COMMONWEALTH OF PENNSYLVANIA

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November 8, 2012

Rosemary Chiavetta, Secretary
PA Public Utility Commission
Commonwealth Keystone Bldg.
400 North Street
Harrisburg, PA 17101

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

Dear Secretary Chiavetta:

Enclosed please find the Office of Consumer Advocate's Exceptions to the Recommended Decision in the above-referenced proceeding.

Copies have been served upon all parties of record as shown on the attached Certificate of Service.

Sincerely yours,

Candis A Tunilo

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Enclosures
cc: Honorable Susan D. Colwell
Certificate of Service
155413.DOC

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

EXCEPTIONS OF THE OFFICE
OF CONSUMER ADVOCATE

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DATED: November 8, 2012
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I. INTRODUCTION

On October 19, 2012, the Office of Administrative Law Judge issued the Recommended Decision of Administrative Law Judge (ALJ) Susan D. Colwell in PPL Electric Utilities Corporation's 2012 base rate case (PPL or Company). PPL filed its 2012 base rate case on March 30, 2012, seeking an increase $104.6 million to its annual operating revenues. In her Recommended Decision, ALJ Colwell recommended that PPL be permitted to increase its annual operating revenues by $63.83 million.

The Office of Consumer Advocate (OCA) recognizes that the Recommended Decision did not recommend adoption of several of OCA's proposals in this proceeding. The OCA has not, however, excepted to all of its proposals that were rejected by the Recommended Decision. Instead, the OCA will address in these Exceptions those issues with the most impact on residential customers overall. Specifically, the OCA excepts to the ALJ's recommended rejection of the OCA's proposed rate base adjustment to PPL's accumulated reserve for depreciation and the OCA's proposed adjustments to payroll expense and incentive compensation expense, as allowance of these expenses is not supported by the record or relevant case law. Further, the OCA excepts to the Recommended Decision's failure to address the OCA's proposals regarding additional Customer Assistance Program (CAP) outreach, which the Company agreed, in part, to implement. In addition, the OCA excepts to the ALJ's recommendation to adopt PPL's capital structure and to award a management performance bonus, neither of which are supported by the record. The OCA also excepts to the ALJ's recommendation to accept PPL's cost of service study and revenue allocation, which assigns virtually the entire increase to the residential class. The OCA asserts that its revenue allocation proposal, guided by a more reasonable cost of service study, should be adopted in this proceeding. The OCA also excepts to the ALJ's recommendation to adopt PPL's alternative residential rate design proposal that would increase the RS class customer charge from $8.75 to $14.09, as it is not supported by Commission precedent or sound ratemaking principles. Finally, the OCA excepts to parts of the ALJ's recommendation to adopt PPL's Competitive Enhancement Rider (CER). Instead, the OCA's proposals to limit the CER to consumer education costs and the OCA's proposed per kWh recovery method should be adopted.

II. EXCEPTIONS

OCA Exception 1: <u>The Recommended Decision Erred In Failing To Recommend Adoption Of OCA's Accumulated Reserve For Depreciation Adjustment.</u> (R.D. at 16-18; OCA M.B. at 12-14; OCA R.B. at 2-4).

In her Recommended Decision, the ALJ recommended that the OCA's proposed adjustment to PPL's accumulated reserve for depreciation, which would result in a $10,417,000 decrease to rate base, be rejected. <u>See</u> R.D. at 18. Instead, the ALJ recommended adoption of PPL's reflected annual depreciation accruals of only $155,248,000 in the reserve, although PPL proposed annual depreciation expenses of $168,920,000. <u>See</u> R.D. at 18; <u>see also</u> PPL Exh. Future D-1 at 1. OCA witness Koda recommended an adjustment to PPL's accumulated reserve for depreciation in order to better match PPL's claimed depreciation expense. <u>See</u> OCA St. 1-REV. at 11-12; Exh. KC-1-REV. Sched. 2 at 3. As explained by Mr. Koda:

> Because the reserve for depreciation is built-up by recording depreciation expense related to plant in service, the reserve should reflect the depreciation expense claimed as a reduction of operating income in the rate proceeding consistent with the period ending plant in service claimed in the proceeding.

