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September 14, 2012

BY E-FILE

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

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

Dear Secretary Chiavetta:

Attached is the Reply Brief of PPL Electric Utilities Corporation for electronic filing in the above-referenced proceeding.

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

Respectfully Submitted,

John H. Isom

John H. Isom

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

CERTIFICATE OF SERVICE

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

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Date: September 14, 2012

John H. Isom

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

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I. INTRODUCTION

On August 29, 2012, in accordance with the litigation schedule established at the Prehearing Conference and set forth in Administrative Law Judge Susan D. Colwell's ("ALJ") Scheduling Order dated June 1, 2012, numerous parties filed briefs in support of their various positions in this proceeding. The parties submitting briefs included PPL Electric Utilities Corporation ("PPL Electric" or the "Company"), the Pennsylvania Public Utility Commission's ("Commission") Bureau of Investigation and Enforcement ("I&E"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), Direct Energy Services, LLC ("Direct"), Granger Energy of Honeybrook LLC and Granger Energy of Morgantown LLC ("Granger"), the PP&L Industrial Customer Alliance ("PPLICA"), the Commission on Economic Opportunity ("CEO"), Dominion Retail, Inc. ("Dominion") and Richards Energy Group, Inc. ("Richards").

PPL Electric's Initial Brief, in explaining that its proposed increase in rates should be approved, anticipated and responded to many of the arguments that have been raised by other parties. In several instances, PPL Electric's position is fully set forth in its Initial Brief and further response is not necessary. Certain arguments of other parties, however, require further response. In responding to other parties, PPL Electric will minimize repetition of arguments set forth in its Initial Brief. For ease of reference, PPL Electric's Reply Brief follows the same sequence contained in its Initial Brief.

II. SUMMARY OF ARGUMENT

As explained in the Company's Initial Brief, the revenue increase requested in this proceeding reflects: (1) declining sales resulting from government-mandated conservation programs and the current economic environment; (2) the need to undertake a major infrastructure improvement program to maintain safe and reliable service to customers; (3) increased

Commission-mandated support for the development and expansion of the competitive retail electricity market; and (4) major storm damage in the Company's service territory during 2011. PPL Electric Initial Brief, p. 1. Remarkably, no party to this proceeding has presented any opposition to these four factors. No party has objected to the Company's sales forecast; no party has disputed any aspect of PPL Electric's infrastructure improvement program; no party has contended that PPL Electric should not comply with Commission orders and directives regarding the competitive market and recover those costs in rates; and no party has disputed the amount of 2011 storm damage expense. Instead, I&E and OCA have proposed a series of erroneous and unprecedented adjustments that would dramatically reduce or eliminate the requested rate increase and jeopardize PPL Electric's future ability to provide safe and reliable service to its customers. The lack of merit in these adjustments is fully addressed in PPL Electric's Initial Brief and below in this Reply Brief. By simply applying long-standing Commission precedent, the opposing party adjustments can and should be rejected. The following table provides a listing of those adjustments which are contrary to long-standing Commission and/or judicial precedent.

Adjustment	**Reason Adjustments Should Be Rejected**
Depreciation Reserve	OCA's adjustment is unprecedented in Pennsylvania. PPL Electric St. 13-R, p. 4.
Regulatory Assessments	66 Pa.C.S. § 511(b) and the Commission's invoice for regulatory assessments clearly indicate that regulatory assessments are paid in advance.
Postage Expense	The Commission rejected the same argument raised by I&E in PPL Electric's 2004 rate proceeding. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, 237 P.U.R. 4^{th} 419, 2004 Pa. LEXIS 40 (Dec. 22, 2004) (Dec. 22, 2004).

Adjustment	Reason Adjustments Should Be Rejected
Incentive Compensation	I&E and OCA's proposed 50/50 sharing of expense has been rejected by the courts. *Butler Township Water Co. v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984); *T.W. Phillips Gas and Oil Co. v. Pa. P.U.C.*, 474 A.2d 355 (Pa. Cmwlth. 1984). I&E's exclusive ratepayer benefit standard has never been adopted by the Commission which has consistently approved recovery of incentive compensation expense where the goals contain both operational and financial components. *See, e.g., Pa. P.U.C. v. PPL Gas Utilities Corp.*, Docket Nos. R-0061398, et al., 2007 Pa. PUC LEXIS 2 (Feb. 8, 2007); *Pa. P.U.C. v. Philadelphia Suburban Water Company*, Docket Nos. R-00016750, et al., 2002 Pa. PUC LEXIS 55 (Aug. 1, 2002).
Storm Insurance	I&E's proposed allowance for storm damage expense is patently inconsistent with over 30 years of Commission precedent. *See, e.g., Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C.*, 149 Pa. Cmwlth. 247, 253, 613 A.2d 74, 76-77 (1992); *Pike County Light and Power Co., v. Pa. P.U.C.*, 487 A.2d 118 (Pa. Cmwlth. 1985); *Blue Mountain Consolidated Water Co. v. Pa. P.U.C.*, 426 A.2d 724 (Pa. Cmwlth. 1981); *UGI Corp. v. Pa. P.U.C.*, 410 A.2d 923 (Pa. Cmwlth. 1980); *Pa. P.U.C. v. The Bell Telephone Co.*, Docket No. R-80061235, 55 Pa. PUC 97, 109-10, 1981 Pa. PUC LEXIS 74 (Apr. 24, 1981); *Pa. P.U.C. v. Pennsylvania Gas & Water Co.*, Rate Investigation Docket No. 296, 52 Pa. PUC 77, 102, 1978 Pa. PUC LEXIS 157 (Apr. 21, 1978).
Capital Structure	I&E's and OCA's use of hypothetical capital structures is plainly inconsistent with Commission decisions that hypothetical capital structures are only to be used when a utility's proposed capital structure is outside the range of comparable company capital structures. *See, e.g., Pa. P.U.C. v. ALLTEL Pa., Inc.*, Docket No. R-942710 *et al.*, 59 Pa. PUC 447, 491, 1985 Pa. PUC LEXIS 53 at *106-07 (May 24, 1985).
Cost of Common Equity	The cost of common equity proposals by I&E and OCA are well below any Commission decision since the adoption of original cost ratemaking in the early 1980s and well outside the central tendency of recent cost of equity findings by other regulatory commissions. PPL Electric St. 12-R, Schedule JMC-1.
Consolidated Tax Savings	I&E's adjustment is inconsistent with long-standing Commission precedent (PPL Electric St. 8-R, p. 35; PPL Electric St. 8-RJ (Part 1), pp. 6-7) and inconsistent with the actual taxes paid doctrine. *Barasch v. Pa. P.U.C.*, 507 Pa. 561, 493 A.2d 653 (1985).

Adjustment	Reason Adjustments Should Be Rejected
Cost Allocation Study	OCA's proposed cost allocation study was specifically rejected by the Commission in PPL Electric's last base rate proceeding. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (December 21, 2010).
Residential Customer Charge	I&E and OCA proposed customer charges are plainly inconsistent with the Commission's recent decision in *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 2004 Pa. PUC LEXIS 39, 236 P.U.R. 4th 218 (Aug. 5, 2004). PPL Electric's alternative proposal for a $14.09 residential customer charge is fully consistent with *Aqua*.
Purchase of Receivables	Direct Energy's proposal to rebundle uncollectible expense accounts is inconsistent with Section 2802 of the Competition Act, inconsistent with the Commonwealth Court's decision in *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006), *appeal denied*, 591 Pa. 676, 916 A.2d 1104 (2007), and was specifically rejected by the Commission in PPL Electric's most recent 2010 base rate proceeding. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010- 2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *153 (Dec. 21, 2010).

Perhaps recognizing the lack of merit in and lack of precedent for its individual adjustments, I&E blames the requested rate increase on PPL Electric's relationship with its affiliates. These arguments are troubling on several counts. First, they are premised on a fundamentally flawed legal analysis. Second, they are completely irrelevant to a determination of just and reasonable rates in this proceeding. Third, they are factually wrong. PPL Electric urges the ALJ and the Commission to ignore these arguments and focus on the relevant issue in this proceeding, *i.e.*, what level of rate relief should PPL Electric receive in this proceeding.

I&E first cites PPL Corporation's 2011 total return to shareholders of 17.5% and boldly asserts that PPL Electric has "unjustly and unreasonably" contributed to this result. First, PPL Corporation's financial performance is completely irrelevant to this proceeding. The Commission should not and indeed cannot take into account PPL Corporation's earnings from unregulated operations or earnings from regulated operations in other jurisdictions in setting PPL

Electric's rates. PPL Electric is entitled to charge rates which provide it a fair opportunity to earn a fair rate of return on the fair value of its investment to serve the public. Reducing an otherwise necessary rate increase because of affiliated earnings would violate this fundamental ratemaking principle, would be confiscatory on its face, and would undoubtedly be reversed on appeal. If PPL Corporation were operating at a loss, I&E would not contend, nor would this Commission countenance, providing additional rate relief to PPL Electric to cover that loss. Similarly, PPL Corporation's earnings from other business lines should not be available to reduce PPL Electric's otherwise just and reasonable rates.

Moreover, I&E's assertion that PPL Electric unjustly contributed to PPL Corporation's 2011 financial performance is simply wrong. First, the 17.5% figure is not PPL Corporation's earnings or its return on equity; it is the total return to shareholders, which consists of dividend payments and price appreciation of PPL Corporation's stock. Second, in 2011, PPL Electric earned 8.00% on its Pennsylvania jurisdictional operations. PPL Electric Ex. 1, Historic-1, Schedule C-1, ln. 14. I&E's assertion that PPL Corporation's financial performance is "unjustly and unreasonably dependent on and enhanced" by PPL Electric's earnings is completely unsupported by the record and simply makes no sense.[1]

I&E next points to storm damage insurance as an example of affiliate abuse. As explained in PPL Electric Initial Brief and below, after correcting for an unfortunate I&E double counting error, the record demonstrates that PPL Electric customers have clearly benefitted from storm damage insurance, which would not have been available but for use of an affiliate for the

[1] I&E also notes PPL Electric's "astounding" record of consecutive dividend payments. I&E Main Brief, p. 6. I&E raised this point for the first time on cross examination, thereby providing PPL Electric no meaningful opportunity to respond on the record. Tr. 283-92. In fact, there is nothing "astounding" about PPL Electric's dividend payment history, and I&E provides no record support for its pejorative description. PPL Electric urges the Commission to ignore this beyond the record characterization of PPL Electric's dividend history or in the alternative to take administrative notice of other utility companies with similar dividend payment histories.

primary layer of insurance coverage. Moreover, PPL Electric's insurance affiliate has not operated at a profit; it has operated at a loss, so it is somewhat difficult to understand I&E's assertion that PPL Electric has unreasonably subsidized its insurance affiliate.

I&E next points to incentive compensation as an example of affiliate abuse. On the contrary, most of the incentive compensation claim is for PPL Electric employees. Moreover, I&E seeks to establish a new standard for incentive compensation under which incentive compensation costs cannot be fully recovered in rates unless the utility demonstrates that all of the goals are for the exclusive benefit of customers. This approach has been repeatedly rejected by the Commission. It would be extraordinarily poor public policy for the Commission to allow other Pennsylvania utilities to recover incentive compensation costs in rates, but deny PPL Electric's full recovery of the costs of its incentive compensation program by adopting a new, unprecedented, and unlawful standard.[2]

The so-called "affiliated interest" adjustments advanced by I&E (cost of equity, capital structure, incentive compensation, storm damage and service company costs) are completely unlawful, unprecedented and factually wrong. PPL Electric urges the ALJ and the Commission to focus on the issues relevant to this proceeding and approve PPL Electric's requested rate increase.

OCA's proposed increase of $47.7 million, while certainly better than I&E's proposed rate decrease and better than OCA's initial $21.0 offering, is still woefully inadequate and not supported by the record. The bulk of OCA's disallowance relates to capital structure and cost of common equity. OCA's proposals are erroneous and should be rejected. OCA repeatedly

[2] I&E also objects to the fact that PPL Electric pays its affiliates for services more quickly than the maximum time period permitted by the underlying services agreement. In fact, PPL Electric pays its affiliates on exactly the same schedule as its pays non-affiliated vendors. It is not clear how or why this constitutes favoritism or subsidization of affiliates.

characterizes PPL Electric's proposed capital structure as "equity rich". This assertion is based solely on historic data which fails to reflect PPL Electric's 2012 redemption of its preference stock, which the OCA has not opposed and which will reduce rates for customers. It also fails to reflect the Company's major construction program and the need for a stronger financial profile in order to finance that construction on reasonable terms. The Commission has repeatedly held that use of a hypothetical capital structure is not appropriate where a utility's claimed capital structure is within the range of capital structures for comparable utility companies. PPL Electric's proposed capital structure is well within the range of capital structures for the Barometer Groups of all witnesses in this proceeding, including OCA's witness. PPL Electric's capital structure therefore should be approved.

The OCA's proposed 9.0% cost of common equity is clearly erroneous for the many reasons discussed in PPL Electric's Initial Brief and below. The OCA's proposal is far below any decision of this Commission for the past thirty years (when Pennsylvania adopted original cost ratemaking), is well below the 10.25% to 10.5% central tendency of recent decisions by other commissions, and in fact, is far below the 10.4% the average commission-allowed return on equity for OCA witness Hill's own Barometer Group of companies. In support of its position, OCA relies heavily on historically low current interest rates. Interest rates are indeed currently low, but this is the result of government manipulation and is not an accurate reflection of a market-based cost of common equity. While interest rates have fallen, the risk of equity investments has significantly increased. OCA completely ignores this risk and, thereby, significantly understates the market cost of common equity.

The determination of the cost of common equity is important in every rate proceeding. It is particularly important in this case as it will undoubtedly inform the Commission's determination of the cost of common equity for use in the new Distribution System Improvement Charge for electric and gas companies throughout the Commonwealth. The investment community and other utilities will be watching this case closely to determine if this Commission will be supportive of new capital investment to replace aging infrastructure, which will create new jobs and assure continued reliable service to all Pennsylvania electric and gas customers. For these reasons, the Company urges the Commission to adopt a reasonable, market-based cost of common equity at the upper end of the zone of reasonableness to evidence its support for infrastructure investment throughout the Commonwealth.

The Company also urges the Commission to adopt its proposed 12 basis point adjustment for management effectiveness. The Commission is required by statute to consider management effectiveness in setting rates, and the credible record evidence in this proceeding fully supports the Company's proposal.

The remaining issues in this proceeding are fully addressed in PPL Electric's Initial Brief and below. For the reasons stated therein, PPL Electric's proposed rate increase, cost allocation, revenue allocation, rate design, Competitive Enhancement Rider, and purchase of receivables program should be approved.

III. <u>RATE BASE</u>

A. OCA'S PROPOSED ADJUSTMENT TO THE ACCUMULATED RESERVE FOR DEPRECIATION SHOULD BE REJECTED

In this proceeding and in all Pennsylvania base rate proceedings utilizing a future test year, rate base is determined at a specific point in time, *i.e.*, the end of the future test year. For this proceeding, that date is December 31, 2012. Consistent with this approach, PPL Electric proposed to bring forward its accumulated reserve for depreciation from the level per books as of the end of the historic test year, *i.e.*, December 31, 2011, to the end of the future test year, *i.e.*, December 31, 2012, by: (1) adding to the reserve as of December 31, 2011 the projected depreciation expense budgeted for calendar year 2012; (2) then subtracting projected retirements; and (3) then adding net salvage budgeted for calendar year 2012. This process produces the projected accumulated depreciation reserve as of December 31, 2012. PPL Electric St. 13-R, pp. 1-2. The same process is used to bring forward plant in service. That is, projected additions to plant and less retirements for calendar year 2012 are added or subtracted to plant in service as of December 31, 2011 to produce projected plant in service as of December 31, 2012.

OCA, in contrast, proposes to bring forward the accumulated reserve for depreciation per books as of December 31, 2011 to December 31, 2012, by adding to the reserve as of December 31, 2011, the annualized depreciation expense based upon the level of plant projected to be in service at the end of the future test year. PPL Electric St. 13-R, p. 2. The depreciation expense for 2012 is projected to be \$155,248,000. The annualized depreciation expense based on plant as of December 31, 2012, is \$168,920,000. This difference, \$10,417,000, is OCA's proposed adjustment to the depreciation reserve. The OCA's adjustment, if adopted, would increase PPL Electric's accumulated reserve for depreciation as of December 31, 2012, by this amount and reduce rate base by the same amount. PPL Electric St. 13-R, p. 5. PPL Electric explained the principal reasons why OCA's proposed adjustment is improper in Section III.B of its Main Brief. Two further observations are appropriate, however, in response to OCA's Main Brief.

First, in its Main Brief at page 12, OCA quotes the following statement by its witness, Mr. Koda: "[T]he reserve for depreciation is built up by recording depreciation expense related to plant in service ...." OCA St. 1-Revised, p. 11. This statement by OCA is correct, and it is why its proposed adjustment to the depreciation reserve is not correct. The reserve for depreciation is built up by recording depreciation expense, but the expense recorded is the expense per books for a particular period of time, here, calendar year 2012. OCA's proposal to ignore the projected per books depreciation expense and use instead the theoretical, annualized level of expense is not correct. The annualized depreciation expense as of December 31, 2012 will not be recorded on PPL Electric's books during calendar year 2012. Therefore, it is not part of the "build-up" of the depreciation reserve by recording depreciation expense related to plant in service.

The flaw in OCA's proposed adjustment can be further demonstrated by reviewing the other components of net plant as of December 31, 2012. As shown in PPL Electric Ex. JJS-2, pp. III-6 through III-7, the accumulated reserve for depreciation as of December 31, 2012 is determined by bringing forward the reserve as of December 31, 2011 by adding the projected annual expense per books, projected retirements per books, and net salvage per books. Similarly, plant in service as of December 31, 2012 is determined by starting with plant in service per books as of December 31, 2011 and adding projected plant additions and subtracting retirements budgeted for 2012. PPL Electric Ex. 1, Part V-A-3, pp. 1-3.

OCA proposes to change one element and one element only in determining net plant in service. Specifically, the OCA would not use the projected depreciation expense per books for 2012 to bring forward the accumulated depreciation reserve as of December 31 2011 to December 31 2012. Its proposed use of the annualized depreciation expense based on projected plant in service as of December 31, 2012 would be a mismatch with every other component of net plant in service. There is no annualized plant in service value, no annualized level of retirements, annualized plant additions or annualized net salvage. Projected budgeted amounts are used for all other components of net plant. OCA's proposed adjustment to the accumulated reserve for depreciation is completely inconsistent with all other components of net plant and should be rejected.

Second, OCA complains that PPL Electric has not been able to cite any case in which the Commission decided this issue in PPL Electric's favor. OCA's observation is factually correct, but the implication of its observation is incorrect.

Although PPL Electric has not been able locate any litigated proceeding in which the issue raised by OCA here has been addressed by the Commission, the fact that Mr. Spanos has sponsored the same methodology in numerous cases in Pennsylvania and elsewhere for many public utilities which have not lead to litigation means that, in those many cases, in which OCA undoubtedly participated, as well as their many accounting and depreciation experts over the years, no one before Mr. Koda has raised this issue. That is why there is no Commission order specifically addressing this issue. The fact is that the methodology used by Mr. Spanos in this proceeding has been widely accepted in many cases in Pennsylvania means, and it is a standard practice and procedure. The many cases in which it has been accepted without controversy demonstrate its acceptance and the lack of merit on Mr. Koda's proposal.

B. I&E'S RATIONALE FOR REMOVING REGULATORY ASSESSMENTS FROM THE PREPAYMENTS COMPONENT OF WORKING CAPITAL IS ERRONEOUS

As explained in PPL Electric's Initial Brief, PPL Electric's payments of regulatory assessments for the Commission, OCA and OSBA are prepayments which are properly included in the prepayments component of working capital because they are paid in June of each year for the next fiscal year commencing July 1. PPL Electric Initial Brief, Section III.C.d. In this Section of the Initial Brief, PPL Electric responded to I&E's arguments that were presented in its evidence, I&E St. 2, p. 60; St. 2-SR, pp. 65-66. In its Main Brief, however, I&E makes several additional arguments in support of its proposal to eliminate regulatory assessments from prepayments. The reasons why these additional arguments lack merit are explained below.

I&E contends that regulatory assessments are not prepayments because they are not subject to refund. I&E Main Brief, p. 15. It stated: "Unlike a prepayment that may be refunded if the services are no longer required, the PUC Assessment is not subject to refund." I&E offers no explanation or support for its statement that, in order to be a prepayment, a payment must be subject to refund, and PPL Electric is not aware of any such support. Indeed, requiring a provision for refund if services are no longer required would seem unnecessary for regulatory assessments because PPL Electric is not aware of any likelihood that the Commission, OCA or OSBA are likely to go out of business any time soon. Furthermore, I&E's statement is incorrect. Although the statutory provisions for assessments do not contain express provisions for refunds, the regulatory assessments are subject to reconciliation if positive or negative balances remain at the end of the prior fiscal year. Such balances, under the statutory system for determining the amounts of assessments, are carried over into the next fiscal year. 66 Pa.C.S. § 510(a)(2). Thus, assessments in excess of expenditures, although not refunded, are used to reduce the assessment for the next fiscal year, which is the economic equivalent of a refund.

In support of its elimination of regulatory assessments from the prepayment component of working capital, I&E next analogizes to personal income taxes. I&E states that regulatory assessments are not prepayments because, like personal income taxes, they are paid after the end of the calendar for which the tax is calculated. I&E Main Brief, p. 16. I&E is incorrect for two reasons. First, the Commission's June 2012 letter imposing the assessments on public utilities expressly states that a payment of a regulatory assessment is a "pre-payment of PPL Electric's estimated Public Utility Commission assessment for the fiscal year 2012-2013." PPL Electric

Ex. BLJ-1. I&E does not and presumably cannot cite any similar statement regarding personal income taxes. Second, the factual basis of I&E's analogy is incorrect. I&E states: "... an individual's personal income tax is determined and paid after the fact based upon the prior year's earned revenues." I&E Main Brief, p. 16. I&E is wrong. Personal income taxes are primarily paid through payroll, withholding and/or estimated tax payments. Thus, the great majority of an individual's income tax liability for a calendar year is paid during that year, and only small amounts necessary to finalize payments are paid after the close of the year.

I&E's argument is also contrary to Section 511(b) of the Public Utility Code, 66 Pa.C.S. § 511(b). This Section contains a clear statement that the assessments paid by public utilities for the Commission, OCA and OSBA are prepayments. It provides:

> All such assessments and fees, having been **advanced** by public utilities for the purpose of deferring the cost of administering this part, shall be held in trust solely for that purpose and shall be earmarked for the use of, and annually appropriated to, the Commission for disbursement solely for that purpose.

66 Pa.C.S. § 511(b) (emphasis added.) I&E's proposed adjustment to remove regulatory assessments from working capital is without merit and should be rejected.

C. I&E'S CRITICISMS OF PPL ELECTRIC'S TREATMENT OF POSTAGE EXPENSE IN WORKING CAPITAL DISREGARD CONTROLLING COMMISSION PRECEDENT

I&E criticizes PPL Electric's ratemaking treatment of postage expense in its working capital requirement. PPL Electric treats postage expense separately for each of two separate periods. The first period starts when PPL Electric pays the United States Postal Service and ends when the postage is used to mail an envelope. For this period, postage is included in the prepayment component of working capital. The second period begins when PPL Electric affixes postage to an envelope and ends when customers pay for services. This period of time is included in PPL Electric's lead/lad study to determine its cash working capital requirement. I&E

Main Brief, pp. 17-18. I&E is correct that PPL Electric treats postage expense in two different ways related to two different time periods, but I&E's criticisms are without basis, as the Commission has previously determined.

OCA raised the same issue in PPL Electric's 2004 base rate case. The Commission explained OCA's position as follows:

> The OCA was the sole party to take issue with PPL's inclusion of prepaid postage within its claimed rate base for the Future Test Year. According to the OCA, PPL's claim for prepaid postage in the average prepayment balances, as well as within the CWC lead/lag study, results in a double recovery.

Pa. P.U.C. v. PPL Electric Utilities Corp, Docket No. R-00049255, Slip Op. 11, 237 P.U.R. 4th 419, 2004 Pa. LEXIS 40 (Dec. 22, 2004). The Commission resolved OCA's contention as follows:

> Based upon the evidence in record, we deny the Exceptions of the OCA and adopt the recommendations of the ALJ. We find that the Company's position, that the period of time captured in its lead/lag study for this issue is from the date bills are mailed to the date payment is received from customers effectively refutes OCA's argument of double counting, since the time period from when the postage is paid to when it is expensed is excluded.

