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

IN REPLY PLEASE
REFER TO OUR FILE

September 14, 2012

Secretary Rosemary Chiavetta
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

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

Dear Secretary Chiavetta:

Enclosed please find an original of the Bureau of Investigation and Enforcement's (I&E) **Reply Brief** in the above-captioned proceeding.

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

Sincerely,

Regina L. Matz

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

Enclosure
RLM/edc

cc: Hon. Susan D. Colwell
Certificate of Service

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY BRIEF
OF THE
BUREAU OF INVESTIGATION AND ENFORCEMENT

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Dated: September 14, 2012

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I. INTRODUCTION

A. History of the Proceeding

The history of this proceeding was addressed in I&E's Main Brief and does not need to be addressed further here.

B. Burden of Proof

I&E fully addressed the burden of proof in its Main Brief. I&E contends that with respect to both existing and proposed tariff rates and terms, the burden of proving the justness and reasonableness of those rates and terms is always on the utility.

Citing a 2007 Philadelphia Gas Works case,[1] PPL claims that "a party challenging a previously-approved tariff provision bears the burden to demonstrate that the Commission's prior approval is no longer justified."[2] PPL's claim does not speak specifically to the burden of proof with respect to existing tariff provisions, and therefore has the potential to confuse the issue. To avoid any ambiguity, I&E notes that the burden of proving the justness and reasonableness of its existing and proposed tariff provisions falls squarely on PPL in this proceeding and never shifts to a challenger.

In its order suspending PPL's filing, the Commission stated the following:

> Our investigation and analysis of PPL's proposed general rate increase and the supporting data indicate that the proposed changes in rates, rules, and regulations may be unlawful, unjust,

[1] *Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-00061931 (Order entered September 28, 2007) ("*2007 PGW*").
[2] PPL M.B. at 6.

> unreasonable, and contrary to the public interest. ***It also appears that consideration should be given to the reasonableness of the Company's existing rates, rules, and regulations.*** Therefore, based on our analysis of PPL's filing, and pursuant to 66 Pa. C.S. §1308(d), we will permit Supplement No. 118 to Tariff Electric – Pa. PUC No. 201to be suspended by operation of law for a period not to exceed seven months, or until January 1, 2013, unless permitted by Commission Order to become effective at an earlier date. In addition, *we will direct that an investigation be instituted to determine the lawfulness, justness, and reasonableness of the rates, rules, and regulations contained in the proposed Supplement No. 118,* ***as well as the Company's existing rates, rules, and regulations.***[3]

In addition, in Ordering Paragraph No. 4, the Commission again stated:

> 4. That the ***investigation*** instituted in Ordering Paragraph No. 2 of this Order ***shall include*** consideration of the lawfulness, justness, and reasonableness of the Company's ***existing rates, rules, and regulations***.[4]

In the PGW proceeding cited by PPL, the Commission noted that the "ALJs correctly determined that PGW had the burden of proof and that the *burden of persuasion* shifted to Hess once PGW had shown that the tariff provisions under challenge had the benefit of prior Commission approval."[5] I&E agrees that the burden of persuasion may shift. However, with respect to an investigation upon Commission motion into a utility's existing or proposed tariff rates and terms in a utility's general rate case filing, the burden of proof does not shift. It remains on the utility.[6]

[3] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-2012-2290597 (Suspension Order entered May 24, 2012) at 2-3 (emphasis added).
[4] *Id*. (emphasis added).
[5] *2007 PGW*, Slip Opinion at 111 (emphasis added).
[6] 66 Pa.C.S. §315.

II. SUMMARY OF ARGUMENT

PPL postures this case as a bellwether for the utility industry on a national scale. Ascribing utmost care to its development of the filing, PPL claims it abided by "fundamental ratemaking principles and established Commission precedent," which opposing parties have "simply ignored" in proposing adjustments "which violate fundamental and long-standing ratemaking principles"[7] and if adopted would "destroy [the Company's] financial integrity."[8]

This PPL rate case is not a history-making national referendum on utility regulation. It is merely the fourth in what PPL asserts will be a series of unending state biennial rate cases. Further, while I&E concedes that the parties' adjustments in this proceeding present a daunting task to the Administrative Law Judge and the Commission to discern between diametrically opposed recommendations, I&E contests PPL's self-assigned mantle of regulatory rectitude. As PPL itself acknowledges, I&E has no "ax to grind."[9] I&E comes into this proceeding with neither prejudgment nor predilection. Rather, I&E reviews the filing as presented, conducts its investigation, and recommends results based upon where the evidence and the numbers lead.

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[7] PPL M.B. at 8. As addressed further herein, I&E has presented regulatory support for each adjustment it has proposed. And while it is up to the presiding Administrative Law Judge and ultimately the Commission to review the evidence and determine the merits of each party's position, I&E submits that the exacting adherence to regulatory precedent PPL ascribes to itself is not evident in each proposal. I&E refers to the Company's claims for rate case amortization, duplicate rate case expense, projected uncollectibles, and expired capital stock tax rates as just a few examples.

[8] PPL M.B. at 8.

[9] PPL M.B. at 154.

I&E also contests the Company's minimization of the impact on customers of this proposed $104.6 million rate increase.[10] Since 2004, PPL has sought and been authorized to implement over $269 million in rate increases.[11] If this pending increase is granted, residential distribution rates will have risen by 104% since January of 2004.[12] Over this same time period, PPL has also collected from ratepayers $2.8 billion in Competitive Transition Charges as compensation for generation deregulation.[13] This notwithstanding, PPL blithely asserts that even if the full $104.6 million proposed rate increase is granted, the average residential customer's total bill will be less than it was when PPL's generation rate cap expired.[14] The portrait PPL paints misleads.

In constructing this comparison, PPL ignores the fact that customers' bills are lower today because generation rates, which comprise 2/3 of a customer's bill, have declined.[15] Moreover, customers have also paid handsomely for the education about shopping and conservation and efficiency opportunities available to them, already contributing $5.4 million annually in rates since 2008 under PPL's

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[10] PPL M.B. at 7, 17.

[11] In 2004, PPL filed for an increase of $164.4 million; the Commission allowed $154.8 million or 86% of what was filed; on remand the award was revised to $137.1 to reflect disallowance of costs related to Hurricane Isabel (*Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (Order entered December 22, 2004) ("*PPL 2004 Base Rate Case*")); in 2007 PPL filed for $83.6 million, which it revised to $76.9 million, and settled at $55 million, or 71.5% of revised claim costs (*Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00072155 (Order entered December 6, 2007) ("*PPL 2007 Base Rate Case*")); in 2010 PPL filed for $114.7 million and settled for $77.5 million, or 67.6% of its claim (*Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-2010-2161694 (Order entered December 16, 2010) ("*PPL 2010 Base Rate Case*")), or a total of $269.6 million in rate relief in 8 years.

[12] Tr. at 466-67; OCA St. 3-SR at 8.

[13] Tr. at 468.

[14] PPL M.B. at 7.

[15] Tr. at 462.

Consumer Education Program, for a total of $27 million through 2012. Yet, PPL also ignores that the 14% increase in distribution rates they propose today could easily negate these savings for which customers have already paid.[16]

In this proceeding, I&E has also raised serious issues about PPL's financial dealings with its affiliates. For 65 years PPL's ratepayers have contributed to uninterrupted dividends to shareholders of its parent, PPL Corp. In 2011 alone, with the economy in general and ratepayers in particular still struggling to recover, ratepayers ensured that PPL Corp. continued to earn 17.5% returns – the high end of the corporate parent's forecast. Over the period of time that witnessed the largest stock market crash since the Great Depression, with investor returns sinking to half their value, with families experiencing unemployment and cuts in income from which they still struggle to recover, and with PPL's ratepayers experiencing over a quarter of a billion dollars in rate increases, PPL Corp. has increased dividends in seven out of eight years and experienced dividend growth of 44% from just 2005.[17] PPL Electric portends financial disaster; evidence of the corporate family's financial health depicts otherwise.

As I&E noted in its Main Brief, 94% of PPL's proposed $104.6 million revenue increase lies in the Administrative Law Judge's and this Commission's resolution of issues that impact PPL affiliates: $73 million in claims related to PPL's proposed rate of return and $25.2 million in expense claims that directly or

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[16] Tr. at 462-66.
[17] *See* I&E M.B. at 78-79, citing several of PPL Corp.'s own reports to its investors.

indirectly benefit affiliated interests.[18] I&E has submitted evidence of the millions of dollars at stake in questionable transactions among PPL affiliates – from delays in submitting storm claims to its private affiliated offshore insurer to early payments to affiliates for services – which not only increase PPL's cost of service to ratepayers but also cast a pall over PPL's claim to regulatory excellence.

As this Commission has recognized in the past:

> We note that the Pennsylvania Supreme Court . . . clearly articulated the utility's responsibilities concerning affiliated interest transactions in the following statements:
>
> It is abundantly clear, therefore, that when [there is] an ascribed value of inter-affiliate transactions, whether as an item of fixed capital or of operating expense, section 701(c) [Section 701(c) of the Public Utility Law of May 28, 1937, P.L. 1053] imposes on the utility a two-fold burden: first, to show that the inter-affiliate transaction was reasonably necessary, and second, to demonstrate that the amounts paid or payable therefor 'are not in excess of the reasonable costs of furnishing such services.' The wisdom of imposing such an obligation on the utility is pointed out in *Solar Electric Co. v. Pennsylvania Public Utility Commission*, 137 Pa. Superior Ct. 325, 374, 9 A.2d 447, 473, where it was said: '**The desire of public utility management, evidenced by various methods, to secure the highest possible return to the ultimate owners is incompatible with the semi-public nature of the utility business, which the management directs. It therefore follows that the commission should scrutinize carefully charges by affiliates, as inflated charges to the operating company may be a means to improperly increase the allowable revenue and raise the costs to consumers of the utility service as well as an unwarranted source of profit to the ultimate holding company**.[19]

[18] *See* PPL's expense claims for storm damage ($18.6 million), payment among affiliates ($1.1 million), incentive compensation ($4.5 million), and cash working capital (CWC) for affiliate services ($1 million).
[19] *Pa. P.U.C. v. Pennsylvania-American Water Company*, 82 Pa. P.U.C. 381, 1995 WL 529581 (Pa. P.U.C.)(1994) at *8 (emphasis added).

I&E submits that PPL's $104.6 million proposed rate increase is driven more by the interests of PPL's affiliates than the interests of its ratepayers. I&E is not suggesting this Commission may exert jurisdiction over PPL's affiliates. However, I&E is clearly recommending that the regulatory balance to strike for ratepayers has to be something other than the status quo. It is appropriate in this proceeding for Your Honor and the Commission to relieve PPL's ratepayers from the responsibility of being the primary source of stability and security to the PPL corporate family.

PPL has failed to adduce substantial credible evidence demonstrating a need for a $104.6 million revenue increase. Instead, I&E submits that its adjustments support a revenue decrease of $8.9 million. These adjustments are summarized in Tables I (Income Summary) and II (Summary of I&E Adjustments), appended to I&E's Main Brief, and the replacement Table III (Rate of Return), attached hereto as Appendix "A," reflecting the adjustment to PPL's debt as more fully described in PPL's Petition to Reopen the Record filed on August 30, 2012.

III. RATE BASE

A. Fair Value

I&E had no fair value adjustment to rate base and therefore has no reply.

B. Plant in Service

I&E had no plant in service adjustment to rate base and therefore has no reply.

C. Depreciation Reserve

I&E had no plant in service adjustment to rate base and therefore has no reply.

D. Additions to Rate Base – Cash Working Capital

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

E. Deductions from Rate Base – Cash Working Capital

PPL's total CWC claim comprises four active components: Operation and Maintenance (O&M) expense, average prepayments, accrued taxes, and interest payments. In adjustments, I&E focused on two of the four active CWC components: the O&M expense and the average prepayment.

1. CWC O&M Expense

I&E witness Morrissey disputed the Company's calculation of 21.5 days as the average lag between its payment of O&M expenses and its receipt of revenues. Ms. Morrissey recommended an average expense payment lag of 47.5 days, which resulted in 9.6 days (57.1 – 47.5) as the average lag in days between PPL's payment of O&M expenses and its receipt of revenue. This recommendation resulted in a jurisdictional CWC – O&M Expense allowance of $10,504,000 which was a $13,021,000 ($23,525,000 - $10,504,000) reduction to the Company's CWC claim to rate base.[20]

I&E's recommended reduction to the Company's CWC claim for O&M expenses was based upon the conclusion that the Company paid its affiliate for services rendered well in advance of when payment was required. This unnecessary early payment contributed to a substantially shorter expense payment lag that resulted in an unnecessary ratepayer CWC contribution of $1 million.

PPL contends it treats its affiliated payments the same as unaffiliated payments; it should not discriminate against its affiliates; a 30 day payment lag is "commercially reasonable and typical;" and it has consistently incorporated a 35-day lag for affiliate payment. Finally, PPL quibbles over semantics, arguing that the affiliated payment is due **"within"** 60 days, which is not the same as due in 60 days.[21]

If PPL can save ratepayers $1 million per year simply by paying its affiliate in the time period allowed under the affiliated interest agreement, it should be required to do so. A million here, a million there may not seem like much to PPL. But that $1 million, along with the remaining $103.6 million, is coming out of

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[20] I&E St. 2 at 56.
[21] PPL M.B. at 25.

ratepayer pockets. PPL should not be allowed the luxury of indifference over how it pays its affiliate when merely paying within an allowable time frame can save $1 million annually.

I&E's recommendation to adjust the CWC expense lag value for payments to affiliates reflects the allowable payment deadline for services rendered by the affiliate. PPL's payment for services to affiliates should be controlled by PPL's service agreement with its affiliate, PPL Services Corporation, which allows PPL up to 60 days to pay, or an allowable payment lag of 75 days. PPL's choice to ignore this Commission-approved agreement and pay its affiliate when it pays other unaffiliated vendors may be convenient, commercially reasonable, and typical in the unregulated private sector. However, PPL is a regulated monopoly with both affiliated transactions and ratepayers. The former should not benefit at the expense of the latter. This is particularly true since PPL provided no evidence its early payment of for affiliate services offers any savings or advantage to the regulated utility. Further there is no discrimination involved in paying vendors pursuant to applicable contract terms. PPL has a different time frame available for payment to its affiliate. If PPL does not feel obliged to save ratepayers money when it can, it should be compelled to do so by the Commission.

Finally, PPL's contention that it has consistently incorporated a 35-day affiliate payment lag in all prior rate cases is not supported by the evidence. PPL witness Johnson expressly denied familiarity with all prior cases and expressed no more than passing familiarity with the Commission's "black box resolution" of the 2010 base rate case, the only case for which PPL provided any evidence of its prior CWC calculation for affiliated interests.[22] Nevertheless, the fact that it was not raised previously does not preclude its being raised now. No prior litigated case addressed CWC generally or this O&M expense lag specifically. No applicable Commission order provided the Company any imprimatur of Commission approval. Even if it did, PPL's existing rates and tariff terms are subject to review in this investigation. PPL's unnecessarily early payment to its affiliate is imprudent. I&E's adjustment is appropriate and should be adopted.[23]

2. CWC – Prepayments

I&E witness Morrissey recommended removal of the Company's claimed PUC Assessments as a prepayment included in PPL's CWC claim, resulting in a reduction of $2,780,000 to the Company's working capital prepayment claim. The basis for I&E witness Morrissey's adjustment was that the PUC Assessment is not a prepayment. Prepayments are payments for and in advance of the receipt of actual goods or services rendered. While assessed on the prior year's revenues, the assessment is not a prepayment in advance of the next year's services. Unlike a prepayment that may be refunded if the services are no longer required, the PUC Assessment is not subject to refund. Rather, more like a tax, the assessment is

[22] *Compare* Tr. at 177-78 and PPL Ex. BLJ-2 (one page from the 2010 proceeding).
[23] I&E M.B. at 9-14.

calculated on the prior year's revenues, but is paid to support the regulatory agencies' fiscal year operations.

PPL opposes I&E's adjustment on two bases. First, citing *1995 NFGDC*,[24] PPL states that "[f]or many years, public utilities have included commission assessments as prepayments in their working capital" and "[d]espite decades of practice," I&E proposes disallowance because the assessment is not a prepayment.[25] Second, PPL quotes language from the Commission's invoice asking for a "pre-payment."[26]

PPL's reliance on *1995 NFGDC* is overstated. The case does not stand for the proposition that the PUC Assessment is properly treated for ratemaking purposes as a prepayment because that was not at issue in the case.[27] The case stands only as one example of one utility at one point in time including the PUC Assessments as a prepayment for CWC purposes. Absent Commission discussion, analysis, and conclusion regarding the treatment of PUC Assessment in that case, it has no value and the issue remains appropriately presented for analysis and conclusion here.

PPL's second assertion of support, the PUC's use of the word "prepayment" in the June assessment letter itself, takes the word out of context.

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[24] *Pa. P.U.C. v. National Fuel Gas Distribution Corporation,* 84 Pa. P.U.C. 134, 1995 WL 933720 (Pa. P.U.C.) ("*1995 NFGDC*").
[25] PPL M.B. at 28-29.
[26] PPL M.B. at 29, citing PPL Ex. BLJ-1.
[27] *1995 NFGDC*, 1995 WL 933720 ** 8 ("While Mr. Springirth criticizes NFGD's payment of AGA dues, no other party has raised any issue with regard to these prepayments.")

Actual assessments are made in August of a fiscal year for the funding of the regulatory expenses of the PUC, OCA, and OSBA during that fiscal year. By statute, the assessment is based upon the utilities' prior calendar year revenues, which are required to be reported by March of the following calendar year.[28]

However, the agencies obviously require funding at the beginning of the fiscal year in order to be able to operate continuously. Therefore, the Commission issues letters in June prior to the beginning of the fiscal year, an example being the one provided in PPL Ex. BLJ-1, in which it "provid[es] a preliminary ***early assessment*** to select jurisdictional utilities in order to accommodate the Commission's need for funds to cover expenses for the first quarter of the fiscal year[.]"[29] It asks these select utilities, PPL being one, to submit early payment of that fiscal year's assessment based on the preliminary early assessment so that the regulatory agencies actually have a flow of funds at the beginning of the fiscal year. What the early assessment letter refers to as a "prepayment" is no more than that "early payment" to assure continuous funding. The assessment letter then notes that the utility will receive the traditional August invoice which will reflect any remaining balance or credit of its annual assessment.

For ratemaking purposes, the assessment is more akin to a tax and, accordingly, should be treated as an expense with an associated lag. The Commission's use of the word "prepayment" in the assessment letter reflects only

[28] 66 Pa. C.S. §510(b).
[29] PPL Ex. BLJ-1 (emphasis added).

an early payment to assure continuous operations of the PUC, OCA, and OSBA. It is not determinative of the status of that payment for the purposes of the appropriate calculation of PPL's CWC requirements. I&E adjustment should be accepted.[30]

3. Miscellaneous CWC Comments - postage

I&E observed that PPL includes its expenses for postage in two components of the Company's CWC calculation, as both an O&M expense and a prepayment. I&E contended that a proper CWC calculation allocates an item to one of the four identified CWC components. Including the same expenditure as both an O&M expense and a prepayment, as PPL does, overstates that expenditure for CWC purposes. In other words, it essentially provides PPL not only a CWC expense recognizing the revenue/expense lag but also a return on the postage meter. I&E proposed no adjustment, but requested that the Company be directed to properly address its postage expense in future filings.[31]

The Company claims I&E misunderstands PPL's treatment of its postage expense. The Company asserts that postage is reflected in both O&M and prepayments because each component addresses postage expense during two separate periods of time. To substantiate its claim, PPL explains how it, "like

[30] I&E M.B. at 15-16.
[31] I&E M.B. at 17-18.

many corporations that make large mailings, uses a postage meter system to pay postage."[32]

I&E appreciates PPL's explanation of the operations of its postage meter and wishes to assure PPL that it does, in fact, understand how a postage meter works. I&E is fairly confident, however, that PPL incurs an expense for that postage only once. It does not pay the USPS when it loads the meter and again when it dispenses postage from the meter. PPL has to choose how it wishes to account for postage in its CWC calculation, as a prepayment, acknowledging its expense upfront when it loads the meter (and pays the USPS), or as an expense, with it actually dispenses postage (but doesn't again pay the USPS). How PPL chooses to reflect the functions of the postage meter on its balance sheet is not relevant to PPL's calculation of its rate case CWC claim. Including the same CWC need for postage in both the O&M expense component and the prepayment component of the CWC calculation improperly inflates PPL's CWC calculation and should be discontinued going forward.[33]

IV. REVENUES

A. Miscellaneous Revenues

This issue is resolved.[34]

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[32] PPL M.B. at 26-27.
[33] I&E M.B. at 17-18.
[34] I&E M.B. at 18-19.