OCA St. 1-REV. at 11. As Mr. Koda further testified, since PPL annualized its depreciation expense, it is appropriate to also annualize depreciation reserve because such synchronization is more fair to ratepayers. <u>See</u> OCA St. 1-SR at 4. In other words, the depreciation expense included in the cost of service and the additions to the depreciation reserve, which are deducted from rate base, should both be based on the level of plant that the Company claims will be in service at the end of the future test year and the depreciation expense claimed for the future test year related to that plant.

The OCA submits that it is reasonable for ratepayers to receive the full benefit of the depreciation expense for which they are being charged by also receiving the corresponding full benefit of accumulated depreciation reserve. Therefore, OCA witness Koda's adjustment to accumulated reserve for depreciation should be adopted. Mr. Koda's recommended adjustment results in a reduction to PPL's rate base of $10,417,000 (rounded to the nearest $1,000). OCA St. 1-REV. at 12; Exh. KC-1-REV. Sched. 1 at 2; see also OCA St. 1-SR at 3-5; Exh. KC-1-SR Sched. 1 at 2; OCA M.B. at Table II.

OCA Exception 2: The Recommended Decision Erred In Failing To Recommend That A Portion Of The Company's And PPL Services' Incentive Compensation Expense Be Allocated To Shareholders. (R.D. at 26-28; OCA M.B. at 20-25; OCA R.B. at 9-13).

In the Recommended Decision, the ALJ rejected the OCA's and I&E's proposed adjustments to PPL's incentive compensation expense and the OCA's proposed adjustment to the portion of PPL Services' incentive compensation expense assigned to PPL. R.D. at 28. The ALJ reasoned that the law does not support OCA's and I&E's positions that shareholders should fund half of the incentive compensation program because shareholders also benefit from the program. Id. The OCA respectfully disagrees with the ALJ's recommendation. There is ample case law in Pennsylvania, as discussed in OCA's Main and Reply Briefs, to support OCA's position that shareholders should fund a portion of the incentive compensation plans that benefit shareholders. See OCA M.B. at 21-25 and OCA R.B. at 9-13, citing Pa. PUC v. UGI Utilities, Inc.-Electric Division, 82 Pa. PUC 488, 508 (1994) (UGI Electric 1994); Pa. PUC v. Roaring Creek Water

Co., 81 Pa. PUC 285 (1994) (RCWC 1994); Pa. PUC v. Philadelphia Gas Works, 2007 Pa. PUC LEXIS 45 (2007) (PGW 2007).

As discussed in the OCA's Main and Reply Briefs, this Commission has held that shareholders should pay a portion of a company's incentive compensation expense when it is shown: (1) that the goals of the company's incentive compensation plan are directed at corporate financial goals and market performance rather than improved ratepayer service; (2) that the goals of the plan are not quantified in either productivity savings to ratepayers or to the incentive expenses themselves; (3) that the goals of the plan are not shown as necessary to providing public utility service; and/or (4) that the company failed to provide clearly articulated, well-defined, quantitative goals and criteria for its plans. See UGI Electric 1994; RCWC 1994; PGW 2007.

In recommending that one-half of the incentive compensation plan expense be borne by shareholders in this proceeding, OCA witness Koda testified that after reviewing the complete plans and PPL's summary description of the plans, it was clear that "a significant goal of the incentive compensation of both plans benefits shareholders more than ratepayers … ." OCA St. 1-SR at 7; see also OCA St. 1-REV. at 18. The Company's own description of the plans indicates that a significant portion of the purpose, goals and targets of these incentive programs are not focused on improving the operational fitness of the electric distribution company to the betterment of customers and ratepayers. OCA St. 1-REV. at 18-19; see also OCA St. 1-SR at 7. Mr. Koda testified:

> [Th]e incentive plans primarily focus on the corporate and financial objectives of the corporate parent and electric distribution company in Pennsylvania. Therefore, it is appropriate that a major portion of incentive compensation costs be borne by the Company's shareholders, who benefit the most from the achievement of certain performance criteria which form the basis of the Plans.