Id., p. 12. I&E's criticisms of PPL Electric's ratemaking treatment of postage expense are without merit.

IV. REVENUES

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

PPL Electric proposes to increase the fee it charges customers for the reconnection of service under Rule 10 of its Tariff from $15 to $30 during normal business hours and from $21 to $50 during non-business hours. OCA accepted PPL Electric's proposal, but recommended that the Company be directed to monitor the costs of reconnection and provide a detailed cost analysis, with and without smart metering, in its next general rate case. OCA Main Brief, p. 17. PPL Electric explained that this effort, which already is being conducted in the context of a Commission proceeding at Docket No. M-2009-2123945, makes it unnecessary to require PPL Electric to provide the same information in its next base rate proceeding. For this reason, OCA's recommendation should be denied. PPL Initial Brief, p. 32.

As explained in the Company's Initial Brief, PPL accepted I&E's recommended revenue adjustment of $355,000. PPL Initial Brief, pp. 32-33. This adjustment is reflected in PPL Electric Ex. 1, Future 1-Revised. For the reasons explained in PPL Electric's Initial Brief, with I&E's recommended revenue adjustment of $355,000, PPL Electric's unopposed proposal to increase its reconnection fee should be approved.

V. <u>EXPENSES</u>

A. OCA'S PROPOSED ADJUSTMENT TO DISALLOW ONE-HALF OF INCENTIVE COMPENSATION SHOULD BE REJECTED

OCA contends that one-half of expenses incurred by PPL Electric for incentive compensation for its employees and employees of PPL Services should be disallowed because the incentive compensation plan benefits both shareholders and ratepayers. PPL Electric explained the principal reasons why the proposed adjustment should be rejected in its Initial Brief, pp. 33-40.

In support of its adjustment, OCA in its Main Brief cites three cases: *Pa. P.U.C. v. UGI Utilities, Inc. – Electric Division*, 82 Pa. PUC 488 (1994) ("*UGI Electric*"); *Pa. P.U.C. v. Roaring Creek Water Co.*, 81 Pa. PUC 285 (1984) ("*Roaring Creek*"); and *Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-00061931, 2007 Pa. PUC LEXIS 45 (Sept. 28, 2007) ("*PGW*"). Despite OCA's contentions, all three cases are readily distinguishable from this proceeding.

Before addressing the specifics of each proceeding, however, one general observation is appropriate. In none of the three cases did the Commission approve what OCA is proposing, a sharing of expenses between shareholders and ratepayers. Instead, in all three cases, 100 percent of the incentive compensation or bonuses were disallowed. They were disallowed in all three cases because the utility did not demonstrate that the incentive compensation or bonuses would benefit ratepayers <u>at all</u>. That is, these cases provide no support for sharing of expenses between ratepayers and shareholders. Instead, they stand for the proposition that expenses that do not provide any benefit for ratepayers may be disallowed in full. These cases have no application to this proceeding, where it is uncontested that the Company's incentive compensation plans contain both operational and financial goals which clearly benefit customers.

Here, in contrast, by proposing a sharing between ratepayers and shareholders of incentive compensation expense, OCA concedes that the incentive compensation benefits ratepayers. OCA has not cited a single case in which the Commission approved sharing of incentive compensation expenses between shareholders and ratepayers. There is no such case because imposing such a sharing of expenses would be improper under the holding of, *inter alia*, *Butler Township Water Co. v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984) and *T.W. Phillips Gas and Oil Co. v. Pa. P.U.C.*, 474 A.2d 355 (Pa. Cmwlth. 1984).

Under these cases, the rule of law is that a public utility is entitled to recover in rates all those expenses reasonably necessary to provide service to its customers and to earn a fair return on its investment in plant used and useful in providing service. If the expenses are reasonable in amount and reasonably necessary to provide service, they are recoverable in full. Here, OCA has made no claim that compensation expenses, including incentive compensation, were unreasonable nor did it challenge the amount of incentive compensation or the structure of the program. OCA stated: "I am not saying that one-half of the incentive compensation expense should not be incurred, but that it should be funded by shareholders." OCA St. 1-SR, p. 7.

Nor do the specifics of any of the three cases make them applicable to the instant proceeding. In *UGI – Electric*, the Commission concluded that the incentive payments at issue were awarded for employee performance contributing to the profitability of the parent corporation and was not related to the operational efficiency or service provided by the utility subsidiary. *UGI – Electric, supra.* at 506-08. This concern was reinforced by the fact that the majority of the persons eligible for the bonuses were employees of the holding company and not the utility. In this proceeding, in contrast, PPL Electric demonstrated that, although the incentive compensation program does include financial objectives, two of the three principal objectives are to achieve operational excellence and to optimize work force readiness and engagement. PPL Electric Ex. DAC-2. In addition, PPL Electric's incentive compensation program is a benefit for all non-union employees. PPL Electric St. 3-R, pp. 25-26. Clearly, *UGI – Electric* does not support OCA's proposed sharing of the incentive compensation expense in this proceeding.

Nor does *Roaring Creek* support OCA's proposed adjustment. There, the principal concern was that the criterion for awarding incentive compensation was the profitability of the parent company and not the operational efficiency of the public utility subsidiary. The Commission expressed concern about the "errant focus on profitability over operational effectiveness." *Roaring Creek, supra*, at 299.

PGW presents a slightly different fact pattern. Instead of concluding that the incentive compensation program was focused on profitability and not operational effectiveness or quality of service, the Commission expressed approval for the objectives of the incentive compensation program of PGW. However, the Commission then concluded that PGW was not following the objectives of the program and that the incentive compensation was not necessary to retain competent management personnel. *PGW, supra*, at 20, 48. The Commission expressed approval of the goals of the plan which were for "improved operations of the Gas Works such as the achievement of the Gas Works' financial plan, customer service, billing and collection efficiencies and development of new revenues (other than from general rate increases). *PGW, supra*, at 19. Clearly, the above-quoted goals of the incentive compensation plan were acceptable to the Commission even though they included both financial and operational objectives.

PPL Electric's incentive compensation program's goals are similar to the program that the Commission viewed favorably in *PGW* in that both compensation plans had goals that included both financial and operational objectives. Clearly, incentive compensation programs are not subject to either full or partial disallowance simply because a portion of the goals relate to financial objectives. OCA's proposed adjustment to share incentive compensation between ratepayers and shareholders should be rejected.

B. I&E'S PROPOSAL TO DISALLOW HALF OF PPL ELECTRIC'S INCENTIVE COMPENSATION EXPENSE SHOULD BE REJECTED

I&E also contends that one-half of PPL Electric's incentive compensation expense should be disallowed for ratemaking purposes because it benefits both shareholders and ratepayers. I&E Main Brief, pp. 28-31. The I&E's contention should be rejected. Ironically, the principal reason why I&E's proposed adjustment to incentive compensation expense should be rejected and why PPL Electric's incentive compensation expense should be accepted in full is provided by I&E at the beginning of the "Expense" section of its Main Brief, pp. 19-20. There, I&E states:

> A utility is entitled to recover **all of its reasonably incurred expenses**. 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 regulated service.

I&E Main Brief, pp. 19-20 (footnotes omitted; emphasis added). PPL Electric concurs with this statement by I&E. It is consistent with the holdings of the Pennsylvania appellate courts in *Butler Township Water Co. v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984) and *T.W. Phillips Gas and Oil Co. v. Pa. P.U.C.*, 474 A.2d 355 (Pa. Cmwlth. 1984). It also fully supports recovery by PPL Electric of its entire incentive compensation expense.

Nowhere does I&E contend that PPL Electric's overall level of payroll expense, which includes incentive compensation, is excessive or unreasonable. Nowhere does I&E contend that incentive compensation is not a "normal operating and maintenance expense." Nowhere does I&E contend that incentive compensation is not incurred "by providing regulated service." Yet I&E would disallow one-half of incentive compensation expense because it benefits shareholders, as well as ratepayers. Based on the correct legal principal stated in I&E's Main Brief, which is quoted above, PPL Electric is entitled to full recovery of all incentive compensation expenses.

I&E's criticisms of PPL Electric's incentive compensation expense lack merit. I&E contends that PPL Electric should have provided more detailed information regarding the goals of its incentive compensation program because such information is needed for proper "weighting" of the benefits between shareholders and ratepayers. I&E Main Brief, pp. 28, 30-31. I&E, however, misses the point. When I&E argues that one-half of incentive compensation should be disallowed because the expense benefits both ratepayers and shareholders, it effectively concedes that the goals of PPL Electric's incentive compensation plan benefit ratepayers. If the expense is normal, reasonable, and benefits ratepayers, no weighting is appropriate; all incentive compensation expenses should be recovered by PPL Electric. The details sought be I&E would serve no purpose. Significantly, I&E has cited no opinion of the Commission or the Pennsylvania appellate courts that supports its recommendation that incentive compensation should be shared between ratepayers and shareholders.

I&E also reiterates its contention that PPL Electric failed to demonstrate that incentive compensation expense benefits ratepayers exclusively. I&E Main Brief, p. 30. I&E does not, and cannot, cite any evidence in this proceeding where PPL Electric made any such contention. To the contrary, PPL Electric has contended steadfastly that incentive compensation, as well as many other expenses, benefit both ratepayers and shareholders. *See, e.g.*, PPL Electric St. 3-R, pp. 23-24. That fact, however, provides no basis for sharing of the expenses.[3]

I&E's proposed adjustment to PPL Electric's incentive compensation expense should be rejected.

C. OCA'S PROPOSED DISALLOWANCE OF A PORTION OF PPL ELECTRIC'S CONSUMER EDUCATION COSTS SHOULD BE REJECTED

OCA proposes to limit PPL Electric's consumer education costs to $5.4 million, an amount approximately equal to the amounts approved by the Commission for PPL Electric's 2008 – 2012 Consumer Education Plan. The effect of OCA's proposed adjustment, if adopted, would be to disallow an amount of money equal to the total of the cost of the future annual postcard mailings required under the Retail Markets Investigation ($400,000 annually), the cost of the 2012 postcard required under the Retail Markets Investigation ($400,000 over two years) and the cost of the tri-fold brochure required under the Retail Markets Investigation ($700,000

[3] I&E, in an attempt to taint PPL Electric's incentive compensation expense, characterizes it as 10 percent of the proposed rate increase. I&E's characterization is incorrect for two principal reasons. First, it compares total O&M incentive compensation expense with the proposed revenue increase, instead of total revenues. Second, it compares PPL Electric's total O&M incentive compensation expense for its employees with jurisdictional revenues. If one were to make the comparison, the more appropriate comparison would be the jurisdictional O&M expense of $8.918 million (I&E Main Brief, p. 28) with jurisdictional revenues at proposed rates of $885.043 million (PPL Electric Ex. 1, Future 1-Revised, Sch. D-1, p. 1). The comparison is that jurisdictional incentive compensation O&M expense is 1% of total jurisdictional revenues at proposed rates.

over two years) or $950,000 annually. In addition, OCA would not make any provision for any additional expenses that PPL Electric may be required to incur to comply with future mandates from the Commission in the Retail Markets Investigation. OCA Main Brief, pp. 28-29.

In support of its adjustment, OCA states that it took into account the recommendations of its witnesses Colton and Watkins. OCA Main Brief, pp. 28-29. Curiously, however, nothing in either Mr. Colton's or Mr. Watkins' testimonies makes specific recommendations as to amounts to be allowed or disallowed for PPL Electric's consumer education program. Effectively, OCA would disallow all amounts in excess of PPL Electric's future test year consumer education expenses in PPL Electric's Consumer Education Plan for 2008 - 2012. OCA has failed to recognize that these amounts, over and above the budget for the Consumer Education Plan, are for consumer education measures that have been mandated by the Commission in the Retail Markets Investigation. The result of OCA's recommendation would be a substantial reduction in amounts available for consumer education programs like those approved by the Commission for 2008 – 2012. PPL Electric St. 5-R, pp. 28-29. There is no basis in either Mr. Watkins' or Mr. Colton's testimony for a disallowance of this amount. In fact, Mr. Watkins testified that he did not object to the recovery of these amounts. Specifically, regarding expenses incurred pursuant to the Retail Markets Investigation, Mr. Watkins stated: "Given the Commission's directives concerning mandated consumer education plans, I have no objection to the recovery of approved specific consumer education program costs through a reconcilable rider mechanism." OCA St. 3, p. 49.

Similarly, Mr. Colton made no recommendation that would reduce the level of expense. In fact, he recommended that the Consumer Education Plan be expanded to provide for education of Local Housing Authorities. OCA St. 4, pp. 16-21. Nothing in this recommendation would reduce PPL Electric's projected consumer education costs; it provides no support for Mr. Koda's recommendation that a portion of PPL Electric's consumer education costs be disallowed.

OCA's proposed adjustment to consumer education expenses should be rejected because it unsupported by the evidence.

D. PPL ELECTRIC'S STORM DAMAGE EXPENSES SHOULD BE APPROVED

1. Overview.

PPL Electric's storm damage expense has three components. The first component is the 2012 budget for normal storm damage expenses. This component consists of an allowance for smaller storms that are not covered by insurance and the amount the PPL Electric must pay for repair damage from large, covered storms up to the level where insurance coverage begins -- *i.e.*, the deductible. The second component is the premium for storm damage insurance. The third component is a five-year amortization of extraordinary storm damage expenses in excess of the storm damage insurance limits of liability experienced in 2011. PPL Electric Initial Brief, p. 48. I&E opposes PPL Electric's storm damage expense in its entirety. I&E, instead proposes to use a five-year average of total storm damage expense, including both normal and extraordinary expenses, to set the level of storm damage expense for ratemaking purposes.

Although PPL Electric has fully explained that its storm damage expense, including the purchase of storm damage insurance, has been reasonable and prudent, I&E continues to press its contention that the entire storm insurance program should be dismantled and replaced with a simple five-year average of all storm damage expenses – normal and extraordinary. In making this proposal, I&E disregards almost 40 years of uninterrupted precedent by the Commission and appellate courts that there should be separate ratemaking allowances for normal storm damage plus an additional amortization of extraordinary storm damage losses for which there otherwise would be no recovery through rates.

Although I&E raises several arguments, the fundamental basis for its proposal is that the purchase of insurance has not benefitted ratepayers because premiums have exceeded losses. I&E is incorrect both conceptually and factually. I&E is incorrect conceptually because the prudence of insurance cannot be fairly judged based upon loss experience over a relatively short period of time, such as five years. If I&E were correct, every purchase of term life insurance would be imprudent if the insured did not die while the insurance was in effect, and health insurance would be imprudent for any period when the insured incurred total medical bills less than the insurance premium. This is simply not a rational basis to measure the prudence of insurance.

I&E also is factually incorrect regarding the relative levels of premiums paid to PPL Insurance for storm insurance and storm insurance benefits paid by PPL Insurance. As shown by the chart below, total insurance reimbursements received by PPL Electric from PPL Insurance for the five years from 2007 through 2011 have totaled $49,143,000. I&E Ex. 2, Sch. 19, p. 2. Storm damage insurance premiums, in contrast, for 2007 through 2011 have totaled $42,645,000.[4]

[4] For the first several years of its storm damage insurance program, PPL Electric' policy year was split between two calendar years, *i.e.*, June 5 through June 4. The premiums are provided on a calendar year basis for 2007 through 2011. In order to make these amounts comparable to the losses, it is necessary to reduce reimbursements by $5,655,000 to remove premiums that cover a portion of 2006 as well as a portion of 2007. This adjustment compares approximately 4 and one half years of reimbursements with five years of premiums, and therefore is favorable to I&E's contention. Even with this adjustment, reimbursements still exceed premiums. For premium amounts, see I&E St. 2, p. 38.

	2007	2008	2009	2010	2011	Total
			($000)			
Premiums	$6,725	$7,260	$6,960	$10,850	$10,850	$42,645
Reimbursements	$12,112	$5,032	$0	$5,499	$26,500	$49,143

I&E's entire analysis on this issue is based on a mistaken interpretation of a PPL Electric interrogatory response which led I&E to erroneously conclude that PPL Electric's budget for storm damage expense and the deductible under the storm insurance policy are separate expense items. As fully explained in PPL Electric's Initial Brief and below, this is simply not the case. PPL Electric's the budgeted amount for storm damage insurance expense includes the deductible amount under the storm damage insurance policy. The deductible is a subset of the budgeted amount for storm damage expense. By analogy, assume a car owner has an insurance policy with a $500 deductible and a $1000 annual premium. In a given year, the car owner has an accident which results in $2500 in damage to the car. The car owner pays the deductible (the first $500 of damage) and receives a check from the insurance company for $2000. The car owner's car damage expense for the year is $1500 (the $1000 annual premium and the first $500 the car owner had to pay when the car was damaged, *i.e.*, the deductible amount). Under I&E's incorrect analysis, the car owner incurred $2000 of expenses (the $1000 annual premium, the $500 deductible and the first $500 in repairs). I&E is wrong because it double counted the deductible. The same is true for I&E's analysis of PPL Electric's storm insurance costs. I&E made a mistake; everyone makes mistakes. But it is not reasonable to refuse to admit one's mistake and then continue to rely on that mistake to dismantle an insurance program which has been approved by the Commission and has greatly benefited customers, and then propose a radical and unprecedented alternative which is inconsistent with over 30 years of uniform

Commission precedent and would deny PPL Electric recovery of its reasonable storm damage costs.

Finally, if some reason, the ALJ and Commission were to conclude that PPL Electric should end its storm insurance program even though it has clearly benefited customers, the correct allowance for storm damage expense in this case would PPL Electric's 2012 budget amount for storm damage expense ($12.625 million for normal storm damage + $8.750 million for storm damage insurance) plus the proposed five-year amortization of 2011 storm damage costs in excess of insurance coverage ($5.324 million annually). As explained above, I&E's five-year average of both ordinary and extraordinary storm damage expense is completely unprecedented and would deny PPL Electric recovery of its undisputed storm damage expense.

2. Payment Of Benefits By PPL Insurance Is Reasonable And, In Any Event, Places No Burden On Ratepayers.

I&E's first contention in support of its proposed use of a five-year average is a criticism of PPL Electric's storm insurance program. I&E contends that the delay between the occurrence of a storm event and payment by PPL Electric's affiliate, PPL Power Insurance, Ltd. ("PPL Insurance") of claims under the storm damage insurance policy makes the purchase of insurance imprudent. I&E Main Brief, pp. 44-48. In making this claim, I&E ignores the unrefuted testimony of PPL Electric that the delay in payment by PPL Insurance of claims has no effect on PPL Electric's revenue requirement in this proceeding. PPL Electric St. 7-R, pp. 7-8. I&E also seems to believe that PPL Electric can submit claims for storm damage to PPL Insurance the moment the clouds part and the sun reappears. I&E's expectation is unrealistic because, especially for large storms, substantial time is required in order for PPL Electric to complete the storm loss claim. Storm damage restoration following large storms is extensive and expensive. For large storms, PPL Electric often uses numerous outside contractors. Invoices and paperwork from these outside contractors to identify and explain the entire cost of restoration and repair is often delayed for several months. PPL Electric St. 14-R, p. 7.

I&E also disregards the fact that the coverage is subject to an annual aggregate deductible. *See, e.g.*, I&E Ex. 2-SR, Sch. 2, p. 9. This provision means that nothing is owed by PPL Insurance for storm damage until annual aggregate losses exceed the deductible. Therefore, it is reasonable for PPL Electric to accumulate losses for an entire year and submit them at one time so that PPL Electric and PPL Insurance can determine whether the annual aggregate losses exceed the deductible. PPL Electric St. 14-R, p. 7.

In response to PPL Electric's explanation, I&E uses the example of losses during 2011, the year of greatest losses ever experienced by PPL Electric from storm damage.[5] PPL Electric St. 14-R, p. 5. During this year, PPL Electric's storm damage losses reached the annual aggregate deductible level much earlier than in more typical years. In years when storm damage equals more typical levels, the annual deductible is not reached until far later in the year.

In addition, I&E ignores how PPL Insurance utilizes any return on the investment of premiums between the time they are received and when claims are paid. First, PPL Insurance uses such investments to pay expenses incurred by PPL Insurance. As PPL Electric has explained, the level of insurance premiums that PPL Electric pays to PPL Insurance are based on actuarial studies to equal claims paid over an extended period of years. No provision is included in the premium for either profit by PPL Insurance or payment of expenses. To the extent that investment income exceeds expenses, it is recorded in the Statutory Capital Surplus of PPL Insurance and is available to pay future claims. PPL Electric St. 14-RJ, p. 7. In fact, despite the income achieved from investing premiums received before claims are paid, PPL Insurance, over

[5] I&E's example is provided at page 46 of its Main Brief, based on data set forth in I&E Ex. 2-SR, Sch. 3, p. 1.

the six years ended December 31, 2011, for all lines of insurance, experienced **negative** net income of $5,480,896. PPL Electric Ex. TN-2.

In response to PPL Electric's explanation that the costs of short term financing related to the delay between the date when PPL Electric pays storm damage expenses and when PPL Electric receives payment for claims, are born by PPL Electric shareholders, I&E assets in a footnote that: "[W]hen shareholder values fall, a claim is made in this case in support of the proposed $104.6 million revenue increase, ratepayers ultimately are responsible for such payment." I&E Main Brief, p. 48, fn. 99. I&E's contention makes no sense. Clearly, PPL Electric did not file this base rate case in order to recover costs that are not reflected in its revenue requirement.

If the ALJ and the Commission, however, are concerned about the timing of payment of claims by PPL Insurance, PPL Electric can attempt to arrange for earlier payments. The solution to any perceived issue regarding the timing of payment of claims is not to throw out the entire storm insurance program, which is prudent and has benefitted ratepayers.

3. The Purchase By PPL Electric Of Storm Insurance Has Been Reasonable And Prudent.

I&E next contends that the purchase of storm insurance is not prudent because the premiums represent a high percentage of the annual coverage. I&E Main Brief, pp. 48-49. Contrary to I&E's contention, however, the premiums for storm insurance are calculated by independent consulting actuaries to equal, over time, expected covered losses without any allowance for profit or payment of expenses. PPL Electric St. 14-R, p. 3. The simple fact is that the level of the annual premium, compared to coverage, reflects the actual level of losses in storm damage experienced by PPL Electric over time. The relationship of the level of premium annual coverage can hardly be a surprise given that, based on I&E's calculations, PPL Electric expects to experience seven insurable storms annually. I&E Main Brief, p. 47. We all know what would happen if our auto insurers believed that we would be involved in seven accidents every year. Further, losses for 2011 alone were approximately 244 percent of the annual premium. I&E Main Brief, pp. 48-49. Under such circumstances, the resulting relationship of annual premium to annual coverage can hardly be surprising.

I&E next presses its argument, despite all the evidence to the contrary, that PPL Insurance is profitable and that the profit is hidden in the provision for losses and loss expenses. I&E Main Brief, pp. 49-52. PPL Electric has explained the principal reasons why I&E's analysis is wrong in its Initial Brief, pp. 57-59. In its Main Brief, however, I&E argues that the provision on PPL Insurance's balance sheet for losses and loss expenses is not reliable because the level of the provisions may be overstated. I&E ignores the fact that PPL Insurance's provision for loss and loss expense for workers compensation coverage is reviewed by an independent actuary. It ignores the fact that PPL Electric's total provision for losses and loss expense is reviewed for accuracy annually by the external auditor and that this entire process is subject to the regulatory jurisdiction of the Territory of Bermuda. I&E seems to assume without basis that these actuaries and regulatory authorities are some combination of incompetent or unreliable. I&E, however, asserts no basis for its recommendation. PPL Electric St. 14-RJ, p. 12.

4. PPL Insurance Has Not Been Profitable.

I&E also challenges the fact that the reserve for losses and loss expenses as of December 31, 2011 includes the entire policy limit for storm damage insurance for 2011. Despite I&E's challenge, PPL Electric's explanation, that the reserve includes the entire policy limit, is eminently reasonable given the fact that insurance coverage for 2011 was $26.5 million (I&E Main Brief, pp. 48-49) and PPL Electric's storm damage losses for 2011 were $89.8 million. I&E Ex. 2, Sch. 25, p. 2. In addition, I&E simply ignores the fact that insurance reimbursements have far exceeded premiums for storm damage insurance. Total insurance reimbursements received by PPL Electric from PPL Insurance for 2007 through 2011 have totaled $49,143,000. I&E Ex. 2, Sch. 19, p. 2. Insurance premiums, in contrast, for 2007 through 2011 have totaled $42,645,000.[6]

5. I&E's Assertion That Ratemaking Provisions For Storm Damage Have Exceeded Actual Storm Damage Expenses Is Based On An Erroneous Double Count Of The Insurance Deductible.