V. EXPENSES

A utility is entitled to recover all of its reasonably incurred expenses.[35] 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.[36] To the extent that expenses are not incurred, imprudently incurred, or abnormally overstated during the test year, they should be disallowed and found not recoverable through rates. The public utility requesting a rate increase has the burden of showing that the rate requested is just and reasonable.[37]

A. Uncollectibles Expense

I&E recommended an uncollectible expense allowance of $1,779,000, which represents a reduction of $554,000 from the Company's claim. This recommendation was based upon I&E's calculation of an uncollectible expense rate of 1.70% using the Company's most recently experienced multi-year actual residential write-off amounts compared to its recent historic billed revenues. I&E witness Morrissey confirmed the reasonableness of her adjustment by comparisons to both the 3-year and 5-year historic averages for the Company, which yielded a similar result. Ms. Morrissey also recommended use of the 1.70% uncollectible expense factor to compute the Company's Purchase of Receivables (POR) program discount rate and the associated Merchant Function Charge (MFC).

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[35] *UGI Corp. v. Pa. P.U.C.*, 410 A.2d 923, 932 (Pa. Cmwlth. 1980).

[36] *Western Pennsylvania Water Company v. Pa. P.U.C.*, 422 A.2d 906 (Pa. Cmwlth. 1980).

[37] 66 Pa.C.S. § 315(a); *See also Cup v. Pa. P.U.C.*, 556 A.2d 470 (Pa. Cmwlth. 1989).

PPL rejects I&E's adjustment on the bases that it does not include an amount for reserves and the historic calculation based upon what PPL claims is a "simple three-year average" is not representative of the future.[38] PPL has apparently backed off its claim that actual costs have not been used for ratemaking purposes "for at least 35 years."[39]

PPL's contention that I&E's recommendation is incomplete because it does not provide a reserve for "doubtful" accounts[40] lacks any legal basis. Hypothetical uncollectibles that may be incurred are not properly included in the ratemaking equation. "[T]he Commission has no authority to permit, in the rate-making process, the inclusion of hypothetical expenses not actually incurred."[41]

PPL's contention that I&E's recommendation is not representative of the future because it is based on historic data, including periods when PPL's rates were capped, ignores the facts underlying Ms. Morrissey's multi-year calculation. Ms. Morrissey's five-year calculation included four years of recession and two years post-rate cap. At no time in any of those years did the Company's actual uncollectible percentage approach its present claim of 2.23%. Ms. Morrissey's 1.7% uncollectibles rate was confirmed by a three-year, a five-year, and even a recent two-year calculation. Further, Ms. Morrissey's use of a three-year average is condoned by the Company's own practices in this case, since the Company uses

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[38] PPL M.B. at 72-73.
[39] PPL St. 8-RJ (part 1) at 4.
[40] PPL M.B. at 72.
[41] *Barasch v. Pa. P.U.C.*, 493 A.2d 653, 655 (Pa. 1985).

a "simple three-year average" in computing its consolidated federal income tax claim,[42] as well as the Company's use of a five-year average in both its 1985[43] and 2010 rate cases.[44]

I&E's adjustment is appropriate and should be adopted.[45]

B. Rate Case Expense

I&E witness Morrissey recommended an allowance of $775,000 for rate case expense, or a reduction of $932,000 from the Company's claim. Ms. Morrissey's recommendation was the result of two adjustments: correction to the Company's proposed normalization period to reflect PPL's historical filing record and rejection of the Company's inclusion of an amortized claim for its 2010 base rate filing.

The Company has accepted I&E's amortization adjustment.[46] In addition to the proper allocation of the $1.2 million related to the Company's Rate Case Expense, which I&E addresses below in Section V.D., the issue remaining is the appropriate period over which PPL's rate case expense should be normalized.

The only reason posed by PPL for normalizing its rate case expense over a two-year period is "the pressure that PPL Electric's capital spending program will

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[42] *See e.g.* PPL's use of a three-year average for computation of its consolidated tax savings. PPL M.B. at 131.

[43] *Pa. P.U.C. v. Pennsylvania Power & Light Company*, 67 P.U.R. 4th 30, 59 Pa. P.U.C. 332 (1985) (accepting the Company's claim for uncollectible accounts expense based on a five-year average of the relationship between revenue and accounts receivable and a five-year average of the relationship between accounts receivable and write-offs).

[44] *PPL 2010 Base Rate Case*, Slip Opinion at 27. *See also Pa. P.U.C. v. Consumers Pennsylvania Water Company – Roaring Creek Division*, 182 P.U.R. 4th 237, 1997 WL 839792 (Pa.P.U.C.) ("*Consumers Pa Water*") (adopting the OCA's proposed five-year average of net write-offs to revenues).

[45] I&E M.B. at 20-23.

[46] I&E M.B. at 27.

place on earnings."[47] Although PPL acknowledges the statutory DSIC mechanism, designed specifically to ameliorate the effects of the distribution system improvement expenses, PPL describes that as "little comfort" and concludes "[i]t is difficult to see how such a significant increase in rate base and plant in service would not drive a rate case during 2014 or before."[48]

PPL provides no factual basis to support a two-year normalization period. That period is based purely on PPL's current thoughts of when it may have to file another rate case. As Commonwealth Court recognized, a normalization proposal based on a utility's intent to file future base rate cases disregards well-established ratemaking principles. "The period of normalization is determined by examining the utility's actual historical rate filings, not upon the utility's intentions."[49]

PPL's claimed two year normalization period would result in an unreasonable expense. I&E's recommended disallowance of $258,000 to the Company's current base rate case should be adopted.

C. Incentive Compensation

I&E witness Morrissey recommended an equal sharing of PPL's claimed FTY incentive compensation expense of $8.918 million between shareholders and

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[47] PPL M.B. at 76.
[48] PPL M.B. at 76.
[49] *Popowsky v. Pa. P.U.C.* 674 A.2d 1149, 1154 (1996); *accord Pa. P.U.C. v. Borough of Quakertown*, Docket No. R-2011-2251181 (Order entered September 13, 2012) (adopting the ALJ's determination that the period of rate case normalization is determined by examining the utility's actual history of rate filings, not the utility's intentions); *Pa. P.U.C.* v. *City of Lancaster- Bureau of Water,* Docket No. R-2010-2179103 (Order entered July 14, 2011); *Pa. P.U.C. v. City of Lancaster – Sewer Fund,* Docket No. R-00049862 (Order entered August 26, 2005) (rejecting the Company's claimed 18-month normalization period based on its expectations and approving a normalization period determined by examining the utility's history of actual rate filings and not the utility's intentions).

ratepayers, resulting in a jurisdictional allowance of $4.459 million and a reduction of an equal $4.459 million from the Company's claim. The basis for I&E's adjustment was the fact that the expense was incurred to achieve not only operational targets for the rate-regulated entity, but also to enhance financial performance of the corporate family, including attaining general goals of stock earnings per share ("EPS") performance and other financial objectives. Further, PPL declined to identify the specific targeted incentive parameters that were assumed in developing its historic test year (HTY) and future test year (FTY) claims by the Company to its affiliate PPL Services. Because I&E recognized that the incentive compensation was designed to benefit both ratepayers and shareholders, and because the Company failed to provide I&E sufficient information to determine a more precise allocation, I&E proposed an equal sharing of this expense.

PPL opposes I&E's adjustment on the basis that incentive compensation packages are a normal practice for employers generally and that PPL's incentive compensation package is "market-driven, reasonable, and appropriate."[50] PPL also relies heavily on a prior case involving its then-affiliate, PPL Gas Utilities Corporation (*PPL Gas*)[51] and the Commonwealth Court decision in *Butler Township Water Co. v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984) ("*Butler*")

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[50] PPL M.B. at 34.

[51] *Pa. P.U.C. v. PPL Gas Utilities Corporation*, Docket No. R-00061398 (Order entered February 8, 2007) ("*PPL Gas*").

for the proposition that it is legally "entitled" to recover all costs of its corporate incentive compensation package fully from PPL ratepayers.[52]

PPL enjoys no "entitlement" to recovery of an expense. As a generally accepted ratemaking principle, "utilities are permitted to set rates which will recover those operating expenses reasonably necessary to provide service to customers, while earning a fair rate of return on the investment in plant used and useful in providing adequate utility service[.]"[53] The public utility has the burden of proving that the expense is reasonable and necessary to the provision of utility service.

As part of its burden, and because the Commission's determination regarding PPL's ability to recover this expense is fact-specific, PPL must provide substantial evidence of the specific parameters of its incentive compensation package. It is also because the issue requires a fact-specific analysis of the relative costs and benefits of the compensation that *Butler*, which addressed rate case expense, is inapposite[54] and PPL's compliance with cases in which the expense was approved cannot be determined.

For example, in *PPL Gas*, the Commission allowed PPL's then-affiliate recovery of expenses related to PPL Gas' variable pay expense claim. However, as

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[52] PPL M.B. at 38.

[53] *Western Pennsylvania Water Company v. Pa. P.U.C.*, 422 A.2d 906, 908 (Pa. Cmwlth. 1980).

[54] While relied on prominently by PPL in its Main Brief, *Butler* is inapposite because it addressed rate case expense. As the Commission recognized in *PPL Gas*, "we do not agree with the Company that the adjustment urged by the OTS [regarding variable pay] would be prohibited as a matter of law under *Butler*[.]" *PPL Gas*, Slip Opinion at 40.

the Commission stated, "several considerations lead us to this conclusion."[55] Notably among those considerations was the Commission's ability to scrutinize the underlying specifics of the claim. For example, the Commission reviewed the percentage of the claim related to net income versus operational and safety goals (30% vs. 70%), the percentage of base pay to variable pay (90% vs. 10%), the program's availability among employees, and the relativity of the performance of another affiliate. On this same basis, the underlying specifics of the program, the Commission distinguished another case in which it had *disallowed* the claim, disproving a legal entitlement to recovery. In that case,[56] a factor persuading the Commission to disallow the expense was that "the bonus program was tied largely to income and earnings targets for the parent company, which were unrelated to improvements in service to ratepayers."[57]

PPL provided insufficient evidence that incurrence of this expense is necessary for the provision of safe and reliable service at just and reasonable rates and that the allocation of 100% of the expense to ratepayers is appropriate. There is no doubt that PPL's program encourages enhancements to both shareholder and ratepayer interests. As PPL witness Cunningham acknowledged repeatedly in her rebuttal testimony[58] and as PPL agrees in brief, "the incentive compensation

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[55] *PPL Gas*, Slip Opinion at 40.
[56] *Pa. P.U.C. v. Roaring Creek Water Co.,* 81 Pa. P.U.C. 285 (1994).
[57] *PPL Gas*, Slip Opinion at 40. *See also Consumers Pa Water*, 1997 WL 839792 at 15 (approving the Company's executive compensation expense because the Commission "was satisfied that the main focus of the Company's management bonus plan has been the improvement of operational effectiveness and that the Company has met its burden of proof in this regard.")
[58] *See* I&E M.B. at 29-30.

benefits ratepayers and shareholders" permitting "organizational success" and allowing employees to understand "organizational results in a tangible way."[59]

This is not a small expense item. Ms. Morrissey sought detail from the Company to allow her to make an appropriate fact-specific recommendation to the Commission on the basis of past precedent. However, as Ms. Morrissey noted:

> Ms. Cunningham does not disclose the target goals or the calculations that result in the Company's total $8,918,000 Incentive Compensation claim. . . . The Company's continued lack of transparency in its rebuttal, by not disclosing the underlying specifics to support its calculated claim, affirms the validity of my recommendation. . . . The Company's omission of detailed calculations and assumed goals that produce the claimed Incentive Compensation Expense denies the Commission the ability to scrutinize the plan's prudence and priorities as they affect ratepayers. For instance, it is not uncommon that shareholder value must first be achieved before any incentive payout occurs and that the level of shareholder value achieved drives the payout factor. However, the Company has failed to produce details of and support for its claimed calculations, not just in its direct case in support of its claim, but also in rebuttal after the issue was directly raised. Only through such detailed support can the Commission appropriately weight each goal and assign its respective monetary value between ratepayers and shareholders.[60]

Ms. Morrissey sought to do no more, and no less, than the type of analysis the Commission employed in the past in determining whether to allow or reject the expense claim. However, the Company's failure to disclose the underlying specifics to support its claim left I&E no ability to analyze the claim and propose any adjustment short of "all or nothing." Recognizing some ratepayer value to the

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[59] PPL M.B. at 35.
[60] I&E St. 2-SR at 10-11.

expense, Ms. Morrissey did not recommend outright rejection. Rather, Ms. Morrissey concluded that a 50/50 sharing of this expense between PPL Electric's ratepayers and the remainder of the PPL corporate family for which the cost is incurred to increase shareowner value was reasonable under the limited facts available for scrutiny.

PPL chose what facts it would and would not reveal to support its claim. PPL continues to argue before the Commission that "the detailed analysis desired by I&E is not necessary."[61] As a direct consequence, I&E contends that PPL has not met its burden of proving that an $8.9 million expense is reasonable and necessary for the provision of regulated utility service. Based, *inter alia*, upon the goal of achieving "best-in-the-sector returns to shareholders," I&E contends that the interests of the entire PPL corporate family are included in the cost of PPL's incentive compensation, a factor that requires at least some allocation of the cost outside the rate-regulated entity. In choosing not to provide more information, PPL allowed its sense of entitlement to cloud its judgment. As another claim impacting affiliated interests at the expense of the rate-regulated ratepayers, I&E contends that its proposal to reduce PPL's $8.9 million incentive compensation expense by $4.459 million is appropriate and should be adopted.[62]

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[61] PPL M.B. at 40, note 6.
[62] I&E M.B. at 28-31.

D. Affiliate Support

1. Introduction

I&E recommended adjustments for the direct affiliate support costs related to Environmental Management, External Affairs, and the Office of General Counsel (OGC) as well as for the indirect affiliate support costs identified as "Office of Chairman."

2. Direct – Environmental Management

I&E proposed a $103,000 reduction to the Company's claim for environmental management expenses essentially on the basis that the Company's claim was unsubstantiated. Citing new environmental rules, PPL argues that its historic level of costs should be ignored because in the coming years PPL will be "required to undertake greater levels of environmental management activities."[63] PPL further cites to increased construction levels, which it maintains will "carr[y] with it an increased need for environmental management services" and contends that its admittedly one-time costs will be replaced by other incremental costs.[64]

I&E witness Morrissey's recommendation was calculated using the Company-reported jurisdictional historical expense for the prior three years. It included the expected future test year expense claim in order to recognize the estimated EMS implementation costs. With respect to one-time costs being

[63] PPL M.B. at 41.
[64] PPL M.B. at 42-43.

replaced by other costs as in the years following the FTY as PPL claims, Ms. Morrissey's calculation provides for a level of expense to cover that.

More importantly, despite PPL's claims before the rate regulator that its environmental compliance costs will increase, PPL has contended otherwise in its reports to investors. There, PPL has more forthrightly described the current environmental landscape more favorably, reporting no environmental downside for its distribution systems, and noting in particular "[n]o significant exposure to currently proposed environmental regulations" which are a driver of "significant upside" for its generation fleet.[65]

I&E's proposed $103,000 reduction to the Company's claim for environmental management is justified on this record and should be adopted. As Ms. Morrissey observed, PPL witness Cunningham failed to substantiate how new environmental regulations may impact PPL's distribution system. This failure, I&E submits, is fully explained by PPL's parent's own investor reports which indicate that environmental compliance going forward is not a concern for the distribution company. I&E's proposed expense reduction is appropriate and should be adopted.[66]

3. Direct – External Affairs

External Affairs provides, in part, for the coordination of government relations activities, corporate communications such as media and public relations

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[65] I&E Cross-Examination Ex. 6 at 3.
[66] I&E M.B. at 32-34.

services, as well as community and economic development activities. I&E originally proposed a disallowance of $1.170 million. Upon review of PPL witness Cunningham's explanation for the 81% increase in the portion of this expense allocated to PPL Electric, however, I&E witness Morrissey revised her recommendation to reduce the O&M External Affairs cost by $620,000. Ms. Morrissey rejected the Company's allocation as proposed because it still represented an almost 50% Company's increase in the allocation to PPL Electric.

PPL claimed that as a result of a review of the day-to-day activities of its Regional Community Relations Directors, who are part of the External Affairs Department, it was determined that some activities are specifically undertaken for PPL Electric. These activities include actions regarding reliability, connections, disconnections, billing, street lighting and economic development, line upgrading, tree trimming, and storm communication protocols. Therefore, according to PPL, from 2012 forward the costs of those activities will be allocated exclusively to PPL Electric.

I&E contends that PPL's reallocation shifts an inordinate proportion of these costs to the rate-regulated entity without express consideration of the broader nature of the function of the External Affairs' department. For example, while Regional Community Relations Directors may become involved in billing and connections, that should be the exception not the norm as the Company has other divisions outside External Affairs specifically designed to address such functions on a daily basis.

On the other hand, there is very little nexus, if any, between to community development activities and the safe and reliable provision of distribution service and the Company provided no evidence of any such nexus. At a minimum, PPL's efforts with respect to community development enhance the corporate brand at least as much as they affect the provision of electric distribution service.

PPL, however, failed to recognize these differences, and instead allocated all the identified activities to the rate-regulated ratepayers. While I&E conceded to an increase in the allocation, it opposes an almost 50% increase in that allocation to PPL Electric because PPL's analysis fails to recognize any benefits to the whole corporate entity from those activities.[67]

The results of PPL's reallocation also defied reasonable explanation. PPL contended that the reason for the increase in direct expense for External Affairs was a re-evaluation of this expense and a reallocation of more of this department's cost as direct expenses rather than as pooled indirect expenses. PPL also stated that the total department costs were changing very little. Therefore it stood to reason that if more department costs were characterized as direct expenses, then remaining costs characterized as indirect should be less. However, the indirect

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[67] *See Pa. P.U.C. v. Consumers Pennsylvania Water Company – Roaring Creek Division*, Docket No. R-00973869 (Order entered October 14, 1997) (expenses from advertising, lobbying, and marketing activities associated with enhancing the parent company's corporate image or not being directly beneficial to customers disallowed).

costs claimed by PPL did not decrease, but rather increased as well. Combining both the indirect and direct External Affairs costs assigned to PPL showed a significant increase of External Affairs department costs funneled into PPL. I&E contends PPL's allocation is unsubstantiated and that I&E's recommendation should be adopted.[68]

4. Direct – Facilities Management

This issue is resolved.[69]

5. Direct – Office of General Counsel

I&E witness Morrissey recommended a ratemaking allowance of $4.833 million for Office of General Counsel (OGC) expense, which was a $1.2 million reduction to the Company's claim. The basis for Ms. Morrissey's adjustment was to eliminate the additional expense associated with outside counsel for this proceeding since the Company also included a claim for rate case expense in its pro forma adjustment. Although PPL witness Kleha agreed with I&E's $1.2 million adjustment, he reflected the adjustment as a reduction to the Company's rate case expense rather than as a disallowance of the allocation of the affiliate support related to OGC services.

