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

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August 29, 2012

Secretary Rosemary Chiavetta
Pennsylvania Public Utility Commission
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 please find an original of the Bureau of Investigation and Enforcement's (I&E) **Main Brief** in the above-captioned proceeding.

Copies are being served on all active parties of record as evidenced in the attached Certificate of Service. If you have any questions, please feel free to contact me at (717) 783-6155.

Sincerely,

Regina L. Matz
Prosecutor
Bureau of Investigation and Enforcement
PA Attorney I.D. #42498

Enclosure
RLM/edc

cc: Hon. Susan D. Colwell
Certificate of Service

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

MAIN BRIEF OF THE BUREAU OF INVESTIGATION AND ENFORCEMENT

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Dated: August 29, 2012

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I. INTRODUCTION

A. History of the Proceeding

On March 30, 2012, PPL Electric Utilities Corporation (PPL, "PPL Electric," or "Company") filed Supplement No. 118 to Tariff Electric - Pa. P.U.C. No. 201 ("Supplement 118"). Supplement 118 contained rates, rules, and regulations designed to increase the Company's distribution rates by approximately $104.6 million. The requested revenue increase equates to an approximate 14% increase[1] over existing distribution rates.[2] Supplement 118 proposes an effective date of January 1, 2013, and is based on a future test year ending December 31, 2012.

Pursuant to 66 Pa.C.S. § 1308(d), on May 24, 2012, the Pennsylvania Public Utility Commission ("Commission") suspended the filing by operation of law and assigned it to the Office of Administrative Law Judge (OALJ) for the development of an evidentiary record and Recommended Decision. The Bureau of Investigation and Enforcement (I&E) filed its Notice of Appearance on April 10, 2012. The case was assigned to Administrative Law Judge (ALJ) Susan D. Colwell, who conducted a prehearing conference on May 31, 2012. In addition to the Commission's Bureau of Investigation & Enforcement and the Company,

---

[1] PPL Ex. JMK-2, Cost Allocation Study, Test Year Ending December 31, 2012, Section VI, at 124, line 2 ÷ line 1 (proposed revenue increase/distribution revenues = 14.24%).

[2] Although the increase is also couched as a 2.9% total bill increase when including distribution, transmission, and generation charges, in ruling on the appeal of PPL's 2004 base rate case, Commonwealth Court found that "using the total bill as a measure masked the true overall percentage increase sought[.]" *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1015 (Pa. Cmwlth. 2006).

parties actively participating in the case also included the Office of Consumer Advocate (OCA), Office of Small Business Advocate (OSBA), the Sustainable Energy Fund (SEF), Dominion Retail ("Dominion"), Granger Energy of Honey Brook, LLC and Granger Energy of Morgantown, LLC ("Granger"), Direct Energy Services, LLC ("Direct Energy"), the PPL Industrial Customer Alliance (PPLICA), the Commission for Economic Opportunity (CEO), and Eric J. Epstein, pro se. Individual complaints were also filed by William Andrews, Dave Kenney, Roberta Kurrell, Donald Leventry, John Lucas, and Helen Schwika. The International Brotherhood of Electrical Workers Local 1600 petitioned to and was granted intervention.

Five public input hearings were held across PPL's service territory: June 18, 2012, in Scranton at 2:00 p.m. and Wilkes-Barre at 6:00 p.m.; June 20, 2012, in Bethlehem at 2:00 p.m. and Allentown at 6:00 p.m.; and June 21, 2012 at 6:00 p.m. in Harrisburg. Pursuant to the procedural schedule agreed to at the prehearing conference, the parties exchanged direct, rebuttal, surrebuttal, and rejoinder testimony. In addition to I&E Cross-Examination Exhibit Nos. 1-7, and 9-13, I&E also introduced the following statements of testimony and exhibits:

- I&E Statement No. 1, I&E Exhibit No. 1, I&E Statement No. 1-SR, and I&E Exhibit No. 1-SR, the prepared direct and surrebuttal testimony and exhibits of I&E witness Emily Sears, who addressed the Company's rate of return requests;

- I&E Statement No. 2, I&E Exhibit No. 2, I&E Statement No. 2-SR, I&E Exhibit No. 2-SR, I&E Statement No. 2-SSR, and I&E Exhibit No. 2-SSR, the prepared direct, surrebuttal, and supplemental

surrebuttal testimony and exhibits of I&E witness Dorothy Morrissey, who addressed the Company's revenue and expense requests, including cash working capital, taxes, and storm damage expenses;

- I&E Statement No. 3, I&E Exhibit No. 3, I&E Statement No. 3-SR, and I&E Exhibit No. 3-SR, the prepared direct and surrebuttal testimony and exhibits of I&E witness Jeremy Hubert, who addressed the Company's rate base and rate structure requests; and

- I&E Statement No. 4-R, the rebuttal testimony of I&E witness Amanda Gordon, who addressed the Company's customer assistance program funding.

Full evidentiary hearings were held August 6, 7, and 9, 2012, in Harrisburg. I&E files this main brief pursuant to the procedural schedule established in this case.

B. Burden of Proof

In any proceeding upon the Commission's motion involving a public utility's proposed rate or in any proceeding upon complaint involving a proposed rate increase, the burden to show that the proposed rate is just and reasonable falls squarely upon the utility.[3] Moreover, it is well-established that the utility must produce substantial evidence to satisfy its burden.[4] Substantial evidence is "that quantum of evidence which a reasonable mind might accept as adequate to support a conclusion."[5]

---

[3] 66 Pa.C.S. § 315(a); *Irwin A. Popowsky v. Pa. P.U.C.*, 674 A.2d 1149 (Pa. Cmwlth. 1996).
[4] *See Brockaway Glass v. Pa. P.U.C.*, 437 A.2d 1067 (Pa. Cmwlth. 1981); *Lower Frederick Township v. Pa. P.U.C.*, 409 A.2d 505 (Pa. Cmwlth. 1980).
[5] *Dutchland Tours, Inc. v. Pa. P.U.C.*, 337 A.2d 922, 925 (Pa. Cmwlth. 1975).

In base rate cases, the Commission has affirmed the utility's burden of proof and clearly indicated that the burden of proof never shifts to the party challenging a requested rate increase.[6] While the burden of going forward may shift, the burden of finally and convincingly establishing the justness and reasonableness of every component of a requested rate increase remains on the utility:

> [t]here is no presumption of reasonableness which attached to a utility's claim, at least none which survives the raising of credible issues regarding a utility's claim. A utility's burden is to affirmatively establish the reasonableness of its claim. It is not the burden of another party to disprove the reasonableness of a utility's claims.[7]

Thus, PPL is under the obligation to affirmatively prove the reasonableness of each element of each of its claims. Pursuant to Section 315(a) of the Public Utility Code, the burden of proof for all claims remains on the Company and the proponent of any adjustment need only go forward with sufficient evidence to support its reasonableness.[8] I&E contends PPL has failed to carry its burden of proof with respect to its proposal to increase its revenues by $104.6 million.

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[6] *See e.g. Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, 236 PUR 4th 218 (2004); *Pa. P.U.C. v. Pennsylvania-American Water Company*, 2002 Pa. PUC LEXIS 1 (January 25, 2002).
[7] *Pa. P.U.C. v. Equitable Gas Company*, 57 Pa. P.U.C. 423, 444, note 37 (1983).
[8] *Pa. P.U.C. v. West Penn Power Company*, 69 P.U.R.4th 470, 59 Pa.P.U.C. 552 (1985).

II. SUMMARY OF ARGUMENT

PPL has failed to adduce substantial credible evidence demonstrating a need for a $104.6 million revenue increase. Based upon I&E's adjustments following hearings and the creation of a full evidentiary hearing on all issues, the record evidence proves that not only is PPL entitled to no revenue increase, but also that a revenue decrease of $8.9 million is warranted. This recommendation is based upon the adjustments offered by I&E, as set forth more fully herein and summarized in Table I (Income Summary), Table II (Summary of I&E Adjustments), and Table III (Rate of Return) collectively attached hereto as Appendix "A."

As described by PPL:

> [T]his filing, in large part, is PPL Electric's response to four critical business challenges:
>
> 1. Reduced revenue resulting from lower customer usage and a stagnant economic climate;
>
> 2. The need to accelerate capital investment programs to maintain reliability and replace aging infrastructure;
>
> 3. Support for the development and expansion of the competitive retail electricity market; and
>
> 4. Major storm damage in PPL Electric's service area during 2011.[9]

I&E contends that with respect to each of these assertions, the evidence adduced in this proceeding proves that PPL's claims are substantially overstated

[9] PPL Exhibit Future 1, Summary of Measures of Value & Rate of Return, A-1 Statement of Reasons, at 1.

and, in many cases, structured to favor PPL's affiliated family of companies ultimately to the benefit of its corporate parent, PPL Corporation.

I&E fully recognizes that it is PPL Electric and not PPL Corp. that is the subject of this proceeding. However, I&E contends that PPL Corp.'s outstanding financial performance, comprising a 17.5% return to shareowners in 2011, which includes a dividend of $2.73/share that attained the high end of the company's 2011 forecast and an astounding 65 years of uninterrupted dividends, is unjustly and unreasonably dependent upon and enhanced by the "stability and security" of PPL Corp.'s rate-regulated earnings, namely, the rates paid by PPL Electric's captive ratepayers.[10] In fact, many of I&E's proposed adjustments are related directly to PPL's relations with its affiliates, with just five of these adjustments, if accepted, resulting in a $98.2 million reduction to PPL's claimed $104.6 million.[11]

PPL's requested return on equity, capital structure, and boost for management effectiveness alone support a reduction of $73 million: a reduction of $55.1 million to a more reasonably calculated cost of equity and excluding an unsupported leverage adjustment; a reduction of $15 million to a more reasonable capital structure; and a reduction of $2.9 million to eliminate management's claimed reward.

In addition to I&E's proposed adjustments to PPL's rate of return claims, which overcompensate PPL Corp. shareholders, I&E also recommends

[10] I&E Cross-Examination Exs. 5, 6, and 7; Transcript ("Tr.") at 291.
[11] Rate of Return, Incentive Compensation, Affiliate Support, Storm Expense, and Cash Working Capital related to payment to affiliate.

adjustments to four other claims that also are structured to inordinately benefit PPL's affiliates: claimed expenses related to storm damage ($18.6 million): the allocation of payment among affiliates for affiliate services ($1.1 million); the allocation among affiliates of incentive compensation expense ($4.5 million), and the calculation of cash working capital (CWC) needed for to pay for affiliate services ($1 million). If accepted, these further reduce PPL Electric's claim by an additional $25.2 million, or to $6.4 million.

PPL Electric's choice to pay its affiliate for services 40 days in advance of its contractual requirement results in a de minimis CWC adjustment (relatively speaking) of $1.1 million. However, this choice stands in stark contrast to the other PPL Electric affiliate choice demonstrated on record, namely not to seek insurance disbursements related to storm damage from its affiliate until well after the costs are incurred and disbursements payable. This, I&E submits, profoundly illustrates the PPL corporate family's unjust and unreasonable financial reliance on its rate-regulated subsidiary, PPL Electric.

I&E respectfully submits that while PPL Electric clearly is not an eleemosynary subsidiary of PPL Corp. neither should its rate-regulated earnings be an unjust and unreasonable source of earnings stability to the parent. Simultaneous to PPL Electric's testimony before regulators of the need for a $104.6 million rate increase because of the critical business challenges facing PPL Electric was PPL Corporation's exhortation to investors of PPL Corp.'s

"Excellent" business risk profile rating by S&P, 17.5% 2011 return to shareholders, and 260 uninterrupted quarters of dividends.

I&E submits that the balance to strike for ratepayers has to be somewhere in between. In this proceeding, I&E submits that the totality of its adjustments demonstrates that PPL's existing rates are already above where they need to be in order for PPL Electric to have the opportunity to earn a fair return on and of its investment while providing safe and reliable service at just and reasonable rates. For these reasons, and as more fully addressed below, I&E contends that PPL's evidence does not substantiate a revenue increase of $104.6 million; instead, based upon the evidence of record, the Commission should reduce PPL's existing revenues by $8.971 million.

III. RATE BASE

A. Fair Value

I&E has no fair value adjustment to rate base.

B. Plant in Service

I&E has no plant in service adjustment to rate base.

C. Depreciation Reserve

I&E has no plant in service adjustment to rate base.

D. Additions to Rate Base – Cash Working Capital

I&E has no additions to rate base resulting from revisions to cash working capital.

E. Deductions from Rate Base – Cash Working Capital

I&E witness Dorothy Morrissey presents I&E's adjustment to PPL's claim for cash working capital. Cash working capital is a measure of liquidity necessary to cover expenses as they are incurred and payable while recovering revenues as they are due and receivable. For ratemaking purposes, CWC is the amount of capital a utility requires to cover the lag between the dates for the payment of operating expenses and taxes and the utility's receipt of revenues from ratepayers. PPL's total CWC claim comprises four active components: Operation and Maintenance (O&M) expense, average prepayments, accrued taxes, and interest payments. The Company's total claim for CWC is $40,506,000, with the

jurisdictional portion comprising $33,069,000.[12] In her adjustment, Ms. Morrissey focuses on two of the four active CWC components: the O&M expense and the average prepayment.

1. CWC O&M Expense

The O&M Expense component of CWC is composed of the average daily future test year (FTY) O&M expense amount (i.e., the FTY total of all cash operating expenses, divided by the number of days in a year), multiplied by the average lag days between payment of O&M expenses and receipt of revenues. The Company's total CWC – O&M Expense claim is $27,499,000, of which $23,525,000 comprises the jurisdictional portion. The basis for the Company's claim is use of an average daily O&M expense claim (the total FTY cash O&M expenses of $467 million divided by 365 days in a year) and the Company's calculation of 21.5 days for the average lag in days between payment of O&M expenses and receipt of revenue.[13]

The Company's average lag in days between payment of O&M expenses and receipt of revenue is the difference between the calculated revenue lag (the average number of days between rendering service and receiving payment for the service) and the calculated expense day (the average number of days between when the expense was incurred and when payment for that expense is made).

[12] I&E St. 2 at 53. As noted in Ms. Morrissey's surrebuttal testimony, I&E St. 2-SR, at 59, the Company revised it total jurisdictional claim downward to $31.6 million. However, because of the iterative nature of CWC, references here remain to the Company's original claim, though the revised claim is used as the starting point in the I&E's final recommendation as set forth in the attached Tables.
[13] I&E St. 2 at 54.

Basically, in presenting a 21.5 calculation of average lag days for payment of O&M expenses, the Company claims that on average it pays its expenses 21.5 days in advance of receiving the related revenue.[14]

The Company computed an average revenue receipt lag of 57.1 days and an average expense payment lag of 35.6 days, to come up with its average lag of 21.5 days (the difference between 57.1 – 35.6). The average revenue lag was developed by assigning its revenues into three categories and weighting the dollars by corresponding revenue receipt days. The average expense lag was developed by evaluating four categories of expenses and weighting the associated dollars by corresponding payment days.[15]

I&E witness Morrissey disputes the Company's calculation of 21.5 days as the average lag between its payment of O&M expenses and its receipt of revenues and instead recommends an average expense payment lag of 47.5 days, which results in a value of 9.6 days (57.1 – 47.5) for the average lag in days between payment of O&M expenses and revenue. Application of this recommendation results in a jurisdictional CWC – O&M Expense allowance of $10,504,000 which is a $13,021,000 ($23,525,000 - $10,504,000) reduction to the Company's CWC claim to rate base.[16]

Ms. Morrissey's recommended reduction to the Company's CWC claim for O&M expenses is based upon her review of the Company's service agreement

[14] I&E St. 2 at 55.
[15] I&E St. 2 at 55.
[16] I&E St. 2 at 56.

with its affiliate, PPL Services Corporation, and her determination that PPL unnecessarily pays its affiliate for services it renders to PPL Electric substantially in advance of the required due date to the detriment of ratepayers.

Per PPL's service agreement with its affiliate, PPL is billed monthly and has 60 days to pay. Thus by contract, PPL has an allowable payment lag of 75 days (the midpoint of the service period of one month, or 15 days, plus the 60-day payment due date). I&E's recommended change to payment to its affiliate, when weighted with the other expense groups, results in an overall average expense lag payment of 47.5 days compared to PPL's claimed average expense payment lag of 35.6 days, and an overall average lag between the payment of O&M expenses and the receipt of revenue of 9.6 days (57.1 revenue lag days minus 47.5 expense lag days).[17]

Instead of taking advantage of the longer affiliate contractual payment term, PPL pays its affiliate's bill on the 20th of each month, a full 40 days in advance of when payment is due, resulting in a substantially shorter expense payment lag of only 35 days. PPL justifies this shorter expense lag by claiming "it does not treat its payment for its Affiliate Supports services differently than it does payments to external vendors" and that a payment for services within 30 days of service is "commercially reasonable."[18] PPL's witness Johnson also claims that its calculation of its 35-day payment lag for affiliate services is in accord with "long-

[17] I&E St. 2 at 56.
[18] PPL St. 7-R at 3.

standing practice and precedent, which consistently has been accepted by the Commission in numerous prior proceedings."[19]

Ms. Johnson admits that she has been employed by PPL electric since 2009 only, and was uninvolved in and unfamiliar with PPL's 2004, 2007, and 2010 rate cases.[20] However, even if PPL internally has previously calculated its O&M expense lag in this fashion, no prior litigated case addressed CWC generally or this O&M expense lag specifically. Therefore, neither I&E nor the Commission is precluded from review and adjustment of this specific CWC calculation based upon the evidence on this record.

Moreover, and more importantly, PPL's affiliate is different from its external vendors. What is "commercially reasonable" between unaffiliated vendors may not be reasonable as between affiliates particularly when, as is the case here, such payment terms can be manipulated to favor the common parent shareholders at the expense of the rate-regulated entity's captive ratepayers.

PPL *chooses* to pay its affiliate in 20 days when in fact it has 60 days to pay. In so doing, this unnecessary early payment creates an approximate $1 million additional rate revenue request through the CWC.[21] PPL should be compelled to minimize rate impacts on customers by taking advantage of opportunities to decrease expenses whenever possible. The Company's *choice* to pay its affiliate 40 days in advance of when payment is required is one of those

[19] PPL St. 7-R at 3.
[20] Tr. at 177-78.
[21] I&E St. 2-SR at 62.

opportunities. Rate-regulated entities with captive ratepayer customer bases and commercial transactions with unregulated affiliates should be required to seize all opportunities to reduce expenses, especially those of the magnitude of $1 million annually, and not rely on what may be "commercially reasonable" among unaffiliated interests in the non-regulated competitive market.

Unnecessarily paying its affiliate's bills in advance not only causes an increased ratepayer expense, it also enriches its shareholders by providing an affiliate early access to funds. PPL's ratepayers should not be required to pay for affiliate services more than a month in advance when a substantially longer payment term is codified in the affiliate contract presumably approved by the Commission under Chapter 21 of the Public Utility Code.[22] Ms. Morrissey's adjustment does nothing more than align the timing of PPL's payment to the terms of its affiliate service agreement, thereby removing an unnecessary early payment and minimizing the cost to ratepayers by fully utilizing the holding period of cash authorized in the affiliate service agreement. As Ms. Morrissey stated, "[r]atepayers should not bear costs associated with CWC increases that result from unnecessary and disadvantageous early payment."[23] I&E's $13,021,000 O&M Expense reduction to the Company's CWC component of the Company's claimed rate base should be accepted.

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[22] 66 Pa. C.S. §§ 2101-2107 (Relations with Affiliated Interests).
[23] I&E St. 2 at 57.

2. CWC – Prepayments

Prepayments are payments for and in advance of the receipt of actual goods or services rendered. The Company's CWC claim in rate base due to prepayments is $3,174,000, based on its claimed 13-month average account balance for prepaid insurance premiums, PUC assessments, postage, and other expenses.[24]

I&E witness Morrissey recommends removal of the Company's claimed PUC Assessments from the prepayments component of its CWC claim. The removal of PUC Assessments from prepayments results in an allowable working capital prepayment amount of $394,000, which is a reduction of $2,780,000 ($3,174,000 - $394,000) to the Company's working capital prepayment claim. This computation simply eliminates the claimed monthly average PUC Assessment total from the Company's CWC prepayment amount.

The basis for I&E witness Morrissey's adjustment is that the PUC Assessment is not a prepayment. PPL's PUC Assessment is calculated as a proportion of PUC, OCA, and OSBA services that have been provided to PPL's utility type (electric) in the prior year.[25] It is billed as a percentage assessed on PPL's prior calendar year jurisdictional revenue, and payable to the PUC, OCA, and OSBA in the subsequent calendar year. Unlike a prepayment that may be refunded if the services are no longer required, the PUC Assessment is not subject to refund.

[24] I&E St. 2 at 57.

[25] The Commission, the OCA, and the OSBA are all funded through PUC Assessments.

For ratemaking purposes, the assessment is more akin to a tax and, accordingly, should be treated as an expense with an associated lag. The billed expense (assessment) should be matched against the revenue generation time period on which the expense was based, namely, the prior year's jurisdictional revenue. Although funding the PUC's, OCA's, and OSBA's budgets for the following fiscal years, it is not a prepayment for the next year. Rather, it is a regulatory expense intended to fund the cost of administration of the Public Utility Code for that fiscal year.

The fact that the expense is calculated based upon the percentage of prior year's revenues determined to have been directly allocated to regulation of each particular utility sector does not render the regulatory expense a prepayment. It is more comparable to a tax on the prior year's earnings designed to fund the following year's regulatory activities[26] just as an individual's personal income tax is determined and paid after the fact based upon the prior year's earned revenues. By statutory design, the allocation is determined based upon the prior year's experienced revenues and regulated activities, the utility's "actual experience" as stated by PPL witness Johnson,[27] and then allocated to the PUC, OCA, and OSBA budgets for the following fiscal year. When these regulatory agencies *spend* the assessment is irrelevant and does not convert the expense to a prepayment.

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[26] I&E St. 2 at 58.
[27] PPL St. 7-R at 4.

3. Miscellaneous CWC Comments

Of the four comments presented in I&E witness Morrissey's direct testimony, only one requires further attention at this time – the Company's reflection of the same expense, namely postage, in more than one CWC component. As stated above, CWC comprises four components: O&M expense, average prepayments, accrued taxes, and interest payments. PPL has presented a CWC expense related to postage as both an O&M expense and a prepayment.[28] Including the same expenditure as both an O&M expense and a prepayment overstates that expenditure for CWC purposes.

In response, the Company attempts to explain how its manner of using a postage meter qualifies the expenditure for postage as both an O&M expense and a prepayment component to its CWC calculation and concludes "there is no double-recovery of a return on prepaid postage."[29]

Ms. Morrissey does not allege a double recovery. Ms. Morrissey states that including the same CWC need for postage in both the O&M expense component and the prepayment component of the CWC calculation improperly inflates the CWC calculation. The Company not only includes a full 12-month expense dollar amount claim for postage in its total CWC O&M expense, but also includes a 12-month average prepayment dollar amount for postage in the Prepayment CWC component. This overstates the actual CWC requirement for postage because the

[28] I&E St. 2 at 60.
[29] PPL St. 7-R at 6-7.

collective inclusion of postage dollars in two different CWC components results in a funding claim greater than what is actually incurred on an annual basis. While not making a specific adjustment for this issue, the Company should be ordered to discontinue this practice in future proceedings as an improper CWC calculation that overstates its CWC needs.[30]

F. Conclusion

Based upon the foregoing, I&E recommends a $15,801,000 deduction from PPL's claimed rate base. This deduction to rate base reflects I&E's disallowance of $13,021,000 as a result of I&E's cash working capital expense adjustment to O&M to accurately reflect the contractual payment term between PPL and its service affiliate and a disallowance of $2,780,000 as a result of I&E's removal of PUC assessments as a CWC prepayment. In both instances PPL has claimed revenues in excess of those necessary to compensate it for a reasonable cash working capital allowance.