I&E next reiterates its claim that ratemaking provision for storm damage expense has exceeded storm losses over the five years ended December 31, 2011. I&E Main Brief, p. 56. PPL Electric has explained in detail why I&E's analysis is incorrect because it double counts the insurance deductible, which is subsumed with the normal budget for storm damages. PPL Electric Initial Brief, pp. 52-55. The reasons why I&E's analysis is incorrect are summarized next.

The I&E's analysis is incorrect because it should not include the insurance deductible. The "insurance deductible" is already included in the "normal storm allowance." An insurance deductible merely identifies an amount of damages which the insured must pay up to the deductible amount. The amount paid by the insured for normal storm damage repair includes the deductible.

The same analysis applies to PPL Electric's budget for normal storm damage insurance. The "normal storm allowance" includes what PPL Electric must pay before storm damage insurance kicks in, *i.e.*, the deductible. Therefore, I&E counts the deductible twice. When this double counting is eliminated, budgets for storm damage and insurance premium for 2007

[6] See the table on page 23.

through 2011 total $87,953,000, which is significantly less than actual storm damage expenses incurred of $118,925,000. PPL Electric St. 2-R, pp. 2-3.[7]

Despite this explanation, I&E persists in including the double counted storm damage insurance deductible as a ratemaking provision for payment of such expenses. *See, e.g.*, I&E St. 2-SR, p. 39). I&E provides four explanations for doing so. First, I&E contends that the storm insurance deductible of $15,750,000 for 2012 "cannot possibly" be included in the normal storm damage budget of $12,625,000. I&E St. 2-SR, p. 40. Second, I&E contends that there were irreconcilable differences between "claims paid" and "insurance reimbursements total." Third, I&E claims that its flawed analysis is based on an interrogatory response from PPL Electric. Fourth, I&E claims that PPL Electric's explanation of the double count error in I&E's incorrect analysis is flawed because PPL Electric failed to include data for 2012 in its correction to I&E's analysis of the data for the five years ended December 31, 2011. As explained next, none of these contentions have merit.

First, contrary to I&E's contention, the normal insurance budget for 2012 does include an amount equal to the portion of the deductible for 2012 expected to be expensed. Of the total normal storm damage budget for 2012 of $12,625,000, $3,175,000 is for non-Commission reportable storms, which are not covered by insurance, and $9,450,000 is applicable to Commission reportable storms. The amount of $9,450,000 represents the portion of the storm

[7] I&E's analysis suffers from additional flaws. For example, I&E confuses PPL Electric's budget with the ratemaking provision for recovery of storm damage expenses. Under I&E's analysis, the ratemaking allowance for storm damage changes every year from 2007 through 2011. PPL Electric, however, had rate cases only in 2007 and 2010, so there could not have been any change in the ratemaking allowance for storm damage expense except for 2008 and 2011. I&E's analysis also ignores the facts that the 2007 rate case resulted in a "black box" settlement that contained no identified provision for recovery of normal storm damage expense, although it did specifically provide for amortization of extraordinary 2005 storm damages and payment of the storm damage insurance premium. *Pa. P.U.C v. PPL Electric*, Docket No. R-00072155, p. 21 (Dec. 6, 2007). Similarly, the 2010 rate case rate case resulted in a "black box" partial settlement which did not identify any amount for recovery of normal storm damage costs, although it did approve the proposed storm damage insurance premium. *Pa. P.U.C. v. PPL Electric*, Docket No. R-2010-216194, 2010 Pa. PUC LEXIS 2001 at *15 (Dec. 21, 2010).

damages that is subject to the insurance deductible that will be expensed, instead of capitalized. Historically, approximately 60 percent of storm costs have been charged to expense, and approximately 40 percent of storm costs have been charged to capital. PPL Electric first recognized this distinction in its budgeting process for 2012. PPL Electric St. 2-R, pp. 4-6; Tr. 186. I&E's contention that the deductible of $15,750,000 "cannot possibly be" in the budget of $12,625,000 is incorrect.

Second, there is no inconsistency between the "claims paid" amounts and the "insurance reimbursement total." These are two separate terms with two separate meanings. At pages 30-31 of I&E St. 2-SR, I&E complains that PPL Electric's analysis is flawed because the "claims paid" information provided by PPL Electric does not equal "insurance reimbursement totals" as of December 31, 2011. I&E is correct that the two amounts are not equal, but otherwise, I&E is incorrect. The two amounts differ because the former represents <u>claims paid</u> during a specific period, while the latter amount reflects the value of <u>claim made</u> for a specific period that will be paid in due course. As PPL Electric has explained, it submits claims for storm losses for an entire year after the year has ended. Therefore, as of December 31, 2011, PPL Insurance had received all premiums for the year but had not paid any storm damage expenses for the year. In order to synchronize for this difference, PPL Insurance included in its financial statements, as required, its best estimate of "claims made" for storms which occurred during calendar year 2011 but will be paid during 2012. "Claims paid," in contrast includes only actual payments. For the reasons explained above, "claims paid" as of December 31, 2011, included no amount for 2011 losses that will be paid in 2012. In essence, when I&E compares premiums paid with claims paid for the five years ended December 31, 2011, it is comparing five years of premium with four years of losses and excluding losses for 2011, the year in which the greatest losses occurred.

PPL Electric St. 14-RJ, pp. 8-9. I&E's comparison between the ratemaking provisions for storm damage and actual storm damage losses should be rejected.

Third, I&E states that its analysis, which includes separately both the budget for normal storm damage expense and the insurance deductible, is based upon an interrogatory response provided by PPL Electric. I&E Main Brief, p. 57. Although I&E does not identify the interrogatory response to which it refers, it apparently refers to PPL Electric's response to interrogatory I&E, RE-108-D, which is provided as Sch. 24 to I&E Ex. 2. There, I&E specifically requests: "the annual amount budgeted in O&M expenses for storm damage repair and storm damage insurance deductibles for each year, 2008 through 2012." PPL Electric provided the requested information. With perfect hindsight, perhaps PPL Electric should have included a footnote explaining that the amounts were duplicative; however, it is clear that the response is accurate and provides the information requested. Clearly, however, PPL Electric's entire storm damage insurance program should not be dismantled and the benefits to customers lost because I&E misinterpreted an interrogatory response.

Fourth, in an attempt to resuscitate its position, I&E complains that PPL Electric should have included 2012 data in its breakdown of the ratemaking provision for recovery of storm damage expenses in PPL Electric Ex. GLB-6. This is a somewhat surprising argument since PPL Electric was responding to an I&E analysis for 2007-2011, which itself did not include 2012. As explained in PPL Electric St. 2-R, pp. 2-4, the purpose of Ex. GLB-6 was to restate, on a corrected basis, I&E's analysis for the five years ended December 31, 2011. PPL Electric included data for the five years ended December 31, 2011 to make it comparable to I&E's analysis that is provided at I&E St. 2, p. 38. Data from 2012 was not included in Ex. GLB-6 because it was totally irrelevant to that exhibit and the refutation of I&E's incorrect analysis provided at page 38 of I&E St. 2.[8]

E. I&E'S PROPOSED ADJUSTMENT TO UNCOLLECTIBLE ACCOUNTS EXPENSE BASED ON AN HISTORIC AVERAGE IGNORES CHANGES IN CIRCUMSTANCES

I&E continues to contend that uncollectible accounts expense should be calculated based upon a multi-year average of the ratios of write-offs to revenues. I&E Main Brief, pp. 20-23. I&E's approach to calculating uncollectible accounts expense should be rejected because it disregards major changes to PPL Electric's rates effective January 1, 2010.

Prior to January 1, 2010, PPL Electric's generation rates were subject to a rate cap established in the restructuring proceeding, *Application of Pennsylvania Power & Light Company for Approval of its Restructuring Plan under Section 2806 of the Public Utility Code*, Docket No. R-00973954, 1998 Pa. PUC LEXIS 131 (June 15, 1998), pursuant to the Electricity Generation Customer Choice and Competition Act, 66 Pa.C.S. Ch. 28. When the generation rate caps expired, PPL Electric and its customers experienced a significant increase in rates and revenues for residential electric generation service. These increases in rates and revenues, including residential rates and revenues, resulted in substantial increases in uncollectible accounts expense in 2010 and 2011. Specifically, uncollectible accounts expense increased from $24.6 million in 2009 to $31.0 million in 2010 – a 26 percent increase. In 2011, uncollectible accounts expense increased from $31.0 million in 2010 to $38.7 million in 2011 – an increase of

[8] I&E's improper double counting of the insurance deductible also causes I&E's final proposed adjustment to be incorrect. As PPL Electric has explained, its storm damage expense in this proceeding includes three components, the budget for normal storm damage, the insurance premium and the amortization of extraordinary 2011 storm deferral costs. The normal budget amount for 2012 is $12.625 million; the insurance premium is $8.750 million, and the annual amortization of the extraordinary expenses in 2011 is $5.324 million. PPL Electric Ex. GLB-9; PPL Electric Ex. 1, Future 1-Revised, Sch. D-9. The total of these amounts is $26.699 million. If PPL Electric's storm damage expense is to be adjusted for any reason, the starting point of the adjustment should be this amount and should exclude any separate, redundant inclusion of the storm insurance deductible. I&E proposes a five-year average as the basis for the expense, which is $23.785 million.

25 percent. PPL Electric St. 8-R, pp. 30-33. These increases in uncollectible accounts expense are much greater than those experienced by PPL Electric in prior years. I&E Ex. 2, Sch. 1.

Further, PPL Electric's projected level of uncollectible accounts expense for 2012 is supported by year-to-date data. In the first six months of any calendar year, PPL Electric experiences about 35 percent of its total actual annual uncollectible accounts expense for each calendar year. PPL Electric experiences only about 35 percent of its annual uncollectible accounts expense during the first half of the calendar year due to the winter moratorium on residential customer terminations and the Chapter 56 notification requirements. When PPL Electric's uncollectible accounts expense for the first six months of 2012 was annualized on this basis, the result is an expected uncollectible accounts expense of more than $45.0 million ($15.8 million ÷ 35%); an amount that is well in excess of PPL Electric's claimed uncollectible accounts expense of $42.1 million shown in PPL Electric Exhibit JMK-4. PPL Electric 8-RJ (Part 1), pp. 2-3. I&E refuses to acknowledge the clear increase in the level of uncollectible accounts expense starting after the expiration of the generation rate caps. I&E's proposed adjustment to PPL Electric's uncollectible accounts expense should be rejected.

F. SUPPORT SERVICES FROM AFFILIATES

1. I&E's Proposed Adjustment to Environmental Management Expense Should Be Rejected.

I&E argues that Environmental Management Expense for 2012 should be based upon a four-year average of such expenses, instead of the amount budgeted by PPL Electric for 2012. I&E Main Brief, pp. 32-34. In support of its adjustment, I&E makes several assertions, none of which are correct.

First, I&E asserts that PPL Electric does not expect its claimed future test year level of expenditures for environmental management to be to be sustained in subsequent years. I&E

Main Brief, p. 33. In support of this contention, it quotes its own testimony, I&E St. 2, p. 20. I&E does make such a statement in its testimony, and I&E provides references to exhibits which are copies of PPL Electric's responses to certain interrogatories from I&E. The interrogatory responses upon which I&E relies, however, support the opposite conclusion. In fact, PPL Electric fully expects its environmental management expenses to rise through 2017. In support of its erroneous assertion, I&E relies upon Schedules 11 and 12 to I&E Exhibit 2. Schedule 12 to I&E Exhibit 2 provides no information for periods beyond 2012. Instead, it provides detail and a breakdown for the projected expenditures for the future test year of $467,000. Schedule 11 to I&E Exhibit 2 provides PPL Electric's projections for direct environmental management expenses from 2013 through 2017 on a jurisdictional basis as follows:

2013	**2014**	**2015**	**2016**	**2017**
$485,000	$494,000	$508,000	$549,000	$549,000

Clearly, contrary to I&E's assertions, PPL Electric expects its environmental management expenses to continue to increase after 2012.

I&E next complains that PPL Electric supplied insufficient detail regarding PPL Electric's future Environmental Management Expenses. In making these comments, I&E apparently overlooks the following explanation provided by PPL Electric:

> The 2012 costs include the costs of 1.5 Full-Time Equivalents ("FTE") to work on the implementation for PPL Electric and seat licenses for PPL Electric employees who will need to use the Enviance software tool. As I mentioned earlier, the need to utilize the software is driven by new federal and state environmental rules that require routine inspection of stormwater and erosion and sedimentation control (after a project is completed) and other more stringent environmental and local rules. The 2013 Environmental Management direct support costs applicable to PPL Electric include the cost of existing and additional seat licenses, additional corresponding Environmental Management support as more PPL Electric employees need to utilize the software, and labor costs to

> support ongoing corporate initiatives that directly impact PPL Electric. After 2013, Environmental Management expects its costs to increase at a modest rate as a result of annual wage increase and other cost increases, such as the cost of software licenses. The projected direct support costs to PPL Electric's distribution business . . . from 2013 through 2017 . . . are higher than the 2012 jurisdictional direct support costs of $467,000 . . . . Therefore, I believe PPL Electric's claim for PPL Services direct support fees related to Environmental Management expenses are appropriate and are representative of costs to be incurred in the future test year and during the period rates set in this proceeding will be in effect.

PPL Electric St. 3-R, pp. 4-5. I&E's criticism of PPL Electric's presentation regarding Environmental Expenses from PPL Services are without merit and should be rejected.

2. PPL Electric's 2012 Budget for External Affairs Expenses Should be Accepted.

PPL Electric has increased its budget for External Affairs expenses directly charged to it from $1,432,000 for 2011 to $2,602,000 for 2012. PPL Electric Ex. DAC-3, Sch. 5. PPL Electric explained that there are two principal reasons for this increase in directly-charged External Affairs expenses. First, a review of the day-to-day activities of the regional community relations directors, who are part of the External Affairs Department, has revealed that these activities center around reliability, connections and disconnections, billing and payment, street lighting and requests related to economic development. All of these activities directly benefit PPL Electric and not other members of the PPL corporate system. Therefore, these expenses now are being directly charged to PPL Electric instead of being allocated as indirect charges among all members of the PPL corporate system. PPL Electric St. 3-R, pp. 6-7.

Second, increases in line siting and upgrading work, tree trimming and enhanced storm damage communication protocols have substantially added to the ongoing responsibilities of both the regional community relations directors and Corporate Communications, which also is part of the External Affairs Department. PPL Electric provided a breakdown of these increases in costs from this historic to the future test year at PPL Electric Ex. DAC-1, Sch. 5, p. 2. PPL Electric St. 3-R, p. 7.

I&E objects to these increases in directly-charged External Affairs expenses. Originally, I&E proposed that PPL Electric's External Affairs charges be limited to historic test year levels. I&E St. 2, p. 22. In response to PPL Electric's rebuttal testimony, however, I&E revised its recommendation to allow an additional increase in External Affairs expense of $620,000, which would allow the average of the historic and future test year levels of External Affairs expenses. I&E Main Brief, p. 36. Under I&E's revised position, PPL Electric would be permitted to recover $1,790,000 instead of the amount of $2,602,000 projected by PPL Electric. I&E explained this revision to its recommendation by stating that it accepted PPL Electric's explanations regarding the reallocation of expenses between direct and indirect costs and the assignment of more costs to PPL Electric due to the greater involvement of the regional community relations directors in the provision of distribution service. However, in I&E's opinion, PPL Electric provided "no evidence substantiating an almost 50 percent increase in the portion of costs allocated to PPL Electric." I&E Main Brief, p. 36. I&E's position makes little sense because PPL Electric's explanation of the reallocation of expenses and increased involvement in the regional community relations directors (as well as Corporate Communications) of distribution service <u>is</u> the explanation of the increase in the portion of total External Affairs assigned to PPL Electric, which I&E accepted with regard to the increase in directly charged expenses.

Further, I&E has provided no explanation in support of its arbitrary use of a simple average of the historic and future test year levels of external affairs budgets for PPL Electric. There is no evidence that such an arbitrary average would be reasonable or appropriate or incurred by PPL Electric during the future test year or during the period when rates established in this proceeding will be in effect. I&E's proposed adjustment should be rejected.

3. PPL Electric's Budget For The Office Of The Chairman Should Be Approved.

PPL Electric's future test year budget for expenses from the Office of the Chairman is $1,010,000. PPL Electric Ex. DAC-1, Sch. 4, p. 2. PPL Electric explained that the level of charges from the Office of the Chairman are increasing due to an initiative by PPL Services to review and, where appropriate, revise indirect support costs to better match the benefits that they provide to the respective affiliates. The initiative commenced in 2010 as a result of the LKE[9] acquisition and was refined in 2011 following the acquisition of WPD Midlands.[10] As a result of this review, it was determined that certain costs of the Office of the Chairman were inappropriately allocated to other affiliates. The 2012 allocation of PPL Services support group fees for the Office of the Chairman results from this initiative and is producing a more appropriate allocation of services provided by the Office of the Chairman. PPL Electric St. 3-R, pp. 13-14.

In addition to the foregoing, PPL Electric's allocation is based upon the three-factor formula recommended by the Commission. The factors included in the formula are invested capital, operation and maintenance expenses and number of employees. PPL Electric Ex. 1, Part II-D-8b, p. 1. PPL Electric's share of allocated expenses under the three-factor formulas has increased from 2011 to 2012. A combination of the increased direct charges from the Office of the Chairman and the increase of allocated expenses under the three-factor formula is producing

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[9] In 2010, PPL Corporation acquired LG&E and KU Energy LLC ("LKE"). PPL Electric St. 3-R, p. 13.

[10] In 2011, PPL Corporation acquired WPD Midlands, an electric distribution company with operations in the United Kingdom. PPL Electric St. 3-R, p. 14.

the increase in the Office of the Chairman expense allocated to PPL Electric for 2012. PPL Electric St. 3-R, p. 14.

I&E challenges this allocation on the grounds that it is greater than historic levels of expense from the Office of the Chairman. In attempting support of the adjustment, I&E simply ignores PPL Electric's explanation of the increase in expenses from the Office of the Chairman which is summarized above. PPL Electric explained the principal reasons why I&E's proposed adjustment to Office of the Chairman expense should be rejected in its Initial Brief, pp. 47-48.

G. CEO'S PROPOSAL TO INCREASE FUNDING FOR PPL ELECTRIC'S LOW INCOME USAGE REDUCTION PROGRAM SHOULD BE REJECTED

CEO argues that PPL Electric's Low Income Usage Reduction Program ("LIURP") funding should be increased from $8 million to $9.5 million. PPL Electric has explained the principal reasons why such proposal should be rejected in its Initial Brief, pp. 77-80. Below, PPL Electric will respond to two points set forth in CEO's Main Brief.

First, in its Main Brief, at pp. 3-4, CEO cites certain provisions of the Electric Generation Customer Choice and Competition Act in support of its proposed increase in LIURP funding. All such references, however, are inapposite because they all require that low income program funding be maintained, *i.e.*, not be reduced. None of the statutes quoted by CEO call for increases in funding. Therefore, none of the statutory provisions support CEO's proposal. In fact, these provisions are especially inapplicable to PPL Electric's LIURP because PPL Electric has substantially increased LIURP funding over the years. PPL Electric St. 9-R, p. 7.

Second, CEO challenges PPL Electric's testimony that changes in universal program funding levels should be addressed in the tri-annual Universal Service and Energy Conservation Plan proceeding, where all appropriate parties can participate and a full review of all issues related to universal service programs can be vetted. PPL Electric St. 9-R, pp. 2-3. CEO contends that such testimony is inconsistent with PPL Electric's positions in its 2004 and 2007 base rate cases, in which PPL Electric proposed changes in funding for universal service programs. Although CEO is factually correct that PPL Electric did propose changes in funding levels in its 2004 and 2007 base rate cases, such prior contentions have no significance in this rate proceeding due to changed circumstances. Prior to 2008, PPL Electric recovered all of its universal service program costs through base rates. Under such circumstances, it was appropriate for funding levels to be considered in base rate proceedings because the level of allowed recovery would also be determined in those proceedings and the approved level of expenses would be recovered through base rates.

Commencing January 1, 2008, however, PPL Electric began recovery of universal service plan expenses through the Universal Service Rider. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00072155, Slip Op. at 10, 2007 Pa. PUC LEXIS 57 (Dec. 6, 2007). Therefore, since January 1, 2008, PPL Electric has not recovered any universal service costs through base rates, and PPL Electric did not make proposals to changes levels of universal service expenses in either its 2010 or 2012 base rate cases. Because PPL Electric's universal service expenses are no longer recovered through base rates, it has no longer been necessary or appropriate for issues pertaining to funding of PPL Electric's universal service program to be addressed in base rate cases. PPL Electric has not produced testimony proposing changes in universal service program funding levels, including LIURP funding, since 2007, recognizing that these costs now are recovered through the Universal Service Rider.

VI. RATE OF RETURN

A. CAPITAL STRUCTURE

1. I&E And OCA's Hypothetical Capital Structures Ignore The Correct Legal Standard.

a. Introduction.

The legal standard in Pennsylvania for deciding whether to use a hypothetical capital structure in setting rates is simple and straightforward. If a utility's actual capital structure is within the range of a similarly situated barometer group of companies, rates are set based on the utility's actual capital structure. *See, e.g., Pa. P.U.C. v. ALLTEL Pa., Inc.*, Docket No. R-942710 *et al.*, 59 Pa. P.U.C. 447, 491, 1985 Pa. P.U.C. LEXIS 53 at *106-07 (May 24, 1985). If a utility's actual capital structure is outside of the range of the barometer group, it is considered atypical and the Commission can rely on a hypothetical capital structure to set rates for the utility. Importantly, the legal standard is not whether the utility's capital structure deviates from the "average" capital structure of the barometer group, but whether it is outside the range. In this proceeding, both I&E and OCA are attempting to drive PPL Electric's actual equity ratio down to the barometer group historic average despite the fact that PPL Electric's actual equity ratio is within the range of the barometer group and despite the need for PPL Electric to maintain a higher equity ratio to maintain or improve the Company's bond rating and to support its construction program.[11]

[11] As explained *infra*, PPL Electric's projected equity ratio is consistent with the projected average equity ratios for the Companies included in the OCA's barometer group.

b. I&E States The Correct Legal Standard For Employing A Hypothetical Capital Structure And Then Immediately Ignores It.

In its Main Brief, I&E again states the correct legal standard for when to use a hypothetical capital structure but then proceeds to ignore the very legal standard it cites. In its Main Brief, I&E states as follows:

> 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 of the range** of the industry's capital structure may result in an overstated overall rate of return. Therefore, a hypothetical capital structure 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.

I&E Main Brief, p. 82 (emphasis added).

I&E states the correct legal standard above. A hypothetical capital structure should be used if a utility's actual capital structure is significantly outside of the industry range. However, I&E then misapplies the legal standard it cites by proposing a hypothetical capital structure for PPL Electric, even through PPL Electric's actual capital structure is within the range of I&E's barometer group.

The equity ratios for I&E's barometer group for 2011 range from 39.34% equity to 52.47% equity. I&E Exh. No. 1, Schedule 1, p. 2. PPL Electric's actual equity ratio, as corrected in this proceeding, is 50.78%. *See* PPL Electric Main Brief at 91. PPL Electric's 2012 equity ratio is lower than the equity ratios of two of the six companies included in I&E's barometer group (ConEd 52.47% and PEPCO 50.92%). PPL Electric's equity ratio is clearly not atypical or outside the industry range.

Moreover, I&E does not cite any cases to support its view that the Commission should impose a hypothetical capital structure when PPL Electric's actual capital structure is within the range of the barometer group. The Commission should not accept I&E's attempts to drive PPL Electric's actual equity ratio down to an historic industry average when PPL Electric's actual equity ratio is within a normal industry range.

c. The OCA Also Ignores The Legal Standard For Employing A Hypothetical Capital Structure.

Like I&E, the OCA also ignores the legal standard and relies on a hypothetical capital structure to drive down PPL Electric's actual equity ratio. The OCA states that PPL Electric's capital structure "contains significantly more equity than comparable utilities." Then, in order to support its point, the OCA compares PPL Electric's equity ratio to industry averages. OCA Main Brief, p. 41. Again, this is not the legal standard for determining whether to rely on an actual or hypothetical capital structure.