PPL continues to oppose reflection of this reduction to its affiliate's allocation of Office of General Counsel expense rather than as a reduction to the rate-regulated entity's direct rate case expense. PPL contends it is more

[68] I&E M.B. at 34-37.
[69] I&E M.B. at 38.

appropriate to reduce the rate case expense because the expense will be incurred by the OGC and then charged to PPL Electric.[70]

I&E contends that PPL's refusal is yet more evidence of PPL's greater interest in benefitting the PPL corporate family rather than providing regulated utility service at just and reasonable rates. PPL does not file a base rate case every year. Since 2004, cases have been filed on average every 32 months. Before that it was 19 years between rate cases. By keeping the expense as a part of PPL Electric's affiliate support allocation, the Company maintains an artificially inflated OGC affiliate expense level.

In other words, if allowed to remain as part of the affiliate expense determination rather than be included as a direct rate case expense, the level of affiliate allocation will be inflated by the inclusion of an expense that is only incurred on a sporadic basis. This will both overstate the level of OGC affiliate support dedicated to the provision of electric distribution service in years when there is no rate case, but also become embedded in future affiliated expense determinations.

In order to protect ratepayers against inflated affiliate allocations, PPL's accepted reduction of $1.2 million to account for the expense of this rate case should be removed from its Affiliate Support (Direct) – Office of General Counsel

[70] PPL M.B. at 47.

expense claim and used to reduce the Company's rate case expense where it directly belongs.[71]

6. Indirect – Office of Chairman

I&E witness Morrissey recommended a ratemaking allowance of $623,000 for Indirect - Office of Chairman, equivalent to the historic test year expense level, which is a $387,000 reduction to the Company's claim. I&E's recommendation was based on three factors: (1) recognition of the Company's historical experience, which was declining; (2) acknowledgement of PPL's revisions of indirect support costs to better match the benefits provided to respective affiliates; and (3) the "three-factor approach," which justified a larger allocation of the Office of Chairman expense to PPL Electric.

PPL's adjustment focuses on the latter two factors, but ignores the first, which also used the "three-factor approach." That approach indicated declining allocation of costs. Since no other indirect expense allocations have increased to the same extent claimed by PPL Electric for Office of Chairman indirect expense allocation, a 62% increase over the HTY, exceeding even the 2009 cost prior to the inclusion of the three new affiliates, is not substantiated. I&E's adjustment is appropriate and should be adopted.[72]

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[71] I&E M.B. at 38-40.
[72] I&E M.B. at 40-42.

E. Storm Costs and Recovery

In this proceeding, PPL included a future test year claim based on estimated 2012 storm expenses and a 5-year amortized expense claim pursuant to petitions for deferred accounting approved by the Commission. Both claims were affected by PPL's storm risk management strategy of procuring insurance through its affiliate PPL Power Insurance, Ltd.

Following exhaustive review of the Company's practices over the approximate five years in which this storm risk management strategy had been in effect, I&E witness Morrissey recommended that prospectively PPL be required to discontinue this strategy of insuring with an affiliate, and instead use a storm reserve account for accrual of budgeted storm amounts to be offset by experienced storm costs or to employ a storm rider. I&E contended that this prospective change in strategy would allow PPL to recover storm damage expenses without involving questionable affiliate transactions that gave the Company a "heads I win, tails you lose" advantage. I&E also recommended rejection of the Company's 2011 and 2012 claims for storm damage expenses on the basis that the Company's budgeted amounts under its storm risk management strategy were already sufficient to cover experienced storm expenses.

PPL opposes I&E's proposed adjustment. PPL claims that "I&E's proposal is entirely premised on a fundamental factual error, reflects a misunderstanding of the purpose of insurance, [and] is completely unprecedented[.]"[73] PPL then describes its understanding of I&E's adjustment. PPL claims I&E "double counts" the insurance deductible and imposes "inappropriate 20/20 hindsight" because the Commission approved PPL's storm insurance in the Company's 2007 rate case. PPL also asserts that I&E claimed the premiums have been too high because PPL Insurance has been profitable, has not saved ratepayers money, and has not benefitted ratepayers because they bear the time value of money until claims are paid.[74] PPL's judgment about the value of its insurance strategy is clouded by the financial dealings of its affiliate. I&E's proposal ensures PPL's financial stability with respect to recovery of storm damage expenses while removing the conflict presented by its affiliate's interests.

I&E responds fully to each of PPL's assertions below. In sum, in evaluating PPL's insurance budget, I&E did not double count the insurance deductible. I&E relied solely on figures provided by PPL, which figures did not reconcile with PPL's own claims until the Company presented an incredible interpretation at the 11th hour. PPL's claim that I&E inappropriately used "20/20 hindsight" in making its recommendation has no merit. The Commission is always free to revisit any determination upon presentation of new evidence and apply a new determination prospectively. I&E never claimed that PPL's premiums are too high, that the insurance is imprudent because insureds have not saved money, or that ratepayers

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[73] PPL M.B. at 50.
[74] PPL M.B. at 51-52.

lose because of the time value of money. Rather, the crux of I&E's adjustment is two-fold based upon review of PPL's budgets over a five-year period: (1) while it is clear there is little to no ratepayer value in the strategy of purchasing storm insurance, the impartiality of this strategy vis-à-vis PPL's affiliate is anything but clear; and (2) the Company's claims for extraordinary expense recovery is unnecessary.

1. PPL's Normal Storm Expense Budget Already Adequately Covers PPL's 2011 and 2012 Claims for Storm Damage Expense

PPL claims that in conducting its analysis of PPL's storm damage budget, I&E included "a double counting of the insurance deductible."[75] PPL correctly notes I&E's position that the 2012 policy deductible of $15,750,000 mathematically could not be included in the normal storm damage budget of $12,625,000.[76]

To conduct its analysis, I&E requested PPL to provide "the annual amount budgeted in O&M expenses for storm damage repair and storm insurance deductibles for each year, 2008 through 2012."[77] After I&E witness Morrissey presented her adjustment based upon I&E's calculation of PPL's storm damage O&M budget using PPL's own data, PPL witness Banzhoff provided rebuttal

[75] PPL M.B. at 51.
[76] PPL M.B. at 54. PPL also contends that I&E contended there were differences between claims paid and insurance reimbursement totals. While I&E did make this observation, it was related to I&E's attempts to conduct a cost/benefit analysis of PPL's strategy of purchasing insurance from an affiliate, and had nothing to do with I&E's calculation of PPL's normal storm expense budget. I&E St. 2-SR at 30.
[77] I&E Ex. 2, Sch. 24 (PPL response to I&E-RE-108).

testimony asserting that I&E double counted the deductible. As support, he also provided a revised budget, but did so only for calendar years 2008 through 2011, and excluded data for calendar year 2012.

As I&E witness Morrissey noted in surrebuttal, however, Mr. Banzhoff's numbers were mathematically impossible, because the amount of the 2012 deductible, $15,750,000, exceeded the $12,625,000 budgeted in O&M for 2012 for normal storm repair. As I&E demonstrated in its Main Brief, it was only hours before Mr. Banzhoff was to be cross-examined that an explanation for this mathematical impossibility was provided: "Historically storm costs are charged 60% to expense and 40% to capital."[78] However, while PPL characterizes this allocation as "historic," in reality Mr. Banzhoff acknowledged that this allocation was conducted for the first time in 2012.

I&E maintains that the explanation PPL offered was simply not credible. An allocation is not "historic" if it is presented for the first time in the Company's future test year. Yet PPL witness Banzhoff casually presented the allocation as one that had been historically performed, clearly leading a fact-finder to believe it was a previously conducted and documented allocation. In fact, it was only through cross-examination that Mr. Banzhoff conceded that this "historic" adjustment was conducted for the first time in 2012. PPL's explanation not only made no sense mathematically, it was conveyed unconvincingly.

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[78] I&E M.B. at 58; *See also* PPL St. 2-RJ at 5.

Moreover, in brief the Company itself seems far from convinced that the 60/40 allocation will even be done in 2012. PPL states "the normal insurance budget does include an amount equal to the portion of the deductible *expected to be expensed*."[79] PPL also states "[t]he amount for reportable storms is based on the operating expense portion (60%) of the $15,750,000 deductible under the 2012 storm insurance policy. *It is expected* that the other 40 percent of the deducible will be capitalized."[80]

Even putting aside the questionable "historic 60/40 allocation," if, for the sake of argument, I&E were to accept as true PPL's explanation that the deductible is included in the Company's normal budgeted O&M expense, the data presented still paints a puzzling picture. In response to I&E's request for the annual amount budgeted in O&M expenses for storm damage repair and storm insurance deductibles for 2008 through 2012, PPL provided the following:

PPL Electric Utilities Corporation
Storm Damage O&M Budget
(Thousands of Dollars)

	2008	**2009**	**2010**	**2011**	**2012**
O&M expenses for storm damage repair	$8,743	$8,161	$9,847	$11,057	$12,625
Storm Insurance Deductibles	$7,500	$7,500	$7,500	$ 7,500	$ 9,450

Source: I&E Ex. 2, Sch. 24, PPL Response to I&E-RE-108.

Using this same PPL table as a starting point, I&E "corrected" for the "double-count" of the deductible by considering it a part of the budgeted amount

[79] PPL M.B. at 54 (emphasis added).
[80] PPL M.B. at 49, note 8 (emphasis added).

represented in the line identified as O&M expenses. Then to provide the full picture since the commencement of PPL's insurance strategy in 2007, I&E added data for the year 2007. What results in the line at the bottom of the table is the amount above the deductible that PPL included in its O&M budget for non-reportable storm damage:

	2007	2008	2009	2010	2011	2012
O&M expenses for storm damage repair	$7,500	$8,743	$8,161	$9,847	$11,057	$12,625
Storm Insurance Deductibles	$7,500*	$7,500	$7,500	$7,500	$ 7,500	$ 9,450
Budget for non-reportable storm damage	$0	$1,243	$ 661	$2,347	$ 3,557	$ 3,175

*I&E Ex. 2, Sch. 39

Again, PPL's numbers make no sense. If PPL includes the deductible within its budget for reportable storms, then for the year 2007 it had no budget for non-reportable storms and for the years 2008-2012, its budget was all over the map, from a low of $661,000 in 2009 to almost four times that amount the following year, and almost six times that amount in 2011, only to drop back down again in 2012 (a decrease which is itself curious because 2011 was an active storm year).

To sum, excluding the deductible is mathematically impossible unless the deductible is historically allocated, for the first time, maybe, in the 2012 future test year. Yet, including the deductible leaves PPL with a non-reportable storm budget that ranges from $0 to $3.6 million over the course of 6 years. For the years in between, budgeted numbers presumably discerned with some factual basis fluctuate randomly without rhyme or reason. Plus, with the exception of the year 2011, the years 2007 and 2008 were the Company's highest storm cost years,[81] yet the Company inexplicably decreased its non-reportable storm allowance from $1.243 million in 2008 to $661,000 in 2009.[82] Again, PPL's explanation made no sense mathematically and was conveyed unconvincingly.

PPL's own data as originally presented proves that PPL already budgets for a normal level of storm damage expense sufficient to recover its 2011 and 2012 storm damage expenses. PPL's amortized claim for recovery of 2011 expenses, which are not extraordinary under PPL's budget, and PPL's future test year claim for storm damage expense both should be denied. I&E's adjustment is appropriate and should be adopted.[83]

2. PPL's Strategy of Purchasing Storm Insurance from its Affiliate has not Proven to be a Prudent Expense and Presents Too Great a Conflict between Corporate Family and Ratepayer Interests – It Should be Discontinued

PPL contests I&E's conclusion that its strategy of purchasing storm damage expense from its affiliate has not proven to be prudent and should be discontinued. Calling it a "20/20 hindsight analysis," PPL contends that it would be improper, presumably on grounds of retroactive ratemaking, for the Commission to compel PPL to discontinue the strategy because it was approved by the Commission in

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[81] *See* I&E Ex. 2, Schs. 25 and 26.
[82] *See* I&E Ex. 2, Sch. 25 (PPL response to I&E-RE-32-D for data for the years 2008-2011); I&E Ex. 2, Sch. 26 (PPL response to I&E-RE-120, for data for the year 2007).
[83] I&E M.B. at 55-60.

2007.[84] PPL also disputes I&E's conclusion that the purchase of insurance from an affiliate has little ratepayer value but considerable affiliate opportunity notwithstanding the undisputed facts that (1) the purchase of insurance that has a premium cost of almost 50% of the benefit provided; (2) the ratepayer premium dollars flow directly to PPL's affiliate; and (3) PPL Electric allows its affiliate to hold on to those premium dollars with no payment for eligible claims for well over 12 to 18 months after claims could and should be presented for payment.[85]

As noted above, PPL's "20/20 hindsight" argument is misplaced, inflamed by regulatory buzz-words designed to get attention but deserving none. Since I&E's proposal is prospective, there is no improper or retroactive "hindsight" analysis. The recommendation is based upon I&E's review of actual experience under the insurance strategy, experience that I&E concludes definitively proves the imprudence of pursuing storm damage insurance from an affiliate as a risk management strategy.

I&E's adjustment as proposed was not based upon the "profitability" of PPL's affiliate, PPL Power Insurance, Ltd. PPL witness Novatnack first introduced the issue of PPL Power Insurance, Ltd.'s profitability in his assertion that the premium for PPL Power Insurance is calculated to equal expected losses over time, with no allowance for profits.[86] In response, however, PPL witness Morrissey ultimately concluded that in fact based upon review of the affiliate

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[84] PPL M.B. at 55-57.
[85] PPL M.B. at 57-60.
[86] PPL St. 14-R at 3.

financial statements, the best that could be ascertained on this record is that PPL has recorded contingent liabilities that, at least for 2011, encompass the entire policy limits.[87] While PPL asserts for the first time in brief that "it is certain that the [2011] policy limit will be paid,"[88] there is no such certainty in the evidence of record. As PPL acknowledges, the contingent jury verdict is on appeal;[89] and the workers compensation claims are not final.[90] Moreover, Ms. Morrissey's evaluation and conclusion considered all applicable years, not just 2011.[91]

I&E did not contend in testimony that the purpose of insurance was to save insureds money. In fact, as was the issue of PPL's affiliate's profitability, the notion that "the principal purpose of insurance is not to save money for the insureds" was first raised by PPL witness Novatnack.[92] As I&E noted, however, since the expenses to ratepayers from this risk management policy flow as revenues exclusively to a PPL affiliate, any protest that insurance should not be viewed as at least being economically prudent to insureds should be critically and skeptically reviewed.[93]

Finally, much the same way PPL witness Banzhoff's explanation of PPL's budgeted normal storm damage expenses made no sense mathematically and was conveyed unconvincingly, PPL's response to I&E's conclusion that PPL was

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[87] I&E M.B. at 51-52.
[88] PPL M.B. at 58.
[89] PPL M.B. at 58.
[90] I&E M.B. at 51.
[91] I&E M.B. at 51.
[92] PPL St. 14-R at 6.
[93] I&E M.B. at 53.

unnecessarily dilatory in presentation of eligible claims to its affiliate likewise makes no sense mathematically and was conveyed unconvincingly. PPL witness Novatnack insisted throughout the proceeding that PPL was **required** under its policy with its affiliate to present only one aggregated claim under the policy.[94] Only when I&E obtained actual copies of the policies through discovery and provided direct evidence of Mr. Novatnack's misstatement,[95] however, did Mr. Novatnack finally admit that it was solely PPL Electric's *practice* to withhold claims, and not PPL Power Insurance, Ltd.'s requirement.

In response to I&E's conclusion that PPL's actual budgeted storm damage O&M expenses render PPL's claimed extraordinary experience ordinary and the recommendation that PPL develop a storm reserve or storm damage rider, PPL contends that I&E lacks support for this recommendation[96] which is unprecedented and contrary to 40 years of Commission precedent.[97] However, I&E's recommendation that PPL be denied its amortized claim with respect to 2011 damage expenses and its claim for a 2012 damage and instead establish a storm reserve account or rider is not without academic or industry support.

As I&E witness Morrissey explained, a 2005 report by the Edison Electric Institute (EEI) concluded that commercial storm insurance has become

[94] I&E M.B. at 45, citing PPL St. 14-R at 7.
[95] I&E St. 2-SR at 25.
[96] PPL M.B. at 60-62.
[97] PPL M.B. at 68-69.

prohibitively expensive or wholly unavailable.[98] Because the costs of repair can be substantial to both utilities and the affected communities, however, a reliable but cost-effective means of expense recovery must be available. One such means is a storm expense reserve.[99]

PPL witness Novatnack dismissed the EEI report. In his opinion, the report was specific to Florida and Florida Power & Light Co. (FPL), and as Mr. Novatnack noted, "FPL is not PPL Electric; Florida is not Pennsylvania; and 1993 is not 2012."[100] As Ms. Morrissey noted, however, this 2005 report examined restoration cost data for 81 major storms including both hurricanes and ice/winter storms, from 14 utility respondents, between 1994 and 2004 with the goal of looking beyond Florida and to the broader electric industry.[101] Either a storm reserve or a storm damage rider (as originally proposed by PPL itself in 2007) are both viable prospects for this Commission to consider in lieu of continuing the ineffective and imprudent strategy of purchasing expensive insurance through an affiliate.

As I&E witness Morrissey effectively summarized:

> In the PPL insurance scenario, *PPL is the consumer, but it is the ratepayers who are funding the premium payment*. Accordingly, *the normal evaluation and perception of insurance benefit and expense prudency is obscured by the insured's business relationship with the insurance company and with the ability to fund the insurance purchase on a 100% basis from its ratepayers through*

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[98] I&E St. 2 at 33-34.
[99] I&E Ex. 2-SR, Sch. 5.
[100] PPL St. 14-R at 5.
[101] I&E St. 2-SR at 32-35; I&E Ex. 2-SR, Sch. 5.

> *their regulated rates*. Given the data that has accumulated since PPL's implementation of this risk management strategy, the cost has been demonstrated not to be worth the benefit from the perspective of PPL's ratepayers, the party ultimately responsible for paying for the insurance. The strategy should be discontinued.[102]

Two undisputed ratemaking principles support I&E's recommendation: PPL Electric should be following the most cost-effective means of protecting itself against storm losses; affiliated transactions should be beyond reproach. PPL's strategy adheres to neither.

All things considered, I&E maintains that PPL's risk management strategy of purchasing storm damage insurance from an offshore affiliate has been proven to be not economically prudent as a ratepayer expense nor sufficiently transparent as an affiliated transaction for this Commission to continue to sanction that strategy. I&E's recommendation is appropriate and should be approved.[103]

F. Consumer Education Plan

PPL's Consumer Education Programs (CEP) were implemented to educate consumers about competitive markets and shopping and how to reduce their electric bill through efficient energy practices. The Consumer Education Programs were approved for five years – 2008 through 2012.

I&E recommended that PPL's request to continue the $5.4 million annual expense associated with the CEP beyond 2012 be rejected. The portion subject to I&E's recommended disallowance related only to the Company's proposal to

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[102] I&E St. No. 2-SR at 36 (emphasis added).
[103] I&E M.B. at 55-60.

continue the existing 5-year CEP beyond its currently scheduled 2012 expiration date. I&E did not oppose recovery of PPL's proposed $1,650,000 RMI costs and the $844,000 related to Eligible Customer List (ECL) mailings.

The basis for I&E witness Morrissey's recommendation was that the two segments of education that the CEP were originally designed in 2007 to address – shopping and energy efficiency – are more effectively addressed going forward by PPL's more recent Act 129 Energy Efficiency and Conservation (EE&C) Plan and the RMI mandates, the former being already separately funded through PPL Act 129 (ACR) Rider and the latter proposed to be funded through the CER in this proceeding.