IV. REVENUES

A. Miscellaneous Revenues

The Company's FTY includes a claim for miscellaneous revenues. These revenues result from miscellaneous services provided by the Company and billed to customers, including changing services, connecting or disconnecting services,

[30] I&E St. 2-SR at 66.

and testing meters at a customer's request. The Company claims the same $425,000 for miscellaneous revenues at both present and proposed rates.

As part of its FTY claim, however, the Company proposes to double its charges for reconnection during normal business hours, from $15.00 to $30.00, and to more than double those charges during non-business hours, from $21.00 to $50.00. Accordingly, I&E witness Hubert recommends that miscellaneous revenues in the FTY under proposed rates be increased by $355,000, to $780.000, to account for the proposed rate increases in reconnection fees.[31]

Although questioning the level of recoveries the Company may experience, PPL witness Krall accepted Mr. Hubert's "recommended revenue adjustment of $355,000 with the knowledge that actual payment experience will be reflected in the Company's next base rate filing."[32] Accordingly, this no longer remains an issue in this proceeding.

V. EXPENSES

A utility is entitled to recover all of its reasonably incurred expenses.[33] Operating and maintenance expenses, if properly incurred, are allowed as part of the overall rate computation. As such, a public utility is entitled to recover all reasonable and normal operating and maintenance expenses incurred by providing

[31] I&E St. 3 at 18-20.
[32] PPL St. 5-R at 20
[33] *UGI Corp. v. Pa. P.U.C.*, 410 A.2d 923, 932 (Pa. Cmwlth. 1980).

regulated service.[34] To the extent that expenses are not incurred, imprudently incurred, or abnormally overstated during the test year, they should be disallowed and found not recoverable through rates. The public utility requesting a rate increase has the burden of showing that the rate requested is just and reasonable.[35]

A. Uncollectibles Expense

The uncollectibles expense percentage represents the percent of billed revenues that are not collected because of customers' default on payment. In this filing, PPL claims an uncollectible expense rate of 2.23% based upon its reserve for bad debts pertaining to the residential class (since the majority of the $104.6 million rate increase is allocated to the residential class).[36]

I&E recommends an uncollectible expense allowance of $1,779,000, which represents a reduction of $554,000 from the Company's claim.[37] This recommendation is based upon I&E's calculation of an uncollectible expense rate of 1.70%. I&E witness Morrissey calculated the 1.70% using the Company's most recently experienced multi-year actual residential write-off amounts compared to its recent historic billed revenues. The reasonableness of Ms. Morrissey's calculation is confirmed by both the 3-year and 5-year historic averages for the Company, which yield a similar actual uncollectible rate of 1.70%. Because of her uncollectible account expense adjustment, Ms. Morrissey also recommends use of

[34] *Western Pennsylvania Water Company v. Pa. P.U.C.*, 422 A.2d 906 (Pa. Cmwlth. 1980).
[35] 66 Pa.C.S. § 315(a); *See also Cup v. Pa. P.U.C.*, 556 A.2d 470 (Pa. Cmwlth. 1989).
[36] I&E St. 2 at 4-5.
[37] I&E St. 2 at 9; Summary of Adjustments at 1.

the 1.70% uncollectible expense factor to compute the Company's Purchase of Receivables (POR) program discount rate and the associated Merchant Function Charge (MFC).[38]

PPL witness Kleha rejects I&E's proposed adjustment because, as Mr. Kleha claims, it does not reflect the Company's "total" expense, which "includes an amount for expected write-offs plus any changes in the reserve for doubtful accounts . . . subject to *potential* write-off"[39] and because he alleges that it is understated due to the "sluggish economic recovery and increasing costs of consumer goods and services," both of which will contribute substantially to customer's ability to manage their bills. Finally, Mr. Kleha claims the allowance will not be sufficient based upon PPL's level of uncollectibles experienced so far in 2012, which he asserts may, at least for 2012, exceed the Company's 2012 claim.[40] Mr. Kleha also apparently takes issue with Ms. Morrissey's use of a 3-year average, which he consistently refers to as a "simple" average,[41] and her use of "actual" costs, which Mr. Kleha claims have not been used for ratemaking purposes "for at least 35 years."[42]

I&E does not dispute the Company's use of a future test year. Mr. Kleha's suggestion, however, that actual costs have played no role in ratemaking

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[38] I&E St. 2 at 5-7.
[39] PPL St. 8-R at 32 (emphasis added).
[40] PPL St. 8-R at 33; PPL St. 8-RJ (part 1) at 3.
[41] PPL St. 8-R at 31-33.
[42] PPL St. 8-RJ (part 1) at 4.

proceedings for at least 35 years is grossly overstated. Even Mr. Kleha concedes he does not contend that actual data is irrelevant for ratemaking purposes.[43]

The Commission's filing regulations require the filing of actual data,[44] and the Company has included in its filing Exhibit Historic 1, which contains summaries of measures of value and rate of return data for the 2011 historic test year. As Ms. Morrissey states, "[u]se of a multi-year historical analysis to calculate a utility's uncollectible expense percentage takes into consideration year-to-year variability and captures this volatility for ratemaking purposes, thereby more accurately reflecting the utility's actual experience."[45] Ms. Morrissey summarizes the Company's actual net write-off uncollectible percentage of revenues over the past five years as follows:

Actual Net Write-Off Uncollectible Percent				
2007	↑ 2008	↓ 2009	↓ 2010	↑ 2011
1.57%	1.72%	1.63%	1.49%	1.97%

As demonstrated in Ms. Morrissey's table, over the past five years, four of which were during the recession that commenced in 2008 and two of which cover the post-rate cap period,[46] at no time did the Company's actual uncollectible percentage approach its present claim of 2.23%. When looked at as more than a

[43] Tr. at 169.
[44] While replete with references to actual data, the Commission's filing regulations at 52 Pa. Code §53.53, Exhibit C, General Filing Information – Electric Utilities, Part II.D.5., Income Statement Supporting Schedules, specifically requires the filing of uncollectible account amounts written off in each of the last three calendar years.
[45] I&E St. 2-SR at 3.
[46] I&E St. 2-SR at 4.

snapshot in time as PPL proposes with its 2012 claim, nothing in PPL's evidence reasonably approximates the level of write-offs the Company has experienced or will likely incur while the new rates are in effect. Even a "simple" 2-year average of the most recent data from 2010 and 2011 confirms the reasonableness of Ms. Morrissey's 1.70% calculation.[47] I&E also notes that in determining the POR administrative factor percentage in the 2010 base rate case, "[t]he ALJ also found record support for PPL's budgeted uncollectible accounts expense being based on an average of the actual bad debt write-offs for the *most recent five calendar years*."[48]

The Company has not substantiated a trend to support a FTY 2.23% uncollectible rate. The Company's claim is not supported by substantial evidence and should be rejected.

B. Rate Case Expense

The estimated costs that comprise a company's allowable claim for rate case expense are those that are prudently incurred to compile, present, and defend a request to increase base rates. These estimated costs typically include legal fees for outside counsel, outside consultants and the costs of printing, collating and postal expenses.[49] In this proceeding, PPL's total claimed rate case expense is $2,025,000 claimed over a normalization period of two years, resulting in a future

[47] I&E St. 2-SR at 4 (1.49% + 1.97% = 3.46% ÷ 2 = 1.73%).
[48] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-2010-2161694 (Order entered December 16, 2010), Slip Opinion at 27 (emphasis added) ("*PPL 2010 Base Rate Case*").
[49] I&E St. 2 at 10; *Butler Township Water Company v. Pennsylvania Public Utility Commission*, 473 A.2d 219 (Pa. Cmwlth. 1984).

test year rate case expense of $1,013,000. In addition, the Company is claiming an amortized $674,000 rate case expense for its prior 2010 base rate case proceeding. These two separate claims equal an overall total claim of $1,687,000 for the 2012 rate case expense.[50]

I&E witness Morrissey recommends an allowance of $775,000 for rate case expense, or a reduction of $932,000 from the Company's claim. Ms. Morrissey's recommendation is the result of two adjustments. First, Ms. Morrissey adjusts the Company's proposed normalization period to reflect PPL's historical filing record; second, Ms. Morrissey rejects the Company's inclusion of an amortized claim for its 2010 base rate filing, which was originally presented as a normalized claim in that 2010 proceeding.[51]

1. Normalization of Rate Case Expense

Normalization is a ratemaking concept that transforms an operating expense that recurs at irregular intervals into a "normal" annual test year expense allowance. Normalization specifically addresses the prospective recovery of an ongoing expense that recurs sporadically. Allowed normalized expenses are no different than any other O&M expense in that the company is given the opportunity to achieve full recovery, with the prospect for an over or under

[50] I&E St. 2 at 12.
[51] I&E St. 2 at 12-13.

recovery dependent upon the timing of when a company's next base rate change will become effective.[52]

The Commission consistently considers prudently incurred rate case expense as an ongoing expense, recurring at irregular intervals, subject to normalization.[53] To determine the length of normalization, the Commission considers a company's historic frequency of rate case filings, as determined by computing the average number of months between rate cases, to be an essential element in determining an appropriate normalized level of rate case expense, and not the company's intentions to file in the future.[54]

PPL provides no basis to support its 2-year normalization period for the 2012 base rate case expense claim.[55] PPL's actual historic filing frequency does not support its claim. Based upon PPL's actual filing history, Ms. Morrissey calculated a 32-month average as follows:

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[52] I&E St. 2 at 10-11.

[53] I&E St. 2 at 11; *Pa. P.U.C. v. Apollo Gas Co.*, 54 Pa. PUC 358, 373 (1980); *See also Pa. P.U.C. v. Carnegie Natural Gas Co.*, 54 Pa. PUC 381 (1980); *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, 54 Pa. PUC 401, 416-417 (1980); *Pa. P.U.C. v. Philadelphia Electric Co.*, 56 Pa. PUC 155, 176 (1982); *Pa. PUC v. West Penn Power Co.*, 73 Pa. PUC 454 (1990); *Pa. PUC v. National Fuel Gas Distribution Corp.*, 73 Pa. PUC 552 (1990).

[54] I&E St. 2 at 11. *Popowsky v. Pa. P.U.C.* 674 A.2d 1149, 1154 (1996); *Pa. P.U.C. v. Borough of Media Water Works*, 72 Pa PUC 144 (1990).

[55] I&E St. 2 at 12; PPL St. 8-R at 42.

<table>
<tr><th>DOCKET NO.</th><th>DATE FILED</th><th>TIME ELAPSED</th></tr>
<tr><td>R-00049255</td><td>March 29, 2004</td><td rowspan="4">➢ 36 mos.
➢ 36 mos.
➢ 24 mos.</td></tr>
<tr><td>R-00072155</td><td>March 29, 2007</td></tr>
<tr><td>R-2010-2161694</td><td>March 31, 2010</td></tr>
<tr><td>R-2012-2290597</td><td>March 30, 2012</td></tr>
</table>

[(36 + 36 + 24) ÷ 3 intervals]. The Company's requested two year recovery period, presumably based upon the time elapsed since its last case alone, is limited and not a representative consideration of the Company's overall recent historic filing record.[56] PPL's claimed two year normalization period would result in an unreasonable increase. I&E's recommended disallowance of $258,000 to the Company's current base rate case should be adopted.

2. Amortization of the 2010 Rate Case Expense

Amortization is the recovery, over time, of an extraordinary, non-recurring expense.[57] Normalization, as stated above, is used to determine a representative level of a fluctuating expense. As discussed, it is well-settled that rate case expense is normalized, not amortized. PPL included a claimed amortization expense of $674,000 associated with its 2010 base rate case.

[56] I&E St. 2 at 14.
[57] *Butler Township Water Company v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984).

Ms. Morrissey recommends disallowance of PPL's claimed amortization of its 2010 base rate expense because amortization of rate case costs is improper for ratemaking purposes. As Ms. Morrissey states:

> Essentially, costs for a particular base rate case are recoverable during the period in which the rates resulting from that case are in effect. Therefore, the prior rate case filing costs in effect expire and only the current allowable rate case costs are normalized to determine the annual operational expense allowance going forward. I recommend that the costs from prior rate cases should be excluded as they compound and overstate the typical rate case expense amount for ratemaking purposes.[58]

While PPL provides no basis at all for inclusion of this amortized portion of its 2010 rate case expense in its direct case, PPL has agreed with Ms. Morrissey's disallowance of this expense claim and the claimed amortization of the 2010 expense is no longer an issue in this proceeding.[59]

3. Summary

Ms. Morrissey's proposed adjustments to PPL's claimed rate case expense should be adopted. These adjustments comprise a reduction of $258,000 to normalize the Company's claim over an accurate historic period of 32 months and a reduction of $674,000 to remove the Company's claim for recovery of an amortization of its 2010 rate case expense. This presents a total reduction of $932,000 from the Company's claim of $1.6 million, allowing for a total rate case expense claim of $755,000.

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[58] I&E St. 2 at 15.
[59] PPL St. 8-R at 42.

C. Incentive Compensation

Incentive compensation comprises payments to eligible employees in addition to their base salaries and wages. Incentive compensation payout is generally based on the attainment of key performance indicators established by the company or an affiliate. In this proceeding, PPL claims a total incentive compensation expense of $10.088 million, the jurisdictional portion (pertaining to distribution) of which is $8.918 million. The basis for the Company's claim is its assumption of attaining the general goals of stock earnings per share ("EPS") performance, financial objectives, and operation goals. The Company declined to identify the specific targeted incentive parameters that were assumed in developing its historic test year (HTY) and FTY claims by the Company to its affiliate PPL Services.[60]

I&E witness Morrissey recommends an equal sharing of the claimed FTY incentive compensation expense between shareholders and ratepayers, resulting in a jurisdictional allowance of $4.459 million and a reduction of an equal $4.459 million from the Company's claim.

Ms. Morrissey describes the basis for her adjustment as follows:

> The basis for my recommendation is that reaching target EPS and financial objectives that cause a nearly $10.1 million payout for Incentive Compensation must also benefit its shareholders in either dividends or stock value. The Company's incentive compensation payout is linked to performance measures that also impact shareholder value. Arguably, a company's stock EPS performance

[60] I&E St. 2 at 16; I&E Ex. 2, Sch. 8.

> and other financial measures directly impact shareholder value, therefore, the incentive compensation costs resulting from achieving these objectives should be borne, in part, by the shareholders. My recommendation that Incentive Compensation expense should be shared equally between shareholders and ratepayers is just and appropriate to fairly represent costs incurred on behalf of the parties benefitting from the Company's performance. In addition, the Company has failed to support its claimed position that ratepayers exclusively benefit from the achievement of the unspecified EPS, Financial Objectives and Operating Goals.[61]

Succinctly stated, PPL presents an extensive almost $9 million expense claim that comprises almost 10% of its proposed rate increase. However, PPL provides no evidence that incurrence of this expense is necessary for the provision of safe and reliable service at just and reasonable rates, let alone that ratepayers are exclusively responsible for, or benefit from, the incurrence of this expense. Accordingly, I&E's proposed 50/50 sharing of the incentive compensation expense claim between the regulated entity and the unregulated service company is wholly reasonable if not outright generous.[62]

In response, PPL witness Cunningham asserts that incentive compensation is an appropriate employee motivator and a reasonable and appropriate market-driven cost of doing business fundamental to hiring and retaining "talent in PPL Electric as well as PPL Services."[63] Ms. Cunningham repeatedly refers to "organizational" performance, stating "[i]ncentive compensation helps PPL Corp. succeed by driving organizational performance[,] . . . . connect[ing] individual

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[61] I&E St. 2 at 17.

[62] OCA witness Koda proposed that shareholders be required to assume 2/3 of these costs since attainment of the incentive financial goals benefits shareholders. OCA St. 1-Revised at 19-20.

[63] PPL St. 3-R at 15-16, 23

performance to organizational success and" . . . align[ing] individual effort and performance to organizational goals" and allowing employees to "experience, in a tangible way, how their efforts impact organizational results."[64] Ms. Cunningham claims that the goals are both financial and operational in nature.

I&E contends that PPL has not provided substantial evidence to support its claim that PPL Electric ratepayers exclusively cause or benefit from PPL Service's incurrence of this expense. To the contrary, as proven by Ms. Cunningham's own testimony, this compensation is a PPL corporate family organizational incentive with organizational goals not tied exclusively to PPL Electric's provision of service to ratepayers. And as proven by Ms. Cunningham's own Exhibit DAC-2, Schedule 1, PPL Corp's strategic goals include "best-in-the-sector returns" through "increase[d] shareowner value."

As Ms. Morrissey notes, the Company's continual refusal to disclose the underlying specifics to support its claim that ratepayers exclusively benefit from or are the cause of PPL's claimed $10 million incentive compensation expense leaves the Commission no ability to "scrutinize the plan's prudence and priorities as they affect ratepayers."[65] As Ms. Morrissey further notes without contradiction:

> [I]t is not uncommon that shareholder value must first be achieved before any incentive payout occurs and that the level of shareholder value achieved drives the payout factor. However, the Company has failed to produce details of and support for its claimed calculation, not just in its direct case in support of its claim, but also in rebuttal

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[64] PPL St. 3-R at 16.
[65] I&E St. 2-SR at 11.

after the issue was directly raised. Only through such detailed support can the Commission appropriately weight each goal and assign its respective monetary value between ratepayers and shareholders.[66]

I&E's proposal, to reduce PPL's $8.9 million incentive compensation expense by $4.459 million to reflect a 50/50 sharing of this expense between PPL Electric's ratepayers and the remainder of the PPL corporate family for which the cost is incurred to increase shareowner value, is reasonable and should be adopted.

D. Affiliate Support

1. Introduction

Affiliate Support comprises administrative and general services rendered directly and indirectly to PPL Electric by its affiliate, PPL Services Corporation. Affiliate Support includes services for Information Services, External Affairs, Human Resources, Environmental Management, Financial, Supply Chain, Office of General Counsel, Risk Management, Auditing, Facilities Management and services from PPLSolutions. Affiliate Support expense claims are part of the Company's Total Other Operating Costs, which in turn are part of the Company's Total O&M expense claim.

I&E witness Morrissey recommends adjustments for the following direct affiliate support costs: Environmental Management, External Affairs, Facilities Management, and the Office of General Counsel. Ms. Morrissey also recommends an adjustment for the indirect affiliate support costs listed as "Chairman." I&E

[66] I&E St. 2-SR at 11.

recommends rejection of approximately $1.1 million in direct and indirect allocations to PPL Electric for Environmental Management, External Affairs, and Office of Chairman. I&E submits that the captive ratepayers of the rate-regulated entity PPL Electric are over-allocated costs associated with environmental management with respect to the provision of electric distribution services, are allocated an inordinate amount of increasing corporate costs related to external affairs resulting in the rate-regulated entity being responsible for over one-third (36%) of that total cost responsibility, and are over-allocated expenses related to the Office of the Chairman Expense, creating a 62% increase over the historic year and dramatically exceeding the historical trend.

2. Direct – Environmental Management

Environmental Management includes, in part, technical support and waste management system training, corporate liability and remediation management. The Company proposes a FTY claim for Environmental Management of $640,000, the jurisdictional (distribution) portion of which is $467,000. Ms. Morrissey recommends a ratemaking allowance of $364,000 for Environmental Management which is a $103,000 ($467,000 - $364,000) reduction to the Company's claim.

The basis for I&E's recommendation is to levelize the Environmental Management expense claim for ratemaking purposes because the costs associated with the claim are irregular and erratic. The year-to-year costs for Environmental Management are erratic, the FTY claimed costs are comparatively higher due to

the planned implementation of its Environmental Management System ("EMS"), an implementation event that does not occur each year, and the Company does not expect its claimed FTY expenditure level to be sustained in subsequent years.[67]

Similar to her calculation of uncollectibles expense, Ms. Morrissey calculates an average yearly cost for Environmental Management expense using the Company- reported jurisdictional historical expense for the prior three years and includes the expected future test year expense claim in order to recognize the estimated EMS implementation costs. These annual expense amounts and the resulting yearly average are summarized as follows:

YEAR				4-YEAR TOTAL	4-YEAR AVERAGE[68]
Historic Actuals			FTY Claim		
2009	2010	2011	2012		
$227,000	$440,000	$323,000	$467,000	$1,457,000,	**$364,000**

In response, PPL witness Cunningham agrees that Environmental Management costs varied between 2009 and 2011, but disagrees that a FTY allowance should be based on historical costs. Rather, Ms. Cunningham assets that projected costs are more appropriate due to expected changes in environmental regulations that will require more work.[69]

[67] I&E St. 2 at 20; I&E Ex. No. 2, Sch. 11, p. 2 and Sch. 12, p. 2.
[68] The four year average is rounded to the nearest $1,000.
[69] PPL St. 3-R at 3-4.

I&E continues to recommend a downward adjustment to PPL's claimed FTY environmental management costs. As stated above, historical costs are relevant to the ratemaking process, and in particular provide a reasonable context for development of future costs when the claimed expense is irregular and erratic. As Ms. Morrissey observes, Ms. Cunningham fails to substantiate how new environmental regulations may impact PPL's distribution system. She provides no existing or proposed schedule of storm water and erosion and sedimentation control projects that will have to be inspected upon completion. Further, she ignores the fact that costs for implementation of a new software system will not recur, and therefore should not be included in the FTY claim as reflective of ongoing system costs.

I&E's recommended adjustment should be adopted as it provides for a reasonable ongoing expense level for ratemaking purposes by smoothing year-to-year variations of this expense.

3. Direct – External Affairs

External Affairs provides, in part, for the coordination of government relations activities, corporate communications, such as media and public relations services, as well as community and economic development activities. The Company's total FTY claim for External Affairs is $2.602 million, which is also the jurisdictional portion of the claim.[70]

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[70] PPL St. 2 at 21-22; I&E Ex. 2, Sch. 13.

I&E witness Morrissey recommends a ratemaking allowance of $1,432,000 for External Affairs which is a $1,170,000 reduction to the Company's claim. The basis for Ms. Morrissey's recommendation is to limit the expense recovery allowance equivalent to the Company's actual historic test year expense experience in order to contain the Company's unsupported 81% spending increase in the future test year for this expense. The historic jurisdictional expense and FTY claim for External Affairs is illustrated below:

YEAR			
Historic Actuals			**FTY Claim**
2009	**2010**	**2011**	**2012**
$1,045,000	$1,185,000	$1,432,000	$2,602,000

The Company does not demonstrate that the requested 81% increase in this expense is prudent or necessary to provide safe and reliable electric distribution service. As shown in I&E Ex. 2, Sch. 13, the primary drivers for its future test year claim result from an increase in spending for *Corporate Communications* and *Community and Economic Development*. The Company has not demonstrated that its historic spending levels are insufficient. Ms. Morrissey's recommendation promotes the need to exercise cost containment measures in order to mitigate unnecessary rate increases.[71]

[71] I&E St. 2 at 22-23.