In its Main Brief, the OCA cites to several cases in support of its argument that the Commission should impose a hypothetical capital structure on PPL Electric. OCA Main Brief, pp. 45-46. The cases cited by the OCA do not support its position because the equity ratios of the utilities in the cases cited by the OCA were widely divergent from the equity ratios employed by the industry barometer groups and, therefore, were clearly atypical.

The first case cited by the OCA is *Lower Paxton Township v. Pa. P.U.C.*, 317 A.2d 917 (Pa. Cmwlth. 1974) ("*Lower Paxton*"). The OCA correctly cites *Lower Paxton* for the proposition that in certain circumstances, a utility's capital structure may be too heavily weighted with regard to debt or equity, and under these circumstances, the Commission must make adjustments to reach a fair result. OCA Main Brief, p 45. In its quote of *Lower Paxton* on page 45, the OCA uses ellipses to identify that it has omitted part of the quote. The part that the OCA omitted reads as follows:

> In this case the record discloses that Dauphin has a capital structure wherein 100 percent is equity capital.

Lower Paxton, at 921. Clearly, 100% equity capital is atypical and outside the range of reasonableness. The *Lower Paxton* case does not provide any support for OCA's proposal to use a hypothetical capital structure for PPL Electric where PPL Electric's actual equity ratio is not atypical and is within the range of the barometer group.

The next case cited by the OCA is *T.W. Phillips Gas and Oil Co. v. Pa. P.U.C.*, 474 A.2d 355 (Pa. Cmwlth. 1984) ("*T.W. Phillips*"). The OCA cites *T.W. Phillips* for the proposition that Pennsylvania courts have upheld the use of a hypothetical capital structure where the utility's actual capital structure imposes an unfair cost burden on ratepayers. OCA Main Brief, p 45. This case does not support the OCA's position. The Commission imposed a hypothetical capital structure because T.W. Phillips' actual equity ratio was 60.1%. *T.W. Phillips*, at 358. T.W. Phillips' actual equity ratio of 60.1% was clearly atypical as compared to the barometer groups, and it was therefore reasonable for the Commission to rely on a hypothetical capital structure for T.W. Phillips.

The next case cited by the OCA is *Carnegie Natural Gas Co. v. Pa. P.U.C.*, 433 A.2d 928 (Pa. Cmwlth. 1981) ("*Carnegie*"). OCA correctly cites *Carnegie* for the proposition that the actual capital structure is a matter within the discretion of corporate management, but this does not preclude the Commission from determining that a particular utility's capital structure is unreasonable. OCA Main Brief, pp. 45-46. However, the OCA fails to mention that Carnegie's equity ratio was 93.39%. *Carnegie*, at 939. Again, this is clearly an atypical capital structure. Like the cases cited above, *Carnegie* provides no support for the OCA's proposal to rely on a hypothetical capital structure.

Next, the OCA cites *Pa. P.U.C. v. Peoples Natural Gas*, 69 Pa. PUC 138, 1989 Pa. P.U.C. LEXIS 36 (Jan. 27, 1989) ("*Peoples*"), as support for its proposal to use a hypothetical capital structure. OCA Main Brief, p. 46. Again, the OCA fails to explain the actual facts of the case. In *Peoples*, the Company proposed an equity ratio of 66%, which was based on its parent's equity ratio. The Commission noted that this equity ratio was atypical in comparison to the averages of three barometer groups which ranged from 49.83% equity to 53.70% equity. However, the Commission adopted a 59.5% hypothetical equity ratio which is well above the average for the barometer group. *Peoples*, at *60-65.

The OCA also cites to *Pa. P.U.C. v. Equitable Gas – Energy Company*, 68 Pa. PUC 438, 1998 Pa. P.U.C. LEXIS 501 (1980) ("*Equitable*"), in support of its proposal to use a hypothetical capital structure. OCA Main Brief, p. 46. In *Equitable*, the Company's actual capital structure consisted of 65.7% common equity. *Equitable*, at *33. Moreover, due to its atypical common equity ratio, Equitable specifically agreed that a hypothetical capital structure should be used. The *Equitable* case clearly cannot be compared to the facts in this case. PPL Electric's actual equity ratio is not atypical, and PPL Electric has not agreed to the use of a hypothetical capital structure.

The last case cited by the OCA is *Pa. P.U.C. v. Citizen Utilities Water Co. of Pa.*, Docket No. R-00953300, 86 Pa. PUC 51, 1996 Pa. PUC LEXIS 167 (Mar. 29, 1996) ("*Citizens*"). OCA Main Brief, p. 46. In the Commission's Order in *Citizens*, it noted that Citizens did not issue its own debt and obtained all of its capital from its parent company. Therefore, Citizens proposed to rely on its parent company's capital structure, which contained 60% common equity. The Commission rejected Citizens' proposal to rely on its parent's capital structure, stating as follows:

> In considering these arguments on exception and replies thereto, we reject Citizens' contention that the capital structure of its parent, CUC, is appropriate in this proceeding. Use of a parent company's capital structure is only appropriate in those instances

> where the parent's capital structure is representative of the industry in which the subsidiary operates. *Pa. P.U.C. v. National Fuel Gas Distribution, supra*, page 194. CUC's capital structure of 40 percent debt and 60 percent [equity] is not representative of the water industry in which Citizens operates. Therefore, it would not be appropriate in this proceeding to use CUC's capital structure as a proxy for Citizens.

Citizens, at *125.

The OCA's reliance on *Citizens* as support for using a hypothetical capital structure is clearly misplaced because Citizens was attempting to rely on its parent's capital structure, which contained an equity ratio that was not representative of the industry. PPL Electric is relying on its own capital structure, not its parent's capital structure, and PPL Electric's capital structure is representative of its industry-specific barometer group.

PPL Electric's equity ratio is within the normal range of equity ratios for similarly situated electric utilities, and is the best indicator of PPL Electric's actual capital costs. PPL Electric's actual equity ratio is not atypical or abnormal. A hypothetical capital structure is not justified under the legal standards and applicable precedent.

2. PPL Electric Has Justified The Need For An Equity Ratio That Is Higher Than The Historic Industry Average.

In their Main Briefs, both the OCA and I&E imply that PPL Electric is proposing a higher equity ratio simply to increase earnings. *See* OCA Main Brief, p. 41-42; I&E Main Brief, p. 78. This is contrary to the facts of the case.

In this proceeding, PPL Electric has explained several reasons why it requires an equity ratio that is above its historic average and closer to the higher end of the historic averages for the barometer group. PPL Electric's witness, Mr. Clelland, explained that the Company's senior unsecured bond rating has been lowered from Baa1 to Baa2 since its last base rate proceeding. PPL Electric St. No. 10, p. 3. PPL Electric requires a higher equity ratio to maintain, and hopefully to improve, the Company's credit rating. As explained by Mr. Clelland, both the OCA's and the I&E's proposed capital structure and ROE create a significant risk of further downgrade of PPL Electric's credit rating. PPL Electric St. No. 10-R, pp. 3-5. Lower credit ratings can increase costs to acquire capital. Therefore, it is reasonable and necessary for PPL Electric to have an equity ratio that is higher than its historic industry average.

PPL Electric also requires an equity ratio that is higher than historical averages to support its construction program. PPL Electric's actual capital spending levels have increased substantially over the past two years, from $298 million in 2009 to $496 million in 2011, and are projected to substantially increase to $671 million in 2012, $870 million in 2013 and $821 million in 2014. This substantial spending is necessary to replace a significant amount of aging infrastructure in the Company's service territory. PPL Electric St. No. 1, p. 5. This demonstrates the significance of the Company's increased capital spending over the next several years, and why it is critically important for PPL Electric to maintain a higher than average equity ratio.

Moreover, PPL Electric's 2012 equity ratio is consistent with the projected average equity ratio for the OCA's barometer group in the near future. As explained in PPL Electric's Main Brief, the expected **average** equity ratios for the OCA's barometer group of companies are projected to be 50.9% in 2012, 51.7% in 2013 and 52.4% in 2015-2017, when one excludes UniSource Energy, a clear outlier to the group. PPL Electric Main Brief, p. 96. Moreover, even if UniSource is included, the **average** equity ratios for the barometer group are 49.6% in 2012, 50.4% in 2013 and 50.8% in 2015-2017. PPL Electric's equity ratio of 50.78%, as corrected in this proceeding, is clearly consistent with the estimated **average** equity ratios of OCA's barometer group for the near future. Comparison of PPL Electric 2012 equity ratios to historic averages is particularly inappropriate where the industry as a whole is moving to higher equity ratios as part of an infrastructure replacement cycle.

3. OCA And I&E's Contentions That A Higher Equity Ratio Increases Rates Are Overstated.

Both the OCA and I&E argue that PPL Electric's higher than average equity ratio substantially increases rates for customers. *See* OCA Main Brief, p. 41; I&E Main Brief, p. 83. These arguments are overstated and should not be accepted.

In its Main Brief, the OCA argues that PPL Electric's equity ratio will cost ratepayers $10.6 million annually as compared to the capital structure that it has employed in previous years. OCA Main Brief, p. 41. In making its calculations, the OCA relies on an average of the Company's capital structures from 2007-2011. The OCA's reliance on a 5-year average is clearly unreasonable because years 2007 and 2008 are not reflective of current conditions. As explained above, PPL Electric's capital spending has substantially increased in recent years as part of the Company's substantial construction program. The data from 2007 and 2008 is stale and does not reflect a reasonable capital structure for embarking on a construction plan whereby PPL Electric is projected to spend approximately $4.8 billion in capital projects from 2009 through 2016. *See* PPL Electric St. No. 10-R, p. 2. Moreover, the 2008 data reflects the onset of the financial crisis. This data cannot reasonably be relied upon to demonstrate PPL Electric's ongoing financing and capital requirements.

The appropriate starting point for any historic analysis of the reasonableness of PPL Electric's equity ratio is the three-year period 2009 through 2011 because 2009 reflects the beginning of the ramp up in capital spending. As shown in the tables below, when the more appropriate three-year historic average is compared to PPL Electric's claimed capital structure in this case there is no increased cost to customers. The table below shows the Company's three-year and five-year average capital structure averages using data from the OCA Ex. SGH-1, Schedule 1.

Type of Capital	2007	2008	2009	2010	2011	3-Year Average	5-Year Average
Common Equity	42.96%	38.28%	46.45%	48.61%	48.41%	47.82%	44.00%
Preferred Stock	10.48%	9.07%	9.23%	7.57%	6.80%	7.87%	9.09%
Long Term Debt	46.83%	52.68%	44.32%	43.83%	44.80%	44.31%	46.91%

Mr. Hill used the five-year average (2007-2011) in the above table to determine the average pre-tax cost rate of 12.07% at an 11.25% equity return. However, when the three-year average is used, the pre-tax cost of capital becomes 12.52% as shown below.

Type of Capital	% of Total	Cost Rate	Wt. Av. Cost Rate	Pre-Tax Cost Rate
Common Equity	47.82%	11.25%	5.38%	9.20%
Preferred Stock	7.87%	6.40%	.50%	.85%
Long Term Debt	44.31%	5.58%	2.47%	2.47%
Total	100.0%		8.35%	12.52%

In comparison, PPL Electric's proposed capital structure in this proceeding, as adjusted to reflect the actual issuance cost of new debt in August 2012, is 12.47% as shown in the following table.[12]

[12] *See* PPL Electric Initial Brief, p. 91, fn. 16. On August 29, 2012, PPL Electric filed a Petition to Reopen the Record in order to provide updated information regarding the actual rate and exact amount of long-term debt actual long-term debt issued by the Company on August 24, 2012, which information was included in Appendix A to the Petition. By Order issued on September 10, 2012, the Petition to Reopen the Record was granted and Appendix A to the Petition, consisting of an affidavit of Russell R. Clelland dated August 29, 2012, was admitted to the record.

Type of Capital	% of Total	Cost Rate	Wt. Av. Cost Rate	Pre-Tax Cost Rate
Common Equity	50.78%	11.25%	5.71%	9.76%
Long Term Debt	49.22%	5.50%	2.71%	2.71%
Total	100.00%		8.42%	12.47%

Thus, PPL Electric's claimed pre-tax cost rate of 12.47% in this proceeding is in fact slightly lower than the 12.52% cost rate based on its three-year capital structure. As a result, the Company's proposed equity ratio in this proceeding will not cost ratepayers more than the capital structure the Company has actually employed over the past three years.[13]

The reason that PPL Electric's proposed capital structure does not increase the pre-tax cost even though it contains more equity than the three-year average is because PPL Electric refinanced its preference stock and replaced it with 50% equity and 50% debt, at no increased cost to customers. As explained in Mr. Clelland's testimony and in the Company's Main Brief, the Company was able to redeem its preference stock and replace it with debt and equity at no net cost to ratepayers. PPL Electric St. 10-RJ, pp. 5-6. PPL Electric Main Brief, p. 93. The replacement of preference stock at no increase in cost explains why the equity ratio increase from the three-year average of 47.82% to 50.78% does not increase and in fact slightly reduces the pre-tax cost rate.

As further support for its contention that a higher equity ratio is unnecessary, OCA also argues that:

> The fact that PPL is expected to issue long-term debt with a 2.39% embedded cost rate is ample evidence that the Company's

[13] The three-year average pre-tax cost rate originally proposed in the Company's filings was 12.54% based on a capital structure including: a weighted average cost of long-term debt of 5.56%, a weighted average cost of capital changes of 8.46%, and a debt to equity ratio of 48.97% / 51.03%. PPL Electric Ex. 1, Future-1 (Revised), Sch. B-6.

> historical common equity ratio provides sufficient financial strength to enable PPL to cost-effectively access capital markets.

OCA Main Brief, p. 40.

OCA's argument that PPL Electric can raise debt now is unrelated to the Company's low equity ratios in 2007 and 2008. The fact that the Company can raise debt now at low rates is related to the Company's current equity ratio, which for 2011 was 51.81% (including 50% of Preference Stock as equity) and at the end of the FTY is 50.78%. It is more likely that the current higher equity ratio is one of the reasons that the Company can raise debt at such a reasonable cost. Moreover, in making this argument, the OCA ignores the fact that a lower equity ratio could further decrease the Company's credit rating and increase the Company's costs to acquire debt and equity capital.

I&E argues that PPL Electric capital structure increases customer rates by $15 million. I&E Main Brief, p. 83. I&E's statement is based on a comparison between I&E's hypothetical capital structure and the Company's actual capital structure. Tr. 364. As explained above, I&E is attempting to use a hypothetical capital structure to drive PPL Electric's actual capital structure down to a barometer group average, even though the Company's actual capital structure is within the industry range. This is contrary to the applicable legal standard concerning application of a hypothetical capital structure and unreasonably reduces PPL Electric's actual capital structure despite the need for PPL Electric to retain a higher equity ratio to maintain its credit rating and continue its substantial construction program. For these reasons, I&E's contention that the Company's actual capital structure overstates its capital needs by $15 million cannot be accepted.

4. OCA's Attempts To Refute The Criticisms Of Its Hypothetical Capital Structure Have No Merit.

In its Brief, the OCA attempts to argue that its hypothetical capital structure is not hypothetical but actual. OCA Main Brief, p. 43. The OCA claims that it calculated its proposed capital structure in the same manner as PPL Electric, with the only difference being classifying a $150 million capital contribution from PPL Corporation to PPL Electric as debt rather than equity. OCA Main Brief, p. 43. The OCA's argument cannot be accepted for several reasons.

First, the $150 million dollar capital contribution is not debt. As explained in the Company's Main Brief, PPL Corporation did not raise debt to make this contribution to PPL Electric. Main Brief, p. 101-102. Mr. Hill's unreasonable attempt to classify equity as debt is, on its face, a scheme to rely on a hypothetical capital structure because it does not reflect PPL Electric's actual capital structure at the end of the future test year and artificially attempts to reclassify equity as debt.

As support for its proposal to re-classify $150 million of equity as debt, the OCA cites to Mr. Hill's testimony where he stated that the Company "plans to reduce its reliance on preferred stock and increase its reliance on more expensive common equity…." OCA Main Brief, p. 42. As explained herein, the Company redeemed its preference stock using debt and equity at no net cost to ratepayers. Therefore, Mr. Hill's argument that the reduction in preference stock would increase costs for ratepayers is erroneous.

Moreover, Mr. Hill is substituting his judgment for that of PPL Electric's management simply because the Company's current equity ratio is higher than it has been in 2007 and 2008 and in his view unnecessary. PPL Electric has explained the reasons why a higher than average equity ratio is necessary, primarily because PPL Electric has embarked on a $4.8 billion capital spending program that will require significant access to capital at reasonable rates.

5. The OCA's Attempts To Compare PPL Electric's Capital Structure With Holding Company Capital Structures Are Unreasonable.

As support for its hypothetical capital structure, the OCA compared its hypothetical capital structure to utility holding company capital structures. OCA Main Brief, p. 44. It was clearly inappropriate for the OCA to rely on holding company capital structures in proposing a hypothetical capital structure in this proceeding.

PPL Electric issues its own debt. Its capital structure and financial profile are used by ratings companies to determine PPL Electric's bond rating. Therefore, it is appropriate to use comparisons of utility operating companies and not parent companies that are involved in other businesses in determining the reasonableness of the Company's capital structure.

In addition, in its Brief, the OCA recognizes that the holding companies that he used for comparisons have capital structures that include short-term debt, which can be substantial for some companies. OCA Main Brief, p. 44. PPL Electric's capital structure does not include any short term debt. This fact also demonstrates that Mr. Hill's comparison of PPL Electric's actual capital structure to holding company capital structures that include short term debt is erroneous.

Moreover, as cited above in Section VI.A.1.c, it is not appropriate to rely on a parent company's capital structure when it is not representative of the capital structure for the industry. *See Citizens*, 86 Pa. P.U.C. at 95. Therefore, Mr. Hill's comparisons to holding companies' capital structures are invalid and unreasonable.

6. PPL Electric's Capital Structure Is Not Equity-Rich.

Throughout its Brief, the OCA argues that PPL Electric's capital structure is "equity-rich" because the 2012 equity ratio above what it has been in recent years. *See e.g.*, OCA Main Brief, p. 39. In fact, this is one of the primary, if not the primary, OCA argument against the Company's actual capital structure.

As explained above, the OCA's argument that PPL Electric's capital structure has a significantly higher equity ratio than what the Company has had in recent years is incorrect and misleading because the OCA improperly relies on a 5-year average of years 2007-2011. The data from 2007 and 2008 reflects equity ratios that existed during the onset of the financial crisis and do not reflect equity ratios that are necessary to maintain a strong credit profile while undertaking a multi-year, $4-plus billion construction program.

As explained above in Section VI.A.3, the appropriate historical comparison is a three-year average from 2009-2011. For this three-year period, PPL Electric's average capital structure was:

Capital Type	2009-2011 Average Percentage
Common Equity	47.82%
Preference Stock	7.87%
Preference Stock	44.31%
Total	100.00%

Moreover, when preference stock was replaced with 50% equity/50% debt at no increased cost to customers, the Company's adjusted three-year historic capital structure would be as follows:[14]

Capital Type	Percentage
Common Equity	47.82% + ½(7.87%) = 51.75%
Debt	44.31% + ½(7.87%) = 48.25%
Total	100.00%

[14] In testimony, Mr. Clelland explained that rating agencies classify Preference Stock as 50% debt and 50% equity. *See* PPL Electric St. 10-RJ, at 4-5. Moreover, the OCA has accepted this classification. *See* Tr. 261; OCA Main Brief, p. 40.

PPL Electric's actual equity ratio, as updated in this proceeding, is 50.78%, which is lower than the Company's adjusted historic 3 year average of 51.75% as demonstrated above.[15] OCA's argument that PPL Electric's actual equity ratio is "well above what it has been in recent years" is inaccurate and misleading. *See* OCA Main Brief, p. 39. PPL Electric's actual equity ratio for the end of the future test year is consistent with, and somewhat lower than, the Company's average equity ratio for the past three years as adjusted for the refinancing of preference stock, which coincides with the onset of the Company's construction program and the substantial increase in capital spending.

B. COST OF COMMON EQUITY

In order to provide perspective on PPL Electric's responses to other parties' position on the common equity cost rate, PPL Electric provides the following summary of the results of Mr. Moul's analysis of cost rate for common equity:

> In general, the use of more than one method provides a superior foundation to arrive at the cost of equity. At any point in time, reliance on a single method can provide an incomplete measure of the cost of equity. The specific application of these methods/models will be described later in my testimony. The following table provides a summary of the indicated costs of equity using each of these approaches.

[15] In its Brief, the OCA states that during cross-examination, Mr. Clelland agreed that PPL Electric has been capitalized with a common equity ratio of approximately 48.5% over the past 5 years. OCA Main Brief, p. 40, fn 8. As explained above, the OCA's reliance on a five-year average is unreasonable because it includes stale data from 2007 and 2008. For these reasons, the OCA's reliance on a five-year average is unreasonable and does not reflect future trends.

	Electric Delivery Group	Integrated Electric Group
DCF	10.37 %	10.87%
RP	10.75%	10.75%
CAPM	11.78%	12.48%
CE	11.60%	11.60%
Average	11.13%	11.43%
Median	11.18%	11.24%
Mid-point	11.08%	11.62%

> Based on these results, I recommend that the Commission set the Company's rate of return on common equity at 11.25% in this case, which is between the average results for the Electric Delivery Group and the Integrated Electric Group. In recommending an 11.25% rate of return on common equity, I have recognized the exemplary performance of the Company's management, as described in the pre-filed direct testimony of Mr. Gregory N. Dudkin, the Company's President. I have done this by moving my recommendation above the average shown above for the Electric Delivery Group. I believe that my final recommended cost of equity of 11.25% is appropriate in this case because it is within the range of cost rates shown above and provides recognition of the excellent management performance of the company.

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

In subsequent sections of the Reply Brief, PPL Electric will explain the reasons that I&E and OCA's analyses of the cost of equity are flawed and respond to the criticisms of PPL Electric's presentation.

1. OCA and I&E Recommend Cost Rates For Common Equity Do Not Reflect The Prospective Cost Of Capital.

OCA and I&E rely on the past to justify their very low recommended equity cost rates. For example, OCA's brief commences with an explanation of the recent relative interest rates of federal debt securities (T Bond and T Bills) claiming that declines in these rates indicates a lower cost of capital. OCA Main Brief, p. 36. The problem with this contention is that OCA's own witness admitted that these interest rates have been manipulated downward by the Federal Open Market Committee ("FOMC") to try to advance economic activity. Tr. 330. OCA also contends that lower utility bond rates signal lower equity costs. OCA Main Brief, pp. 36-37. However, OCA conveniently ignores the fact that investors continue to seek out fixed income securities precisely because they continue to see significant risk in investing in equities. Even OCA witness Hill admitted that the equity risk premium over debt costs increases as interest rates fall. Tr. 329-30. Yet, OCA clings to its contention that equity cost rates have declined with declining interest rates.

Similarly, I&E witness Sears relies on a CAPM analysis using a historic risk premium that reflects a negative premium for the last five years and produces a cost rate of equity of only 5.06% to support her DCF cost rate of 8.38%. I&E St. 1, pp. 34-36.

OCA and I&E apply simplistic equity cost rate models as if the past few years were normal years. But these are not typical times. Investors remain wary of investing in common equities in the aftermath of the financial crisis in which equity indices fell by approximately 50%. Mr. Moul illustrated this unease through the Volatility Index ("VIX"), which measures volatility in stock prices. For the first six months of 2012, the VIX was significantly higher than prior to the recession, demonstrating greater risk. PPL Electric St. 11-R, p. 49. Simply relying on lower historic interest rates and concluding the equity cost rates have declined in lock step with such interest rate ignores that investors view equities as more risky than in the pre-recession environment. As explained by Ms. Cannell, utility credit ratings also have declined, indicating increased risk for utility investors despite declines in interest rates. PPL Electric St. 12-R, p. 6, Sch. JMC-2.

OCA and I&E also ignore the fact that the cost rate of common equity capital is expectational. Investors do not rely on historic results to set the cost of capital when they price stocks; they rely on their expectations of the future. This is why properly performed risk premium and CAPM analyses look to expected utility bond yields and government securities as the starting point to which is added an investor expected risk premium.

It is not surprising the customer representatives would seek to rely on the recent turmoil in financial markets to attempt to lower the allowed ROE. Indeed, as cited by OCA in its brief, two Commissions have recently done so, but even these Commissions allowed ROEs above OCA's and I&E's recommendations. OCA Main Brief, p. 35. In contrast, and as explained below, other Commissions have recently taken a different long term prospective and expectational view of the cost of equity and allowed more reasonable ROEs in the range of 10.25% to 10.5%. *See* Section VI.B.3.c, *infra*.