PPL opposes I&E's adjustment. PPL contends that the CEP complements the EE&C Plan and the RMI mandates.[104] PPL maintains this posture even though it concedes that the CEP educates consumers on "shopping for electricity [and] the importance of energy efficiency and conservation,"[105] the same goals of the Commission's RMI investigation and PPL's newer Act 129 EE&C Plan. PPL contends that the CEP is purely educational while the Act 120 Plan is purely financial.[106] PPL also contends that there is an "ongoing opportunity to increase the percentage of customers who take competitive supply,"[107] despite its recognition

[104] PPL M.B. at 81.
[105] PPL M.B. at 82.
[106] PPL M.B. at 82.
[107] PPL M.B. at 83.

that that is precisely the purpose of activities mandated under the RMI investigation.

While the specific activities and specific programs may differ, the goals under all these programs are the same: education customers about shopping and efficiency and provide financial incentives to modify behavior. PPL's distinction that the CEP educates while the Act 129 Plan financially incentivizes is incorrect. While the Company's Act 129 Plan does provide financial incentives for energy efficiency, it also contains explicit educational components providing education about free or very low cost measures to reduce energy use as well as education about online resources and EE&C programs.[108] Since the newer Act 129 Plan both educates and provides financial incentives, the 5-year plan and its substantial $5.4 million in annual ratepayer costs should be allowed to lapse naturally. Further, with respect to educating consumers about shopping, there is virtually no difference in the goals of the CEP and the RMI mandates. Under both programs consumers are educated on generation shopping.

It is neither reasonable nor cost-effective to require ratepayers to support duplicate goals at the cost of an additional $5.4 million in rates annually to continue the 5-year CEP when newer programs under Act 129 and the Commission's RMI investigation have evolved to fund and accomplish the same goals. While there is an on-going need to educate consumers about shopping and

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

efficiency, that need is being met by newer programs. As was the case with the Commission's disallowance of PPL's proposed Community Betterment Initiative (CBI) in its 2004 rate case, PPL provided no "concrete record evidence quantifying how" the CEP will benefit ratepayers in ways the Act 129 and RMI programs will not.[109] Continuation of the CEP is not necessary to achieve the same educational and financial goals associated with shopping and efficiency that are now established under the Act 129 EE&C and RMI programs.

PPL cannot continue to view its captive rate-regulated customer base as the source of unlimited funding. If PPL wishes to continue its initial programs it should be on a voluntary basis with funding through voluntary shareholder, customer, or supplier contributions as the Commission encouraged with respect to the CBI. I&E's adjustment is appropriate and should be adopted.[110]

G. Customer Assistance Programs

Community on Economic Opportunity (CEO) requested an increase in LIURP funding of $1.5 million annually. CEO cited to a 44% increase in potentially eligible low-income customers in PPL's territory for the period 2000 to 2008 and asserted that funding under PPL's Operation Help runs out before the end of the quarter.[111] CEO also notes that it is a subcontractor for PPL's WRAP program.[112]

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[109] *PPL 2004 Base Rate Case*, Slip Opinion at 47.
[110] I&E M.B. at 60-66.
[111] CEO M.B. at 5.
[112] CEO M.B. at 2.

I&E witness Gordon opposed CEO's request for increased funding. When comparing the growth in universal service benefits and funding over the same time period as CEO compared the growth in PPL's potential low income population, I&E concluded that PPL's ratepayers had already incurred a disproportionate burden in funding low-income programs. From 2000 to 2010, PPL's ratepayer funding for its OnTrack (customer assistance) program grew from $9.5 million to $41.2 million, an increase of over 400%. From 2000 to 2008, the same time period used by CEO to measure the growth in PPL's low income population, PPL's ratepayer funding of its weatherization funding increased from $5.7 million to $8 million, a 40.35% increase.

Exponential growth in those programs aside, I&E noted that CEO also excluded any consideration of ratepayer funding under PPL's Act 129 WRAP program, which provides additional assistance to low-income ratepayers. Further, while Operation Help funds run out before the end of every quarter, CEO disregarded the fact that additional funding is made available at the beginning of every new quarter. While at $1.5 million annually Operation Help funding is not insubstantial, it is just a small fraction of the total $75.3 million in mandatory ratepayer funding of universal service programs already embedded in rates.[113] Finally, CEO also failed to address Ms. Gordon's observations that factors other than funding also affect both a community's need and the Company's ability to

[113] I&E Cross-Examination Ex. 12, lns 5 and 11, col. 6.

deliver services. Simply mandating more ratepayer funding will not necessarily result in greater energy savings by the low-income population.

The Commission has exceeded its requirements under the Electricity Generation Customer Choice and Competition Act[114] to provide protections, policies, and services that assist low income customers. I&E submits that PPL's ratepayers are more than contributing sufficiently towards relief for their low-income neighbors. Ratepayers have been subjected to substantial increases in their mandatory funding of PPL's "family of universal service programs," rising from $31.8 million to $75.3 million from 2008 through 2012, an amount PPL projects will increase further to $78 million by 2014. This represents a 145% increase from 2008 through 2014 alone,[115] on top of the increases described above imposed since 2000. PPL's ratepayers should not be required to provide an additional $1.5 million in LIURP funding. I&E's position should be adopted.[116]

VI. TAXES

A. Gross Receipts Tax

The Pennsylvania gross receipts tax (GRT) is a tax imposed on EDCs' receipts from sales and distribution of electricity at a total tax rate of 59 mills (i.e. the equivalent of a 5.9% tax rate). The Company's total claim for GRT is $50,102,000, which comprises a pro forma GRT claim of $43,930,000 and an

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[114] 66 Pa. C.S. §§2801-2815 ("Electric Competition Act").
[115] I&E Cross-Examination Ex. 12, ln 17.
[116] I&E M.B. at 66-68.

increase to its GRT claim of $6,172,000 related to its proposed rate increase. The Company's claim is based upon its estimated total billed base rate revenues subject to this tax.

I&E witness Morrissey recommended a total GRT allowance of $49,168,000. This represented a $934,000 reduction to the Company's total claim. The recommended allowance comprised a recommended pro forma allowance of $43,100,000 and a rate increase allowance of $6,068,000 (assuming a full rate increase). The respective recommended GRT adjustments were reductions of $830,000 to the pro forma claim and $104,000 to the rate increase claim. The basis for Ms. Morrissey's recommendation was that the Company's tax liability for the GRT was limited to actual received revenues, and therefore the GRT tax allowance in rates should be calculated using the net revenues collected by the Company

PPL opposes I&E's proposed adjustment. PPL claims that a July 2011 Department of Revenue (DOR) Corporate Tax Bulletin does not limit taxes to actual revenues received but instead is based on accrual accounting. PPL further contends that it is unable to track unpaid customer balances by tax period without implementing "significant and costly system changes."[117]

The DOR bulletin is in evidence as I&E Ex. 2-SR, Sch.1. The DOR bulletin does not mandate that PPL follow an accrual method of accounting. The DOR

[117] PPL M.B. at 134.

bulletin sets out various scenarios. While one of those may result in PPL following an accrual method of accounting, PPL is not specific and several options are provided. Even under an accrual methodology, however, PPL will deduct from its accrued billed revenues accounts actually written off. In other words, PPL will not pay taxes on written off, uncollected revenues. If PPL does not pay taxes on uncollected revenues, it is improper to build into rates, as PPL proposes, an expense to cover taxes it will not pay.

PPL contends that it will not be able to comport with "onerous documentation requirements" to support a deduction to taxable revenues resulting from bad debt without "significant and costly system changes" due to "complexities" and "significant testing and corrective actions" to resolve "potential 'glitches.'"[118] But this is pure conjecture. There is no evidence of glitches, just speculative "potential" glitches. There is no evidence of documentation requirements, only PPL's characterization of them as "onerous." There is no evidence of the costs of required system changes, only PPL's unsubstantiated claims they will be "significant and costly." In the end, and again without evidence, PPL concludes that "based on the volume of customer accounts written off by PPL Electric each year, the resources that would be required to perform the matching of write-offs to tax periods would not be cost effective."[119]

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[118] PPL M.B. at 134.
[119] PPL M.B. at 134.

PPL will not pay taxes on uncollected billed revenues. If it does, it is a gratuity to the Commonwealth of Pennsylvania that should not come at PPL's ratepayers' expense. Until such time that PPL can provide evidence that it pays taxes on uncollected revenues and that the cost of avoiding such tax actually exceeds its cost of avoidance, I&E's recommendation is appropriate. I&E's recommendation produces a better match of the claimed actual receipts of revenue that will produce the Company's actual GRT tax liability and should be accepted.[120]

B. PA Capital Stock Tax

I&E witness Morrissey proposed a Capital Stock Tax allowance of $873,000, which was a $1,225,000 reduction to the Company's claim. Ms. Morrissey's adjustment was based on the undisputed fact that the current tax rate of 1.89 mils or 0.1.89% will be cut in half, to 0.89 mills or 0.089%, effective January 1, 2013, the same date PPL's proposed rates will become effective.

PPL opposes I&E's adjustment solely based on its position that the effective mechanism to deal with the known and measurable tax change is the Company's State Tax Adjustment Surcharge (STAS) clause in its tariff and, as PPL states, "it is unnecessary to reach beyond the end of the future test year."[121]

As a known and measurable change to become effective the same date as PPL's proposed new rates (if any), there is no improper "reaching beyond the end

[120] I&E M.B. at 68-71.
[121] PPL M.B. at 135.

of the future test year." The reason this adjustment is necessary is to avoid having ratepayers pay a tax rate that all affected parties, including the Public Utility Commission which sets PPL's rates, know will be reduced by 50% the same day any new rates take effect. I&E certainly considers saving ratepayers avoidable utility payments a necessary reason to adopt I&E's adjustment. STAS exists to address tax changes outside a base rate case. It does not exist to avoid known and measurable tax changes within a base rate case. When a base rate case is pending the same time a known and measurable tax change will take effect, there is simply no reason not to design rates with the new tax rate. Certainly if the tax rate were increasing PPL would be more concerned with its timely receipt of money. Ratepayers should be shown that same consideration as well.

The recommendation will not only result in STAS being set to zero when rates go into effect, but also aid in maintaining STAS to stay at or near zero for the entire year in accordance with the requirements of 52 Pa. Code § 69.52. It also comports with adjustments made or agreed to in PPL's 2004 and 2007 base rate cases. I&E's adjustment is appropriate and should be adopted.[122]

C. Consolidated Tax Savings

I&E witness Morrissey recommended applying the computed Consolidated Tax Savings that is applicable to PPL's use of a consolidated tax return among its corporate entities to the Company's FTY, resulting in a tax savings of $210,000.

[122] I&E M.B. at 71-73.

I&E proposed this adjustment because the Company has claimed a positive, normalized federal income tax expense for ratemaking purposes and this claimed positive expense is available and should be reduced by the Company's allocated share of these consolidated tax savings. This recommendation passes on to ratepayers the tax savings that result from filing a consolidated tax return.[123]

PPL opposes I&E's adjustment. The Company claims that PPL is in a current tax loss position, and that any calculated income tax savings must be calculated at present rates only. PPL describes I&E's proposed adjustment as "an attempt to reach improperly beyond the end of the future test year"[124] and that according to *Barasch*,[125] I&E's adjustment must be rejected as based on a hypothetical level of taxable income that PPL Electric will not experience.[126] PPL also claims that "the Commission has established guidelines for the calculation of tax benefits derived from participation by a public utility in a consolidated federal income tax return."[127]

I&E's proposed consolidated tax savings adjustment is appropriate and neither violates *Barasch* nor the uncited Commission guidelines.[128] The Company's proposed $104.6 million rate increase is not hypothetical. The

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[123] I&E St. 2 at 51-52.
[124] PPL M.B. at 132.
[125] *Barasch v. Pa. P.U.C.*, 493 A.2d 653 (Pa. 1985) ("*Barasch*").
[126] PPL M.B. at 133.
[127] PPL M.B. at 131.
[128] PPL witness Kleha first referred to "Commission established guidelines" in his Rebuttal Testimony at pp. 34-35. PPL refers to the same "Commission established guidelines" in its Main Brief at 131-32. Nowhere, however, does Mr. Kleha or PPL provide a formal citation to support its own attribution of "Commission established" to the proffered guidelines.

Company's FTY claimed positive *normalized* federal tax position is not hypothetical. The Company's claimed recovery of federal income taxes for ratemaking purposes is not hypothetical. It is not hypothetical that if the Commission grants PPL no rate relief as I&E recommends, no consolidated tax savings adjustment should be applied. Conversely, it is not hypothetical that if the Commission grants a rate increase in any amount at or above $1 million, based upon the Company's filing and known and measureable tax rates, it would be in a positive tax position sufficient to apply the entire computed jurisdictional consolidated tax savings of $210,000.

Despite PPL's argument that its pro forma test year show a negative federal tax position at present rates, which results primarily from bonus depreciation,[129] PPL is requesting to set rates to include recovery of a federal tax expense. Therefore, application of consolidated tax savings is appropriate in order to flow these tax savings through to ratepayers when determining the proper level of rates prospectively. If the Company benefits from the grant of a rate increase, the resulting positive tax position should be offset by a consolidated tax savings (not to exceed $210,000) in order to pass the tax savings benefit to ratepayers by reducing the resultant amount of federal taxes claimed for recovery. I&E's proposed adjustment is appropriate and should be adopted.[130]

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[129] PPL M.B. at 132.
[130] I&E M.B. at 73-75.

VII. RATE OF RETURN

A. Introduction

On the issue of an appropriate rate of return, PPL attempts to transform this proceeding from a case-specific filing to a history-making referendum. The Commission's action, PPL warns, will either be disastrous to or supportive of the utility industry in general:

> PPL Electric's rate proceeding will be the first litigated rate case for a major utility decided by the Commission in the recovery following the Great Recession. It, therefore, will be viewed by investors as a bellwether of the Commission's views and intentions with regard to infrastructure replacement in Pennsylvania. The Commission's decisions in this case are critical to all Pennsylvania utilities and their customers.[131]
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> * * *
>
> In the end, investors want to see that utilities in Pennsylvania operate in a supportive and constructive regulatory environment.[132]

PPL is not satisfied simply with a dire warning to the Commission that any equity decision on this specific factual record that is not to PPL's satisfaction will signal to all investors that Pennsylvania is a hostile regulatory environment. To support its implicit threat, PPL relies on the most irrelevant information. Citing a schedule of "154 data points," PPL concludes that I&E's equity recommendation in this proceeding is wholly untenable because:

> the 8.38% ROE proposed by I&E is lower than any ROE granted by any regulatory body for a public company during the period

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[131] PPL M.B. at 87.
[132] PPL M.B. at 88-89.

> examined by Ms. Cannell (January 1, 2009 - June 30, 2012), a period that includes a portion of the recession.[133]

That data, however, lacks any context. Even the PPL witness supporting this schedule identified it as nothing more than "recent nationwide trends."[134] Never has this Commission or any serious expert relied on "nationwide trends" as evidentiary support for a company-specific equity return. As I&E witness Sears characterized these "data points":

> [C]ommensurate with the risks, there are other jurisdictions which have not deregulated generation which could increase the risk of the utility as a whole. There's different geographic areas listed in here. They go back to 2009. So comparing [I&E's] return on equity stated today to other returns on equity from other cases in other jurisdictions with other information in them, it's not an even comparison.[135]

This case is not a state- or nationwide investigation designed to give substantive consideration to national returns that completely lack factual context and legal relevance. It is not even a state bellwether. I&E submits that this is no more than the fourth of a regular drum beat of PPL base rate cases, occurring historically on average every 32 months, having already secured for PPL over a quarter of a billion dollars in rate relief from 2004 through 2010, and projected by PPL to continue at a regular pace well into the future.

The Commission must be guided by one standard in this proceeding: the evidence of record. Through its dramatization of the import of the Commission's

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[133] PPL M.B. at 87.
[134] PPL St. 12-R at 4.
[135] Tr. at 361.

action in this one proceeding, however, PPL overshadows that appropriate standard for review. Rate of return is a fact-specific determination. Substantive findings must be based upon the case-specific evidentiary record developed in this proceeding. And, this evidence must be substantial, relevant, and material to PPL in this jurisdiction. In other words, this case is a bellwether for PPL – no more – and must establish an appropriate rate of return for PPL today based upon the evidence available today. PPL's conjecture that today's interest rates may already be deemed "historic" because the economy is already "in the *recovery following* the Great Recession"[136] presumes a fact that the evidence of record does not support.

I&E has no "ax to grind."[137] Its evidence is objectively presented. Ms. Sears evaluated the data available and provided an objective result neither designed to ignore the reality of today's investment market nor based on the premise that double-digit utility returns will be perfunctorily delivered by this Commission. Though the equity market for utilities has changed, PPL witness Moul admits he consistently recommends ROEs of 11% to 12%,[138] as if stuck in a time-warp when 11% to 12% returns were the norm, if not downright insufficient.[139]

Today, reconcilable riders predominate, utility revenues are very stable, and the opportunity to earn a return is more assured. PPL has identified no less than

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[136] PPL M.B. at 87.
[137] PPL M.B. at 154.
[138] Tr.at 237-39.
[139] *See* Tr. at 222-23 and discussion of 1994 article relied on by Mr. Moul complaining at that time that 11%-12% returns derived from recognized regulatory financial methodologies were inadequate.

five new riders (excluding the STAS), that encompass nearly 50% of revenues and costs that, absent the rider, would be included in base rates. Some of these riders even provide the Company interest at attractive rates.[140] And in this proceeding, PPL has not only proposed a sixth new rider (the CER, with interest[141]) that would remove even more revenues and expenses from the uncertainty of recovery, but also requested unprecedented increases to its customer charges, all designed to secure even more certainty to its revenue recovery.

Yet, in continuing his consistent calculation of his 11% to 12% returns today, Mr. Moul has no idea how many riders PPL has implemented,[142] appears to have given no consideration to the Company's proposed rate design, and all but dismisses the DSIC and fully forecasted future test year legislation recently enacted. Mr. Moul's recommendations are remnants of a different era and should be relegated to ratemaking history. On this record, and in today's market, I&E submits that its recommended 8.38% return on equity and 6.84% overall rate of return is most supported.

The time has come for PPL's ratepayers to be relieved from the responsibility of being the primary source of "stability and security to PPL Corp.'s

[140] I&E Cross-Examination Ex. 11; *See e.g.* PPL's USR and GSC riders, PPL Ex. DAK-1 at Tenth Revised Page No. 18 (USR) ("Interest on overcollections and undercollections shall be computed monthly at the appropriate rate, as provided for in Section 1308(d) of the Public Utility Code[.]"), PPL Ex. DAK-1 at Ninth Revised Page No. 19Z.5 (GSC-1) ("Interest on recoveries of under collections shall be calculated at the legal rate of interest.").
[141] PPL Ex. DAK-1 at Original Page No. 19A.15 ("Interest on overcollections and undercollections shall be computed monthly at the appropriate rate, as provided for in Section 1308(d) of the Public Utility Code[.]").
[142] Tr. at 227.

earnings forecasts and its dividends." For 65 years PPL's ratepayers have ensured uninterrupted dividends to PPL Corp.'s shareholders. In 2011 alone, with the economy in general and ratepayers in particular still struggling to recover, ratepayers ensured that PPL Corp. continued to earn 17.5% returns – the high end of the corporate parent's forecast. Over the period of time that witnessed the largest stock market crash since the Great Depression with investor returns sinking to half their value and families experiencing unemployment and cuts in income from which they still struggle to recover, PPL's ratepayers served up over $269 million in increased ratepayer revenues, supporting PPL Corp.'s increase to dividends in seven out of eight years in this same time frame with dividend growth of 44% from just 2005.[143]

I&E submits that Ms. Sears' analysis most substantively comports with not only Commission precedent but also market and industry reality. Most assuredly, if I&E is wrong, PPL will have another opportunity to prove higher returns are necessary in the next base rate case it is already planning. The data then will either confirm PPL's allegations that I&E's recommendation is an outlier or, as I&E believes the evidence supports, is an accurate predictor of the new normal in the utility investment community.