In response, PPL witness Cunningham provides an explanation to the apparent 81% increase, noting that the overall budgeted amount increases minimally over the 2011 HTY amount, but explaining that the means of allocation of External Affairs costs among subsidiaries has changed with more costs being characterized as direct support rather than indirect.[72]

Upon review of Ms. Cunningham's explanation, Ms. Morrissey revises her recommendation to reduce the O&M External Affairs cost by $620,000, rather than the original $1,170,000. The basis for Ms. Morrissey's revised recommendation is that while in the HTY PPL electric absorbed approximately 25% of the total corporate External Affairs costs, under the new allocation, PPL Electric is charged with recovery of approximately 36% of the total corporate budget, an increase of almost 50%.

Ms. Morrissey's revised recommendation accepts the Company's reallocation of expenses between direct and indirect costs as well as its assignment of more costs to PPL Electric due to the greater involvement of regional community relations directors in the provision of distribution service as explained by Ms. Cunningham. However, the Company provides no evidence substantiating an almost 50% increase in the portion of costs allocated to PPL Electric. Thus, Ms. Morrissey moderates the increase attributed to ratepayers by developing an average of the actual HTY and FTY percent claims. PPL Electric's cost

[72] PPL St. 3-R at 6-7.

allocations within its corporate family must be strictly scrutinized. I&E's proposal is reasonable and should be accepted.

4. Direct – Facilities Management

Facilities Management provides building management services. The Company's total FTY claim for Facilities Management is $22.156 million, the jurisdictional portion of which is $21.782 million. The Company based its claim on its HTY total cost increased by estimated costs related to planned space rearrangements, other deferred work and maintenance.[73]

I&E witness Morrissey disagrees with the Company's claim and recommends a ratemaking allowance of $16.634 million, which is a reduction of $5.148 million to the Company's claim. The basis for Ms. Morrissey's recommendation is that the Company's HTY expense amount is an aberration compared to prior years as illustrated below:

Historic Actuals		
2009	**2010**	**2011**
$13,577,000	$14,581,000	$20,825,000

As stated by Ms. Morrissey, the almost 43% increase from 2010 to 2011 of $6.244 million, charged to PPL by its affiliate PPL Services, is substantial, is not representative of its prior years' expense experience, and is not supported by PPL as an appropriate and prudent expense level upon which to base its future test year

[73] I&E St. 2 at 23-24.

claim. Accordingly, Ms. Morrissey determined an allowable allowance of $16.634 million by calculating a three year Facilities Management expense average using PPL's most recent experience (2009 – 2011), and increasing this average by a normalized portion (one-fifth) of the future test year's expected cost for infrequent and non-recurring work.

In response, PPL witness Cunningham provides a further explanation of facilities allocation. Based upon that further explanation, I&E witness Morrissey withdraws her recommendation regarding Affiliate Support (Direct) – Facilities Management.[74]

5. Direct – Office of General Counsel

PPL Corp.'s Office of General (OGC) counsel provides legal services. The Company's total FTY claim for OGC is $8.386 million, the jurisdictional portion of which is $6.083 million. The Company's claim is based on its HTY expense increased by $1.2 million in estimated costs for outside counsel fees related to this proceeding.

I&E witness Morrissey recommends a ratemaking allowance of $4.833 million for OGC expense, which is a $1.2 million reduction to the Company's claim. The basis for Ms. Morrissey's adjustment is to eliminate the additional

[74] I&E St. 2-SR at 19.

expense associated with outside counsel for this proceeding since the Company also includes a claim for rate case expense in its pro forma adjustment.[75]

PPL witness Kleha agrees with Ms. Morrissey's $1.2 million adjustment. However, Mr. Kleha chooses to reflect the adjustment as a $1.2 million reduction to the Company's rate case expense rather than as a disallowance of the allocation of the affiliate support related to OGC services.

I&E acknowledges Mr. Kleha's acceptance of the expense reduction, but contends that it is appropriate to reflect the reduction as a part of the affiliate support allocation, and not as a rate case expense reduction. By keeping the expense as a part of PPL Electric's affiliate support allocation as Mr. Kleha has, that expense category will overstate the level of OGC affiliate support dedicated to the provision of electric distribution service in years when there is no rate case. In other words, ratepayers will be allocated an inflated portion of OGC expenses based upon rate proceeding expenses that are not provided annually or regularly by OGC. Further, the overstated level of OGC affiliate support allocated to PPL Electric in this proceeding will then be used in future proceedings to support similarly overstated OGC allocations.

PPL's transactions with its affiliates must be strictly scrutinized and properly accounted for in order to protect against inflated allocations. In order to avoid overstating the appropriate corporate allocation expense and confusing the

[75] I&E St. 2 at 28.

appropriate level of affiliate support to the Office of General Counsel in this or future rate cases, PPL's accepted reduction of $1.2 million should be reflected as a reduction to its Affiliate Support (Direct) – Office of General Counsel expense claim.[76]

6. Indirect – Office of Chairman

Indirect Support overall represents general and administrative support that is not readily identified as being incurred for a specific affiliate but is generally characterized as benefitting all PPL Corporation subsidiaries.[77] The Office of the Chairman expense is a component of indirect support. The Company's total jurisdictional future test year claim for Office of Chairman is $1.010 million.

I&E witness Morrissey recommends a ratemaking allowance of $623,000 for Indirect - Office of Chairman, equivalent to the historic test year expense level, which is a $387,000 reduction to the Company's claim. The basis for I&E's recommendation is to recognize the historical experience which, as the table below demonstrates, shows the declining historical experience regarding these costs.

YEAR			
Historic Actuals			**FTY Claim**
2009	**2010**	**2011**	**2012**
$979,000	$738,000	$623,000	$1,010,000

[76] I&E St. 2-SR at 20-21.

[77] An organizational chart of PPL Corporation and the Company's corporate relationship is provided in PPL Exhibit Regs., Part III, III-E-4.

Ms. Morrissey's recommendation also recognizes the addition of two new rate-regulated entities, LG&E and KU Energy, LLC (jointly LKE) that should also absorb a portion of the Indirect – Office of Chairman costs on a prospective basis, further justifying a reduction of PPL Electric's portion of these prorated costs that, prior to the acquisition, were spread among fewer affiliates.[78]

PPL witness Cunningham opposes I&E's adjustment. Ms. Cunningham concedes PPL Corp.'s acquisition of two additional domestic affiliates and also points to PPL Corp.'s 2011 acquisition of WPD Midlands, the United Kingdom rate regulated entity. Ms. Cunningham asserts, however, that these acquisitions have already been reflected in the allocation of PPL services indirect support fees. Ms. Cunningham also asserts that PPL Services has conducted a review of affiliate allocations, and that using a Commission-approved three-factor approach has justified a larger allocation of the Office of Chairman expense to PPL Electric.[79]

I&E witness Morrissey maintains her recommendation on the basis that the Company's FTY allocation of Office of Chairman expenses to PPL Electric is overstated. Ms. Morrissey acknowledges the Company's use of the three-factor approach as well as the fact that that same approach was used over the historic years reviewed by Ms. Morrissey. That approach indicates declining allocation of costs. Further, no other indirect expense allocations have increased to the same extent claimed by PPL Electric for Office of Chairman indirect expense allocation,

[78] I&E St. 2 at 28-30.
[79] PPL St. 3-R at 13-14.

a 62% increase over the HTY and exceeding even the 2009 cost prior to the inclusion of the three new affiliates.

The Company's FTY claim should be rejected as unsubstantiated, not representative of prior years' actual experience, and not supported as an appropriate expense level for establishing rates going forward.

E. Storm Costs and Recovery

1. Introduction

PPL recovers expenses related to annual storm repairs through a combination of budgeting an amount from rates to cover normal storm damage and, for storms designated as major storms, through procuring storm insurance from its affiliate, PPL Power Insurance Limited, an offshore subsidiary of PPL Corp. subject to the regulatory jurisdiction of Bermuda.[80] In this proceeding, PPL proposes to continue this storm damage risk management strategy by including a future test year claim based on estimated 2012 storm expenses. The Company also includes a 5-year amortized expense claim pursuant to petitions for deferred accounting approved by the Commission at Docket Nos. P-2011-2270396 and P-2011-2274298 for amortized recovery of 2011 storm related damages from Hurricane Irene in August and a snowstorm in October. The value of the 2011

[80] I&E St. No. 2 at 30; PPL St. No. 14-RJ at 7.

storms subject to deferred accounting as updated by PPL witness Banzhoff is $26,622,371.[81]

I&E asserts that the Company's purchase of storm insurance from its affiliate has proven to be economically advantageous to the Company's affiliate and disadvantageous to its ratepayers. Therefore, I&E recommends that PPL be required to discontinue this risk management strategy of insuring with an affiliate, and instead use a storm reserve account for accrual of budgeted storm amounts to be offset by experienced storm costs or to employ a storm rider.[82] This strategy, to be implemented prospectively, allows PPL to recover storm damage expenses without involving questionable affiliate transactions. It also removes ratepayers from the "heads I win, tails you lose" position whereby in lean storm years the PPL corporate family retains budgeted amounts that exceed storm costs, but conversely in more active storm years such as 2011 where insurance coverage and the budgeted deductible were insufficient to restitute to PPL its actual storm costs, the Company files a petition to defer storm costs for financial reporting and ratepayer recovery. For these same reasons, I&E also opposes the Company's 2011 and 2012 claims for storm damage expenses.[83]

2. Value and Strategy of Storm Insurance

PPL introduced its risk management strategy of insuring against storm damage in 2006 and first included the cost of this insurance in its 2007 base rate

[81] PPL St. 2-R at 4.
[82] I&E St. 2 at 32-33; I&E St. 2-SR at 23.
[83] I&E St. No. 2 at 32-33.

case as one of the ten issues specifically identified in what was otherwise a settlement of the revenue requirement part of that proceeding.[84] In the intervening years, experience with this strategy has proven that it is neither economical nor prudent and should be discontinued.

First, claims are not presented in a timely fashion. This causes the rate-regulated entity directly or indirectly to finance short-term costs while the unregulated insurance affiliate enjoys the use of PPL premiums for in excess of 12 to 18 months. Second, the combined cost of the insurance premium and deductible far outweigh the value of the insurance provided, leaving the rate-regulated entity again bearing costs that ultimately benefit the private insurance affiliate and corporate parent.

a. Timing of Insurance Disbursements

One benefit of insurance should be the timely availability and receipt of policy proceeds to fund storm repairs. However, as I&E's evidence demonstrates, PPL consistently delays submitting claims for recovery from its affiliate for a year or more after the storm event.[85] PPL's affiliate service agreement provides that services provided by affiliates must be invoiced monthly or more frequently, and payment is due within 60 days of receipt. While this agreement requires timely payment for the service from PPL to its affiliate, PPL delays in filing of insurance claims with its affiliate for over a year, allowing the non-regulated affiliate

[84] *Pa. P.U.C. et al. v. PPL Electric Utilities Corporation*, Docket Nos. R-00072155 et al., (Order entered December 6, 2007).
[85] I&E St. 2 at 31; I&E Ex. No. 2, Sch. 19.

continued use of insurance funds for a year or longer. The rate-regulated ratepayers assume the costs of any short term financing or loss of investment opportunities associated with should be the payment of immediately due and payable expenses associated with storm recovery.[86]

PPL's first response to I&E's adjustment was unequivocal testimony that it cannot submit claims as incurred. As PPL witness Novatnack stated, "storm damage insurance policies pay claims on an annual aggregate basis. That is, insureds are *required* to make not more than one claim per year, which is for the entire year. . . . Under this practice, *as required by the policy*, PPL Electric submits one storm loss claim for each policy year."[87]

I&E's evidence, however, refutes PPL's assertion. PPL's storm insurance policy contains no annual aggregate claim requirement. While coverage and deductible limits are presented as annual aggregates, no policy provision requires an aggregate annual claim. To the contrary, claims may be submitted as incurred and they are due and payable in 60 days.[88]

Facing these incontrovertible facts, PPL changed its testimony in rejoinder and then finally clearly admitted on cross-examination[89] that it is merely "PPL's *practice*" and not a requirement, to submit one claim for an entire calendar year

[86] I&E St. 2 at 32.
[87] PPL St. 14-R at 7 (emphasis added).
[88] I&E St. No. 2-SR at 25.
[89] Tr. at 193, 197.

"after the year has ended."[90] However, even that statement is incorrect since PPL does not submit claims at the close of the year. Rather, it waits "until *at least six months after the end of the policy term*"[91] or not before July 1 of the following year at the earliest, before submitting its claim for the prior year.[92]

Policy year 2011 illustrates the egregious impact of PPL's "practice" of submitting only one claim to its affiliate insurer. Based upon the $7.5 million deductible in the 2011 policy, PPL had already surpassed its deductible by April 28, 2011.[93] Having met its deductible in the first four calendar months of 2011, any expense incurred afterwards is legitimately subject to the timely payment of insurance proceeds within 60 days of presentment of the claim. Yet, despite having exceeded both its deductible and its policy limits, as evidenced by its petition for recovery of a deferred regulatory asset, as of August 6, 2012 – more than 16 months after the deductible had been exceeded and 9 months after PPL had filed petitions for deferred accounting to recovery storm losses in excess of the policy limits – PPL had *still not submitted any claim under its 2011 policy.*[94]

PPL submits that "[i]t wants to make sure that all of the costs have been accumulated for all the storms which happen during the policy year" and thus only submits one claim per year.[95] However, as I&E witness Morrissey testified without

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[90] PPL St. No. 14-RJ at 3 (emphasis added).
[91] I&E Ex. 2-SR, Sch. 4 (emphasis added).
[92] I&E St. No. 2-SR at 28.
[93] Tr. at 194-95; I&E Ex. 2-SR, Sch. 3.
[94] Tr. at 195. PPL's petitions related to Hurricane Irene and the October snow were filed November 1 and November 18, 2011, respectively.
[95] Tr. at 196.

refutation, "[s]upplemental claims would be made as additional costs are identified through ongoing repair efforts."[96] Nor is presentation of claims as they incur burdensome, (a claim not even asserted by PPL).

Ms. Morrissey calculated a 5-year average for PPL's PUC reportable storms and determined that on average PPL could experience 7 reportable (insurable) storms annually. Presentation of seven claims throughout the policy term does not present "a burdensome claim frequency" that justifies the self-imposed annual aggregate claim requirement.[97] As Ms. Morrissey concludes, "[t]he regulated utility and, consequentially, the ratepayers, bear the costs associated with funding all of the storm expenses for more than a year after" the policy deductible and coverage limits were reached.[98]

As is the case with PPL's choice to pay its affiliate bills well in advance of their payment due date causing an overstated CWC expense, PPL's choice of an insurance claims practice that unreasonably delays the presentation of claims evidences another example of the Company's affiliated dealings disadvantaging ratepayers. With respect to CWC, PPL disregards the terms of its affiliate agreement and pays affiliate bills 40 days in advance of its contractual requirement, giving rise to an approximate $1 million in additional claimed CWC expense. With respect to storm insurance, PPL also disregards its affiliate contract terms and withholds presenting claims as they occur in favor of withholding

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[96] I&E St. 2-SR at 28.
[97] I&E St. 2-SR at 27.
[98] I&E St. 2-SR at 28.

claims for more than a year after they are incurred, providing the affiliate the time value of PPL's premium monies and denying PPL Electric timely access to insurance proceeds.[99] As Ms. Morrissey concludes:

> PPL's storm risk management strategy has not proven economically prudent or beneficial to ratepayers. The purchase of a policy that requires the transfer of substantial premium funds from the regulated utility to an unregulated affiliate but is implemented in such a manner that the regulated entity makes no claim against those funds for twelve to eighteen months afterwards decidedly works in favor of PPL Corp. shareholders and not PPL ratepayers. PPL should be compelled to change its risk management strategy for storm damage on a prospective basis as recommended in my direct testimony.[100]

b. Storm Insurance Value

I&E also contends that the cost of the insurance from its affiliate compared to the value it obtains in terms of coverage proves that insuring against losses, particularly with an affiliate, is not economical to PPL Electric's ratepayers. While PPL submits that the policy is designed so that its affiliate will not prosper on the transactions, I&E disagrees.

As I&E initially notes, in general the value of storm insurance coverage provided has not proven to be economically prudent given the cost of purchasing the insurance. As Ms. Morrissey testified, in 2011, PPL purchased storm insurance from its affiliate, PPL Power Insurance, at a cost of $10.85 million for $26.5

[99] Even if there is no direct ratepayer expense for short-term financing necessitated by the delay between when PPL must pay its storm expenses and when PPL finally requests coverage proceeds from its affiliate, because, as Mr. Novatnack claims, "[s]uch costs are born by PPL Electric shareholders[,]" (PPL St. 14-RJ at 2), when shareholder values fall, a claim made in this case in support of the proposed $104.6 million revenue increase, ratepayers ultimately are responsible for payment. Tr. at 193.
[100] I&E St. 2-SR at 29 (citation omitted).

million in storm coverage, or a premium that represented 41% of the coverage provided. With the policy changes in 2012, the Company contracted for a policy from PPL Power Insurance at a premium of $8.75 million for $18.25 million in storm coverage, or a premium that represents 48% of the coverage provided.[101] Given that PPL Electric must spend almost 50 cents for every dollar of coverage provided (and also incur the cost of a deductible that has at its lowest been $7.5 million), the purchase of insurance is not cost-effective.

In response to I&E's adjustment, PPL witness Novatnack testified that the premium "is calculated to equal expected losses over time, with no allowance for profits."[102] I&E contends, however, that PPL Power Insurance's financial statements prove otherwise.

As I&E witness Morrissey notes, PPL Power Insurance's loss or profitability becomes apparent when the information on PPL Power Insurance's income statements is carried over to the balance sheets. On I&E's summary balance sheet spreadsheet,[103] PPL Power Insurance's assets have increased by $14,112,773 from 2006 to 2011. While the Statutory Capital Summary[104] reflects a declining surplus, as expected given the storm damage expenses incurred, the

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[101] I&E St. No. 2 at 31.
[102] PPL St. 14-R at 3.
[103] I&E Ex. 2-SSR, Sch. 2, p. 3, ln 15.
[104] I&E Ex. 2-SSR, Sch. 2, p. 2.

offsetting liability to account for the increased assets is found in the Loss and Loss Expense Provisions account.[105]

The value of the Loss and Loss Expense Provisions account has increased by $24,931,599 between 2006 and 2011.[106] While this increase would tend to indicate that PPL Power Insurance actually had incurred some liability to which it is obligated, that is not the fact in the case of a "Provisions" account since a "Provisions" account is actually a contingent liability. A contingent liability is a company's method of accounting for a potential liability that may or may not ever be realized. Contingent liability accounts accrue a balance by increasing in response to income statement loss expenses that are not actually realized.[107]

In rejoinder, PPL witness Novatnack disputes I&E's conclusions that the substantial growth in PPL Power Insurance's contingent liability (Loss and Loss Expense Provisions) account evidenced PPL Power Insurance's profitability because the increase "reflects an increased obligation to make future claims."[108] PPL contends that because PPL Power Insurance "knew that it would have to pay claims equal to policy limits on storm damage expense coverage for 2011"[109] (even though no claim has yet been presented), PPL Power Insurance moved the entire 2011 policy limits into contingent liability account. According to Mr. Novatnack, PPL's insurance affiliate also includes within that Loss and Loss Expense

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[105] I&E Ex. 2-SSR, Sch. 2, p. 2, ln 17.
[106] I&E Ex. 2-SSR, Sch. 2, p. 3. ln 17.
[107] I&E St. No. 2-SSR at 3-4.
[108] PPL St. No. 14-RJ at 12.
[109] PPL St. No. 14-RJ at 11.

Provisions account contingent liabilities for a jury verdict on appeal and contingent losses relating to workers compensation.[110] Mr. Novatnack concludes that PPL Power Insurance has not paid a dividend to PPL Corp. This, PPL contends, contradicts I&E's assertion that PPL Electric's deal with PPL Power Insurance is uneconomic to PPL Electric's ratepayers.

I&E disputes PPL's evidence. First, I&E witness Morrissey measures the increase in value of the Loss and Loss Expense Provisions account over the entire life of the PPL insurance coverage period – 2006 to 2011, not just the increase from 2010 to 2011 as Mr. Novatnack does. Over the more extended time period, the growth has been greater than just between the years 2010 and 2011.

Second, without any evidence of the finality of either the jury verdict and workers compensation claims or even their size relative to the storm insurance claims, it is not possible to conclude, as PPL does, that PPL Power Insurance's Loss and Loss Expense Provisions account is not overstated and ultimately profitable to the insurance affiliate. Similarly, absent any evidence of the separate adjustments that comprise the final total for the year 2011, it is impossible to verify what has caused the growth in that one year. On one hand PPL witness Novatnack claims "the entire policy limit [is included] in the provision for loss and loss expense."[111] On the other, however, he also claims that while not

[110] PPL St. 14-RJ at 12.
[111] PPL St. 14-RJ at 11.

separately shown, the liabilities are "reported net of reinsurance reimbursements."[112]

What is clear is this: If a contingent liability never materializes, the company income is understated because a lower expense would contribute to net income and subsequently flow to retained earnings. Thus PPL Power Insurance's Loss and Loss Expense Provisions account remains precisely as I&E witness Morrissey concluded in her surrebuttal testimony – a contingent liability that PPL Power Insurance may or may not ultimately incur depending on factors that are outside this record.[113]

Third, whether or not PPL Power Insurance has paid a dividend to PPL Corp. is irrelevant. PPL Power Insurance is a wholly-owned subsidiary of PPL Corp. that exists for the sole purpose of insuring certain affiliates against certain losses.[114] Financial benefits among affiliated entities can take many forms outside the payment of dividends. Ultimately, the profit or loss of this wholly-owned captive insurance affiliate will inherently flow to PPL Corp.'s consolidated balance sheet regardless of whether or not a dividend is paid. While I&E submits the evidence shows actual ratepayer detriment, clearly even the mere appearance of a financial benefit flowing to affiliated entities as a result of PPL Electric's storm damage insurance practices with its affiliate should be sufficient to find against continuation of this practice.

[112] PPL St. 14-RJ at 9.
[113] I&E St. No. 2-SR at 4.
[114] I&E Ex. 2-SR, Sch. 8.

PPL witness Novatnack's claim that "the principal purpose of insurance is not to save money for the insureds"[115] should be received with skepticism in PPL Electric's rate-regulated world. PPL's ratepayers pay for insurance to cover storm damage so that service can be reliably provided at reasonable rates. As I&E witness Morrissey states:

> When the cost of the insurance represents such a large percentage of coverage provided, not only is there little incentive to acquire insurance, but also the cost of such insurance can become imprudent compared to the potential benefit. The average consumer would most likely implement some type of self-insurance mechanism to realize the benefits of premium savings relative to the infrequency of loss.
>
> In the PPL insurance scenario, *PPL is the consumer, but it is the ratepayers who are funding the premium payment*. Accordingly, *the normal evaluation and perception of insurance benefit and expense prudency is obscured by the insured's business relationship with the insurance company and with the ability to fund the insurance purchase on a 100% basis from its ratepayers through their regulated rates*. Given the data that has accumulated since PPL's implementation of this risk management strategy, the cost has been demonstrated not to be worth the benefit from the perspective of PPL's ratepayers, the party ultimately responsible for paying for the insurance. The strategy should be discontinued.[116]

PPL Electric should be following the most cost-effective means of protecting itself against storm losses. Whether an affiliated entity profits should be beyond reproach. I&E concludes, however, that the evidence demonstrates that PPL Power Insurance, and ultimately the PPL corporate family, is profiting from PPL Electric's current storm damage risk management policy. Coupled with the

[115] PPL St. 14-R at 6.
[116] I&E St. No. 2-SR at 36 (emphasis added).

facts that the cost of the combined premium and deductible in 2012 ($24.5 million) exceeds the total coverage provided ($18.25 million) and that PPL Electric delays seeking its insurance benefits, PPL Power Insurance's "non-profit status" is questionable at best and further evidence that supports the conclusion that the rate-regulated ratepayer is better served through a storm reserve account or storm rider.