The Commission should follow the more constructive and supportive path and allow an ROE that reflects investor expectations of the reasonable ROE and the long-term cost of common equity capital. PPL Electric Initial Brief, p. 114-115. Doing so will not only support PPL Electric's enhanced infrastructure investments, but will also avoid the substantial risk of a future downgrade of PPL Electric's credit rating. PPL Electric Initial Brief, pp. 88-89.

2. I&E's Cost Of Common Equity Recommendation Is Flawed.

PPL Electric has explained in its Initial Brief the principal reasons why I&E's 8.38% cost of equity recommendation is flawed. These reasons can be summarized as: (1) a flawed DCF growth rate derived from a log linear analysis not used by investors or investor services; (2) the failure to include a leverage adjustment in the DCF analysis; and (3) the failure to present any credible alternative analysis that provides any check on the reasonableness of the extraordinarily low 8.38% result of Ms. Sears' DCF analysis. PPL Electric Initial Brief, pp. 123-125. Despite substantial criticisms of Ms. Sears' analysis on the record, I&E has chosen not to address these critiques in its Main Brief.

While it is not necessary to explain the differences of Ms. Sears' analysis again in this brief, PPL Electric will address certain statements in I&E's Main Brief that PPL Electric believes are not correct or might be misconstrued.

First, as to the first critical defect in Ms. Sears' analysis, I&E contends that Ms. Sears used both analysts' projections of earnings growth rates and Ms. Sears' own log linear growth rates. I&E Main Brief, p. 86-87. However, Ms. Sears' analysis clearly shows that her selected growth rate of 3.49% is solely the result of her log linear analysis. I&E St. 1, pp. 26 and 29. Ms. Sears simply converts analysts' projections to a lower growth rate through her log linear analysis. Mr. Moul demonstrated that Ms. Sears in fact reduced the analysts' 4.79% projections of growth to 3.49%, or by 130 bases points or by 27% (1.3 ÷ 4.79) through her log linear analysis. PPL Electric St. 11-R, p. 23. Furthermore, the record demonstrates that there is no basis for Ms. Sears' log linear growth rate calculation, and Ms. Sears could not identify any analyst or publication that used it to project growth rates to be used in a DCF analysis. PPL Electric St. 12-R, pp. 23-24; Tr. 350.

Furthermore, Mr. Moul demonstrated that several of the individual company DCF calculations for each of Ms. Sears' barometer group companies produces either negative or very low growth rates using Ms. Sears' log linear analysis. PPL Electric St. 11-R, p. 23. Ms. Sears has not explained why a utility investor should expect a negative growth rate or why any rational investor would invest in a company expecting to lose money.

The second error of Ms. Sears' analysis is the failure to include a leverage adjustment under these market circumstances. PPL Electric has explained the basis and need for a leverage adjustment and related precedents in its Initial Brief, and will not repeat those explanations here. PPL Electric Initial Brief, pp. 105-109.[16]

Finally, Ms. Sears has presented no credible alternative analysis of the cost of equity. In this regard, I&E presented two CAPM analyses; one which uses an historic market premium and one which uses a projected market premium. The former produces a cost rate of 5.06% and latter produces a cost rate of 12.31%. I&E St. 1, pp. 31-37. I&E argues in its brief that the 8.68% average of a 5.06% cost rate and a 12.31% cost rate for Ms. Sears' two CAPM analyses supports an 8.38% DCF cost rate. It is simply not rational to conclude that averaging these two widely divergent results produces a reliable indication of the cost of equity where the 5.06% cost rate is below the Company's embedded cost of debt.[17] Instead, Ms. Sears' own CAPM cost rate of 12.31% based upon projected market returns strongly suggests that Ms. Sears' DCF cost rate of 8.38% is significantly understated. I&E St. 1, p. 35.

No reliance can be placed on Ms. Sears' DCF analysis since it is both flawed and unconfirmed by any credible alternative analysis. Accordingly, I&E's recommended 8.38% cost of equity should be rejected.

3. OCA's Cost of Common Equity Recommendation Is Flawed.

a. OCA's DCF Analysis Is Inadequate.

OCA's 9.0% cost of common equity recommendation also is flawed and suffers from the same basic problems as I&E's recommendation. In particular, OCA witness Hill relies primarily on a DCF analysis: (1) which understates the growth rate component, and (2) fails to include a

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[16] PPL Electric responds to I&E's and OCA's criticisms of the leverage adjustment in Section VI.B.4.a, *infra*.

[17] Ms. Sears was asked on cross-examination as to whether the 5.06% cost rate was a credible cost of equity. Ms. Sears responded that it was during the historic period. Tr. 353-54. However, it is not rational to conclude that equity cost rates could have fallen to such levels when the yield on a Baa rated public utility bond is 5.3%. PPL Electric St. 11-R, p. 40. Ms. Sears reliance on historic risk premiums that include negative returns over the latest 5 years in her analysis again demonstrates the flaws of looking backward rather than forward. I&E St. 1, p. 34. PPL Electric St. 11-R, p. 41.

leverage adjustment. In addition, OCA witness Hill then improperly relied on a two-company electric distribution company sample to justify a cost rate at the lower end of his DCF range.

In its brief, OCA cites several cases in which the Commission has stated that primary reliance on the DCF analysis is appropriate. OCA Main Brief, pp. 51-52. *Pa. P.U.C. v. Pennsylvania American Water Company*, Docket No. R-00038304, 99 Pa. P.U.C. 38, 2004 Pa. PUC LEXIS 29 (Jan. 16, 2004) ("*PAWC 2004*"), *aff'd*, *Popowsky v. Pa. P.U.C.*, 868 A.2d 606 (Pa. Cmwlth. 2004); *Pa. P.U.C. v. Aqua Pa., Inc.*, 99 Pa. P.U.C. 204, 233 (2004) ("*Aqua 2004*"), and *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, 237 P.U.R. 4th 419, 2004 Pa. LEXIS 40 (Dec. 22, 2004) ("*PPL 2004*"). However, OCA fails to note that in each of these cases the Commission employed a leverage adjustment to the DCF analysis because the unadjusted DCF results were deemed inadequate by the Commission. The Commission added a 60 basis point leverage adjustment in *PAWC 2004*, a 60 basis point leverage adjustment in *Aqua 2004* and a 45 basis leverage adjustment in *PPL 2004*. Therefore, in the cases OCA cites where the Commission decided to rely primarily on DCF, the Commission also used a leverage adjustment. Furthermore, OCA appealed the use of the leverage adjustment by the Commission in *PAWC 2004,* and the Commission's action was affirmed by the Commonwealth Court. *Popowsky v. Pa. P.U.C.*, 868 A.2d 606, 612-13. *See* PPL Electric Initial Brief, pp. 106-07.

PPL Electric explained that primary reliance on the DCF analysis is not appropriate in these market circumstances because of uncertainties about investor expected future growth rates. Failure to employ the leverage adjustment compounds the error in Mr. Hill's DCF analysis. *See* PPL Electric Initial Brief, pp. 105-109. In its Main Brief, OCA states its DCF cost rate is 8.97%. OCA Main Brief, p. 49. This cost rate is Mr. Hill's cost rate for "Wires Companies." Mr. Moul explained that there are only two companies in Mr. Hill's Wires Company Group, PEPCO and

Consolidated Edison. PPL Electric St. 11-R, p. 5. By reference to the data shown on Mr. Hill's OCA Exhibit SGH-1, Schedule 6, Mr. Hill used a growth rate for this "Wires Group" of only 4.03% (4.39% for "Ed" and 3.66% for POM"). This growth rate is clearly inadequate because Mr. Hill's average growth rate for the entire barometer group is 4.94%, which is essentially equal to Mr. Moul's growth rate of 5.00%. OCA St. 2, p. 33; PPL Electric St. 11, p. 41.

As explained by Mr. Moul, it is unprecedented and inappropriate to rely on only two companies as a barometer group and doing so is likely to create unreliable results. PPL Electric St. 11-R, pp. 4-5. Furthermore, Mr. Hill has not provided any analysis to support his contention that companies in his barometer group that own generation are more risky than "Wires Only" companies. Indeed, Mr. Hill has not even demonstrated that the electric generation investment of these companies is unregulated. Where generation is regulated by the same state agency, there is no reason to conclude that generation assets are deemed more risky than distribution or wires assets. PPL Electric St. 11, p. 5.

For these reasons, use of Mr. Hill's average growth rate of 4.94% is more appropriate in the DCF analysis rather than the 4.02% he used for his "Wires Companies." This moves Mr. Hill's DCF cost rate from the 8.97% to essentially the top of his 9.5% cost rate range.[18] As noted by Mr. Moul, adding the .7% leverage adjustment to 9.5% indicates a DCF cost rate of 10.2%. This DCF cost rate is similar to the 10.37% cost rate calculated by Mr. Moul for his Electric Distribution Group. Accordingly, if primary reliance is to be placed on the DCF results, the equity cost rate is in the range of 10.2% to 10.37%, prior to any adjustment for good management. Increasing the top end of this range by the requested 12 basis points for

[18] While the growth rate difference is .92% (4.94% - 4.02%), Mr. Hill also has understated the growth rates by relying on projected dividend growth rates. As explained by Mr. Moul, projected dividend growth rates understate the growth rate when investors expect that earnings will grow faster than dividends. Faster growth in earnings than dividends is not only projected by Value Line but consistent with increased retained earnings to support expanded construction. PPL Electric St. 11-R, pp. 19-20.

management performance produces a common equity cost rate of 10.49%.[19] PPL Electric St. 11, p. 6.

b. OCA's CAPM Analysis Is Flawed and Provides No Support for Its Erroneous DCF Result.

If primary reliance is to be placed on the DCF analysis, it is important to provide a reliable alternative measure of the cost of equity to determine the reasonableness of the results of the DCF, and particularly the results of a DCF analysis before application of the leverage adjustment.

OCA witness Hill performed a CAPM analysis for this purpose. OCA St. 2, p. 44. However, as noted in the quote page 58 of OCA's brief, Mr. Hill testified that "... the CAPM results, especially at the lowest end, are unlikely to represent investor equity return expectations..." OCA St. 2, pp. 52-53. Therefore, by Mr. Hill's own admission, his CAPM analysis, which produces a cost rate range of 7.66% to 8.14%, produces an unreliable and understated cost rate for common equity. Nevertheless, Mr. Hill made no attempt to correct the flaws in his CAPM analysis to produce a reliable result, apparently satisfied that his flawed analysis did not indicate a cost rate in excess of his DCF result.

Mr. Moul explained the multiple reasons Mr. Hill's CAPM analysis understates the cost of equity. PPL Electric St. 11-R, pp. 36-40. These errors include an understated risk premium, failure to use adjusted betas and failure to add a size adjustment.

Mr. Moul explained that Mr. Hill has miscalculated the risk premium to be added to the risk free rate of return in the CAPM analysis:

> A. Mr. Hill used a market premium ("Rm-Rf") of 4.4% measured with the geometric mean and 6.0% measured with the arithmetic mean. Together with his proposed risk-

[19] Mr. Moul calculated a 10.87% DCF cost rate for his Integrated Electric Group. However, the difference is almost entirely the result of a greater leverage adjustment. PPL Electric St. 11, p. 6.

> free rate of return, this suggests a total market return of 8.4% (4.4% + 4.0%) to 10.0% (6.0% + 4.0%). At the low end of his range, an 8.4% total market return is completely unrealistic given that Mr. Hill determined a DCF return for his electric barometer group to be 9.35%. Given that the beta of his electric barometer group is 0.69 this indicates that the systematic risk is lower for his utilities than the overall market, which by definition has a beta of 1.0. It is inconceivable that the total market could have a lower (i.e., 8.4%) return than his presumably lower risk electric barometer group (i.e., 9.35%).

PPL Electric St. 11-R, p. 38.

Mr. Moul then calculated a prospective market premium of 10.96% based on the implicit growth rate for the S&P 500 from Mr. Hill's data. PPL Electric St. 11-R, pp. 38-39. It is to be noted that a revised CAPM cost rate using Mr. Hill's risk free rate and betas and adjusting only the prospective market premium to 10.96% can be calculated as follows:

Rf + B X (Rm-Rf) = K

4.00% + .69 X (10.96%) = 11.56%

Accordingly, adjusting Mr. Hill's CAPM only for a realistic market premium produces an 11.56% CAPM cost rate, which clearly shows that Mr. Hill's unadjusted DCF result of 9.0% understates the cost of capital.[20] PPL Electric St. 11-R, p. 40. As with I&E, performing an inadequate CAPM calculation provides no support for OCA's inadequate DCF analysis.[21]

[20] OCA criticizes Mr. Moul for use of an arithmetic mean in calculating historic risk premiums. OCA Main Brief, p. 59. Mr. Moul has explained why such criticisms are unfounded. PPL Electric St. 11-R, pp. 37-38. As noted in the text, the very low historic risk premiums used by OCA are the result of improperly using the geometric mean. Importantly, the issue of which method is used to determine historic risk premiums is irrelevant when a prospective market premium issued because no arithmetic mean for a period of years is necessary.

[21] Mr. Moul also explained that a size adjustment would be appropriate in the risk premium and higher betas to reflect the same effects as the leverage adjustment in the DCF. PPL Electric St. 11, pp. 51-55.

c. OCA's Selective Discussion of ROE Determinations in Other States Does Not Support Its Inadequate ROE Recommendation.

OCA cites the ROE determinations in several cases as support of its 9.0% recommendation. OCA Main Brief, pp. 35 and 48. OCA's citations are both misleading and selective.

With regard to the Maryland decision in July 2012 involving PEPCO, OCA states that Maryland approved a 9.31% return on equity. OCA Main Brief, p. 35. However, as the following quote illustrates, there were at least two significant factors that caused the Maryland Commission to lower the allowed ROE for PEPCO by at least 50 basis points:

> [W]e find that Pepco's ROE should reflect the substandard reliability and service quality of Pepco's distribution system, as our recent decision in Case No. 9240 emphasizes. The Company must be held accountable, and cannot provide poor service and expect that its return on equity and overall rate of return will be unaffected, let alone increased. In a competitive market, for which regulation is intended to be a substitute, Pepco's continuing poor reliability would cause it to lose business and profits to its competitors. We cannot and will not allow Pepco, a monopoly distribution company, to reap growing profits while it provides subpar service to its customers.
>
> As a result of these considerations, we conclude that Pepco's appropriate ROE should be near the middle of the stated range. Our chosen ROE of 9.25% includes a 50 basis point reduction for the risk-stabilizing effect of the BSA, which continues to effectively levelize Pepco's income stream, thus reducing Pepco's risk. Without the BSA, Pepco would see more dramatic swings in its earnings than currently. The BSA adjustment and the ROE are linked, and lowering Pepco's risk through the BSA also reduces the need to lower Pepco's risk through a higher ROE. We further add a 6 basis point upward adjustment for flotation costs, based on the reasoning of Mr. Campbell, and consistent with our prior decisions in recent Pepco and Delmarva base rate cases. The final ROE of 9.31% recognizes the less risky nature of Pepco's operations, is based on a wide and varied range of methodologies, and balances the interests of Pepco's ratepayers and shareholders.

In RE PEPCO, Order No. 85028, 2012 Md. PSC LEXIS 41 at *188 (Md. PSC, July 20, 2012).

Therefore, it is clear that the 9.31% ROE adopted by the Maryland PSC has been reduced to reflect "substandard reliability" and to reflect the effects of the Bill Stabilization Adjustment ("BSA"), which is a revenue stabilization mechanism authorized for PEPCO in its 2007 rate case. *In the Matter of the Application of Potomac Electric Power Company for Authority to Revise its Rates and Charges fro Electric Service and for Certain Rate Design Changes*, Order No. 81517, 2007 Md. PSC LEXIS 13 (Md. PSC, July 19, 2007). Neither of those circumstances apply to PPL Electric and, therefore, the 9.31% ROE does not demonstrate the reasonableness of OCA's proposed 9.0% allowance for PPL Electric.

OCA also cites cases with ROE allowances in the range of 9.25% to 9.8% in its brief. OCA Main Brief, p. 48. It is noted that none of those cases supports a 9.0% recommendation, and OCA's recommendation, if adopted, still would be the second lowest ROE allowance in the United States since the beginning of 2009. PPL Electric St. 12-R, Schedule JMC-1. Further, PPL Electric notes that a number of other Commissions have approved significantly higher ROE allowances since the beginning of 2012. *See In the Matter of the Application of Consumers Energy Company for Authority to Increase its Rates for the Generation and Distribution of Electricity and for Other Relief*, Case No. U-16794, 2012 Mich. PSC LEXIS 156 at *118 (Mi. PSC, June 7, 2012) (Commission approved an ROE of 10.3%); *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-10-971, 2012 Minn. PUC LEXIS 132 at *19 (Mn. PUC, May 14, 2012) (Commission approved an ROE of 10.37%); *In re: Petition for Increase in Rates by Gulf Power Company*, Docket No. 110138-EI, 2012 Fla. PUC LEXIS 233 at *138 (Fl. PSC, April 3, 2012) (Commission approved an ROE of 10.25%); *In the Matter of Application of Duke Energy Carolinas, LLC, for Adjustment of Rates and Charges Applicable to*

Electric Utility Service in North Carolina, Docket No. E-7, SUB 989, 2012 N.C. PUC LEXIS 103 at *74 (NC UC, January 27, 2012) (Commission approved an ROE of 10.5%); *Application of Duke Energy Carolinas, LLC for Authority to Adjust and Increase its Electric Rates and Charges*, Docket No. 2011-271-E, 2012 S.C. PUC LEXIS 14 at *30 (SC PSC, February 3, 2012) (Commission approved an ROE of 10.5%); *Application of Wisconsin Power and Light Company for Authority to Adjust Electric and Natural Gas Rates*, Docket No. 6680-UR-118, 2012 Wisc. PUC LEXIS 257 at *11 (Wi. PSC, July 19, 2012) (Commission approved an ROE of 10.4%).

As explained in PPL Electric's Initial Brief, Ms. Cannell explained that investors expect consistent and supportive ROE allowances. PPL Electric Initial Brief, pp. 114-115.[22] Based on the above review of relevant recent Commission decisions, OCA's 9.0% recommendation does not meet this standard.

d. The ALJ Should Reject OCA's Contention that the ROE Should be Adjusted If PPL Electric's Capital Structure Is Accepted.

OCA contends that its already very low recommended ROE of 9.0% should be reduced to 8.75% if PPL Electric's capital structure is accepted. OCA Main Brief, p. 49. OCA contends that PPL Electric's somewhat higher equity ratio than the average of the barometric group creates less risk to PPL Electric. *Id.* OCA's contention should be rejected for several reasons.

First, risk is a question of numerous factors, only one of which is capital structure. Other risks include the mix of customers, earnings variability, size and percentage of capital generated by internally generated funds. PPL Electric St. 11, pp. 14-19. As explained by Mr. Moul, all of

[22] OCA and I&E criticize Ms. Cannell for not calculating the cost of equity. OCA Main Brief, p. 5; I&E Main Brief, p. 51. However, Ms. Cannell was presented to review the ROE recommendations of the witnesses and provide an opinion as to how investors would react to those recommendations. While Ms. Cannell opined that investors would not find I&E's or OCA's ROE recommendations acceptable, she made it clear that it was up to the Commission to decide the allowed ROE based on the entire record. PPL Electric St. 12-R, p. 12.

these risk factors, including the capital structure, are captured by the credit quality rating of company and the barometer groups:

> The Company's credit quality rating by S&P is one notch weaker as compared to the Electric Delivery Group and two notches weaker than the Integrated Electric Group. The Moody's credit quality rating for PPL Electric is one notch weaker than these groups. The Company's weaker credit ratings indicate higher risk for the Company.

PPL Electric St. 11, p. 13.

As a result, if there is any adjustment to be made to the ROE for relative risk relative to the barometer group, it should be an upward adjustment, not a downward adjustment as proposed by OCA. Similarly, I&E devotes 10 pages of its brief attacking Mr. Moul's risk analysis. I&E, Main Brief, pp. 103-112. However, the credit ratings which encompass all risks are an independent and direct measure of investors' risk in investing in PPL Electric debt, which is issued directly to investors and not, as I&E suggests, a measure of PPL Corporation's risk.

The second reason OCA's contention for a lower ROE is erroneous is that OCA is comparing PPL Electric's capital structure at the end of 2012 to historic capital structures of the barometer group. OCA St. 2, Ex. SGH-1, Schedule 1, p. 3. Mr. Moul explained that investors expect common equity ratios of electric distribution companies to increase. Mr. Moul explained that Value Line is projecting that the common equity ratios of Mr. Hill's barometer will average 49.6% in 2012 and 50.4% for 2013, and that with exclusion of a clear outlier (Unisource) will average 50.9% and 51.7% for these years respectively. PPL Electric St. 11-R, p. 9. Clearly, PPL Electric's revised 2012 equity ratio of 50.78% is essentially equal to these averages when comparable periods are considered.

Finally, PPL Electric has demonstrated that its equity ratio is within the range of that employed by Mr. Moul's Electric Delivery Group. *See* Section VI.B, *supra*. There is no basis for adjusting the PPL Electric ROE when the barometer group reflects the range of risks and costs for the barometer group as a whole and PPL Electric is within that range. Again, if there is to be any adjustment, it should be upward for PPL Electric's greater risk as demonstrated by its lower credit rating.

For these reasons, OCA's proposal to lower its recommended ROE even further, if PPL Electric's capital structure is accepted, must be rejected.

4. OCA's and I&E's Criticisms of PPL Electric's Cost of Common Equity Presentation Should Be Rejected.

OCA and I&E criticize multiple aspects of PPL Electric's cost of common equity presentations. OCA Main Brief, pp. 57-64; I&E Main Brief, pp. 90-116. PPL Electric has responded to each of these criticisms in Mr. Moul's rebuttal and rejoinder. PPL Electric St. 12-R and St. 12-RJ. PPL Electric will respond to these criticisms briefly below, and refers the ALJ to Mr. Moul's rebuttal and rejoinder for further explanation.

a. OCA's and I&E's Criticisms of the Leverage Adjustment Are Without Merit.

OCA and I&E continue to challenge the use of a leverage adjustment in the DCF analysis. OCA Main Brief, pp. 60-64; I&E Main Brief, pp. 95-101. OCA and I&E arguments are essentially the same and Mr. Moul explained that each of these arguments have been made by these parties in prior cases where the Commission adopted the leverage adjustment. PPL Electric St. 11-R, p. 26-27.

OCA states as follows:

> PPL witness Moul testified that when utility market prices exceed book values a risk difference exists between market-value base cost of capital structures and book-value capitals structures, and market based cost of equity estimates should therefore be adjusted upwards to account for that difference. This is the basis for the "leverage adjustment".

OCA Main Brief, p. 60 (citing OCA St. 2, pp. 55-56).

OCA contends that this theory is flawed. Before addressing the alleged flaws, PPL Electric notes that the Commonwealth Court accepted the basis for the adjustment and affirmed the Commission's authority to use the adjustment in the approval from *PAWC 2004*. The Court stated as follows:

> As to economic theory, the PUC explains the reasons the common equity costs rate adjustment is appropriate. First, the formula used to estimate cost rate is market based, but Utility's stock is not publicly traded and is listed at a much lower book value. Under these circumstances the formula can understate the cost of capital.
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> Similarly, Utility highlights the testimony of its expert, who opined that "the capital structure ratios measured at the utility's book value show more financial leverage, and hence higher risk, than the capitalization measured at its market values." R.R. at 987a.
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> • • •
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> The present issue involves the application of a market value cost to a book value amount of common stock. The PUC made its adjustment to the common equity cost rate in recognition of the "financial risk" arising from the different valuation methods.

Popowsky v. Pa. P.U.C., 868 A.2d 606, 612-13 (Pa. Cmwlth. 2004). Therefore, the Commission has been affirmed by the Court in making this adjustment.

Nevertheless, PPL Electric will respond briefly to the arguments made by OCA as summarized on page 64 of its brief.

OCA's and I&E's contention that the adjustments for financial risk are not supported by literature is contrary to Mr. Moul's explanation that the formulas are supported by the work of Modigliani and Miller and Hamada as well as Dr. Morin. PPL Electric St. 11-R, p. 32-33.[23]

[23] I&E also contends that Mr. Moul's leverage adjustment is mathematically incorrect. I&E Main Brief, pp. 98-99. Mr. Moul also refuted this and other contentions offered by Ms. Sears. PPL Electric St. 11, pp. 30-34.

