the cost to serve customers.

PPL Electric Ex. Future 1 – Revised, Sch. A1, pp. 3-6.

The rate increase in this proceeding is designed to provide a return on, and a return of through depreciation, the above-referenced substantial investments made by PPL Electric in 2011 and 2012 after the end of the 2010 future test year in PPL Electric's last base rate case. However, of equal or greater importance, PPL Electric cannot continue to make these investments if its credit ratings are permitted to continue to decline. Accordingly, the capital structure, rate of return on common equity and overall fair rate of return determinations in this proceeding are critical to PPL Electric's ability to provide continued safe and reliable service to its customers.

Other electric and gas utilities in Pennsylvania also must undertake significant increases in construction activities as they face the same factors as PPL Electric in terms of replacing aging infrastructure installed in post World War II expansion. See, *Natural Gas Pipeline Replacement and Performance Plans*, Docket No. M-2011-2271982, 2011 Pa. PUC LEXIS 375 (Tentative Order Nov. 10, 2011). Indeed, the Pennsylvania General Assembly and the Governor have recently enacted Act 11 of 2012 creating new rate mechanisms to allow more current reflection of infrastructure investments in rates. In order to be successful, these mechanisms require, however, that the rate of return be adequate to permit utilities to raise capital to replace infrastructure on reasonable terms.

PPL Electric's rate proceeding will be the first litigated rate case for a major utility decided by the Commission in the recovery following the Great Recession. It, therefore, will be viewed by investors as a bellwether of the Commission's views and intentions with regard to infrastructure replacement in Pennsylvania. The Commission's decisions in this case are critical to all Pennsylvania utilities and their customers.

Faced with these circumstances, I&E and OCA choose to look backward rather than forward. They rely on historically low interest rates instituted during the recession and its aftermath by the Federal Open Market Committee ("FOMC") to artificially suppress interest rates in an attempt to justify returns on common equity ("ROE") that are far below ROEs allowed by the Commission in decades. In fact, the 8.38% ROE proposed by I&E is lower than any ROE granted by any regulatory body for a public company during the period examined by Ms. Cannell (January 1, 2009 – June 30, 2012), a period that includes a portion of the recession. PPL Electric St. 12-R, Sch. JMC-1. OCA's proposed ROE of only 9.0% is better only in that it exceeds only one of the 154 allowances during the same period. *Id.* The data on Ms. Cannell's schedule in fact demonstrate that even in this difficult period the central tendency of other allowed ROEs have ranged between <u>9.75% and 10.99%</u>, with several Commissions authorizing allowed ROEs between 11.0% and 11.25%. These data demonstrate that the recommendations of I&E and OCA will not, if adopted, be viewed by financial markets as constructive and supportive and will place Pennsylvania utilities at a disadvantage to other utilities in the country in raising capital during a critical infrastructure replacement phase. PPL Electric St. 12-R, pp. 3-5.

Finally, the results of adopting either the I&E or OCA recommended rates of return, which include their respective adjustments to PPL Electric's capital structure ratios as well as their inadequate ROE recommendations, would place PPL Electric at risk for another downgrade in its credit rating. In rebuttal testimony, PPL Electric demonstrated that OCA's rate of return recommendation, even if earned, would support a credit rating of Baa2/Baa3, which is lower than PPL Electric's current rating. PPL Electric St. 10-R, p. 3. I&E's recommendations produce even worse results and risk the downgrade of PPL Electric's credit rating to below a Baa3 rating, even if PPL Electric can earn the allowed return proposed by I&E. PPL Electric St. 10-R, p. 6.[15] Accordingly, the recommendations of I&E and OCA create risks of higher debt costs as well as potential limits of access to capital in difficult markets such as those experienced during the financial crisis.

In subsequent sections of this Initial Brief, PPL Electric will address the unreasonableness of I&E's and OCA's hypothetical capital structures and the various theoretical models used to estimate the cost of equity. However, these calculations do not set the cost of capital; investors set the cost of capital. In the end, investors want to see that utilities in

[15] It is not likely that PPL Electric will earn its allowed return. PPL Electric expects only to earn 6.7% return on equity in 2012, despite an increase in rates on January 1, 2011. Statement of Reasons, PPL Electric Ex. Future 1–Revised, Sch. A-1, p. 5. While implementation of a DSIC would improve PPL Electric's chances of achieving its allowed ROE, not all plant additions are covered by the DSIC, the DSIC is capped at 5% and many other factors such as continued conservation by customers make it unlikely that PPL Electric will earn its allowed return. Since the metrics are based upon achieved results, it is even more likely that metrics will be below those calculated by Mr. Clelland creating even more of a concern of a further downgrade if I&E and OCA's recommendations are accepted.

Pennsylvania operate in a supportive and constructive regulatory environment. Record low ROEs, rejection of proposed capital structures and lower metrics for credit rating agencies will not meet the expectations of capital markets, which will ultimately disadvantage Pennsylvania utilities and their customers. PPL Electric St. 12-R, pp. 1-12.

B. RATE OF RETURN STANDARDS

A public utility, whose facilities and assets have been dedicated to the service of the public, 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 return rate is fair are well-established, having been set forth by the United States Supreme Court in *Bluefield Waterworks and Imp. Co. v. P.S.C. of West Virginia*, 262 U.S. 679, 690 (1923), over eighty years ago:

> 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 their enforcement deprives the public utility of its property in violation of the Fourteenth Amendment.

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 cases. *See, e.g., Riverton Consolidated Water Co. v. Pa. P.U.C.*, 186 Pa. Super. 1, 140 A.2d 114 (1958); *City of 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 (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* at 692, requires that the rate of return reflect:

> . . . a return on the value of the [utility's] property 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 risks and uncertainties. . . .

Twenty-one years later, the Supreme Court reiterated that standard in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (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.

Later, in reaffirming *Hope*, the Supreme Court, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 109 S. Ct. 609, 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 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 that are necessary to assure confidence in the financial integrity of the company and to provide a reasonable credit profile to permit access to capital markets on reasonable terms, and (2) the amount of the investment, the size and nature of the utility and, its business and financial risks, in comparison to other enterprises. *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 States Steel Corp. v. 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).

C. RATE OF RETURN COMPONENTS

In estimating the overall fair rate of return, the Commission uses the weighted average cost of capital method. This method determines the percentages of debt, common equity and, where applicable, preferred stock in the Company's capital structure. It then determines the cost rate of capital for each class of capital and "weights" it by multiplying the percentage of each type of capital times the cost rate for that type of capital. This calculation is illustrated below by PPL Electric's calculation of the overall fair rate of return in this proceeding:

Type of Capital	Ratios	Cost Rate	Weighted Cost Rate
Long Term Debt	48.97%	5.56%[16]	2.72%
Common Equity	51.03%	11.25%	5.74%
	100.00%		8.46%

PPL Electric Ex. 1, Future Revised, Sch. B-6.

The issues in this proceeding with regard to rate of return concern PPL Electric's capital structure ratios and cost rate of common equity.

D. CAPITAL STRUCTURE

1. Positions of the Parties

The positions of the Parties with regard to capital structure ratios are as follows:

[16] This table and the Company's claim in this case includes the projected issuance of $240 million in new long-term debt at an interest rate of 3.03%. The Company actually issued $250 million of new debt at an interest rate of 2.61% on August 24, 2012. Reflecting these actual data reduces the weighted average long-term debt cost rate from 5.56% to 5.50%. It also increases the long-term debt ratio in the capital structure from 48.97% to 49.22%, and decreases the common equity ratio from 51.03% to 50.78%. The combination of these two adjustments reduces the Company's overall weighted cost of capital from 8.46% to 8.42%. For ease of reference, the argument in this section of the Brief refers to the Company's debt and equity numbers as filed. In order to appropriately reflect the updated debt cost rate and capital structure ratios in the record, the Company is filing a Petition to Reopen the Record in this proceeding. If the Petition is granted, the Company respectfully requests that the ALJ and the Commission rely on the updated debt cost rate and capital structure ratios, which reduce the Company's overall return, in the final calculation of the Company's revenue requirement in this proceeding.

	PPL Electric[1]	I&E[2]	OCA[3]
Type of Capital			
Long Term Debt	48.97%	55.00%	52.84%
Common Equity	51.03%	45.00%	47.16%
	100.00%	100.00%	100.00%

[1] PPL Electric Ex. 1, Future Revised, Sch. B-8

[2] I&E St. 1, p. 14; I&E Ex. 1, Sch. 1, p. 1

[3] OCA St. 2, p. 25; OCA Ex. (SGH-1), Sch. 1, p. 4

2. Explanation of PPL Electric's Capital Structure

PPL Electric's capital structure of 51.03% equity and 48.97% debt is its projected capital structure as of December 31, 2012, the end of the future test year in this proceeding. PPL Electric Future 1-Revised, Sch. B-6 through B-9. PPL Electric St. 10, pp. 2-3. PPL Electric's witness Clelland explained that the future test year capital structure is based on PPL Electric's actual capital structure at December 31, 2011, updated for changes during the future test year. PPL Electric St. 10, pp. 2-5. The changes to the future test year are the replacement of $250 million of preference stock with a combination of first mortgage bonds issued by PPL Electric and an equity contribution from PPL Corporation. *Id.*, at p. 4. Mr. Clelland explained the reasons for replacement of the preference stock:

> In April 2006, PPL Electric issued $250 million of 6.25% perpetual Preference Stock that is callable at par anytime after five years from date of issuance. At that time, Moody's and Standard & Poor's ("S&P") generally provided between 75% - 100% equity credit for this type of perpetual Preference Stock. Since that time, each rating agency has reduced the amount of equity credit afforded hybrid securities such as preferred or preference stock, mandatory convertibles and junior subordinated debt securities. Currently, Moody's and S&P provide only 50% equity to the Preference Stock at PPL Electric. This reduction in the credit reduces one of the primary benefits of hybrid securities. As a result, PPL Electric plans to refund the Preference Stock with proceeds provided by a combination of First Mortgage Bonds issued at PPL Electric and a capital contribution (*i.e.* equity) from PPL Corporation. I would also note

> that the reduction/elimination of hybrid securities from electric utility capital structures is a growing trend across the country and reflects current financing practices.

PPL Electric St. 10, p. 4. Mr. Clelland also estimated, based on information available at the time of filing rejoinder testimony, that the replacement of $250 million of preferred stock with $125 million in equity and $125 million in debt slightly reduced the cost to ratepayers, largely due to low debt costs currently available in the market.

> I would also point out that PPL Electric's redemption of its Preference Stock in June 2012 has been funded with a combination of debt and equity in a manner consistent with the 50% equity treatment the rating agencies afford Preference Stock in their methodologies. In fact, redemption of the Preference Stock based on a funding of 50% debt and 50% equity, which is credit neutral, is cost beneficial to ratepayers. See table below.

Funding Comparative	Amount	Ratio	Cost	Weighted Avg. After-Tax Cost
Debt - FMBs	$125,000,000	50.0%	2.39% *	0.70%
Common Equity	$125,000,000	50.0%	11.25%	5.63%
Total - As Re-financed	$250,000,000	100.0%		6.32%
Redeemed Pref. Stock - Embedded Cost				6.39% *

* includes cost of issuance

PPL Electric St. 10-RJ, p. 5.[17] By referencing that the revised capital structure is "credit neutral," Mr. Clelland is explaining that the revised capital structure achieves the 50%/50% weighting of equity/debt weighting of the preference stock as revised by the credit rating agencies.

[17] As noted above, the Company actually issued $125 million of debt to replace the preference stock on August 24, 2012. The actual debt rate for the issuance was 2.61% (as opposed to the estimated rate of 2.39% presented by Mr. Clelland in PPL Electric St. 10-RJ, p. 5). This changes the weighted average after-tax cost rate in Mr. Clelland's table from 6.32% to 6.39%, which equals the embedded cost of the preference stock as shown on the table above. In summary, the Company was able to redeem the preference stock and replace it with debt and equity at no net cost to ratepayers. As explained above, the Company is filing a Petition to Reopen the Record contemporaneously with this Brief so that the updated data is accurately reflected in the record in this proceeding.

Mr. Clelland also explained that PPL Electric's unsecured bond rating was downgraded by Moody's Investors Services ("Moody's) in April 2010 from Baa1 to Baa2 as a result of Moody's:

> . . . opinion that PPL Electric's cash flow credit metrics will decline dramatically from their recent levels and will remain toward the low end of the Baa range (Baa2 to Baa3), due, in part to the <u>increased expenditures for capital investments</u> to support and maintain the reliability of PPL Electric's aging delivery systems. (emphasis provided)

PPL Electric St. 10, p. 3. Mr. Clelland explained that PPL Electric has also modestly increased its equity ratio over the levels experienced prior to 2010, excluding the effects of replacement of the preference stock, to enhance PPL Electric's credit metrics. As explained by Mr. Clelland:

> . . . PPL Electric is in the midst of a major capital program to replace aging infrastructure and assure continued safe and reliable service to customers. To complete this program at a reasonable cost it is imperative that PPL Electric be able to access the credit markets on reasonable terms. The capitalization structure proposed by PPL Electric should support PPL Electric's need to maintain a strong investment-grade credit rating that will enable the Company to continue its commitment to maintain and improve system performance, as demonstrated by its growing capital investments. Consistent access to capital at reasonable borrowing rates is extremely important to the Company and, ultimately, to its customers.

PPL Electric St. 10, p. 5.

In this regard, the following table demonstrates the marked increases in PPL Electric's capital spending since 2009:

Years	Construction
2009	298,000,000
2010	411,000,000
2011	496,000,000
2012	671,000,000
2013	870,000,000
2014	821,000,000
2015	676,000,000
2016	589,000,000

PPL Electric St. 10-R, p. 2. As identified in the table, PPL Electric's capital spending in 2012 is more than double the spending in 2009 and in 2013 it will be almost triple the level of spending of 2009. It is expected to continue at high levels through 2016. These levels fully justify a higher equity ratio to support the ability of the Company to raise debt capital to finance these capital projects. PPL Electric St. 10-R, p. 2.

In support of PPL Electric's capital structure ratio, Mr. Moul explained that PPL Electric's future test year end capital structure ratios are within the range of those employed by Mr. Moul's barometer group companies. PPL Electric St. 11, p. 22. And, as demonstrated by Mr. Moul, PPL Electric's 51.02% common equity ratio is well within the range of common equity ratios of I&E witness Sears' barometer group. I&E Ex. 1, Sch. 1, 2011 shows that the common equity ratios are 52.47% for Consolidated Edison and 50.92 % for PEPCO. Therefore, two of her 6 barometer group companies have common equity ratios essentially at or above PPL Electric's 2012 projected equity ratio. PPL Electric St. 11-R, p. 6. Further, Mr. Hill's barometer group has 16 companies out of 55 companies with equity ratios above 50% and averaging 54.6% for these 16 companies. Clearly, PPL Electric's equity ratio cannot be deemed abnormal or atypical.

Further, Mr. Moul demonstrated that investors expect equity ratios to rise. Excluding a clear outlier of 31% for Unisource, the expected equity ratio for the remaining 15 companies averages 50.9% for 2012, 51.7% for 2013 and 52.4% for 2015 to 2017. Even without excluding Unisorce, the average for these periods ranges from 49.6% to 50.8%, well above the recommendations of I&E and OCA. Since the cost of capital is expectational of the future (Tr. 349), it is also reasonable to consider investors' expectations of near term projected equity ratios in determining whether PPL Electric's equity ratio is atypical. PPL Electric St. 11-R, p. 9.

PPL Electric's capital structure has been demonstrated to be reasonable and necessary to support PPL Electric's construction program and credit ratings. It, therefore, should be accepted for calculation of the cost of capital and fair rate of return.

3. I&E's and OCA's Hypothetical Capital Structures Are Unjustified Under Applicable Legal Standards

a. Applicable legal standard for applying a hypothetical capital structure

The Pennsylvania Appellate Courts have permitted the Commission to use a capital structure different from the utility's actual capital structure in circumstances where the actual capital structure is atypical for the type of utility being considered.

For example, in *Carnegie Natural Gas Company v. Pa. P.U.C.*, 61 Pa. Cmwlth. 436, 433 A.2d 930 (1981), the Commonwealth Court stated as follows:

> Where a utility's actual capital structure is too heavily weighted on either the debt or equity side, the commission, which is responsible for determining a capital structure which allocates the cost of debt and equity in their proper proportions, must make adjustments to the utility's capital structure. *Lower Paxton Township v. Pennsylvania Public Utility Commission,* 13 Pa. Commonwealth Ct. 135, 317 A.2d 917 (1974); *Riverton Consolidated Water Co. v. Pennsylvania Public Utility Commission*, 186 Pa. Superior Ct. 1, 140 A.2d 114 (1958). In *Lower Paxton*, this court gave the following explanation for using a hypothetical capital structure:

> The capital structure of a corporation may affect, sometimes drastically, the cost of capital. The capital structure is, in reality, little more than those dollars represented by its common and preferred stock and its debt. In some cases where the public utility is a wholly-owned subsidiary, its capital structure may not be comparable to another public utility which **[*440]** is obliged to obtain its equity and debt financing on the open market. In other words, it may have on balance a too heavily weighted debt or equity. In this case the record discloses that Dauphin has a capital structure wherein 100 percent is equity capital. Under such circumstances the PUC must make adjustments based upon substantial evidence in order to reach a fair result. . . . It is also conceivable that there may be evidence on the record which will permit the PUC to utilize the capital structure and cost of capital statistics of comparable public utilities instead of those of the company or its parent.

61 Pa. Cmwlth. at 439-440.

In determining whether the claimed utility capital structure is atypical, the Commission and the Courts have looked to see whether the capital structure used by the utility is outside the range of that employed by the barometer group of companies considered in the rate of return analysis. If a utility's capital structure is within a reasonable range of similar risk barometer group companies, the utility's capital structure should be used and not a hypothetical capital structure. For example, in *Pa. P.U.C. v. ALLTEL,* the Commission stated as follows:

> The ALJ recommended use of the Company's stand-alone capital structure since it met the following characteristics of an appropriate capital structure:
>
> 1. It was within a reasonable range of similar risk barometer group companies.
>
> 2. It reflected the Company's actual capital structure and projected near term capital structure.
>
> 3. It is consistent with the Company's apparent capital structure goal. (R.D., p. 28).
>
> We concur with the recommendation of the ALJ, particularly for the reason that the Company's actual capital structure falls within a range employed by similar risk barometer group companies, described by Mr.

Shiavo as commensurate with capital ratios employed by other independent telephone operating companies.

Pa. P.U.C. v. ALLTEL Pa., Inc., Docket No. R-942710 et al., 59 Pa. PUC 447, 491, 1985 Pa. PUC LEXIS 53, *106 - *107, (Order entered May 24, 1985), ("*ALLTEL*").

b. I&E has not justified the use of a hypothetical capital structure for PPL Electric

I&E witness Sears states the correct standard for use of a hypothetical capital structure in her direct testimony:

> "Q. What is the basis for your recommendation of a hypothetical capital structure instead of using the Company's actual capital structure?"
>
> "A. A capital structure should be representative of the industry norm and be an efficient use of capital. The use of a capital structure that is significantly outside the range of the industry's capital structure may result in an overstated overall rate of return. Therefore, a hypothetical capital structure based upon an industry average should be used for ratemaking purposes."

I&E St. 1, p. 13.

However, I&E witness Sears makes no attempt in her direct testimony to demonstrate that PPL Electric's equity "... is significantly outside the range of the industry's capital structure…". In fact, her own data shows that two of her six barometer group companies have 2011 common equity ratios essentially equal to or in excess of the 51.03% which PPL Electric will employ at the end of the future test year (ConEd 52.47%, and PEPCO 50.92%). I&E Ex. 1, Sch. 1, p. 2. In fact, ConEd's five year average (2007-2011) capital structure ratio is 51.5%. I&E Ex. 1, Sch. 1, p. 2. It must be emphasized that Ms. Sears chose this barometer group as a reasonable proxy for PPL Electric and cannot now claim that ConEd or PEPCO employ unreasonable common equity ratios.

When asked on cross-examination what standard Ms. Sears employed to determine that PPL Electric's common equity ratio was outside range, Ms. Sears indicated that she does not look at the range but simply looks at the average and applies her judgment. Tr. 346-349. On redirect, Ms. Sears, announced for the first time on the record that she believed a capital structure was unreasonable if it was 5% above or 5% below the average for the barometer group. Tr. 363. When asked what support there was for this standard, Ms. Sears could not identify any support. Tr. 365.

Applying Ms. Sears unsupported ad hoc standard to her own barometer group provides interesting results. Five percent of Ms. Sears' average common equity ratio of 45.00% produces a spread of 2.25% (45% x .05) around her average common equity ratio or a range of 42.75% to 47.25%. Review of the 2011 common equity ratios for her six barometer group companies demonstrates that only <u>one</u> company, TECO Energy at 45.75% would fall within Ms. Sears' acceptable range. Therefore, Ms. Sears ad hoc standard concludes that five of the six companies in her own barometer group have abnormal common equity ratios.[18] Such a result is not rational.[19]

Moreover, Ms. Sears' position is directly contrary to the position taken by the Office of Trial Staff in prior proceedings. In the *ALLTEL* case cited above, the OTS took the position that utilities should rely on their actual capital structure when it was within a range of reasonableness. Therein, the OTS position is described as follows:

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[18] Ms. Sears did not indicate whether her standard was 5% or 5 percentage points. If Ms. Sears' equity ratio range is intended to add 5 percentage points to her average, which is actually 45.11 percent, than the range is 40.11 percent to 50.11 percent. PPL Electric's 51.03 percent equity ratio cannot be considered substantially outside this range particularly when 2 of Ms. Sears' companies have equity ratios at or above this level. Further, this range is not consistent with the Commission adopted range, which is defined by the equity ratios employed by the barometer group companies.

[19] Ms. Sears advances in her Surrebuttal Testimony the proposition that rating agencies are not concerned with the capital structure employed for ratemaking purposes. I&E St. 1-SR, p. 3. However, Ms. Sears admitted on cross that her hypothetical equity ratio would lower PPL Electric's revenues and cash flow, which is the primary concern of rating agencies. Tr. 343. PPL Electric St. 10-RJ, p. 3.

Trial Staff witness Schiavo was of the opinion that the Company's capital structure is within a range of reasonableness for the industry. He testified:

> I believe that ALLTEL's capital structure and cost rate of debt are appropriate for determining an overall fair rate of return in this case. ALLTEL's capital structure and cost rate of debt are within a range of reasonableness for its industry. In other words, the portions of each type of capital employed and commensurate cost rates are similar to those employed by other independent telephone operating companies. Accordingly, I suggest adhering to the principle of cost-based ratemaking whenever possible. Only the cost rate for common equity needs to be estimated.

ALLTEL, 59 Pa. PUC at 490-491, 1985 Pa. PUC LEXIS at *105 - *106.

For these reasons, I&E has failed to demonstrate that a hypothetical capital structure ratio should be employed in this proceeding.

c. OCA's attempt to disguise its hypothetical capital structure as a revised assumption of future test year financing is contrary to PPL Electric's actual financing and an improper interference with the management by the Company of its capital structure within a reasonable range.

OCA proposes to adjust PPL Electric's capital structure for the future test year by assuming that the $150 million of equity capital planned to be provided by PPL Corporation to PPL Electric be treated as debt capital, to produce a 47.16% equity ratio. OCA St. 2, p. 25. OCA seeks to recharacterize PPL Corporation's equity contribution as debt because OCA cannot justify a hypothetical capital structure for PPL Electric for all the reasons previously explained in this brief. *supra*, pp. 96-98.

There are several reasons that OCA's recharacterization of equity contributions is inappropriate. First, as explained previously in this brief, $125 million of the $150 million equity contribution is to refinance 50% of preference stock with additional equity and the remainder with debt. *supra*, p. 93. If the equity infusion is "converted" to debt, the previously explained benefits of the refinancing of preference stock on credit ratings would be lost.[20]

Second, OCA's contention that PPL Electric's proposed capital structure departs significantly from historic equity ratios is incorrect in terms of how it is viewed by rating agencies.

> In terms of equity levels as viewed by the rating agencies, PPL Electric's proposed equity level is slightly less than its prior four-year average of approximately 48% debt and 52% equity, (including Preference Stock as 50% debt and 50% equity as is the current treatment afforded by the rating agencies and as noted in my initial testimony). As a comparison, during PPL Electric's major generation build related to its Susquehanna SES nuclear plan construction in the early – mid 1980s, PPL Electric employed a capitalization structure as viewed by the rating agencies that averaged approximately 47% debt and 53% equity (including Preferred/Preference Stock as 100% equity credit as was the practice of the rating agencies at that time). In addition, PPL Electric's capital structure is designed to allow the Company to support its planned expanded construction program and raise cost-effective capital in all capital market conditions.

PPL Electric St. 10-RJ, pp. 4-5.

Third, recharacterizing PPL Corporation's equity capital as debt is contrary to reality, since $125 million of the equity contribution already has been made by PPL Corporation and received by PPL Electric, in conjunction with the redemption of PPL Electric of preference stock. PPL Electric St. 10-RJ, p. 6.

Fourth, OCA witness Hill has not demonstrated that PPL Corporation has raised debt to infuse these funds to PPL Electric, and PPL Electric witness Clelland explained that PPL

[20] In cross-examination, the OCA suggested that PPL Electric's historic equity ratio, including 50% of preferred stock as equity, was 48.54%, which is the sum of the 44% average historic common equity ratio for 2007 – 2010 plus one-half of the average preferred stock of 9.09% shown on OCA Ex. SGH-1, Sch. 1, p. 4; Tr. 261. This historic average, as calculated by OCA, should not be a cap on the Company's equity ratio. First, OCA's own schedule shows a rising amount of common equity over these years, excluding the unusual circumstances in 2008 during the financial crisis. Therefore, an average does not reflect the need to reduce debt levels in the post financial crisis period. Second, the historic average 48.54% equity ratio does not reflect the need for a stronger equity ratio to support PPL Electric's expanded infrastructure replacement program and the reaction by Moody's in 2010 in downgrading PPL Electric.