OCA St. 1-REV. at 18. The Company acknowledged that of the three goals of the plans described in PPL's strategic goals framework, two are financially driven. See PPL M.B. at 35-36.

In UGI Electric 1994, the Office of Trial Staff (OTS, now I&E) recommended that a portion of the company's two incentive compensation programs be charged to shareholders because (1) the programs were directed at corporate financial goals and market performance rather than improved ratepayer service; (2) the company had not quantified either productivity savings to ratepayers or the incentive expenses themselves; and (3) the company had not shown that such incentives were necessary for providing public utility service. UGI Electric 1994, 82 Pa. PUC at 504. UGI Electric, similar to the assertions of PPL in this matter, argued that incentive compensation constitutes a component of total compensation, and base salaries would have to be higher without it. Id. Also, UGI Electric argued that incentive compensation programs are appropriate and effective management tools widely utilized by regulated and non-regulated companies. Id. In recommending disallowance of the entire expense related to UGI Electric's incentive compensation plans, the administrative law judge noted how disturbing it is when the focus of incentive compensation plans is the parent company's profitability rather than focusing on the operational effectiveness of the subsidiary. Id. at 505. The Commission adopted the ALJ's recommendation to disallow the company's incentive compensation plan expense. UGI Electric 1994 at 508.

In RCWC 1994, the company sought recovery of an incentive bonus program for management. RCWC 1994, 81 Pa. PUC at 297. OTS (now I&E) recommended disallowance of the entire expense claim because the main goals of the program involved meeting income and earnings targets. Id. The OCA also recommended disallowance of the entire claim because the program goals were the enhancement of earnings, not company improvements in service to ratepayers. Id. The ALJ recommended that OCA's proposal to disallow the expense be adopted because RCWC's incentive bonus program was not aimed at enhancing productivity and efficiency of the company. Id. at 298. The Commission agreed with the ALJ and denied RCWC's incentive bonus expense. Id. at 299.

In PGW 2007, PGW sought to include a $500,000 management incentive compensation program in rates. Id. at *68. OCA and OTS (now I&E) objected to the expense because PGW failed to provide documentation showing that the program actually achieved its stated goal of attracting and retaining its 55 top managers. Id. at *69-70. In denying the expense, the Commission noted that the program's clearly articulated, well-defined, quantitative goals and criteria, as are used in private industry for such 'pay-for-performance' programs, are absent. Id. at *76.

Under the facts of this case, UGI Electric 1994, RCWC 1994 and PGW 2007 control. I&E witness Morrissey testified, similarly to OCA witness Koda, stating that PPL failed to disclose the target goals of the plan or the calculations that result in the Company's incentive compensation plan claim. See I&E St. 2-SR at 10. Ms. Morrissey also testified that the omission of these detailed calculations and goals do not allow the Commission to scrutinize the plan's prudence and priorities. Id. at 11. Instead, as noted by Ms. Morrissey, the plans show that the focus of PPL's mission includes giving best-in-sector returns to its shareholders and that generally, shareholder value must be first achieved before any incentive payout occurs, with the level of shareholder value achieved being the driving payout factor. Id. The evidence of record supports OCA witness Koda's and I&E witness Morrissey's testimony in this regard.