OCA's contention that there is no financial risk difference between market and book capitalization because interest expense does not change ignores the fact that the level of debt for the equity investor and financial risk rises because the percentage of debt is higher at book capitalization than market capitalization. PPL Electric St. No. 11-R, pp. 29-30. In fact, the quote in I&E's brief that "debt affects the cost of equity and that a company has a different cost of equity at a different capital structure" confirms the basis of the leverage adjustment. I&E Main Brief, p. 99.

OCA's contention that the DCF does not misstate the cost of equity without the leverage adjustment is a conclusion and is contrary to the Commission's adoption of the adjustment and the Commonwealth Court's affirming such action.

Mr. Moul's leverage adjustment is not a market to book adjustment as it does not use market to book ratios in any manner. PPL Electric St. 11-R, pp. 26-27.

The leverage adjustment is not refuted by Mr. Hill's contention that market prices in excess of book value means that utilities earn in excess of the cost of equity because the Commission has repeatedly rejected the assertion that it should try to control market prices. See PPL Electric Initial Brief, p. 128.

The leverage adjustment does not result in a fair value rate base and has nothing to do with valuation of rate base. PPL Electric St. 11-R, pp. 27-28.

In contrast, Mr. Hill's Market to Book ratio method is a market to book adjustment. As explained in PPL Electric's Initial Brief, p. 128, Mr. Hill converts an investor expected 10.4% ROE to 9.0% because he believes incorrectly that stock prices in excess of book value mean that investors are earning a return in excess of the cost of equity. As noted there, the Commission has not accepted such theory.

Finally, rejection of the leverage adjustment in other jurisdictions is not relevant because other jurisdictions have not relied exclusively on the DCF analysis and at least one other jurisdiction has accepted the adjustment. Tr. 250-53.

As explained in PPL Electric's Initial brief, the Commission has employed the leverage adjustment to the DCF in circumstances where it believed the DCF understated the cost of equity. PPL Electric Main Brief, pp. 105-108. This is such a circumstance. The economic uncertainty as well as uncertainty concerning future allowed ROEs may be depressing projections of growth rates. In contrast, growth should be expected to accelerate as electric utilities enter into expanded infrastructure investments. The circularity of using investor expected growth rates that are affected by Commission allowed ROEs requires caution in using an unadjusted DCF result in times like these as the sole source for determining the cost of equity. PPL Electric St. 11, pp. 24-25.

b. OCA's and I&E's Criticisms of the Risk Premium Method Should be Rejected.

OCA argues that the Commission has rejected the Risk Premium as a "primary, reliable indicator of the cost of equity." OCA Main Brief, pp. 58-59. On the contrary, the Commission has used the Risk Premium Method both as a primary method and a check on the DCF analysis.[24] Here the Risk Premium cost rate of 10.75% strongly suggests that the DCF results offered by OCA and I&E are grossly inadequate. As noted earlier, OCA and I&E provide no reliable check on their extraordinarily low DCF results. *See* Section VI.B.2 and 3, *supra.*

I&E contends, incorrectly, that the risk premium is not a direct measure of the cost of equity. Mr. Moul explained why this is incorrect.

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[24] *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, pp. 67 and 72 (Dec. 22, 2007); *Pa. P.U.C. v. Philadelphia Suburban Water Co.*, Docket Nos. R-870840 *et al.*, 96 P.U.R. 4th 158, 207, 1988 Pa. PUC LEXIS 433 at *135 - *137, Order entered July 26, 1988; See also, *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, Docket No. R-891218 et al., 109 P.U.R. 4th 250, 272, 1989 Pa. PUC LEXIS 225 at *52 (Dec. 29, 1989).

> Ms. Sears' assertion that the Risk Premium method does not measure the current cost of equity as directly as the DCF is without foundation for the very reason that components of each model carry varying levels of precision in their measurement. For example, the yield on A-rated public utility bonds used in the RP model, and the dividend yields used in the DCF can be measured with a fairly high degree of precision. But the equity risk premium used in the RP model and the DCF growth rate must all be inferred because they are not directly observable. This reality shows that no one method is superior to another because they all require use of informed judgment to obtain a meaningful result. As I established in my direct testimony, the Risk Premium cost of equity is 10.75%, which consists of a 5.25% yield on public utility bonds and a 5.50% equity risk premium.

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

In addition, I&E contends that the risk premium added to the prospective bond yield overstates the cost rate because historic data used ended in 2007 before the financial crisis. I&E Main Brief, pp. 92-93. I&E contends that since the S&P 500 has only regained 91% of its pre-financial crisis level, the 10.75% cost rate should be reduced to 9.78 (10.75% X .91). However, as noted in Mr. Moul's direct, Mr. Moul already reduced the actual risk premium of 6.23% to 5.50%, thereby adjusting for this effect and others.[25]

The criticisms of the Risk Premium analysis should be rejected. The 10.75% result of the analysis provides valid confirmation of Mr. Moul's DCF analyses of 10.37% to 10.87%. PPL Electric St. 11, p. 4.

5. I&E's And OCA's Criticism Of The Incremental Upward Adjustment To The Cost Of Common Equity To Reflect Management Effectiveness Should Be Rejected.

As explained in the Company's Initial Brief, the Commission is required to consider management effectiveness in setting rates, and the Commission has, where appropriate, included an incremental upward adjustment to the cost of common equity to reflect management

[25] The adjustment was properly made by Mr. Moul to the risk premium and not the entire cost rate because the prospective utility bond rate would not be affected.

effectiveness. PPL Electric Initial Brief, pp. 115-16. PPL Electric has presented extensive evidence of its management effectiveness, which fully supports its proposed 12 basis point addition to the market based cost of common equity. In their Main Briefs, I&E and OCA each oppose the Company's claim, but neither party provides any substantial basis for its position.

I&E brushes aside PPL Electric's examples of management effectiveness as irrelevant because the cost of the program or accomplishment is reflected in PPL Electric's rates. In I&E's view, management effectiveness can only be shown if it is funded by utility shareholders. I&E cites no support for this extreme position, and there is none. As I&E acknowledges, a utility is entitled to recover all reasonable operating expenses in rates. I&E Main Brief, pp. 19-20. If a utility manages those costs effectively and provides excellent service to customers, an adjustment for management effectiveness is appropriate. I&E's unsupported position would effectively preclude any possibility of a management effectiveness adjustment and would read Section 523 out of the Public Utility Code.

I&E also cites certain isolated statistics from 2009-2010 to contend that PPL Electric's service in these limited areas has declined both on an absolute basis and in comparison to other EDCs in Pennsylvania. I&E Main Brief, pp. 119-20. These isolated statistics do not support I&E's position and further demonstrate the danger of relying on historic average to set prospective rates. I&E focuses the slight change in certain parameters from 2009-2010, but fails to note that beginning January 1, 2010, PPL Electric generation rate caps expired, time of use rates were available to all customers for the first time and large numbers of PPL Electric's customers shopped with an EGS for the first time. This "triple whammy" obviously had a temporary effect on the statistical results cited in I&E's Brief and provides no support for denying PPL Electric's claim.

Similarly, OCA spends less than two pages of its Main Brief addressing management effectiveness. The OCA challenges none of the evidence presented by PPL Electric on this subject, and instead references a single interrogatory response which summarizes five instances over the last four years where PPL Electric paid a civil penalty. PPL Electric has 1.4 million customers and millions and millions of annual interactions with these customers. In only four instances, has any penalty been applied, and in three of those instances, the Company settled the matter without any finding of any violation of the Code or Commission order. In only one instance in the past four years has PPL Electric been found to have violated the Public Utility Code, and on that occasion, it was assessed a civil penalty of $100. On its face, this interrogatory fully demonstrated PPL Electric's management effectiveness. The standard for management effectiveness is not perfection. The fact that this is the only evidence OCA can cite to attack PPL Electric's management effectiveness demonstrates the merit of the Company's claim.

VII. TAXES

In its Initial Brief, PPL Electric anticipated and, as a practical matter, fully responded to the I&E's proposed adjustments to the Company's claims for consolidated federal tax savings, gross receipts tax, and capital tax. *See* PPL Electric Initial Brief, pp. 130-35. For the reasons fully explained in the Company's Initial Brief, the I&E's proposed tax adjustments are without merit and should be rejected.

VIII. RATE STRUCTURE

A. COST OF SERVICE

PPL Electric explained that the cost of service study proposed in this proceeding is virtually identical to the methodology adopted by the Commission in the 2010 base rate case. PPL Electric's proposed cost of service study classified both its primary voltage level and secondary voltage level distribution system as part customer related and part demand related. PPL Electric Initial Brief, pp. 137-140. The only party to oppose PPL Electric's cost of service study was the OCA.

The OCA proposes a cost of service study that allocates 100% of PPL Electric's primary voltage level facilities as demand related and, after making adjustments to PPL Electric's minimum size system study,[26] allocates secondary voltage level facilities as part customer related and part demand related. In support of its proposal, the OCA contends that its cost of service study is: (1) consistent with the methodology used by PPL Electric prior to 2010; (2) consistent with a "NARUC report" that has been available since 2000; (3) consistent with the design of PPL Electric's distribution system; and (4) consistent with the customer mix and density in PPL Electric's service territory. In its Initial Brief, PPL Electric responded to the OCA's proposed cost of service study and opposition to PPL Electric's cost of service study. Nevertheless, it is appropriate for PPL Electric to respond to certain contentions advanced by the OCA. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, the OCA's proposed cost of service study and opposition to PPL Electric's cost of service study are without merit and should be rejected.

1. OCA's Reliance On Cost Of Service Studies Prior to 2010 Is Improper And Should Be Rejected.

The fundamental difference between PPL Electric's and the OCA's respective cost of service studies is that PPL Electric allocated its primary voltage level facilities as part customer related and part demand related, while the OCA allocated the primary voltage level facilities as 100% demand related. OCA Main Brief, p. 73. The OCA repeatedly states that its proposal is consistent with the methodology used by PPL Electric prior to 2010. OCA Main Brief, pp. 70,

[26] OCA's proposed adjustments to PPL Electric's minimum size system study are discussed below.

71, 73, 76. However, the OCA completely disregards that in 2010 the Commission previously considered and specifically rejected the OCA's proposal.[27] PPL Electric Initial Brief, pp. 142-43.

The OCA presented in this case the same cost of service study proposal it offered in the 2010 base rate case proceeding. The issue of the appropriate cost of service study was fully litigated and the Commission rejected the OCA's proposal. Although the OCA is correct that the Commission concluded that there is no single absolute correct method, the Commission rejected the OCA's proposal and approved PPL Electric's cost of service study in the 2010 base rate proceeding. PPL Electric Initial Brief, pp. 137-38, 142-43. The OCA has offered no change in law or fact that would warrant a departure from the Commission's decision in the 2010 base rate proceeding. For this reason alone, the OCA's proposal to "move the ball backward" and use a cost of service study previously rejected by the Commission should be denied.

2. OCA's Reliance On The "NARUC Report" Is Misplaced And Should Be Rejected

In the 2010 base rate case, the Commission concluded that PPL Electric's cost of service study is consistent with the NARUC Manual. PPL Electric Initial Brief, pp. 137-38, 142-43. The OCA, however, contends that the NARUC Manual is outdated and proposes to use a "NARUC report" as the basis for classifying distribution facilities. According to the OCA, the "NARUC report" does not mandate that distribution plant be classified as partially demand-related and partially customer-related and indicates that the majority of states use a basic customer method in which all distribution costs, except for service and meters, are classified as

[27] *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *57-58 (Dec. 21, 2010) ("We have considered the OCA's position and Exceptions on this issue and find them to be contrary to prior Commission action in PPL's 2004 and 2007 base rate proceedings and inconsistent with recommended COSS principles as outlined in the NARUC Manual.").

demand related. OCA Main Brief, pp. 82-83. The OCA's reliance on the "NARUC report" to support its proposal is misplaced for several reasons.

First, there is significant uncertainty as to the import of the "NARUC report" and whether it is intended to be a statement of NARUC policy.[28] PPL Main Brief, p. 145. Second, the "NARUC report" supports rate designs based on principles that are not used in Pennsylvania. PPL Main Brief, p. 145. Third, although the "NARUC report" indicates that the basic customer method is the "general approach" used in more than thirty states, the OCA has failed to identify any EDC in the Commonwealth that has adopted such an approach. OCA Main Brief, p. 83. Indeed, it appears that the basic customer method advocated in the "NARUC report" is not the "general approach" in Pennsylvania. Finally, PPL Electric and other electric utilities have followed the actual guidance provided in the NARUC Manual since 1973. The NARUC Manual clearly states that distribution plant and expenses have both a demand-related component and customer-related component. PPL Electric St. 8-R, p. 12; PPL Electric St. 8-RJ, pp. 6-7.

3. OCA's Criticism That PPL Electric's Distribution Facilities Have Some Capability To Carry Load For Emergencies And Interruptions Should Be Rejected.

In support of its proposal to allocate 100% of the primary voltage level distribution facilities as demand related, the OCA argues that PPL Electric failed to account for how the distribution system is engineered and designed to work on a day-to-day basis. The OCA contends that much of an EDC's primary voltage level distribution system is interconnected to prevent outages and, as a result, these facilities are sized to meet not only the loads normally

[28] Despite the OCA's assertion to the contrary, OCA Main Brief, p. 83, n.20, there is nothing of record to support the OCA's suggestion that the "NARUC report" was adopted by the NARUC or that it is an official policy statement of NARUC. Indeed, the "NARUC report" specifically disclaims that it reflects the positions of NARUC. Tr. 518. Further, the OCA's statement that "the NARUC Report can only be obtained from NARUC," OCA Main Brief, p. 83, n.20, is not only irrelevant to whether it was officially adopted by the NARUC, but also is directly contrary to the record. Tr. 517.

placed on a particular segment, but also capable of carrying additional load in the case of emergencies and interruptions. The OCA therefore concludes that PPL Electric's primary distribution system is not built such that the majority of the costs are incurred to simply connect customers and, according to the OCA, the primary voltage level distribution facilities should not be allocated a customer-related component. OCA Main Brief, p. 78. The OCA's argument is without merit and should be rejected.

PPL Electric's distribution system utilizes both primary and secondary voltage level conductors and service lines to provide electric service to its retail customers. PPL Electric St. 8-R, p. 22. In response to the OCA's criticism that PPL Electric's primary voltage level facilities are capable of carrying additional load for emergencies, PPL Electric offered the following description of its primary voltage level circuits:

> The primary voltage level circuits on PPL Electric's distribution system can best be described as a series of radial lines that emanate from a substation. The distribution system resembles a tree where the roots (substation) feed the trunk and main branches (main line circuits) which, in turn, feed the smaller branches and leaders (tap line circuits). Normally-closed switches are located on the main line circuits to isolate faulted line sections and enable the restoration of service to customers back towards the substation. Many of these main line circuits are connected to each other or to main line circuits from other substations by normally-open switches. This allows for the transfer of some customers from their normal main line circuit to alternate main line circuits to restore service to customers during main line circuit outages. However, because the Company's primary voltage level conductors are radial from a design and operations basis, they are not fully interconnected to prevent customer service outages.

PPL Electric St. 8-R, pp. 19-20.

PPL Electric explained that the primary voltage level distribution facilities are in fact needed to connect its customers to the electric system. PPL Electric further explained that customers located in rural and suburban areas are primarily served by primary level overhead and underground facilities, while customers in urban areas are served by both primary and secondary level overhead and underground facilities. Because PPL Electric's service territory is mostly rural and suburban in nature, there is a much higher quantity of primary voltage level facilities required to connect these customer located in rural and suburban areas to the electric distribution system. PPL Main Brief, pp. 148-49. Stated otherwise, these customers would not be connected to the system but for the primary level voltage facilities. In fact, all customers who are receiving distribution service must be connected to the primary voltage level facilities of PPL Electric's distribution system in order to actually be provided with electric service, regardless of the amount of load imposed on the system by the customer. PPL Electric St. 8-R, pp. 12-13.

The fact that the primary voltage level facilities have some capability to carry additional load for emergencies and interruptions provides no basis for rejecting it. PPL Electric explained that it accounts for the fact that its primary voltage level facilities have the capability to carry additional load for emergences, stating:

> A minimum size distribution system, by definition, must have some capability to carry load.... As shown on pages 13 and 14 of Exhibit JMK 3, primary and secondary voltage level line transformers are adjusted to a nominal load-carrying condition by the application of a specific "no load" factor. As such, PPL Electric's minimum size distribution equipment reflects the appropriate level of capability to carry load that meets the requirements of its minimum size distribution system.
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> [I]n response to the criticism received from several parties in the Company's prior base rate proceedings regarding the capability to carry load of some equipment used in its minimum size system study, in 2006, PPL Electric undertook an analysis to identify the customer-related "minimum or no load" portion of that equipment. This analysis is updated each year to reflect the most current applicable information. As more fully described in Statement No. 8, the results of this analysis were applied to primary and secondary voltage level overhead and underground transformers. Accordingly, only the "minimum or no load" portion of these

> facilities has been classified as customer-related; the remaining portion of these facilities has been classified as demand-related.... Historically, PPL Electric has allocated the distribution system costs of its primary voltage-related overhead and underground conductors and devices, as well as applicable poles, towers and fixtures, and conduit, solely on the basis of the demand imposed on those facilities by the customer classes using those facilities to take retail service, even though those primary voltage level facilities have a customer-related cost component. The Company was criticized for following this approach.

PPL Electric St. 8-R, pp. 16-18.

Finally, PPL Electric notes that the NARUC Manual (p. 87) clearly shows that overhead and underground conductors, among other facilities, and their related O&M expenses (p. 88) all have both a demand-related component and a customer-related component. PPL Electric St. 8-R, p. 12. As such, PPL Electric properly classified its primary voltage level distribution facilities into their applicable demand-related and customer-related components using its minimum size study, as set forth in PPL Electric Ex. JMK 3.

Based on the foregoing, the OCA's contention that PPL Electric's primary voltage level facilities should be classified as 100% demand related because they have the capability to carry additional load for emergencies and interruptions should be rejected. Clearly, PPL Electric's primary voltage level facilities are required to connect customers located in rural and suburban areas to the electric system. Further, PPL Electric's cost of service study accounts for the fact that its primary voltage level facilities have additional load carrying capacity by classifying only the "minimum or no load" portion of these facilities as customer-related.

4. OCA's Reliance On Its Customer Mix/Density Analysis Is Misplaced And Should Be Rejected.

In support of its proposal to allocate 100% of PPL Electric's primary voltage level distribution facilities as demand related, the OCA states that the only reason to have a customer component for the distribution system is if the mix of customers classes (residential v. business) is significantly different across the rural and urban parts of the Company's service territory. The OCA analyzed the density and mix of customers throughout PPL Electric's service territory and found that, because all customer classes are equally represented in all portions of PPL Electric's service territory, there is no basis for classifying or allocating distribution plant as a customer-related component. OCA Main Brief, pp. 78-80, 84. The OCA's reliance on its customer mix/density analysis is misplaced and fails to support its proposed cost of service study.

It must be noted that in PPL Electric's 2010 base rate proceeding, the Commission previously considered and rejected the OCA's customer mix/density analysis as a basis to support its proposal to allocate 100% of the Company's primary voltage level distribution facilities as demand related. *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-2010-2161694, 2010 Pa. PUC LEXIS 2011 at *46-48, *57-58 (Dec. 21, 2010). The OCA has offered no change in law or fact that would warrant a departure from the Commission's decision in the 2010 base rate proceeding and the re-litigation of OCA's customer mix/density argument.

Further, the OCA's study is flawed because it focuses only on the relative proportion of residential v. business customers in rural and urban areas and ignores the obvious and indisputable fact that there are many more residential customers than businesses connected to PPL Electric's distribution system. PPL Electric Initial Brief, p. 144. In addition, the OCA's customer mix/density analysis does not address the issue of whether a customer component is appropriate. Rather, the OCA's analysis addresses the issue of whether primary voltage level facilities should be classified by separate, regional analyses rather than on a statewide class basis. For the reasons explained in the Company's Initial Brief, this approach is not relevant or appropriate. PPL Electric Initial Brief, pp. 144-45.

B. MINIMUM SIZE STUDY

In this proceeding, PPL Electric employed a minimum size system study to allocate distribution plant and expenses as customer-related and demand-related. PPL Electric Initial Brief, p. 146. The only party to oppose PPL Electric's minimum size system study was the OCA. The OCA opposes PPL Electric's minimum size system study arguing that the customer component of distribution plant must be the theoretical minimum size system that is required to connect a customer with no load, rather than the smallest size distribution plant actually installed and used on the system. OCA Main Brief, p. 86. The OCA further recommends several adjustments to PPL Electric's minimum size system study. OCA Main Brief, pp. 87-89.

In its Initial Brief, PPL Electric anticipated and, as a practical matter, responded to the OCA's opposition to PPL Electric's minimum size system study. Nevertheless, it is appropriate for PPL Electric to respond to certain contentions advanced by the OCA. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, the OCA's arguments are without merit and should be rejected.

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

Preliminarily, the minimum size system study used by PPL Electric in this proceeding is the same methodology approved by the Commission in the Company's 2010 base rate proceeding at Docket No. R-2010-2161694. PPL Electric Initial Brief, p. 146. In that proceeding, the OCA attacked PPL Electric's minimus size system study, stating:

> PPL's use of a minimum system study as based on a misconception, *i.e.*, that the smallest size installed equipment makes up the distribution network to connect customers and that all larger sizes of equipment serve peak demands. OCA St. No. 3 at 12; OCA Main Brief at 27 - 30; R.D. at 43. The OCA contended that this method overstates the customer percentage because even the smallest size installed equipment is used to meet the required

> level of peak demand. OCA St. 3 at 13; OCA Main Brief at 28; R.D. at 43, 44.

Pa. P.U.C. v. PPL Electric Utilities Corp., Docket No. R-2010-2161694, 2010 Pa. PUC LEXIS 2011 at *48-49 (Dec. 21, 2010). However, the Commission rejected the OCA's argument and concluded that PPL Electric's methodology is consistent with the recommended principles outlined in the NARUC Manual. *Id.* at *57-58. The OCA has offered no change in law or fact that would warrant a departure from the Commission's decision in the 2010 base rate proceeding.

In support of its contention that the customer component of distribution plant must be the theoretical minimum size system that is required to connect a customer with no load, rather than the smallest size distribution plant actually installed and used on the system, the OCA quotes *Pa. P.U.C. v. Duquesne Light Co.*, Docket No. R-842583, 59 Pa. PUC 67, 1985 Pa. PUC LEXIS 68 (Jan. 25, 1985). OCA Main Brief, p. 86. However, OCA's reliance on this case is misplaced. The passage quoted by OCA is not a statement or holding of the Commission as OCA represents in its brief; rather, the passage quoted by OCA is Duquesne's own description of "its rationale regarding a determination of the customer component of distribution plant." *Id.* at *230-231. Contrary to the OCA's assertion, the Commission in *Duquesne* recognized that Duquesne's minimum size system study "assumes that each component of the distribution system is replaced by the minimum sized component which Duquesne <u>normally installs</u>." *Id.* at *232 (emphasis added).

In this proceeding, PPL Electric explained that it has followed the minimum size system guidelines set forth in the NARUC Manual, which defines a minimum size distribution system as that based on the smallest size equipment <u>currently</u> being installed by the utility. Clearly the NARUC Manual contemplates that the minimum size facilities can change over time as the load imposed by customers and/or the number of customers on the facilities changes. Further, the NARUC Manual clearly provides that the customer-class non-coincident peak demands are the load characteristics that normally are used to allocate the demand-related component of the distribution-related facilities. PPL Main Brief, p. 147. Based on the foregoing, the OCA's criticisms of PPL Electric's minimum size system study are unsupported and inconsistent with the NARUC Manual.

The OCA also asserts that PPL Electric's minimum size system study failed to make the required adjustments for load carrying capability. OCA Main Brief, p. 87. PPL Electric explained that a minimum size system, by definition, must have some capability to carry load, and that PPL Electric's minimum size system study accounts for the fact that its primary voltage level facilities have additional carrying capacity by classifying only the "minimum or no load" portion of these facilities as customer-related. *See* Section VIII.A.3, *supra*; PPL Main Brief, pp. 147-79.

The OCA also criticizes PPL Electric's minimum size system study because the conductors are recorded on a linear foot basis, not a circuit foot basis. OCA Main Brief, pp. 87-88. The Company has fully addressed this issue in its Initial Brief. *See* PPL Electric Initial Brief, p. 149.