Corporation does not raise debt to infuse equity capital to PPL Electric. PPL Electric St. 10-R, p. 4.

OCA witness Hill argues that use of less equity would reduce the rate increase to PPL Electric's customers. OCA St. 2, p. 22. However, this contention ignores the previously explained effect of refinancing preference stock, and the effects on PPL Electric's credit rating and the future cost of debt as PPL Electric continues to ramp up its major capital replacement program. *supra*, pp. 94-95. As explained previously, PPL Electric's proposed equity ratio and a reasonable ROE are necessary to maintain PPL Electric's credit ratings, which were downgraded by Moody's in April 2010. PPL Electric St. 10-R, pp. 3-6, PPL Electric St. 10, p. 3.

OCA has not, and cannot, show that PPL Electric's capital structure is outside the norm for comparable electric companies. Having failed to do so, OCA impermissibly attempts to interfere in the management discretion of PPL Electric to determine the capital structure PPL Electric believes is necessary by disallowing the costs of a portion of that capital structure. While such disallowance may be made if PPL Electric has been shown to be acting imprudently, OCA has made no such showing. To the contrary, PPL Electric is acting prudently to replace aging plant to maintain reliable service, and PPL Electric is creating a financial profile that will enable it to obtain the necessary financing to do so. OCA has shown no basis to interfere with this by disallowing PPL Electric's recovery of the costs of PPL Electric's capital structure. Therefore, OCA's hypothetical capital structure must be rejected.

E. RETURN ON COMMON EQUITY

The record in this proceeding contains extensive testimony concerning the cost rate for common equity capital. PPL Electric Sts. 11, 11-R and 11-RJ; I&E Sts. 1 and 1-SR; OCA Sts. 2 and 2-SR. In these Statements, witnesses for the Company, I&E and OCA apply various theoretical models using various inputs to estimate the cost of equity. The appropriate components of these models and the selection of inputs to these models is a matter of the judgment of each witness. It is important in reviewing these judgments that the realities of the marketplace and the concerns of investors, who determine the cost of equity capital by purchasing common stocks of utilities, be considered. For this reason, PPL Electric also submitted testimony of Ms. Cannell, an experienced securities analyst and portfolio manager of utility common stocks. PPL Electric Sts. 12 and 12-R.

1. PPL Electric's Return on Common Equity Should Be Adopted

PPL Electric's witness, Mr. Moul, summarized his approach to determining the cost rate for common equity and the results of such analysis, as follows:

> In general, the use of more than one method provides a superior foundation to arrive at the cost of equity. At any point in time, reliance on a single method can provide an incomplete measure of the cost of equity. The specific application of these methods/models will be described later in my testimony. The following table provides a summary of the indicated costs of equity using each of these approaches.
>
> | | Electric Delivery Group | Integrated Electric Group |
> |---|---|---|
> | DCF | 10.37 % | 10.87% |
> | RP | 10.75% | 10.75% |
> | CAPM | 11.78% | 12.48% |
> | CE | 11.60% | 11.60% |
> | Average | 11.13% | 11.43% |
> | Median | 11.18% | 11.24% |
> | Mid-point | 11.08% | 11.62% |
>
> Based on these results, I recommend that the Commission set the Company's rate of return on common equity at 11.25% in this case, which is between the average results for the Electric Delivery Group and the Integrated Electric Group. In recommending an 11.25% rate of return on common equity, I have recognized the exemplary performance of the Company's management, as described in the pre-filed direct testimony of Mr. Gregory N. Dudkin, the Company's President. I have done this by moving my recommendation above the average shown above for the Electric Delivery Group. I believe that my final recommended cost of equity of 11.25% is appropriate in this case because it is within the range

of cost rates shown above and provides recognition of the excellent management performance of the company.

PPL Electric St. 11, pp. 5-6.

Mr. Moul elaborated on the reasons for using more than one model to determine the cost of equity:

> It also is important to reiterate that no one method or model of the cost of equity can be applied in an isolated manner. As I noted previously, each of the methods used to measure the cost of equity has its own limitations that can cause the model to generate unrealistic results under certain circumstances. Therefore, I favor considering the results from a variety of methods. In this regard, I applied each of the methods with data taken from the Electric Delivery Group and the Integrated Electric Group and considering those results along with the other factors I have identified I have arrived at a cost of equity of 11.25% for PPL Electric.

a. DCF

Mr. Moul's DCF cost rate for his Electric Delivery Group and Integrated Electric Group is comprised of a dividend yield, growth rate and leverage adjustment as follows:

	Dividend	+	Growth	+	Leverage	=	DCF Cost Rate
Electric Delivery Group	4.67%		5.00%		0.70%		10.37%
Integrated Electric Group	4.69%		5.00%		1.18%		10.87%

PPL Electric St. 11, p. 41.

i. Dividend Yield

Mr. Moul derived the dividend yield by calculating the six month average dividend yields for each group and adjusting those yields for expected growth in the following year to produce the 4.67% for the Electric Delivery Group and 4.69% for the Integrated Electric Group. PPL Electric St. 11, p. 26.

ii. Growth Rate

Mr. Moul reviewed various methods of calculating investor expected growth rates and concluded that analysts' projections of growth rates are the best indicator of expected growth. PPL Electric St. 11, p. 34. This conclusion is supported by the research of Myron Gordon, the foremost proponent of the use of DCF in utility rate proceedings. *Id.*, p. 34.[21] The range of such growth rates was 4.50% to 5.08% for the Electric Delivery Group and 4.59% to 6.00% for the Integrated Group. Mr. Moul chose a growth rate of 5.00% for both groups.[22]

iii. Leverage Adjustment

There is much testimony in this proceeding about the reasonableness of employing a leverage adjustment as part of the DCF analysis. The simple response to opposition to this component is to point out that the Commission has included such adjustment in numerous past cases, including two PPL rate cases. *Pa. P.U.C. v. PPL Electric Utilities Corp.,* (Dec. 6, 2004), Docket No. R-00049255, *Pa. P.U.C. v. PPL Gas Utilities Corp.,* (Feb. 8, 2007) at R-00061398 (Feb. 8, 2007). However, before addressing such cases, PPL Electric will briefly explain the basis for the leverage adjustment.

The leverage adjustment is designed to adjust the DCF cost rate for the different percentage level of debt in the capital structure when capital structure is calculated at the market prices of equity and debt securities as opposed to book value. For example, a utility that has a

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21 OCA contends that analysts' growth rates can be overstated because analysts are encouraging investors to purchase securities. OCA St. 2, p. 34. The recent evidence is exactly to the contrary. As reported in *The Wall Street Journal "Wall Street's Missed Expectations,"* April 26, 2010, 64% of companies had achieved growth rates in excess of analysts forecasts since the start of 1999. PPL Electric St. 12-R, p. 14.

22 I&E and OCA criticize the use of an Integrated Electric Group. I&E St. 1, p. 12; OCA St. 2, p. 53. The barometer groups employed by the I&E and OCA were heavily weighted with integrated electric companies. Mr. Moul used an Integrated Electric Group which contains state rate regulated generation to obtain additional information because of the limited number of separately traded electric delivery group companies. PPL Electric St. 11, pp. 4-5. There is no basis to argue that such companies are significantly more risky than Electric Delivery Group where the assets are subject to the same regulation. Further, Mr. Moul has selected a conservative growth rate for this group of 5.00% in the range of 4.59% to 6.00%. PPL Electric St. 11, p. 35.

stock price above book value has a market value or capitalization of its equity that is greater than the book value of its equity. When an investor purchases that equity at the market price, the percentage of equity in the market capitalization is greater than the percentage of equity at book value. Under such circumstances, the DCF cost rate based on market prices must be adjusted to reflect the greater financial risk to investors when that cost rate is applied to a book value rate base in utility proceedings.

The Commonwealth Court has held that the decision of whether to adopt a leverage adjustment is within the Commission's discretion. In a 2004 case involving Pennsylvania American Water Company ("PAWC"), the Commonwealth Court stated as follows:

> As to economic theory, the PUC explains the reasons the common equity costs rate adjustment is appropriate. First, the formula used to estimate cost rate is market based, but Utility's stock is not publicly traded and is listed at a much lower book value. Under these circumstances the formula can understate the cost of capital.
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> Similarly, Utility highlights the testimony of its expert, who opined that "the capital structure ratios measured at the utility's book value show more financial leverage, and hence higher risk, than the capitalization measured at its market values." R.R. at 987a.
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> The present issue involves the application of a market value cost to a book value amount of common stock. The PUC made its adjustment to the common equity cost rate in recognition of the "financial risk" arising from the different valuation methods.
>
> No witness stated that 0.6% was an appropriate adjustment. However, as Utility's expert opined that an adjustment of about 0.8% was appropriate, the record supports an adjustment larger than that approved. Further, case law supports an adjustment. E.g., West Penn Power Co. Also, the amount of the adjustment is exactly the same in this case as in the last rate proceeding involving Utility. R.R. at 900a. That prior order was not appealed. Under these circumstances, there was [**19] no abuse of discretion in making the identical adjustment.

Popowsky v. Pa. P.U.C., 868 A.2d 606, 612-13 ("PaAmerican"). (Footnote omitted).

The Commission has accepted the leverage adjustment in a number of cases, including PPL Electric's last fully litigated rate case in 2004. *Pa. P.U.C. v. Pa. American Water Co.*, (Jan. 10, 2012), Docket No. R-0001639 (60 basis point adjustment); *Pa. P.U.C. v. Philadelphia Suburban Water Company,* (Aug. 1, 2002), Docket No. R-00016750, 80 basis points; *Pa. P.U.C. v. Pa. American Water Co.*, (Nov. 8, 2004), Docket No. R-00038304, 60 basis points, affirmed. *Popowsky v. Pa. P.U.C.*, 868 A.2d 606 (Pa. Cmwlth. 2004); *Pa. P.U.C. v. Aqua Pa. Inc,* (Aug. 5, 2004), Docket No. R-00038805, 60 basis point adjustment; *Pa. P.U.C. v. PPL Electric Utilities Corp.,* (Dec. 22, 2004), Docket No. R-00049255, 45 basis point adjustment; *Pa. P.U.C. v. PPL Gas Utilities Corp.,* (Feb. 8, 2007), Docket No. R-00061398, 70 basis points.

In *Pa. P.U.C. v. Aqua Pa. Inc.,* (July 17, 2008), Docket No. R-00072711, ("*Aqua 2008*") the Commission declined to use a leverage adjustment in arriving at the DCF cost of equity, stating as follows:

> Based upon our analysis and review of the record, the Recommended Decision, and the Exceptions and Replies thereto, we reject the ALJ's recommendation to add a 65 basis point risk adjustment. The award of such an adjustment is not precedential but discretionary with the Commission. In fact, in *Met Ed/Penelec* (*Pa. P.U.C. v. Metropolitan Edison Co./Pennsylvania Electric Co.* Order of Jan. 11, 2007, at R-000161366 and R-00061367), we specifically approved the removal of any risk adders from the cost of equity calculations. *Met Ed/Penelec* at 136.
>
> In the cases cited by Aqua in support of its leverage adjustment, it is obvious that the DCF results in those cases were not as high as the unadjusted DCF result we have in this proceeding, since the final cost of equity in those cases was no higher than 10.6% with the leverage adjustment. The unadjusted DCF results presented by the Parties in this case are generally higher than the DCF recommendations from the earlier cases cited by Aqua. When viewed in the context of the other methodologies, we conclude that there is no need to have an upwards adjustment to compensate for any perceived risk related to Aqua's market-to-book ratio. Accordingly, we reject the ALJ's recommendation to allow a 65 basis point leverage adjustment.

Id., pp. 38-39, (*Aqua 2008*).

In the *Aqua 2008* case cited above, the Commission concluded that the cost of equity was 11.0% applied to a 50.9% common equity ratio. *Id.*, pp. 3 and 53. As noted in the above quote from the Commission Order, the Commission has applied the leverage adjustment in cases where it believes market conditions have resulted in a DCF cost rate that is understated. PPL Electric submits that such conditions appear again in this case. The DCF result for Mr. Moul's Electric Delivery Group would be 9.67% without the leverage adjustment and 9.69% for the Integrated Electric Group. Mr. Moul cautioned that use of the DCF alone, and certainly without consideration of the leverage adjustment, significantly understates the cost of equity. When investors expectation of future earnings are pessimistic due to factors including future regulatory allowances, there is the potential for the DCF to be circular and not market based. PPL Electric St. 11, p. 24. As explained subsequently in this brief, appropriate application of the Risk Premium and CAPM analyses confirms that sole use of the DCF analysis without inclusion of the leverage adjustment will understate the cost of equity.[23]

Parties to this proceeding also state that the Commission declined to adopt a leverage adjustment in the City of Lancaster's (Water) 2011 base rate proceeding. *See Pa. P.U.C. v. City of Lancaster Bureau of Water,* Docket Nos. R-2010-2179103, et al. (July 14, 2011). It is important to note that the City of Lancaster decision does not stand for the proposition that the Commission has forever shut the door on adopting a leverage adjustment. Rather, the Commission simply exercised its discretion in that proceeding not to adopt a leverage adjustment, citing the Aqua 2008 case that it was unnecessary to adopt the leverage adjustment in that proceeding. *Id.,* p. 79. This is consistent with the Commission's actions in other

[23] I&E and OCA offer a series of criticisms of the leverage adjustment in their testimonies. All of these criticisms have been refuted in this and prior proceedings and rejected by the Commission by adopting the leverage adjustment. PPL Electric St. 11-R, pp. 26-34; PPL Electric St. 11-RJ, pp. 2-6.

proceedings where it has reviewed the entire record and either chose to adopt or chose not to adopt a leverage adjustment based upon the specific circumstances of each case. As explained above, it is especially appropriate to adopt the leverage adjustment in this proceeding due to the historically low DCF results. Further, as noted previously, the Commonwealth Court in *PaAmerican* specifically affirmed the Commission's authority to include the leverage adjustment in the DCF analysis.

Moreover, the *City of Lancaster* decision is clearly distinguishable. The City is not an investor owned utility, such as PPL Electric. In its Order, the Commission specifically recognized that the City did not have the same financial risk as an investor owned utility, stating as follows:

> "We note that the City's debt cost rate in this proceeding is at 4.66%, which reflects the City's ability to tax. This illustrates that the City's taxing power lowers the City's financial risk when compared to an investor-owned utility. Since Lancaster's status as a municipally owned utility provides it with the opportunity to obtain debt at this low cost rate as a result of the City's ability to tax, this low cost debt should not be shifted to higher cost equity at the expense of the City's customers. **As a result, we do not find that the City has to be treated like an investor owned utility for ratemaking purposes.**

(*Id.*, p. 54; Emphasis supplied). It is clear from reading the Order that the Commission recognized that the City did not have the same financial risk as an investor-owned utility, and this lower risk impacted the Commission's decision in that proceeding.

b. Risk Premium

PPL Electric witness Moul also performed a risk premium analysis to determine the cost equity. The risk premium analysis is based upon the basic financial tenet that an equity investor in a company has greater risk than a bond holder in a company because all interest on bonds are paid before any return is received by the equity investor and upon bankruptcy or dissolving a company the bond holder receives their capital before any capital is provided to the equity investors. PPL Electric St. 11, p. 44, and Appendix G, p. G-2.

The Risk Premium has common sense appeal to investors, who would expect to earn equity returns in excess of bond returns, as has been the case for any extended period in the capital markets. Accordingly, the Risk Premium method determines the cost of equity by summing the expected public utility bond yield and the return of equities over bond returns (the "equity premium") over an historic period, as adjusted to reflect lower risk of utilities compared to the common equity of all corporations. PPL Electric St. 11, pp. 49-50.

Mr. Moul determined the risk premium cost of equity to be 10.75% as follows:

Interest Rate	Risk Premium		Cost Rate
5.25%	5.50%	=	10.75%

The interest rate used for this calculation is an estimated interest rate for A-rated public utility bonds. PPL Electric St. 11, pp. 45-46. The risk premium is the average of actual premium earned by stocks over bonds over recent periods of 1974 – 2007 and 1979 – 2007, reflecting periods of modern financial circumstances, to produce an unadjusted premium of 6.22%. This historic premium was then adjusted to produce a premium of 5.50%.[24] PPL Electric St. 11, pp. 49-50.

It is to be noted that the risk premium analysis produces a likely low estimate of the cost of equity for PPL Electric because PPL Electric's bond rating is lower than the A-rating used in this analysis indicating greater risk and cost for PPL Electric. PPL Electric's rating is also somewhat lower than the ratings for the Electric Delivery Group. PPL Electric St. 11, p. 13.

[24] Beta reflects the degree to which utility stock prices vary in accordance with the general stock market and is a measure of the relative lower risk of utilities as compared to the total market which by definition has a beta of 1.0. PPL Electric St. 11, Appendix H, p. H-3.

I&E witness Sears contends that the risk premium cannot be used because it relies on historic risk premiums achieved over bond yields which may not be applicable for the future. I&E St. 1, p. 19. However, witness Sears uses historic premiums as part of her own CAPM analysis as a check on her DCF. I&E St. 1, pp. 34-36. Ms. Sears fails to realize that no model is perfect, and that there are defects in the DCF model as well. PPL Electric St. 11, pp. 24-25. Investors can weigh historic risk premiums to determine which premiums are reasonable for the future. Further, the Risk Premium method has been relied upon by the Commission in the past to check the reasonableness of the DCF model.

In PPL Electric's 2004 base rate proceeding, the Commission held as follows:

> As noted previously, we have primarily relied upon the DCF methodology in arriving at our determination of the proper cost of common equity. The ALJ interpreted our previous actions in *PA WC* and *Aqua* as not compelling the use of other methods such as RP and CAPM to form an equity return based on a composite of the DCF and other methods. We agree with the ALJ insofar as these prior actions do not compel the use of methods in addition to the DCF method. However, we conclude that methods other than the DCF can be used as a check upon the reasonableness of the DCF derived equity return calculation. We note that all of the parties in this proceeding with the exception of the OTS have done so. We will also use the results of the CAPM and RP methods as a check of the reasonableness of our DCF calculation.
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> Those returns indicated by alternative, standard cost-estimation techniques provide additional measures so as to test the reasonable of our DCF based cost of equity capital rate of 10.70% (10.25 + .45 for financial risk). The PPL CAPM study produces a 10.70% return rate for its Electric Company Proxy Group. A USDOD CAPM study estimates an appropriate equity return of 11.00% [*103] The USDOD risk premium result is 10.44%. The OCA estimates a CAPM rate range of 9.0 to 10.0%. Additionally, a Risk Premium analysis that indicates an appropriate return on equity for its electric proxy group of 11.75%.

Pa. P.U.C. v. PPL Electric Utilities Corp., Docket No. R-00049255, pp. 67 and 72 (Dec. 22, 2007).

Moreover, in a Philadelphia Suburban Water Company base rate proceeding, the Commission stated as follows:

> We shall adopt the ALJ's DCF derived cost of common equity of 12.05% because we are persuaded that the growth factor adopted by the ALJ is well within the zone of reasonableness supported by the record evidence. **For all their infirmities, the parties' risk premium results are persuasive that the cost of common equity is higher than the DCF derived result. DCF results have seemed to be on the low side for some time.** In addition, we are persuaded that due to the Company's capitalization ratios, it faces a higher financial risk than the barometer group of companies. In addition, the evidence indicates a need for capital investment to improve and upgrade its plant. We concur with the OCA that the correlation between the cost of equity and financial risk cannot be precisely quantified. **The use of informed judgment, however is a *sine qua non* of ratemaking in general and setting the cost of capital in particular. It is attendant upon an evaluation of the unique facts presented in each proceeding. In this regard, the parties' analyses resulted in a range in the cost of equity of between 12.0 to 14.5%. Due to the evidence that derived DCF results may not fully reflect current capital costs as well as persuasive evidence that PSWC's increased leverage may increase its financial risk vis-à-vis the barometer group of companies, we are persuaded that a range of reasonableness in the cost of equity is 13.0 to 14.0 and that a 13.7% cost of equity is appropriate in this proceeding.**

Emphasis supplied. *Pa. P.U.C. v. Philadelphia Suburban Water Co.*, Docket Nos. R-870840 *et al.*, 96 P.U.R. 4th 158, 207, 1988 Pa. PUC LEXIS 433 at *135 - *137, Order entered July 26, 1988; See also, *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, Docket No. R-891218 et al., 109 P.U.R. 4th 250, 272, 1989 Pa. PUC LEXIS 225 at *52, Order entered December 29, 1989.

The Commission has clearly relied on the risk premium and CAPM methodologies in setting the rate of return for utilities. It is especially appropriate for the Commission to rely on these methodologies in this proceeding given the low, unadjusted DCF results.

c. CAPM

PPL Electric witness Moul also performed a CAPM analysis to estimate the cost of equity for the Electric Delivery Group and Integrated Electric Group. The CAPM analysis is similar in concept to the Risk Premium in that it determines a "risk-free" interest rate based on U.S. Treasury obligations and an equity risk premium that is proportional to the systematic (*i.e.*, beta) risk of a stock, which are combined to produce cost rate of equity. PPL Electric St. 11, pp. 50-52.

Mr. Moul determined the risk free rate to be 3.75% based on current and near term project yields on long term treasury bonds. PPL Electric St. 11, pp. 53-54. Mr. Moul determined the market or equity premium to be 8.76% premium based upon an average of historic and projected market premiums. PPL Electric St. 11, p. 54 and Appendix H, pp. H-4 to H-6. Betas are applied to the market premiums to adjust for electric company risks relative to the total market and the betas are adjusted for the same reasons as the leverage adjustment to the DCF. PPL Electric St. 11, pp. 52-53. Finally, a size adjustment to reflect greater risk for smaller firms relative to the market. PPL Electric St. 11, pp. 54-55. The results of the CAPM analysis are 11.78% for the Electric Delivery Group and 12.48% for the Integrated Electric Group.

The results of the CAPM analysis indicate the upper range of the cost of equity analysis using the theoretical models typically employed in utility rate cases.

d. Comparable Earnings

PPL Electric witness Moul also performed a Comparable Earnings analysis based on the principle set forth by the United States Supreme Court that a utility should be afforded an opportunity to earn a return on its property equal to that being earned on investments in other businesses with corresponding risks and uncertainties. *Bluefield Water Works v. Public Service*

Commission, 262 U.S. 668 (1982). The analysis identifies non-regulated companies with comparable risk and produces a cost rate of 11.60%. PPL Electric St. 11, pp. 56-59.

e. PPL Electric's Evidence Concerning Investors' Expectations of the Allowed ROE Confirm PPL Electric's Requested ROE

Ms. Cannell, a securities analyst and portfolio manager of investments in utility stocks for nearly twenty years, provided evidence concerning the expectations of investors with regard to the ROE. PPL Electric St. 12, PPL Electric St. 12-R.

Ms. Cannell explained that markets and credit rating agencies expect supportive and consistent regulation of utilities and that the ROE is a transparent indicator to capital markets of the relative supportiveness of each regulatory jurisdiction. PPL Electric St. 12, pp. 24-25; pp. 32-38. Ms. Cannell concluded that PPL Electric's requested ROE of 11.25% would be considered supportive by investors and credit rating agencies, noting increased risk to equity investors as reflected in downgrades of PPL Electric and other electric utilities since the Commission's 10.7% ROE allowance in PPL Electric's last litigated rate proceeding in 2004. PPL Electric St. 12, p. 39.

Ms. Cannell also reviewed the proposed ROEs recommended by the I&E and OCA and provided the following evaluation.

> Both I&E's recommendation of a 8.38% equity return and OCA's proposal of a 9.00% ROE are below the 10.7% level the Company was last authorized by the PUC in 2004. While interest rates are, indeed, near historically low levels, that is due to the monetary policy of the Federal Reserve Board, as stated in my Direct Testimony. Should the PUC adopt either proposal, both of which reflect an overreaction to artificially low interest rates, I believe it would have a very deleterious impact on investor perceptions regarding the Company's earnings and dividend prospects as well as investors' view of the quality and consistency of Pennsylvania regulation. An ROE outcome in the current proceeding deemed as being inadequate in meeting investors' requirements for risk compensation most likely would result in a deterioration of perceptions of the quality of Pennsylvania regulation. Because regulatory consistency is important to investors, a reduction of the currently allowed 10.7% return to anywhere

> within a range of 8.38% to 9.0%, particularly since industry and market risk have risen significantly since 2004, is likely to be disappointing to investors and create a negative perception of Pennsylvania regulation, A negative regulatory perception requires a higher compensation for risk associated with utilities governed by that regulatory jurisdiction.

PPL Electric St. 12-R, pp. 3-4.

Ms. Cannell also illustrated her conclusion by demonstrating that I&E's proposed ROE would be the lowest ROE allowed in the United States during the period examined (beginning of 2009), and OCA's would be higher than only one of the 154 authorized during this period. PPL Electric St. 11-R, p. 4, Sch. JMC-1. Ms. Cannell also noted as follows:

> This data suggests that neither I&E's nor OCA's ROE recommendations would meet investor expectations for the Company. Moreover, an authorized return at or near the levels proposed would put the Company at a distinct disadvantage in the competition for capital going forward. Adopting either the I&E or OCA proposal also would represent a step backward by the Commission in establishing a constructive, consistent regulatory framework for Pennsylvania. It bears mention that Regulatory Research Associates continues to maintain the "Average/3" ranking of Pennsylvania regulation it has had in place since late 1998. The undue reliance on low interest rates by these witnesses produces unrealistic equity return rates that do not reflect the requirement that utilities must raise capital in all markets. Dramatic changes in allowed ROEs like those proposed in this case by Ms. Sears and Mr. Hill ignore the fact that investments in utility assets is a long term proposition.