If PPL had utilized a risk management approach with a storm reserve account within the regulated utility, its profitability would not have been impacted by the storm costs that exceeded the insurance limit as the storm reserve account's accumulated balance would have shielded PPL from the large storm expenses encountered in 2011. Through its existing risk management policy, however, PPL essentially shifts ratepayer funds out of the regulated utility and to the corporate family by way of PPL Power Insurance. The mere failure to provide PPL Electric timely access to insurance proceeds for over one year contributes to PPL Electric's lower realized rate of return, which then, supplies PPL Electric purported grounds to support its proposed $104.6 million rate increase. This storm risk management policy has not proven to be cost-effective to ratepayers and should be terminated.[117]

[117] I&E St. 2-SSR at 4-5.

3. 2012 and 2011 Storm Cost Recovery

In its filing, PPL included a FTY claim of $37,125,000 for budgeted storm damage expenses, insurance premium, and insurance deductible. I&E witness Morrissey proposes an allowance of $23,785,000, which represents a reduction of $13,340,000 from the Company's claim.[118] This recommendation is based upon I&E's review of the Company's budgeted amount for storm damage over a 5-year period and I&E witness Morrissey's conclusion that the Company should recalculate an annual budget amount to reflect a 5-year average of storm expenses to account for yearly fluctuations in storm expenses, or in the alternative establish a reconcilable storm reserve account or storm cost rider.[119]

Ms. Morrissey calculated an appropriate annual budget amount using a 5-year average of PPL's actual annual storm expense amounts. The 5-year average was $23,785,000, resulting in a reduction of $13,340,000 from the Company's $37,125,000 FTY claim. As an alternative, approval of a storm reserve account rider would result in the removal of PPL's entire $37.1 million budgeted claim for storm costs.

On the same basis as its adjustment to the Company's FTY claim for storm damage expense, I&E witness Morrissey also recommends rejection of PPL's claim for a 5-year amortization of its 2011 storm damage expenses that are the

[118] I&E St. 2 Summary of Adjustments at 1; I&E St. 2 at 35.
[119] I&E St. 2 at 32-33.

subject of the two filed petitions for deferred accounting to recover extraordinary expenses. As stated by Ms. Morrissey:

> I believe PPL has budgeted amounts sufficient to cover the expenses related to the storms experienced. In other words, while these storms in isolation may appear to be extraordinary, the cumulative five year total costs incurred for storm expense falls below the cumulative total amount budgeted in that same five year period, in essence rendering the level of expenses incurred by the Company from the storms ordinary.[120]

As calculated by I&E, from 2007 through 2011, PPL budgeted $124.6 million for normal storm damage expenses and insurance based upon data provided by PPL for expenses related to insurance premium, insurance deductible, and normal storm allowance.[121] However, PPL only experienced $118.9 in total storm expenses over the same time period. Since ratepayers have paid rates over that same time period based upon budgeted storm expense amounts that should have been sufficient to cover PPL's experienced storm damage expenses on a normal basis, no extraordinary relief is warranted.[122]

In response, PPL contends that Ms. Morrissey erred by including in her calculation of the Company's annual storm damage O&M budget a separate value for storm insurance deductibles which, PPL avers, were subsumed within the figure for O&M expenses for storm damage repair.[123] In essence, PPL claims that

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[120] I&E St. 2 at 37.
[121] I&E St. 2 at 38; I&E Ex. No. 2, Sch. 38 (Company provided data in I&E-RE-109 showing budgeted amounts for insurance premiums) and Sch. 24 (Company provided data in I&E 108 showing budgeted amounts for O&M expenses for storm damage repair and for storm insurance deductibles).
[122] I&E St. 2 at 38.
[123] PPL St. 2-R at 2-3.

the values it provided in response to I&E-RE-108 (I&E Ex. No. 2, Sch. 24) are not separate components as represented on that response, but rather one total (O&M expenses for storm damage repair, or budgeted amounts for normal storms) with a separately identified subpart (storm insurance deductibles), which are a part of and not in addition to the first part.

I&E's calculation, however, was based upon data provided directly by the Company in discovery in response to an interrogatory that specifically requested the "annual amount budgeted in O&M expenses for storm damage repair *and* storm insurance deductibles" as separate elements, which were in fact provided as separate elements in a document styled as PPL's "Storm Damage O&M Budget."

Further, *if*, as stated by PPL witness Banzhoff in his rebuttal testimony, the line for storm insurance deductibles *were* included in and part of the overall number provided for O&M expenses for storm damage repair, the figures provided as budgeted amounts for the year 2012 are irreconcilable: Mr. Banzhoff's factual explanation presents a mathematical impossibility because the amount of the deductible, $15.750 million, exceeds the 2012 budgeted O&M storm repair costs of $12.625 by over $3 million.[124]

As part of his effort to refute Ms. Morrissey's calculation, Mr. Banzhoff provided a revised budget calculation (PPL Ex. GLB-6). However, this exhibit omitted data for the year 2012, the year for which inclusion of the insurance

[124] I&E St. 2-SR at 44.

deductible within the normal storm expense budgeted amount was mathematically impossible. While Mr. Banzhoff's explanation for this omission was that he was replicating Ms. Morrissey's calculation on page 38 of her direct testimony,[125] the mathematical impossibility of Mr. Banzhoff's explanation remained unaddressed.

The ***only*** explanation PPL finally offered was one sentence in Mr. Banzhoff's rejoinder testimony received the evening of Sunday, August 5, 2012, at 6:55 p.m., over 4 months after its filing was made, over 6 weeks after I&E's adjustment was first presented in its June 22, 2012 direct testimony, and just 15 hours before Mr. Banzhoff was to appear for cross-examination. As explained by Mr. Banzhoff: "***Historically***, storm costs have been charged approximately 60% to expense and 40% to capital."[126]

It is ***only*** if 60% of the year 2012 deductible is included in PPL's 2012 budget for normal storm costs, rather than 100% of the deductible, that PPL's explanation of the "correct" calculation of its Storm Damage O&M Budget can be verified or even explained mathematically. However, as PPL's own data shows[127] and as confirmed by Mr. Banzhoff during cross-examination,[128] ***historically*** storm costs have ***not*** been charged 60%/40% to expenses/capital. Rather, that "historic" adjustment appears just one time and for the first time in the year 2012, and only

[125] Tr. at 187-88.
[126] PPL St. 2-RJ at 5 (emphasis added).
[127] I&E Ex. 2, Sch. 24, p 2 of 2 shows 100% of the storm insurance deductibles allocated to O&M for the years 2008 through 2011.
[128] Tr. at 186.

after Ms. Morrissey explained the mathematical impossibility that directly belied PPL's explanation.

I&E submits that PPL has failed to carry its burden of proving its claims for 2011 and 2012 storm damage expenses and has failed to provide evidence sufficient to refute I&E's proposed FTY budgeted calculation in the amount of $23,785,000 using a 5-year average of PPL's past budgeted storm damage repair expenses. PPL's claim for a FTY expense for storm damage and its proposed amortization and recovery of 2011 storm damage expenses should be disallowed as unsubstantiated. I&E's proposed adjustment should be adopted.

4. Summary – Storm Costs and Recovery

I&E's evidence proves that PPL's claim for 2011 and 2012 storm damage expenses is overstated by $18.6 million. PPL's own budgetary figures prove that PPL already budgets for a normal level of storm damage expense that is sufficient to cover expenses it today attempts to portray as extraordinary. While PPL disputes I&E adjustments, the math does not lie. PPL's 11th hour effort to reconcile its own figures in rejoinder testimony presented on the Sunday evening before cross-examination on this very important claim still leaves unanswered questions and is simply not credible.

The claim is rendered more questionable as a result of PPL's storm damage risk management policy of insuring against storm damage through yet another affiliate, PPL Power Insurance, a PPL Corp. subsidiary. While PPL Electric timely

pays its affiliate multimillion dollar ratepayer premiums, at PPL Electric's *choice,* initially wrongly cast as a *requirement*, it does not present any claims to its affiliate for over a year. In 2011 alone, the year for which PPL Electric claims $26.6 million in extraordinary rate relief, PPL has yet to submit any insurance claim despite having met its deductible in April of 2011. Through yet another opportunity to provide corporate family benefits from the rate-regulated stability of its dealings with PPL Electric, PPL has overstated its revenue requirement in this proceeding by $18.6 million. PPL's claims for 2011 and 2012 storm damage expenses should be disallowed.

F. Consumer Education Plan

PPL's Consumer Education Programs (CEP) were implemented to prepare ratepayers for the expiration of generation supply rate caps. The programs were designed to educate consumers about their ability to shop among generation suppliers and reduce their electric bill through efficient energy practices. The Consumer Education Programs were recommended to be in effect for at least five years, after which time the "education plans [were to] be reevaluated and revised accordingly, based on market conditions and retail customers' level of knowledge and response to these programs."[129]

The Company includes a FTY claim of $7,976,220 for continuation of the existing 5-year CEP as well as implementation of new programs pursuant to the

[129] *Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957 (Final Order entered May 17, 2007) at 8.

Commission's Retail Markets Investigation (RMI). The Company proposes to collect these new aggregate costs related to consumer education through a new reconcilable Competitive Enhancement Rider (CER). The Company contends that the success of the existing CEP as well as the need for continuing education relative to shopping and energy efficiency justifies continuation of the initial 5-year CEP components.[130]

I&E witness Morrissey recommends disallowance of $5,482,000 of the Company's FTY claim for the CER Rider, or a recommended allowance of $2,494,000 of the original $7,976,220 proposed by PPL. The portion subject to I&E's recommended disallowance relates to the Company's proposal to continue the existing 5-year CEP currently scheduled to expire in 2012. I&E does not oppose recovery of PPL's proposed $1,650,000 RMI costs and the $844,000 related to Eligible Customer List (ECL) mailings.[131] Since RMI and ECL costs are currently reflected as a base rate claim, if the Company's proposed CER is approved, the recommended allowance of $2,494,000 should be removed from the Company's overall O&M base rate claim when determining an allowable base rate revenue increase.

The basis for Ms. Morrissey's recommendation is that the two segments of education that the CEP were originally designed in 2007 to address – shopping and energy efficiency – are more effectively addressed going forward by PPL's

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[130] I&E St. 2 at 40-42.
[131] I&E St. 2 at 45.

more recent Act 129 Energy Efficiency and Conservation (EE&C) Plan and the RMI mandates, the former being already separately funded through PPL Act 129 (ACR) Rider and the latter proposed to be funded through the CER in this proceeding.[132]

While the goals of the RMI are not identical to those of the CEP, they substantially overlap. The RMI investigation grew out of the Allegheny Energy/First Energy merger proceeding in which the Commission decided to open a state-wide investigation, ultimately known as the Retail Markets Investigation, in order "to ensure that a properly functioning and workable competitive retail electricity market exists in Pennsylvania."[133] The RMI order directs electric distribution companies (EDCs) to mail three coordinated consumer education mailings to their customers. Although the Company's existing CEP uses different educational means, the goal of educating consumers is the same.[134]

The same claim of duplication applies to the goals of the Company's Act 129 Rider as compared to its existing CEP. The Act 129 Rider, implemented after the Company implemented its 2008-2012 CEP in 2007, requires that EDCs create an EE&C plan to reduce energy consumption and demand. The goals of both the CEP and the Act 129 Rider benefit PPL Electric's ratepayers by both educating

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[132] I&E St. 2 at 45.

[133] *Joint Application of West Penn Power Company d/b/a Allegheny Power, Trans-Allegheny Interstate Line Company and FirstEnergy Corp. for a Certificate of Public Convenience under Section 1102(a)(3) of the Public Utility Code approving a change of control of West Penn Power Company and Trans-Allegheny Interstate Line Company*, Docket Nos. A-2010-2176520 and A-2010-2176732 (Order entered March 8, 2011), Slip Opinion at 46.

[134] I&E St. 2 at 43.

consumers on making decisions and incenting behavior or other changes in ways that reduce the cost and quantity of electricity used. Although each program educates about energy usage reduction in slightly different ways, the overall aim of instructing customers on the efficient use of energy is the same.[135]

In response to I&E's proposed adjustment, PPL witness Stathos asserts that since the goals of the CEP are "complementary to, but separate from, the goals of the Act 129 EE&C plan, and . . . complementary to the RMI mandates," the annual $5.4 million in CEP funding should continue beyond 2012.[136] As support, Mr. Stathos contends that the Company's 5-year CEP educates consumers about shopping and efficiency, while the Act 129 Plan provides specific efficiency incentives. Similarly Mr. Stathos contends that the Company's 5-year CEP educates consumers about shopping in ways that are complementary to the RMI mandates. Accepting that 76% of PPL's load is already provided through alternative suppliers, Mr. Stathos nonetheless asserts that that load only represents about 42% of customers, and therefore more customers need to be educated about choice.[137]

I&E contends that PPL witness Stathos' observations insufficiently distinguish the goals of the CEP from the goals of the RMI and Act 129 Plan and therefore fail to substantiate PPL's FTY expense of $5,482,000 as necessary or prudent for the continued provision of safe and reliable service at reasonable costs.

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[135] I&E St. 2 at 44.
[136] PPL St. 6-R at 2.
[137] PPL St. 6-R at 4-5.

While the Company's Act 129 Plan does provide financial incentives for energy efficiency, it also contains explicit educational components. PPL's Energy Efficiency Behavior & Education Program specifically provides for education about free or very low cost measures and behaviors that can significantly reduce energy consumption or demand as well as education about PPL Electric's online resources and EE&C programs. The program also encourages customers to adopt more energy efficient behaviors and to install energy efficiency measures in their homes. The financial incentives themselves implicitly incent customers to change behavior, thereby also providing an educational component to modifying behavior. Both the 5-year CEP and the Act 129 Plan educate customers about and facilitate change to energy consumption. Newer programs and costs under PPL's Act 129 Rider and the Commission's RMI should be approved. The 5-year plan and its attendant costs should be allowed to lapse naturally.[138]

With respect to the goals of the 5-year plan and the RMI mandates, the goals are not at all complementary. They are duplicative. Under both programs, consumers are educated on generation shopping. It is neither reasonable nor cost-effective to require ratepayers to support duplicate goals at the cost of an additional $5.4 million in rates annually to continue the 5-year CEP when newer RMI mandates have evolved to fund and accomplish the same goals.

[138] I&E St. 2-SR at 47-48, citing PPL's *Final Report for Year 2 of PPL Electric Utilities Corporation's Act 129 Plan* at Docket No. M-2009-2093216.

Mr. Stathos' efforts to distinguish the expenses fall short of proving by substantial evidence PPL's claims for additional annual funding. Ratepayer funding is not unlimited. In the Commission's May 17, 2007 Order commencing the Consumer Education Programs, the Commission identified eight Energy Education Standards that EDCs were required to address in their individual consumer education plans. Among those were the goals of educating consumers about the expiration of the rate caps and mitigation of those effects through shopping and conservation. Those broad goals, first established in PPL's initial 5-year CEP have evolved and been refined through the subsequent Act 129 program and RMI initiatives. PPL's funding must evolve as well. The Commission has now established newer programs to facilitate shopping and conservation.

Today over 40% of PPL's residential customers, almost 50% of PPL's commercial customers, and 66% of PPL's industrial customers are shopping. Customers are informed of shopping alternatives through myriad sources including the Commission itself, other regulatory parties such as the OCA, and the Electric Generation Suppliers (EGSs) directly. PPL provided no evidence that its initial 5-year CEP was directly responsible for the shopping results achieved so far, or that continuation of its initial plan is necessary in light of the newer plans and funding put into place subsequent to 2008. If PPL wishes to continue its initial programs it should be on a voluntary basis with funding through voluntary shareholder, customer, or supplier contributions. As Ms. Morrissey concludes:

"PPL's ratepayers are not the source of unlimited funding. They should not be required to continue to fund multiple programs with the same goals."[139]

G. Customer Assistance Programs

Community on Economic Opportunity witness Brady proposed increasing LIURP funding by $1.5 million. Mr. Brady cites to an increase in the low-income population on PPL's service territory from the period 2000 to 2008 as support for the increased funding. Mr. Brady contends that in that period the number of potentially eligible low-income customers in PPL's territory rose by 44% and the Company typically "exhausts" its Operation Help funding in the first half of the year.[140]

I&E witness Amanda Gordon opposes the increased funding. As stated by Ms. Gordon, Mr. Brady's analysis is too one-dimensional. Although Mr. Brady reviews the growth in PPL's low-income population from 2000 to 2008, he fails to review the total increase in the funding of universal service benefits PPL has experienced, and PPL's ratepayers have paid for, over the intervening years.

Since 2004, PPL has implemented three substantial base rate increases. From 2000 to 2010, PPL's funding for its OnTrack (customer assistance) program increased four-fold – by over 400% - from $9.5 million to $41.2 million. Further, from 2000 to 2008, the same time period in which Mr. Brady contends PPL's low-

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[139] I&E St. 2-SR at 52.
[140] CEO St. 1 at 7.

income population grew by 44%, PPL's ratepayer funding of its weatherization funding increased from $5.7 million to $8 million, a 40.35% increase.

Mr. Brady also excludes from his analysis PPL's implementation of its Act 129 WRAP program, which is estimated to assist an additional 23,590 low-income customers beyond those assisted through PPL's pre-existing WRAP program.[141] As PPL witness Dahl also noted, PPL does not "exhaust" its Operation Help funding mid-year. Rather, PPL dispenses that voluntary funding, which is limited, in four equal quarterly distributions.[142] Thus, CEO witness Brady's assertion that it is exhausted by mid-year is inaccurate.

As I&E witness Gordon also notes, aspects of LIURP other than funding also affect both a community's need and the Company's ability to deliver services. Simply mandating more ratepayer funding will not necessarily result in greater energy savings by the low-income population. First, the fact that less than 3% of PPL's electric-heat CAP customers exceeded their maximum CAP credit (their "asked-to-pay amount") indicates that PPL's CAP customers' required CAP payment is affordable. Second, more resources does not guarantee that the neediest of PPL's customers will receive weatherization. Many low-income ratepayers are also tenants: 15% of landlords do not give permission to PPL

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[141] I&E St. 4-R at 3.
[142] PPL St. 9-R at 5.

contractors to weatherize homes; another 15% fail to provide PPL with their landlords' contact information.[143]

Through 2012 PPL ratepayers will be compelled to contribute $75.35 million annually to the funding of PPL's universal service program benefits. That mandatory ratepayer funding is projected to increase to $78 million by 2014.[144] The trajectory of mandatory ratepayer funding of PPL's universal service benefits has skyrocketed upward, increasing 122% from 2008 to 2011 and projected to increase by 145% through 2014.[145] I&E submits that PPL's ratepayers are contributing sufficiently towards relief for their low-income neighbors. PPL's LIURP funding should remain at its current $8 million.

VI. TAXES

A. Gross Receipts Tax

The Pennsylvania gross receipts tax (GRT) is a tax imposed on EDCs' receipts from sales and distribution of electricity at a total tax rate of 59 mills (i.e. the equivalent of a 5.9% tax rate). The Company's total claim for GRT is $50,102,000, which comprises a pro forma GRT claim of $43,930,000 and an increase to its GRT claim of $6,172,000 related to its proposed rate increase. The Company's claim is based upon its estimated total billed base rate revenues subject to this tax.

[143] I&E St. 4-R at 4.
[144] I&E Cross-Examination Ex. 12, ln 9.
[145] I&E Cross-Examination Ex. 12, lns 13, 17.

I&E witness Morrissey recommends a total GRT allowance of $49,168,000, which is a $934,000 reduction to the Company's total claim. The recommended allowance comprises a recommended pro forma allowance of $43,100,000 and a rate increase allowance of $6,068,000 (assuming a full rate increase). The respective recommended GRT adjustments are reductions of $830,000 to the pro forma claim and $104,000 to the rate increase claim.

The basis for Ms. Morrissey's recommendation is that the Company's tax liability for the GRT is limited to the *actual* revenues it receives. Therefore, Ms. Morrissey recommends that the GRT tax allowance in rates should be calculated using the net revenues collected by the Company.

To determine the appropriate GRT allowance, Ms. Morrissey reduced gross billed revenues by the uncollectible expense because the Company does not incur a GRT tax liability on uncollected billed revenues. Ms. Morrissey reduced the Company's claimed pro forma revenues by the corresponding claimed pro forma uncollectible expense and applied the 59 mills to the net revenue to determine the pro forma GRT allowance and corresponding adjustment, i.e. a $830,000 reduction. For the GRT adjustment resulting from the Company's requested revenue increase, similarly Ms. Morrissey determined the net revenues by reducing the revenue increase request by her recommended uncollectible expense amount and applied the GRT tax rate and compared the recommended allowance to the Company's claim to determine the corresponding adjustment, i.e., a

$104,000 reduction.[146] I&E's recommendation to calculate the GRT allowance using net revenues is appropriate because it is a better match of the claimed actual receipts of revenue that will produce the Company's actual GRT tax liability.[147]

PPL witness Kleha contests Ms. Morrissey's GRT adjustment. Mr. Kleha claims that the Pennsylvania Department of Revenue (DOR) requires PPL to file its GRT returns using an accrual method of accounting and not actual revenues received. Mr. Kleha also contends that the DOR's documentation requirements for write-offs are very onerous, including matching write-offs to customers in the applicable tax period.[148]

Ms. Morrissey maintains her proposed adjustment. Mr. Kleha's claims about accrual accounting and his reliance on the DOR Corporate Tax Bulletin (supplied as I&E Ex. 2-SR, Sch. 1) do not invalidate Ms. Morrissey's adjustment. To the contrary, the bulletin confirms that the Company's net uncollected revenues will reduce its GRT tax liability, supporting Ms. Morrissey's proposed adjustment. As to Mr. Kleha's claim that the DOR has denied the Company's proposal to reduce its taxable revenue by its uncollectibles expense, that claim is unsubstantiated because the DOR audit is incomplete. Finally, Mr. Kleha's claim that the process of documenting uncollected revenues by customer by tax year is

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[146] Use of Ms. Morrissey's recommended uncollectible expense adjustment is subject to change dependent upon the final revenue increase approved as well as the acceptance of I&E's recommended uncollectible expense rate, addressed above. Using the Company's claimed uncollectible rate of 2.23% and revenue increase request, the resulting adjustment would result in a $138,000 reduction.

[147] I&E St. 2 at 46-48.

[148] PPL St. 8-R at 36-37.

burdensome and costly is not credible. Mr. Kleha offers no support that the cost of documentation would exceed the Company's overvaluation of its GRT absent the documentation. And Mr. Kleha admitted on cross-examination that the Company maintains records of customers' bad debt.[149]

B. PA Capital Stock Tax

PA Capital Stock Tax is a state tax imposed on a corporation's net worth. The current tax rate is 1.89 mils or 0.189% taxation of a computed modified net worth amount. This corporate tax is being phased out gradually and will be reduced January 1, 2013. The Company's FTY claim is $2,098,000 using the existing 0.189% tax rate.