Finally, the OCA criticizes PPL Electric's minimum size system because, according to OCA, the Company's cost allocation methodology is biased against residential customers. OCA Main Brief, p. 88. PPL Electric's cost allocation methodology follows the guidance set forth in the published NARUC Manual to determine the overall and rate class results of the cost allocation studies. Further the residential class is the largest customer class and, therefore, uses the largest proportion of PPL Electric's distribution facilities. There simply is nothing of record to suggest that the Company's minimum size system study is biased against the residential class. PPL Electric Initial Brief, pp. 149-50.

Based on the foregoing, OCA's criticisms of PPL Electric's minimum size system study are unsupported, inconsistent with Commission precedent and the NARUC Manual, and should be rejected.

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

The OCA recommended several adjustments to PPL Electric's minimum size system study, including the minimum size poles, overhead conductors, underground conduit, underground conductors, and line transformers. The OCA also recommends that PPL Electric's minimum size system study exclude fiber optic communication cables. OCA Main Brief, pp. 89-90. PPL Electric fully addressed OCA's recommended adjustments to the Company's minimum size system study in its Initial Brief. PPL Electric Initial Brief, pp. 150-52. For the reason fully explained therein, OCA's recommended adjustments should be rejected.

C. REVENUE ALLOCATION

1. Revenue Allocation.

PPL Electric's proposed revenue allocation follows the results of the Company's cost of service study, PPL Electric Ex. JMK-2. The Company's allocation does not perfectly match the results that would be achieved by strict adherence to the cost of service study; however, it does result in substantial movement of all rate classes toward the system average rate of return. PPL Electric Initial Brief, pp. 152-54.

The OCA proposed an alternative revenue allocation based on the results of its own cost of service study. OCA Main Brief, pp. 93-97. Although the OCA concedes that the ALJ and the Commission previously accepted PPL Electric's cost of service study, the OCA argues that the

Company's revenue allocation should be rejected because the OCA's cost of service study is superior. In support, the OCA simply restates its arguments in opposition to PPL Electric's cost of service study. OCA Main Brief, pp. 97-101. For the reasons explained more fully above and in PPL Electric's Initial Brief, the OCA's cost of service study should be rejected. *See* Section VIII.A, *supra*, PPL Electric Initial Brief, pp. 140-52.

In summary, OCA's cost of service study, under which all primary voltage level distribution plant is classified as demand-related, should be rejected because it is based on the assumption that there is no customer component of distribution plant and is contrary to the NARUC Manual, general industry practices, and decisions of this Commission in prior PPL Electric rate proceedings. Similarly, OCA's criticisms of PPL Electric's minimum size system study should be rejected because they are unsupported by the record and clearly inconsistent with the NARUC Manual. Finally, OCA's revenue allocation should be rejected because it clearly favors the residential class over other rate classes by failing to properly allocate to the residential class all costs incurred to serve it.

2. Scale Back

Several parties offered a scale back proposal in the event that the revenue increase granted PPL Electric in this proceeding is less than that which the Company has proposed. I&E recommends that the first $1,784,000 of any scale back be used to reduce the allocation to Rate Schedule RTS and then additional reductions be applied to Rate Schedules RS, GH-2, SL/AL, and, contingent on other factors, LP-5. I&E Main Brief, pp. 126-28. The OSBA proposes that any reduction in the overall rate increase be shared among the rate classes in proportion to the Company's proposed total revenues in this proceeding. OSBA Main Brief, pp. 15-16. The OCA proposes that any reduction in the overall rate increase be proportionally scaled back based on

OCA's cost of service study, OCA Main Brief, pp. 95-97, which should be rejected for the reasons explained above.

Although the Company recognizes that the OSBA's proposed scale back does continue to move rate classes towards the system average return, PPL Electric believes it will be difficult for customers, especially residential customers, to accept a scale back that gives reductions to customers who were not, in the first instance, expecting an increase or, in the extreme, gives greater reductions to certain customers than were originally proposed. Accordingly, the Company recommends that any scale back of revenues be applied on a proportional basis to only those rate schedules which, under the Company's original proposal, would be receiving increases. PPL Electric Initial Brief, pp. 156-57.

D. TARIFF STRUCTURE

Certain intervenors raised concerns regarding PPL Electric's proposed rate design. In particular, these parties opposed PPL Electric's proposal to increase the residential and non-residential customer charges. For the reasons explained below, these concerns should be rejected and the rate design proposed by PPL Electric should be approved.

1. Residential Customer Charge.

As explained in the Company's Initial Brief, PPL Electric proposed to increase the Rate Schedule RS customer charge from \$8.75 per month to \$16.00 per month based on its cost of service study and the underlying minimum size system study. The proposed increase in the customer charge for Rate Schedule RS is supported by the results of PPL Electric's cost of service study that has previously been approved by the Commission. Further, PPL Electric's proposal is consistent with *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006) *appeal denied*, 591 Pa. 676, 916 A.2d 1104 (2007) ("*Lloyd*"), which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization, and should be approved. PPL Electric Initial Brief, pp. 162-63.

In rebuttal, PPL Electric proposed an alternative Rate Schedule RS customer charge of $14.09 per month based on the same type of direct and indirect cost components approved by the Commission in *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 236 P.U.R. 4th 218, 2004 Pa. PUC LEXIS 39 (Aug. 5, 2004). Although PPL Electric believes that the customer component of each rate schedule should include all customer-related costs determined by the cost of service study, if the ALJ and the Commission wish to consider an alternative compromise customer charge, a charge of $14.09 would be acceptable to the Company as it would recover the same type of direct and indirect cost components as those approved in *Aqua*, and would provide some improvement in the level of fixed cost recovery in the customer charge. PPL Electric Initial Brief, pp. 170-73.

I&E, OCA, and CEO all argue that the customer charge for Rate Schedule RS should not increase as the Company has proposed. These parties raise several arguments in opposition to the proposal to increase the customer charge and recommend that the customer charge for Rate Schedule RS remain unchanged. In its Initial Brief, PPL Electric anticipated and, as a practical matter, responded to the parties' opposition to the proposed Rate Schedule RS customer charge. Nevertheless, it is appropriate for PPL Electric to respond to certain contentions advanced by I&E, OCA, and CEO. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, these parties' arguments in opposition to the proposal to increase the Rate Schedule RS customer charge should be rejected.

a. Incentive To Conserve

The OCA and CEO argue that the Company's proposal reduces the incentive for customers to conserve.[29] OCA Main Brief, p. 108; CEO Main Brief, pp. 7-8. These parties largely ignore that PPL Electric's proposal will maintain an energy charge component of Rate Schedule RS distribution charges that is only 0.7% lower than the current energy charge, and that, if approved, the Company's proposal would still leave 86% of the charges on an average residential customer's total bill subject to usage-based charges. PPL Electric Initial Brief, pp. 164-65. Clearly, customers would still have a significant economic incentive to conserve.

Opposition to the Company's cost based proposal on the grounds that it will disincent conservation simply disregards the fixed cost nature of an electric distribution system and the fundamental rationale for the Company's proposal -- to recover fixed costs through fixed charges and variable costs through variable charges consistent with *Lloyd*. Conservation cannot and does not trump cost of service and cannot be used to support a below cost of service customer charge.

b. Impact On Low Income/Low Usage Customers

The OCA argues that the proposal has a disproportionate impact on low income/low usage customers.[30] The OCA observes that PPL Electric's proposal to increase its customer charge will adversely affect low income/low usage customers to a far greater degree than high income/high usage customers. The OCA, therefore, concludes that the Company's proposal to increase its customer charge will disproportionately impose adverse impacts on the customers least able to afford the bills. OCA Main Brief, pp. 109-10. The OCA's concerns should be rejected.

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[29] In its direct testimony, I&E also raised the issue of whether the Company's proposal reduces the incentive for customers to conserve. I&E St. 3, pp. 5-6. However, I&E has not presented this issue in its Main Brief.

[30] In its direct testimony, CEO raised the issue of whether the Company's proposal has a disproportionate impact on low income customers. CEO St. 1, pp. 4-5. CEO failed to brief this issue.

First, it must be remembered that the Company is not proposing a fixed customer charge that is exactly equal to the amount determined by its minimum system study, but, instead, has used the minimum system study as a guide to determine a fixed monthly charge that is more appropriate than the current charge and consistent with the principles of *Lloyd.* Utility rates should be designed based upon cost of service, not on customers' income levels.

Second, as a utility with an obligation to serve customers, PPL Electric must provide fixed assets to serve the needs of those customers. Importantly, the existence of these fixed assets, and their associated fixed costs, do not change as a result of a customer's income or whether a customer uses 1 kWh/month or 5,000 kWh/month. PPL Electric St. 5-R, p. 8.

Third, the OCA's argument is premised on the assumption that all low income customers are low usage customers, *i.e.*, that electric consumption increases as income increases.[31] However, as explained in rebuttal, the data relied upon by OCA is incomplete and unrelated to the income level and usage level of specific customers. PPL Electric St. 5-R, pp. 9-10.

Finally, customers do not pay percentages, they pay dollars. While the increase in the customer charge may produce significant percentage increases to low use customers, the dollar increase is approximately $7.00 per month, if the Company's proposed rate increase were granted in its entirety. To the extent that such an increase is cost prohibitive to low income customers, PPL Electric has extensive Commission-approved universal service programs to assist low-income customers who are payment troubled. Importantly, participants in the Company's customer assistant program pay an amount determined not from their bill, but from their ability to pay. PPL Electric St. 5-R, pp. 8-9, 11.

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

c. Use of Minimum System Study As A Basis For Establishing A Fixed Monthly Charge

Both I&E and OCA argue that PPL Electric erred in relying on its class cost of service study to determine the proposed increase in the Rate Schedule RS customer charge. Specifically, I&E contends that PPL Electric's minimum size system study confuses fixed costs with customer costs. I&E Main Brief, pp. 133-36. The OCA simply restates its arguments in opposition to PPL Electric's cost of service study and argues that PPL Electric's minimum size system study should not be used as a guide to set rates in this matter. OCA Main Brief, p. 107. These arguments are without merit and should be rejected.

As explained in the Company's Initial Brief, I&E and OCA disregard that the minimum size system study used by PPL Electric in this proceeding to determine the proposed Rate Schedule RS customer charge is virtually identical to the minimum size system study approved by the ALJ and adopted by the Commission in the 2010 base rate proceeding. PPL Electric Initial Brief, pp. 137-38, 146, 167-68. I&E's and OCA's opposition to PPL Electric's proposed increase in the Rate Schedule RS customer charge based on the results of its previously-approved minimum size system study should be rejected.

I&E argues that PPL Electric's minimum size system study confuses fixed costs and customer costs. I&E contends that 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. I&E Main Brief, pp. 133-36. However, I&E ignores that all of PPL Electric's distribution costs are fixed costs. PPL Electric's cost of service study separates these fixed costs into a demand or customer component and seeks to recover a portion of the customer component through its proposed $16.00 per month customer charges. PPL Electric Initial Brief, p. 168.

I&E also contends that PPL Electric's minimum size system study improperly assumes a direct relationship between the number of customers and the size and cost of poles, conductors, and transformers on PPL Electric's system. In support, I&E asserts that poles, conductors, and transformers are not required for each customer and do not vary with the number of customer connections. I&E Main Brief, pp. 134-35. I&E's argument simply ignores that the number and type of customers served by electric distribution facilities does in fact affect the size and quantity, as well as the cost, of such facilities. PPL Electric Initial Brief, p. 168.

I&E even goes so far as to suggest that PPL Electric's approach is "precisely" the same analysis offered by Columbia Gas in *Pa. P.U.C. v. Columbia Gas of Pa., Inc.*, Docket No. R-2010-2215623, 293 P.U.R. 4th 235, 2011 Pa. PUC LEXIS 185 (Oct. 14, 2011).[32] I&E Main Brief, p. 135-36. I&E's attempt to analogize PPL Electric's proposal to the one offered in *Columbia* is simply incorrect. As I&E conceded, Columbia proposed to eliminate its delivery rate (volumetric charge) and recover the entirety of its base rate costs through a fixed customer charge, *i.e.*, 100% fixed customer charges. Tr. 539-40; *see also Columbia*, at *44-46. Here, PPL Electric is not proposing to recover 100% of its base rate costs through fixed customer charges. Rather, if approved, PPL Electric's proposal will recover only 14% of an average residential customer's total bill based on fixed charges. PPL Electric St. 5-R, p. 6.

The OCA's argument that PPL Electric erred in relying on its class cost of service study to determine the proposed increase in the Rate Schedule RS customer charge is nothing more than a restatement of its opposition to PPL Electric's cost of service study. OCA Main Brief, p. 107. For the reasons explained more fully above and in PPL Electric's Initial Brief, the OCA's

[32] I&E's suggestion that PPL Electric's approach is "precisely" the same analysis offered by Columbia Gas is remarkable given that I&E conceded on the record that PPL Electric's proposal is dissimilar from the one offered by Columbia Gas. Tr. 540.

criticism of PPL Electric's cost of service study should be rejected. *See* Section VIII.A, *supra*, PPL Electric Initial Brief, pp. 140-52.

Finally, it must be remembered that the Company is not proposing a customer charge that is exactly equal to the customer cost component of its cost of service study. PPL Electric's cost of service study could have justified a Rate Schedule RS customer charge of $36.70 on the basis of all customer-related costs. PPL Electric Ex. JMK 5. Consistent with the results of the cost of service study and the cost causation principles established in *Lloyd*, PPL Electric proposes to recover all of the proposed distribution revenue increase for the residential customer class in the customer charge, resulting in the proposed Rate Schedule RS customer charge of only $16.00 per month

d. The Alternative Customer Cost Analyses Of I&E And OCA Should Be Rejected.

Both I&E and OCA argue that PPL Electric's proposed customer charge for Rate Schedule RS includes cost components that Commission has rejected as customer related. I&E and OCA, therefore, both propose their own direct customer cost analysis. Based thereon, I&E and OCA conclude that the residential customer charge should remain at $8.75.

The fundamental dispute between the cost analyses used by OCA and I&E and the cost of service study used by PPL Electric is whether the customer charge should include indirect costs. Both I&E and OCA include <u>only</u> direct meter and service costs and exclude all other customer costs. PPL Electric's cost of service study included <u>all</u> relevant direct and indirect revenue cost components. PPL Electric St. 8-RJ (Part 2), p. 4. However, PPL Electric proposed to only recover a <u>portion</u> of these cost components through the customer charge, resulting in the proposed Rate Schedule RS customer charge of $16.00 per month.[33] Although PPL Electric's proposal does not exactly match the results of its cost of service study, it does move Rate Schedule RS closer to cost based rates, which is consistent with the principles established in *Lloyd*.

The Company recognizes that the Commission has limited the costs that may be recovered through the customer charge. However, I&E and OCA have misapplied that precedent by excluding certain indirect customer costs components that the Commission has concluded should be recovered through the customer charge, *i.e.*, employee benefits, payroll taxes, local taxes, and administrative and general costs. For the reasons explained below, the direct customer cost analyses proposed by I&E and OCA are incomplete and should be rejected.

I&E initially argues that, while PPL Electric provided a cost of service study, the Company failed to conduct a specific customer cost analysis. I&E Main Brief, pp. 131-32, 137. PPL Electric acknowledges that its proposed increase to the Rate Schedule RS customer charge is based on the Company's fully allocated cost of service study and underlying minimum size system study. However, PPL Electric's cost of service study does undertake a customer cost analysis by separating the fixed costs into demand-related and customer-related costs. Using its minimum size system study, PPL Electric identifies each of the minimum size system customer-related costs and associated revenue requirement to determine the level of customer charge to be applied to monthly billings for the RS customer rate class. PPL Electric St. 8-R, p.29. This study and its predecessors, which have used the same methodologies regarding customer costs, have been reviewed and accepted in many prior PPL Electric base rate proceedings. PPL Electric St. 8-RJ (Part 2), pp. 2.3. Further, it must be remembered that in response to the

[33] PPL Electric's cost of service study justifies a Rate Schedule RS customer charge of $36.70 on the basis of all direct and indirect customer-related costs. PPL Electric Ex. JMK 5.

criticism of I&E and OCA, PPL Electric did in fact prepare a separate customer cost analysis, which was the basis for its alternative Rate Schedule RS customer charge of $14.09 per month as explained below. PPL Electric Ex. JMK 5. Contrary to I&E's assertion, PPL Electric clearly prepared an analysis of its customer costs.

I&E also asserts that, in preparing its customer cost analysis, it relied upon long-standing Commission precedent to identify the appropriate items to be included in the customer charge, citing to *Pa. P.U.C. v. West Penn Power Co.*, Docket No. R-842651, 59 Pa. P.U.C. 552, 1985 Pa. PUC LEXIS 42 (Aug. 28, 1985), and *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket No. R-00049255, 237 P.U.R. 4th 419, 2004 Pa. LEXIS 40 (Dec. 22, 2004). I&E Main Brief, pp. 131, 136. This is contrary to the record. Indeed, I&E conceded that its customer cost analysis in this proceeding is the same direct customer cost analysis it used in *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc.*, Docket No. R-2010-2215623, 2011 Pa. PUC LEXIS 185, 293 P.U.R. 4th 235 (October 14, 2011). Tr. 537-39. According to I&E, the Commission in *Columbia* adopted I&E's recommendation and held that employee benefits, payroll taxes, local taxes, administrative and general costs, other O&M expenses, and subtractive and additive rate base adjustments should not be recovered in the customer charge because they are not direct customer costs. Therefore, in this proceeding, I&E excluded such costs from its customer analysis. Tr. 536-37. However, it is clear that the customer cost analysis "adopted" by the Commission in *Columbia* was limited solely to the facts of that case and was not intended to be used in other proceedings that present viable rate mechanisms. *Id.* at *80-83; Tr. 540-41. Accordingly, I&E's customer cost analysis, which is the same customer cost analysis used in the *Columbia* case, is inappropriate and must be rejected.

Similar to I&E, OCA's cost analysis excluded employee benefits, payroll taxes, local taxes, and administrative and general costs from the items proposed by PPL Electric to be recovered through the customer charge. OCA St. 3, p. 44; OCA Schedule GAW-8. The Commission has rejected I&E's and OCA's assertion that allocated indirect costs, such as employee benefits, local and payroll taxes, and other general and administrative costs, must be excluded from a customer cost study and customer charge. Indeed, the Commission concluded that requests to include indirect costs in such studies and customer charges should be reviewed on a case-by-case basis. PPL Electric Initial Brief, p. 171; *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00038805, 236 P.U.R. 4th 218, 2004 Pa. PUC LEXIS 39 at *97-98 (Aug. 5, 2004).

Both I&E and OCA acknowledge that the customer cost analysis for water, gas, and electric companies is basically the same. Tr. 514, 535. However, I&E and OCA disregard the Commission's holding in *Aqua*. Furthermore, I&E and OCA have offered no reason to exclude from the customer cost study and customer charge the indirect costs that PPL Electric allocated for employee benefits, local and payroll taxes, and other general and administrative costs. For these reasons, the proposals of I&E and OCA to exclude such customer costs from recovery through the customer charge should be rejected.

e. PPL Electric's Alternative Residential Customer Charge Proposal.

The Company recognizes that its proposal to recover the entire residential rate increase through the customer charge, while cost based, has drawn considerable criticism from a variety of parties. The Company also recognizes, as explained above, that the Commission has limited the costs that may be recovered through the customer charge. PPL Electric therefore proposed an alternative Rate Schedule RS customer charge of $14.09 per month. As explained in the

Company's Initial Brief, the revenue requirement cost components included in the calculation of this alternative customer charge are based on the same type of direct and indirect cost components approved by the Commission in *Aqua*. PPL Electric Initial Brief, pp. 170-73.

Although PPL Electric's alternative proposal was offered in rebuttal testimony, OCA offered no analysis of or objection to the Company's alternative Rate Schedule RS customer charge based on *Aqua*. Despite its statement on the record that the customer cost analysis for water and electric companies is basically the same, Tr. 535, I&E remarkably states that *Aqua* is an "outlier" for purposes of PPL Electric's current proceeding. I&E Main Brief, p. 136, n.314. However, I&E provided no analysis of the Commission's decision in *Aqua* and, moreover, provided absolutely no basis or support for its contention that it is an "outlier."

PPL Electric's alternative Rate Schedule RS customer charge reasonably relied on the Commission's decision in *Aqua*. Although PPL Electric believes that the customer component of each rate schedule should include all customer-related costs determined by the cost of service study, if the ALJ and the Commission wish to consider an alternative compromise customer charge, a charge of $14.09 would be acceptable to the Company as it would recover the same type of direct and indirect cost components as those approved in *Aqua*, and would provide some improvement in the level of fixed cost recovery in the customer charge. In that event, revenue requirements not recovered through the smaller fixed charge would be recovered through a larger usage charge. PPL Electric Initial Brief, p. 173

2. Non-Residential Customer Charges.

I&E argues that the customer charge for Rate Schedules GS-1, GS-3, LP-4, and LP-5 should not be increased. I&E Main Brief, p. 136. I&E's non-residential customer charges are based on its own direct customer cost analysis used in the *Columbia* case, which, as described above, excluded certain items proposed by PPL Electric to be recovered through the customer charge. For the reasons explained above and in the Company's Initial Brief, I&E's customer cost analysis based on *Columbia* and resulting proposed non-residential customer charges are inappropriate and should be rejected. PPL Electric Initial Brief, pp. 173-74.

The OSBA generally supports the customer charges proposed for the Small C&I customer classes, GH-2, GS-1, and GS-3. OSBA Main Brief, pp. 19-21. However, OSBA recommends that PPL Electric be directed to take steps to determine whether single-phase service GS-3 customers would pay lower rates under Rate Schedule GS-1 and, if so, contact such GS-3 customers to switch service to GS-1. OSBA Main Brief, p. 21. If PPL Electric's proposed customer charges for Rate Schedules GS-1 and GS-3 are approved, the OSBA's recommendation is acceptable to the Company.

IX. <u>MISCELLANEOUS ISSUES</u>

A. PURCHASE OF RECEIVABLES/MERCHANT FUNCTION CHARGE

As explained in PPL Electric's Initial Brief, in this proceeding the Company is proposing to update the discount rates for the Purchase of Receivables ("POR") plan and Merchant Function Charge ("MFC"). The proposed discount rate for the residential customer class is 2.23%. This discount reflects an uncollectible accounts expense percentage factor of 2.23% and a POR administrative factor of 0.00%. The proposed discount rate for the small C&I customer class is 0.23%. This discount reflects an uncollectible accounts expense percentage factor of 0.23% and a POR administrative factor of 0.00%. PPL Electric Initial Brief, pp. 183-86.

Dominion and Direct Energy oppose PPL Electric's proposed POR discount and its MFC percentages. Dominion and Direct Energy contend that the record evidence fails to support the discount percentage factor proposed for the POR discount and MFC percentages, and that the proposed increase in the discount percentage factor impedes the development of a competitive market. Dominion Main Brief, pp. 10-13; Direct Energy Main Brief, pp. 11-12.

In addition, Dominion and Direct Energy propose to use late payment charges to reduce the POR and MFC uncollectible account percentages. Dominion Main Brief, pp. 13-14; Direct Energy Main Brief, p. 24. Direct Energy also proposes to rebundle the uncollectible accounts expense presently recovered through the MFC and the POR discount into a "non-bypassable" distribution charge and, thereby, set the MFC and the POR discount to zero. Direct Energy Main Brief, pp. 16-23. Direct Energy further proposes to refund all amounts that PPL Electric has received under the "administrative" component of the POR discount percentage. Direct Energy Main Brief, pp. 28-30. Finally, Direct Energy recommends that PPL Electric's POR should be made consistent with the final determination of uncollectible accounts expense in this case. Direct Energy Main Brief, p. 32.

In its Initial Brief, PPL Electric explained its positions on the POR issues pending before the ALJ and the Commission in this proceeding. In so doing, PPL Electric anticipated and, as a practical matter, responded to many of the arguments raised by Dominion and Direct Energy in their briefs. Nevertheless, it is appropriate for PPL Electric to respond to certain contentions advanced by these parties. Before addressing the arguments raised by Dominion and Direct Energy, there are several important and preliminary points that must be remembered when considering these parties' opposition to PPL Electric's proposed POR discount and MFC percentages, as well as these parties' alternative proposals.