PPL Electric St. 12-R, pp. 4-5.

f. The Cost of Equity Should Include an Increment for Management Performance

The Commission is required to consider management effectiveness in setting rates. *See* 66 Pa.C.S. § 523 (in determining just and reasonable rates, the Commission shall consider a public utility's management effectiveness, operating efficiency and activity or inactivity regarding conservation). In addition, the Commission has, where appropriate, included an incremental upward adjustment to the cost of common equity to reflect management effectiveness. *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, R-00072711, 2008 Pa. PUC LEXIS 50, *63 (July 31, 2008); *Pa. P.U.C. v. West Penn Power Co.*, Docket Nos. R-00942986, *et al.*, 1994 Pa. PUC LEXIS 144, *147 (Dec. 29, 1994). In this proceeding, PPL Electric has presented extensive evidence as to its management effectiveness. PPL Electric's rate of return witness recommended a 12 basis point addition to the rate of return for management effectiveness. I&E and OCA oppose any allowance for management effectiveness and devoted substantial time in testimony and at hearings attacking the Company's claim. As explained below, their arguments are without merit, are unprecedented and should be rejected.

i. Evidence Of PPL Electric's Management Effectiveness.

PPL Electric has presented extensive evidence as to its management effectiveness. Below is a summary of the evidence introduced by PPL Electric to demonstrate its exceptional management performance.

PPL Electric's management is effectively controlling costs, while at the same time, providing customers with high quality service and expanded service options. As detailed in the Statement of Reasons, the Company has taken substantial efforts to improve productivity and manage costs, including, but not limited to: (1) new technology to improve productivity and including advanced meters; (2) a smart grid distribution automation system, which will provide direct reliability benefits to over 60,000 customers in the project area and lead to increased reliability benefits to all customers by providing system operators advanced and timely situational awareness and control capabilities through a wider deployment throughout PPL Electric's service territory; (3) a work and asset management system, which is a new large scale software solution that will improve associated work management business processes in order to more effectively and efficiently manage the portfolio of work; (4) several initiatives to improve storm processes including call handling time and volume; (5) increased investment to address aging infrastructure, which will have a positive, long-term benefit in controlling reactive operating costs; and (6) capital investment in information systems to support customer choice and to provide expanded self-service options for customers, which improves service to customers while controlling operating costs. In addition, the Company is testing and evaluating a variety of applications and features that will expand the capabilities of the current system and equipment over the next five years. PPL Electric St. 1, p. 7; PPL Electric Ex. 1, Statement of Reasons.

Although all utilities are required to deploy smart meters, PPL Electric is the only utility in the Commonwealth that has deployed smart meters to all of its customers. PPL Electric also is actively pursuing and implementing smart grid technology. PPL Electric plans to deploy self-healing smart grid functionality to approximately 50% of all customers and circuits by 2019. PPL Electric Ex. 1, Statement of Reasons, pp. 9-10.

PPL Electric is in the process of developing an enterprise work and asset management system that will be used to optimize maintenance and aging infrastructure programs. As the system is deployed, it will provide the future capability to more effectively store conditional and operational information associated with specific assets. The Company's plan is to leverage this new asset information to optimize maintenance and aging infrastructure replacement programs. PPL Electric Ex. 1, Statement of Reasons, p. 10.

After the historic storms of 2011, PPL Electric has undertaken new initiatives to improve storm processes and systems, including:

- Hardware and software upgrades of the Company's Outage Management System to speed outage processing;
- Integration with a third-party service to handle customer outage calls when the telephone infrastructure reaches capacity;

- Revamped damage assessment processes to better utilize employees with mobile damage reporting capabilities and, in some cases, utilize retirees;
- Re-configured regional storm centers to optimize the flow of outage information and provide all required support; and
- Implementation of improved estimated restoration time ("ERT") processes and associated metrics.

PPL Electric Ex. 1, Statement of Reasons, p. 11.

The Company has successfully deployed a comprehensive family of programs to meet its requirements under Pennsylvania Act 129. That Act requires electric distribution companies to work with customers to reduce energy use by 1 percent by May 31, 2011, and 3 percent by May 31, 2013. It also requires a 4.5 percent reduction in peak demand by May 31, 2013. The Company met the 2011 requirement and expects to meet both of the 2013 requirements. PPL Electric Ex. 1, Statement of Reasons, p. 12.

PPL Electric implemented a pilot program that allows residential customers to use self-serve tools (IVR and the web) to establish payment agreements. No other utility has implemented such a program. This program has been highly successful over 2011, with 275,000 self-serve payments and 107,000 self-serve payment agreements. PPL Electric Ex. 1, Statement of Reasons, pp. 13-14. Given the success of the program, PPL Electric plans to request Commission approval to implement the program on a permanent basis.

In 2011, for the ninth time, PPL Electric was ranked highest among large electric utilities in the eastern United States in J.D. Power and Associates' annual study of business satisfaction. PPL Electric St. 1, p. 8. On July 12, 2012, the Company received its 18th J.D. Power and

Associates award for being first in customer satisfaction in the eastern United States. PPL Electric St. 3-R, pp. 23-24.

PPL Electric has undertaken many activities and programs to provide an educational foundation to help consumers understand a variety of issues associated with shopping for electricity, the importance of energy efficiency and conservation, and the steps they can take to help them control the size of their electric bills. PPL Electric Ex. 1, Statement of Reasons, pp. 14-15; PPL Electric St. 6-R, p. 7.

PPL Electric has been an active supporter of competition. Nearly 75% of the energy consumed in the PPL Electric service territory is provided by EGSs. PPL Electric Ex. 1, Statement of Reasons, p. 14. Further, PPL Electric has the highest percentage of total customers shopping in Pennsylvania among large EDCs. The statewide average of shopping customers is 31.1%, while PPL Electric's total is approximately 42%. PPL Electric has the highest referral rate to the papowerswitch.com website. PPL Electric consistently led in "hits" to the website from its customers, compared to other EDCs. PPL Electric St. 6-R, p. 7; PPL Electric Ex. TCS-2.

PPL Electric also has been a leader in the development and implementation of universal service programs. PPL Electric explained that:

> In 1980, PPL Electric was the first utility in Pennsylvania to develop and implement CARES, which is an outreach and referral service for household confronted with hardships. The Commission issued a Secretarial Letter on May 31, 1985 (Docket No. M-840403) encouraging regulated utilities in the state to implement CARES programs. The Company was one of the first electric utilities to implement a utility-sponsored hardship fund ("Operation HELP") in 1983. Among regulated utilities, Operation HELP has been a top fund raiser in Pennsylvania. From the start of the program in 1983 through 2011, the Company has donated and raised approximately $23 million to assist 80,000 low-income households. In 1985, PPL Electric introduced the first

> utility-sponsored weatherization program ("WRAP") for low-income households in Pennsylvania. The Commission promulgated regulations in 1988 (Chapter 58, Residential Low-Income Usage Reduction Programs) requiring utilities to implement low-income weatherization programs. As noted earlier, from 1985 through 2011, PPL Electric has expended approximately $128.4 million to provide weatherization services to 70,000 low-income households.

PPL Electric St. 9-R, pp. 26-27.

The foregoing clearly demonstrates PPL Electric's efforts to improve its operations in ways that strengthen reliability, enhance customer satisfaction, respond to customer needs, and reinforce public and employee safety. For these reasons, the cost of common equity should include an increment for management performance.

ii. I&E's And OCA's Arguments Against Any Allowance For Management Effectiveness Should Be Rejected.

I&E and OCA oppose any allowance for management effectiveness and devoted substantial time in testimony and at hearings attacking the Company's claim. As explained below, their arguments are without merit, unprecedented, and should be rejected.

In several areas where PPL Electric presented clear evidence of management effectiveness (advanced metering infrastructure, operating initiatives, customer contact center, customer education, energy efficiency programs, and customer assistance programs), I&E rejected the evidence because PPL did not demonstrate that its performance was better than all other EDCs in Pennsylvania. I&E St. 1, pp. 69-76. This is not the standard for demonstrating management effectiveness and should be ignored.

The Commission may reward utilities through rates, particularly by way of rate of return premiums, for their performance. Section 523 of the Public Utility Code provides as follows:

> (a) Considerations. --The commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when

> determining just and reasonable rates under this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.
>
> (b) Fixed utilities. --As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:
>
> > (1) Management effectiveness and operating efficiency as measured by an audit pursuant to section 516 (relating to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.
> >
> > * * *
> >
> > (4) Action or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management, cogeneration or small power production for electric and gas utilities.
> >
> > * * *
> >
> > (7) Any other relevant and material evidence of efficiency, effectiveness and adequacy of service.

66 Pa.C.S. § 523. Clearly, there is nothing in Section 523 that requires a finding that a utility is performing better than all other utilities in the Commonwealth before it is eligible for an increment to the rate of return for management effectiveness.

In those areas where PPL Electric is in fact performing better than other similar EDCs, I&E rejects any consideration because the Company recovered the costs in rates or through riders. I&E St. 1, pp. 69-76. Under I&E's view, utilities cannot demonstrate effective management in any area unless the utility pays for the associated costs with shareholder money. There simply is nothing in Section 523 of the Public Utility Code or any order of the Commission to support I&E's unprecedented position. I&E's position would lead to nonsensical results, under which no utility would be eligible for a management effectiveness allowance.

The principal issue is not whether PPL Electric's various practices, processes, or programs are superior to other electric utilities, or whether the programs and initiatives are funded by ratepayers. Rather, the principal issue is the broad scope of PPL Electric's efforts to improve its operations in ways that strengthen reliability, enhance customer satisfaction, respond to customer needs, and reinforce public and employee safety. It involves a commitment to customer services, effective leadership, operational excellence, and a culture of continuous improvement.

Straying further from any relevance, I&E appears to contend that because PPL Corporation (holding company) had a profitable year no allowance for management effectiveness is needed. Tr. 283-91, 311-13. Of course, the profitability of PPL Corp.'s out of state operations (regulated or unregulated) is irrelevant to this proceeding. I&E certainly would not consider, and neither would Commission consider out of state operating losses in setting rates for PPL Electric; the converse also should be true. In any event, PPL Electric did not have a profitable year that resulted in its earning a reasonable return, which is why the Company is asking for a rate increase. PPL Electric St. 1, pp. 5, 12; Tr. 312.

Finally, without studying PPL Electric's management performance, OCA argues that no allowance should be made because economic times are hard for PPL Electric's customers and, therefore, rates should kept as low as possible. OCA St. 2, p. 6; Tr. 320. PPL Electric recognizes the hard economic times and has responded appropriately. PPL Electric has proposed just and reasonable rates that continue to move the rate classes towards cost of service rates, consistent with the *Lloyd* decision and the principles of gradualism. Indeed, even if the proposed rate increase were granted in full, including recognition of management effectiveness, the average residential customer's total bill will be lower than when generation rate caps expired. PPL Electric St. 5-RJ, p. 4. PPL Electric has not contributed to economic hard times, it has made them easier by its numerous programs to assist those customers that are affected the most by these circumstances. Moreover, the increase requested in this proceeding, if granted in full, would result in a $7 month increase in the average residential customer's bill.

I&E's and OCA's arguments in opposition to PPL Electric's proposed 12 basis point addition to the rate of return for management effectiveness and their contentions are contrary to Section 523 of the Public Utility Code and largely ignore the extensive evidence of management effectiveness presented by PPL Electric in this proceeding. For these reasons, I&E's and OCA's arguments should be rejected and PPL Electric's proposed management effectiveness adder should be approved.

g. Summary of PPL Electric's Cost of Equity Presentation

PPL Electric witness Moul has demonstrated that the cost of equity for the Electric Delivery Group is between 10.37% and 11.78%. The average of the results of his models is 11.13%, to which he added 0.12% to reflect the management performance of PPL Electric to arrive at a cost rate of 11.25%.

2. I&E's Return On Common Equity Recommendation Is Flawed And Should Be Rejected

I&E witness Sears uses a DCF model to derive her recommended cost of equity of 8.38%. I&E St. 1, pp. 24-31. Ms. Sears then employs a CAPM analysis, which yields results of

5.06% based upon an historic market premium and 12.31% based upon a forecasted market premium. I&E St. 1, pp. 36 and 37.

The fundamental flaw in Ms. Sears' cost of equity analysis is that she has performed a flawed DCF analysis. Ms. Sears then compounded this error by not performing any analysis that can be considered a reasonable check on the reliability of DFC results. In this regard, Ms. Sears states in her own direct testimony she has "not given [the CAPM] results a specific weight in determining my cost of common equity because of the flaws in the CAPM model ..." I&E St. 1, p. 36. Nor has Ms. Sears explained how a CAPM result of either 5.06% or 12.91% provides any support to her recommended DCF cost rate of 8.38%.

There are numerous flaws in Ms. Sears' calculation of the DCF cost rate. These flaws have been explained in detail in Mr. Moul's rebuttal testimony. PPL Electric St. 11-R, pp. 15-26. The principal errors are use of Ms. Sears' own calculation of log linear growth to determine the DCF growth rate and the failure of Ms. Sears to employ a leverage adjustment in the DCF analysis. *Id.*

As to the use of Ms. Sears' calculated log linear growth rates, Mr. Moul explained that no investor publication uses log linear analysis to estimate future growth rates, and Ms. Sears could not identify any such publication in cross-examination. PPL Electric St. 11-R, pp. 23-24; Tr. 350. Further, Mr. Moul demonstrated that the log linear process employed by Ms. Sears reduces analysts' projections of growth rates by 1.3038%. Analysts' projections of earnings growth are available to investors and influence prices paid for utility stocks and the dividend yield component of the DCF. In contrast, there is no basis to conclude that log linear growth rates of future earnings have any effect on the market price since they are not reported by any publication. PPL Electric St. 11-R, p. 23. Finally, Mr. Moul demonstrated that the log linear process employed by Ms. Sears develops regressions that explain only a small percentage of the change in earnings, and therefore are unreliable estimates of growth. PPL Electric St. 11-R, p. 26.

PPL Electric has previously addressed the reasons for use of the leverage adjustment in the DCF analysis, *supra*, pp. 105-109. Ms. Sears' failure to include the leverage adjustment is also a significant error in her DCF analysis.

An appropriate DCF analysis, using Ms. Sears' dividend yield, the analysts' projection of earnings reported in her testimony and an appropriate leverage adjustment, indicates a DCF cost rate of 10.38%. PPL Electric St. 11-R, p. 26.

However, it again must be emphasized that Ms. Sears' testimony contains no reliable check on the reasonableness of her DCF result. In addition, Ms. Sears recommends a lower ROE allowance than any other state regulatory commission has allowed since the beginning of 2009. PPL Electric St. 12-R, Sch. JMC-2. These two circumstances, as well as the evidence of the errors of Ms. Sears' DCF analysis, require rejection of her recommendation as to the cost of common equity.

3. OCA's Recommended Cost Of Equity Is Flawed And Should Be Rejected

OCA's witness, Mr. Hill, also relies primarily on a DCF analysis in arriving at his recommended cost of equity. OCA St. 3, p. 52. Mr. Hill arrives at a cost rate range of 8.75% to 9.5%, from which he selects a 9.0% cost rate for PPL Electric. OCA St. 2, p. 53.

The principal deficiencies of Mr. Hill's DCF analysis are that: (1) Mr. Hill understates the DCF growth rate; (2) Mr. Hill declines to include the leverage adjustment; and (3) Mr. Hill improperly selects a cost rate in the lower end of his range.

With regard to the growth rate, Mr. Hill has not given adequate weight to analysts' projections of earnings growth rates, relying instead on other measures of growth. As explained by Mr. Moul:

> Q. As to the DCF growth component, what financial variables should be given greatest weight when assessing investor expectations?
>
> A. The theory of the DCF holds that (1) the value of a firm's equity (i.e., share price) will grow at the same rate as earnings per share and (2) dividend growth will equal earnings growth with a constant payout ratio. Therefore, to properly reflect investor expectations within the limitations of the DCF model, earnings per share growth, which is the basis for the capital gains yield and the source of dividend payments, must be emphasized. The reason that earnings per share growth is the primary determinant of investor expectations rests with the fact that the capital gains yield (i.e., price appreciation) will track earnings growth with a constant price earnings multiple (another key assumption of the DCF model). It is also important to recognize that analysts' forecasts significantly influence investor growth expectations (see pages E-7 through E-12 of Appendix E that accompanies my direct testimony). Finally, it is instructive to note that Professor Myron Gordon, the foremost proponent of the DCF model in public utility rate cases, has established that the best measure of growth for use in the DCF model is forecasts of earnings per share growth.[25] For these reasons, earnings per share forecasts must be given primary weight.

PPL Electric St. 11-R, pp. 18-19

Mr. Moul also demonstrated that earnings projections are particularly important where dividend payout ratios are projected to decline in part, as a result of an enhanced investment cycle in the electric industry, and explained why use of projected earnings in the DCF analysis is appropriate under such circumstances:

> "Declining payout ratios mean that earnings per share will grow at a faster rate than dividends, contrary to one of the basic tenets of the DCF model. This suggests that the constant dividend payout assumption of the DCF is

[25] "Choice Among Methods of Estimating Share Yield," *The Journal of Portfolio Management*, Spring 1989 by Gordon, Gordon & Gould.

> particularly inappropriate. It is particularly important to give substantial weight to forecasted earnings growth rates under these circumstances."

PPL Electric St. 11-R, p. 20

The second error in Mr. Hill's DCF analysis is his failure to employ the leverage adjustment, which is required in this case for the reasons explained previously in this brief, *supra*, pp. 105-109.

Mr. Hill then compounds these errors by selecting an equity cost rate of 9.0% within his cost rate range of 8.75% to 9.5%. Mr. Hill argues that a lower end cost rate is justified because PPL Electric is a distribution company only and his group includes electric companies with generation. OCA St. 2, p. 22. Mr. Moul explained the error of selecting the lower end of the cost rate range as follows:

> "I do wish to emphasize however, that Mr. Hill has created a subset of his electric barometer group that he has identified as "wires companies." His group of "wires companies" consists of just two companies -- Consolidated Edison and PEPCO Holdings. I have never encountered a situation where a proxy group has consisted of just two companies. A very small two company group does not contain an adequate sample for statistical purposes. I am not aware of a situation where the Commission, or any other regulatory agency, has ever relied upon a two company sample for barometer group purposes. As such, Mr. Hill's "wires companies" subgroup should not be relied upon to set the Company's cost of equity in this case. Mr. Hill's reliance on his two wires company barometer group to recommend a cost of equity of 9.0% in the bottom one third of his 8.75% to 9.5 % range is therefore clearly unjustified."

PPL Electric St. 11-R, p. 5.

It is clear that Mr. Hill has favored the lower end of the range of his cost of equity range because Mr. Hill believes that the Commission should lower ROEs because of recent difficult economic times and the effects of those economic difficulties on customers. OCA St. 2, p. 6. Again, Mr. Hill looks backward to justify his recommendation instead of forward to reflect the expectational nature of the cost of capital.

Mr. Moul illustrated how these errors in Mr. Hill's analysis can be remedied on the basis of Mr. Hill's own data. Even accepting Mr. Hill's own DCF analysis based on his dividend yield and growth rates, simply adopting the top end of his range and adding the leverage adjustment of 0.7% indicates a cost rate for common equity of 10.2%. PPL Electric St. 11-R, p. 6.

The error of Mr. Hill's recommendation can also be illustrated through other statements and data provided in his testimony. In Mr. Hill's surrebuttal, he states that the expected return on book value is a measure of the cost of capital. OCA St. 2-SR, pp. 22-33. In that same testimony, he notes that his electric group has an average allowed return on equity of 10.4%. When asked on cross whether an investor could conclude that the cost of equity was 10.4% for his group, Mr. Hill replied that it cannot be cost rate because the companies in the group sell at market prices above book value. Tr. 328. It is clear that Mr. Hill, through his recommendation, thinks that the Commission should lower equity returns in order to reduce market prices of utilities to book value. The Commission has previously concluded that controlling market prices of utility stocks are not the province of the Commission. *Pa. P.U.C. v. Blue Mountain Consolidated Water Company*, Docket No. R-78100686, 55 Pa. PUC 502, 1982 Pa. PUC LEXIS 160 *2, *11, (Order entered January 14, 1982); *Pa. P.U.C. v. The York Water Co.*, Docket No. R-850268 *et al.*, 62 Pa. PUC 459 1986 Pa. PUC LEXIS 26, *103, n. 24, (Order entered November 25, 1986). Contrary to Mr. Hill's suggestion, the average allowed ROE for his barometer group of 10.4% is one valid indication of the cost of equity that should be granted in this proceeding.

Mr. Hill seeks to support his DCF with other cost rate models. Curiously, all of these models produce rates within or below his DCF cost rate range. OCA St. 2, p. 52. Nevertheless, Mr. Moul has explained deficiencies of Mr. Hill's CAPM analysis which produces a cost rate range of 7.66% to 8.14%. PPL Electric St. 11-R, pp. 36-50. As to Mr. Hill's Market to Book

Method ("MTB") method, Mr. Hill has simply reformulated his DCF analysis. Accordingly, this method cannot be considered an independent method. PPL Electric St. 11-R, p. 36. Mr. Hill's modified earnings price ratio method averages a cost rate based on earnings price ratios of 7.22% with projected earned returns on equity of 9.88%. OCA Ex. SGH-1, Sch. 9. The Commission has not used earning price ratios to determine the cost of equity since the change to original cost regulation. Mr. Hill contends that earnings price ratios understate the cost of equity and his ROE on book value overstates the cost of equity, when market prices exceed book value. By averaging these methods, Mr. Hill is again attempting to determine the ROE that will produce a market to book ratio of 1.0. PPL Electric St. 11-R, p. 11. As previously noted, the Commission does not accept Mr. Hill's contentions that the Commission should seek to reset utility stock prices to equal book value. Doing so would dramatically reduce stock prices and be highly detrimental to attempts to raise capital in a market that sells on average well above book value. PPL Electric St. 11-R, p. 35. Further, Mr. Hill did not identify any investor or investor publication that suggests that his method is used by investors to determine the cost of equity.

Mr. Hill's inadequate DCF analysis is not supported by his alternative methods, and should be rejected.

4. Return on Equity Conclusion

As explained in this brief, Pennsylvania utilities and the Commission are at a critical crossroad in terms of raising capital in public markets to finance replacement of aging infrastructure. The Commission can look backward and base the allowed return on equity on low interest rates fostered by FOMC action to stimulate the economy. If it does so and adopts the recommendations of either I&E or OCA, PPL Electric will face a significantly increased likelihood of further downgrade in its credit ratings, even if PPL Electric is actually able to earn the allowed return.

Alternatively, the Commission can look forward, with a keen eye to the requirements of capital markets as Pennsylvania utilities, and PPL Electric in particular, seek to set financial profiles that will allow them to raise increasing amounts of capital in public markets to fund infrastructure improvements. To be sure, the capital markets are watching carefully. While the amount of the rate increase is important to investors, and cash flows produced by increased rates produce are important to credit rating agencies, the allowed return on equity is a clear and important indicator to investors of the quality and consistency of Pennsylvania regulation. PPL Electric St. 12-R, pp. 3-4.

For these reasons, the ALJ should recommend, and the Commission should adopt, PPL Electric's proposed return on equity of 11.25%, recognizing, as part thereof, an increment for PPL Electric's management performance.

VII. TAXES

A. CONSOLIDATED FEDERAL INCOME TAX SAVINGS

PPL Electric is a wholly-owned subsidiary of PPL Corporation, and as such, it is part of the PPL Corporate System. PPL Corporation, each year, files for all members of the Corporate System a consolidated federal income tax return. Through the consolidated federal income tax return, the PPL Corporate System is permitted to offset net tax losses of certain affiliated companies against net taxable income, thereby reducing the federal income tax liability of the Corporate System in comparison to the total tax liability of all of the affiliates if they filed federal income tax returns on a stand alone basis. Under application of the "actual taxes paid" ratemaking doctrine, subject to certain limitations and exceptions, public utilities are required to flow through to ratepayers their actual savings from participating in a consolidated federal income tax return. *Barasch v. Pa. P.U.C.*, 507 Pa. 561, 493 A.2d 653 (1985).

In accordance with this precedent, PPL Electric performed a calculation of consolidated federal income tax savings. The savings calculation is set forth in PPL Electric St. Future 1-Revised, Sch. D-12, p. 4. PPL Electric's calculation was based on a three-year average of the consolidated tax savings generated by the PPL Corporate System. PPL Electric performed its calculation using data from the three most recent years for which actual data are available, 2009 – 2011. PPL Electric St. 8, p. 16. However, under the particular facts and circumstances of this proceeding, no consolidated tax savings adjustment is appropriate because PPL Electric, for 2012, the future test year in this proceeding, will not be able to take advantage of any theoretical consolidated tax savings because it is incurring a net operating loss for federal income tax purposes. Similarly, it experienced a net operating loss for federal income tax purposes for the historic test year. PPL Electric St. 8, p. 14.

I&E proposes that a consolidated federal tax savings adjustment should be made for PPL Electric in this proceeding, despite the fact that PPL Electric is in a net operating loss position for federal income tax purposes for **both** the historic **and** future test years. In order to make the adjustment, I&E would calculate federal income taxes for the future test year as if rates set in this proceeding had become effective on January 1, 2012, instead of the date on which they will actually become effective, January 1, 2013. I&E St. 2, pp. 51-52.