I&E witness Morrissey proposes a Capital Stock Tax allowance of $873,000, which is a $1,225,000 reduction to the Company's claim. The primary basis for Ms. Morrissey's adjustment is her recognition that this tax is gradually being phased out and that the tax rate used will change in 2013, decreasing to 0.89 mills or 0.089%, effective January 1, 2013.

While the Company's State Tax Adjustment Surcharge (STAS) clause in its tariff can accommodate changes in tax rates such as the PA Capital Stock Tax, Ms. Morrissey contends that the Company should use the applicable PA Capital Stock tax rate that will be in effect at the expected implementation date of any rate changes that result from this proceeding. This will alleviate any immediate tariff

[149] Tr. at 171-72.

changes required because of a known tax rate change that differs from what is used in the base rate proceeding and give the financial benefit of the lower tax rate to ratepayers in a more timely fashion. Since the Company expects the tariff effective date of any rate changes resulting from this proceeding to be implemented January 1, 2013, it would be appropriate to use the applicable PA Capital Stock Tax rate for 2013.[150]

PPL witness Kleha contests Ms. Morrissey's adjustment. Mr. Kleha states the Company's STAS is the appropriate mechanism to reflect the capital stock tax rate reduction because it will ensure that PPL recovers no more or less that the actual tax liability for the year.[151]

I&E witness Morrissey maintains her proposed adjustment. Her recommendation will not only result in STAS being set to zero when rates go into effect, but also aid in maintaining STAS to stay at or near zero for the entire year in accordance with the requirements of 52 Pa. Code § 69.52. This recommendation uses known and measureable tax rates and benefits both the Company and ratepayers by reducing reconciliation complexity and eliminating any need for refunding. This, in turn, allows customers to keep their monies in pocket upfront for other immediate uses.[152]

An identical adjustment was raised by I&E (then OTS) and opposed by PPL in the Company's 2004 base rate case. The ALJ agreed with the OTS that the

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[150] I&E St. 2 at 49-50.
[151] PPL St. 8-R at 38.
[152] I&E St 2-SR at 56-57.

allowance for the CST "should be forward looking" and should be set based upon the tax rate to be effective January 1, 2005, not the older, higher rate claimed by PPL.[153] PPL did not except. The identical adjustment was also a specifically identified component to what was otherwise a black box settlement of PPL's 2007 base rate case, with PPL agreeing to incorporate the anticipated January 1, 2008 CST reduction into the filing, eliminating the need for the Company to file a STAS.[154] The same result should occur in this base rate proceeding.

C. Consolidated Tax Savings

Consolidated Tax Savings is the result of allocating tax loss deductions of affiliate companies to the positive tax companies of that same parent holding company group that comprise a federally-filed consolidated tax return. Though the Company computed a Consolidate Tax Savings, it claimed zero dollars in its FTY. The basis for the Company's claim is that PPL is in a current tax loss position.

I&E witness Morrissey recommends applying the computed Consolidated Tax Savings that is applicable to jurisdictional activity to the Company's FTY, resulting in a tax savings of $210,000. The basis for I&E's adjustment is that the Company has claimed a positive, normalized federal income tax expense for ratemaking purposes and this claimed positive expense is available and should be reduced by the Company's allocated share of these consolidated tax savings. This

[153] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (Order entered December 22, 2004), Slip Opinion at 54.
[154] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00072155 (Order entered December 6, 2007).

recommendation passes on to ratepayers the tax savings that result from filing a consolidated tax return.[155]

PPL witness Kleha contests Ms. Morrissey's adjustment. Mr. Kleha asserts that because the Company's FTY tax position is negative, no consolidated tax savings should apply. Even in consideration of the Company's proposed rate increase, at which point the Company will be in a positive tax position, Mr. Kleha contends reflection of a consolidated tax savings is premature until the Company files its 2012 tax returns.[156]

I&E's proposed consolidated tax savings adjustment is appropriate. The Company has proposed a $104.6 million rate increase. In the Company's FTY, the Company's claimed *normalized* federal tax position is positive. Stated otherwise, the Company is requesting recovery of federal income taxes for ratemaking purposes. If the Commission grants PPL no rate relief as I&E recommends, no consolidated tax savings adjustment should be applied. However, if the Commission grants a rate increase in any amount at or above $1 million, based upon the Company's filing and known and measureable tax rates it would be in a positive tax position sufficient to apply the entire computed jurisdictional consolidated tax savings of $210,000. If the Company benefits from the grant of a rate increase, the resulting positive tax position should be offset by a consolidated tax savings (not to exceed $210,000) in order to pass the tax savings benefit to

[155] I&E St. 2 at 51-52.
[156] PPL St. 8-R at 33-35; PPL St. 8-RJ at 6-7.

ratepayers by reducing the resultant amount of federal taxes claimed for recovery.[157]

VII. RATE OF RETURN

A. Introduction

In utility ratemaking, the concept of rate of return enjoys the dubious status of being at once both well-documented legally and highly disputed factually. Simply stated, rate of return is the revenue an investment generates in the form of net income, and is generally expressed as a percentage of the amount of capital invested over a given period of time. It is perhaps the most controversial component of the revenue requirement formula.[158]

A fair and reasonable overall rate of return allows the utility the opportunity to recover those costs prudently incurred by all classes of capital used to finance the rate base during the prospective period in which its rates will be in effect. *Bluefield Water Works & Improvements Co. v. Public Service Comm. of West Virginia*, 292 U.S. 679, 692-93 (1923) ("*Bluefield*"), and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope Natural Gas*") are the seminal cases that present the legal standards applicable to regulators calculating utility rates of return.

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[157] I&E St. 2-SR at 58.

[158] For calculation of a utility's base rate revenue requirements, the formula used RR = E + D + T + (RB x ROR), where RR = Revenue Requirement; E = Operating Expense; D = Depreciation Expense; T = Taxes; RB = Rate Base; and ROR = Overall Rate of Return. I&E St. 1 at 4-5.

In *Bluefield,* the Supreme Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.[159]

Twenty years later, in *Hope Natural Gas,* the Supreme Court reiterated:

> 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 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.[160]

Restated, the principles generally accepted by state and federal regulators as the appropriate criteria for measuring a fair rate of return are these:

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[159] *Bluefield,* 262 U.S. at 692-93.
[160] *Hope Natural Gas,* 320 U.S. at 603.

- A utility is entitled to a return similar to that being earned by other enterprises with corresponding risks and uncertainties, but not as high as those earned by highly profitable or speculative ventures;

- A utility is entitled to a return level reasonably sufficient to assure financial soundness;

- A utility is entitled to a return sufficient to maintain and support its credit and raise necessary capital;

- A fair return can change (increase or decrease) along with economic conditions and capital markets.[161]

I&E witness Emily Sears recommends the following rate of return for PPL:

Type of Capital	Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	55.00 %	5.58 %	3.07 %
Common Equity	45.00 %	8.38 %	3.77 %
Total	100.00 %		6.84 %[162]

Ms. Sears' recommendation is based upon her use of a barometer group of companies with characteristics similar to PPL. Ms. Sears also employs a hypothetical capital structure that is less reliant on the more costly equity capitalization, and calculates her recommended return on equity pursuant to the Discounted Cash Flow (DCF) methodology frequently used by the Commission while using the Capital Asset Pricing Model (CAPM) as an alternate means to verify the reasonableness of her return.

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[161] I&E St. 1 at 6. *See also Pennsylvania Gas & Water Company v. Pa. P.U.C.*, 341 A.2d 239 (Pa. Cmwlth. 1975).

[162] I&E St. 1 at 7; I&E Ex. 1, Sch. 1 at 1.

PPL Electric's proposed return on equity comprises the substantial component of PPL's $104.6 million proposed rate increase. As I&E's evidence incontrovertibly demonstrates, however, the pressure of sustaining the earnings of its parent, PPL Corp., is the real force behind the filing. As PPL Corp. itself repeatedly espouses to investors:

> PPL Corp.'s business mix is now heavily weighted toward rate-regulated earnings;
>
> Rate-regulated earnings provide stability and security to PPL Corp.'s earnings forecasts and its dividend;
>
> Rate-regulated earnings support PPL Corp.'s "Excellent" business risk profile rating by S&P and provide stable ratings outlooks;
>
> Rate-regulated earnings secure PPL Corp.'s dividend and support a platform for continued growth, increasing the dividend by 44% since 2005, providing shareowners a 17.5% return for 2011 attaining the high end of the company's 2011 forecast of $2.55-$2.75/share, outperforming the S&P 500 Index for 2011, and ensuring continued dividends that have already spanned 260 consecutive quarters – or an astounding 65 years of uninterrupted dividends;
>
> Rate-regulated earnings provide significant growth prospects with operations in "constructive" jurisdictions, approximately two-thirds of regulated capital expenditures earning real-time or near real-time returns, an approximate 9% compound annual growth in rate base from 2011 to 2015, and the expectation of 75% of 2013 EBITDA [Earnings Before Interest, Taxes, Depreciation, and Amortization] from regulated businesses;
>
> PPL Corp. has a highly attractive and differentiated position in the electric industry;
>
> The bottom line is this: Without the additional earnings from these rate-regulated operations, PPL [Corp.'s] earnings per share would be significantly depressed for 2012 and the foreseeable future[.] The fundamental driver of [PPL Corp.'s] acquisitions in 2010 and 2011

[of more rate-regulated entities] was reducing risk for [PPL Corp.] at a time of unprecedented turmoil in competitive electricity markets.[163]

As a subsidiary of PPL Corp., a public for-profit corporation intended to provide shareholder returns, it is entirely reasonable and expected that PPL Electric would contribute to corporate earnings. As the evidence in this proceeding confirms, however, with a 2011 17.5% return and uninterrupted dividends spanning 65 years, the Commission must carefully scrutinize the operations and claims of the rate-regulated entity PPL Electric to assure that the financial growth of PPL Corp. results from the entirety of its business operations and not unreasonably or unjustly from the "stability and security" of its rate-regulated subsidiary. I&E submits that the recommendation of its witness Sears assures just that.

B. Barometer Group

A barometer (or proxy) group is a group of companies that act as a benchmark for determining the utility's rate of return. In this instance, a barometer group is necessary because PPL is a private wholly-owned subsidiary of PPL Corp and is not publicly traded. A barometer group is also typically used because using data exclusively from one company may be less reliable than using a group of companies because the data for one company may be subject to short-term anomalies that distort its return on equity. Use of a barometer group smooths these

[163] I&E Cross-Examination Exs. 7 (PPL Corp. 2011 Annual Report to Shareholders); 6 (PPL Corp. Investor Presentation September 20, 2011); 5 (PPL Corp. May 15, 2012 Press Release Statement of PPL Chairman, President and Chief Executive Officer William H. Spence); Tr. at 291.

potential anomalies. Use of a barometer group also satisfies the long-established principle of utility regulation that seeks to provide the utility the opportunity to earn a return equal to that of similar risk enterprises.[164]

Ms. Sears selected her barometer group based on the following criteria:

1. 50% or more of the company's revenue were generated from the electric distribution industry;

2. The company's stock was publicly traded;

3. Investment information for the company was available from more than one source;

4. The company was not currently involved/targeted in an announced merger or acquisition; and

5. The company had six consecutive years of historic earnings data.

Ms. Sears' barometer group comprises Consolidated Edison, Dominion Resources, Nextera Energy, TECO Energy, PEPCO Holdings, and UIL Holdings.[165]

PPL witness Paul Moul selected two barometer groups, an Electric Distribution Group (EDG) and an Integrated Electric Group (IEG). Mr. Moul's EDG group was based upon the following criteria:

1. Their stock is traded on the New York Stock Exchange;

2. They are listed in the Electric Utility (East) section of *The Value Line Investment Survey*;

[164] I&E St. 1 at 8-9.
[165] I&E St. 1 at 9-11

3. They are not currently the target of a publicly-announced merger or acquisition; and

4. They do not have a significant amount of electric generation.

Mr. Moul's criteria for his IEG are identical except for criterion 4, which requires that at least 75% of the companies' identifiable assets are subject to public regulation.[166]

Mr. Moul's EDG group comprises Consolidated Edison, Northeast Utilities, Pepco Holdings, and UIL Holdings.[167] His IEG group comprises Dominion Resources, Duke Energy, SCANA Corp., Southern Co., and TECO Energy, Inc.[168]

I&E witness Sears disputes Mr. Moul's selected EDG and IEG barometer groups. Northeast Utilities must be excluded from his EDG and Duke must be excluded from his IEG because their inclusion violates Mr. Moul's own presumably objective criteria number 3 in that it Northeast is the subject of an announced merger with NSTAR and Duke is the subject of an announced merger with Progress Energy.

TECO Energy and Dominion Resources should be excluded from Mr. Moul's IEG and instead included in his EDG because they derive more than 50% of their revenues from their regulated electric distribution sector. However, Ms. Sears contends that Mr. Moul's IEG group should be disregarded in its entirety

[166] PPL St. 11 at 4-5.
[167] PPL Ex. PRM 1 at 5, Sch. 3.
[168] PPL Ex. PRM 1 at 7, Sch. 4.

because the group is too dissimilar in terms of business lines to be comparable to PPL in this proceeding: PPL does not have regulated generation or *gas* distribution, properties common to SCANA Corp. and Southern Co. included in Mr. Moul's IEG; and neither companies' revenues are derive more than 50% from electric distribution only.[169]

I&E submits that Ms. Sears' barometer is most comparable to PPL Electric and should be employed in developing an appropriate capital structure and cost of equity for PPL.

C. Capital Structure

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 if use of the utility's actual hypothetical capital structure has the potential to overstate the overall cost of capital. Ms. Sears recommends a hypothetical capital structure based upon her industry average of 54.89% long-term debt and 45.11% equity for the FTY (or 55% debt/45% equity).[170]

PPL witness Moul, on the other hand, employs PPL's actual capital structure of 48.98% long-term debt and 51.02% equity (or almost an even split of

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[169] I&E St. 1 at 11-12.
[170] I&E St. 1 at 12-13.

debt to equity at 49%/51%). Mr. Moul asserts this capital structure best approximates the mix of capital the Company will employ to finance its rate base during the period new rates are in effect.[171]

PPL's claimed capital structure alone, which effectively *is established by its parent*,[172] overstates PPL Electric's capital needs by $15 million[173] if left unadjusted to a structure more within the range of a comparable barometer group as I&E recommends. As Ms. Sears' notes, even the industry common equity ratio averages from Mr. Moul's own barometer groups – 44.8% for the EDG, 45.1% for the IEG, and 45.3% for the S&P Public Utilities – more closely approximate and support I&E's recommended capital structure of 55% debt and 45% equity.[174]

D. Cost of Long-Term Debt

I&E witness Sears recommends 5.58% as the appropriate cost of long-term debt for purposes of this proceeding. This represents PPL's expected cost of long-term debt and amortization of loss on reacquired debt for the FTY as calculated by PPL witness Moul, which Ms. Sears agrees is reasonable.[175]

E. Return on Common Equity

1. Introduction

Because PPL does not have publicly traded common stock, it is necessary to calculate a market-based recommendation predicated upon a similarly-situated

[171] PPL St. 11 at 22.
[172] OCA St. 2-SR at 12-13; Tr. at 325-26.
[173] Tr. at 364.
[174] I&E St. 1 at 14.
[175] I&E St. 1 at 14-15.

barometer group to determine an appropriate return on common equity. As the Pennsylvania Supreme Court noted in interpreting *Hope Natural Gas:*

> [w]e do not believe, however, that the *Hope* decision stands for the proposition ... that the end result of a ratemaking body's adjudication must be the setting of rates at a level that will, in any given case, guarantee the continued financial integrity of the utility concerned: Rather the *Hope* decision requires only that the regulatory authority balance consumer and investor interests to determine "just and reasonable" rates.[176]

As recommended by I&E witness Sears, an 8.38% return on common equity, based upon Ms. Sears' use of a similarly-situated barometer group of companies for purposes of determining capital structure, best balances the interests of the ratepayers and the Company.

2. I&E's Discounted Cash Flow Analysis

To arrive at an appropriate recommended return on common equity, I&E witness Sears uses the DCF method applied to a barometer group of similar utilities. Although there are four generally recognizable methods for determining the cost of equity, the DCF, CAPM, Risk Premium (RP), and Comparable Earnings (CE), the Commission historically has used the DCF as the primary

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[176] *Pennsylvania Electric Company v. Pa. P.U.C.* 502 A.2d 130, 133 (Pa. 1985); *appeal dismissed*, 476 U.S. 1137, 106 S. Ct. 2239, 90 L. Ed. 2d 687 (1986).

methodology to determine a utility's cost of equity.[177]

In sum, the DCF is "the 'dividend discount model' of financial theory, which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows. The DCF model assumes that investors evaluate stocks in the classical economic framework, which maintains that the value of a financial asset is determined by its earning power, or its ability to generate future cash flows."[178]

The DCF recognizes the time value of money, is forward-looking, and has wide-spread regulatory acceptance. Ms. Sears confirms the reasonableness of her DCF calculation with a comparison to the CAPM results because the Commission has expressed an interest in having results from another methodology as a point of comparison. While the CAPM is also forward-looking, has wide-spread regulatory acceptance, and is based on the concept of risk and return, it and the other methodologies have flaws that should discount their use as primary determinants.[179] Further, the DCF has greater regulatory acceptance than any other methodology.

Based upon her analysis, Ms. Sears recommends a cost of common equity of 8.38%. Ms. Sears' analysis uses a spot dividend yield and a 52-week dividend

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[177] The Commission has a long history of determining the cost of common equity by primarily by using the DCF method and informed judgment. *See Pa. P.U.C. v. PECO Energy Co.*, 87 Pa PUC 184, 212 (1997); *Pa. P.U.C. v. City of Bethlehem)*, 84 Pa PUC 275, 304-05 (1995); *Pa. P.U.C. v. Media Borough*, 77 Pa PUC 446, 481 (1992); *Pa. P.U.C. v. Philadelphia Suburban Water Co.*, 71 Pa PUC 593, 623-32 (1989); *Pa. P.U.C. v. Western Pennsylvania Water Co.*, 67 Pa PUC 529, 559-70 (1988); *Pa. P.U.C. v. Consumers Pennsylvania Water Company – Roaring Creek Division*, 87 Pa. PUC 826 (1997).
[178] I&E St. 1 at 16.
[179] I&E St. 1 at 17-22.

yield, and a combination of earnings growth forecasts and a log-linear regression analysis growth rate. Ms. Sears employs the standard DCF model formula, $k = D_1/P_0 + g$, where k = the cost of equity, D_1 = the dividend expected during the year; P_0 = the current price of the stock; and g = the expected growth rate. When a forecast of D_1 is not available, D_0 (the current dividend) must be adjusted by ½ the expected growth rate[180] in order to account for changes in the dividend paid in period 1.[181]

Using her recommended dividend yield of 4.89% and her recommended growth rate of 3.49%, Ms. Sears calculates an appropriate return on common equity for PPL to be 8.38%.

a. Dividend yields

A representative yield must be calculated over a time frame sufficient to avoid short-term anomalies and state data. Ms. Sears' dividend yield calculation places equal emphasis on the most recent spot (4.78%) and 52-week average (5%) dividend yields resulting in an average dividend yield of 4.89%.[182]

b. Growth rates

Ms. Sears used both earnings growth forecasts and a log-linear regression analysis data to calculate her expected growth rate. Her earnings forecasts are

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[180] The adjustment of ½ the growth rate is used when the timing of the dividend increase is not known for certain. It could occur next month, or in the twelfth month. On average, it is safe to assume that the increase will occur half way through the prospective year. Therefore, an adjustment by ½ the expected growth rate is appropriate.

[181] I&E St. 1 at 24.

[182] I&E St. 1 at 24-25.

developed from projected growth rates using 5-year estimates from established forecasting entities for her barometer group of companies, yielding an average 5-year growth forecast of 4.79%.[183]

Because investor forecasts may be biased and/or distorted by misestimates, Ms. Sears used a log-linear regression analysis to determine a more appropriate long term growth rate. Ms. Sears' log-linear regression analysis used historic earnings per share (EPS) from *Value Line* for the years 2006-2011. She then used the financial analysts forecasted growth rate to project EPS values for the FTY (2012) through 2016, and calculated the natural log of the EPS for each company in her barometer group for each year 2006 through 2016. She then calculated the slope (or best fit) of the linear regression created by the EPS data points, converted the slope coefficient of the continuous growth rate to an annual growth rate, and took the antilog of the continuous growth rate minus 1 to arrive at an annual growth rate. The result of her log-linear regression analysis provided an average growth rate of 3.49%.[184]

c. Market Pressure, Selling and Issuance Expenses

In her analysis, Ms. Sears considered but made no adjustment to account for market pressure, selling expenses, and issuance expenses. Market pressure, and selling and issuance expenses are additional costs of capital incurred at the time of issuance. An efficient market hypothesis asserts that prices on any market-traded

[183] I&E St. 1 at 25-26.
[184] I&E St. 1 at 25-30.

assets already reflect all known information. Therefore, a market-based analysis is unbiased in that it reflects the collective beliefs of all investors about future prospects. The current market price of common stock already reflects these selling and issuance costs as they are already included in determining the value of the stock at the time of purchase. Since Ms. Sears' analysis is market-based, these items have been taken into consideration and no additional adjustments are necessary.[185]

d. Comparison to CAPM

I&E witness Sears' analysis of a return on equity using the CAPM methodology uses the standard CAPM formula $K = R_f + \beta(R_m - R_f)$, where K = the cost of equity, R_f = the risk-free rate of return; β = beta, which measures the systematic risk of an asset, and R_m = the expected rate of return on the overall stock. The CAPM formula is actually a form of the more general risk premium approach and is based on modern portfolio theory.[186]

For her CAPM analysis, Ms. Sears chose the risk-free rate of return (R_f) from the projected yield on 10-year Treasury Bonds as the most stable risk-free measure. With this choice, Ms. Sears balanced out issues related to use of long term bonds and short term T-Bills. For her Beta, Ms. Sears used the average of the betas from *Value Line.* To arrive at a representative expected return on the overall stock market, Ms. Sears surveyed *Value Line*, *Morningstar*, and the S&P 500

[185] I&E St. 1 at 30, citing Fama, Eugene (1970), "Efficient Capital Markets: A Review of Theory and Empirical Work," *Journal of Finance* 25: 383-417.
[186] I&E St. 1 at 31.

Index. For the S&P returns, Ms. Sears selected five different time periods ranging from 5 to 86 years in order to represent a variety of investor experiences and time horizons. The results of these two overall stock market returns based on Ms. Sears' forecasted and historic CAPM analyses are 16.02% and 6.02%, respectively. These, in turn, yield cost of equity results under the forecasted and historic analyses of 12.31% and 5.06%, respectively.

I&E witness Sears gave no specific weight to her CAPM results because of her concerns that unlike the DCF, which measures the cost of equity directly by measuring the discounted present value of future cash flows, the CAPM measures the cost of equity indirectly and can be manipulated by the time period used. However, having presented two analyses – historic and forecasted – both of which are comprehensive in the time periods covered, I&E submits that for purposes of providing another point of comparison, the 8.68% simple average of those two analyses confirms the reasonableness of Ms. Sears' 8.38% return under her DCF calculation.[187]

[187] I&E St. 1 at 31-37. The presentation of the CAPM analyses is purely for Commission consideration of an alternative means of analyzing financial data. For the reasons fully set forth in Ms. Sears direct testimony, I&E supports the DCF as the superior methodology for conducting a rate of return analysis in a utility ratemaking proceeding.