First, as explained in the Company's Initial Brief, the Commission cannot require PPL Electric to offer a POR program and EGSs are not required to participate in the program. *See Petition of PPL Electric Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivables Program and Merchant Function Charge*, Docket No. P-2009-2129502, 279 PUR 4th 539, 2009 Pa. PUC LEXIS 266 at *12 (Nov. 19, 2009). PPL Electric presently has a POR program that it is proposing to update in this proceeding. The Company is not proposing to change the design of the POR program; rather, it is merely updating the discount percentage factor. To the extent that Dominion or Direct Energy, or any other EGS, is dissatisfied with PPL Electric's POR program, they are not required to participate in the program. Furthermore, to the extent that the Commission adopts changes that are unacceptable to Company, the Company can terminate its voluntary POR program. Dominion and Direct Energy have taken advantage of the POR program and have not threatened to discontinue participation in the program. Clearly, the POR program has been acceptable to Dominion and Direct Energy.

Second, both Dominion and Direct Energy propose substantive changes to the current POR program that were not proposed by PPL Electric. PPL Electric's existing POR program has been approved by the Commission. Accordingly, Dominion and Direct Energy bear the burden of proof as to their respective proposals to: use late payment charges to reduce the POR and MFC uncollectible account percentages; rebundle the uncollectible accounts expense presently recovered through the MFC and the POR discount into a "non-bypassable" distribution charge; and refund all amounts that PPL Electric has received under the "administrative" component of the POR discount percentage. *See Pa. P.U.C. v. Metropolitan Edison Company, et al.*, Docket Nos. R-00061366, *et al.*, 2007 Pa. PUC LEXIS 5 at *111-12 (January 11, 2007) (a party that raises an issue that is not included in a public utility's general rate case filing bears the burden of proof); *Pa. P.U.C. v. Philadelphia Gas Works*, Docket Nos. R-00061931, *et al.*, 2007 Pa. PUC LEXIS 45 at *165-68 (September 28, 2007) (same). For the reasons explained below and in the Company's Initial Brief, Dominion and Direct Energy have failed to satisfy their respective burdens of proof.

1. The Record Evidence Supports The Proposed Discount Percentage Factor.

Dominion and Direct Energy contend that the proposed discount percentage factors for the residential and small C&I customers are not supported by the record. Dominion argues that PPL Electric has not adequately explained how it determines the proposed discount percentage factors. Dominion therefore recommends that the discount percentage factors should be based on average of the 2011 and 201212 actual write-offs, and should not include bad debt reserves. Dominion Main Brief, pp. 10-12. Direct Energy argues that the proposed discount percentage factors do not reflect the actual uncollectible costs for shopping customers. Direct Energy Main Brief, pp. 11-12. As explained below and in the Company's Initial Brief, the evidence of record supports PPL Electric's proposed discount percentage factors for its residential and small C&I POR program.

In this proceeding, the Company has explained that the budgeted uncollectible accounts expense is a forward looking number based upon future test year data for the 12 months ending December 31, 2012, which is the sum of projected write-offs and the projected change in the reserve for doubtful accounts due to increased accounts receivable that are subject to potential write-off. The Company explained that it determined its projected write-offs and projected change in reserve from the actual bad debt write-offs for the most recent three calendar years. PPL Electric St. 8, pp. 28-29; PPL Electric St. 8-R, pp. 43-44; PPL Electric St. 8-RJ (Part 1), p. 2; PPL Electric Ex. JMK-4. The Company's use of this historic data to develop the budgeted uncollectible accounts expense is reasonable and appropriate because the POR program only became effective January 1, 2010, and prior to the expiration of the generation rate caps almost all of the current shopping customers were customers of PPL Electric.

Notwithstanding, Dominion contends that the discount percentage factors should be based upon $31 million, which Dominion asserts is the average of the 2011 and 2012 actual write-offs and does not include any bad debt reserves. Dominion Main Brief, pp. 11-12. Dominion's position is based on a misinterpretation of the information set forth on page 15 of PPL Electric's annual report to the Commission for the 12 months ended December 31, 2011. According to Dominion, PPL Electric's write-offs amounted to $29 million for 2010 and $33 million for 2011. Dominion Main Brief, pp. 11-12; Dominion Ex. TJB-1. PPL Electric explained that the data contained in this report is simply a summary of the change in the level of PPL Electric's reserve for doubtful accounts between 2010 and 2011. The Company has explained that its actual write-offs, net of recoveries, for 2011 were approximately $40 million, not $33 million as asserted by Dominion. PPL Electric St. 8-R, p. 43; PPL Electric St. 8-RJ (Part 1), p. 4; PPL Electric Ex. JMK 6.

Direct Energy contends that a system-wide uncollectible accounts expense should not be applied to both shopping and non-shopping customers. Direct Energy Main Brief, pp. 11-13. In essence, Direct Energy is advocating for discount factors that reflect the actual uncollectible accounts expense experienced for shopping customers. Direct Energy even goes so far as to suggest that shopping customers are better paying customers than non-shopping customers, which Direct Energy contends would justify a lower discount rate. Direct Energy Main Brief, p. 12. Direct Energy's arguments are without merit.

Other than Direct Energy's unsupported speculation, there is no record evidence to support the conclusion that shopping customers are better paying customers than non-shopping customers. If shopping customers really are better paying customers than non-shopping customers, as Direct Energy suggests, why would EGSs bother participating in a POR program where they sell their accounts receivable at a discount to reflect collection risk that, according to Direct Energy, is non-existent. The evidence of record demonstrates that the uncollectible accounts expense has been higher for both shopping and non-shopping customers as a result of the expiration of the generation rate caps and difficult economy. Tr. 408-10. Further, Direct Energy ignores that EGSs participating in the residential POR program must agree not to reject a customer on credit-related issues, and that any customer who wishes to be served by an EGS participating in the residential POR program must be accepted by that EGS. *See Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivable Program and Merchant Function Charge*, 2009 Pa. PUC LEXIS 266 at *5 (Nov. 19, 2009).

Based on the foregoing, the evidence of record demonstrates that PPL Electric used its 2012 budget amount of uncollectible accounts expense to calculate its proposed POR discount percentages. This budgeted amount was based on historical uncollectible accounts expense data and more accurately reflects current conditions. This is consistent with traditional ratemaking principles and should be approved by the Commission.

2. The Minor Increase In The Discount Percentage Factor Will Not Impede The Development Of A Competitive Market.

Dominion and Direct Energy contend that PPL Electric's proposal to increase the discount rate would impede the development of a competitive market. Dominion and Direct Energy argue that EGSs have fixed price contracts that do not anticipate a change in the discount percentage factor. Dominion argues that any such increase in the discount factor would force EGSs to "eat the difference" until the contracts expire. Dominion Main Brief, p. 10; Direct Energy Main Brief, pp. 21-22. Direct Energy also argues that there is no viable alternative to a POR because EGSs cannot maintain their own accounts, and that a POR discount percentage factor that is too high will stall the development of a fully robust competitive retail market.

Direct Energy Main Brief, pp. 14-15. For the reasons that follow, these arguments are without merit.

PPL Electric acknowledges that the slight increase in the discount percentage factor is a minor change from the current POR program. However, EGSs could not have reasonably expected the POR program, and the discount percentage factor applied thereunder, to continue without change. There are no settlement provisions or Commission orders that obligate PPL Electric to even offer a POR program, let alone continue its current POR program without any modification. *See, generally, Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivable Program and Merchant Function Charge,* 2009 Pa. PUC LEXIS 266 (Nov. 19, 2009). Furthermore, Dominion ignores that the Commission previously approved an increase in the POR discount percentage factor in PPL Electric's most recent base rate proceeding. *See Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (Dec. 21, 2010). Dominion has failed to present any evidence that the previously approved increase in the POR discount percentage factor had any negative effect on any competition or EGSs with fixed priced contracts.

To the extent that an EGS entered into a long-term agreement with a customer on the assumption that a voluntary POR program, which has previously been changed, would continue indefinitely without any change or modification, such assumption was a business decision of the EGS to bear the risk that the voluntary POR program would not be terminated and/or be modified. This risk, which was willingly undertaken by Dominion and Direct Energy despite the voluntary nature of and prior changes to the POR program, cannot not now be used to credibly argue that the minor increase in the discount percentage factor impedes the competitive market. Further, Dominion's concerns that EGSs may "eat the difference" under their fixed price contracts if the slight increase in the POR discount percentage factors are approved is without merit and nothing more than an attempt to shift the risk of doing business as an EGS to PPL Electric and its customers.

Direct Energy argues that PPL Electric's proposed POR discount percentage factor will stall the development of a fully robust competitive retail market because EGSs cannot maintain their own accounts. Direct Energy Main Brief, pp. 14-15. Direct Energy's argument is directly contrary to the Commission's finding in PPL Electric's last rate case in which the Commission approved the request of Retail Energy Supply Association to modify the POR program to allow EGSs to maintain their own residential accounts under limited circumstances. *Pa. P.U.C. v. PPL Electric Utilities Corp.*, Docket Nos. R-2010-2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 (Dec. 21, 2010) ("we find RESA's argument with regard to the all-in/all-out POR program provision constituting a barrier to competitive markets persuasive. Therefore, we shall grant RESA's Exceptions in part on this limited issue and direct PPL to adjust its POR program tariff language to allow EGSs that are participating in its POR program under PPL's consolidated billing service to bill customers separately..."). Furthermore, PPL Electric is not proposing to eliminate the voluntary POR program. Rather, the only change the Company is proposing is to update the POR discount percentage factors to more accurately reflect current conditions, which is clearly supported by the record evidence as explained above.

Finally, it must be remembered that PPL Electric's POR program is a voluntary program and, therefore, EGSs are not required to participate. Because EGSs are functioning business entities, they can make rational financial decisions to participate or not participate in PPL Electric's POR Program. If an EGS determines that the cost of participating in PPL Electric's proposed POR Program, including the applicable POR discount, is too high and does not meet the needs of its business model, the EGS can choose to retain and manage its own accounts receivable, rather than having PPL Electric purchase those accounts receivable from the EGS. Accordingly, under the voluntary POR program, EGSs are provided with the competitive advantage of determining the extent of the generation-related uncollectible accounts expense that they are willing to bear.

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

Both Dominion and Direct Energy propose to use late payment charges to reduce the POR uncollectible account percentages. Dominion therefore contends that late payment fees generated from shopping customers should be used to offset the POR discount percentage factor that is paid by those same shopping customers. Dominion Main Brief, pp. 13-14. Direct Energy similarly contends that late payment fees paid by shopping customers should not be used to reduce PPL Electric's overall distribution revenue requirement but, instead, should be allocated to shopping customers as a credit to offset the POR discount percentage factor. Direct Energy Main Brief, pp. 24-25. In its Initial Brief, PPL Electric anticipated and, as a practical matter, responded to the proposal to use late payment charges to reduce the POR uncollectible account percentages. Nevertheless, it is appropriate for PPL Electric to respond to certain contentions advanced by Dominion and Direct Energy. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, Dominion's and Direct Energy's recommendation should be rejected.

PPL Electric has explained that late payment charges are not related to uncollectible accounts expense. Late payment charges are actually paid by customers and the revenues received from late payments are, by definition, not uncollectible. Late payment fees are treated as an addition to a utility's revenues, not as an offset or reduction to the utility's uncollectible accounts expense. PPL Electric Initial Brief, pp. 188-89.

Dominion incorrectly states that late payment fee revenues are being used to subsidize the cash working capital costs related to energy supply purchases for default service.[34] Dominion Main Brief, p. 14. Late payment charges are assessed to those customers who carry an overdue balance for any service provided by PPL Electric, not just the generation portion of the bill. Late payment charges are imposed to offset the carrying costs of those overdue accounts receivable. PPL Electric St. 8-RJ (Part 2), p. 8

The Company explained that late payment charges properly are treated as revenue credits that benefit customer rate classes that incur those charges, because the same customer classes bear the working capital requirement associated with overdue accounts receivable. The proposal to offset late payment charges against uncollectible accounts expense in the calculation of the POR discount percentages would result in double counting of late payment revenues by crediting these revenues to customers twice. Finally, if Dominion's and Direct Energy's proposal were adopted, the amount of late payment fee revenue credited against the POR discount rate must be accompanied by a corresponding adjustment to PPL Electric's base rate revenues, which will

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[34] Dominion even goes so far as to suggest that PPL Electric conceded that shopping customers are subsidizing default service customers by paying late payment fees that are treated as additional distribution revenue. Dominion Main Brief, p. 14. However, this clearly was not what was stated by the Company. Rather the portion of Mr Kleha's rejoinder testimony cited by Dominion provides as follows:

> If Mr. Cerniglia's proposal regarding late payment fees were adopted, not all late payment fee revenue should be credited against the POR discount rate. Rather, a substantial portion of late payment fee revenue is associated with default service and, as such, should not be used to reduce the POR discount rate. Moreover, if Mr. Cerniglia's proposal were adopted, the amount of late payment fee revenue credited against the POR discount rate must be accompanied by a corresponding adjustment to PPL Electric's base rate revenues, which will increase those rates for all distribution customers.

PPL Electric St. 8-RJ (Part 2), pp. 8-9.

increase those rates for all distribution customers, including shopping customers. PPL Electric Initial Brief, pp. 188-89.

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

Direct Energy recommends that the Company should eliminate the uncollectible accounts expense percentage factor from the discount rate and recover costs associated with all generation-related uncollectible accounts expense though the application of a non-bypassable charge to both shopping and non-shopping customers. Direct Energy contends that its proposal will encourage more competitors to enter the market, and that its proposal is consistent with the structure of other POR programs. Direct Energy Main Brief, pp. 17-23. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, Direct Energy's recommendation should be rejected.

As explained in PPL Electric's Initial Brief, the whole purpose of a POR program is to sell accounts receivables to a third party to take advantage of the time value of money and to receive immediate payment for the receivables less an agreed upon discount to reflect collection risk. PPL Electric Initial Brief, p. 183-84. The discount percentage factor accounts for the estimated risks associated with the collection of amounts owed by the shopping customer to the EGS. If the discount to reflect the collection risk is removed, there simply would be no point in purchasing the accounts receivable. Direct Energy seeks to shift this risk to PPL Electric and its customers by rebundling the shopping and non-shopping uncollectible accounts expenses and recovering it through a non-bypassable charge assessed to all distribution customers regardless of whether they shop. Stated otherwise, Direct Energy believes that EGSs should bear none of the risk that *their* customers will fail to pay the amounts owed to the EGSs. As explained in the Company's Initial Brief, the Commission previously has rejected such a proposal. *See Pa.*

P.U.C. v. PPL Electric Utilities Corp., Docket Nos. R-2010- 2161694, *et al.*, 2010 Pa. PUC LEXIS 2001 at *153 (Dec. 21, 2010) (concluding that the collection risk for shopping customers should remain with the EGSs).

The purpose of the Electricity Generation Customer Choice and Competition Act, 66 Pa.C.S. §§ 2801-2812 ("Competition Act") is not to promote competition by eliminating the risks of doing business as an EGSs. Rather, the purpose of the Competition Act is to benefit customers by having the costs for generation supply determined through a competitive generation market. The Commission has explained the purpose of the Competition Act as follows:

> A primary innovation mandated by the Competition Act is to provide customers with direct access to a competitive generation market. 66 Pa.C.S. § 2802(3). The reason for this change is the legislative finding that "competitive market forces are more effective than economic regulation in controlling the costs of generating electricity." 66 Pa.C.S. § 2802(5); *see, Green Mountain Energy Company, et at v. Pa. PUC*, 812 A.2d 740, 742 (Pa. Cmwlth. 2002). Accordingly, a fundamental policy underlying the Competition Act is that competition is more effective than economic regulation in controlling the costs of generating electricity. 66 Pa.C.S. § 2802(5). Another fundamental policy of the Competition Act is that electric service is an essential service and should be available to all customers "on reasonable terms and conditions." 66 Pa.C.S. § 2802(9).

Petition of Pike County Light & Power Company For Expedited Approval of its Default Service Implementation Plan, Docket No. P-00072245, 2007 Pa. PUC LEXIS 39 at *12 (August 16, 2007).

An EGS has a collection risk when it sells electricity to a wholesaler, retailer, or the end-user. EGSs incorporate the risk of incurring uncollectible accounts receivable into their pricing margins, and those margins are passed on to shopping customers through the EGSs' competitive supply offers. Direct Energy Main Brief, p. 18. The elimination of the uncollectible accounts expense from the discount percentage factor would undoubtedly be a benefit to EGSs because they could offer lower supply prices that do not reflect the costs associated with uncollectible accounts receivable. However, this would produce artificially lower prices that would not accurately reflect the actual costs associated with the competitive generation supply. In turn, EGSs that do not participate in the POR program would be at a competitive disadvantage because their competitive supply prices would be higher to reflect their costs associated with uncollectible accounts.

In order for the costs of generation supply to be accurately determined through a competitive market, the EGSs' competitive supply offers should all reflect their uncollectible accounts expenses, whether determined through the actual uncollectible accounts experienced by the EGS or through a discount percentage factor applied to the purchase of the accounts receivable. The purpose of the Competition Act is not to benefit EGSs but, rather, to benefit customers through access to a competitive market. Direct Energy's proposal is contrary to the spirit and purpose of the Act.

In support of its proposal, Direct Energy argues that its proposal avoids the potential that shopping customers are being forced to pay an excessive amount for uncollectible expense through the POR discount when the shopping customers are causing less uncollectible accounts expense. Direct Energy Main Brief, p. 18. As explained above, other than Direct Energy's unsupported speculation, there is no record evidence to support the conclusion that shopping customers are better paying customers than non-shopping customers. If they truly were, there would be no point for EGSs to participate in the POR program.

Direct Energy also asserts that its proposal to recover uncollectible accounts expense though the application of a non-bypassable charge to all distribution customers is consistent with

POR programs of other EDCs. Direct Energy Main Brief, p. 20, 22. However, as explained in PPL Electric's Initial Brief, there is no state-wide standard EDC POR program. PPL Electric Initial Brief, p. 192. Direct Energy completely disregards that each EDC is different, has different capabilities, and serves entirely different customers located in different service territories. Clearly, such differences will be reflected in any non-standard POR program, especially if the EDCs are not required to offer the program. Direct Energy's logic for why PPL Electric's POR program should be consistent with those offered by other EDCs is flawed and leads to nonsensical results. For example, under Direct Energy's theory, it could be argued that all of PPL Electric's customer assistance programs should be identical to the programs offered by other Pennsylvania EDCs simply because the Commission has approved the other EDC's customer assistance programs. However, such a result clearly would ignore the differences among the EDCs and the customers they serve, which could be a detriment to the customers served by such important programs.

Further, although the Commission approved a POR program for PECO that included the generation-related uncollectible accounts expense within PECO's distribution rates, unlike PPL Electric, PECO had not previously unbundled its generation-related uncollectible accounts expense from its distribution accounts expense. Rather, PECO proposed to continue to recover uncollectible expenses, including the expense associated with purchased EGS receivables, in its distribution rates. *Petition of PECO Energy Company for Approval of its Revised Electric Purchase of Receivables Program*, Docket No. P-2009-2143607, Slip. Op. at 37, 2010 Pa. PUC LEXIS 998 (June 18, 2010). In addition, pursuant to the settlement of PECO's POR program, all parties other than the Office of Trial Staff agreed that the issue of unbundling generation-related uncollectible accounts expense would be deferred until PECO's next Default Service proceeding. *Id.* at 40.

Direct Energy also attempts to distinguish Duquesne Light Company's use of an uncollectible accounts expense factor. However, in doing so, Direct Energy concedes that the discount factor in Duquesne Light Company's POR program also includes an uncollectible accounts expense factor. Direct Energy Main Brief, pp. 22-23. Further, Direct Energy acknowledges that the uncollectible accounts expense factor was the result of a settlement that was intended to compensate Duquesne Light Company for assuming the risk associated with EGSs' uncollectible accounts. Direct Energy Main Brief, p. 23. Notwithstanding, Direct Energy contends that the discount to offset the risk was justified for Duquesne Light Company because it reflects the actual uncollectible accounts expense for the shopping customers rather than the class average uncollectible accounts expense applied by the Company in this proceeding. Direct Energy's attempt to distinguish the Duquesne POR program on this basis should be disregarded. Throughout its brief, Direct Energy has been inconsistent on whether the discount factor should or should not reflect the actual uncollectible accounts expense for shopping customers. *See, e.g.*, Direct Energy Brief, pp. 10, 17-18. Further, as explained above, the Company's use of the actual historic uncollectible accounts expense data to determine its budgeted uncollectible accounts expense is reasonable.

Finally, it must be remembered that PPL Electric is not required to offer a POR program. *See Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivable Program and Merchant Function Charge*, 2009 Pa. PUC LEXIS 266 at *12 (Nov. 19, 2009). Direct Energy's proposal to recover uncollectible accounts expense though the application of a non-bypassable charge is not acceptable to PPL Electric and, for that reason alone, should be rejected. For the many reasons set forth in PPL Electric's Initial Brief, Direct Energy's proposal to eliminate the uncollectible accounts expense from the discount percentage factor is not acceptable to the Company and should be rejected. *See* PPL Electric Initial Brief, Section IX.A.4

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

As an alternative, Direct Energy proposes to refund all amounts that PPL Electric has received under the "administrative" component of the POR discount percentage because, according to Direct Energy, the Company has not incurred the incremental expenses that it anticipated. Direct Energy Main Brief, pp. 28-31. For the reasons explained below, as well as those more fully explained in the Company's Initial Brief, Direct Energy's recommendation should be rejected.

Direct Energy attempts to downplay the administrative costs incurred by PPL Electric in implementing its POR program by contending that the Company used existing personnel, procedures, and vendor contracts. Direct Energy Main Brief, pp. 29. However, this is not a situation where PPL Electric did not incur a projected cost. PPL Electric explained that the Company has incurred incremental expenses with its POR program, including costs related to personnel from PPL Services' Information Services and Financial departments, as well as an outside vendor. PPL Electric St. 8-RJ, p. 11; Tr. 417-21; PPL Electric Ex. JMK 8. As a result, there is no basis for Direct Energy's proposed POR administrative component refund.

Further, as explained in the Company's Initial Brief, the MFC and the POR are both Section 1308 rates and cannot be retroactively changed. PPL Electric Initial Brief, p. 193. In addition, although the Company, to date, has not performed the necessary analysis to track this cost, PPL Electric did indicate that it will be monitoring its POR Program administrative costs on a going-forward basis using the results of a formal tracking mechanism that was implemented in April 2012. PPL Electric St. 8-R, p. 47.

6. The POR Discount Factor Should Be Consistent With The Final Determination Of Uncollectible Accounts Expense.

Direct Energy contends that if the Commission adopts any of the adjustments to the uncollectible accounts expense proposed by other parties, then the MFC and POR discount percentage factors should be adjusted consistent with the uncollectible accounts expense ultimately approved by the Commission. Direct Energy Main Brief, p. 32. As explained above, the discount percentage factors are based on the budgeted uncollectible accounts expense that was determined from the from the actual bad debt write-offs for the most recent three calendar years. To the extent that adjustments are made to the Company's uncollectible accounts expense claim, PPL Electric agrees that corresponding adjustments should be made to the MFC and POR discount percentage factors.

B. PPL ELECTRIC'S COMPETITIVE ENHANCEMENT RIDER SHOULD BE APPROVED

OSBA contends that PPL Electric's proposed Competitive Enhancement Rider ("CER") should be addressed in PPL Electric's current default service proceeding, at Docket No. P-2012-2302074, where specific costs and programs that might be covered by such a rider can be evaluated more fully. OSBA's concerns, however, are misplaced. It is important for PPL Electric's proposed CER to be approved in this base rate proceeding because, if it is adopted, it will have a direct impact on the level of base rates charged by PPL Electric to customers. If the CER is approved, competitive enhancement costs, including those arising under PPL Electric's proposed ongoing consumer education plan as well as all costs that the Commission requires PPL Electric to incur in the Retail Markets Investigation, including annual mailings to customers and the preparation and mailing of a tri-fold brochure, will be recovered through the CER. If these costs are recovered through base rates, then obviously the level of base rates established in this proceeding should include a provision for recovery of these costs. If such costs are to be recovered through the proposed CER, then it would be appropriate and proper to remove these costs from base rates. Clearly, a base rate proceeding is the appropriate forum in which such adjustments to base rates can be made. OSBA's concerns are misplaced.

X. CONCLUSION

For the foregoing reasons, as well as those more fully explained in the Company's Initial Brief, PPL Electric Utilities Corporation respectfully requests that Administrative Law Judge Colwell and the Pennsylvania Public Utility Commission approve the rate increase and other proposals set forth in Supplement No. 118 to Tariff-Electric Pa. P.U.C. No. 201.

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