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[143] *See* I&E M.B. at 78-79, citing several of PPL Corp.'s own reports to its investors.

B. Barometer Group

I&E addressed both I&E witness Sears' barometer group and the flaws in PPL witness Moul's barometer group in its Main Brief.[144] I&E submits that Ms. Sears' barometer is most comparable to PPL Electric and should be employed in developing an appropriate capital structure and cost of equity for PPL.

C. Capital Structure

The capital structure PPL Corp. has established for its subsidiary is essentially 50% debt and 50% equity. I&E's recommended capital structure is essentially 55% debt and 45% equity. Although close, the difference is not without substantial value to PPL: the slight movement downward in equity and equally upward in debt proposed by I&E witness Sears, if not accepted, has a cost of $15 million annually to PPL's ratepayers.[145]

I&E's recommended capital structure is based upon Ms. Sears' calculation of the industry average of her barometer group. Use of a hypothetical capital structure based upon a barometer group of comparable companies is appropriate because it smooths out potential anomalies associated with a single company and satisfies the ratemaking principle that utilities should be afforded to earn a return equal to similar risk enterprises. Also, in this particular case, PPL Electric's stock is not publicly traded.[146] Rather, PPL's capitalization is effectuated not by PPL

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[144] I&E M.B. at 79-82.
[145] I&E M.B. at 82-83.
[146] I&E St. 1 at 8-9.

Electric itself on the open market, but rather by the interests of the corporate family.[147]

Given that situation, I&E's recommendation to use a hypothetical capital structure based on the average of I&E's industry barometer group also serves to negate any impact from PPL Service Corporation's conflict of interest between maximizing returns to the corporate parent while also striving to ensure the rate-regulated entity provides utility service at rates that are both economical to ratepayers and compensatory to the parent.

As PPL acknowledges, the Commission clearly has the authority and discretion to employ a hypothetical capital structure where the utility's capital structure is weighted too heavily on either the debt or equity side.

> An important element of a utility's rates is the utility's cost of capital, which indicates the fair rate of return to be allowed on the fair value of its property used and useful in the public service, after allowance for proper operating expenses, taxes, depreciation and any other legitimate item. Where a utility's actual capital structure is too heavily weighted on either the debt or equity side, the commission, which is responsible for determining a capital structure which allocates the cost of debt and equity ***in their proper proportions***, must make adjustments to the utility's capital structure. In *Lower Paxton*, this court gave the following explanation for using a hypothetical capital structure:
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> > ***The capital structure of a corporation may affect, sometimes drastically, the cost of capital***. The capital structure is, in reality, little more than those dollars represented by its common and preferred stock and its debt. In some cases where the public utility is a

[147] PPL St. 10 at 1; PPL Petition to Reopen the Record, Affidavit of Russell R. Clelland, paragraphs 2-3, both identifying Mr. Clelland's responsibility as an employee of PPL Services Corporation for, inter alia, liquidity management and capital markets financing; I&E M.B. at 83.

> wholly-owned subsidiary, its capital structure may not be comparable to another public utility which is obliged to obtain its equity and debt financing in the open market. In other words, ***it may have on balance a too heavily weighted*** debt or equity.[148]

PPL contends that I&E's proposed capital structure is not justified under applicable legal standards. In PPL's interpretation, this requires that the actual capital structure be "atypical for the type of utility being considered."[149] Misapplying the results of Ms. Sears' analysis, PPL then contends that "two of her six barometer group companies have 2011 common equity ratios essentially equal to or in excess of the 51.03% which PPL Electric will employ."[150] Finally, PPL appears to criticize Ms. Sears both for using her informed judgment as well as employing an objective standard in exercising that judgment.[151]

In none of the cases cited by PPL has the Commission enunciated a standard that the actual capital structure must be "atypical" let alone defined at what point a structure ceases to be typical and becomes atypical. To the contrary, the Commission has acknowledged that debt and equity must be "in proper proportions" and that "on balance" it must not be "too heavily weighted" one way or another. How much is "too much" is undefined and case-specific. As the Commission is very careful to acknowledge, as has Ms. Sears:

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[148] *Carnegie Natural Gas Company v. Pa. P.U.C.*, 433 A.2d 938 (Pa. Cmwlth. 1981), citing *Lower Paxton Township v. Pa. P.U.C.* 317 A.2d 917 (Pa. Cmwlth. 1974) (other citations omitted) (emphasis added). *See also Emporium Water Company v. Pa. P.U.C.*, 955 A.2d 456 (2008).
[149] PPL M.B. at 96.
[150] PPL M.B. at 98.
[151] PPL M.B. at 99.

> Regardless of the procedure employed in determining fair rate of return, we must exercise "informed judgment." . . . A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. ***It requires the exercise of informed judgment based upon an evaluation of the particular facts presented in each proceeding***. There is no one precise answer to the question as to what constitutes a proper rate of return.[152]

Indeed, this Commission has clearly recognized that "there are no magic numbers for the proper percentage of debt and equity."[153] Ultimately, the Commission must decide upon a capital structure that is "fair and reasonable to both the utility and the ratepayers in the computation of the cost of capital."[154] I&E submits that a $15 million ratepayer expense based solely upon a capital structure chosen by the same PPL affiliates that benefit from the profitability of the rate regulated entity is eminently unfair and unreasonable to ratepayers. It can and should be ameliorated without any financial harm to PPL Electric through the minor adjustment to the rate-regulated entity's capital structure as recommended by I&E witness Sears.

PPL's use of miscellaneous "154 data points" is as flawed as its criticism of Ms. Sears for allegedly taking a position directly contrary to a 27-year old position of the Office of Trial Staff in a telephone utility proceeding.[155] These arguments illustrate PPL's misguided efforts to focus on something other than the facts

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[152] *Pa. P.U.C. v. Pennsylvania Power and Light Company*, 67 P.U.R.4th 30, 79 (1985) ("*PP&L 1985 Base Rate Case"*) (emphasis added).
[153] *Pa. P.U.C. et al. v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103 (Order entered July 14, 2011) ("*City of Lancaster – 2011*"), Slip Opinion at 54.
[154] *City of Lancaster – 2011*, Slip Opinion at 54, *citing Riverton Consolidated Water Company v. Pa. P.U.C.*, 140 A.2d 114, 121-22 (Pa. Super. 1958).
[155] PPL M.B. at 99-100.

applicable today to PPL, and not a 27-year old telephone case or unidentified data points for unidentified companies across the country.

In 1985, PPL's capital structure was approximately 47% debt and 53% equity, which was not disputed and found by the Commission to be reasonable and appropriate.[156] As the Commission confirmed then, "[t]he interests of the company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved."[157] From 2007 through 2011, the capital structure on PPL Electric's balance sheet consisted of a 47% to 53% debt to equity ratio, more closely aligned with the PPL's historic capitalization rather than the debt/equity capitalization currently claimed for ratemaking purposes.[158]

I&E contends that PPL Electric's ratepayers have sufficiently paid rates that compensate the Company for a capital structure that could be structured more economically for ratepayers without jeopardizing the Company's financial stability. Since ratepayers could realize a savings of $15 million per year by simply adjusting PPL Electric's capital structure to a more reasonable level that approximates the average of an industry of similar risk, I&E contends the adjustment is proper.

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156 *PP&L 1985 Base Rate Case*, 67 P.U.R.4th at 80.
157 *PP&L 1985,* 67 P.U.R. 4th at 78.
158 OCA M.B. at 40, citing OCA St. 2 at 19-20.

The fact that PPL's present rates have been based upon its actual capital structure does not preclude this Commission from readjusting the Company's capital structure. Indeed, it is appropriate to do so if the record demonstrates, as it does here, that a hypothetical capital structure would better "achieve a fair balance between the consumer and the stockholder interests."[159]

PPL's argument that the capital structures of two companies in Ms. Sears' barometer group support PPL's capital structure also misstates Ms. Sears' use of the barometer group. Ms. Sears not only did not use any one individual company's actual capital structure as a measure for PPL, she expressly contested PPL's attempts to portray her analysis as such.[160] As this Commission has recognized in a prior proceeding involving PPL, the capital structure that should be recognized from use of a barometer group is the *average* of the barometer group,[161] as Ms. Sears has done, and not that of any one *individual* company within the barometer group, as PPL contends based upon 2011 returns for ConEd and PEPCO.[162] Further, PPL's contention that the Company's requested capital structure falls

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[159] *Pa. P.U.C. v. Western Utilities, Inc.*, 88 Pa. P.U.C. 124, 1998 WL 201481 (Pa.P.U.C.)(1998) *7 (citations omitted).

[160] Tr. at 348-49 ("I look at the average of the entire barometer group to say what the average of the industry is and what the industry as a whole is doing, not just what one specific company is doing.")

[161] *Petition of PPL Electric Utilities Corporation for Approval of Smart Meter Technology Procurement and Installation Plan*, Docket No. M-2009-2123945 (Order entered June 24, 2010), Slip Opinion at 15 (*PPL June 24, 2010 Smart Meter Order*") ("If, however, the Company's actual capital structure from the Quarterly Earnings Report is outside the zone of reasonableness for the electric utility industry,[4] the capital structure ratio that will be used is the ***average of the electric utility barometer group*** that is included in the then most recent Quarterly Earnings Report.")(emphasis added).

[4] The zone of reasonableness is defined by the capital structures of the electric barometer group included in the then most recent Quarterly Earnings Report.

[162] PPL M.B. at 95, 98.

within the range of equity ratios for the barometer group is inappropriate.[163] A range is not always indicative of an industry norm. A range could be from 0% to 100% equity with an average of 30%. In this case, the average, 30%, would show where the majority of companies fell. A 99% equity ratio, however, while still within the "range" is nonetheless still grossly outside the norm and not evidence of an appropriate ratio.[164]

Although Ms. Sears' recommendation is objectively developed and presented, PPL criticizes her for deploying judgment, which the Commission recognizes is necessary.[165] PPL inconsistently simultaneously criticizes Ms. Sears for tempering that judgment with an objective standard of "5 percent above or 5 percent below that average as a guide to a range of appropriate [ ] capital structures."[166] Ms. Sears' "5%" standard is similar conceptually to the Commission own "zone of reasonableness" as addressed in the *PPL June 24, 2010 Smart Meter Order.*

At some point, what is reasonable becomes unreasonable, typical becomes atypical, balanced with respect to ratepayers and investors becomes imbalanced. I&E submits than an annual $15 million expense that is wholly avoidable at the exercise of the judgment of PPL Electric's corporate family renders PPL's current

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163 PPL M.B. at 9.

164 I&E St. 1-SR at 8.

165 PPL itself also recognizes the role judgment plays in the development of a rate of return. *See* PPL M.B. at 103 (components and inputs to costing models is a matter of witness judgment).

166 Tr. at 363. Ms. Sears' standard is clearly a difference of 5% up from her results, or the difference between a 50% equity and a 55% equity, a point apparently understood by PPL at the time of cross-examination since no clarification was sought. PPL's contorted math at page 99 of its Main Brief is entertaining but meaningless.

capital structure – on this record at this point in time – unreasonable to ratepayers and must be adjusted by the Commission in order to achieve a fair balance between the consumer and stockholder interests.

D. Cost of Long-Term Debt

No response is necessary.

E. Return on Common Equity

1. Introduction

The Commission historically uses the Discounted Cash Flow (DCF) methodology as the primary methodology to determine a utility's cost of equity.

> Although there are various models used to estimate the cost of equity, the Discounted Cash Flow (DCF) method applied to a barometer group of similar utilities, has historically been the primary determinant utilized by the Commission. The DCF model assumes that the market price of a stock is the present value of the future benefits of holding that stock. These benefits are the future cash flows of holding the stock, *i.e.*, the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than dollars received today, the cash flow must be "discounted" back to the present value at the investor's rate of return.[167]

Although the Commission may review results of other methodologies as a check on the DCF, it relies primarily on the DCF. "Although some of the parties presented more than one methodology, the major focus was on their various DCF analyses. This accords with our own recent practice."[168] In evaluating other

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[167] *City of Lancaster – 2011,* Slip Opinion at 56.
[168] *Pa. P.U.C. v. West Penn Power Company*, 59 Pa. P.U.C. 552, 600 (1985), citing *inter alia PPL 1985 Base Rate Case*.

methodologies, the Commission has both criticized as well as accepted other methods to confirm the reasonableness of the DCF results.[169]

Consistent with Commission precedent, I&E witness Sears recommended an 8.38% return on common equity. Ms. Sears' recommendation was based on her use of a similarly-situated barometer group comprising electric companies with, *inter alia*, at least 50% of their revenues derived from the regulated distribution business and calculation of a cost of equity using the DCF methodology with alternative CAPM calculations presented for the Commission's consideration as to reasonableness.

2. Discounted Cash Flow Analyses

Employing a DCF analysis, Ms. Sears recommended a cost of common equity of 8.38%, comprising a dividend yield of 4.89% and a growth rate of 3.49%. To arrive at a dividend yield, Ms. Sears used a spot dividend yield and a 52-week dividend yield. To support her growth rate, Ms. Sears used a combination of earnings growth forecasts and a log-linear regression analysis growth rate.

Excluding PPL witness Moul's proposed leverage adjustment, PPL recommends a DCF-based cost of equity of 9.67%, comprising a dividend yield of

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[169] *See Pa. P.U.C. v. City of Lancaster*, 93 Pa. P.U.C. 120 (1999) ("*City of Lancaster – 1999*"); *Pa. P.U.C. v. Pennsylvania-American Water Company*, 85 Pa. P.U.C. 13 (1995) (wherein the Commission expressed its preference for the DCF while criticizing the Capital Asset Pricing Model (CAPM) and Risk Premium (RP) approaches); *but see Pa. P.U.C. v. PPL Electric Utilities Corporation*, 99 Pa. P.U.C. 389, 2004 WL 3119796 (Pa. P.U.C.) (2004) *35 (wherein the Commission relied primarily on the DCF methodology but also used the results of the CAPM and RP "as a check of the reasonableness of our DCF calculation") ("*PPL 2004 Base Rate Case*").

4.67% and a growth rate of 5% for his EDG.[170] PPL contends Ms. Sears' recommendation is flawed because she performed a flawed DCF analysis that was compounded by performing no other analysis "that can be considered a reasonable check on the reliability of DFC [sic] results."[171] PPL also cites to Ms. Sears' use of a log-linear regression to determine the DCF growth rate and her failure to include a leverage adjustment in her DCF analysis as the "principal errors" in I&E's DCF recommendation.[172]

In claiming that Ms. Sears has not performed any analysis that may be considered a reasonable check on her DCF calculation, PPL misrepresents Ms. Sears' presentation. In an attempt to ameliorate the ability to manipulate the methodology through the time period chosen, Ms. Sears calculated both forecast and historic CAPM analyses, yielding cost of equity returns of 12.31% and 5.06%, respectively. As Ms. Sears testified, while she gave no specific weight to her CAPM results because of her concerns about its ability to be manipulated by the time period chosen and its indirect measure of the cost of equity, her 8.38% DCF result falls within her CAPM range[173] and, in fact, is very close to the simple average of those two analyses.[174] That Ms. Sears gave no give specific weight to her CAPM results neither voids her DCF recommendation nor removes her CAPM

[170] PPL M.B. at 104.
[171] PPL M.B. at 124.
[172] PPL M.B. at 124.
[173] I&E St. 1-SR at 11.
[174] I&E M.B. at 89. PPL should not oppose a simple average of the results of I&E's two CAPM analyses since that approach is no different in principle from Mr. Moul's simple average of his DCF, CAPM, RP, and CE methodologies.

results from the Commission's consideration as confirmation of the reasonableness of her DCF results.

PPL witness Moul on the other hand presents the results of no fewer than four different methodologies with no qualitative analysis by Mr. Moul how each confirms the other beyond presentation of mathematical averaging. His "standard of reasonableness" encompasses the inclusion of authorized returns for several companies without regard for either the time frame in which the returns were authorized or the fact that several of the companies lack both geographic and business similarity to PPL.[175]

In purportedly attempting to address Ms. Sears' concerns, Mr. Moul reduces the size of his barometer sampling so that it is no longer a representative sampling and it creates upward biases.[176] To this he includes a series of financial adders all intended to boost whatever analysis the Commission ultimately accepts. This final recommendation is then supported by the irrelevant presentation of PPL witness Cannell, who essentially offers the simplistic syllogism that because all investors want the high returns and PPL has investors, PPL should be awarded

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[175] I&E St. 1-SR at 11-12.

[176] I&E St. 1-SR at 14-16. The full extent to which Mr. Moul either further massaged the results of his DCF analysis or erroneously attacked Ms. Sears' calculation, in order to present the highest recommendation possible, is addressed in Ms. Sears' surrebuttal testimony at pages 13-26. Therein Ms. Sears describes Mr. Moul's inflated effect of using an unsupported ex-dividend adjustment, his erroneous criticism of Ms. Sears' failure to adjust her dividend yield by half the growth rate when it was already incorporated into the data she used, and his other misguided attacks on the log-linear analysis.

high returns.[177]

PPL also criticizes Ms. Sears' calculation of an appropriate growth rate within her DCF analysis because she used a log-linear analysis as part of her calculation. As PPL asserts, this is erroneous because "no investor publication uses log linear analysis to estimate future growth rates."[178] This criticism is based upon Mr. Moul's lack of understanding of the log-linear analysis and is insufficient to justify ignorance of Ms. Sears' recommendation.

First, as Ms. Sears clearly testified, she used *both* earnings growth forecasts *and* a log-linear regression analysis data to calculate her expected growth rate. Her earnings forecasts were developed from projected growth rates using 5-year estimates from established forecasting entities for her barometer group of companies, yielding an average 5-year growth forecast of 4.79%. However, because, as Ms. Sears testified, investor forecasts may be biased and/or distorted, Ms. Sears also used a standard mathematical formula, a log-linear regression analysis, as a check on investor forecasts in order to determine a more reliable and less biased long term growth rate.

Using published data from *Value Line* for the years 2006-2011 and financial analysts forecasted growth rates for 2012 through 2016, Ms. Sears

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[177] As Ms. Sears noted, "Ms. Cannell's testimony offers no value to this case, as shown by her unsubstantiated comments, speculations, and lack of a cost of equity study. Ms. Cannell further has not demonstrated any meaningful understanding of the determination of a rate of return for the regulated utility industry." I&E St. 1-SR at 63.

[178] PPL M.B. at 124.

plotted the "best fit" of the data, and arrived at an average growth rate of 3.49%.[179] As Ms. Sears testified, the log-linear regression analysis negates investor bias, it does not introduce it:

> Mr. Moul does not understand the log-linear process. The log-linear process is unbiased. It is not used or designed to achieve any specific quantifiable result. It simply plots the numbers and creates a line which best fits the data input and provides a slope with which to determine a growth rate. Furthermore, as in the case of Nextera Energy, the log-linear process does not always lower a growth rate. I&E Exhibit No. 1-SR, Schedule No. 6, also demonstrates how the log-linear process can determine a growth rate which is higher than the analysts' growth rate. This is because, as stated above, the log-linear process is unbiased.[180]

Disagreeing with use of a log-linear analysis as a check on calculation of unbiased growth rates, PPL urges the Commission to disregard Ms. Sears' growth rate because no investor publication uses the log-linear regression analysis. This criticism fails on multiple grounds. First, it ignores the entirety of Ms. Sears' calculation, which included consideration of investor forecasts as the starting point for her calculated growth rate. Second, it also ignores the fact that published investor data are integral inputs to her log-linear analysis. Finally, unlike Mr. Moul's leverage adjustment, which enjoys no published support in either academic or investor literatures, use of the log-linear regression analysis has investment and academic support.