3. PPL's Proposed Return on Common Equity

PPL witness Moul relies on the DCF, CAPM, RP, and CE methodologies in presenting his recommended return on equity. Based upon the use of his EDG and IEG barometer groups, Mr. Moul calculates the following equity returns:[188]

Measure	EDG	IEG
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%
Indicated Cost of Equity		**11.25%**

While calculating average returns on equity for his respective groups of 11.13% and 11.43%, Mr. Moul's indicated cost of common equity reflects his upward adjustment of 70 basis points for his EDG and 118 basis points for his IEG to account for his leverage claim. It further reflects his upward adjustment of 120 basis points for both EDG and IEG to reflect his claim that PPL has higher business risk due to its small size relative to his proxy group. Finally, his indicated cost of common equity reflects his upward adjustment of still another 12 basis points to reflect PPL's requested award for claimed management efficiency.[189]

[188] PPL St. 11 at 3-6.
[189] I&E St. 1 at 37.

I&E witness Sears opposes Mr. Moul's calculated return on equity for several reasons. First, as stated above in the discussion of barometer groups, Mr. Moul's selected barometer group is flawed in that several of his selections fail to meet even Mr. Moul's own purportedly objective selection criteria. Second, Mr. Moul gives undue weight to the RP and CE methods. Third, Mr. Moul employs an inflated DCF growth rate and a dividend yield adjustment that is unnecessary. Fourth, Mr. Moul employs inflated CAPM betas. Finally, Mr. Moul's extra-method adjustments for leverage, size (business risk), and management efficiency are unsupported and inappropriate.

a. PPL's Flawed Barometer Group

As stated above in Section VII.B., Mr. Moul's barometer groups are faulty. Two utilities, Northeast and Duke, must be removed from his EDG because they are each individually the subject of an announced merger. TECO Energy and Dominion Resources should be excluded from Mr. Moul's IEG because they derive more than 50% of their revenues from their regulated electric distribution sector. However, Mr. Moul's IEG group should be disregarded in total because the group is too dissimilar in terms of business lines to be comparable to PPL.

b. PPL's Flawed Equal Weighting of DCF, CAPM, RP, and CE

It is inappropriate to give equal weighting to the four different methodologies as Mr. Moul does. The CAPM suffers from being an indirect measure of the cost of equity that is easily manipulated depending on the time

period employed in the analysis. The CE methodology is subjective in terms of the selection of comparable companies, has generally been rejected by the Commission, and, in Mr. Moul's particular analysis, compares projected returns of companies of dissimilar business and financial risk.[190] The RP is merely a simplified version of the CAPM – the "evil clone" of the CAPM as stated by the author of an article relied upon by Mr. Moul[191] – and therefore suffers the same flaws. In addition, in calculating equity risk premium, Mr. Moul concludes his analysis at 2007, leaving out 4 years (2008-2011) of data.[192]

While Mr. Moul cites the Lehman Brothers bankruptcy as a reason to conclude his analysis at 2007, omitting this data not only renders it stale, but also since Lehman Brothers announced bankruptcy four years ago, continuing to use 2007 data does not allow for determining a *current* cost of equity. Even if the markets have almost returned to pre-financial crisis levels as Mr. Moul asserts, his omission renders his data analysis incomplete and dated. If the markets have recovered to about 91% of the peak level prior to the financial crisis, meaning the 2012 numbers are 91% of what they were in 2007, omission of those four years of data in theory causes the current cost of equity (2012) to account for only 91% of Mr. Moul's determined cost of equity (2007).

Although Mr. Moul presents no evidence what this number would be if based upon a complete and current analysis, Ms. Sears does. Using Mr. Moul's

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[190] I&E St. 1 at 19-23, 38-39.
[191] I&E Cross-Examination Ex. 1; Tr. 222-23.
[192] PPL Ex. PRM-1 at 27, Sch. 36.

91% figure but not correcting for the other flaws identified by Ms. Sears, Mr. Moul's RP determined through 2007 should be lowered to 9.78% (10.75% x 91%) for 2012. Clearly this missing data is an important factor and must be included if determining the appropriate cost of equity using the RP model.[193]

c. PPL's Inflated DCF Growth Rates

PPL witness Moul employed a growth rate of 5% based upon an average EDG growth rate of 4.87% and an average IEG growth rate of 5.14%. However, because Mr. Moul's growth rate is developed from his flawed barometer groups, his growth rates are overstated. As stated above, Mr. Moul's EDG contains two companies that are the subject of announced mergers. Because announced mergers typically affect analysts' forecasts, use of those companies in the EDG overstates the DCF analysis. Further, the IEG includes companies that are not similar in business risk to PPL. Again, such dissimilarity can overstate growth rates, thus overstating Mr. Moul's DCF analysis.[194]

d. PPL's Unnecessary Dividend Yield Adjustment

Mr. Moul proposes an ex-dividend adjustment to the dividend yields of his barometer group by adjusting the "month-end prices to reflect the buildup of the dividend in the price that has occurred since the last ex-dividend date."[195] The ex-dividend adjustment as proposed by Mr. Moul is inappropriate because it is unsupported in academic literature, there is no evidence that investors make this

[193] I&E St. 1 at 52-53.
[194] I&E St. 1 at 39-40.
[195] PPL St. 11 at 25.

adjustment in the context of the DCF model, and financial publications do not provide ex-dividend adjusted yields to investors that might be used for their financial investment decision making. If such information were an important factor in an investor's decision-making process, main stream financial publications would regularly include it. That they do not is indicative of the lack of support for Mr. Moul's adjustment.[196] Before adjustment, Mr. Moul uses a dividend yield of 4.54% for his EDG and 4.56% for his IEG, both before adjustments.[197]

e. PPL's Inflated CAPM Betas

Mr. Moul justifies inflation of his CAPM betas in the same manner through which he enhances his DCF returns – application of a financial risk or leverage adjustment.[198] As addressed more fully below, a leverage adjustment, in this case to inflate the betas, is as unwarranted in a CAPM analysis as it is in a DCF analysis. If the unadjusted *Value Line* betas do not accurately reflect investment risk as Mr. Moul contends, *Value Line* would not publish unadjusted betas. Until a leverage adjustment is demonstrated in the academic literature to be valid, such leverage adjusted betas in a CAPM model should be rejected as unsound and unsupported.[199]

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[196] I&E St. 1 at 40-41.
[197] PPL St. 11 at 26.
[198] PPL St. 11 at 52-53.
[199] I&E St. 1 at 53-54.

f. PPL's Inappropriate Leverage Adjustment

Financial leverage is the use of debt capital to supplement equity capital. A firm with significantly more debt than equity is considered highly leveraged. Generally, a market-to-book ratio is used to evaluate a public firm's equity value. This is done by comparing a company's equity market value to a company's equity book value.[200]

In his return on equity analysis, Mr. Moul proposes a 70 basis point leverage adjustment to his EDG and a 118 basis point leverage adjustment to his IEG. Mr. Moul justifies the adjustment as necessary when the results of the DCF model (k) are to be applied to a capital structure that is different than that which underlies the market price (P).[201] This adjustment is not made to change the capital structure of the utility (a leverage adjustment) nor does it apply the market-to-book ratio to the DCF model (a market-to-book adjustment). Instead, Mr. Moul proposes the adjustment to account for applying the market value cost rate of equity to the book value of the utility's equity. Currently, there is no term in academic journals or text books that describes this type of adjustment.[202]

Mr. Moul theorizes that if regulators use the results of the DCF to compute the weighted average cost of capital based on a book value capital structure used for ratemaking purposes, the utility will not, by definition, recover its risk-adjusted capital cost. Mr. Moul believes this is because market valuations of equity are

[200] I&E St. 1 at 41-42.
[201] PPL St. 11 at 37.
[202] I&E St. 1 at 42.

based on market value capital structures, which in general have more equity, less debt and, therefore, less risk than the capitalization measured at its book value.[203]

Ms. Sears' thorough analysis of Mr. Moul's leverage adjustment debunks any purported validity. First, rating agencies assess financial risk based upon the company's booked debt obligations and the ability of its cash flow to cover the interest payments on those obligations. The agencies use a company's financial statements, particularly income statements, for their analyses, not market capitalization. Regardless how the market values investments, the financial statements show the interest expense and income volatility, not the market, therefore a leverage adjustment to account for differences in market-to-book ratios is not necessary.

Second, while the Commission has granted this adjustment on occasion, it has also clearly rejected it in the past. In a Blue Mountain Water Company case on remand from Commonwealth Court to clarify findings concerning fair rate of return, the Commission identified seven principles that were applied to analyze the company's required and lawful rate of return. The Commission's third identified principle stated that "[m]arket price-book value ratios are not a goal of regulation but a result of regulation, general economic factors and individual company's characteristics of management, operations and perceived future. *In general, we*

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[203] PPL St. 11 at 35.

view a market-book ratio in the area of one-to-one as appropriate for regulated industry."[204]

In a 2008 case involving Aqua Pennsylvania, Inc., the Commission rejected the ALJ's recommendation for a leverage adjustment stating, "the fact that we have granted leverage adjustments in the past does not mean that such adjustments are indicated in all cases."[205] In a 2007 Metropolitan Edison Company case, the Commission rejected the Company's financial risk increment related to the leverage difference between market capital structures and book value capital structures.[206] Most recently in a City of Lancaster case, the Commission agreed with Ms. Sears' recommendation to reject the leverage adjustment, stating "any adjustment to the results of the market based DCF as we have previously adopted are unnecessary and will harm ratepayers. Consistent with our determination in *Aqua 2008* there is no need to add a leverage adjustment."[207]

Mr. Moul points to six cases in which the Commission accepted his leverage adjustment. All but one of those cases date from 2004, with the last dating to 2007.[208] Moreover, his devotion to the adjustment is certainly more

[204] *Pa. P.U.C. v. Blue Mountain Consolidated Water Co.*, 1982 WL 213115 (Pa. P.U.C.), at 1 (emphasis added).
[205] *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, (Order entered July 31, 2008) at 38.
[206] *Pa. P.U.C. v. Metropolitan Edison Co.*, Docket No. R-00061366, p. 34 (Order entered January 11, 2007) at 34.
[207] *Pa. P.U.C. et al. v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103 (Order entered July 14, 2011) at 79.
[208] PPL St. 11 at 37.

consistent than the Commission's, having proposed it in 68 cases over a 23 year period yielding just 6 successful results.[209]

Third, the cited literature does not support Mr. Moul's calculation. Mr. Moul supports his calculation of the leverage adjustment as a "convenient way to compare the return computed directly with the Modigliani & Miller formulas to the return generated by the DCF model based on a market value capital structure."[210] However, Mr. Moul misinterprets Modigliani and Miller's theory and employs it in a way the researchers never advocated.

Modigliani and Miller's research is focused primarily on understanding company capital investment behavior, not purported financial risk associated with the divergence of a stock's market price from its book value. In fact, the work of Modigliani and Miller actually supports the opposite conclusion, that is, that the market value of any firm is independent of its capital structure[211] and that the value of any firm must be independent of its financial structure.[212] The adjustment and formula employed by Mr. Moul are not even found in the research he cites nor in any other academic literature.[213]

Finally, Mr. Moul's formulae for the adjustment are flawed. Mr. Moul uses the following formulae:

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[209] I&E Cross-Examination Ex. 3; Tr. at 234-35.
[210] PPL St. 11 at 43.
[211] I&E St. 1 at 47, citing Modigliani, Franco and Miller, Merton H. "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, June 1958, at 268.
[212] *Id.*, citing Modigliani, Franco and Miller, Merton H. "The Cost of Capital, Corporation Finance, and the Theory of Investment: Reply" *American Economic Review*, June 1965 at 525.
[213] I&E St. 1 at 46-47.

$$ku = ke - (((ku - i)\ 1\text{-}t)\ D/E) - (ku - d)\ P/E; \text{ and}$$

$$ke = ku + (((ku - i)\ 1\text{-}t)\ D/E) + (ku - d)\ P/E$$

where ku = cost of equity for an all equity firm, ke = market determined cost equity, i = cost of debt; d = dividend rate on preferred stock, D = debt ratio, P = preferred stock ratio, and E = common equity ratio.[214]

These formulae do *not* appear anywhere in the research Mr. Moul cites nor does the literature Mr. Moul cites espouse using its native formulae in a DCF adjustment setting. As previously stated, Mr. Moul's leverage formulae are found nowhere in the Modigliani and Miller literature or the Roger Morin *Regulatory Finance: Utilities' Cost of Capital* book also purportedly relied upon by Mr. Moul. Even if present in Dr. Morin's literature, which it is not, Mr. Moul again uses the information in ways the author, Dr. Morin, has not advocated. Dr. Morin discusses the cost of equity in relation to an optimal capital structure, not any relation to market price and book value capital structure. Dr. Morin concludes as follows:

> Given that there are several theories of capital structure and that none has emerged as the victor, the one inescapable conclusion from the research is that debt affects the cost of equity and that a company has a different cost of equity at a different capital structure. Therefore, the capital structure used to estimate the cost of equity is an integral inseparable part of that estimate.

Since Mr. Moul claims the capital structures in his barometer groups are comparable to PPL's, it would be erroneous to adjust the return determined by the

[214] PPL St. 11, Appendix E at 14 and 15.

barometer group on the basis of Dr. Morin's book.[215]

Further, Mr. Moul's formula to determine the cost of equity of a 100% equity firm ("ku") does not actually determine the cost of equity of a 100% equity firm. Rather, it assumes the cost of equity of a 100% equity firm to be 7.93% for the EDG and 8.11% for the IEG. Mr. Moul provides no support for these figures. The effect of the assumed "ku" rate of 7.93%/8.11% is amplified by its presence in the formula for the market determined cost of equity ("ke").

Also, on a very basic algebraic level, the formula "solving" for *ku* cost of equity for an all-equity firm does not actually solve for "ku." As shown on Mr. Moul's Appendix E, page E-14, the term "ku" is listed on *both sides* of the equation. Since Mr. Moul is trying to solve for "ku," it should only be listed on one side. Elementary algebra teaches that in order to solve for a variable, such as "ku" in this case, every appearance of that variable must be moved to one side. Mr. Moul has not done this. When asked to provide a detailed calculation to solve for ku = 7.93% and 8.11%, it was offered that the "ku" on the right hand side of the equation is solved for before the left hand side "ku" is solved (which are the same factor). In other words, Mr. Moul offers that "ku" is solved before "ku" is solved, which is a mathematical impossibility. There is also no source for the 7.93%/8.11% on the right hand side of the equation, which is the "ku" variable.

[215] I&E St. 1 at 49-50.

Therefore, Mr. Moul's 7.93% and 8.11% values for the EDG and IEG, respectively, are assumed arbitrary values for "ku" and cannot be relied upon.[216]

Last, investor information also supports rejection of Mr. Moul's leverage adjustment. A *Value Line Investment Survey* for Mr. Moul's EDG showing the market and book values of debt and equity assigns the book valued capital structure percentages and the book value of debt at the end of 2010. While Mr. Moul testifies that the market return is based upon market valued capital structures, this investment information proves this to be untrue for the regulated utility industry. Thus, investors base their decisions, and therefore their required market return, on the *book* values, not the *market* values. No leverage adjustment is needed or supported.[217]

g. PPL's Inappropriate Risk Assessment

Mr. Moul's rate of return recommendations are also grossly overstated by his assignment of several faulty assumptions of risk to PPL.

i. Unsupported Business Risk – Size

In addition to his inflated DCF growths rates, unnecessary dividend yield adjustment, inflated CAPM betas, and unnecessary upward adjustments for leverage, Mr. Moul also proposes a 120 basis point upward adjustment because he believes that as the size of a firm decreases, its risk and, hence, its required return, increases. Further, Mr. Moul uses the SBBI Yearbook to argue that the returns for

[216] I&E St. 1 at 50-51.
[217] I&E St. 1 at 52; I&E Ex. 1, Sch. 14 at 2.

stocks in lower deciles had returns in excess of those shown by the simple CAPM.[218] Mr. Moul's size adjustment is unnecessary.

While some technical market literature supports adjustments relating to a company's size, in a critical point of distinction, this literature is *not* specific to the utility industry. On the other hand, utility-specific academic literature specifically argues against a size adjustment for utilities. A specific study of utility stocks and the size effect concluded as follows:

> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that *there is no need to adjust for the firm size in utility rate regulation*.[219]

In addition, as explained by Ms. Sears without response from Mr. Moul, this adjustment also suffers from the January effect and is unpredictable. The size effect is seasonal and sometimes referred to as the January effect because virtually all of the small stock effect occurs in the month of January. As a consequence, the excess returns Mr. Moul attributes to a firm's size are also equally attributable to the month of January, a consequence Mr. Moul neither recognizes nor explains.

As to unpredictability, the Ibbotson SBBI 2012 Valuation Yearbook states:

> By simple definition, one cannot expect risky companies to always outperform less risky companies; otherwise they would not

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[218] PPL St. 11 at 54-55.

[219] I&E St. 1 at 55, citing Dr. Annie Wong, "Utility Stocks and the Size Effect: An Empirical Analysis," *Journal of Midwest Finance Association*, 1993, at 95-101 (emphasis added), reproduced in I&E Ex. I, Sch. 15.

be risky. ...One thing that we do know about the size premium is that it is cyclical in nature...It is not unusual for the size premium to follow several years of consistently positive values with several years of consistently negative values...We should actually expect periods of small stock underperformance as well as over performance in the future. ...One might observe the last 20 years of market data to see that the performance of large-capitalization stocks. In fact, large-capitalization stocks have outperformed small-capitalization stocks in four of the last ten years.[220]

Mr. Moul's proposed size adjustment is unsupported, inapplicable to utilities, unpredictable, and indistinguishable from other equally explicable variations in risk. At the very minimum, until current and credible literature specifically supports Mr. Moul's size adjustment for utilities, it should be rejected.

ii. Flawed Electric Utility Risk Analysis

In addition to his unsupported risk adjustment based upon size, I&E submits that PPL witness Moul has grossly overstated the business risk faced by PPL specifically and the electric distribution industry generally, further contributing to his gross overstatement of the appropriate cost rate for PPL's equity capital.

PPL witness Moul identifies the primary risk factors PPL faces as regulation, which diminishes management's ability to adjust its business strategy quickly; a potential for bypass; the potential for financial penalties associated with operation problems; and growth in the utilization of the transmission and

[220] I&E St. 1 at 55-58, citing Ibbotson SBGI 2012 Valuation Yearbook at 102-03.

distribution network by non-affiliated generators and marketers.[221] Mr. Moul's statements, however, lack support and directly result in an overstatement of his equity cost recommendation.

Mr. Moul stated he could provide no evidence that PPL has paid any financial penalties, which he defines as foregone revenues, regulatory disallowance, and additional expenses. He admitted that he had no access to and reviewed no data specific to PPL, and that in addition to this purported risk not applying to PPL in particular, it did not even apply to the electric utility industry in general.[222]

With respect to the purported risk of growth in transmission and distribution network bypass, despite the experience of over a decade of competition and Mr. Moul's admission that he expressed this same concern in 2010, there is no evidence that PPL is experiencing this risk. According to current data provided by PPL, the Company has over 18 non-affiliated generators interconnected with its transmission network, and approximately 2,400 non-affiliated generators connected to its distribution network, yet *none* of these parties serves other customers or potential customers of PPL.[223] Mr. Moul's concerns are unsupported and gross exaggerations that cannot be relied upon.

Mr. Moul also grossly underestimates the mitigation of risk that accompanies the legislative introduction of the Distribution System Improvement

[221] PPL St. 11 at 8-9.
[222] I&E St. 2 at 58; Tr. at 236-37.
[223] I&E St. 2 at 58; I&E Cross-Examination Ex. 2; Tr. at 231-32, 447-48.

Charge (DSIC) for PPL. Mr. Moul ignores the fact that PPL first sought approval of a DSIC in 2004 on the basis that it would "facilitate" the Company's investment.[224] Mr. Moul believes the DSIC will have "no impact" on the rates set in this proceeding because the DSIC will not be effective until 2013, and because the DSIC is subject to a variety of limitations including a cap on the amount of revenues that can be collected. He also notes that the Commission has never adjusted a water utility's return for the existence of a DSIC.[225]

While it is true that the DSIC will not become effective until 2013 and is subject to limitations as to plant and revenues, Mr. Moul's failure to recognize *any* effect on risk factors prospectively and thereby appropriately determine the equity cost rate to allow in this proceeding overstates the risk PPL faces prospectively, and, consequently, the equity return Mr. Moul recommends. Rate of return is forward looking. PPL will file in *this future test year* the infrastructure improvement plan that is a necessary precursor to effectuation of the DSIC in 2013.[226] Clearly, filing for the DSIC will timely follow. Consequently, if not appropriate actually to reflect PPL's lower risk as a result of PPL's highly anticipated implementation of the DSIC, it is certainly entirely inappropriate to continue to inflate PPL's risk, as Mr. Moul does, in light of PPL's ultimate legislative success in attaining that alternative ratemaking mechanism.[227]

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[224] *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, at 19-23.
[225] PPL St. 11 at 10-11.
[226] Tr. at 445.
[227] I&E St. 1 at 58-60.

The fact that PPL's own parent, PPL Corp., views passage of the DSIC as a positive investment risk development is well-documented on this record.[228] In its investor presentations from late 2011 through early 2012, PPL Corp. closely tracked and reported on the status of the DSIC legislation in Pennsylvania. Almost monthly PPL Corp. reported on the movement of the DSIC legislation from the House Consumer Affairs Committee[229] to passage by the full House of Representatives, to review by the Senate Consumer Protection and Professional Licensure Committee, to passage by the full General Assembly and ultimately approval by the Governor.[230]

Yet, despite the parent company's complete embrace of the positive impact on the investor community resulting from the DSIC, Mr. Moul not only completely ignores it in his evaluation of PPL's risk, he continues to assert PPL specifically, and the EDC community in general, face such risk as to warrant a higher cost of equity. I&E submits that the behavior of PPL's own parent more accurately reflects the anticipated impact the DSIC will have on PPL's investment risk, and that such behavior directly proves the flaw of Mr. Moul's exclusion of consideration of the DSIC in developing his recommendations in this proceeding. Thus, again, Mr. Moul overstates PPL's risk and thereby overstates his recommended cost of equity.

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[228] Tr. at 292.
[229] I&E Cross Examination Ex. 6 at 9.
[230] Tr. at 293-94.

While the Commission may not have adjusted water equity returns downward because of the existence of a DSIC, at a minimum Act 11 of 2012 should offset Mr. Moul's concerns of increased risk due to the increased capital needed for infrastructure improvements. The existence of the DSIC will also allow PPL to be similar in risk to the EDG in its ability to collect its infrastructure needs on a current basis rather than on a deferred basis including a return on equity. If there is no need to *decrease* the rate of return for the existence of a DSIC, there certainly is no need to *increase* the rate of return for the increased infrastructure needs, the costs of which will be recovered on a timely basis by the DSIC.[231]

iii. Flawed Barometer Group Risk Comparisons

PPL witness Moul discusses several other categories of financial and business risk facing PPL, including bond ratings, size, market ratios, common equity ratio, return on equity, operating ratios, coverage, quality of earnings, internally generated funds, and betas. Comparing PPL, his EDG, his IEG, and the S&P Public Utilities, Mr. Moul concludes that the "Company requires a higher common equity ratio prospectively in order to reduce its financial risk in order to offset its higher business risk attributed to the factors noted above."[232] I&E submits that these risk assessments are likewise flawed.