The ALJ relied on the Commission's holding in the 2007 PPL Gas base rate case approving that company's incentive compensation program for ratemaking purposes in reaching her recommendation that PPL's and PPL Services' incentive compensation program expenses be approved. R.D. at 27-28, citing Pa. PUC v. PPL Gas Utilities Corporation, 255 PUR 4^{th} 209 (Pa. PUC 2007) (PPL Gas 2007). The ALJ also cites to Butler Township Water Co. v. Pa. PUC, 473 A.2d 219 (Pa. Commw. 1984) (Butler Township) and T.W. Phillips Gas and Oil Co. v. Pa. PUC, 474 A.2d 355 (Pa. Commw. 1984) (T.W. Phillips) in support of her recommendation. As explained in OCA's Reply Brief regarding the Butler Township case, the Commission specifically stated in PPL Gas 2007 that its holding regarding the sharing of rate case expense between ratepayers and shareholders stated in Butler Township does not apply to incentive compensation expense.[1] See PPL Gas 2007 255 P.U.R. 4^{th} at 233. Thus, this case is inapposite. Additionally, as stated in OCA's Reply Brief, T.W. Phillips is not controlling for the same reasons as Butler Township. See OCA R.B. at 10. However, the facts surrounding PPL Gas's incentive compensation expense claim in PPL Gas 2007 are distinguishable from the facts in this matter, and therefore, PPL Gas 2007 does not control the outcome here.

At issue in PPL Gas 2007 was the company's variable pay expense claim that comprised 10% of non-union employees' salaries, which was at risk based on the achievement of certain financial, operational and safety-related objectives. Id. at 230. In permitting the expense, the Commission accepted the company's argument that the variable pay program was intended to be combined with employees' base salaries to provide market rate compensation, and shareholders

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1 In Butler Township, the Commission disallowed one-half of the company's claimed rate case expense under a policy determination that rate case expense should be shared between shareholders and ratepayers. 81 Pa. Commw. at 43-44, 473 A.2d at 221. The Commonwealth Court found that this was improper and held that in the absence of a showing that the claimed rate case expense was unreasonable, imprudently incurred or excessive, the company was entitled to recover the entire claimed amount. Id. This Commission later specifically held that the Commonwealth Court's holding regarding rate case expense in Butler Township is not determinative with respect to bonus compensation expenses. See PPL Gas 2007, 255 P.U.R. 4^{th} at 233.

contributed to the expense when payments exceeded budgeted amounts. Id. at 231, 232-33. In the present matter, there is no evidence that any portion of PPL's or PPL Services' employees' base salaries are put at risk in the incentive compensation programs. Importantly, the Commission explicitly stated in PPL Gas 2007 that: "we do not agree with the Company that the adjustment urged by the OTS would be prohibited as a matter of law under Butler." PPL Gas 2007, 255 P.U.R. 4th at 233.

Other cases cited by PPL in support of the incentive compensation expense are similarly distinguishable from the facts in this matter. See OCA R.B. at 9-13. The OCA submits that the case law on this issue supports a finding that, based on the evidence of record in this matter, shareholders should fund 50% of PPL's claimed incentive compensation expenses because: (1) PPL failed to disclose the target goals of the plan or the calculations that result in the Company's incentive compensation plan claim and (2) the plans show that the focus of PPL's mission includes giving best-in-sector returns to its shareholders and that generally, shareholder value must be first achieved before any incentive payout occurs, with the level of shareholder value achieved being the driving payout factor.

The OCA submits that it is not just or reasonable to require ratepayers to pay for 100% of PPL's and the Company's portion of PPL Services' incentive compensation expense when the primary goals of the programs are related to the financial targets of the Company. The OCA submits that OCA witness Koda's recommendation that PPL's ratepayers and shareholders should share equally in the cost of PPL's and PPL's portion of PPL Services' incentive compensation plans expense is reasonable and appropriate and should therefore, be adopted. Mr. Koda's recommendation resulted in a downward adjustment to PPL's proposed expenses of $4,468,000 related to PPL's incentive compensation plan and $4,902,000 related to PPL's share of PPL Services' incentive compensation plan. See OCA Exh. KC-1-SR, Sched. 4 at 4; Sched. 1 at 2 (lines 19 and 20); see also Table II-REVISED, attached to OCA's R.B. as App. A.