I&E's proposed consolidated federal income tax savings adjustment should be rejected. Contrary to I&E's contentions, the Commission has established guidelines for the calculation of tax benefits derived from participation by a public utility in a consolidated federal income tax return.

> These guidelines permit a jurisdiction utility to: (1) determine a consolidated tax savings benefit based on the average of three most recently available filed consolidated tax-year returns; (2) adjust the taxable income of the utility and its affiliates to exclude all non-recurring items

> which contributed to their taxable income and tax losses in that three-year period; (3) apply on a pro forma basis any tax benefit determined based on the adjusted historic data to the utility's future test year results at present rates; and (4) set the adjustment rate to zero, if the utility's future test year tax position is negative.

PPL Electric St. 8-R, p. 35. As shown in Ex. Future 1, Sch. D-12, PPL Electric's pro forma results of operations at present rates as adjusted for ratemaking purposes for the future test year ending December 31, 2012 are negative for federal income tax purposes. In other words, PPL Electric is incurring a loss at present. The principal reason for the loss position is bonus depreciation and a resulting tax loss carry forward available to the Company. Bonus depreciation was established under the Small Business Jobs Act of 2010, which was signed into law on September 27, 2010 and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, which was signed into law on December 17, 2010. PPL Electric St. 8, p. 14.

Contrary to I&E's proposal, consolidated federal income tax savings are calculated at present rates only, before the determination of any rate increase for four principal reasons. First, the consolidated tax savings calculation is properly performed based on the actual federal income data for the utility based upon the parent's three most recent filed income tax returns. If any calculated consolidated income tax savings can be derived by the utility, such savings are applied to the utility's test year income tax liability, in this proceeding, 2012. Second, the consolidated tax savings benefit is not applied when the utility is in a tax loss position because the proposed rate increase cannot and will not increase PPL Electric's taxable income for the 2012 future test year. No consolidated tax savings can be derived by PPL Electric related to its proposed rate increase in this proceeding until the parent files a consolidated tax return for 2013, which will be filed in 2014. As such, I&E's proposed adjustment is an attempt to reach improperly beyond the end of the future test year in order to find taxable income to which a consolidated tax savings adjustment could be applied. PPL Electric St. 8-RJ (Part 1), pp. 6-7. Third, the calculation of consolidated tax savings must be performed at present rates because it is one of the steps performed in determining whether rate relief is needed. Fourth, as explained above, the consolidated tax savings calculation is an application of the "actual taxes paid" doctrine. *Barasch v. Pa. P.U.C.*, 507 Pa. 561, 493 A.2d 653 (1985). The Supreme Court explained the application of the doctrine as follows:

> Although the Commission is vested in broad discretion in determining what expenses incurred by a utility may be charged to the ratepayers, the Commission has no authority to permit, in the rate-making process, the inclusion of hypothetical expenses not actually incurred. When it does so, as it did in this case, it is an error of law subject to reversal.

Id., 507 Pa. at 655, 493 A.2d at 566. I&E's attempt to calculate consolidated tax savings based on a hypothetical level of taxable income that PPL Electric will not experience during the future test year should be rejected as contrary to law.

I&E's attempt to impute consolidated tax savings to PPL Electric in this proceeding is improper and should be rejected.

B. GROSS RECEIPTS TAX

PPL Electric's total future test year gross receipts tax expense is $50,102,000, which is comprised of two components. The first component is a pro forma calculation of gross receipts tax for the future test year at present rates of $43,930,000 (PPL Electric Ex. Future 1, Sch. D-11, p. 3) and the second component is $6,172,000 resulting from the proposed increase in rates. PPL Electric Ex. Future 1-Sch. D-12, p. 6.

I&E proposes to adjust PPL Electric's gross receipt tax. I&E's argues that PPL Electric owes gross receipts tax only on revenues it actually receives, *i.e.,* total billed revenues less uncollectible accounts. I&E St. 2, p. 47. I&E's proposed adjustment should be rejected because it disregards changes to the calculation of gross receipts tax imposed by the Pennsylvania Department of Revenue in Corporate Tax Bulletin 211-02, which was issued on July 20, 2011.

Under the recent Department of Revenue Corporate Tax Bulletin on gross receipt tax, PPL Electric's liability for gross receipts tax is **not** limited to actual revenues received. Instead, PPL Electric is required to file its gross receipts tax utilizing the accrual method of accounting. Further, the Corporate Tax Bulletin establishes a reduction against taxable gross income in the tax year when specific customer accounts actually are written off. This reduction, however, is subject to onerous documentation requirements including matching of each write-off amount by customer to the tax period during which the receipts were reported as taxable to Pennsylvania. Another difficulty, that PPL Electric presently does not have the capability of resolving, is that PPL Electric's current system for applying customer payments does not separate payments from customers between PPL Electric revenue and revenue that it bills for EGSs (who are required to remit their own gross receipts tax payments) and purchased accounts receivable. PPL Electric St. 8-RJ (Part 1), pp. 36-37.

In order to obtain the necessary detail at the individual account level, as required by the Department of Revenue, PPL Electric would have to implement significant and costly system changes that would require ongoing IT support and business resources. Due to the complexities of PPL Electric's billing and payment system, significant testing and corrective actions would be needed to address and resolve the various potential "glitches" identified during the implementation process. Based on the volume of customer accounts written off by PPL Electric each year, the resources that would be required to perform the matching of write-offs to tax periods would not be cost effective. PPL Electric St. 8-R, pp. 36-37.

PPL Electric's calculation of gross receipts tax should be approved because utilizing the deduction for uncollectible accounts, as recommended by I&E, is not practical at this time for PPL Electric now and for the foreseeable future.

C. CAPITAL STOCK TAX

PPL Electric's pro forma future test year capital stock tax liability is $2,098,000. PPL Electric Ex. Future 1, Sch. D-12, p. 7. This tax was calculated by applying the currently effective tax rate of 1.89 mils, or 0.189 percent, to the corporation's net worth, as determined under the applicable capital stock tax rules. I&E St. 2, p. 49. I&E proposes to adjust PPL Electric's capital stock tax. It recommends that the capital stock tax be calculated based upon the capital stock tax rate of 0.89 mils, or 0.089 percent, that will become effective on January 1, 2013. I&E St. 2, pp. 49-50.

The capital stock tax rate of 0.89 mils should not be used to calculate base rates in this proceeding. Instead, the change in tax rate that will become effective January 1, 2013 should be handled through the State Tax Adjustment Surcharge ("STAS") which is specifically designed to accommodate changes in four different state taxes, including the capital stock tax, public utility realty tax, corporate net income tax and gross receipts tax. 52 Pa. Code §§ 69.51, *etc.* Consequently, any change in the capital stock tax rate and any resulting change to PPL Electric's resulting tax liability should be handled through the STAS mechanism which is subject to annual reconciliation. 66 Pa.C.S. § 1307(e).

Because there is a currently effective mechanism for dealing with state tax rate changes, it is unnecessary to reach beyond the end of the future test year, as I&E proposes to do. Instead, PPL Electric's reconcilable STAS should be used as it has been designed by the Commission. PPL Electric St. 8-R, p. 38.

VIII. <u>RATE STRUCTURE</u>

A. COST OF SERVICE

1. Introduction

The fundamental purpose of a cost allocation study is to aid in revenue allocation and the design of rates by identifying all of the capital costs (plant and equipment) and operating costs (O&M expenses, depreciation, and taxes) incurred by a utility to provide service to its customers, and then assigning and/or allocating these costs to individual rate classes on the basis of how those rate classes cause these costs to be incurred. Fully allocated cost of service studies, such as those presented by PPL Electric in this proceeding, take the Company's total cost of service and allocate it to the various rate classes and then calculate the rate of return provided by that class. The studies then compare the rate of return provided by each rate class to the system average rate of return to determine if each rate class is paying above or below its allocated cost of service. That conclusion provides important guidance in base rate proceedings as to whether a rate class should receive a rate increase, and if so, the amount of the increase. PPL Electric St. 8-R., p. 6.

Although cost of service studies may appear to have great precision, the Commission has repeatedly recognized that the cost of service study is only a guide to designing rates and is only one factor, albeit an important one, to be considered in the rate setting process. *See, e.g., Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, R-00072711, 2008 Pa. PUC LEXIS 50 (July 31, 2008); *Pa. P.U.C. v. West Penn Power Co.*, Docket Nos. R-901609, *et al.*, 1990 Pa. PUC LEXIS 142, 73 Pa. PUC 454, 119 P.U.R.4th 110 (Dec. 13, 1990); *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th 185, 249 (1983). The Commission has concluded further that there is no one single absolutely correct method for preparing cost of service studies. PPL Electric St. 8-R, p. 3; OCA St. 3, p. 4. In fact, the Commission has referred to cost of service studies as more of an art form than science. *Application of Metropolitan Edison Co.*, R-00974008 (June 30, 1998); *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th 185 (1983).

Recently, the Commonwealth Court of Pennsylvania has concluded that cost is the "polestar" of utility ratemaking. *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010 (Pa. Cmwlth. 2006), *appeal denied*, 591 Pa. 676, 916 A.2d 1104 (2007) ("*Lloyd*"). As a result of the *Lloyd* decision, cost of service studies have assumed a greater degree of importance in utility ratemaking, but it still should be recognized that cost allocation is not an exact science, that there is no single "correct" cost allocation methodology, and that the Court did not hold that all other considerations are to be disregarded.

2. PPL Electric's Cost of Service Study

Pursuant to the Commission's regulations at 52 Pa. Code §§ 53.53, *et seq.*, PPL Electric presented fully-allocated cost of service studies showing the allocation of its distribution costs among the various rate classes at both present and proposed rates for the historic (PPL Electric Ex. JMK-1) and future (PPL Electric Ex. JMK12) test years. PPL Electric's witness, Mr. Joseph M. Kleha, who has over 30 years experience in preparing cost allocation studies, applied well-established and appropriate cost allocation principles in preparing these studies. The Company's cost of service studies are supported by the testimony of Mr. Kleha, PPL Electric St. 8 and 8-R, and PPL Electric Ex. JMK-3.

Prior to PPL Electric's last base rate proceeding, Docket No. R-2010-2161694, the Company's cost allocation studies were criticized because not all of the primary voltage level distribution facilities used in its minimum size system studies had been classified into their applicable customer-related and demand related components. In response to those criticisms, in its 2010 base rate proceeding, PPL Electric classified its primary voltage level distribution facilities into their applicable demand-related and "minimum no load" customer-related cost components consistent with the National Association of Regulatory Utility Commissioners' ("NARUC") Electric Utility Cost Allocation Manual ("Manual"). This approach was opposed by the OCA and fully litigated in the 2010 base rate proceeding. The ALJ and the Commission rejected OCA's proposed cost of service study and adopted PPL Electric's cost of service study. PPL Electric St. 8-R, p. 9; OSBA St. 1, p. 5; *see also Pa. PUC v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (December 21, 2010).

The cost of service study methodology proposed by PPL Electric in this proceeding is virtually identical to the methodology adopted by the Commission in the 2010 base rate proceeding. PPL Electric's proposed cost of service study continues the complete classification of its distribution facilities into their applicable demand-related and customer components. PPL Electric St. 8-R, p. 9. As noted by the OSBA, there have not been any significant changes since the Commission adopted PPL Electric's cost of service study in the 2010 base rate proceeding and, therefore, there is no reasonable basis, in the Company's or OSBA's view, to re-litigate the cost of service study in this proceeding. OSBA St. 1, p. 5.

PPL Electric adheres to and follows the NARUC Manual, and the cost allocation principles set forth therein, to classify its distribution capital and operating costs. Cost of service studies generally include three fundamental steps. First, costs are functionalized into their appropriate function: generation, transmission, or distribution. Second, costs are classified as demand, customer, or energy related. Third, costs are allocated among the rate classes. PPL Electric St. 8, p. 23.

Consistent therewith, PPL Electric first separated its costs into transmission and distribution segments.[26] PPL Electric St. 8, p. 23. PPL Electric next sub-functionalized distribution costs between the primary and secondary distribution systems. These primary and

[26] PPL Electric no longer owns any generation facilities.

secondary voltage level capital and operating costs are then classified as customer, demand, or energy related based on a "minimum size system" study.[27] A minimum system study seeks to identify and quantify the costs that would be incurred to serve a customer with minimal or no load. The cost of serving a customer with minimal or no load is based on the smallest size equipment currently being installed on the system. This portion of the distribution system is classified as customer related. The remaining portion of the costs is allocated on a demand basis. PPL Electric St. 8, pp. 23-24; PPL Electric Ex. JMK-3.

The next step in preparation of the cost of service study was to allocate the cost of service among the rate classes. In this step, the costs associated with components of the distribution system are assigned to the specific rate classes as either demand-related, customer-related, or a combination of both. Demand-related costs are allocated to each customer rate class based on that class' maximum non-coincident peak ("NCP") demand.[28] Customer-related costs are allocated based on the number of customers in the customer rate class. PPL Electric St. 8-R, pp. 7-8.

The only party to oppose PPL Electric's cost of service study was the OCA. Predictably, most of the revisions proposed by the OCA would, if adopted, place the residential rate classes in a more advantageous position. PPL Electric St. 8-R, p. 4. PPL Electric, as a party without incentives to favor one rate class or another, has taken a reasonable, moderate, middle-of-the-road position in allocating costs to various customer classes. It also should be noted that I&E,

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[27] Customer-related costs are those that relate to the number of customers served by the Company, *e.g.*, meters. Demand-related costs are those that relate to the peak load/demand imposed on the Company's facilities, *e.g.*, primary and secondary substation. Energy costs are those costs that related to the total amount of electricity consumed during a given period of time, *e.g.*, purchased generation supply. In general, however, no electric distribution costs are caused by average or annual amounts of energy delivered by PPL Electric. PPL Electric's approach of not classifying any electric distribution costs as energy related is consistent with the NARUC Manual. PPL Electric St. 8, pp. 23-24; PPL Electric Ex. JMK-3.

[28] The NCP demand is based on the highest demand imposed by each rate class on the distribution system at any time during the test year, regardless of the demand placed on the system by other classes at that time. PPL Electric St. 8, p. 19.

which represents the public interest in general and not any particular rate class, has not opposed or criticized the Company's cost of service study.

3. OCA's Criticism Of PPL Electric's Cost Of Service Study Should Be Rejected

The only party to this proceeding who offered any substantial criticism of PPL Electric's cost of service studies was OCA. Specifically, the OCA contended that 100% of PPL Electric's primary voltage level facilities are demand related, criticized the use of the minimum system methodology to determine any customer component of the distribution system, and criticized the data used by PPL Electric in its minimum system study. For the reasons explained below, OCA's criticisms of PPL Electric's cost of service study are without merit and should be rejected.

a. The OCA's Argument That PPL Electric's Primary Voltage Level Distribution Facilities Are 100% Demand Related And Have No Customer Component Should Be Rejected

The central contention presented by OCA is the conclusion that all of PPL Electric's primary voltage level distribution system should be classified as demand related, and none of it should be classified as customer related. OCA St. 3, pp. 17-18. In support of its contention, OCA argues that there is no distinct difference in the mix of customer classes across the rural and urban portions of PPL Electric's service territory and, as such, the Company's distribution plant and expenses should be assigned to classes only on utilization and not based on number of customers. OCA St. 3, p. 18. OCA also argues that the NARUC Manual does not mandate that all distribution plant be classified as both customer-related and demand-related. OCA St. 3, p. 21. OCA's arguments are without merit and should be rejected.

Contrary to OCA's assertions, it is clear that two factors cause electric distribution companies to invest in plant: (1) the need to meet the peak demands of individual customers and

(2) the need to interconnect all customers on the distribution system with the transmission system. A customer who is receiving distribution service must be connected to the primary voltage level facilities of PPL Electric's distribution system in order to be actually provided with electric service, regardless of the amount of demand/load imposed on the system by the customer. PPL Electric St. 8-R, pp. 12-13.

Under the OCA's view of the world, the number of customers would be irrelevant to the design and structure of a primary voltage level distribution system, as primary voltage level distribution system costs are only incurred to meet peak demand. Under this view, two utilities with identical peak demands would have the same primary voltage level distribution system, both as to design and cost, even if one utility had one customer and the other had a million customers. Such a conclusion makes no sense and demonstrates the lack of merit in the OCA's position.

It is PPL Electric's position, based on long-standing practice and precedent, that the distribution system, both primary and secondary, should be classified as part customer related *and* part demand related. The purpose of the minimum size system methodology is to identify the customer component by determining what portion of the distribution system is required to simply connect the customer to the system. Obviously, the minimum size system allocation methodology makes no attempt to address the sizing of those portions of the system needed to meet peak load requirements or the possible over-sizing of portions of the system. Those portions of the system should be and are classified as demand related.

In support of its contention that there is no customer component of the distribution system, OCA relies on a study it conducted of the distribution of customers, by rate class, throughout PPL Electric's service territory, as determined by zip codes. OCA explains its zip code analysis as follows:

> PPL has made an *a priori* assumption that it is appropriate to allocate a portion of its distribution plant based on customer counts and a portion based on demand levels. As indicated earlier, the only reason why it may be appropriate to allocate a portion of distribution plant expenses based on number of customers, rather than utilization, is due to the possibility that the mix of customer classes varies significantly across the urban and rural portions of a service territory. In this regard, I conducted an analysis of the distribution, or mix, of PPL's customer classes across its service area.
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> . . . .
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> PPL's customers are dispersed in a reasonably proportional manner throughout its service area. In other words, there is no distinct difference in the mix of customers (by class) across the rural and urban portions of PPL's service area. The relationship of Residential customers relative to non-Residential customers is relatively constant throughout PPL's service area.
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> . . . .
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> As such, PPL's distribution plant and expenses are properly assigned to classes based only on utilization and any consideration of customer counts is improper for the allocation of distribution plant, as such, these PPL distribution plant should be classified as 100% demand-related.

OCA St. 3, pp. 17-18. OCA's approach is erroneous for numerous reasons.

First, OCA's proposal to classify PPL Electric's primary voltage level facilities as 100% demand-related previously was not accepted by the Commission. In PPL Electric's most recent base rate proceeding at Docket No. R-2010-2161694, the OCA presented this same proposal using the same zip code analysis. The Commission did not accept OCA's proposal, stating that "We have reviewed the OCA's position and Exceptions on this issue and find them to be contrary to prior Commission action in PPL's 2004 and 2007 base rate proceedings and inconsistent with recommended COSS principles as outlined in the NARUC Manual." *Pa.*

P.U.C. v. PPL Electric Utilities Corp., Docket No. R-20120-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *57-58 (Dec. 21, 2010). Rather, the Commission adopted PPL Electric's allocation methodology that classifies both its primary and secondary voltage level distribution facilities based on their applicable demand-related and customer-related components.

Second, OCA begins with an incorrect assumption. OCA opens its discussion of this issue with the following statement: "PPL has made an *a priori* assumption that it is appropriate to allocate a portion of its distribution plant based on customer counts and a portion based on demand levels." This statement is simply not true. PPL Electric has at least for the last 30 years classified a portion of its distribution system as demand related and a portion as customer related and has at least for the last 30 years used a minimum system study to determine these two components. PPL Electric St. 8, p. 19. Indeed, in PPL Electric's 2004 base rate case, ALJ Turner, in her Recommended Decision specifically noted that PPL Electric's cost of service studies both were performed using the "minimum size" method and recommended that the Commission rely primarily on PPL Electric's cost of service studies for guidance in allocation of revenue requirement. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, p. 142, 2004 Pa. PUC LEXIS 41 (Oct. 21, 2004).[29] Moreover, as explained above, the cost of service study proposed by PPL Electric in this proceeding is substantially similar to the methodology adopted by the Commission in the 2010 base rate proceeding. PPL Electric St. 8-R, p. 9.

Third, OCA further states that the only reason to have customer component for the distribution system is if the mix of customer classes (residential vs. business) is significantly different across the rural and urban parts of a utility's service territory. OCA St. 3, p. 18. This

[29] In its Order, the Commission did not address issues related to the cost of service studies.

statement also is incorrect and simply ignores the explanations provided by PPL Electric. Specifically, it is appropriate to have a customer component of distribution plant because the number of customers affects distribution system investment. PPL Electric St. 8-R, p. 13. Costs should be allocated based on the factors that cause a cost to be incurred or cause a cost to vary. PPL Electric's distribution costs are incurred and vary based on the number of customers connected to the system and the demand imposed by those customers on the system. A utility distribution system with one customer will look quite different from one with one million customers. The number of customers is clearly a relevant factor in classifying and allocating distribution system costs.

Fourth, OCA's study is flawed because it focuses only on the relative proportion of residential vs. business customers in rural and urban areas and ignores the obvious and indisputable fact that, on an absolute basis, there are many more residential customers than business customers connected to PPL Electric's distribution system. Even if the cost of connecting business customers to the system were the same as the cost of connecting residential customers, a greater proportion of distribution system plant cost should be allocated to residential customers because there are so many more residential customers, and therefore a much greater amount of plant investment is needed to connect residential customers to the system. Although the relative percentage of residential and business customers may be the same throughout PPL Electric's system in both urban and rural areas, the fact remains that there are many more residential customers than business customers.

Finally, OCA's geographic customer mix by rate class analysis does not address the issue of whether a customer component is appropriate. Rather, OCA's analysis addresses the issue of whether primary voltage level facilities should be classified by separate, regional analyses rather than on a statewide basis. This issue is irrelevant because, as confirmed by OCA's own study, there are no distinct differences in the mix of customers across the rural and urban portions of PPL Electric's service territory. OCA St. 3, p. 18. Further, OCA has not proposed and PPL Electric does not support a regional approach to classification. Such a regional approach would result in different rates for different customers in the same customer rate class based upon their geographic location. PPL Electric St. 8-R, p. 14.

In further support of its proposal that PPL Electric's primary voltage level facilities be classified as 100% demand-related, OCA contends that there is nothing in the NARUC Manual that mandates that all distribution plant and expenses must be classified as both customer-related and demand-related. OCA St. 3, p. 21. OCA proposes to use a "NARUC report," which has been available since December 2000, and Mr. Watkins' opinion of the guidance the report provides as the basis for classifying distribution facilities, rather than the actual guidance provided in the NARUC Manual. However, there is significant uncertainty as to the import of the "NARUC report" and whether it is intended to be a statement of NARUC policy. Tr. 515-19, 522-23. Indeed, the "NARUC report" explicitly states that "[the views and opinions expressed herein are strictly those of the authors and may not necessarily agree with, state or reflect the positions of NARUC, the Energy Foundation or those who commented on the paper during its drafting." Tr. 518. Further, the "NARUC report" does not even support OCA's recommendation. Instead, it supports rate designs based on marginal pricing principles that are not used in Pennsylvania. Tr. 520-21.

PPL Electric and other electric utilities have followed the actual guidance provided in the NARUC Manual since 1973. The NARUC Manual clearly states that distribution plant and expenses have both a demand-related component and a customer-related component. PPL

Electric St. 8-R, p. 12; PPL Electric St. 8-RJ, pp. 6-7. Further, OCA ignores that, in PPL Electric's 2010 base rate proceeding, the Commission specifically found that PPL Electric's cost allocation study, and the results of its related minimum size system study, were consistent with the published NARUC Manual.

b. The OCA's Criticisms Of PPL Electric's Minimum Size System Study Should Be Rejected

In this proceeding, PPL Electric employed a minimum size system study to allocate distribution plant and expenses as customer-related and demand-related. A minimum size system study seeks to identify and quantify the costs that would be incurred to serve a customer with minimal or no load. The cost of serving a customer with minimal or no load is based on the smallest size equipment currently being installed on the system. This portion of the distribution system is classified as customer related. The remainder of the system is classified as demand related. The minimum size system study used in this proceeding is the same methodology approved by the Commission in PPL Electric's 2010 base rate proceeding at Docket No. R-2010-2161694. PPL Electric St. 8, pp. 20-22; PPL Electric Ex. JMK-3.

Although the OCA prefers the zero-intercept method to allocate distribution plant,[30] OCA concedes that the minimum size system method is a generally accepted methodology for allocating distribution plant. OCA St. 3, pp. 23-25. The OCA also concedes that the minimum size system study used by PPL Electric in this proceeding is consistent with the methodology approved by the Commission in the Company's 2010 base rate proceeding. OCA St. 3, p. 25. Notwithstanding, the OCA criticizes PPL Electric because its minimum size system study is based on the smallest size distribution equipment currently being installed on its system; because certain individual components of that equipment may be sized not just for peak loads, but also

[30] Although the OCA raised the "zero intercept" method as an alternative method for classifying costs as customer-related, it did not offer the results of using that method. OCA St. 3, p. 27.

for safety, reliability and a level of growth in load; because of the classification of primary voltage level overhead and underground conductors and devices and associated poles, towers, fixtures, conduits, and facilities as customer-related and demand-related components; and, because, in the OCA's opinion, PPL Electric purchases some materials that are smaller than the minimum size used in its study. OCA St. 3, pp. 28-35. For the reasons that follow, the OCA's criticisms of PPL Electric's minimum size system study should be rejected.

Preliminarily, PPL Electric notes that it has followed the minimum size system guidelines set forth in the NARUC Manual (pp. 90-91), which defines a minimum size distribution system as that based on the smallest size equipment currently being installed by the utility. As such, it clearly is recognized that the size of individual components of the minimum size system can change over time as the load imposed by customers and/or the number of customers on an electric utility's distribution-related facilities changes. Moreover, the NARUC Manual (p. 97) clearly states that customer-class NCP demands are the load characteristics that normally are used to allocate the demand-related component of distribution-related facilities. Therefore, the OCA's criticisms of PPL Electric's use of a minimum size system study are unsupported and clearly inconsistent with the NARUC Manual. PPL St. 8-R, p. 15.