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[231] I&E St. 2 at 61.
[232] PPL St. 11 at 12-19.

aa. Credit ratings

With respect to PPL's credit quality, Mr. Moul states that PPL's credit ratings are "one notch" below the EDG. Mr. Moul believes that the Company's weaker credit ratings indicate higher risk for the Company.[233] I&E witness Sears disagrees.

PPL's actual capital structure includes 6% less debt (54%-48%) than Mr. Moul's barometer groups or even I&E's barometer group. As Mr. Moul agrees, less debt makes a company less risky.[234] Further, credit rating agencies acknowledge PPL's "predictable nature of its regulated transmission and distribution utility cash flows," and its "excellent business risk profile,"[235] precisely the same business mix that is "weighted heavily toward rate-regulated earnings, provid[ing] stability and security to [PPL Corp.'s] earnings forecasts, [its] dividend and [ ] credit ratings."[236]

S&P appropriately ties PPL to its parent, PPL Corp., stating in several publications that "lower ratings on PPL [Corp.] could result in lower ratings on PPL Electric Utilities Corp. [PPL]."[237] As Ms. Sears noted, however, PPL's downgrade was due to its parent company's credit problems and its fluctuating revenues from its non-regulated businesses, not due to PPL itself. In fact, the

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[233] PPL St. 11 at 13.
[234] PPL St. 11 at 15, 19, 36, 38-40.
[235] I&E St. 1 at 63.
[236] Tr. at 290.
[237] I&E St. 1 at 63.

credit agencies cite to PPL the rate-regulated entity as the source for the stable cash flows which help PPL Corp. retain a stable rating.[238]

This is precisely the turn-about in credit and risk exposure the PPL Corp. sought by its "exceptional transformation" in just two years.[239] PPL Corp. itself acknowledges something Mr. Moul refuses to do, namely that it is a "fundamentally different company compared with two years ago, having changed its business mix" and "forecasting that 70 percent of PPL [Corp.'s] 2012 ongoing earnings will come from our rate regulated businesses in the United Kingdom, Kentucky and Pennsylvania."[240] This is a stark comparison to 2010, when 73% of PPL Corp.'s ongoing earnings came from its unregulated sector. As PPL Chairman, President, and Chief Executive Officer William Spence clearly concluded:

> The bottom line is this: Without the additional earnings from these rate-regulated operations, PPL's earnings per share would be significantly depressed for 2012 and the foreseeable future. . . . *The fundamental driver of our [rate-regulated] acquisitions in 2010 and 2011 was reducing risk for the company* at a time of unprecedented turmoil in competitive electricity markets."[241]

By substantially restructuring its business profile to a substantially rate-regulated business operation, PPL has a low-business risk and less percentage debt than the

[238] *Id.*
[239] I&E Cross-Examination Ex. 7 at 1; I&E Cross-Examination Ex. 5; Tr. at 289-90.
[240] I&E Cross-Examination Ex. 5 at 1; Tr. at 283.
[241] I&E Cross-Examination Ex. 5 at 1. Tr. at 284 (emphasis added).

barometer group, and is therefore inappropriate to increase the return on equity in this case due to the parent company's weaker credit profile.[242]

bb. Common equity ratios

With respect to common equity ratios, Mr. Moul testifies that the Company's 51.02% is similar to the average common equity ratio of 51.03% for the regulated utility subsidiaries of the IEG.[243] However, the 44.8% equity for the EDG and the 45.3% equity ratio for the S&P Public Utilities are both lower (and therefore more risky) than PPL's own 51.02% equity ratio. Therefore, using the common equity ratio metric, PPL is less risky than the average of Mr. Moul's barometer groups.[244]

cc. Book equity

Mr. Moul testifies that PPL has higher earnings variability than his groups, which he translates to PPL having greater risk.[245] Mr. Moul states that PPL's coefficient of variation is 0.267, while the EDG is 0.094, the IEG is 0.163, and the S&P Public Utilities is 0.096. However, using the information Mr. Moul provided with respect to each company in his barometer groups, Ms. Sears calculated the coefficient of variation range for the EDG as 0.0799 – 0.3364, and the same range for the IEG as 0.0334 – 0.3919. Because PPL's coefficient of variation (and

[242] I&E St. 1 at 63.
[243] PPL St. 11 at 15.
[244] I&E St. 1 at 64.
[245] PPL St. 11 at 16.

earnings variability) is within these stated ranges, it is, therefore, is in line with both groups' risk.[246]

dd. Operating ratios

Mr. Moul states that the operating risk of PPL is fairly similar to the EDG.[247] Again, however, the information Mr. Moul provided with respect to each company in his barometer groups, Ms. Sears calculated the range for operating for companies in PPL's EDG as 85.9% - 91.7%, and the range for the IEG as 78.3%-86.6%. PPL's 89.0% ratio is within these ranges and therefore, is in line with both groups' risk.[248]

ee. Coverage

Mr. Moul testifies that the Company's interest coverage was marginally better than the EDG.[249] Again, however, using the information Mr. Moul provides with respect to each company in his barometer groups, Ms. Sears calculates the interest coverage range for the EDG as 2.07x– 3.37x, and the range for the IEG as 2.55x– 4.37x. Therefore, PPL's 2.95x is in line with both groups' risk, while acknowledging that PPL has a slightly better average coverage ratio than the EDG.[250]

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[246] I&E St. 1 at 64.
[247] PPL St. 11 at 16.
[248] I&E St. 1 at 65.
[249] PPL St. 1 at 17.
[250] I&E St. 1 at 65.

ff. Internally Generated Funds

Mr. Moul shows that the percentage of internally generated funds to capital expenditures for PPL was well above the average of all three of Mr. Moul's comparison groups (EDG, IEG, S&P).[251] This means that PPL is less risky, as PPL's 5-year average is 145.3% compared to 75.3% for the EDG and 75.2% for the IEG. Even when discussing the future percentage, PPL is still above both groups at 76.2%. Clearly with regards to internally generated funds PPL is less risky.[252]

gg. Summary

Mr. Moul believes that his EDG barometer group presents a good comparison for PPL in terms of risk in that he believes PPL's risk generally exceeds that of the EDG based on size, earnings variability, coverage, and credit ratings. On this basis, Mr. Moul asserts that the Company requires a higher common equity ratio in order to reduce its financial risk in order to offset its higher business risk. However, the data provided by Mr. Moul for his barometer groups show that not only are PPL's metrics in line with the EDG, but also it is less risky than the EDG in many cases, as the credit agencies also acknowledge. Mr. Moul's own analysis concludes that the Company does not require a higher common equity ratio.[253]

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[251] PPL St. 1 at 17.
[252] I&E St. 1 at 66.
[253] I&E St. 1 at 57-66.

iv. Unsupported Assessment of Investor Expectations

PPL witness Cannell provides testimony regarding investors' expectations. However, Ms. Cannell's testimony is replete with statements that are unsupported by anything other than her claim to have worked for investors for years.

Ms. Cannell states that the electric utility industry has become more risky.[254] However, when asked to support this statement, Ms. Cannell relies on her years of experience and credit ratings along with analysts' opinions. Contrary to Ms. Cannell's unsupported statement, credit reports make no reference to *increased* risk. The change in credit ratings cannot be directly tied to higher risk. Many credit agencies have changed the rating criteria, which led to the downgrading of whole sectors in some cases. The downgrade did not make the sector more risky simply due to a rating criteria change, it merely reevaluated the comparisons.[255]

Ms. Cannell also fails to acknowledge the increase of the use of riders, surcharges, and DSIC-like mechanisms, which decrease the risk of the utilities. Ms. Cannell claims "investors will be watching this issue [the DSIC]) closely to determine exactly what benefits are actually provided from this new legislation."[256] Utilities' operation of the DSIC in Pennsylvania is not new. Investors already can see the benefits provided by a DSIC mechanism through Pennsylvania's current

[254] PPL St. 12 at 9-10.
[255] I&E St. 1 at 78; I&E Ex. 1, Sch. 19.
[256] PPL St. 12 at 13.

DSIC for the water companies.[257] And clearly PPL itself knows the benefits of the DSIC in terms of risk mitigation, having sought its implementation since 2004 and very closely advised investors of the its final approval throughout 2011 and 2012.

Ms. Cannell also claims that utilities are particularly vulnerable during times of recession. In fact, as demonstrated by I&E witness Sears, utilities do better than the market during times of recession due to their safety. Unlike Ms. Cannell, Ms. Sears documents her position, presenting evidence of utilities' stability during a recession in an article titled "Advantages of Investing in Utility ETF," which shows that utilities lose less value than other areas of the market in recessionary times.[258] For example, utilities lost 4.5% of their market value while banks lost 25.2% in the same time period. Another article titled "Lower Risk Stocks" shows that "According to T. Rowe Price research covering the 10-year period ended September 30, 2011, three defensive sectors-consumer staples, health care, and utilities-have outperformed the S&P 500 in down markets 75% of the time.[259] Contrary to Ms. Cannell's unsupported opinion, Ms. Sears' evidence clearly demonstrates that utilities are not vulnerable as Ms. Cannell claims.

Ms. Cannell also refers to the average age of those investing in utilities, concluding that most individual (non-institutional) investors in utility stocks are over 50 with incomes less than $100,000 and rely on the income from their utility

[257] I&E St. 1 at 78.
[258] I&E Ex. 1, Sch. 20.
[259] I&E St. 1 at 78-79.

holdings,[260] as if this somehow justifies a higher equity return for PPL. However, as Ms. Sears noted, Ms. Cannell fails to fully discuss the tax advantages and the stability in utility dividends that group also enjoys,[261] negating any inherent justification for a higher return for which that demographic fact was offered.

Ms. Cannell also speculates that investors will not wait to see the how a regulatory decision might play out, but rather will sell their shares if a regulator's decision runs counter to their expectations.[262] The only documentation provided by Ms. Cannell to support this statement, however, was citation to one case in Connecticut. One case result hardly constitutes substantial evidence. Moreover reviewing the stock prices of the barometer group, including that "one case," UIL Holdings, for January 1, 2009 through March 31, 2009, revealed that the entire electric utility barometer group experienced a decline in stock price around February 6, 2009, with recoveries beginning around March 9, 2009. Thus, the entire electric utility industry experienced a decline in the same time period and Ms. Cannell's conclusion that the Connecticut regulatory decision caused the decline in UIL's stock is unsupported because it ignores the entire industry behavior in that time period.[263]

Finally, Ms. Cannell could not determine what investors expect for this case other than they expect a return commensurate with the investments risk. Ms.

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[260] PPL St. 12 at 18-19.
[261] I&E St. 1 at 79.
[262] PPL St. 12 at 20.
[263] I&E St. 1 at 79; I&E St. 1-SR at 58-59.

Cannell has not done any cost of equity analysis to support what return investors warrant. As an investment advisor, Ms. Cannell's testimony on investor expectations offers no value to the ratemaking aspects of this case, including the appropriate determination of the cost of equity.[264]

h. PPL's Inappropriate and Unsupported Management Effectiveness Adjustment

Mr. Moul recognizes the performance of PPL's management, as described in the direct testimony of PPL witness Gregory Dudkin, the Company's President, by moving his recommended equity cost above the average cost of equity shown for his EDG.[265] The management effective boost to equity returns amounts to 12 basis points, or almost an additional $3 million in rate revenues.[266] This upward adjustment is inappropriate and unsupported.

Mr. Dudkin states that the ultimate measure of an electric utility's management effectiveness is its ability to provide safe, reliable, and high-quality service at reasonable rates. Mr. Dudkin further states that PPL Electric is facing substantial upward pressure on its costs, declining revenues, and lower credit ratings. Mr. Dudkin believes that PPL's efforts to address these issues while at the same time providing customers high-quality service should be reflected as a higher Commission-allowed return on common equity in this proceeding.[267]

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[264] I&E St. 1 at 80.
[265] PPL St. 11 at 6.
[266] Tr. at 335.
[267] PPL St. 1 at 6.

Mr. Dudkin's testimony on the issue of management effectiveness is further supported in the Company's Statement of Reasons, which is included in the Company's Exhibit Future 1. Mr. Dudkin's examples of effective management warranting a boost to the Company's equity return include its advanced metering infrastructure, operating initiatives, customer contact center, performance in retail electric competition, customer education and energy efficiency programs, customer assistance programs, and industry awards.[268]

With regard to its provision of advanced meters, PPL cites the fact that it deployed advanced meter infrastructure in advance of Act 129's statutory requirements as proof of management effectiveness that should increase the Company's equity return.[269]

PPL's advanced metering infrastructure is not a reason to award additional return on equity points in this case. All large electric utilities were required by Act 129 to begin implementing smart meters in 2009. Even though PPL had already implemented new technology for its meters that was ultimately deemed to satisfy Act 129, it is inappropriate to award additional equity points in 2012 for something that began in 2002 as a result of the natural progression of technology and which all Pennsylvania's large electric utilities ultimately were statutorily required to do. Furthermore, PPL's expenditures for its smart meters were included in rate base, were already earning a return of and a return on the

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[268] PPL Exhibit Future 1 at 8.

[269] PPL Exhibit Future 1, Statement of Reasons at 9.

Company's investment, and are now subject to full reconcilable recovery with interest through its Smart Meter Rider. PPL has earned an adequate return on and of its smart meter investment. An additional recovery through a boost to equity is unwarranted.[270]

With regard to its operating initiatives, PPL cites to its Smart Grid functionality for the Harrisburg area, which was funded by a matching grant from the U.S. Department of Energy, its enterprise work and asset management system (WAM), its claimed improvements to its storm processes and systems, its improvement projects on portions of the distribution system exhibiting particularly high interruption frequencies, and its work with its customers to reduce energy under Act 129.[271]

PPL's ability to implement the advanced Smart Grid functionality was partially credited to the U.S. Department of Energy's matching grant. While a beneficial improvement, its implementation is as much a credit to federal funding as it is to management effectiveness. Furthermore, as with the smart meters, both the Smart Grid and the WAM are included in rate base, thus earning a return of and return on this investment. The inclusion of the storm process improvements and distribution improvements that exhibit high interruption frequencies is a necessary process to provide safe and reliable service. PPL provided no reasons why these improvements are better than any other utilities' improvements. In fact,

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[270] I&E St. 1 at 69.

[271] PPL Exhibit Future 1, Statement of Reasons at 10-12.

as noted by Mr. Epstein during cross-examination of PPL witness Kleha, who was unaware of the figure, the Commission found in a report issued on August 7, 2012, that 14.5% of PPL's major outages caused by trees were preventable, the highest reported percentage.[272] Clearly PPL's improvements could have been better. Finally, Act 129 sets *minimum* reduction targets in energy consumption. If these reductions are not met, the Company could face a fine of up to $1,000,000. PPL is doing what it has to do. No boost to its equity return is warranted.[273]

PPL also cites to improvements in its customer contact center as justification for its requested additional equity return.[274] While PPL claims to have increased customer contact and improved systems, the Customer Service Performance Report in 2010 created by the Bureau of Consumer Services reveals a different story. While PPL's "busy out rate" decreased from 1% in 2009 to 0% in 2010, its call abandonment rate increased from 2% in 2009 to 3% in 2010, and the percentage of calls answered within 30 seconds decreased from 81% in 2009 to 79% in 2010. The number and percentage of bills not rendered to residential customers increased from 60 in 2009 to 162 in 2010. Further, PPL had the highest percentage of bills not rendered to residential customers out of the eight Pennsylvania companies represented. The number and percentage of bills not rendered to small business customers also increased, from 34 in 2009 to 96 in

[272] Tr. at 428, a reference to the Report of the Technical Utility Services Division of the Pennsylvania Public Utility Commission issued on August 7, 2012, and available at http://www.puc.pa.gov/electric/pdf/Summary_Rpt2012-Outage_Info_Reported_EDCs.pdf (Table 6).
[273] I&E St. 1 at 70-71.
[274] PPL Exhibit Future 1, Statement of Reasons at 12-14.

2010, and again PPL had the highest percentage of bills not rendered to customers. The number of residential disputes with no response within 30 days increased from 72 in 2009 to 99 in 2010. In comparison, the utility with the second largest number of residential disputes with no response within 30 days was Allegheny Power, with 14 disputes with no response in 30 days. The remaining six companies were all below 14. Finally, in 2010 PPL ranked 5th out of 8 companies for satisfaction with the automated system. While PPL claims superior customer contact center efficiencies warranting a boost to equity, customer care data does not support that boost. No additional rate of return points should be awarded for PPL's Customer Care Center performance.[275]

Regarding its performance in retail electric competition, PPL boasts that approximately three-quarters of the energy consumed within the PPL Electric service territory is provided by competitive EGSs.[276] While PPL is involved in promoting retail electric competition, PPL proved no direct causation between its programs and the level of success of electric generation competition in its territory. Certainly other factors are at play as well, such as efforts of the many licensed marketers, brokers, or suppliers in PPL's territory or possibly PPL's own non-competitive price-to-compare. Further, as an aspect of the deregulated generation sector, it is particularly inappropriate to award PPL the distribution company an extra equity reward for the success of electric utility generation.

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[275] I&E St. 1 at 71-72.

[276] PPL Exhibit Future 1, Statement of Reasons at 14.

Certainly from the perspective of PPL's ratepayers who have already paid PPL through rates $2.8 billion in recognition of PPL's stranded generation assets,[277] the Company has been sufficiently compensated following electric generation deregulation. A further boost to its equity return is unwarranted.

Regarding PPL's customer education and energy efficiency programs, the Company includes $8 million in its 2012 operating budget to continue providing consumers with programs and information that demonstrate how to use electric energy more efficiently.[278] PPL's customer education and energy efficiency programs exist as a result of the Company's initial Commission-approved Consumer Education Program for 2008-2012, Act 129, and the currently on-going Retail Markets Investigation. PPL's costs under its Act 129 programs are collected on a reconcilable dollar-for-dollar basis. The costs of its Consumer Education Program are built into base rates and if they do not expire in 2012 as recommended by I&E, may also be subject to a dollar-for-dollar reconcilable rider. RMI costs are also proposed to be recovered through a reconcilable rider.

These consumer education programs have been and continue to be paid for by PPL's ratepayers in order to educate themselves about mitigating price increases due to the expiration of the rate caps, which occurred in 2009. I&E disputes the need for continuing the levels of education and ratepayer cost PPL seeks and in particular sees no basis for further requiring ratepayer funding

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[277] Tr. at 468.
[278] PPL Exhibit Future 1, Statement of Reasons at 14-15.

through a boost to equity. Finally, PPL has not shown that their programs are superior to those of the other electric distribution companies with the same requirements. As shown above, there is no need for additional return on equity consideration for management efficiency for these programs.[279]

PPL also points to its "family of universal service programs" as support for its requested boost on equity. PPL admits it will spend upwards of $77 million in 2012 to fund this universal service family.[280] What PPL ignores, however, is that almost 99% of this funding is provided not out of the benevolence of PPL's corporate family, but rather as mandatory funding from ratepayers. Not only has PPL failed to demonstrate that its customer assistance programs are superior to any other utility's customer assistance programs (which all energy utilities have), but also because 98.77% of this 2012 funding is provided exclusively through mandatory ratepayer funds,[281] PPL has provided no reason at all for ratepayers to have to provide an additional several million dollars to PPL in the form of a boost to common equity for management effectiveness. The Company should not be rewarded additional return on equity points in this proceeding based on its Customer Assistance Program.[282]

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[279] I&E St. 1 at 74-75.
[280] PPL Exhibit Future 1, Statement of Reasons at 15-16.
[281] I&E Cross-Examination Ex. 12, line 10.
[282] I&E St. 1 at 75-76.

Finally, PPL seeks a boost to equity because it has received the J.D. Powers & Associates awards for customer service.[283] Industry awards should not support an additional award of equity points.[284] Customers already pay for the service they receive. They should not be compelled to pay more because of how J.D. Powers ranks them pursuant to a survey that is not part of this record and has not been subject to any regulatory review or input.

PPL provides no evidence that it has exceeded its statutory and regulatory requirements under the Public Utility Code to provide safe and reliable service at just and reasonable rates. PPL's requested 12 basis point upward adjustment to the cost of equity is neither warranted nor supported. It should be rejected.

F. Overall Rate of Return

The Company's proposed overall rate of return is 8.47%.[285] I&E's proposed overall rate of return is 6.84%.[286] I&E submits that the evidence in this proceeding does not support the inputs that went into the development of PPL's proposed return on equity, capital structure, or overall rate of return, and therefore the I&E's proposed overall return of 6.84% should be adopted.

G. Conclusion

PPL's claimed rate of return overstates PPL's need for a revenue increase by $73 million. PPL's requested rate of return is wholly out of synch with and

[283] PPL Exhibit Future 1, Statement of Reasons at 16-17.
[284] I&E St. 1 at 77.
[285] PPL Ex. PRM-1 at 1, Sch. 1.
[286] I&E St. 1 at 80; I&E Ex. 1, Sch. 1 at 1.

unsupported by any reasonable measure of returns in today's market. It can only be justified as affiliate support from the rate-regulated entity for the parent company's continued remarkable financial performance. PPL's claimed capital structure overstates PPL Electric's capital needs by $15 million; the Company's request for an equity reward to recognize its management contributes another $2.9 million in over-capitalization; and PPL witness Moul's proposed leverage adjustment and inflated cost of equity calculations contribute another $55.1 million in unnecessary and unsupported cost of capital claims.

The evidence overwhelmingly demonstrates that PPL's claim for a return on equity of 11.25% and an overall rate of return of 8.47% grossly overstates what reasonable investors should expect from a regulated public utility and is not necessary for PPL Electric to safely and reliably provide electric distribution service to its captive ratepayers.

When adjusted by I&E to more reasonable levels that approximate expected returns in today's economy for similarly-situated EDCs, PPL's evidentiary support for its $104.6 million rate increase is substantially reduced. PPL's proposed rate of return is not supported by substantial record evidence and is improperly calculated. As demonstrated by I&E witness Sears, the appropriate overall rate of return that will result in just and reasonable rates is 6.84% with an included 8.38% cost rate of common equity.

VIII. RATE STRUCTURE

A utility's rate structure addresses how the Commission's approved revenue increase will be allocated among the utility's various tariffed rate classes. Once a class revenue allocation is determined, development of a rate design will address how the tariffed rates and rate elements will generate the allocated revenues. A properly designed rate structure will not unduly burden one class of ratepayers to the benefit of another. Under the Public Utility Code, "[n]o public utility shall...make or grant any unreasonable preference to any person, corporation....No public utility shall establish or maintain any unreasonable difference as to rates, either as between localities or as between classes of service."[287] Differences in rates charged to different classes are permissible so long as there is reasonable basis for the discrepancy.[288] "Public utility rates should enable the utility to recover its cost of providing service and should allocate this cost among the utility's customers in a just, reasonable and nondiscriminatory manner."[289]

A. Cost of Service Study

I&E takes no position on PPL's cost of service study.