Additionally, as explained in OCA's Main Brief, adjustments must be made to: (1) Plant in Service to reflect the capitalized portions of Mr. Koda's recommended adjustment to PPL's incentive compensation plan and (2) to accumulated deferred taxes. See OCA M.B. at 11-12. The capitalized portion of Mr. Koda's recommended adjustment to PPL's incentive compensation plan results in a downward adjustment to PPL's proposed rate base of $1,678,000. See OCA Exh. KC-1-SR Sched. 1 at 2. Mr. Koda's recommended adjustment to PPL's proposed incentive compensation plan expense affected PPL's accumulated deferred tax requirements, which increased PPL's proposed rate base by $696,000. See OCA Exh. KC-1-SR Sched. 1 at 2 (line 12).

OCA Exception 3: The Recommended Decision Erred In Recommending Adoption of PPL's Proposed Employee Complement When It Is Not Supported by the Record. (R.D. at 40-41; OCA M.B. at 17-20; OCA R.B. at 6-8).

Although the ALJ acknowledged the validity of the OCA's assertion that PPL's employee complement should be 1,942 rather than the Company's proposed 2,002 for purposes of determining payroll expense, the ALJ stated that PPL's proposed employee complement was reasonable and should be adopted. See R.D. at 41. The OCA submits that PPL's proposed employee complement of 2,002 employees is not supported by the record.

As OCA witness Koda testified, PPL has exhibited a pattern of significantly over-budgeting its employee levels in its future test year. See OCA St. 1-REV. at 17-18; see also OCA Exh. KC-1-REV. Sched. 4 at 3. For example, for January 2012, PPL budgeted for 1,989 employees but actually employed only 1,929 people (a difference of 60 employees) for that month. See OCA Exh. KC-1-REV. Sched. 4 at 3. For February 2012, PPL budgeted for 1,991 employees but actually employed only 1,920 people (a difference of 71 employees) for that month. Id. For March 2012, PPL budgeted for 2,000 employees, but PPL actually employed only 1,917 people (a difference of 83 employees) for that month. Id. Further, as Mr. Koda testified, PPL's employee complement has been steadily declining since December 2010, when it had 1,974 employees, to its 16-month low of 1,917 employees in March 2012. Id. Mr. Koda noted that PPL's employee level as of June 30, 2012 (1,942 employees), is still below the number on which Mr. Koda recommended that PPL's payroll be based (1,943 employees). OCA St. 1-SR at 5-6.

This Commission has stated that budgeted employee levels should be reasonably based on historic data. See e.g. Pa. PUC v. PPL Gas Utilities Corporation, 255 P.U.R. 4th 209, 242 (Pa. PUC 2007) (PPL Gas 2007). In PPL Gas 2007, the ALJ accepted the company's employee complement claim, stating that it was reasonable and supported by the record. Id. at 241. The record evidence showed the PPL Gas's employee complement had been less than 1/5 of one position below the company's budgeted amount of employees, and at times, the company's employee complement was greater than budgeted. Id. The Commission adopted the ALJ's recommendation, reasoning that the company's budgeted employee complement was reasonably accurate and supported by historic data. Id. at 242. The Commission also noted that over time, the difference between PPL Gas's actual employee complement and its budgeted employee complement had been insignificant. Id.

In this matter, PPL has failed to show that its proposed employee complement is reasonable. PPL's actual employee complement has declined since December 2010, when it had 1,974 employees, until March 2012, when the Company had 1,917 employees. See OCA Exh. KC-1-SR, Sched. 4 at 3. It is not reasonable to conclude, as PPL proposes, that the Company's complement will increase by at least 3% by December 2012,[2] when the Company's employee complement had increased by only 0.67% between January 2012 and June 2012.[3] As such, OCA's proposed employee complement of 1,943 is supported by the Company's historic data, and in accordance with Commission precedent, and should be adopted. The OCA's recommendation results in a downward adjustment to PPL's payroll expense in the amount of $3,740,000. See OCA St. 1-SR at Exh. KC-1-SR Sched. 4 at 3; Sched. 1 at 2. See also Table II-REVISED, which is attached to OCA's R.B. as App. A.