The OCA also criticizes the Company's minimum size system study because its minimum equipment has some capability to carry load in case of emergencies and interruptions on other equipment. OCA St. 3, pp. 26-27. However, a minimum size distribution system, by definition, must have some capability to carry load. The fact that some equipment in the Company's minimum size system has some nominal capability to carry load provides no basis for rejecting it.

PPL Electric explained that in response to the criticism received from several parties in the Company's prior base rate proceedings regarding the capability to carry load of some equipment used in its minimum size system study, PPL Electric undertakes a yearly analysis to identify the customer-related "minimum or no load" portion of that equipment. The results of this analysis were applied to primary and secondary voltage level overhead and underground transformers. Accordingly, only the "minimum or no load" portion of these facilities has been classified as customer-related; the remaining portion of these facilities has been classified as demand-related. All other distribution facilities are considered to be in a "no load" condition until such time as a customer imposes some level of load (demand) on those facilities. PPL Electric St. 8-R, pp. 16-17. As such, PPL Electric's minimum size distribution equipment reflects the appropriate level of capability to carry load that meets the requirements of its minimum size distribution system. PPL Electric St. 8-R, pp. 18-19.

The OCA also contends that PPL Electric's study is unreasonable because it allocates of 57% of the cost of primary voltage level overhead conductors and 82% of the cost of primary voltage level underground conductors as customer-related because they are required to connect customers, while 64% of the cost of secondary voltage level overhead conductors and 55% of the cost of secondary voltage underground conductors are required to connect customers. OCA St. 3, pp. 31-32. In rebuttal, PPL Electric explained that customers located in rural and suburban areas primarily are served by primary voltage level overhead and underground facilities, while customers located in urban areas are served by both primary and secondary level overhead and underground facilities. Because PPL Electric's service territory is mostly rural and suburban in nature, the design and operation of PPL Electric's distribution system results in the utilization of a much lower quantity of secondary voltage level conductors than mostly urban electric utilities.

PPL Electric St. 8-R, pp. 22-23. Therefore, it is not surprising that PPL Electric's minimum size system study reflects a higher customer-related component for the primary voltage system.

The OCA also criticizes PPL Electric's minimum size system study because the Company's record keeping practices are insufficient to determine the cost per foot of wires sizes smaller than 1/0. OCA St. 3, pp. 29-30. In rebuttal, PPL Electric explained that PPL Electric's continuing property records are kept in full compliance with the FERC's Uniform System of Accounts ("USOA"), 18 C.F.R., Part 101, which has been adopted by this Commission. Further, the Company's books and records are subject to audit by both the FERC and this Commission. PPL Electric St. 8-R, p. 23.

The OCA further criticizes PPL Electric's minimum size system study because PPL Electric's conductors are recorded on a linear foot basis, not a circuit foot basis. OCA St. 3, p. 30. However, there is nothing in the USOA instructions for Accounts 365 - Overhead Conductors and Devices and 367 - Underground Conductors and Devices that requires that these conductors must be accounted for on a circuit foot basis. PPL Electric has been accounting for its conductors on a linear foot basis for at least 50 years. PPL Electric St. 8-R, p. 23.

Finally, the OCA criticizes PPL Electric's minimum size system study because, in OCA's opinion, PPL Electric's cost allocation methodology is biased against the residential customer class. OCA St. 3-SR, p. 2. However, as explained in the direct, rebuttal, and rejoinder testimony of Joseph M. Kleha, the Company's cost allocation methodology follows the guidance set forth in the published NARUC Manual to determine the overall and rate class results of the cost allocation studies. PPL Electric does not skew or manipulate its minimum size system study to obtain specific results. Further, the residential class is the largest customer class and, therefore, utilizes the largest proportion of PPL Electric's primary voltage level and secondary voltage level distribution facilities. PPL Electric St. 8-RJ, p. 7. Clearly, this supports the allocation of the majority of the costs associated with these facilities to the residential class. There simply is nothing of record to suggest that PPL Electric's minimum size system study is biased against the residential class.

c. The OCA's Recommended Adjustments To PPL Electric's Minimum Size System Study Should Be Rejected

The OCA proposes several adjustments to PPL Electric's minimum size system study. The OCA recommends that PPL Electric's minimum size study exclude fiber optic communication cables. In support, the OCA contends that fiber optic cables should not be included with primary voltage level overhead conductors because they are not being used to conduct electricity. OCA St. 3, p. 31. However, the OCA overlooks the fact that these fiber optic cables are necessary for the proper, safe, and reliable operation of PPL Electric's primary voltage level distribution facilities. PPL Electric explained that the fiber optic cable is required to communicate with the Company's System Control and Data Acquisition ("SCADA") devices, circuit breakers, and sectionalizing devices. These facilities are attached to PPL Electric's primary voltage level distribution facilities and are required for the system to operate in a reliable and safe manner. PPL Electric St. 8-R, pp. 23-24. Therefore, it is entirely appropriate for PPL Electric's minimum size system study to include fiber optic communication cables with its primary voltage level overhead conductors.

The OCA further criticizes the use of multiplex secondary voltage level overhead conductors in PPL Electric's minimum size system. The OCA recommends that the minimum size system study include two-wire size overhead conductor at the secondary voltage level. OCA St. 3, pp. 30-31. The two-wire minimum recommended by the OCA is a hypothetical system that does not reflect PPL Electric's actual system. PPL Electric does not currently have a two-wire size conductor distribution system and has not had such a system since the 1960s. PPL St. 8-R, p. 24, 27-29. The OCA's proposal to use hypothetical two-wire conductors is inappropriate and should be rejected.

The OCA also rejects PPL Electric's use of a 40-foot wood pole as the minimum size pole for purposes of its minimum size system study and, instead, recommends that PPL Electric use the average cost of a 35-foot pool. In support, the OCA interprets a discovery response provided by PPL Electric to conclude that the Company "currently purchases a significant number of poles under 40-feet in length." OCA St. 3, p. 28. Although PPL Electric does purchase 25, 30 and 35-foot poles, PPL Electric clearly explained that these pole sizes are considered to be specialty items because their limited and specialized use on PPL Electric's distribution system. These smaller pole sizes are used to serve street lighting appliances and for service drops and guying applications, rather than to carry overhead primary and secondary conductors and devices that directly serve customers. The minimum size pole that is actually used on PPL Electric's distribution system to carry overhead primary and secondary conductors and devices is a 40-foot pole. PPL Electric St. 8-R, p. 25. Using 40-foot poles instead of smaller poles allows for longer spans of conductors and decreases the number of poles required. Tr. 526-27. Accordingly, the OCA's proposal to price a 40-foot pole at the cost of a 35-foot pole is inappropriate and should be rejected.

The OCA also rejects PPL Electric's use of 1/0 aluminum conductor steel-reinforced ("ACSR") conductor as the minimum size conductor for purposes of its minimum size system study and, instead, recommends that PPL Electric use the cost of a smaller 2/0 ACSR bare conductor. In support, the OCA interprets a discovery response provided by PPL Electric to conclude that the Company currently purchases a "significant amount" of smaller ACSR bare aluminum cable at a lower per unit cost. OCA St. 3, p. 29. Although PPL Electric does purchase 2/0 ACSR conductor, PPL Electric clearly explained that this smaller conductor has a limited use on the Company's distribution system, generally for temporary repairs during emergencies. PPL Electric St. 8-R, p. 26. Accordingly, the OCA's suggestion that 1/0 ACSR conductor should be priced at the cost of 2/0 ACSR conductor is inappropriate and should be rejected.

B. REVENUE ALLOCATION

1. Introduction

PPL Electric's proposed allocation of revenue requirement among the rate classes in this proceeding is driven largely by the Commonwealth Court's decision in *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010 (Pa. Cmwlth. 2006), which involved, *inter alia*, an appeal of the revenue allocation in PPL Electric's 2004 base rate proceeding. In that case, the Court concluded that, although other factors can be given some consideration, cost of service is the "polestar" of utility rates. The Court concluded further that other considerations, such as gradualism, should not be permitted to "trump" cost of service as the primary basis for allocating the revenue increase. The Court remanded the proceeding to the Commission for further consideration of the revenue allocation in light of the principles set forth in the Court's decision. PPL Electric St. 5, p. 7.

In the remand proceeding before the Commission, PPL Electric and the other parties entered into a settlement, which was approved by the Commission in an Order entered on July 25, 2007. As part of the settlement, PPL Electric agreed to move distribution rates to "at or near" the full cost of providing service over a series of future distribution rate cases. PPL Electric St. 5, pp. 7-8.

In this proceeding, PPL Electric has sought to allocate the proposed distribution rate increase in a way that is consistent with regulatory practice and precedent, including the *Lloyd* decision and the Commission's order approving the remand settlement, and which reasonably balances the interests of customers in the various rate classes and does not result in undue rate discrimination. PPL Electric St. 5, pp. 8-9.

2. PPL Electric's Revenue Allocation

As an initial step in allocating the proposed distribution rate increase, PPL Electric first developed a revenue allocation that strictly followed cost of service and moved all rate classes to the proposed system average rate of return. Upon review, however, PPL Electric determined that this approach did not produce a just and reasonable result. Specifically, the increase to the residential rate classes would have been far in excess of the total increase requested in this case. Further, this initial cost-based allocation produced a distribution rate increase to customers served under Rate Schedule RTS of about 165 percent. PPL Electric St. 5, p. 9. Such increases for an entire rate class are to be mitigated where it is practical to do so and where mitigation can be accomplished without unfair effects on other customers.

In order to avoid these unreasonable results, PPL Electric developed an alternative allocation. Specifically, PPL Electric limited the increase to Rate Schedule RTS to approximately one-half the amount that would have been required to move the class to the system average rate of return. This reduced the increase to Rate RTS from about 165 percent to about 78 percent. Although virtually all of the proposed revenue increase was applied to the residential class, PPL Electric also is proposing increases to some non-residential rate schedules that are offset by decreases in other rate schedules to bring all rate classes closer to the system average rate of return, while still considering the principle of gradualism. PPL Electric St. 5, pp. 10.

In this context, it should be noted that, unlike most other parties to this proceeding, PPL Electric has no "ax to grind" regarding the allocation of revenue to any particular rate classes. Instead, PPL Electric again in this proceeding has proposed allocations that are fair, reasonable, even-handed and consistent with sound rate-making principles. It must be noted also that I&E, the other party with no "ax to grind" on revenue allocation issues, has voiced no objection or opposition to PPL Electric's proposals.

PPL Electric's proposed allocation follows the results of PPL Electric's cost of service study, PPL Electric Ex. JMK-2. Although this allocation does not perfectly match the results that would be achieved by strict adherence to the cost-of-service study, it does result in substantial movement of all rate classes toward the system average rate of return, as shown by the chart below, which is taken from PPL Electric Ex. JMK-2, pp. 8-11:

	Relative Rate of Return	
Rate Classes	**Present Rates**	**Proposed Rates**
RS	63.03%	83.81%
RTS	-65.31%	23.05%
GS-1	133.55%	99.05%
GS-3	285.18%	196.34%
LP-4	163.36%	118.44%
LP-5	-90.72%	98.94%
LPEP	353.09%	256.26%
GH-2	86.64%	103.55%
SL/AL	100.49%	99.65%
Total PA Jurisdictional	100%	100%

Clearly, PPL Electric's proposed allocation of revenue requirement among the rate classes is reasonable and achieves substantial progress in moving rate classes toward the system average rate of return. This result is consistent with the *Lloyd* decision and the Commission's order approving the remand settlement. PPL Electric's proposed allocation should be adopted.

3. OCA's Proposed Allocation Should Be Rejected

OCA proposed an alternate cost of service study that results in a substantially different revenue allocation than that proposed by the Company. Based thereon, the OCA also proposed a different allocation of revenue requirement, as shown by the chart below, which is taken from OCA St. 3, pp. 37, 41:

	Relative Rate of Return	
Rate Classes	**Present Rates**	**Proposed Rates**
RS	112%	111%
RTS	-93%	-53%
GS-1	180%	131%
GS-3	104%	109%
LP-4	-13%	11%
LP-5	-88%	-4%
LPEP	399%	289%
GH-2	30%	50%
SL/AL	91%	111%
Total PA Jurisdictional	100%	100%

The OCA's proposed allocation of PPL Electric's distribution revenue requirement is clearly strongly influenced by its own cost of service study, which should be disregarded for the reasons explained more fully above.[31] In summary, OCA's cost of service study, under which all primary voltage level distribution plant is classified as demand-related, should be rejected because it is based on the assumption that there is no customer component of distribution plant and is contrary to the NARUC Manual, general industry practices, and decisions of this Commission in prior PPL Electric rate proceedings. Similarly, OCA's criticisms of PPL Electric's minimum size system study should be rejected because they are unsupported by the

[31] *See* Section VIII.A.3, *supra*.

record and clearly inconsistent with the NARUC Manual. Finally, OCA's revenue allocation should be rejected because it clearly favors the residential class over other rate classes by failing to properly allocate to the residential class all costs incurred to serve it.[32]

4. Scale Back

I&E and OSBA each offer a scale back proposal in the event that the revenue increase granted PPL Electric in this proceeding is less than that which the Company has proposed. I&E recommends that the first $1,784,000 of any scale back be used to reduce the allocation to Rate Schedule RTS and then additional reductions be applied to Rate Schedules RS, GH-2, SL/AL, and, contingent on other factors, LP-5. I&E St. 3, pp. 15-20. OSBA proposes that any reduction in the overall rate increase be shared among the rate classes in proportion to the Company's proposed total revenues in this proceeding. OSBA St. 1, pp. 12-13.

The Company believes that OSBA's proposed scale back, while not achieving system average returns in all rate schedules, does continue to move rate classes towards the system average return. The Company acknowledges that movement toward the system average return is an important objective and has made certain proposals in its direct case in this proceeding toward that end. However, the Company also believes it is important to consider the expectations of customers who may not be experts in revenue allocation and rate design principles. The Company believes it will be difficult for customers, especially residential customers, to accept a scale back that gives reductions to customers who were not, in the first instance, expecting an increase or, in the extreme, gives greater reductions to certain customers than were originally proposed. Accordingly, the Company recommends that any scale back of revenues be applied on

[32] *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (December 21, 2010) (rejecting OCA's revenue allocation in PPL Electric's 2010 base rate proceeding, holding that it did not represent an accurate allocation methodology because it did not properly allocate to the residential class all costs incurred to serve it).

a proportional basis to only those rate schedules which, under the Company's original proposal, would be receiving increases. PPL Electric St. 5-R, p. 4.

C. TARIFF STRUCTURE

1. Rate Design

a. Summary of Proposed Rate Design

PPL Electric explained that there are only two types of costs of providing service for distribution customers, customer-based and demand-based. The fundamental principle employed to guide the design of rates was, consistent with the nature of distribution service, to move from revenue collection through usage-based charges to revenue collection that more accurately reflects how costs are actually incurred by an electric distribution company. In this proceeding, PPL Electric has proposed to continue to move toward distribution rates that are more demand- and customer-based, and less usage-based. PPL Electric St. 5, pp. 11-12. A summary of proposed changes in rate design for each rate schedule is provided below.

<u>Rate Schedule RS-Residential Service</u>: In PPL Electric's presently effective residential Rate Schedule RS, a large portion of the distribution revenue is being collected through usage or kWh charges. PPL Electric's minimum size system study indicates that residential customers should be paying a monthly customer charge in excess of $30 as compared to the current monthly charge of $8.75. In this proceeding, PPL Electric has proposed to increase the customer charge for Rate Schedule RS from $8.75 to $16.00 per month and decrease the kWh charges from $0.03364 to $0.03340. PPL Electric St. 5, pp. 11-14; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. PPL Electric's proposal to increase the customer charges and reduce the energy charge for Rate Schedule RS is consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization. I&E, OCA, and

CEO oppose PPL Electric's proposal to increase the Rate Schedule RS customer charge, which the Company addresses below.

Residential Thermal Storage – Rate Schedule RTS: As previously explained, the increase in revenue requirements for Rate Schedule RTS was capped to limit the increase to approximately one-half the amount require to move this rate schedule to the system average. The customer charge for Rate Schedule RTS presently is $18.06. PPL Electric has proposed that the entire increase to Rate Schedule RTS be recovered through kWh charges. Therefore, PPL Electric proposes that the customer charge for Rate Schedule RTS remain at $18.06, and that the kWh charges be increased from $0.01425 to $0.02598. PPL Electric St. 5, p. 14; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. PPL Electric's proposal is consistent with the principles of gradualism, while continuing to move Rate Schedule RTS towards cost of service rates. This proposal was unopposed and should be approved.

Residential Time of Date – Rate Schedule RTD: The distribution rates charged under Rate Schedule RTD are identical to the distribution rates charged under Rate Schedule RS. Rate Schedule RTD is an older rate schedule that has been superseded by the Time of Use ("TOU") rate option under GSC-1. PPL Electric therefore has proposed to eliminate Rate Schedule RTD. PPL Electric St. 5, p. 14; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. I&E opposes PPL Electric's proposal to eliminate Rate Schedule RTD, which the Company addresses below. No other parties opposed this proposal.

Small General Service – Rate Schedule GS-1: PPL Electric has proposed to increase the customer charge from $14.00 to $16.00 per month and decrease the demand charge from $4.530 to $4.258 per kW. PPL Electric has installed demand meters on all GS-1 customer premises, except for small unmetered constant load accounts. PPL Electric St. 5, p. 15; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. PPL Electric's proposal to increase the customer charges and reduce the demand charge for Rate Schedule GS-1 is consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization. I&E argues that the customer charge for Rate Schedule GS-1 should not be increased, which the Company addresses below. No other parties opposed this proposal.

Large General Service – Rate Schedule GS-3: PPL Electric has proposed to increase the customer charge from $30.00 to $40.00 per month and decrease the demand charge from $4.510 to $4.192 per kW. PPL Electric St. 5, p. 15; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. PPL Electric's proposal to increase the customer charge and reduce the demand charge for Rate Schedule GS-3 is consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization. I&E argues that the customer charge for Rate Schedule GS-3 should not be increased, which the Company addresses below. No other parties opposed this proposal.

Large Power Firm Service at 12 kV – Rate Schedule LP-4: PPL Electric has proposed to increase the customer charge from $160.19 to $170.00 per month and decrease the demand charge from $2.136 to $2.127 per kW. PPL Electric St. 5, p. 16; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. PPL Electric's proposal to increase the customer charges and reduce the demand charge for Rate Schedule LP-4 is consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization. I&E argues that the customer charge for Rate Schedule LP-4, should not be increased, which the Company addresses below. No other parties opposed this proposal.

Large Power Interruptible Service at 12 kV – Rate Schedule IS-P: There are only two accounts on Rate Schedule IS-P, both owned by the same corporation. PPL Electric has proposed to eliminate Rate Schedule IS-P and move these two accounts to Rate Schedule LP-4. From a delivery perspective, there is no difference between Rate Schedules IS-P and LP-4 because the metering, meter reading, billing, and service are the same. Further these two rate schedules are part of the same default generation supply procurement group. Finally, all of PPL Electric's interruptible service programs have been superseded by PJM's programs, and these two accounts are enrolled in the PJM programs. The elimination of Rate Schedule IS-P will not affect the participation of these accounts in the PJM programs. PPL Electric St. 5, p. 16; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. This proposal was unopposed and should be approved.

Large Power Service at 69 kV – Rate Schedules LP-5, LP-6, and IS-T: PPL Electric has proposed to increase the customer charge for Rate Schedule LP-5 from $709.00 to $1,125.00 per month. Presently there are only two customers on Rate Schedule LP-6. There is no difference between Rate Schedules LP-6 and LP-5 and, therefore, PPL Electric has proposed to eliminate LP-6 and move the two remaining customers to Rate Schedule LP-5. Finally, PPL Electric has proposed to eliminate Rate Schedule IS-T because there are no customers on this interruptible service program. All of PPL Electric's interruptible service programs have been superseded by PJM's programs. PPL Electric St. 5, p. 17; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. I&E argues that the customer charge for Rate Schedule LP-5 should not be increased, which the Company addresses below. No other parties opposed this proposal.

Electric Propulsion, - Rate Schedule LPEP: PPL Electric has not proposed any changes to this rate schedule. PPL Electric St. 5, p. 18.

Interruptible Green House Lighting – Rate Schedule IS-1: There currently is only one customer on Rate Schedule IS-1. PPL Electric has proposed to begin phasing out this rate schedule over the next few rate cases. Currently, customers on Rate Schedule IS-1 do not have an incentive to interrupt during an emergency. Accordingly, PPL Electric has proposed a new $25.00 per kW penalty for load that exceeds the interruptible requirement during the period of the requested interruption. PPL Electric also has proposed the elimination of the Time of Day provisions of Rate Schedule IS-1. Instead, the customer's demand will be the maximum 15-minute demand in the month without Time of Day considerations. Finally, PPL Electric has proposed to decrease the customer charge from $840.00 per month to $40.00 per month, the same as that proposed for Rate Schedule GS-3, and to introduce a demand charge of $2.75 per kW. PPL Electric St. 5, pp. 18-19. This proposal was unopposed and should be approved.

Commercial space Heating – Rate Schedules GH-1 and GH-2: All GH-1 customers currently are paying more for distribution service than they would pay on comparable rate schedules. PPL Electric has proposed to eliminate Rate Schedule GH-1 and transfer the remaining customers to Rate Schedules LP-4, GS-3, or GS-1, depending on the service voltage and number of phases supplied by the Company. For Rate Schedule GH-2, the Company proposes to increase the customer charge from $14.00 per month to $16.00 per month. PPL Electric St. 5, pp. 19-20; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits

Regs., § 53.53, Part IV, Questions C through E. This proposal was unopposed and should be approved.

As indicated above, certain intervenors raised concerns regarding PPL Electric's proposed rate design. In particular, these parties opposed PPL Electric's proposal to increase the residential and non-residential customer charges, as well as the elimination of Rate Schedule RTD. For the reasons explained below, these concerns should be rejected and the rate design proposed by PPL Electric should be approved.

b. Residential Customer Charge

i. PPL Electric's Proposed Residential Customer Charge Should Be Approved

PPL Electric proposed to increase the Rate Schedule RS customer charge from $8.75 per month to $16.00 per month based on its cost of service study and the underlying minimum size system study. PPL Electric St. 5, pp. 11-12; PPL Electric St. 8-R, p. 29; PPL Electric Ex. JMK 5. As explained above, the cost of service study and minimum size system study used by PPL Electric in this proceeding is virtually identical to the methodology approved by ALJ Colwell and adopted by the Commission in the 2010 base rate proceeding. PPL Electric St. 8-R, p. 9; OSBA St. 1, p. 5; *see also Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (Dec. 21, 2010).

PPL Electric's cost of service study indicates that residential customers should be paying a customer charge of $36.70 as compared to the current monthly charge of $8.75. PPL Electric St. 5, pp. 11-12; PPL Electric Ex. JMK 5. In this proceeding, PPL Electric proposed to recover the entire proposed distribution revenue increase for the residential customer class in the customer charge, resulting in the proposed Rate Schedule RS customer charge of $16.00 per month. The proposed increase in the customer charge for Rate Schedule RS is within the results of PPL Electric's cost of service study that has previously been approved by the Commission. Further, PPL Electric's proposal is consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization, and should be approved. For these reasons, PPL Electric's proposal to increase the Rate Schedule RS customer charge from $8.75 per month to $16.00 per month is just and reasonable and should be approved.

ii. The Parties' Opposition To The Proposed Residential Customer Charge Should Be Rejected

I&E, OCA and CEO all argue that the customer charge for Rate Schedule RS should not increase as the Company has proposed. These parties raise several arguments in opposition to the proposal to increase the customer charge and recommend that the customer charge for Rate Schedule RS remain unchanged.

Preliminarily, it must be noted that these parties disregard that in the last nine years the customer charge for the residential class has increased from $8.00 to $8.74, less than 10%, while the total amount of distribution revenues since January 2004 will have increased by 104% PPL Electric's proposed increase is granted. Tr. 532-33. Consequently, a much larger portion of distribution costs has been recovered from residential customers through energy or variable charges and less has been recovered through fixed charges. OCA St. 3-SR, p. 8; Tr. 533-35. The proposal that the customer charge for Rate Schedule RS remain unchanged will result in fewer fixed costs being recovered in the customer charge than under the Company's present rates. In other words, their proposed rate designs move in the wrong direction and would result in a customer charge that recovers a smaller percentage of fixed costs than the current charge. PPL Electric St. 5-R, pp. 14-15. Such a result is inconsistent with *Lloyd* and the fixed cost nature of an electric distribution system.

PPL Electric will separately address below these parties' arguments in opposition to the proposed residential customer charge. For the reasons explained below, these parties' arguments in opposition to the proposal to increase the Rate Schedule RS customer charge should be rejected.

(A) Incentive to Conserve

I&E, OCA, and CEO argue that the Company's proposal reduces the incentive for customers to conserve. I&E St. 3, pp. 5-6; OCA St. 3, p. 46; CEO St. 1, pp. 3-4. However, as the Company explained, the proposal to increase the customer charge for Rate Schedule RS would have very little impact on residential consumers' economic incentive to conserve. These parties largely ignore that PPL Electric's proposal will maintain an energy charge component of Rate Schedule RS distribution charges that is only 0.7% lower than the current energy charge. Further, if approved, the Company's proposal would still leave 86% of the charges on an average residential customer's total bill subject to usage-based charges. PPL Electric St. 5-R, p. 6; Exhibit DAK 4. Clearly, customers would still have a significant economic incentive to conserve.