B. Revenue Allocation

I&E proposes no changes to the Company's inter-class revenue allocations. I&E's proposals regarding revenue allocation affect the intra-class revenue

[287] 66 Pa.C.S. §1304.
[288] *Peoples Natural Gas Company v. Pa. P.U.C.*, 409 A.2d 446 (Pa. Cmwlth 1979).
[289] *Pa. P.U.C. v. West Penn Power*, 73 Pa. P.U.C. 454, 510, 199 PUR 4th 110 (1990)

allocations as between fixed and usage charges as addressed below in subsection C.2 below.

1. Scale-back

The Company's proposed changes in revenue range from a decrease of $4,674,000 (-3.8%) for the GS-3 class to an increase of $3,568,000 (77.5%) for the RTS class. The proposed increase in the RS class is $101,068,000 (21.3%). The Company's proposed revenue distribution is presented in the following table:

Company Proposed Revenue Distribution[290]				
Class	**Present Rates**	**Proposed Rates**	**Increase**	**Percent**
RS	$474,659,000	$575,745,000	$101,086,000	21.3%
RTS	$4,604,000	$8,172,000	$3,568,000	77.5%
GS-1	$72,149,000	$72,964,000	$815,000	1.1%
GS-3	$123,336,000	$118,662,000	($4,674,000)	-3.8%
LP-4	$33,726,000	$40,726,000	$7,000	0.02%
LP-5	$1,209,000	$1,921,000	$712,000	58.9%
LPEP	$445,000	$445,000	$0	0%
GH-2	$1,387,000	$1,710,000	$323,000	23.3%
SL/AL	$22,947,000	$25,726,000	$2,779,000	12.1%
Total	**$734,462,000**	**$839,078,000**	**$104,616,000**	**14.2%**

[290] I&E St. 3 at 16.

If the Commission grants PPL less than the full increase it has requested, I&E witness Hubert recommends that the first $1,784,000 be used to reduce the proposed RTS usage rate, which is one half of the proposed increase of $3,568,000 because an increase of 77.5% is too large. Also, for customers that use over 3,300 kWh per month, there would be over 100% increase in distribution rates, which violates the concept of gradualism.

Any further decrease should be used to reduce the RS usage rate, the GH-2 rates and the SL/AL rates so that the increase is proportional to the percentage increase originally proposed for these classes. These are the only remaining classes that did not receive a decrease or significant increase under proposed rates. The increase proposed for the LP-5 customer charge is 58.6%. Therefore, it should be reduced based upon Mr. Hubert's customer cost analysis or scaled back to reduce the 58.6% increase in the customer charge. If the Commission rejects Mr. Hubert's recommendation to reduce the LP-5 customer charge based on his customer cost analysis, it should be scaled back so the increase for the LP-5 class is proportional to the percentage increase originally proposed for this class. However, if the Commission accepts Mr. Hubert's recommendation to reduce the LP-5 customer charge based on his customer cost analysis, it should not be scaled back.[291]

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[291] I&E St. 3 at 15-17.

PPL witness Krall agreed that a scale-back should be "applied on a proportional basis to only those rate schedules which, under the Company's original proposal, would be receiving increases" and that Mr. Hubert's approach was consistent with that recommendation.[292] OSBA witness Knecht disagreed, and proposed that if the Commission were to reduce PPL's requested revenue increase, then the benefit of that proposal should inure first to those customer classes in greater need of movement towards the system rate of return.[293]

I&E concurs with PPL witness Krall's observations that it would be improper to offer rate decreases to customers who were not proposed in the first instance to receive a rate increase. Further, a proportional scale-back of the Company's proposal would still move most classes closer to the system-average rate of return. This is not a rate rebalancing proceeding in which PPL has proposed to rebalance revenues among rate classes. This is a Section 1308 base rate case. To the extent the Commission approves a lesser proposed rate increase, the allowed increases should be scaled back proportionately as proposed by I&E witness Hubert.

C. Tariff Structure

1. Rate Design

I&E's recommendations regarding rate design are addressed below under "customer charge."

[292] PPL St. 5-R at 4.
[293] OSBA St. 3 at 5-7.

2. Customer Charge

PPL currently has three different residential distribution rate schedules: Residential Service ("RS"); Residential Thermal Storage ("RTS"); and Residential Time-of-Day ("RTD"). All three rate schedules have a fixed monthly customer charge along with one usage (kWh) charge for each rate schedule.

As originally proposed, the entire increase proposed for the residential class was allocated to that class in the form of an 82% increase to the RS class customer charge, raising the current RS customer charge from $8.75 to $16.00, with a slight decrease to the usage charge. Since the RTS customer charge was already at $18.06, PPL proposed that the entire increase for the RTS class solely increase the kWh charges.[294] In rebuttal, PPL moderated its proposed increase in the RS customer charge to no less than $14.09.[295] PPL also proposed increases to all non-residential customer charges as well. In total, PPL's proposed increases to the customer charges are as follows:

[294] I&E St. 3 at 2-3.

[295] PPL St. 8-R at 30; PPL St. 8RJ (part 2) at 5. PPL witness Krall identifies $10.75 as the minimum customer charge required to ensure the relative percentage of fixed costs recovered in the customer charge does not decrease. PPL St. No. 5-R at 14-15. However, the Company did not reduce its second proposal, as confirmed by Mr. Krall on page 14 of his rebuttal testimony based upon the costs identified by PPL witness Kleha on page 30 of his rebuttal testimony his Exhibit JMK 5.

PPL Proposed Class Customer Charges

Rate	Pres Cust Chrg	Prop'd Cust Chrg	% Increase[296]
RS	$8.75	$16.00	82% (DT)
RS	$8.75	$14.09	61% (RT)
RTS	$18.06	--	--
GS-1	$14.00	$16.00	14.3%
GS-3	$30.00	$40.00	33.3%
LP-4	$160.19	$170.00	6.1%
LP-5	$709.00	$1,125.00	58.7%

I&E witness Hubert opposes those of PPL's proposals that exceed the correct calculation of class customer charges pursuant to a properly constructed customer cost analysis. Mr. Hubert's proposed customer charges are as follows:

I&E Proposed Class Customer Charges

Rate	Pres Cust Chrg	Cust Cost Analy	Prop'd Cust Chrg	% Increase[297]
RS	$8.75	$8.13	$8.75	0%
RTS	$18.06	$10.94	--	--
GS-1	$14.00	$9.27	$14.00	0%
GS-3	$30.00	$30.96	$31.00	3.3%
LP-4	$160.19	$116.88	$160.19	0%
LP-5	$709.00	$892.28	$892.00	25.8%

I&E witness Hubert's recommendations follow directly from the results of his customer cost analysis. Where Mr. Hubert's direct customer cost analysis results in a lower customer charge than currently exists, he recommends no change

[296] I&E St. 3 at 2-3, 13-14.
[297] I&E St. 3 at 11-14; I&E Ex. 3, Sch. 2, p. 2.

in the customer charge. Where his direct customer cost analysis results in a higher customer charge than currently exists, he recommends an increase for that class customer charge to a level that is roughly equal to his calculation.[298]

The difference between PPL's proposed customer charges and those of I&E witness Hubert is stark: Mr. Hubert conducted a direct customer cost analysis; PPL did not. While PPL provides a cost of service study, it did not conduct a specific customer cost analysis. Although the customer cost analysis uses data from the cost of service study, it is an entirely different cost analysis.[299]

In preparing his direct customer cost analysis, Mr. Hubert was guided by long-standing Commission precedent that identifies the appropriate items to be included in a customer charge. Those items, those that change with the addition or loss of a customer, are the direct customer costs that were identified in the Company's cost of service study as follows: meter expenses, expenses for services and customer installations, expenses for meter reading and customer records & collection, other customer accounting expenses, depreciation expense and net salvage amortized for meters and services, and the rate base related return and income taxes on customer-based rate base.[300] The Commission has long held these costs to be those most appropriately included in a customer cost study.[301] Most

[298] I&E St 3-SR at 8.
[299] I&E St. 3 at 9-10.
[300] I&E St. 3 at 11-12.
[301] *See Pa. P.U.C. v. West Penn Power Company*, 59 Pa. P.U.C. 552 (1985). In that case, the Commission's Prosecutory Staff witness defined "basic customer cost" as expenses for those items a company must have in place each month for each customer including meters, service drops, meter reading, and billing, and specifically excluded "assertedly 'customer-related' costs of transformation and distribution plant" which

recently the Commission accepted a direct customer cost analysis identical to that conducted by Mr. Hubert in this proceeding[302] in the Columbia Gas of Pennsylvania base rate case at Docket No. R-2010-2251623 (Order entered October 14, 2011).[303]

Relying on PPL witness Kleha's class cost of service study, PPL witness Krall concludes that "residential customers ought to be paying a monthly customer charge in excess of $30 as compared to the current monthly charge of $8.75."[304] In Mr. Krall's opinion, "there are very few, if any, distribution system-related costs that are a function of usage. ... As a matter of correct economics, it is appropriate, from the perspective of customers, utilities, and the Commonwealth, to collect fixed costs on a fixed-charge basis."[305] Mr. Krall also opines that customers are sent "clearer" signals about competitive purchasing and energy efficiency when only those "very few, if any" usage-related distribution costs are collected in the usage charge.[306]

However, as clarified by I&E witness Hubert, PPL did not conduct a customer cost analysis. Rather, the Company simply classified all costs as either demand or customer related and then used those classifications to drive its

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were 'better recovered through energy charges to avoid subsidies from low usage customers to high usage customers." *Id.*, Slip Opinion at 42. The Commission adopted staff's position, stating: "We have adopted the 'basic customer cost' method for several major Pennsylvania electric utilities, and no we conclude that it is likewise appropriate for WPP." *Id.*

[302] Tr. at 541-42.

[303] *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc.*, 293 P.U.R.4th 235, 2011 WL 5026079 (Pa.P.U.C.)

[304] PPL St. 5 at 12.

[305] PPL St. 5 at 12.

[306] PPL St. 5 at 12-13.

proposed customer charge. For the residential class alone, of the Company's total proposed distribution residential class rate revenues of $571,811,000, the Company classified $454,908,000, or approximately 80% as customer related, and $116,903,000, as demand related. This classification of 80% of residential costs as customer related then served as the basis for the Company's proposed RS customer charge.[307] The failure to present an appropriately constructed customer cost analysis, and instead rely on the class cost of service study classifications alone, confirms the Company's erroneous position that all fixed costs should be recovered in the customer charge

As Mr. Hubert further explained, fixed costs and customer costs are not synonymous.

> Once an investment is made, it may be considered a fixed cost. However, that alone does not dictate the manner in which the fixed cost should be recovered. Fixed costs assigned to the customer charge are limited to those fixed costs for which there is a direct impact from an individual customer. For example, each individual customer requires a meter and a bill. Therefore, fixed costs associated with meters and billing are properly attributable to the fixed customer charge. On the other hand, there is no direct relationship between the number of customers and the size or the cost of poles, conductors or transformers. Accordingly, those costs are not properly attributable to the customer charge. Instead, those items are common costs that should be billed to the customer class through volumetric rates.[308]

In rebuttal the Company contends it presents the "development of total customer-related costs applicable to PPL Electric's distribution system from which

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[307] I&E St. 3 at 4.
[308] I&E St. 3-SR at 4.

the costs associated with its proposed customer charge are derived."[309] Based upon that calculation, PPL presents its alternative RS customer charge of $14.09, which it claims represents the direct customer costs incurred in providing service to the RS class, and which would also support a RS customer charge of $36.70 if PPL's claimed direct and indirect customer-related costs are included.

While the Company denies it has "confused fixed costs with customer costs,"[310] it has nonetheless included within its calculation of a customer charge all fixed costs that are customer, as opposed to demand, related. Thus, it has not distinguished between those direct costs that change with the addition or deletion of a customer (those costs that vary directly with customer connections). In relying on its cost of service study customer/demand allocations rather than conducting an appropriate customer cost analysis, PPL in essence renders all fixed customer-related investment synonymous with direct customer costs and uses that analysis to support its proposed customer charges.

Mr. Kleha contests I&E witness Hubert's criticism of PPL's use of its cost of service designations, contending that all fixed customer-related (as opposed to demand-related) costs should be recovered through a fixed customer charge:

> [C]ontrary to Mr. Hubert'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 devises, and transformers) does

[309] PPL St. 8-R at 30.
[310] PPL St. 8-RJ (part 2) at 2.

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.[311]

Once any capital investment is made, it may be considered a fixed cost. That, alone, however should not dictate how those costs should be recovered. There is no direct relationship between the number of customers and the size or the cost of poles, conductors, or transformers.[312] A company serving 1.4 million customers may require more poles and transformers than a company serving 700,000 customers. Unlike meters, services, and billing, however, neither company will require a pole and transformer for each customer. That is because not all fixed costs vary directly with the number of customer connections. That is the purpose of a direct customer cost analysis. Those fixed costs that are not directly related to the cost of serving individual customers are common costs that should be billed to the customer class as a whole through volumetric rates.

Adopting PPL's approach, however, would be akin to precisely the analysis proffered by Columbia Gas, namely, that fixed customer-related distribution charges should recover all if not almost all customer-related investment. As clearly characterized by PPL in this proceeding, usage charges should be left solely to recover those "very few, if any" usage-related distribution costs. While it may not have proposed 100% recovery of all fixed customer-related costs in its monthly charge in this proceeding, in truth PPL recognizes "very few, if any" usage-related

[311] PPL St. 8-RJ (part 2) at 3.
[312] I&E St. 3-SR at 4.

distribution costs. As such, in theory, its proposal is for all intents and purposes identical to that proposed by Columbia Gas, simply to a lesser degree, for now. On ratemaking principles, it should be equally rejected by the Commission.

Moreover, as Mr. Hubert identified, his customer cost analysis adheres to the same principles adopted by the Commission in the last PPL base rate proceeding in which a customer cost analysis was at issue, the 2004 base rate case. In that case, the Commission affirmed that increases in customer charges should be moderated not only by the concept of gradualism, a principle advanced by Mr. Hubert,[313] but also because the "nature and amount of costs to be recovered through the customer charge must be closely monitored[.]"[314]

Much of the discussion regarding the appropriate level of customer charges to be approved in this proceeding centered on the RS customer charge. However, the Company's proposals regarding all class customer charges were based upon its belief that fixed costs associated with permanent customer-related fixed infrastructure should be recovered through the customer charge for both residential and non-residential customers. Further, OSBA witness Knecht also opposes Mr. Hubert's proposed customer charge for the non-residential classes, claiming that a larger fixed monthly charge will not negatively impact conservation and

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[313] I&E St. 3 at 12.

[314] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (Order entered December 22, 2004), Slip Opinion at 84; I&E St. 3-SR at 6-7. While PPL relies on a 2004 Aqua Pennsylvania case as support for its inclusion of indirect costs, I&E submits that case is an outlier for purposes of PPL's current proceeding. I&E also notes that in that case the Commission repeated the same concerns that while "these are costs which *may be considered* for inclusion in the customer charge, [ ] such claims are *subject to scrutiny on a case-by-case basis*." *Pa. P.U.C. v. Aqua Pennsylvania Inc.*, Docket No. R-00038805 (Order entered August 5, 2004), Slip Opinion at 72 (emphasis added).

may discourage business growth by resulting in larger customers subsidizing smaller customers.[315]

I&E's recommendations for appropriate customer charge levels encompass all customer classes, because I&E's recommendations are based on the same Commission standard, namely, the correct calculation of direct customer costs in a customer cost analysis. OSBA witness Knecht's proposal suffers the same flaw as PPL's, namely that it is based upon the Company's fully allocated cost of service study and not a separately conducted customer cost analysis. For this reason alone, it, too, should be rejected. Moreover, as Mr. Hubert also noted, the OSBA's position on the relative size of fixed monthly customer charges is inconsistent with past positions. In previously filed comments before this Commission, OSBA has argued the opposite that it argues in this proceeding. In several rounds of comments before the Commission in an investigation into the implementation of the American Recovery and Reinvestment Act of 2009, OSBA clearly contended that higher fixed distribution charges not only "undermine the incentive for customers to conserve[,]" but also "smaller customers within an existing class would likely be subsidizing the larger customers within that class" where "recovery of most (if not all) of the utility's fixed costs" were to be through a fixed monthly charge.[316]

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[315] OSBA St. 2 at 7.

[316] I&E St. 3-SR at 13-15, citing *Compliance of Commonwealth of Pennsylvania with Section 410(a) of the American Recovery and Reinvestment Act of 2009*, Docket No. I-2009-2099881, Reply Comments of the OSBA dated July 29, 2009 at 4-5.

I&E witness Hubert's position is objective and soundly based on past Commission practice. Mr. Hubert's proposed customer charges for all of PPL's customer classes employ the Commission's long-standing policy for the conduct of such analyses. The appropriate customer charges for all customer classes are those calculated by Mr. Hubert in his direct customer cost analysis for each customer class and should be adopted.[317]

3. Elimination of Rate Schedule RTD

I&E witness Hubert originally opposed the Company's proposal to eliminate Rate RTD, but dropped that opposition upon further explanation of its impact on a pending proposal affecting an undercollection for the residential Time-of-Use class, which is pending resolution by the Commission at Docket No. R-2011-2264771.[318]

D. Tariff Rules and Riders

I&E has no recommendations regarding PPL's proposed tariff rules and riders.

E. Summary and Alternatives

I&E's proposed monthly customer charges are based on sound Commission ratemaking policies and precedent and should be adopted.

[317] I&E St. 3-SR at 9
[318] I&E St. 3-SR at 18; Tr. at 531.

IX. MISCELLANEOUS ISSUES

A. Purchase of Receivables

To the extent I&E addresses PPL's proposed Purchase of Receivables (POR), it is found in the I&E discussion of the Company's uncollectibles expense rate as set forth above in Section V of this brief.

B. Customer Assistance Programs

To the extent I&E addresses PPL's Customer Assistance Programs, it is found in the I&E discussion of the Company's customer assistance programs expense as set forth above in Section V of this brief.

C. Consumer Education

To the extent I&E addresses PPL's proposed Consumer Education, it is found in the I&E discussion of the Company's consumer education program expenses as set forth above in Section V of this brief.

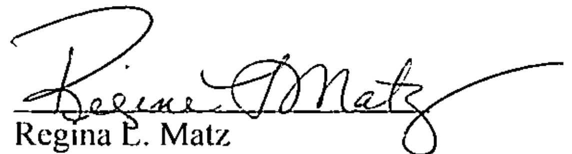
D. CER/RMI

To the extent I&E addresses PPL's proposed CER/RMI, it is found in the I&E discussion of the Company's consumer education program expenses as set forth above in Section V of this brief.

X. CONCLUSION

PPL has failed to bear its burden of proof with respect to each and every element of its proposed $104.6 million rate increase. The Company's proposal must be amended to reflect the necessary and appropriate adjustments proposed by the Bureau of Investigation & Enforcement fixed utility financial analyst and engineer witnesses. For the reasons stated herein, the Bureau of Investigation & Enforcement respectfully requests the Administrative Law Judge and the Commission to adopt its recommendations in this proceeding, which include a reduction to present rate revenues of $8,971,000 as supported herein and reflected on the attached I&E tables.

Respectfully submitted,



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Dated: August 29, 2012

APPENDIX A

PPL Electric
R-2012-2290597
8/27/12

TABLE I
INCOME SUMMARY

	12/31/12 Proforma Present Rates	INVESTIGATION & ENFORCEMENT Adjustments	Present Rates	Allowances	Proposed
	$	$	$	$	$
Operating Revenue	780,425	0	780,425	-8,971	771,454
Deductions:					
O&M Expenses	417,869	-29,973	387,896	-153	387,743
Depreciation	139,719	0	139,719		139,719
Taxes, Other	53,516	-2,055	51,461	-532	50,929
Income Taxes:					
Current State	1,571	2,409	3,980	-828	3,152
Current Federal	-7,321	7,383	62	-2,610	-2,548
Deferred Taxes	28,861	0	28,861		28,861
ITC	-915	0	-915		-915
Total Deductions	633,300	-22,236	611,064	-4,123	606,941
Income Available	147,125	22,236	169,361	-4,848	164,513
Measure of Value	2,420,963	-15,801	2,405,162	0	2,405,162
Rate of Return	6.08%		7.04%		6.84%

PPL Electric
R-2012-2290597

8/27/2012

Table II - Summary Of I&E Adjustments

Issues	Rate Base	Revenues	Expenses	Depr.	Taxes Other	Current FIT	Current PACNI	Combined Deferred Inc Taxes	ITC
MEASURE OF VALUE:									
CWC (AUTO) 1/8	0								
O&M Expense (avg lag day issue)	-13,021								
Avg. Prepayment (assessment)	-2,780								
0	0								
0	0								
0	0								
0	0								
CWC(INT OFFSET) - AUTO	0								
Revenues:									
0		0	0		0	0	0		
0		0	0		0	0	0		
0		0	0		0	0	0		
0		0	0		0	0	0		
0		0	0		0	0	0		
Expenses:									
Uncoll.Accts.Exp. (AUTO)			0			0	0		
2012 rate case (normalized period)			-258			61	25		
Incentive Compensation			-4,459			1,405	445		
Affl. Sup. - Enviro Mgmt			-103			33	10		
Affl. Sup. - Ext. Affairs			-620			195	52		
Affl. Sup. - Chairman			-387			122	39		
Storm - normal cost			-13,340			4,202	1,333		
2011 Storm deferral			-5,324			1,677	532		
Consumer Education Plan			-5,482			1,727	548		
0			0			0	0		
0			0			0	0		
0			0			0	0		
Depreciation:									
0				0		0	0		
0				0		0	0		
0				0		0	0		
0				0		0	0		
0				0		0	0		
Taxes Other:									
GRT proforma					-830	261	83		
PA Capital Stock					-1,225	366	122		
0					0	0	0		
0					0	0	0		
0					0	0	0		
Income Taxes:									
0						0	0		
0						0	0		
0						0	0		
Consol. Tax Savings						-210			
Deferred Taxes									
0								0	
0								0	
ITC									0
Interest Synchronization						-2,495	-791		
Total Additions / Deductions	-15,801	0	-29,973	0	-2,055	7,383	2,409	0	0
Company Measure of Value	2,420,963								

Table III
Rate of Return

Per Company	Structure	Cost	Weighted Cost
Total Debt	48.97	0.0555	2.7200
Long Term Debt	48.97	0.0556	2.7200
Short Term Debt	0.00	0.0000	0.0000
Preferred Stock	0.00	0.0000	0.0000
Common Equity	51.03	0.1113	5.6800
TOTAL	100.00		8.40

Per Staff	Structure	Cost	Weighted Cost
Total Debt	55.00	0.0558	3.0700
Long Term Debt	55.00	0.0558	3.0700
Short Term Debt	0.00	0.0000	0.0000
Preferred Stock	0.00	0.0000	0.0000
Common Equity	45.00	0.0838	3.7700
TOTAL	100.00		6.8400

PPL Electric
R-2012-2290597
8/27/12

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Main Brief** of the Bureau of Investigation & Enforcement either personally, by first class mail, electronic mail, express mail, and/or by fax upon the persons listed below:

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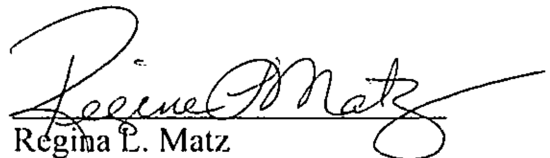

Regina L. Matz
Prosecutor
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Dated: August 29, 2012