As Ms. Sears stated:

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[179] I&E M.B. at 86-87, citing I&E St. 1 at 25-30.
[180] I&E St. 1-SR at 25-26.

> The log-linear regression analysis is not a personal one, but one shared by I/B/E/S International, Inc. and supported by academic literature. I/B/E/S employs a log-linear regression analysis when calculating five year growth rates. Therefore, if investors do not rely on log-linear analyses as Mr. Moul suggests, that is [the same as saying] investors do not use I/B/E/S as a source for financial information. Academic literature also supports the use of a log-linear regression analysis when calculating growth rates (See I&E Exhibit No. 1, Schedule No. 7). Furthermore, when calculating the log-linear regression analysis, market data is used and transformed to obtain a linear relationship in the data series. I have used the published Value Line earnings per share market data for each company in the Barometer Group from 2006 to 2011. I have further incorporated the analyst's growth estimates from I&E Exhibit No. 1, Schedule 6, page 1, for each company in the Barometer Group from 2012 to 2016. Many sophisticated investors use Value Line data in order to perform their own analyses as well. The sophisticated investors are well aware of the financial literature concerning biased analysts' estimates. To assume that investors do not make some adjustment for this bias would be to assume that investors are myopic.[181]

Ms. Sears continued by noting that "[t]he log-linear analysis provides a means of smoothing out the historic earnings and providing a non-biased starting point from which to project growth. The log-linear analysis also includes the analysts' projected estimates to determine a balanced growth rate."[182]

Further, as Ms. Sears explained fully in cross-examination, because "sophisticated investors are well aware that there is a bias to the analysts' estimates," it is "more than appropriate" to use both analysts' projections or earnings as well as a log-linear analysis of historic earnings, which also uses published data, to remove analysts' bias.[183]

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[181] I&E St. 1-SR at 22-23.
[182] I&E St. 1-SR at 23.
[183] Tr. at 350.

Investments today are very sophisticated and take into consideration a number of factors. PPL's suggestion that Ms. Sears' evaluation of a proper growth rate in this PPL ratemaking proceeding should be disregarded because "no investor publication uses log linear analysis"[184] is a quaint anachronism based on the erroneous predicate that ignores the reality of today's highly sophisticated investment community.

Further, Mr. Moul's recommended growth rate is upwardly biased as a result of his flawed barometer group.[185] In PPL's 2004 base rate case, this Commission noted that PPL's estimated growth rate, "at the high end of the array of growth rates offered by all parties of record" was "justified at this time due to the current uncertainties surrounding electric distribution companies."[186] Rather than uncertain, clearly PPL Corp. itself today views the EDC business line as stable.[187] Calculation of an appropriate cost of equity for PPL today based on the high end of the record's growth rates is not supported by the evidence of today's environment.

Both sophisticated investors and this Commission would be well-served by giving full consideration to all known and measurable inputs today rather than the

[184] PPL M.B. at 124.
[185] I&E M.B. at 93.
[186] *PPL 2004 Base Rate Case*, Slip Opinion at 69.
[187] I&E M.B. at 78-79.

high-end growth rates PPL urges.[188] Ms. Sears' recommendation represents principled adherence to the Commission-accepted DCF analysis based upon the facts on this record along with alternative CAPM calculations for the Commission's consideration. Ms. Sears has not proposed unlimited cost rate analyses and adders with the hope that something will support a number acceptable to PPL.

3. PPL's Flawed Return on Equity Recommendation

a. The Unsubstantiated Leverage Adjustment

In his return on equity analysis, Mr. Moul proposed an upward adjustment of 70 basis points to his EDG results and 118 basis points to his IEG results to account for his "leverage adjustment." PPL describes the leverage adjustment as designed to adjust the DCF cost rate for the different percentage level of debt in the capital structure when the capital structure is calculated at the market prices of equity and debt rather than the book value.[189]

In support of its adjustment, PPL cites to those 6 cases out of 68 over a 23-year history in which the Commission accepted Mr. Moul's proposed adjustment: the 2002 and 2004 base rate cases of PA American; a 2002 Philadelphia Suburban

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[188] In a similar vein, in the 1999 City of Lancaster proceeding the City excluded all negative information from its DCF calculation (creating an upward bias) because it argued investors only considered positive data. The ALJ observed that "an investor would have to be myopic and irrational to only consider positive information. An investor that excludes all negative information will consistently overestimate investment returns in his decision making process and consistently underperform the market benchmarks." *City of Lancaster – 1999*, 93 Pa. P.U.C. *10. I&E contends that PPL, too, is myopic to suggest that I&E's growth rate, which is otherwise very well-substantiated, should be ignored simply because no one investor publication publishes both historic and projected growth rates in combination.

[189] PPL M.B. at 105.

base rate case; a 2004 Aqua Pennsylvania base rate case; PPL Electric's 2004 base rate case; and PPL Gas' 2007 base rate case.[190] PPL acknowledges the 2008 Aqua Pennsylvania base rate case, in which the Commission declined the Company's proposed leverage adjustment, and attempts to distinguish the Commission's rejection of the leverage adjustment in *City of Lancaster – 2011*, claiming that case is "clearly distinguishable,"[191] but citing no differences other than the City was municipal, and not investor, owned.

I&E does not dispute that the Commission has accepted the leverage adjustment on six occasions over the history of regulation and that the ability to do so is squarely within the Commission's discretion. I&E strongly disputes, however, that Mr. Moul's leverage adjustment enjoys any support outside the context of those limited cases. Even if it did, I&E asserts that on the facts of this record, any upward adjustment from the objective results of the I&E recommendation is not warranted.

Mr. Moul's leverage adjustment is a results-oriented proposal designed solely as an opportunity to boost an equity return. As acknowledged in the 2008 Aqua Pennsylvania case,[192] the Commission rejected the adjustment for Aqua because the cases then cited as support for the adjustment presented DCF results

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[190] PPL M.B. at 105-09, incorrectly citing the date (2012 instead of 2002) and docket number (R-0001639 instead of R-00016339) for the 2002 PA American 2002 base rate case. *See* PPL St. 11 at 36-37 for Mr. Moul's complete list of cases accepting his leverage adjustment and I&E Cross-Examination Ex. 3 for a list of all proceedings in which it was proposed.
[191] PPL M.B. at 109.
[192] *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, (Order entered July 31, 2008) ("*2008 Aqua Pennsylvania*").

that were "not as high"[193] as the DCF results presented in the then pending Aqua proceeding. As otherwise described by PPL, "the Commission has applied the leverage adjustment in cases where it believes market conditions have resulted in a DCF cost rate that is understated[, conditions which PPL submits] appear again in this case."[194] I&E submits that Mr. Moul is always dissatisfied with the results of the DCF analysis, and that even though, as PPL notes, the Commission "chose to adopt or chose not to adopt a leverage adjustment based upon the specific circumstances of each case[,]"[195] Mr. Moul will always choose to ignore the specific circumstances of each case.

The equity cost rates resulting from the methodology employed should determine what is reasonable for investors to expect without any adder. The DCF model assumes that investors evaluate stocks in the classical economic framework, or, stated differently, that the value of a financial asset is determined by its earning power or its ability to generate future cash flows.[196] Market conditions do not understate the equity cost rate under the DCF sometimes but not others. Market conditions are what they are. Current market conditions determine the appropriate current equity cost rate warranted under the "specific circumstances of each case." An equity cost rate is neither low nor high; it is what the market conditions determine it should be. To find otherwise presupposes that utilities have a right to

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[193] PPL M.B. at 107.
[194] PPL M.B. at 108.
[195] PPL M.B. at 109.
[196] I&E St. 1 at 16.

earn an equity return of some predetermined minimum level, and if that level is not achieved by an objective analysis, then an adder is appropriate. This simply perpetuates PPL's results-oriented approach.

While the Commission has accepted the leverage adder in prior cases, it did so most prevalently in the early to mid-2000's and last in 2007. This was a time period when the market was much different than it is today. Most recently, in *City of Lancaster – 2011*, the Commission rejected the leverage adder, stating:

> Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we shall reject the recommendation of the ALJ [to accept the adder] on this issue. We are persuaded by the arguments espoused by the OTS, the OCA and Kellogg that the ALJ's recommendation is in error as any adjustment to the results of the market based DCF as we have previously adopted are unnecessary and will harm ratepayers. Consistent with our determination in *Aqua 2008* there is no need to add a leverage adjustment to the 10.00% DCF based cost of equity determination previously adopted in this proceeding.[197]

Citing from the *City of Lancaster – 2011* opinion, PPL distinguishes this holding on the basis that the City is not an investor owned utility. However, the city's status was not at issue in the Commission's resolution of the leverage adder issue. Rather, while ignoring the unambiguous direction from the Commission quoted above that the previously adopted adders "are unnecessary and will harm ratepayers," PPL cites to a section of the opinion addressing the impact of the City's ability to tax in determining the appropriate capital structure. In addressing the issue at hand, the Commission clearly determined, upon review of the impact

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[197] *City of Lancaster – 2011*, Slip Opinion at 79.

on ratepayers, that there was no need to boost the DCF based cost of equity determination adopted in that case.

Notwithstanding that interest rates remain at historic low levels, PPL contends in this proceeding that a 70 to 118 basis point boost is necessary because the 9.67% to 9.69%[198] DCF based cost of equity determination resulting from Mr. Moul's DCF analysis (which is itself overstated for the reasons identified in I&E's Main Brief[199]) without the equity boost is too low.

I&E notes, however, that *with* the adder, PPL's requested equity cost rates of 10.37% or 10.87% are well above the "adder-free" unadjusted 10% equity return determined most recently in the most comparable market conditions in *City of Lancaster – 2011.* They are also higher than the unadjusted 10.1% equity return the Commission found reasonable and appropriate in 2007, when it rejected a financial risk adder for the Met-Ed and Penelec companies,[200] and the adjusted 10.26% equity return the Commission found reasonable and appropriate in 2007 for the then-PPL affiliate PPL Gas, having soundly rejected PPL's 11.75% requested equity return as "excessive and unreasonable."[201] Notable as well is that both of these cases were decided in a time when market conditions reflected substantially higher investor expectations than are present today. On the basis of

[198] PPL M.B. at 104, DCF Cost Rate minus the leverage adder.
[199] I&E M.B. at 93.
[200] *Pa. P.U.C. v. Metropolitan Edison Company et al.*, 2007 WL 496359 (Pa. P.U.C.) (Docket Nos. R-00061366 et al.; Order entered January 11, 2007) at *74.
[201] *PPL Gas*, Slip Opinion at 107-08.

established legal precedent, I&E respectfully submits that PPL has not proven that Mr. Moul's equity adder should be adopted in this proceeding.

I&E has also proven that, on a factual basis, Mr. Moul's leverage adjustment has no support in the ratemaking process specifically and in financial literature generally, and is also seriously flawed, facts unrefuted by Mr. Moul. As Ms. Sears demonstrated, not only did the Commission decide as far back as 1982 in the *Blue Mountain* case[202] that such a financial adder was not a necessary in the ratemaking equation, but also that Mr. Moul is inconsistent in his presentation of the adder, suggesting it only when it raises his recommended equity cost rate.[203] While Mr. Moul today disputes the description of his adder as a "market-to-book adjustment," past Commission decisions[204] as well as PPL's own Main Brief[205] clearly describe that as the intended effect of and previously understood basis for his proposal.

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[202] *Pa. P.U.C. v. Blue Mountain Consolidated Water Co.*, 1982 WL 213115 (Pa. P.U.C.) ("*Blue Mountain*").
[203] I&E St. 1-SR at 29-30 ("The Blue Mountain case has been used to show that Mr. Moul's recommendations are not consistent.")
[204] *See also Blue Mountain*, 1982 WL 213115 at * 1 (marketprice-book value ratios are not a goal of regulation but a result of regulation); *PPL Gas*, Slip Opinion at 104 ("PPL Gas notes, as the Commission has recognized, that the leverage adjustment reflects the greater risk caused by the greater level of debt as a percentage of total capital with equity and debt at book value when compared to the percentage of debt of total capital with equity at market prices"); *2008 Aqua Pennsylvania*, Slip Opinion at 39 (When viewed in the context of the other methodologies, we conclude that there is no need to have an upwards adjustment to compensate for any perceived risk related to Aqua's market-to-book ratio. Accordingly, we reject the ALJs' recommendation to allow a 65 basis point leverage adjustment."); *City of Lancaster – 2011*, Slip Opinion at 64 ("the City derived an average market value CAPM for its comparison group of 10.5%, or 11.1% after application of the 0.6% leverage (market-to-book) adjustment previously mentioned"); PPL M. B. at 105 ("The leverage adjustment is designed to adjust the DCF cost rate for the different percentage level of debt in the capital structure when capital structure is calculated at the market prices of equity and debt securities as opposed to book value. For example, a utility that has a stock price above book value has a market value or capitalization of its equity that is greater than the book value of its equity.")
[205] PPL M.B. at 105 (the leverage adjustment adjusts the DCF cost rate for the different percentage level of debt in the capital structure when calculated at market, rather than book, value).

Mr. Moul did not dispute that his adder is not supported in any financial literature applicable to utility ratemaking, that he uses the literature he does reference in a manner not advocated in that literature, and that the referenced literature does not account for financial risk.[206] In fact, as I&E proved, the literature Mr. Moul espouses actually supports the opposite conclusion for which he asserts the adjustment is necessary.

Modigliani and Miller's research concludes that the market value of any firm is independent of its capital structure and that the value of any firm must be independent of its financial structure.[207] Investor information for Mr. Moul's EDG in *Value Line Investment Survey* also supports the opposite of Mr. Moul's assumption. *Value Line Investment Survey* assigns the *book* valued capital structure percentages and the *book* value of debt at the end of 2010. While Mr. Moul's adjustment presupposes that the market return is based upon market valued capital structures, this investment information proves this to be false for the regulated utility industry. Thus, investors base their decisions, and therefore their required market return, on the *book* values, not the *market* values. [208]Finally, Mr. Moul's adjustment not only lacks support in academic, financial, or any other relevant literature, but also in any other jurisdiction outside Pennsylvania.[209]

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[206] I&E St. 1-SR at 32-33.
[207] I&E M.B. at 98, citing I&E St. 1 at 47.
[208] I&E M.B. at 101, citing I&E St. 1 at 52; I&E Ex. 1, Sch. 14 at 2.
[209] Tr. at 251.

Mr. Moul's formulae are also flawed. While Mr. Moul stated in rejoinder that "[n]either Mr. Hill nor Ms. Sears has challenged any aspect of the calculations that produce the leverage adjustment[,]"[210] he ignores Ms. Sears' criticism of his formula as solving for "ku" while the variable remains on both sides of the equation.[211] Ms. Sears also demonstrated that Mr. Moul's formula to determine the cost of equity of a 100% equity firm (ku) did not actually determine the cost of equity of a 100% equity firm. Rather, it assumed the cost of equity of a 100% equity firm to be 7.93% for the EDG and 8.11% for the IEG, figures unsupported on the record.[212]

Mr. Moul's statement that credit rating agencies are only concerned with the timely payment of interest and principle by utilities (i.e. its financial risk) and his agreement that credit agencies assess financial risk in terms of the book value of debt also prove I&E's point that this financial risk adder is unnecessary because credit agencies review book values.[213]

I&E respectfully submits that PPL's proposed equity adder has no place in the cost of equity determined on this record. I&E respectfully submits that if, notwithstanding the substantial evidence discrediting the validity of this adjustment, it is nonetheless accepted as legitimate, then the determinative fact the Commission should consider in evaluating whether or not to adopt an adjustment

[210] PPL St. 11-RJ at 2.
[211] I&E St. 1-SR at 33.
[212] I&E M.B. at 100.
[213] I&E St. 1-SR at 26-27, 29.

on this record in this economic time should be realistic investor expectations based upon current market conditions. It should not be unrealistic investor expectations based on the false notion that utility returns must achieve some predetermined level of equity return or otherwise be faulted as "too low."

b. The Unsubstantiated Management Effectiveness Adjustment

PPL claims the cost of equity allowed by the Commission in this proceeding should also include a reward for management effectiveness. PPL maintains that it is "controlling costs" while also providing "high quality service and expanded service options."[214] To support the Company's claim to reward-worthy management, PPL witness Moul added 12 to 13 basis points to his recommended equity return.[215] Although Mr. Moul professed to have no knowledge of the dollar impact in this proceeding from his management boost,[216] it is valued at almost an additional $3 million in additional annual rate revenues meant solely to reward investors.[217]

i. PPL's evidence fails to support an equity boost

Examples the Company provided as evidence to support its request were its advanced metering infrastructure, operating initiatives including initial investment in smart grid technology and improvement in storm management, investment in its

[214] PPL M.B. at 116.
[215] Tr. at 242.
[216] Tr. at 242.
[217] Tr. at 335.

customer contact center to support customer choice and expand self-service options, the percentage load served by EGSs, its Act 129 education and efficiency programs, and its customer assistance programs.[218]

As more fully addressed in I&E's Main Brief, I&E opposed granting a management reward to the Company. In terms of investment generally, I&E contended ratepayers have already paid for PPL's smart meters in the form of a return of and on investment for the past decade and are now a statutory requirement subject to full reconcilable recovery with interest. Improvements to operations and infrastructure are a necessary cost of doing business that affect and are being undertaken by all Pennsylvania's utilities and will now enjoy more timely recovery through the DSIC.

With regard to specific improvements, such as PPL's storm processes, the evidence demonstrated that such improvements were already late, as the Commission recently found PPL's avoidable storm percentage to be the highest. As for PPL's programs and services, PPL's Act 129 programs were statutorily mandated and its costs are fully recoverable. Claimed improvements in customer contacts were refuted by the Bureau of Consumer Services (BCS) 2010 Customer Service Performance Report. And PPL's claim to success in retail electric competition was inconsistent. On one hand, to support its equity claim, PPL boasted success by citing to the percentage of *load* served by EGSs. On the other,

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[218] PPL Exhibit Future 1 at 9-16.

to support its request to continue spending $5.4 million annually, PPL cited to the percentage of *customers* served by EGSs. Further, PPL proved no direct causation between its programs and the competitive success of EGSs in its territory and failed even to prove it was a leader in competition.[219]

With respect to other programs and their costs, I&E proved that PPL's customer education and energy efficiency programs were already wholly ratepayer funded and included a return of and on investment through reconcilable riders with interest. The same applied to PPL's "family of universal service programs," which already come at an annual *ratepayer cost* of $76 million in 2012.[220]

The evidence PPL relies on tells only half the story. Despite its claims for customer care improvements, PPL provided no rebuttal addressing the degradation in its service reported in the BCS 2010 Customer Service Performance Report. PPL touted implementation of residential self-service tools, but ignored the fact that it ranked 5th out of 8 companies for satisfaction with its automated system. While J.D. Powers standards in compiling industry reports are unknown and unexplored, the Commission's BCS reports have employed objective standards and been subject to comprehensive Commission review and acceptance for decades.