Additionally, as explained in OCA's Main Brief, adjustments must be made to: (1) Plant in Service to reflect the capitalized portions of Mr. Koda's recommended adjustment to PPL's employee levels and (2) to PPL's accumulated deferred taxes. See OCA M.B. at 11-12, 14. The capitalized portion of Mr. Koda's recommended adjustment to employee levels results in a downward adjustment to PPL's proposed rate base of $1,883,000. See OCA Exh. KC-1-SR Sched. 1 at 2. Mr. Koda's recommended adjustment to PPL's proposed payroll expense based on employee levels affected PPL's accumulated deferred tax requirements, which increased PPL's proposed rate base by $781,000. See OCA Exh. KC-1-SR Sched. 1 at 2 (line 11).

OCA Exception 4: The Recommended Decision Did Not Address OCA's Proposals Regarding CAP Outreach. (OCA M.B. at 113-124; OCA R.B. at 66-70).

As discussed in OCA's Main and Reply Briefs, PPL does not engage in targeted outreach to its low-income, payment troubled customers about the Company's Customer Assistance

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2 (2,002 proposed employee complement - 1,942 employees as of June 2012) / 1,942 employees as of June 2012 = 3%.

3 (1,942 employees as of June 2012 – 1,929 employees as of January 2012) / 1,929 employees as of January 2012 = 0.67%. See OCA Exh. KC-1-SR, Sched. 4 at 3. In rebuttal, PPL witness Banzhoff asserted that the Company is in the process of filling 106 positions. PPL St. 2-R at 8. The OCA submits that, just as the record does not support a 3% increase in PPL's workforce, the record in this matter does not support Mr. Banzhoff's claim that PPL will increase its workforce by 5.5% (106 additional positions / 1,942 employees as of June 2012 = 5.5%) by December 2012.

Program (CAP)[4] even though the Company has the lowest participation rate in the Commonwealth. See OCA M.B. at 113-19; OCA R.B. at 66-69. OCA witness Colton recommended that PPL be directed to take the following actions:

> First, I recommend that the Company engage in a direct-contact outreach program aimed at a population of customers that meet *both* of two criteria: (1) the customer is a confirmed low-income customer; and (2) the customer is 120 or more days in arrears. Second, in addition to this targeted outreach, I recommend that all shutoff notices to confirmed low-income customers be modified so that they *also* contain a notice of the availability of CAP and the means of accessing CAP. Third, I recommend that the Company engage in a direct-contact outreach program focused on customers 120 or more days in arrears whether or not those customers are "confirmed" low-income customers.

OCA St. 4 at 33-34. (Footnote omitted). As explained in OCA's Main Brief, PPL was not opposed to implementing additional targeted outreach to promote the availability of the Company's CAP. See OCA M.B. at 116-17, citing PPL St. 9-R at 19. The OCA has indicated that it would be happy to assist the Company in developing additional outreach initiatives. PPL, however, opposed Mr. Colton's first and third recommendations. PPL St. 9-R at 21-24.

In her Recommended Decision, the ALJ did not address OCA witness Colton's recommendations regarding CAP outreach. The OCA submits that Mr. Colton's recommendations are reasonable and should be adopted in this proceeding.

OCA Exception 5: The ALJ's Recommendation To Accept PPL's Capital Structure Proposal Should Be Rejected. (R.D. at 56-60; OCA M.B. at 38-46; OCA R.B. at 18-22).

The Company's proposed capital structure[5] (50.78% equity/49.22% debt) is unnecessarily burdensome to ratepayers, contains more common equity capital than the electric industry on average, and is inconsistent with how PPL has been capitalized over the last several

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4 PPL's CAP is called OnTrack.