The Company fully supports appropriate incentives to encourage customers to conserve energy. However, conservation cannot and does not trump cost of service. Conservation cannot be used to support a below cost of service customer charge. Freezing the customer charge at its current level, which recovers less than one half of fixed distribution costs, is contrary to the cost causation principles established in *Lloyd*. Fixed costs should be recovered through fixed charges and variable costs should be recovered through variable charges.

PPL Electric has explained that, currently, some elements in its rate design are distorted and need to be substantially revised. Indeed, as explained above, PPL Electric's minimum size system study indicates that residential customers should be paying a customer charge in excess of $30.00 as compared to the current monthly charge of $8.75. PPL Electric St. 5, pp. 11-12. Opposition to the Company's cost based proposal on the grounds that it will disincent conservation simply disregards the fundamental rationale for the Company's proposal.

(B) Impact on Low Income/Low Usage Customers

OCA and CEO also argue that the proposal has a disproportionate impact on low income/low usage customers. OCA St. 4, pp. 5-12; CEO St. 1, pp. 4-5. Both of these parties observe that PPL Electric's proposal results in a greater than average increase to lower use customers and that the Company's proposal, therefore, has a disproportionate impact on lower income customers. For the reasons explained below, these parties' concerns should be rejected.

PPL Electric acknowledges that increasing the monthly charge while essentially maintaining the usage charge at its current level will result in a greater than average percentage increase to low use customers.[33] However, this does not change the fact that, as a utility with an obligation to serve customers, PPL Electric must provide infrastructure to serve the needs of those customers. Importantly, the existence of that infrastructure does not change, nor does it grow larger or smaller, as a result of whether a customer uses 1 kWh/month, 1,000 kWh/month, or 5,000 kWh/month. PPL Electric St. 5-R, p. 8.

A customer charge that fails to cover the fixed costs of the infrastructure the Company must install to provide service to its customers unfairly disadvantages the Company's shareowners and inhibits the Company's ability to attract new investment. Further, freezing the customer charge is fundamentally unfair to those customers with above average levels of usage who pay a disproportionate share of the fixed costs of service through usage-based charges. In

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[33] This mathematical result is captured in OCA's Schedule RDC-7, which lists the average proposed distribution rate increase of 20.7% associated with what PPL Electric knows to be its average usage customer (*i.e.*, about 1,000 kWh/month), higher percentage increases for customers using less than 1,000 kwh/month, and lower percentage increases for customers using more than 1,000 kWh/month.

addition, it must be remembered that customers do not pay percentages, they pay dollars. While the increase in the customer charge may produce significant percentage increases to low use customers, if PPL Electric's proposal is approved the dollar increase is approximately $7 per month. PPL Electric St. 5-R, pp. 8-9.

The Company does not believe that the ability to pay should influence rate design. Utility rates should be designed based upon cost of service, not customers' income levels. Ability to pay issues should be addressed through universal service programs, not by setting rates that do not remotely reflect cost of service. PPL Electric has extensive Commission-approved universal service programs to assist low-income customers who are payment troubled. The participants in the Company's customer assistance programs pay an amount determined not from their bill, but from their ability to pay. Therefore, participants in these programs should not be adversely impacted by the proposed rate design. PPL Electric St. 5-R, p. 11.

(C) The Pricing For Competitive Goods In Competitive Markets

OCA further criticizes the Company's proposal to increase the residential customer charge relative to the pricing for competitive goods in competitive markets. The OCA opines that electric distribution companies are not unlike competitive industries in the respect that their cost structures include significant amounts of fixed costs. The OCA further asserts that the pricing structures of competitive industries are overwhelmingly volumetric based and that, as it has been regulated over its existence, the pricing structures of the regulated electric industry have been largely volumetric. The OCA contends that the "only reason utilities are able to achieve pricing structures with high fixed monthly charges is due to their monopoly status" and, therefore, concludes that "a regulated utility's pricing structure should not be allowed to counter the collective wisdom of markets and consumers." OCA St. 3, pp. 45-46. The OCA's argument fails to address an important part of the regulatory compact.

Under the regulatory compact, regulated electric utilities, in exchange for "their monopoly status," took on an obligation to serve. This means that an electric distribution company must, with very few exceptions, incur fixed costs to provide service to any customer located within its franchised service territory who desires service regardless of the supplier or the level of use that customer may have. Competitive industries have no such obligation. This difference fully supports the need for a utility to recover fixed costs through fixed charges. PPL Electric St. 5-R, p. 12.

(D) Use of Minimum System Study As A Basis For Establishing A Fixed Monthly Charge

As described above, PPL Electric used its minimum size system study to determine all of the customer-related costs applicable to its distribution system. These minimum size system customer-related costs are identified and the associated revenue requirement is calculated to determine the level of the customer charge to be applied to monthly billings for the RS customer rate class. PPL Electric St. 8-R, p. 29; PPL Electric Ex. JMK 5. The OCA and I&E oppose PPL Electric's proposed increase in the Rate Schedule RS customer charge based on the Company's cost of service study.

Preliminarily, it must be noted that these parties disregard that the minimum size system study used by PPL Electric in this proceeding to determine the proposed Rate Schedule RS customer charge is virtually identical to the minimum size system study approved by ALJ Colwell and adopted by the Commission in the 2010 base rate proceeding. PPL Electric St. 8-R, p. 9; OSBA St. 1, p. 5; *see also Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (Dec. 21, 2010). For this reason alone, I&E's and

OCA's opposition to PPL Electric's proposed increase in the Rate Schedule RS customer charge based on its minimum size system study should be rejected.

I&E opposes PPL Electric's proposed increase in the Rate Schedule RS customer charge based on the Company's cost of service study. I&E contends that PPL Electric's minimum size system study confuses fixed costs with customer costs. I&E St. 3-SR, p. 3. This is simply not the case. Fixed costs are all costs that do not vary with kWh usage. All of PPL Electric's distribution costs are fixed costs. PPL Electric's cost of service study separates these fixed cots into a demand or customer component and seeks to recover a portion of the customer component through its proposed $16.00 per month customer charges. PPL Electric St. 8-R, pp. 12-13; PPL Electric Ex. JMK 3. This study and its predecessors, which have used the same methodologies regarding customer costs, have been reviewed and accepted in many prior PPL Electric base rate proceedings. PPL Electric St. 8-RJ (Part 2), pp. 2-3. Finally, PPL Electric Ex. JMK 3 has not been challenged by I&E in this proceeding.

I&E also contends that PPL Electric's minimum size system study improperly assumes a direct relationship between the number of customers and the size and cost of poles, conductors, and transformers on PPL Electric's system. I&E St. 3-SR, p. 4. However, contrary to I&E's opinion, there is a direct relationship between the number of customers and the size and cost of poles, conductors and transformers on PPL Electric's system. The number and type of customers served by electric distribution facilities (*i.e.*, poles, conductors and devices, and transformers) does affect the size and quantity, as well as the cost, of such facilities. Obviously, the size and cost of the Company's poles, conductors and transformers will increase as the number of customers increase. PPL Electric St. 8-R, pp. 18-19; PPL Electric St. 8-RJ (Part 2), p. 3.

Finally, it must be remembered that the Company is not proposing a customer charge that is exactly equal to the customer cost component of tis cost of service study. PPL Electric's cost of service study could have justified a Rate Schedule RS customer charge of $36.70 on the basis of all customer-related costs. Consistent with the results of the cost of service study and the cost causation principles established in *Lloyd*, PPL Electric proposes to recover all of the proposed distribution revenue increase for the residential customer class in the customer charge, resulting in the proposed Rate Schedule RS customer charge of $16.00 per month.

(E) The Alternative Customer Cost Analyses Of I&E and OCA Should Be Rejected

The proper development of a customer charge should include all relevant direct and indirect revenue requirement cost components to be recovered through the customer charge. This approach is appropriate because an EDC's base rates is designed to recover the revenue requirement associated with its distribution capital and operating costs. PPL Electric St. 8-RJ (Part 2), p. 4. The Company has limited the costs included in the calculation of its proposed customer charge to only the revenue requirement associated with those directly assignable customer-related costs and their related indirect costs. PPL Electric Ex. JMK-5; PPL Electric St. 8-R, p. 30.

Both I&E and OCA propose their own direct customer cost analyses, which exclude certain cost components proposed by PPL Electric to be recovered through the customer charge. I&E concluded that the Company only incurs $8.13 per month in customer costs for Rate Schedule RS.[34] I&E St. 3, p. 11. The OCA concluded that the direct customer costs incurred by

[34] I&E employed the same direct customer cost analysis it used in *Pa. PUC v. Columbia Gas of Pennsylvania, Inc.*, Docket No. R-2010-2215623, 2011 Pa. PUC LEXIS 185, 293 P.U.R.4th 235 (October 14, 2011). I&E St. 3, p. 10; I&E St. 3-SR, p. 6; Tr. 536-37; I&E Ex. 3, Schedule 2. However, the customer cost analysis "adopted" by the Commission in *Columbia* was limited solely to the facts of that case and was not intended to be used in other proceedings that present viable rate mechanisms. *Columbia*, at *80-83. Accordingly, I&E's reliance on the same customer cost analysis used in the *Columbia* case is inappropriate and must be rejected.

the Company for Rate Schedule RS rage from $7.70 to $8.24 per month. OCA St. 3, p. 44. For the reasons explained below, the direct customer cost analyses proposed by I&E and OCA should be rejected.

Their studies are based on analyses that include only meters and services and exclude all other customer costs. The Company recognizes that the Commission has limited the costs that may be recovered through the customer charge. However, I&E and OCA have misapplied that precedent by excluding certain indirect customer costs components that the Commission has concluded should be recovered through the customer charge, *i.e.*, employee benefits, payroll taxes, local taxes, and administrative and general costs. As explained below, including the same type of direct and indirect cost components approved by the Commission supports a customer charge of $14.09.

iii. PPL Electric's Alternative Residential Customer Charge Proposal

As explained above, PPL Electric's cost of service study justifies a Rate Schedule RS customer charge of $36.70 on the basis of all customer-related costs. PPL Electric Ex. JMK 5. PPL Electric therefore proposed to recover the entire proposed distribution revenue increase for the residential customer class in the customer charge, resulting in the proposed Rate Schedule RS customer charge of $16.00 per month.

The Company recognizes, however, that its proposal to recover the entire residential rate increase through the customer charge, while cost based, has drawn considerable criticism from a variety of parties. The Company also recognizes, as explained above, that the Commission has limited the costs that may be recovered through the customer charge. Therefore, in response to the criticism of I&E and OCA, PPL Electric proposed an alternative Rate Schedule RS customer charge of $14.09 per month. PPL Electric St. 5-R, p. 15; PPL Electric Ex. JMK 5. The revenue requirement cost components included in the calculation of this alternative customer charge are based on the same type of direct and indirect cost components approved by the Commission in *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 2004 Pa. PUC LEXIS 39, 236 P.U.R.4th 218 (Aug. 5, 2004).

In *Aqua*, Aqua proposed to increase the customer charge from $ 8.75 per month to $10.00. In that proceeding, the Office of Trial Staff and OCA opposed the increase arguing that Aqua's calculation of the customer charge improperly included indirect costs, and that the calculation of the customer charge should only include costs for meters and services. *Id*, at *96-97. The Commission rejected these arguments holding as follows:

> On review of the evidentiary record herein, we shall adopt the ALJ's Recommendation on this issue. First, the ALJ correctly found that the cost of customer equipment, and also of meters and service line maintenance, is properly includable in a cost study. We find that the [I&E] proposed *limitation of costs to only services and meters is unreasonably narrow*.
>
> Second, we find that *it is reasonable and proper to include allocated portions of indirect costs, such as employee benefits, local taxes and other general and administrative costs, in a cost study*. We caution that these are costs which may be considered for inclusion in the customer charge, but such claims are subject to scrutiny on a case-by-case basis.
>
> We note that in [*Pa. P.U.C. v. Citizens Water Company of Pennsylvania*, 86 Pa. PUC 51, 107 (1996)] the Commission adopted the utility's claim to include the allocated portion of associated payroll taxes and benefits as part of customer expenses.

Id. at *97-98 (emphasis added).

The approach outlined in *Aqua* is exactly the approach PPL Electric has taken to propose an alternative Rate Schedule RS customer charge of $14.09 per month. The analysis supporting this alternative proposal is set forth in Exhibit JMK 5, the relevant portion of which is reproduced below.

PPL ELECTRIC UTILITIES CORPORATION
COST OF SERVICE SUMMARY – RS CUSTOMER CHARGE
REVENUE REQUIREMENTS
($1,000)

Customer Class: RS		Rate Class Total	Total Demand	Total Customer	Meters	Services	Meter Reading	Other Cust. Exps.	Total Direct[1]
Rate Base:									
Plant in Service		3,391,885	836,767	2,555,118	171,016	497,616			668,632
Depreciation Reserve		1,249,089	280,412	968,677	94,731	241,367			336,098
Net Plant		2,142,796	556,355	1,586,441	76,285	256,249			332,534
Subtractive Adjustments		501,254	125,655	375,599	18,061	60,668			78,729
Additive Adjustments		46,958	10,521	36,437	1,752	5,885			7,638
Total Rate Base		1,688,500	441,221	1,247,279	59,976	201,466			261,442
Operating Expenses:									
Misc Distrib Expenses		12,463	3,258	9,205					
Customer Service Costs[2]		12,764		12,764				12,764	12,764
PUC Annual Assessment		3,635	598	3,037					
Employee Benefits		23,611	3,837	19,774	6,034	783	1,390	6,969	15,176
Other A&G		88,765	14,421	74,344	6,946	4,096	2,532	26,201	39,774
Other O&M Expenses		163,328	27,626	135,702	12,678	7,476	4,621	47,826	72,600
Proforma Adjustments		3,738	627	3,111					0
Depreciation Expense		97,165	21,270	75,895	10,399	9,050			19,449
Taxes Other Than Income		6,504	1,205	5,299	255	856			1,111
Return	8.46%	142,847	37,327	105,520	5,074	17,044			22,118
Income Taxes	41.49%	68,718	17,957	50,761	2,441	8,199			10,640
Tax Adjustment		13,983	4,947	9,036					0
Gross Revenue Requirements		637,521	133,073	504,448	43,826	47,503	8,542	93,760	193,632
Annualization Adjustment		(1,209)	(252)	(957)	(83)	(90)	(16)	(178)	(367)
Late Payment Charges		10,668	2,227	8,441	733	795	143	1,569	3,240
Other Operating Revenues		27,296	7,136	20,160	1,751	1,898	341	3,747	7,738
Total Revenues		36,755	9,110	27,645	2,402	2,603	468	5,138	10,611
Net Revenue Requirements		600,766	123,963	476,804	41,424	44,900	8,074	88,622	183,020
GRT Base		610,225	125,937	484,288	42,075	45,605	8,201	90,013	185,893
GRT Gross-up		648,486	133,833	514,653	44,713	48,464	8,715	95,657	197,549
GRT	5.90%	38,261	7,896	30,365	2,638	2,859	514	5,644	11,655
Total Revenue Requirements		675,782	140,969	534,813	46,464	50,362	9,057	99,404	205,287
Customer Charge		64,898		$36.70	$3.19	$3.46	$0.62	$6.82	$14.09
Number Customers				1,214,512					
Annual Customer Billings				14,574,144					

Notes:
[1] Includes meters, services and directly assignable operating costs.
[2] Excludes Universal Service Rider costs.

The costs included in PPL Electric's alternative Rate Schedule RS customer charge of $14.09 per month is included in the black box on the right side of PPL Electric Ex. JMK 5. As illustrated above, the portion of PPL Electric Ex. JMK 5 included in the black box precisely follows the *Aqua* decision and properly reflects meters and services net plant and related O&M expenses; meter reading and billing and collection expenses, and the Company's Meter Data Management System; and related employee benefits, administrative and general expenses and other O&M expenses related to the above items. These revenue requirement cost components represent the same type of direct and indirect cost components as those approved in *Aqua*. The only difference is that PPL Electric Ex. JMK 5 also includes $12,678,000 for customer call center-related expense. This expense was not specifically addressed in Aqua, but it is consistent with the expenses included in the customer charge in Aqua, because it is a directly assignable customer service-related expense, and it varies with the number of customer calls and the number of customers. PPL Electric St. 8-RJ (Part 2), p. 8.

Although PPL Electric believes that the customer component of each rate schedule should include all customer-related costs determined by the cost of service study, if the ALJ and the Commission wish to consider an alternative compromise customer charge, a charge of $14.09 would be acceptable to the Company as it would recover the same type of direct and indirect cost components as those approved in *Aqua*, and would provide some improvement in the level of fixed cost recovery in the customer charge. In that event, revenue requirements not recovered through the smaller fixed charge would be recovered through a larger usage charge. PPL Electric St. 5-R, p. 15.

c. Non-Residential Customer Charges

I&E also argues that the customer charge for Rate Schedules GS-1, GS-3, LP-4, and LP-5 should not be increased. In those cases where I&E's calculation would lead to an amount lower than the current monthly charge (GS-1 and LP-4), I&E recommends no change in the customer charge. In those cases where the calculation would lead to an amount higher than the current monthly charge (GS-3 and LP-5) I&E recommends an increase in the customer charge to a level roughly equal to its calculation, but, in both cases, an amount that is less than the Company's proposal. I&E St. 3, pp. 12-14.

I&E's non-residential customer charges are based on its own direct customer cost analysis used in the *Columbia* case, which, as described above, excluded certain items proposed by PPL Electric to be recovered through the customer charge. OCA St. 3, p. 11. For the reasons explained above, I&E's customer cost analysis and resulting proposed non-residential customer charges are inappropriate and should be rejected.

The Company continues to believe that its minimum size system study is the appropriate basis for determining the fixed customer costs that are incurred to serve customers, and that those fixed costs should be recovered through a fixed customer charge. As explained above, I&E's approach to setting the fixed monthly customer charges ignores the customer costs of the fixed and permanent infrastructure that the electric distribution company is obligated to provide and which exists between a customer's service and the transmission substation from which the customer's load is served. For these reasons, as more fully explained above, I&E's proposed non-residential customer charges should be rejected.

d. Elimination of Rate Schedule RTD

PPL Electric has proposed to eliminate Rate Schedule RTD and merge those customers into Rate Schedule RS. PPL Electric St. 5, p. 14; PPL Electric Exs. DAK 1, DAK 2; PPL Electric Ex. No. 1, Exhibits Regs., § 53.53, Part IV, Questions C through E. I&E recommends that the Commission reject the Company's proposal to eliminate Rate Schedule RTD and move those customers to Rate Schedule RS. In support, I&E contends that the Company's proposal is premature in light of proceedings pending before the Commission that involve undercollected default service charges that might or might not be recoverable, in part, from Rate Schedule RTD customers. I&E St. 3, pp. 3-4. I&E's recommendation should be rejected for several reasons.

First, the Commission recently denied PPL Electric's proposal to implement a reconciliation rider and competitive transition rider to refund/recover over/under collections associated with generation supply and transmission services. *See Petition of PPL Electric Utilities Corporation for Approval to Implement a Reconciliation Rider and Competitive Transmission Rider for Default Supply Service*, Docket No. P-2011-2256365 (July 19, 2012).

Therefore, the Commission's decision in this proceeding will have no impact on Rate Schedule RTD customers relative to any reconciliation of default service charges because the proposed reconciliation rider and competitive transition rider were not adopted.

Second, the Company's proposal to move Rate Schedule RTD customers to Rate Schedule RS will not be affected by the Commission's disposition of the pending *Petition of PPL Electric Utilities Corporation for Approval of a Default Service Program and Procurement Plan for the Period of June 1, 2013 through May 31, 2015*, Docket No. P-2012-2302074. As explained above, the distribution rates charged under Rate Schedule RTD are identical to the distribution rates charged under Rate Schedule RS. Both Rate Schedule RTD and Rate Schedule RS customers who do not select competitive generation supply are served under the same GSC-1 default service rider. Therefore, the Company's proposal to move Rate Schedule RTD customers to Rate Schedule RS means that they will remain within the same default service procurement group (*i.e.*, GSC-1). PPL Electric St. 5-R, p. 17. Consequently, the Company's proposal to move Rate Schedule RTD customers to Rate Schedule RS will neither advantage nor disadvantage Rate Schedule RTD customers relative to any reconciliation of default service as a result of the Commission's resolution of the Company's proposed default service procurement plan.

In surrebuttal, I&E accepted the explanation from the Company and withdrew its objection to the merging of Rate Schedule RTS into Rate Schedule RS. I&E St. 3-SR, pp. 17-18. PPL Electric's proposal is now unopposed and should be approved.

2. Tariff Rules and Riders

a. Introduction

In addition to the proposed rate increase and rate design for each class, PPL Electric proposed several changes to various tariff rules and riders. Below is a summary of the major changes proposed by PPL Electric in this proceeding.

i. Major Rule Changes

Tariff Rule 6 – PPL Electric proposed to remove the Adjustments to the Competitive Transition Charge because this Charge expired on December 31, 2010. PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Tariff Rule 6A – PPL Electric proposed to remove the Adjustments to the Competitive Transition Charge because this Charge expired on December 31, 2010. No parties opposed this proposal. PPL Electric also has proposed changes in the Distribution charges for stand-by Basic Utility Supply Service. These proposed changes will have no revenue impact because currently no customers take service under Rule 6A. PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Tariff Rule 8 – PPL Electric proposed to add a Demand Information section to Rule 8. There is a need to efficiently manage the growing number of customer requests for Demand Information as customers begin to enroll in PJM's Demand Side Management ("DSM") programs and TOU rate options. This addition demonstrates PPL Electric's commitment to existing and future DSM programs offered by PJM and the generation marketplace. PPL Electric St. 5, pp. 20-12; PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

ii. Major Rider and Charge Changes

Tariff Rule 10 – PPL Electric proposes to increase the fee it charges customers for the reconnection of service from $15 to $30 during normal business hours and from $21 to $50 during non-business hours. PPL St. 5, p. 21; PPL Electric Ex. DAK 2. OCA accepted PPL Electric's proposal, but recommended that the Company be directed to monitor the costs of reconnection. I&E also accepted PPL Electric's proposal to increase its reconnection fee, but recommends that the Company's miscellaneous revenues be increased. These parties' concerns are addressed above.

Generation Rate Adjustment (GRA) Rider – The GRA Rider expired on January 1, 2011. PPL Electric proposed to remove all references to the GRA from the STAS and Rate Schedules. PPL Electric St. 5, p. 22; PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Universal Service Charge Rider (USR) – PPL Electric proposed to delete the Rate Schedule RTD (R) reference that was removed from the Tariff. PPL Electric also proposed to revise the filing date to December 21 of each year. Finally, the Company proposed to delete the sentence "The third quarter report shall be accompanied by a preliminary forecast of the USR charge for the next computation year." PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Rate Stabilization Plan Rider – The Rate Stabilization Plan Rider expired on December 31, 2011. PPL Electric proposed to remove this Rider. PPL Electric St. 5, p. 22; PPL Ex. DAK 2. This proposal was unopposed and should be approved.

Competitive Transition Charge (CTC) Reconciliation Rider – The CTC Reconciliation Rider expired December 31, 2010. PPL Electric proposed to remove this Rider and all references to it from Rule 6 and 6A, Net Metering, and the Rate Schedules. PPL Electric St. 5, p. 22; PPL Ex. DAK 2. This proposal was unopposed and should be approved.

Renewable Energy Development (RED) Rider – The Net Metering for Renewable Customer-Generators Rider already addresses the eligibility, terms, and conditions applicable to all renewable customer-generators less than or equal to 10 kW. PPL Electric therefore has proposed to remove the RED Rider. PPL Electric St. 5, p. 22; PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Net Metering for Renewable Customer-Generators Rider – PPL Electric proposed two changes to its Net Metering tariff provisions for Renewable Customer-Generators. First, PPL Electric proposed to establish a limitation on the size of generator relative to the associated customer usage that would be eligible for net metering. Second, PPL Electric proposed to clarify that, for eligible customer-generators served under PPL Electric's Time Of Use default service rate option, a weighted average of the on-peak and off-peak hour prices would be used to derive the Price to Compare for the purpose of compensating customer-generators for excess generation. PPL Electric St. 5, p. 25; PPL Electric Ex. DAK 2. Both SEF and Granger opposed PPL Electric's proposal to limit the eligibility for net metering based on the size of the generator relative to the associated customer usage. PPL Electric addresses these parties' concerns below.

Metering and Billing Credit Rider – PPL Electric proposed to update the Metering, Meter Reading, and Billing and Collection credits in accordance with the future test year cost of service data. PPL Electric St. 5, p. 23; PPL Electric Ex. DAK 2. The OCA raised several criticisms related to PPL Electric's cost of service study, which the Company addresses above.

Demand Side Initiative Rider and Demand Side Response Rider – These experimental Riders expired on January 1, 2011. PPL Electric therefore proposed to remove these Riders. PPL Electric St. 5, pp. 22-23; PPL Electric Ex. DAK 5. This proposal was unopposed and should be approved.

Generation Supply Charge – The Generation Supply Charge rider expired on December 31, 2010. It has been replaced by the Generation Supply Charge — 1 and Generation Supply Charge — 2 riders. PPL Electric therefore proposed to eliminate the Generation Supply Charge rider. PPL Electric St. 5, p. 23; PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Generation Supply Charge – 1 – PPL Electric proposed to remove the RTS discount, which expired on December 31, 2011. The Company also proposed to revise the "E" term calculation to end one month prior to the computation quarter. PPL Electric Ex. DAK 2. This proposal was unopposed and should be approved.