PPL cited to its implementation of a smart grid, but ignored the larger context that the grid benefits only **4%** (60,000) of PPL's 1.4 million customers

[219] I&E St. 1-SR at 64-65.
[220] I&E M.B. at 116-23.

and was funded by a matching federal grant. Context was also very revealing with respect to PPL's Act 129 and universal service claims. While PPL met its 2011 Act 129 goals and expects to meet its 2013 goals, viewed within the progress of its peers, its performance was mediocre at best. All EDCs except West Penn power exceeded their energy savings targets for 2011, and PPL was below the 2011 statewide average energy savings target, below the 2013 statewide average energy savings target, and below the 2013 statewide demand reduction target.[221]

Perhaps the most untenable of PPL's evidence is its reliance on its "family of universal service programs" to support its equity boost. In this regard, PPL's "family" is its ratepayers, not its shareholders. PPL's ratepayers currently fund **98.77%** of the Company's universal service programs. And the shareholders' current 1.23% contribution is projected to fall to 1.19% in 2014, when PPL's universal service programs are projected to exceed $79 million, with $78.5 million coming exclusively from ratepayers, and $78 million of that through mandatory payment through rates under a reconcilable rider that is subject to interest from ratepayers.[222] And PPL totally ignored evidence of the nearly $1 million in civil penalties it has paid since November 2007 as a result of Commission investigations involving PPL Electric.[223]

In seeking a totally gratuitous $3 million annually from ratepayers to reward management performance, PPL ignores the fact that for years ratepayers

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[221] I&E Cross-Examination Ex. 10; Tr. at 306.
[222] I&E Cross-Examination Ex. 12.
[223] OCA Cross-Examination Ex. 1.

have already paid for the cost of and a return on the very programs and investment for which PPL now seeks an equity boost. And despite Mr. Dudkin's acknowledgment of the applicability of reconcilable rider recovery of costs associated with the cited programs providing for full cost recovery,[224] PPL completely disregards the shareholder benefit from having multiple ratepayer riders and surcharges. Having removed from the base rate equation the costs and investment associated with smart meters, Act 129 programs, universal service programs, and the transmission system, not to mention costs associated with generation and taxes, PPL Corp.'s investors are guaranteed recovery of these costs, often with interest. These revenue guarantees are wholly extraordinary to the traditional ratemaking equation.

ii. PPL avoids objectivity in measuring management effectiveness

In ignoring this record evidence, PPL contends that I&E sets forth an unsupported standard for demonstrating justification for an equity boost related to effective management. Rather than addressing I&E's evidence directly, PPL, referencing Ms. Sears' direct testimony at pages 69-76, concludes that "demonstrat[ing] that its performance was better than all other EDCs in Pennsylvania . . . is not the standard for demonstrating management effectiveness and [I&E] should be ignored."[225] PPL then contends that the "principal issue is not

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[224] Tr. at 301-03.
[225] PPL M.B. at 120.

whether PPL Electric's various practices, processes, or programs are superior to other electric utilities, or whether the programs and initiatives are funded by ratepayers[,]" but instead the utility's 'broad scope" of efforts to improve" and its "commitment to customer services, effective leadership, operational excellence, and a culture of continuous improvement."[226]

Ms. Sears' statement that PPL's programs were not superior to others was made within the context of PPL's Act 129 education and efficiency programs specifically, and was not a general standard applicable to review of PPL's evidence as a whole.[227] Even if applied across the board, however, in fact none of PPL's programs is superior as the evidence discussed above demonstrates.

As measured by this Commission, PPL's customer service and Act 129 compliance are clearly inferior, and entirely customer funded. The programs do not provide evidence of operational excellence or a culture of continuous improvement. PPL's universal service programs are also statutorily required and almost entirely funded through rates, with ratepayers contributing $75.9 million out of the total $76.8 million in funding. It is inconceivable that PPL would contend that ratepayers should be required to provide an additional $3 million in management rewards because of the $75.9 million they already are required to provide. PPL's distribution system investment is required under the law and has been granted extraordinary rate relief treatment under Act 11. These programs

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[226] PPL M.B. at 122.
[227] I&E St. 1 at 75, lines 11-13.

provide no evidence of operational excellence or a culture of continuous improvement. They merely prove PPL's ability to spend ratepayer funds in accordance with statutory requirements.

In reviewing PPL's request and supporting evidence, I&E attempted to discern why what PPL does under the Public Utility Code warrants an equity boost of an additional $3 million annually. Surely, if there is no such clear distinction, then PPL's equity adder opens the door for all other utilities to seek, and be granted, this bonus as well. In discovery with respect to each of his cited examples of management effectiveness, I&E sought elaboration from PPL witness Dudkin how PPL was distinguished among its EDC peers specifically or in the industry generally. In each instance, Mr. Dudkin's well-rehearsed response was the same:

> The issue is not whether the Company's various practices, processes or programs are unique. Rather, the issue is the broad scope of PPL electric's efforts to improve its operations in ways that strengthens [sic] reliability, enhance customer satisfaction, respond to customer needs and reinforce public and employee safety. It involves a commitment to customer services [sic] effective leadership, a focus on operational excellence and a culture of continuous improvement.[228]

I&E's further efforts attempted to distinguish between vague platitudes and objective, measurable, and quantifiable differences by requesting PPL to address how its operations differed from its regulatory obligations to provide safe and reliable service at just and reasonable rates. PPL witness Dudkin responded that

[228] I&E Cross-Examination Ex. 9 (quoting from the response to I&E-RR-69, but acknowledging that the typographical errors were corrected in subsequent responses); Tr. at 298-301.

"[t]he two concepts are related, but quite different" with the statutory requirements establishing a "minimum standard."[229] In fact, with the exception of Act 129, PPL witness Dudkin was at a loss to identify any other statutory or regulatory standard that was clearly established as a "minimum."[230]

Rather than distinguishing its service from the utility pack, PPL argues that nothing in Section 523 requires the utility to perform better than others and that any notion that shareholders in some manner contribute to the "operational excellence" would be "nonsensical."[231] I&E simply posits that before ratepayers are required not just to pay for their service but also to tip the service provider, there should be some objective standard by which to measure PPL's "excellence" other than PPL's own self-image. Instead, PPL cavalierly dismisses any reasonable measure of a standard, reflecting conceit more than operational excellence. Given the contradictory evidence on this record refuting PPL's claims of "operational excellence and culture of continuous improvement," I&E contends that PPL's "we deserve it" attitude is not supported on the record.

iii. An objective standard must apply to distinguish PPL's service and warrant an equity boost

The Commission is not unaware of the vagaries that are implicated by a monopoly utility's request for a ratemaking allowance that exceeds compensation and actually rewards investors at ratepayer expense. As far back as 1982 when

[229] I&E Cross-Examination Ex. 9 (I&E RR-75); Tr. at 303.
[230] Tr. at 303-04.
[231] PPL M.B. at 121-22.

faced with Mr. Moul's request for "an allowance to stimulate good management," the Commission stated:

> We also find it significant that Mr. Moul has testified that utilities should be given (in addition to the cost of capital) an allowance to stimulate good management and an allowance for attrition of earnings. Whether and to what extent Mr. Moul's assumptions were influenced by these factors remains unclear. What is clear is that **good management is amply rewarded by decreased operating costs and thus greater return**. It is not permissible, under our law to "reward" good management **(however defined)** by an **arbitrary increase** in the fair rate of return.[232]

Shortly thereafter, in 1986, Section 523 of the Public Utility Code was enacted.

Section 523, however, provided no clear standard for "'reward[ing]' good management (however defined)" either. Rather, it obligated the Commission to "set forth criteria by which it will evaluate future fixed utility performance,"[233] and, in assessing such performance, identified seven factors, all of which but two have been effectively rendered moot by subsequent legislative enactments.

The two potentially relevant factors the Commission shall consider are "management effectiveness and operating efficiency *as measured by an audit* pursuant to section 516"[234] that is properly introduced into evidence, or "any other relevant and material evidence of efficiency, effectiveness and adequacy of service."[235] PPL presented no management audit, so clearly subsection (b)(1) is inapplicable. While PPL also cites subsection (b)(4), action regarding alternative

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[232] *Blue Mountain*, Slip Opinion at 2 (emphasis added).
[233] 66 Pa. C.S. §523(b).
[234] 66 Pa. C.S. §523(b)(1)(emphasis added).
[235] 66 Pa. C.S. §523(b)(7).

energy, as a consideration, that section, like subsections (b)(2), upgrades for coal, (b)(3), efficiency and cost-effectiveness of electric generation, (b)(5), water conservation, and (b)(6) new electric generation, are standards that were subsequently supplanted by specific electric alternative energy, conservation, or deregulation statutes,[236] or are not applicable.

This leaves the Commission one standard of review, subsection (b)(7), which is so broad as to constitute essentially no standard. This is particularly true in light of Section 1501 of the Code, which separately obligates PPL to "furnish and maintain adequate, efficient, safe, and reasonable service and facilities" and to make all repairs and "improvements in or to such service and facilities as shall be necessary or proper for the accommodation, convenience, and safety of its patrons, employees, and the public."[237]

The two Commission cases PPL cites, *1994 West Penn Power*[238] and *2008 Aqua Pennsylvania,*[239] are equally vague. In the West Penn Power case, the Commission awarded 25 basis points because of the utility's "management of the necessity to meet" compliance with amendments to the Clean Air Act and the belief that "stockholders who install such managers should be rewarded."[240] In the Aqua Pennsylvania case, the Commission found that "Aqua has done much to

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[236] For example, the Electric Competition Act supplanted standards related to electric generation, and Act 2004-213 (73 P.S. §§ 1648.1-1648.8), the Alternative Energy Portfolio Standards Act, and Act 129 (66 Pa. C.S. §§ 2806.1-2807) supplanted standards related to alternative energy and efficiency/conservation.
[237] 66 Pa. C.S. §1501.
[238] *Pa. P.U.C. v. West Penn Power Company*, Docket Nos. R-00942986 et al. (Order entered December 29, 1994) ("*1994 West Penn Power*").
[239] PPL M.B. at 115-16.
[240] *1994 West Penn Power*, Slip Opinion at 52.

improve the quality of service throughout its growing service territory"[241] while acknowledging that Aqua had undertaken a course of acquiring small troubled water systems.

iv. Conclusion

The lack of standards by which to evaluate PPL's performance is troubling. If there are no objective standards to follow, then the Commission is left to discern a distinction between PPL's provision of safe and reliable service at just and reasonable rates and that of every other utility, since all utilities are subject to and, absent enforcement action by the Commission, comply with those standards. But as I&E has noted above, PPL dismisses any I&E effort to distinguish it from the pack. While I&E has not contended that utilities cannot demonstrate effective management unless the utility pays for the associated costs with shareholder money,[242] it is not at all unreasonable to consider shareholder contributions in order to give some definition to an otherwise amorphous standard. In that regard as well, however, PPL fails, contributing 1% to the very same $76 million in universal service funding PPL contends merits a shareholder reward.

I&E submits that while the Commission clearly has the authority to award such an equity boost to PPL, PPL's evidence does not warrant one. Moreover, as this award is discretionary, I&E submits that it would be a particularly unwarranted exercise of discretion on the Commission's part because PPL's

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[241] *2008 Aqua Pennsylvania*, Slip Opinion at 50.
[242] PPL M.B. at 122.

ratepayers have been subject to an unyielding series of PPL base rate cases since 2004 and by all PPL's projections continue to face not only unrelenting rate case increases but also intervening DSIC filings.

PPL has not exceeded its statutory and regulatory requirements under the Public Utility Code to provide safe and reliable service at just and reasonable rates. All utilities share the same obligations under the Public Utility Code and all are meeting those, some better than PPL. PPL's requested boost to the cost of equity is neither warranted nor supported. Service industry workers who earn below minimum wage while expecting to be made better by providing superior service deserve a tip. A regulated entity whose full costs of service are already recovered, 50% through reconcilable riders with interest, should not. In order to invoke Section 523 for an annual $3 million tip from ratepayers, PPL should be required to articulate, if not adhere to, a superior standard. It has done neither.

4. Return on Equity Summary

I&E has already addressed PPL witness Moul's inflated growth rate and unnecessarily adjusted dividend yield to his DCF calculation, its flaws related to his equal weighting of the four unrelated DCF, CAPM, RP, and CE methodologies as a means of calculating an appropriate equity return, and the lack of value of the testimony of PPL's career investment advisor, Ms. Cannell, on the high returns investors would like to see result from this case.

PPL has aggressively assumed a carrot and stick posture before this Commission. PPL claims that the 10.7% return on equity the Commission awarded in PPL's 2004 base rate case, before the economic crash and slow recovery the economy is in today, caused a downgrade in its and other electric utilities credit ratings.[243] As the stick, PPL threatens that it will be unable to improve its distribution system and its credit ratings will fall if it is not awarded its requested equity return in this case.[244] PPL then suggests three carrots for the Commission to further boost its return: a leverage adjustment, a management efficiency adjustment, and other financial and business risk adjustments related to PPL's size and other factors.

I&E witness Sears addressed the lack of nexus between PPL's credit ratings and PPL's 2004 case. Coexistence is not evidence of correlation. As I&E addressed, credit rating agencies look at actual book values to determine debt coverage, not at the individual components of the ratemaking process.[245] Further, the evidence demonstrates that in general electric distribution companies today are simply not as risky as they were 30 or even 10 years ago.[246] PPL Corp. itself sought to *reduce* its risk by fundamentally transforming itself from a predominantly unregulated business to a predominantly rate-regulated business mix, with credit agencies citing PPL the rate-regulated entity as the source for the

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[243] PPL M.B. at 114.
[244] PPL M.B. at 86.
[245] I&E St. 1-SR at 3.
[246] *E.g.* I&E St. 1-SR at 5.

stable cash flows which help PPL Corp. retain a stable ratings.[247] The evidence of the financial market today does not support PPL's requested return.

F. Overall Rate of Return

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

G. Conclusion

I&E contends that PPL's claimed rate of return is grossly overstated by $73 million. PPL's claimed capital structure overstates PPL Electric's capital needs by $15 million; the Company's request for an equity reward to recognize its management contributes another $2.9 million in over-capitalization; and PPL witness Moul's proposed leverage adjustment and inflated cost of equity calculations contribute another $55.1 million in unnecessary and unsupported cost of capital claims.

PPL's unsubstantiated rate of return request can only be justified as affiliate support from the rate-regulated entity for the parent company's continued remarkable financial performance. PPL accuses I&E of "straying further from any relevance," misinterpreting I&E's evidence of PPL Corp.'s extraordinary profitability as I&E's contention that "because PPL Corporation (holding

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[247] I&E M.B. at 108-10.

company) had a profitable year no allowance for management effectiveness is needed."[248] PPL also contends that "the profitability of PPL Corp.'s out of state operations (regulated or unregulated) is irrelevant to this proceeding."[249]

I&E does not contend that PPL Corp. had a profitable year. I&E contends that PPL Corp. has had a profitable several decades. PPL investors have profited from 260 quarters, or 65 years of uninterrupted dividend payouts, including a 44% increase in dividend growth since 2005 alone despite the Commission's "financially disastrous" award of a 10.7% return on equity in 2004 and PPL's credit downgrade. While the Commission has regulatory authority over only the jurisdictional utility PPL Electric, the highly profitable financial performance of its parent company is neither meaningless nor irrelevant, particularly given the many interrelated affiliated transactions within the PPL family, which provide financial benefit to affiliates at PPL Electric's expense. The Commission should not ignore the role PPL Electric plays in the PPL family. In PPL Corp.'s own words:

> PPL Corp.'s business mix is now **heavily weighted toward rate-regulated earnings**;
>
> **Rate-regulated earnings provide stability and security to PPL Corp**.'s earnings forecasts and its dividend;
>
> **Rate-regulated earnings support PPL Corp.'s "Excellent" business risk profile** rating by S&P and provide stable ratings outlooks;

[248] PPL M.B. at 122.
[249] *Id.*

> **Rate-regulated earnings secure PPL Corp.'s dividend** and support a platform for continued growth, **increasing the dividend by 44% since 2005**, providing shareowners a **17.5% return for 2011** attaining the high end of the company's 2011 forecast of \$2.55-\$2.75/share, outperforming the S&P 500 Index for 2011, and **ensuring continued dividends that have already spanned 260 consecutive quarters** – or an astounding 65 years of uninterrupted dividends;
>
> **Rate-regulated earnings provide significant growth** prospects with operations in "constructive" jurisdictions, approximately two-thirds of regulated capital expenditures **earning real-time or near real-time returns**, an approximate 9% compound annual growth in rate base from 2011 to 2015, and the expectation of 75% of 2013 EBITDA [Earnings Before Interest, Taxes, Depreciation, and Amortization] from regulated businesses;
>
> **PPL Corp**. has a **highly attractive and differentiated position** in the electric industry;
>
> The bottom line is this: **Without the additional earnings from these rate-regulated operations, PPL [Corp.'s] earnings per share would be significantly depressed** for 2012 and the foreseeable future[.] The fundamental driver of [PPL Corp.'s] acquisitions in 2010 and 2011 [of more rate-regulated entities] was reducing risk for [PPL Corp.] at a time of unprecedented turmoil in competitive electricity markets. [250]

PPL Electric's rate-regulated earnings provide stability and security to PPL Corp. and secure PPL Corp.'s dividend. PPL Electric's regulated rates, including its allowed rate of return, are directly material and relevant to PPL Corp. PPL Electric's rates should be set to assure that the financial growth of PPL Corp. results from all of its business operations and not just the captive ratepayers of PPL Electric.

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[250] I&E M.B. at 78-79.

VIII. RATE STRUCTURE

A. Cost of Service Study

I&E took no position on PPL's cost of service study and therefore has no reply.

B. Revenue Allocation

I&E proposed no changes to the Company's inter-class revenue allocations and therefore has no substantive reply on the issue.

I&E notes, however, its strong agreement with PPL's characterization that I&E has "'no ax to grind' on revenue allocation issues."[251] I&E further submits that it has no "ax to grind" on **any** issue in this proceeding.

1. Scale-back

If the Commission grants PPL less than the full increase it has requested, I&E witness Hubert recommended that the first $1,784,000 be used to reduce the proposed RTS usage rate, which is one half of the proposed increase of $3,568,000 because the increase of 77.5% proposed for RTS is should be ameliorated. Any further decrease should reduce the RS usage rate, the GH-2 rates and the SL/AL rates so that the increase for those classes is proportional to the percentage increase originally proposed since these classes were the only remaining classes that did not receive a significant increase or a decrease under proposed rates. The increase proposed for the LP-5 customer charge should be reduced based upon

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[251] PPL M.B. at 154.

Mr. Hubert's customer cost analysis. If the Commission does not accept Mr. Hubert's recommendation to reduce the LP-5 customer charge, it should be scaled back so the increase for the LP-5 class is proportional to the percentage increase originally proposed for this class. However, if the Commission accepts Mr. Hubert's recommendation to reduce the LP-5 customer charge based on his customer cost analysis, it should not be scaled back.[252]

PPL does not contest I&E's proposed scale-back in its Main Brief, and as I&E has already noted, PPL witness Krall agreed that a scale-back should be "applied on a proportional basis to only those rate schedules which, under the Company's original proposal, would be receiving increases" and that Mr. Hubert's approach was consistent with that recommendation.[253]

OSBA likewise does not address I&E's proposed scale-back in its Main Brief. However, I&E agrees with PPL's observations that it would not be right for customers who were originally proposed to have no increase or a slight decrease to be awarded an even greater decrease in the event the Commission grants a lesser overall increase. The Commission rejected a similar proposal by OSBA in PPL's 2004 base rate case.[254] Further, I&E's proposed proportional scale-back of the Company's proposal would still move most classes closer to the system-average

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[252] I&E M.B. at 126-27.
[253] I&E M.B. at 128.
[254] *PPL 2004 Base Rate Case,* Slip Opinion at 85 (denying OSBA's Exception that any reduction in the proposed increase be assigned to classes currently overpaying their cost of service).

rate of return in accordance with *Lloyd*.[255] Any allowed increases should be scaled back proportionately as proposed by I&E witness Hubert.