5 As filed, the Company's proposed capital structure was 51.03% equity/48.97% debt. After the close of the record, PPL issued $250 million of new debt at a 2.61% interest rate. This large debt issuance, coupled with the interest rate for this new debt that is almost 300 basis points lower than PPL's average, embedded long-term debt cost (5.56%) results in a proposed capital structure of 50.78% equity/49.22% debt. PPL M.B. at 91, fn 16.

years prior to this rate case being filed. OCA witness Stephen Hill's proposed capital structure of 47.16% equity/52.84% debt is reasonable, consistent with how PPL has been capitalized over the last few years prior to its current rate case filing, and similar to the manner in which the electric utility industry is capitalized. The ALJ recommended that PPL's actual capital structure should be accepted, and stated that "The law permits the use of a hypothetical when the Company's actual capital structure is atypical, not when it is inconvenient." R.D. at 60. The OCA is opposed to the use of PPL's proposed capital structure for setting rates in this matter.[6] The Commission should act to protect consumers against excessive costs and set rates based on the capital structure as recommended by OCA witness Hill.

The ALJ erred by finding that PPL's proposed capital structure is not atypical. PPL's proposed capital structure contains significantly more equity than comparable utilities. As Mr. Hill testified:

> Page 3 of Schedule 1 shows the common equity averages for the electric utility and combination gas and electric utility industry, as reported by AUS Utility Reports in its May 2012 publication. That average common equity ratio for publicly-traded electric and combination gas and electric utilities is 45.9% of total capital.
>
> . . .
>
> Also, the data shown on Mr. Moul's Schedules 3, 4 and 5 show that the average common equity ratio of his integrated electric sample group, and the S&P Public Utilities was 44.4%, and 45% in 2010, respectively. Those average common equity ratios are far below the 51.01% [now 50.78%] common equity ratio requested for PPL—a lower-risk electric delivery company. Those data indicate that the Company's actual historical common equity ratio (approximately 44%) was in line with that of the publicly-traded electric utility industry.

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6 It is important to note that OCA witness Hill testified that PPL's proposed capital structure is not really an "actual" capital structure, but rather a projection based on 2012 year-end data. The ALJ's acceptance of PPL's "actual" capital structure is really a hypothetical capital structure, as it is based on estimates of PPL's actual debt and equity positions at year-end 2012. OCA St. 2-SR at 12; OCA M.B. at 43.

OCA St. 2 at 22-23. As Mr. Hill testified, the record in this case provides that the Company's own barometer group shows that a 45% common equity ratio is common in the industry for publicly traded companies. I&E's findings are similar, as provided in its Main Brief:

> As Ms. Sears' notes, even the industry common equity ratio averages from Mr. Moul's own barometer groups- 44.8% for the EDG, 45.1% for the IEG, and 45.3% for the S&P Public Utilities- more closely approximate and support I&E's recommended capital structure of 55% debt and 45% equity.

I&E M.B. at 83 (footnote omitted).

Pennsylvania courts have upheld the use of a hypothetical capital structure where the utility's management adopts an actual capital structure that imposes an unfair cost burden on ratepayers. See T.W. Phillips Gas and Oil Co. v. Pa. PUC, 81 Pa. Commw. 205, 217, 474 A.2d 355, 362 (1984) (T.W. Phillips); Carnegie Natural Gas Co. v. Pa. PUC, 61 Pa. Commw. 436, 433 A.2d 938 (1981) (Carnegie). The Commission has explained its rationale several times. It has stated:

> [T]he Commission has the duty to regulate utilities in a manner which provides customers with reliable service at reasonable cost. This is not to say that we may mandate to regulated utilities the proportions of debt and equity contained in their capital structures. Rather, the actual capital structure is a matter within the discretion of corporate management; however, this does not preclude the commission from determining that a particular utility's capital structure is unreasonable or uneconomical when balancing the goals of safety, prudent management, and economy and utilize a hypothetical capital structure for rate-making purposes.