Merchant Function Charge Rider (MFC) – Uncollectible accounts expense associated with generation supply and transmission service for default service customers is separated from the Company's distribution rates and recovered through the MFC and included in its Price to Compare. The MFC percentages for the residential and small C&I customer classes have been calculated on the Company's expected 2012 uncollectible accounts expense for those customer classes. Based thereon, PPL Electric proposed to change the MFC for the residential class from 1.80% to 2.23% and for small C&I customers from 0.10% to 0.23%. PPL Electric St. 8, pp. 29-30; PPL Electric St. 8-R, pp. 43-44; PPL Electric Ex. JMK 4. Dominion Retial and Direct Energy have opposed PPL Electric's expected 2012 uncollectible accounts expense, which the Company addresses below.

Competitive Enhancement Rider (CER) –PPL Electric will estimate the total costs it expects to incur, on a calendar-year basis, to provide consumer education programs and competitive retail electricity market enhancement initiatives for all customers who receive distribution service from PPL Electric. The CER will be a Section 1307(e) cost recovery mechanism to recover the Company's education and retail market enhancement-related costs. PPL St. 8, pp. 30-32; PPL Electric Ex. DAK 2. OCA, OSBA, and Direct Energy have raised various issues and concerns regarding the proposed CER, which the Company addresses below.

Reference to Rate Schedules RTD, LP-6, IS-P, IS-T, and GH-1 – PPL Electric proposed to eliminate the references to Rate Schedules RTD, LP-6, IS-P, IS-T, and GH-1 from the following riders, where applicable, because these rate schedules are being eliminated from the Tariff: Transmission Service Charge (TSC), Act 129 Compliance Rider, Generation Supply Charge – 1, Generation Supply Charge – 2, Merchant Function Charge Rider (MFC), Smart Meter Rider, as well as the Rider Matrix. PPL Electric St. 5, pp. 22-23; PPL Electric Ex. DAK 2. With the exception of the elimination of Rate Schedule RTD from the Tariff, which is addressed above, no parties opposed this proposal.

b. Net Metering

In its initial filing, PPL Electric proposed two changes to its Net Metering tariff provisions for Renewable Customer-Generators. First, PPL Electric proposed to establish a limitation on the size of generator relative to the associated customer usage that would be eligible for net metering. This proposal was in response to a Tentative Order entered July 28, 2011, at Docket No. M-2011-2249441. PPL Electric St. 5, p. 24. Second, PPL Electric proposed to clarify that, for eligible customer-generators served under PPL Electric's Time Of Use default service rate option, a weighted average of the on-peak and off-peak hour prices would be used to derive the Price to Compare for the purpose of compensating customer-generators for excess generation. PPL Electric St. 5, p. 25.

Both SEF and Granger opposed PPL Electric's proposal to limit the eligibility for net metering based on the size of the generator relative to the associated customer usage. Both SEF and Granger noted that the Commission's Final Order entered on March 29, 2012, at Docket No. M-2011-2249441, applied the 110% limitation only to alternative energy systems that are installed as part of a third-party owner or operator business model and not to those systems directly owned and operated by a customer-generator that is not using a third-party owner or operator model. SEF St. 1, pp. 9-10; Granger St. 1, pp. 15-16. SEF and Granger asserted that PPL Electric's proposal is inconsistent with the Commission's Final Order.

In response to the concerns raised by SEF and Granger, PPL Electric explained all customer-generators, including those that do not use a third-party owner or operator model, rely on the distribution system to not only receive electricity, but also to deliver excess generation for compensation. Thus, applying the 110% limitation only to third-party owned or operated systems would allow customer-generators not using a third-party owner or operator model to avoid-usage based distribution charges and shift recovery of the cost of the distribution system to customers who are not customer-generators. PPL Electric St. 5-R, pp. 21-22; PPL Electric St. 5-RJ, p. 3. Further, these net metering customers clearly cause PPL Electric to incur costs that support an increase in the customer charge.

Notwithstanding the foregoing, PPL Electric acknowledged that its proposal to apply the 110% limitation to all customer-generators goes beyond the specific ruling in the Commission's Final Order that was issued subsequent to the Company developing its proposal. Consequently, PPL Electric withdrew its proposal and, instead, revised its proposed tariff to incorporate the

110% limitation language from the Commission's Final Order. PPL Electric St. 5-RJ, p. 2; PPL Electric Ex. DAK 6. PPL Electric's revised proposal to apply the 110% limitation to systems using the third-party business model and not to systems directly owned or operated by a customer-generator is consistent with the Commission's Final Order and, therefore, should be approved.

PPL Electric's proposal to revise its tariff to use the weighted average of the on-peak and off-peak hour TOU prices to derive the Price to Compare helps to ensure that compensation for excess generation by TOU customer-generators more closely reflects their actual on-peak and off-peak usage and generation. No party to this proceeding opposed this proposal. PPL Electric's unopposed proposal is just and reasonable and, therefore, should be approved.

D. SUMMARY AND ALTERNATIVES

The cost of service study methodology proposed by PPL Electric in this proceeding is virtually identical to the methodology adopted by the Commission in the 2010 base rate proceeding. Therefore, PPL Electric's cost of service study should be approved in this proceeding.

PPL Electric's proposed allocation of revenue requirement among the rate classes is reasonable and achieves substantial progress in moving rate classes toward the system average rate of return. This result is consistent with the *Lloyd* decision and the Commission's order approving the remand settlement. PPL Electric's proposed allocation should be adopted.

The Company acknowledges that movement toward the system average return is an important objective and has made certain proposals in its direct case in this proceeding toward that end. However, the Company recommends that any scale back of revenues be applied on a proportional basis to only those rate schedules which, under the Company's original proposal, would be receiving increases.

PPL Electric's proposal to recover the entire proposed distribution revenue increase for the residential customer class in the customer charge, resulting in the proposed Rate Schedule RS customer charge of $16.00 per month, is within the results of PPL Electric's cost of service study, which is virtually identical to the cost of service study approved by ALJ Colwell and adopted by the Commission in the 2010 base rate proceeding. Therefore, the Rate Schedule RS customer charge of $16.00 per month should be approved.

If the Rate Schedule RS customer charge of $16.00 per month is not approved, at a minimum, the ALJ and Commission should approve PPL Electric's alternative Rate Schedule RS customer charge of $14.09 per month. The revenue requirement cost components included in the calculation of this alternative customer charge are based on the same type of direct and indirect cost components approved by the Commission in *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 2004 Pa. PUC LEXIS 39, 236 P.U.R.4th 218 (Aug. 5, 2004).

PPL Electric proposed to limit the eligibility for net metering based on the size of the generator relative to the associated customer usage. PPL Electric acknowledged that its proposal to apply the 110% limitation to all customer-generators goes beyond the specific ruling in the Commission's Final Order that was issued subsequent to the Company developing its proposal. Consequently, PPL Electric withdrew its proposal and, instead, revised its proposed tariff to incorporate the 110% limitation language from the Commission's Final Order.

IX. <u>MISCELLANEOUS ISSUES</u>

A. PURCHASE OF RECEIVABLES/MERCHANT FUNCTION CHARGE

1. Background of PPL Electric's Current and Proposed Purchase of Receivables Program And Merchant Function Charge

The purchase and sale of accounts receivable is a financial transaction employed by commercial entities to avoid credit and collection activities and to take advantage of the time-value of money. In its most basic sense, accounts receivable are moneys owed for specific services rendered. In the absence of a Purchase of Receivables ("POR") program, the entity rendering the service is responsible for the costs and efforts associated with the billing and collection of the amounts owed by its customer and bears the risk that the customer will not timely remit payment and/or not pay the outstanding amount in full. Under a POR program, the entity rendering the service sells its accounts receivable to a third party and receives immediate payment for the receivables less an agreed upon discount to reflect collection risk and the time value of money. A POR program therefore allows the seller of the receivable to receive payment sooner and avoid the costs and risks associated with collecting any delinquent amounts owed by the customer.

In 2009, as part of the settlement of the Company's Default Service Plan for the Period January 1, 2011 through May 31, 2013, PPL Electric agreed to file a voluntary POR plan as either part of its next distribution rate case or a stand-alone POR plan to become effective on January 1, 2011.[35] Thereafter, the Commission issued an order on August 11, 2009, directing PPL Electric to file a POR program to be effective on January 1, 2010.[36] Pursuant thereto, PPL Electric filed a voluntary POR program, together with a Merchant Function Charge ("MFC"), which was approved by the Commission for the period January 1, 2010 through December 31, 2010. *Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivables Program and Merchant Function Charge*, Docket No. P-2009-2129502, 279 PUR4th 539, 2009 Pa. PUC LEXIS 266 (Nov. 19, 2009). In approving the POR program, the Commission specifically held that POR programs are voluntary and the Commission is

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[35] *Petition of PPL Electric Utilities Corporation for Approval of a Default Service Program and Procurement Plan for the Period January 1, 2011 Through May 31, 2013*, Docket No. P-2008-2060309 (June 30, 2009).
[36] *PPL Electric Utilities Corporation Retail Markets*, Docket No. M-2009-2104271 (August 11, 2009).

without authority to require electric distribution companies to offer POR programs. *Id.* at *12-13.

Initially, PPL Electric's POR was approved for the period January 1, 2010 through December 31, 2010. In its 2010 base rate proceeding, PPL Electric proposed to extend its voluntary Commission-approved POR program beyond its expiration date of December 31, 2010. The Commission approved PPL Electric's proposal to extend the POR program, with a minor modification.[37] *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (Dec. 21, 2010).

PPL Electric's current POR program applies to residential and small C&I customers. The accounts receivables purchased by PPL Electric are the moneys owed by shopping customers to the EGS for generation services. PPL Electric purchases these accounts receivable at a discount from the standard supply charges to offset the risks and expenses associated with accounts that may ultimately be uncollectible. PPL Electric St. 8, p. 26-27.

The discount rate is composed of two components: (1) an uncollectible accounts expense percentage factor, which equals the MFC; and (2) a POR development, implementation, and administration percentage factor. Given the different energy requirements, collection mechanisms available, and uncollectible accounts expense percentages, the discount rates for the residential and small C&I customers are different. PPL Electric St. 8, pp. 27-28.

In this proceeding, PPL Electric is proposing to update the discount rates for the POR and MFC. The proposed discount rate for the residential customer class is 2.23%. This discount reflects an uncollectible accounts expense percentage factor of 2.23% and a POR administrative

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[37] The Commission directed PPL Electric to adjust its POR program tariff language to allow EGSs that are participating in its POR program under PPL Electric's consolidated billing service to bill customers separately if: (1) the Electric Distribution Company's billing system cannot accommodate it; or (2) an Electric Generation Supplier's customer purchases products that are bundled with non-basic services. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *151-52 (Dec. 21, 2010).

factor of 0.00%. The proposed discount rate for the small C&I customer class is 0.23%. This discount reflects an uncollectible accounts expense percentage factor of 0.23% and a POR administrative factor of 0.00%. PPL Electric St. 8, p. 28. Dominion and Direct Energy oppose PPL Electric's proposed POR discount and its MFC percentages. For the reasons explained below, the arguments of Dominion and Direct Energy should be rejected and PPL Electric's proposed discount rate for the POR and MFC should be approved.

2. PPL Electric Properly Calculated The Proposed Purchase Of Receivables Discount and Its Merchant Function Charge Percentages.

Dominion proposes to reduce the level of PPL Electric's proposed POR discount and its MFC percentages because, according to Dominion, PPL Electric's uncollectible accounts expense is overstated. Dominion believes that this overstatement is driven by a perceived discrepancy between PPL Electric's claim in this proceeding and the information set forth in its annual report filed with the Commission for 2011. Based thereon, Dominion recommends that the POR and MFC discount rates be set at 1.62% for residential customers and 0.17% for small C&I customers based on the average write-offs for 2010 and 2011. Dominion St. 1, pp. 5-7. Similarly, Direct Energy argues that PPL Electric's proposed POR discount and MFC percentages have increased and should be reduced to encourage competition. Direct Energy St. 1, pp. 9-11. These arguments are fundamentally flawed for several reasons.

First, it must be remembered that PPL Electric's current POR Program is a voluntary program. The Commission cannot make PPL Electric offer a POR Program and EGSs are not required to participate in the Program. *Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivable Program and Merchant Function Charge*, Docket No. P-2009-2129502, 279 PUR4th 539, 2009 Pa. PUC LEXIS 266 at *12-13 (Nov. 19, 2009). Because EGSs are functioning business entities, they can make rational financial decisions to participate or not participate in PPL Electric's POR Program. If an EGS determines that the cost of participating in PPL Electric's proposed POR Program, including the applicable POR discount, is too high and does not meet the needs of its business model, the EGS can choose to retain and manage its own accounts receivable, rather than having PPL Electric purchase those accounts receivable from the EGS. PPL Electric St. 8-R, pp. 45-46.

Second, Dominion's foundational premise of a discrepancy regarding the level of PPL Electric's actual write-offs of uncollectible accounts in 2011 is simply wrong. PPL Electric's actual write-offs for 2011 were approximately $40 million, not $33 million as Dominion asserts, based on its erroneous assumption that the net annual change in the reserve for doubtful accounts is equal to the actual write-offs amount for the year. Annual activity related to PPL Electric's reserve for doubtful accounts in 2011, which follows generally accepted accounting principles ("GAAP"), starts with the beginning balance of the reserve (which is equal to the ending balance of the reserve for the prior year, 2010), or $15.9 million. To that balance, the provision for uncollectible accounts expense of $31.4 million is added. Next, the actual write-offs amount for the year of $39.7 million is subtracted. Finally, the amount of POR discount received for the year of $9.9 million is added to produce the ending balance of $17.5 million, or a net increase to the reserve of approximately $1.5 million. PPL Electric St. 8-R, p. 43.

Third, as shown on PPL Electric Ex. JMK 4, when calculating its proposed MFC and POR discount percentages in this proceeding, PPL Electric used its 2012 budget amount of uncollectible accounts expense, which is the sum of projected write-offs and the projected change in the reserve for doubtful accounts for 2012. PPL Electric St. 8-R, p. 44.

Finally, PPL Electric's proposed MFC percentages of 2.23% for the residential customer class and 0.23% for the small C&I customer class have been properly calculated based on the

Company's expected 2012 uncollectible accounts expense for those customer classes. PPL Electric St. 8-R, p. 44, PPL Electric Ex. JMK 4. For these reasons, PPL Electric properly calculated the proposed POR discount and MFC percentages

3. Dominion's and Direct Energy's Proposal To Use Late Payment Charges To Reduce The POR And MFC Percentages Should Be Rejected

Both Dominion and Direct Energy propose to use late payment charges to reduce the POR and MFC uncollectible account percentages. Dominion St. 1, pp. 6-7; Direct Energy St. 1, pp. 15-17. This proposal should be rejected.

Late payment charges are assessed to those customers who carry an overdue balance for service provided by PPL Electric. Late payment charges are imposed to offset the carrying costs of those overdue accounts receivable. Late payment charges are actually paid by customers and the revenues received from late payments are, by definition, not uncollectible. Uncollectible accounts expense is incurred when a customer does not pay his/her bills over an extended period; the service is terminated and subsequently written-off. Late payment fees are treated as an addition to a utility's revenues, not as an offset or reduction to the utility's uncollectible accounts expense. PPL Electric has used this accounting and ratemaking treatment for decades and its approach repeatedly has been approved by the Commission. PPL Electric St. 8-RJ, p. 8.

Further, late payment charges already are used to reduce PPL Electric's overall distribution revenue requirement for those customer rate classes that bear the working capital requirement associated with overdue accounts receivable. The proposal to offset late payment charges against uncollectible accounts expense in the calculation of the POR discount and MFC percentages would result in double counting of late payment revenues by crediting these revenues to customers twice. PPL Electric St. 8-R, pp. 44, 46; PPL Electric St. 8-RJ, p. 8. Such a result clearly is inappropriate.

PPL Electric further notes that if the proposal to use late payment charges to reduce the POR and MFC percentages were adopted, not all late payment fee revenue should be credited against the POR discount rate. A substantial portion of late payment fee revenue is associated with default service and, as such, should not be used to reduce the POR discount rate. Further, if this proposal were adopted, the amount of late payment revenue credited against the POR discount rate would need to be accompanied by a corresponding adjustment in PPL Electric's base rate revenues, which will increase rates for all distribution customers. PPL Electric 8-RJ, pp. 8-9.

4. Direct Energy's Proposal To Eliminate the Uncollectible Accounts Expense Percentage Factor Should be Rejected

Direct Energy proposes to rebundle the uncollectible accounts expense presently recovered through the MFC and the POR discount into a "non-bypassable" distribution charge and, thereby, set the MFC and the POR discount to zero. Direct Energy St. 1, pp. 12-15. Direct Energy's recommendation should be rejected for several reasons.

Preliminarily, it must be noted that the Commission recently considered and rejected the proposal to rebundle uncollectible accounts expense into a non-bypassable distribution charge. PPL Electric St. 8-RJ, pp. 10-11. In PPL Electric's 2010 base rate proceeding, the Retail Energy Supply Association ("RESA") recommended that the Company should eliminate the uncollectible accounts expense percentage factor from the discount rate and recover the costs associated with all generation-related uncollectible accounts expense through a non-bypassable MFC assessed on all distribution customers. The Commission expressly rejected RESA's recommendation concluding that the collection risk for shopping customers should remain with the EGSs, and that RESA's approach would require a non-residential customer on EGS dual billing to pay for collection risk twice for supply -- once in the EGS's charges which incorporate customer payment risk, and once in the non-bypassable EDC charge. *Pa. P.U.C. v. PPL Electric Utilities Cor.*, Docket Nos. R-2010- 2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *153 (Dec. 21, 2010).

PPL Electric, with express Commission approval, has unbundled the generation supply-related uncollectible accounts expense from its distribution base rates and recovers this expense through the MFC. The MFC is paid by all default service customers, and PPL Electric includes the MFC in its Price to Compare. The MFC, however, is a bypassable charge, *i.e.*, shopping customers do not pay the MFC. PPL Electric St. 8, pp. 26-27, 29-30. This construct provides EGSs with two options for dealing with the risk of collection. One option is to not participate in the POR program and reflect the risk of uncollectibles in the price they charge shopping customers. The second option is to sell the account receivable to PPL Electric at a discount and have the Company assume the costs of collection and the risk of non-collection. Accordingly, under the voluntary POR program, EGSs are provided with the competitive advantage of determining the extent of the generation-related uncollectible accounts expense that they are willing to bear.

Direct Energy proposes to eliminate the uncollectible accounts expense from the discount percentage factor, thereby increasing the amount that PPL Electric pays EGSs for their accounts receivable, eliminating all EGS collection risk, and shifting the risk of non-payment for competitive supply to all customers through a non-bypassable MFC, which would be paid by all distribution customers whether or not they shop for their energy supply. Direct Energy St. 1, pp. 12-13. Stated otherwise, Direct Energy's proposal attempts to shift the risk of non-payment for competitive supply from EGSs, and their shopping customers, to all customers. However, as explained above, the Commission clearly concluded that EGSs should bear the collection risk for their own customers, either by including it in the charges to those customers or by selling their receivables to PPL Electric at a discount. *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010- 2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *153 (Dec. 21, 2010) (holding that the collection risk for shopping customers should remain with the EGSs)

In addition to improperly reassigning risk, Direct Energy's proposal also should be rejected because it, in essence, rebundles generation-related and distribution-related uncollectible accounts expense charges through a non-bypassable MFC. Although PPL Electric acknowledges that the charges would not be rebundled as a single distribution charge as they were prior to the establishment of the current POR program and the MFC, the creation of a non-bypassable MFC that applies to shoppers and non-shoppers is, in essence, a return to the prior bundled state.

Such a result is inconsistent with the goals of the Competition Act and clear Commission policy. Section 2804(3) of the Competition Act provides as follows:

> The commission shall require the unbundling of electric utility services, tariffs and customer bills to separate the charges for generation, transmission and distribution....

66 Pa.C.S. § 2804(3). *See also Lloyd* (holding that Section 2804(3) mandates rates for services as unbundled charges for transmission, distribution and generation). Further, the Commission has encouraged EDCs to unbundle generation-related costs from distribution rates.

> While utility rates were unbundled into transmission, distribution and generation components as part of the restructuring process, there is significant concern on the part of the Commission and others that some generation costs have been improperly allocated, or "embedded," in EDC distribution rates. The Commission has not undertaken a full-fledged review of distribution rates with the goal of resolving this issue. This was in part due to the existence of rate caps and the agreements reached in the restructuring settlements. With the coming expiration of the remaining rate caps, there is now no obstacle to taking this issue up for consideration.

> Our preference is that this issue will be addressed in the next distribution rate case for each EDC. For those EDCs who have not initiated cases by the end of 2007, the Commission reserves the right to initiate a cost allocation proceeding to resolve this issue.

Default Service and Retail Electric Markets, Final Policy Statement, Docket No. M-00072009, 256 PUR 4th 341, 2007 Pa. PUC LEXIS 3 at *12-13 (May 10, 2007).

In support of its proposal to rebundle uncollectible accounts expense into a non-bypassable distribution charge, Direct Energy relies on the POR programs of other EDCs. However, the POR programs of other EDCs do not establish a statewide standard. Rather, each POR program adopted by an EDC reflects the unique circumstances of the individual EDC, including the ability of its customer information and billing systems to accommodate specific program structures. Indeed, Direct Energy relies on the POR program adopted by PECO; however, Direct Energy disregards that, unlike PPL Electric, PECO has not unbundled its uncollectible accounts expense. Further, as conceded by Direct Energy, PPL Electric's program is consistent with the POR program administered by Duquesne Light. Direct Energy St. 1, pp. 13-14; *see also Pa. P.U.C. v. Duquesne Light Co.*, Docket No. R-00061346 (Dec. 1, 2006). Finally, because POR programs are voluntary as explained above, the fact that another EDC's POR program has conditions that are different from those proposed by PPL Electric has no bearing on PPL Electric's voluntarily offered POR program.

Direct Energy's proposal to rebundle uncollectible accounts expense into a non-bypassable distribution charge, and set the MFC and the POR discount to zero, would be a significant step backward to conditions that existed prior to the end of PPL Electric's capped generation rates. If such a proposal were adopted, PPL Electric's current POR Program should be terminated, and the accounts receivable procedures, which were in place and available to all

EGSs from 1999 through 2009, should be reinstated. Under these circumstances, all parties (PPL Electric and EGSs) would be on a level playing field. PPL Electric St. 8-R, p. 16.

5. Direct Energy's Proposal To Refund All Amounts That PPL Electric Has Received Under The Administrative Component Of the POR Should Be Rejected

As an alternative, Direct Energy proposes to refund all amounts that PPL Electric has received under the "administrative" component of the POR discount percentage because, according to Direct Energy, the Company has not "incurred the incremental expenses that it anticipated." Direct Energy St. 1, pp. 18-19. Direct Energy's recommendation should be rejected for several reasons.

First, the MFC and the POR are both Section 1308 rates and cannot be retroactively changed. PPL Electric St. 8-R, p. 46. The Commonwealth Court has explained that:

> 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 or recovery, respectively, on the occasion of the utility's subsequent rate increase requests.

Philadelphia Elec. Co. v. Pa. PUC, 502 A.2d 722, 727-28 (Pa. Cmwlth. 1985); *see also Popowsky v. Pa. PUC*, 642 A.2d 648, 651 (Pa. Cmwlth. 1994) ("The rule against retroactive ratemaking prohibits a public utility commission from setting future rates to allow a utility to recoup past losses or to refund to consumers excess utility profits"). Clearly, if Direct Energy's refund proposal were adopted, such an approach could result in impermissible retroactive ratemaking.

Second, if Direct Energy's proposal were approved, EGSs could possibly be required to retroactively pay for administrative costs that were higher than projected. Undoubtedly, EGSs, including Direct Energy, would oppose such a result.

Finally, this is not a situation where PPL Electric did not incur a cost. As indicated in PPL Electric Ex. JMK 8, PPL Electric has incurred incremental expenses with its POR program, including costs related to personnel from PPL Services' Information Services and Financial departments. PPL Electric St. 8-RJ, p. 11. However, the Company, to date, has not performed the necessary analysis to track this cost. PPL Electric did indicate that it will be monitoring its POR Program administrative costs on a going-forward basis using the results of a formal tracking mechanism that was implemented in April 2012. PPL Electric St. 8-R, p. 47. For these reasons, Direct Energy's proposal should be rejected.

B. UNIVERSAL SERVICE

OCA has made recommendations concerning PPL Electric's Universal Service Programs. They include: (1) PPL Electric should direct a portion of its customer education funding toward local housing authorities, as one mechanism for reaching low-income tenants, (2) PPL Electric should resolve the process for integrating LIHEAP benefits with the customer assistance program benefits as set forth in the draft LIHEAP state plan and report on whether PPL Electric intends to adopt that new proposal should the final State Plan include the same resolution, (3) PPL Electric should target additional customer assistance program outreach to payment-troubled, low-income customers and (4) PPL Electric "should confirm that ratepayers will not be charged the costs of forgoing charging CAP accounts the $8 "CAP Plus" amount when the account has LIHEAP balance sufficient to completely pay the CAP bill as prescribed in the settlement of the *Koons* proceeding." OCA St. 4, p. 4. As explained below, PPL Electric concurs with some of these recommendations, concurs in part with other recommendations and disagrees with certain recommendations.

OCA's recommendation that PPL Electric direct a portion of its consumer education funding to local housing authorities has merit. As part of its consumer education plan, PPL

Electric has already offered seminars and "webinars" to targeted populations such as school districts and municipalities to raise awareness about energy efficiency conservation, as well as opportunities via customer choice to reduce energy bills. Local housing authorities could also benefit from similar information regarding how their buildings use energy, how they can evaluate energy performance and opportunities to lower their energy bills through conservation or shopping. Nevertheless, current efforts should not be supplanted to refocus the entire consumer education plan to local housing authorities. PPL Electric, however, will commit to incorporating into its consumer education plan a program for local housing authority administrators along the lines of what we had previously provided to school districts and municipalities. This effort will further the objectives of the plan while allowing the Company to continue to reach all customer segments. PPL Electric St. 6-R, pp. 14-15.