C. Tariff Structure

1. Rate Design

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

2. Customer Charge

I&E presented a customer cost analysis performed in accordance with past Commission decisions. In response to the results of that customer cost analysis, I&E proposed either reductions to PPL's proposed customer charges or no change to the rates of existing customer charges that already exceeded the results of the customer cost analysis. I&E did not distinguish between residential and non-residential classes in proposing its customer charges. Rather, I&E witness Hubert was guided exclusively by the results of his customer cost analysis.[256] This had the effect of substantially moderating PPL's proposed increases to the Rate Schedules RS (under either PPL's original or modified proposal), GS-1 and GS-3, and LP-5.[257]

Without any specific citation, PPL broadly contends that its proposal to substantially increase customer charges and reduce energy charges is consistent

[255] *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010 (Pa. Cmwlth. 2006) ("*Lloyd*").
[256] I&E M.B. at 129-38.
[257] See specifically the chart on page 130 of I&E's Main Brief.

with *Lloyd*.[258] This is incorrect and reflects the predominant flaw in PPL's customer charge argument that permeates the entirety of PPL's customer charge proposal, namely that revenue allocation for cost of service purposes is synonymous with customer cost analysis for rate design purposes. As I&E has maintained throughout this proceeding, the two are not the same. Although the customer cost analysis uses data from the cost of service study, it is an entirely different cost analysis.[259] A customer cost analysis is more focused and is conducted to determine the proper direct costs that should be recovered in the customer charge.[260] However, by failing to differentiate between the two, PPL has proposed flawed customer charges that violate the Commission's articulated standards.

PPL also contends, as did OSBA witness Knecht,[261] that some lesser, unspecified standard other than a customer cost analysis applies to non-residential customers. As demonstrated below, while most discussions of an appropriate customer charge level are raised within the context of the residential class, the Commission has not restricted its basic customer cost analysis to residential customers only.

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[258] PPL M.B. at 157 (Rate Schedule RS), 159 (Rate Schedules GS-1, GS-3, and LP-4), and 163 (Rate Schedule RS).
[259] I&E St. 3 at 9-10.
[260] I&E St. 3-SR at 11.
[261] OSBA St. 2 at 9.

a. *Lloyd* Does Not Support PPL's Intra-Class Rate Design

PPL repeatedly cites generally to *Lloyd* for the proposition that its proposed rate design is compelled by that case. That is inaccurate.

In *Lloyd*, Commonwealth Court did not address intra-class rate design generally or the intra-class revenue allocation between customer and usage charges specifically. The Court summarized the rate setting process as comprising "two factors – what increase in revenues over those produced by existing rates is needed to give the utility a fair rate of return and what increased revenues are going to be allocated in the rates *among the various rate classes, i.e., the rate structure.*[262] The Court then noted that the issue at hand was the latter, the "differential in rates between rate classes."[263]

The opinion is replete with references to "determining the proper ratios among the different customer classes for cost of service"[264] and the "substantial difference in costs required to deliver services between classes."[265] The Court did not, and was not asked to, address the revenue allocation *within* a class. It, therefore, has no applicability to the determination of a proper customer charge.

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[262] *Lloyd*, 904 A.2d at 1015 (emphasis added).
[263] *Lloyd*, 904 A.2d at 1016.
[264] *Lloyd*, 904 A.2d at 1019.
[265] *Lloyd*, 904 A.2d at 1020.

b. Customer Charges Are Determined by a Properly Constructed Customer Cost Analysis

PPL's reliance on *Lloyd* only reinforces PPL's confusion between cost of service and intra-class rate design. This confusion is also reflected in its erroneous accusations and innuendo attributing to I&E statements about PPL's minimum cost of service study that I&E never made. PPL contends that I&E opposed PPL's proposed customer charges on the basis of the Company's cost of service study, which is "virtually identical to the minimum size system study" approved and used in the 2010 base rate case[266] and that "I&E contends that PPL Electric's minimum size system study confuses fixed costs with customer costs" citing I&E St. 3-SR at p. 3.[267] This misrepresents I&E witness Hubert's testimony, which did not take issue with the Company's cost of service study.

I&E did not oppose the Company's cost of service study or its minimum system study. The Company recognized that fact in stating "[t]he only party to oppose PPL Electric's cost of service study was the OCA."[268] Rather, as I&E witness Hubert unambiguously explained in his direct testimony, "[w]hile the Company provided a cost of service study, it did not conduct a specific customer cost analysis, which uses data from but is different from the cost of service study."[269] If fact, Mr. Hubert used data from the Company's cost of service study

[266] PPL M.B. at 167.
[267] PPL M.B. at 168.
[268] PPL M.B. at 139.
[269] I&E St. 3 at 10.

in conducting his customer cost analysis.[270] The flaw in the Company's proposal, however, as Mr. Hubert explained in his direct testimony, and then again in his surrebuttal, is that

> [t]he Company is confusing fixed costs with customer costs, which are two distinct groups of costs. Recovering fixed costs in the customer charge simply because they are fixed costs would be incorrect. Customer costs are costs that vary with the number of customers served. Stated differently, they are costs that could be avoided if a customer ceased taking service.[271]

The Company also attempts to justify its proposed customer charges on the bases that if the RS customer charge remains unchanged, it will result in fewer fixed costs being recovered in the customer charge than under present rates[272] and that PPL's proposed RS customer charge will maintain an energy charge component that is only 0.7% lower than the current RS energy charge, retaining 86% of charges on an average residential customer's bill as usage-based. This, PPL contends, will not negatively impact customers' incentives to conserve.[273]

A correctly conducted customer cost analysis dictates the appropriate level of customer charge, not the effects of the passage of time between rate cases and the relativity of past customer charge increases. Moreover, I&E disputes PPL's in-brief analysis of the percentage of residential charges that would remain subject to usage-based rates if the RS customer charge is increased as proposed. While the Company does not show its calculation, based on the same cited Company exhibit,

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[270] I&E St. 3 at 11.
[271] I&E St. 3-SR at 3.
[272] PPL M.B. at 163.
[273] PPL M.B. at 164.

PPL Ex. DAK 4 attached to PPL St. 5-R, I&E contends that the revenue from usage-based charges would decrease from 79% to 67% of the total distribution service revenues, with revenues from the customer charge increasing from 21% to 33%.[274] That represents a much more substantial shift in revenue recovery from usage to fixed charges than PPL contends. Plus, increasing the collection of customer costs from 1/5 to 1/3 of the Company's revenue allocation will clearly inhibit customer conservation efforts since the most obvious means by which customers measure conservation success is through lower utility bills.[275] Losing control over a substantial part of the customer's bill because it is a fixed, unavoidable charge, will very likely deter further efforts to use energy wisely, despite the millions of ratepayer dollars already expended and to continue to be expended on that very effort. Finally, as utilities often say, customers do not pay percentages, they pay dollars.

The fundamental flaw with respect to PPL's proposed customer charges remains the Company's refusal to accept that a properly designed customer cost analysis must support its proposed customer charges. This PPL has not done.

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[274] I&E's calculation is as follows:

	Dist. Rev. from Customer Charge	Dist. Revenue from Usage Charge	Total Dist. Rev.
Pres:	14,413,381 x $8.75 = **$126,117,084** (21%)	14,017,103,900 x $0.03364 = **$471,535,375** (79%)	**$597,652,459**
Prpsd:	14,413,381 x $16.00 = **$230,614,096** (33%)	14,017,103,900 x $0.03340 = **$468,171,270** (67%)	**$698,785,366**

[275] The fact that bills today even with the increase may still be lower than they were, as PPL contends, simply takes the benefits customers have earned through past conservation efforts or the reductions to generation costs, which comprise the majority of customers' bills, and passes those directly to the Company. Tr. at 463-65.

c. PPL's Proposed Customer Charges Are Not Supported by a Properly Constructed Customer Cost Analysis

Initially, PPL conducted no customer cost analysis, and instead relied on the results of its cost of service study to support its proposed increases in the customer charges. In rebuttal, retaining the untenable position that "all of PPL Electric's distribution costs are fixed costs,"[276] PPL presented an "alternative compromise customer charge"[277] of $14.09, which it contends is supported by the Commission's decision in a 2004 case involving Aqua Pennsylvania, Inc.[278] In addition, while never expressly contending that a different standard applies to non-residential customers, PPL casts its argument with respect to its proposed customer charges in two separate contexts, residential and non-residential. This, as I&E contends and demonstrates below, is not relevant to the proper construct of a customer cost analysis.

As to PPL's "alternative compromise" proposal, I&E submits that it is improper to submit a "compromise" outside the context of a settlement, as PPL does. Settlements are not subject to the same standards and burdens of proof as are litigated issues. In order to support PPL's "alternative compromise proposal" on this record, PPL still requires a properly constructed customer cost analysis, which it has not submitted. I&E submits that Company's submission of an "alternative

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[276] PPL M.B. at 168.
[277] PPL M.B. at 173.
[278] *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, 236 P.U.R. 4th 218 (2004), with citations herein taken from the Slip Opinion at Docket No. R-00038805 (Order entered August 5, 2004) ("*2004 Aqua*"). *See* PPL M.B. at 171-73.

compromise" simply demonstrates the Company's lack of support for and confidence in its own proposals.

The Commission adopted the "basic customer cost" methodology for developing customer charges for electric companies decades ago. In a 1985 West Penn Power case, the Commission adopted the Commission Staff proposal that "basic customer cost" be defined as:

> those expenses for items the company must have in place each month for each customer. This includes costs for the meter and service drop, meter reading and billings. It excludes consideration of assertedly "customer-related" costs of transformation and distribution plant. [Staff] testified that these latter costs are better recovered through energy charges to avoid subsidies from low usage customers to high usage customers.[279]

As the Commission concluded, "[w]e have adopted the 'basic customer cost' method for several major Pennsylvania electric utilities, and we now conclude that it is likewise appropriate for WPP."[280]

While the issue was raised and discussed solely in the context of challenges to the residential customer charge, the West Penn Power Industrial Intervenors (WPPII) also challenged the energy/demand allocation of in commercial and industrial intraclass rate design. WPPII did not base their challenge on the results of a customer cost analysis, however, and the Commission rejected their challenge

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[279] *Pa. P.U.C. v. West Penn Power Company*, 69 P.U.R. 4th 470, 521 (1985) ("*1985 West Penn Power*").
[280] *1985 West Penn Power*, 69 P.U.R. 4th at 521.

finding the record insufficiently developed "to explain the conflicting results of the two witnesses."[281]

A decade later, and notably after the creation of the OSBA, the Commission again resolved challenges to the residential customer charge and again affirmed its basic customer cost analysis excluding indirect customer and administrative costs, as follows:

> We agree with OTS and OCA on this issue. Despite NFG's arguments to the contrary, we believe the Commission has clearly defined the costs to be included in a residential customer charge as being limited to those costs which directly relate to the meter and service drop, and customer service expenses associated with meter reading and billing. The evidence in this case reveals that NFG developed its customer cost figure on the basis of costs that fall outside of this definition of applicable customer costs. Moreover, we agree with OTS and OCA that NFG's proposed increase to the residential customer charge violates the principle of gradualism, given the fact that it amounts to a 15.58% increase as compared to the overall requested revenue increase of 6.78%. Therefore, we recommend that NFG's proposed residential customer charge be rejected.[282]

While this discussion focused on the OTS and OCA challenges to the residential customer charge, in this case the OSBA also mounted a challenge to the small commercial and public authority class customer charge contending that NFG's cost analysis was flawed. OSBA proposed that the customer charge be decreased rather than increased. As it did for the industrial intervenors in *1985 West Penn Power*, however, the Commission rejected the OSBA's

[281] *1985 West Penn Power*, 69 P.U.R. 4^{th} at 522.
[282] *1995 NFGDC,* 1995 WL 933720 **108 (citations omitted).

recommendation on the basis that the OSBA did not provide a rigorous cost analysis. Nonetheless, in its discussion of the issue, the Commission clearly confirmed the applicability of the basic customer cost analysis to non-residential customers.

As the Commission declared, the cost analysis performed by NFG for non-residential classes suffered the same flaw as NFG's analysis of its residential customer costs:

> That is, the customer cost figures which NFG developed for these small commercial and industrial classes appear to include more than the direct customer costs relating to these classes as defined earlier. *See*, NFG Ex. 111-E. Furthermore, we note that the percentage increase proposed for the small commercial and public authority customer charge is 15.38%, while that proposed for the small SVIS customer charge is 16.79%. These are in contrast to the Company's overall requested increase of 6.78%. Therefore, we cannot accept NFG's proposed customer charges for these classes.
>
> For the reasons discussed above, we recommend that the customer charges for the small commercial and public authority class and the small SVIS class be held at their present levels of $26.00/month and $68.50/month, respectively in this proceeding. We further recommend that the difference in the amount of revenue recovery between that produced by the current charges and that which would be produced by NFG's proposed charges be made up in the commodity charges of these respective classes to maintain revenue neutrality.[283]

The Commission also adopted this approach for water utilities. In a 1994 Pennsylvania American water case, the ALJ accepted the OCA and OTS positions that the existing customer charges more than recovered the appropriate direct

[283] *1995 NFGDC*, 1995 WL 933720 ** 110.

charges for billing and collections costs, meter reading costs, and the costs of meters and services. On that basis, the ALJ rejected the Company's proposed increase to 5/8' and ¾' services to **residential and commercial** customers, the only customer charges that were contested, which the Commission affirmed.[284]

Thus, the Commission has clearly and repeatedly affirmed that an appropriately constructed customer cost analysis considers direct costs only, those costs that vary with the number of customers served, and not indirect or transmission or distribution related costs. And, while most challenges involve increases in the residential customer charge, where those challenges extended to non-residential classes, the Commission has likewise extended its basic customer cost analysis to those classes. The Commission has not rejected challenges to non-residential customer charges on the basis that a different standard of measure should apply, but rather because an appropriately constructed customer cost analysis was not performed. When presented the issue, it has affirmed the applicability of its direct cost standard to residential and non-residential customers alike.

Recognizing that its initial proposal far exceeded any reasonable bounds of Commission precedent, PPL attempts to support its "alternative compromise customer charge" with one case, *2004 Aqua*. I&E notes, however, that the holding of that case with respect to the inclusion of indirect costs in the calculation of a

[284] *Pa. P.U.C. v. Pennsylvania-American Water Company,* 82 Pa. P.U.C. 381, *429-30, 1995 WL 529581 (Pa.P.U.C.) ** 55 ("*1995 Pa. American*").

customer charge not been reaffirmed or reapplied since 2004. Moreover, in the intervening years, most recently last year, the Commission affirmed the basic customer cost analysis articulated in *1985 West Penn Power*. Thus, based upon the overwhelming majority of Commission decisions that support I&E witness Hubert's customer cost analysis, I&E contends that *2004 Aqua* relied on by PPL is the exception, not the norm, and is not in keeping with recent decisions.

In the Columbia Gas of Pennsylvania base rate case at Docket No. R-2010-2251623 (Order entered October 14, 2011) decided just last year by the Commission,[285] I&E witness Hubert conducted a customer cost analysis that included the same direct customer costs that he included in this proceeding: meters and house regulators, customer installations, services, meter reading, customer records and collection and customer assistance costs.[286] Mr. Hubert noted then, as he did now, that his calculations were based upon the same method the Commission adopted in a case involving PPL's former affiliate, PPL Gas Utilities Corporation.[287] As Mr. Hubert also noted, his analysis applies the same parameters the Commission affirmed in PPL's 2004 base rate case.[288]

The Company attempts to isolate the Commission's holding in *2011 Columbia Gas* on the basis that it was "limited solely to the facts of that case and was not intended to be used in other proceedings that present viable rate

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[285] *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc.*, 293 P.U.R. 4th 235, 2011 WL 5026079 (Pa.P.U.C.) ("*2011 Columbia Gas*").
[286] *2011 Columbia Gas*, 2011 WL 5026079 * 16; Tr.at 541-42.
[287] *See PPL Gas, supra.*
[288] I&E St. 3-SR at 7.

mechanisms."[289] With respect to the Commission's caution that its decision is limited to the facts of that case, this is not substantively different from the Commission's decision in *2004 Aqua*, the sole case upon which PPL relies. As the Commission articulated then, "[w]e caution that these are costs which may be considered for inclusion in the customer charge, but such claims are subject to scrutiny on a case-by-case basis."[290]

Moreover, when reviewed within the context of the charge at issue in *2011 Columbia Gas*, the Commission's declaration about the decision's applicability to future rate designs applies to Columbia's proposal to implement a fixed, flat monthly rate with no usage component. The Commission did not declare that its "basic customer cost" methodology for developing a proper customer cost analysis was no longer precedent, nor did it void decades of prior Commission decisions describing the direct customer costs properly to be included in the conduct of a customer cost analysis.[291]

Thus, both PPL's initial and "alternative compromise" customer charge proposals fail to meet the parameters of a properly constructed customer cost analysis, and both must fail. PPL has not distinguished between those direct costs that change with the addition or deletion of a customer (those costs that vary

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[289] PPL M.B. at 169, note 34.
[290] *2004 Aqua*, Slip Opinion at 72.
[291] I&E also notes that despite OSBA witness Knecht's concerns that Mr. Hubert's non-residential customer charge recommendations may result in larger customers subsidizing smaller customers, in fact OSBA expressed the opposite concern in *2011 Columbia Gas*, noting that if Columbia's proposal were applied to small business customers, it "would result in unreasonable *intra-class* cross-subsidies from smaller customers to larger customers." *2011 Columbia Gas,* 2011 WL 5026079 *19, citing the OSBA Reply Brief.

directly with customer connections) and every other fixed investment it incurs.[292] In relying on its cost of service study customer/demand allocations rather than conducting an appropriate customer cost analysis, PPL has rendered all fixed customer-related investment synonymous with direct customer costs. That contradicts the Commission's accepted practice.

If PPL's approach is adopted, it would sanction the same analysis offered by Columbia Gas and rejected by the Commission, namely, that fixed customer-related distribution charges should recover all if not almost all customer-related investment. PPL's proposal should not be accepted just because the Company has proposed something less than 100% recovery of all fixed customer-related costs when in reality PPL recognizes "very few, if any" usage-related distribution costs. If adopted here, the Commission will have no substantive reason not to apply that same rationale when PPL proposes 100% recovery of fixed investment through a fixed charge. Relevant and time-honored ratemaking principles compel rejection of PPL's approach to development of its proposed customer charges. If, however, the Commission finds that higher customer charges are warranted, then I&E respectfully submits that such should "give rise to a corresponding adjustment to the cost of common equity to reflect such increased [revenue] stability."[293]

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[292] While PPL continues to maintain that there is a direct relationship between the number of customers and the size and cost of poles, conductors, and transformers (PPL M.B. at 168), this contention overlooks the reality that if the Company's service area remains fixed, as it does because the distribution monopoly certification remains a legal and factual reality, an increase in the number of customers will not notably increase the costs of a minimum size distribution system.

[293] *2011 Columbia Gas*, 2011 WL 5026079 * 17 (noting the provision in the Joint Petition that acknowledged that rate designs that increase revenue stability warrant a reduced equity award).

3. Elimination of Rate Schedule RTD

This issue is resolved.

D. Tariff Rules and Riders

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

E. Summary and Alternatives

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

IX. MISCELLANEOUS ISSUES

A. Purchase of Receivables

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

B. Customer Assistance Programs

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

C. Consumer Education

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

D. CER/RMI

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

I&E notes that if the Commission allows a CER Rider, then the overall O&M costs should be reduced by the total CER costs claimed by PPL, regardless of the amount approved by the Commission, because PPL currently reflects these claimed costs as O&M expenses.

X. CONCLUSION

PPL has failed to bear its burden of proof with respect to each and every element of its proposed $104.6 million rate increase. The Company's proposal must be adjusted. For the reasons stated herein and in its Main Brief, the Bureau of Investigation & Enforcement respectfully requests the Administrative Law Judge and the Commission to adopt its recommendations in this proceeding, which include a reduction to present rate revenues of $8,971,000 as supported herein and reflected on the tables provided in I&E's Appendices A.

Respectfully submitted,

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Dated: September 14, 2012

APPENDIX A

Table III
Rate of Return

Per Company	Structure	Cost	Weighted Cost
Total Debt	49.22	0.0551	2.7100
Long Term Debt	49.22	0.0550	2.7100
Short Term Debt	0.00	0.0000	0.0000
Preferred Stock	0.00	0.0000	0.0000
Common Equity	50.78	0.1125	5.7100
TOTAL	100.00		8.42

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

PPL Electric
R-2012-2290597
9/13/12

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

CERTIFICATE OF SERVICE

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

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