Regarding OCA's recommendation that PPL Electric consider integrating LIHEAP benefits with customer assistance program benefits consistent with the draft LIHEAP State Plan, PPL Electric agrees that this proposed change in the LIHEAP State Plan is a positive development. Under the draft LIHEAP State Plan, PPL Electric and other utilities would not be required to apply LIHEAP grants only to "asked for" amounts on bills to LIHEAP customers. Instead, PPL Electric would be permitted to apply LIHEAP grants to customer assistance program credits and stop the CAP Plus program. If practical, PPL Electric would like to implement these changes by November 1, 2012, which is the start of LIHEAP for fiscal year 2013. Nevertheless, it may be difficult for PPL Electric to meet this deadline. PPL Electric St. 9-R, pp. 9-10.

Specific difficulties arise under Section 601.45 of the LIHEAP State Plan, which indicates that "Public utilities that operate CAPS based on a Percent of Income Payment Plan

("PIPP") may apply the LIHEAP cash component benefits to the customer's PA CAP credit ...." To provide payment flexibility to meet customers' needs, however, PPL Electric's CAP offers five different payment options, including percent of bill, percent of income, annualized average payment, minimum payment and agency selected. PPL Electric's computer system automatically calculates the first four payment options for the OnTrack caseworkers who enroll customers and establish the payment agreements. PPL Electric's concern is that, if Department of Public Welfare's ("DPW") were to interpret Section 601.45 to apply only to a PIPP, then it is unlikely that PPL Electric would implement this provision because only 18 percent of its current CAP participants are on a PIPP. Applying the new draft LIHEAP State Plan provision to PIPP customers only would require significant manual work by OnTrack case workers, who would have to individually cancel tens of thousands of existing CAP payment agreements and create new percent of income payment agreements. PPL Electric St. 9-R, pp. 9-10.

Even more importantly, PIPP may not match a customer's ability to pay which could result in thousands of defaults from CAP. In addition, the process changes in communications requirements for internal and external audiences would be considerable. This type of drastic move would likely result in more telephone calls to PPL Electric's customer contact center, more complaints filed with the Commission, more work for OnTrack administrative agencies and more dissatisfied customers. For these reasons, shifting all OnTrack participants to a PIPP would be impractical and costly. PPL Electric St. 9-R, p. 10.

Nor is it advisable for PPL Electric to implement a "split" CAP whereby it would have to identify and treat customers separately based on their payment option. For OnTrack customers on a PIPP, PPL Electric would apply LIHEAP cash grants to CAP credits. For all other payment options, PPL Electric would not. This "split" CAP approach would present numerous practical implementation concerns regarding computer programming, processing changes, training and internal and external communications. It would probably result in confusion for customers and CAP agencies alike. PPL Electric St. 9-R, p. 10.

Further, if Section 601.45 were to apply only to PIPPs, then PPL Electric would have to maintain CAP Plus for the other four payment options. Again, this complication would create numerous concerns and issues regarding computer programming, implementation processes, communications, *etc.* PPL Electric St. 9-R, p. 11.

In addition, certain regulatory issues must be addressed and resolved before the draft State Plan could be implemented. Presently it is uncertain whether PPL Electric would have to file a petition to modify its three-year universal service plan and its tariff, and it is uncertain whether the Commission is planning to issue guidance to utilities regarding CAP and the implementation of Section 601.45. In addition, PPL Electric would have to explore the implications of the *Koons* settlement at Docket No. M-2010-2179796, if the Commission were to require utilities to file petitions to modify their three-year plans to accommodate the implementation of Section 601.45. PPL Electric St. 9-R, p. 11.

Moreover, if a petition to modify the three-year universal service plan were required, other stakeholders may file complaints that could lead to formal hearings and substantial delays while the Commission adjudicates the complaints. PPL Electric St. 9-R, p. 11. There is also the practical concern regarding computer programming and testing necessary to implement Section 601.45.

For these reasons, PPL Electric is reluctant to move forward with the necessary programming enhancements and process changes to implement the draft State Plan without timely direction and clarification from DPW and the Commission. PPL Electric St. 9-R, pp. 11-

12. If PPL Electric does not receive timely direction and guidance from DPW and the Commission or DPW confirms that Section 601.45 only applies to PIPP, PPL Electric will continue to implement OnTrack as described in its 2011 – 2013 Universal Service & Energy Conservation Plan, including the continuation of CAP Plus. PPL Electric St. 9-R, p. 12.

In conjunction with its recommendations regarding the draft State Plan and the "Cap Plus" program, OCA also recommends that PPL Electric evaluate the impact of applying LIHEAP cash grants to CAP credits if DPW retains the methodology proposed in the draft State Plan. PPL Electric notes initially that such evaluation may be unnecessary if any of the circumstances explained above, under which PPL Electric would not implement Section 601.45 prevail, materialize. Under such circumstances, Section 601.45 of the proposed LIHEAP State Plan would have no effect. If DPW indicates, however, that Section 601.45 applies to all CAP payment agreement types, then PPL Electric will conduct such an evaluation in order to determine whether an increase in residential rates and the customer charge causes more OnTrack customers to exceed their annual limit of CAP credits. PPL Electric St. 9-R, pp. 12-14.

OCA next recommends that PPL Electric engage in greater outreach efforts for payment-troubled, low-income customers. OCA attempts to justify this recommendation by observing that PPL Electric's enrollment rate for its CAP is the lowest of any major electric utility in Pennsylvania. PPL Electric St. 9-R, p. 14. PPL Electric does not believe that it should engage in further outreach to enroll payment-troubled low-income customers into its CAP. PPL Electric also believes its CAP enrollment rate is not relevant in this context.

Initially, it must be noted that the Commission has not adopted any enrollment goal requirement for CAP, and PPL Electric has no such requirement in its current three-year universal service plan. The absence of such an enrollment goal is consistent with the

Commission's Final Order in *Customer Assistance Program: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051923 (Dec. 18, 2006). There, the Commission eliminated enrollment ceilings to ensure that CAPS are available under the Competition Act.

Further, 52 Pa. Code Section 69.264 of the Commission's CAP Policy Statement provides that CAPs should target low-income, payment-troubled customers. Some Pennsylvania utilities automatically enroll low-income customers, regardless of whether they are payment-troubled. PPL Electric has chosen a different path in order to target its most vulnerable customers and to control costs for the residential customers who fund PPL Electric's CAP through the Universal Service Rider. It is not necessary to enroll all low-income customers in the CAP because some confirmed low-income customers do not need the assistance. Such customers may face short-term circumstances that require assistance through LIHEAP, CARES, Operation HELP or a short-term payment plan, rather than enrollment in CAP. PPL Electric St. 9-R, pp. 14-15. Comparisons of PPL Electric's CAP enrollment level with those of other Pennsylvania EDCs are not meaningful.

OCA also criticizes the low level of participation in PPL Electric's CAP by stating that the CAP is limited to customers who are confronting termination of service. OCA St. 4-SR, p. 6. OCA's statement is not correct. To the contrary, PPL Electric's CAP is directed toward low-income, payment-troubled customers. The latter category includes all customers who have past due accounts and all customers who have broken payment arrangements as well as customers who have received termination notices. PPL Electric does not restrict, and has not restricted participation in its CAP to customers who have received termination notices. PPL Electric St. 9-RJ, p. 4.

It should be noted also that PPL Electric has taken substantial steps, already, to improve referrals to its CAP. Prior to 2009, PPL Electric's Customer Service Representatives made all referrals to its CAP. Such referrals were made when establishing payment arrangements with residential customers. Through these efforts, customer service representatives made approximately 50,000 referrals to the CAP annually. In 2009, PPL Electric automated the referral process. As customer service representatives took household income information while establishing payment agreements, the computer system would automatically determine if customers were income eligible for the CAP. If so, the computer system would automatically send customer referral letters and simultaneously issue electronic work orders to appropriate CAP agencies for follow up. Through this enhanced process, PPL Electric more than doubled the number of referrals to OnTrack to approximately 9,400 per month, or almost 113,000 annually. As a result of these efforts, OnTrack enrollment has increased by 52.3 percent from 23,305 customers as of December 31, 2008 to 35,491 customers as of June 30, 2012. Due to this increased enrollment, as well as other factors, annual expenditures for PPL Electric's CAP have risen from about $24 million in 2008 to more than $53 million in 2011, an increase of 120 percent. PPL Electric St. 9-R, pp. 15-16.

Given that PPL Electric's CAP is limited to low-income, payment-troubled customers, it does not appear to be necessary or appropriate to conduct broad-based outreach efforts to promote the program. Almost all residential customers who have received various Chapter 56 collection notices or have had their service terminated call PPL Electric to make payments or to set up payment agreements. They may also call to discuss reconnection of service. In all such circumstances, PPL Electric informs the customers of the availability of the CAP. PPL Electric St. 9-R, p. 17.

An overwhelming majority of residential customers with past due accounts do call the Company. As of June 30, 2012, PPL Electric 226,847 overdue residential accounts. PPL Electric has household income data on 159,328 or 70.2 percent of the total number of overdue accounts. Because the primary manner in which PPL Electric obtains household income information is from direct discussions with customers regarding payment arrangements, clearly approximately 70.2 percent of PPL Electric's residential customers with past due accounts call PPL Electric's Customer Service Representatives. PPL Electric St. 9-RJ, pp. 2-3.

The percentage is even higher for confirmed low-income residential customers. As of June 30, 2012, 85,718 residential accounts had balances that had been overdue for at least 120 days. For these accounts, PPL Electric has household income information for 74,658 accounts or 87.1 percent of the total. Again, the primary method of obtaining household income information is direct discussions between customers and customer service representatives. Of these 74,658 customers, 58,546, or 78.4 percent have household incomes at or below 150 percent of the federal poverty level. Clearly, PPL Electric's collection of household income information from payment-troubled, low-income customers has been successful. PPL Electric St. 9-RJ, pp. 2-3.

Further outreach to low-income, payment-troubled customers is unnecessary for the additional reason that PPL Electric conducts outreach activities for its CAP. PPL Electric provides information to social service agencies and community organizations regarding programs and services for low-income customers. PPL Electric also participates in community forums and workshops to inform the public of the availability of its CAP. Information is also provided on PPL Electric's website about its CAP and other assistance programs. PPL Electric attempts to draw customers attention to this information with a red "HELP" button. PPL Electric also includes information about its CAP when contractors disseminate energy education packets during WRAP site visits. PPL Electric St. 9-R, pp. 18-19.

PPL Electric is also concerned about the impact of a substantial increase in CAP enrollment on other residential customers who pay the Universal Service Charge. As explained previously, PPL Electric has household income information on 74,658 residential accounts that have accounts more than 120 days past due. Of this total, 58,546 have household incomes at or below 150 percent of the federal poverty level which is the income criteria for participation in PPL Electric's CAP. Stated otherwise, nearly 80 percent of residential customers with accounts more than 120 days past due have incomes that qualify them for the CAP. If PPL Electric were successful in enrolling even 20 percent of this pool of customers into its CAP, the annual costs for the CAP would increase by $16.7 million (58,500 customers x 20 percent x $1,424, the annual cost of CAP per customer). PPL Electric would recover these additional costs from residential customers through the Universal Service Rider. PPL Electric St. 9-R, pp. 19-20; PPL Electric St. 9-RJ, p. 3.

OCA made three specific proposals for increased outreach for PPL Electric's CAP: (1) the Company should engage in a direct-contact outreach program aimed at customers who are confirmed low-income and are 120 or more days in arrears; (2) for confirmed low-income customers who receive termination notices, PPL Electric should modify its notice to include information about the availability of CAP and means of accessing the program; and (3) PPL Electric should engage in direct-contact outreach programs focused on 120 or more days in arrears regardless of whether they are confirmed low-income customers.

PPL Electric opposes OCA's first recommendation for four principal reasons. First, because customers must be payment-troubled in order to participate in the CAP, OCA has presented no compelling reason why additional outreach is required. As explained above, over the past three years, PPL Electric has doubled the number of referrals annually to CAP and has increased enrollment by more than 50 percent. Second, because only payment-troubled customers may enroll in PPL Electric's CAP, and other EDCs in Pennsylvania do not have such a requirement, PPL Electric's lower percentage of low-income customers enrolled does not provide meaningful proof that low-income, payment-troubled customers are not aware of the program. OCA seems to assume that there is some "awareness gap," but there is no evidence of any such problem. Third, because customers move in and out of 120 day overdue status, PPL Electric is concerned that certain customers could miss any type of targeted communications, if they were not 120 days in arrears when the communications were disseminated. Instead, it is preferable to have communications regarding the availability of the CAP incorporated into existing collection processes so that all customers in the same overdue category receive the same information and have the same opportunity to act. Fourth, providing additional CAP outreach may create confusion for some customers regarding the terms of their current payment arrangement or actions required with collection notices they have received. PPL Electric does not wish to create confusion which would put customers at risk of termination if they confuse outreach information with requirements to avoid termination. PPL Electric St. 9-R, pp. 21-22.

PPL Electric is willing to accept OCA's second recommendation, with certain caveats. First, PPL Electric is willing to include information with the termination notice as long as the inclusion of the additional information does not add another page to the termination notice. Adding another page to the termination notice would increase costs, a result PPL Electric wishes to avoid. PPL Electric is willing to propose the additional content for its termination notices and to review the revised termination notice with the Commission staff, the OCA and other interested parties in this proceeding. Second, PPL Electric should not be required to use two separate forms of termination notices for residential customers, one for confirmed low-income customers and one for other customers who are overdue but not confirmed low-income. Identifying low-income customers and sending them a special termination notice would require computer programming, process changes and communications to educate customer service representatives regarding the differences in the forms and their proper use. To simplify matters, PPL Electric would include the additional CAP language in all residential termination notices. The result would be a streamed-lined implementation avoidance of programming costs, reductions of impacts on collections processes, elimination of procedural changes and mitigation of possible confusion. Use of one form of termination notice also makes sense as a practical matter since most residential customers receiving termination notices are low income. PPL Electric St. 9-R, pp. 22-23.

PPL Electric opposes OCA's third recommendation for CAP outreach. It is not necessary for PPL Electric to engage in a direct-contact outreach program focused on customers 120 or more days in arrears, regardless of whether they are confirmed low-income customers. As explained previously, most residential customers with overdue balances or terminated accounts call PPL Electric regarding address their concerns. Therefore, there is no need for a direct-contact campaign for all residential customers 120 or more days is arrears. In addition, such an outreach program could cause customer confusion between the eligibility for the CAP and requirements needed to avoid termination. PPL Electric does not wish to create confusion which could result in unnecessary customer terminations. PPL Electric St. 9-R, pp 23-24.

It should be emphasized also that PPL Electric does not ignore residential customers with arrearages of 120 days or more. PPL Electric has implemented enhanced collection efforts for these accounts. In 2012, PPL Electric refined its risk ranking system for collections to include more than 50 behavioral attributes and the age of the overdue money is a key factor. Customers with accounts more than 120 days overdue progress along the collection path without delay. Further, customers with a higher risk score receive collection priority including terminations of service, compared with customers who have a lower risk score. All these activities encourage customers to contact PPL Electric regarding their past due balances which gives PPL Electric the opportunity to refer them to universal service programs, including CAP.

OCA's final recommendation is that PPL Electric confirm that the Universal Service Rider will not provide for recovery of the $8 that the Company excludes when OnTrack CAP customers have credit balances due to LIHEAP grants and confirm that distribution rates will not provide for recovery of the $8 that the Company excludes when CAP customers have a credit balance due to LIHEAP cash grants. In response to this request, PPL Electric confirms that it currently does not include the $8 CAP Plus amount in its Universal Service Rider or base rates and is not proposing to recover such amounts in this proceeding. If DPW indicates, in a timely manner, that Section 601.45 applies to all payment agreement types, PPL Electric would implement this provision of the LIHEAP State Plan for fiscal year 2013 and would discontinue the CAP Plus program. This action would eliminate the need for PPL Electric to confirm its treatment of certain CAP expenses. PPL Electric St. 9-R, pp. 24-25.

OCA's recommendations should be implemented to the extent the PPL Electric has explained above. The remaining recommendations should be rejected.

C. PPL ELECTRIC'S COMPETITIVE ENHANCEMENT RIDER SHOULD BE APPROVED

PPL Electric's expenses for customer education in order to enhance a competitive retail market for electric generation supply have expanded substantially in recent years. In order to recover the costs of all the customer education programs, PPL Electric proposes to institute, effective January 1, 2013, a reconcilable Competitive Enhancement Rider ("CER"). PPL Electric is making this proposal for three principal reasons.

The Commission and the appellate courts have explained the circumstances in which an automatic adjustment clause, such as the proposed CER is appropriate. Clauses are appropriate when the expenses to be recovered through the clause are substantial, subject to variation and beyond the control of the utility. *See, e.g., Popowsky v. Pa. P.U.C.*, 869 A.2d 1144, 1159 (Pa. Cmwlth. 2005) *appeal denied*, 586 Pa. 761, 895 A.2d 552 (2006); *Pennsylvania Industrial Energy Coalition v. Pa. P.U.C.*, 653 A.2d 1336 (Pa. Cmwlth. 1995); *Pa. P.U.C. v. Newtown Artesian Water Co.*, Docket Nos. R-2009-2117550, *et al.*, 2010 Pa. PUC LEXIS 757 (Apr. 15, 2010); *Pa. P.U.C. v. Philadelphia Thermal Energy Corp.*, Docket No. R-911920, 1991 Pa. PUC LEXIS 80 (May 3, 1991). As explained below, the competitive enhancement expenses should be recovered through a clause because they are substantial, intially more than $6 million annually. They are subject to variation because they will increase and decrease depending on Commission mandates in the Retail Markets Investigation and other proceedings, and they are substantially beyond PPL Electric's control because many of the expenses are required by directives from the Commission.

PPL Electric proposes to recover, beginning in 2013, the amount of $5,482,220 for ongoing needs consistent with the Company's Consumer Education Plan. In addition, PPL Electric proposes to amortize $400,000 for the 2012 annual Retail Markets Investigation postcard over two years. Recovery should also include a two-year amortization of the amount to be spent on the Retail Markets Investigation Tri-Fold brochure anticipated to be mailed in November, 2012. In addition, PPL Electric proposes to recover all future amounts including but not limited to amounts related to the Retail Markets Investigation EDC letter and amounts that may arise from programs included in PPL Electric's default service program that are subject to separate and explicit approval. All of the expenses complying with mandates of the Commission, including the Retail Markets Investigation, should be recovered by PPL Electric because they are not currently reflected in rates. PPL Electric St. 5-R, pp. 29-30.

It is time for the Commission to approve the CER for PPL Electric, which will enable PPL Electric to adopt a more flexible approach that can be adjusted from time-to-time should the need for consumer education, programs and spending levels change in the future. A reconcilable rider was not required for the period from 2008 through 2012 because PPL Electric's Consumer Education Plan had been specifically approved by the Commission and resulted in a level annual cost that could easily be recovered through base rates. That situation, however, will not persist into the future.

Because many of the costs that will be recovered through the CER are Commission-mandated, they are beyond PPL Electric's control Several costs arise from the Retail Markets Investigation, such as the mailing of information educating consumers on the process for obtaining and potential benefits from competitive retail supply, are a form of consumer education. Because the mandates under the Retail Markets Investigation and Consumer Education Plan will change as the Commission progresses through the Retail Markets Investigation, PPL Electric cannot avoid such costs. Having the CER will benefit both PPL Electric and ratepayers because it will permit timely and precise recovery of competitive enhancement costs. PPL Electric St. 5, pp. 37-38.

PPL Electric also notes that other EDCs are employing Commission-approved rider mechanisms to recover costs incurred in response to the Commission's Retail Markets

Investigation. No party to this proceeding has contended that the expenses to be recovered under the CER are not the type for which a clause is appropriate.

Certain parties have expressed concerns regarding the CER. OCA and OSBA express concern that use of a separate rider to recover consumer education costs could result in double recovery of costs. OCA St. 3, pp. 50-51; OSBA St. 1, p. 19. OCA recommends also that costs undertaken in response to the Commission's Retail Markets Investigation, other than those related to Commission-approved consumer education mailings, not be recovered through the CER. OCA also makes certain recommendations concerning the design and implementation of the Rider. OSBA also recommended that customer education costs should be allocated on the basis of cost causation.

OCA's and OSBA's concern, that use of a separate rider for customer education costs might result in double recovery, is misplaced. To the contrary, use of a specific rider is the best way to eliminate the possibility of any double recovery. Use of a separate rider, through which **all** consumer education expenses are recovered, and having no customer education expenses recovered through base rates, would assure that all costs are recovered only once. The possibility of double recovery under a separate rider would be further reduced by the fact that PPL Electric's customer education expenses would be reviewed annually in reconciliation proceedings, and expenses and revenue for recovery of such expenses would be trued up annually to make sure that actual expenses are recovered on a dollar for dollar basis. PPL Electric St. 5-R, pp. 34-35.

OCA contends also that the cost of competitive enhancement should be recovered from EGSs and not through the CER. OCA St. 3, p. 50. PPL Electric believes that some costs associated with the enhancement of retail markets should be recovered from EGSs, and PPL

Electric has made such a proposal in its pending Default Service Procurement Plan. The outcome of that proceeding, however, is unknown at this time. More importantly, however, is that, regardless of how that issue is decided, PPL Electric should be able to fully and timely recover the costs that it is directed to incur. Of course, to the extent that PPL Electric recovers such costs from EGSs, they would not be recovered through the CER.

OCA contends also that the purposes of the programs whose expenses are recovered through the CER should be limited to those identified by the Commission in its Final Order in *Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957, pp. 6-7 (May 17, 2007). Such safeguards, however, would be unnecessary and unduly restrictive. Such safeguards are unnecessary because PPL Electric submits its consumer education programs to the Commission's Office of Communications and the OCA for review and input. For each program, PPL Electric specifically identifies, among other things, which of the eight specific Energy Education Standards are met by the program. Therefore, both the Commission and the OCA have ongoing review of all of PPL Electric's customer education programs. PPL Electric St. 6-R, p. 9. PPL Electric expects this review process to continue into the future. PPL Electric St. 5-R, p. 33.

OCA's recommendation is too restrictive because it could be used to preclude inclusion of non-capital expenditures arising from the Commission's Retail Markets Investigation for which the Company has no alternative recovery mechanism. Therefore, the Retail Markets Investigation and the review processes associated with that proceeding provide appropriate safeguards regarding expenditures mandated in that proceeding. PPL Electric St. 5-R, pp. 32-33.

OSBA raises a concern that the CER, if approved, should be directly assigned to rate classes to which costs can be attributed and that costs that are not specifically associated with a specific rate class be allocated using a reasonable cost-based allocation factor. OSBA St. 1, p. 20. OSBA's concerns are not well founded.

PPL Electric always develops revenue allocations and rate designs taking into consideration costs causation factors. Nevertheless, PPL Electric also takes into account other factors. For the CER, PPL Electric believes that it is not necessary to expend substantial resources to develop a more precise allocation for two principal reasons. First, the costs of PPL Electric's Consumer Education Plan are general in nature and benefit all rate classes. Therefore, allocating such costs equally among all of PPL Electric's customers is consistent with the concept that each account benefits from such programs. PPL Electric St. 5-R, p. 31.

Second, certain costs, especially those arising from the Retail Markets Investigation, relate to programs for which only specific rate classes are eligible. Such costs might be more appropriately directly assigned to specific rate classes. Such costs include the customer referral mailing, standard offer referral program and retail opt-in auction. In all of these instances, however, PPL Electric has proposed that costs be recovered from participating EGSs. Therefore, these costs that could be directly assigned to specific classes may not be recovered through the CER at all. PPL Electric St. 5-R, pp. 31-32.

OCA contends also that the CER should be redesigned to recover costs on an energy or per kWh basis instead of on a customer basis. OCA St. 3, p. 51. PPL Electric, however, believes that customer education costs should be recovered through the CER on a per customer basis. This approach is consistent with the idea that each account benefits from such programs, and therefore, each account should bear a similar portion of the costs. PPL Electric St. 5-R, p. 31.

PPL Electric's proposed Competitive Enhancement Rider should be approved as filed.

X. CONCLUSION

For all the foregoing reasons, PPL Electric Utilities Corporation respectfully requests that Administrative Law Judge Colwell and the Pennsylvania Public Utility Commission approve the rate increase and other proposals set forth in Supplement No. 118 to Tariff-Electric Pa. P.U.C. No. 201.

Respectfully submitted,

David B. MacGregor (ID # 28804)
Post & Schell, P.C.
Four Penn Center
1600 John F. Kennedy Boulevard
Philadelphia, PA 19103-2808
Phone: 215-587-1197
Fax: 215-320-4879
E-mail: dmacgregor@postschell.com

Paul E. Russell (ID # 21643)
Associate General Counsel
PPL Services Corporation
Office of General Counsel
Two North Ninth Street
Allentown, PA 18106
Phone: 610-774-4254
Fax: 610-774-6726
E-mail: perussell@pplweb.com

Michael W. Gang (ID # 25670)
John H. Isom (ID # 16569)
Christopher T. Wright (ID # 203412)
Post & Schell, P.C.
17 North Second Street
12th Floor
Harrisburg, PA 17101-1601
Phone: 717-731-1970
Fax: 717-731-1985
E-mail: mgang@postschell.com
E-mail: jisom@postschell.com
E-mail: cwright@postschell.com

Of Counsel:

Post & Schell, P.C.

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Attorneys for PPL Electric Utilities Corporation