Pa. PUC v. Carnegie Natural Gas Co., 54 Pa. PUC 381, 393 (1980) aff'd on appeal Carnegie, supra, followed Pa. PUC v. Peoples Natural Gas , 69 Pa. PUC 138, 164 (1989). As Mr. Hill testified:

> As shown on page 1 of Schedule 1 attached to this testimony, the capital structure that appears on the balance sheet of PPL Electric Utilities from 2007 through 2011 consisted of 44.00% common equity, 9.09% preferred stock and 46.91% long-term debt, on average. Also, Mr. Moul's Exhibit PRM 1, Schedule 2 shows the Company's average common equity ratio from 2006 through 2010 to be *43.7%* of permanent capital. Therefore, the Company's requested ratemaking

capital structure contains considerably more common equity than the manner with which it has been successfully capitalized historically.

OCA St. 2 at 20 (emphasis added). As Mr. Hill explained, PPL's historic common equity ratio is significantly below what the Company has presented for ratemaking purposes in this case. As to how this transformation of its capital structure has taken place, Mr. Hill testified that:

> The Company plans to shift its capital structure to one that contains more common equity than it has used in the past and more common equity than is used in the electric utility industry, on average. As shown on Mr. Moul's Schedule 6 attached to his Direct Testimony, the Company plans to reduce its reliance on preferred stock and increase its reliance on more expensive common equity, by means of a $150 million capital contribution to PPL Electric by its parent company. Again, this is simply a management decision at PPL Corp., to attempt to change the regulated capital structure of PPL Electric.
>
> If included in rates, the proposed increase in common equity will be *substantially* more expensive than the capital structure PPL had used for many years prior to that time. As I note in my Direct Testimony, at page 22, the new test-year capitalization will cost the Company's ratepayers approximately $10.6 Million more *every year* than the capital structure it has relied on for many years.

OCA St. 2 at 11.

The record in this matter as to the capital structure issue is clear – PPL's proposed capital structure is atypical, and significantly higher in equity than it has historically been for many years. The record is also clear that the unnecessary levels of common equity, if approved, will cost PPL's customers over $10 million in additional costs, *annually*. <u>See</u> OCA St. 2 at 22. The OCA submits that ratepayers should not bear this unnecessary and unfair burden. The ALJ's capital structure recommendation should be rejected. That OCA submits that a more reasonable capital structure of 47.16% equity/52.84% debt should be adopted for ratemaking purposes, as proposed by OCA witness Hill.

OCA Exception 6: <u>The ALJ Erred By Awarding PPL A Management Performance Bonus.</u> (R.D. at 84-89; OCA M.B. at 64-66; OCA R.B. at 28-30).

The Company has requested that the Commission adopt a cost of equity for PPL, which includes an additional 12 basis points for what has been described as PPL's "exemplary management performance." PPL St. 11 at 6. The OCA opposed the Company's request for a higher equity cost rate. In the R.D. the ALJ disagreed with PPL's characterization of 66 Pa. C.S. Section 523 of the Public Utility Code, but concluded that PPL should still receive a 6 basis point ROE adder. R.D. at 84-85, 89. The OCA disagrees with the ALJ's conclusion that PPL should receive a management performance bonus, as the evidence of record does not support such a conclusion.

All regulated utilities in Pennsylvania are required to provide safe, adequate, reasonable and efficient service as a matter of law. 66 Pa. C.S. § 1501. An appropriate rate of return on common equity assumes efficient and reasonable management of a utility. This is established by the fact that the Commission will allow a utility less than the indicated rate of return where service does not meet the requirements of Section 1501. See, e.g., Pa. PUC v. Pennsylvania Gas & Water Co., 61 PaPUC 409, 415-16, 425, 427, 74 PUR4th 238, 244-45, 254, 256 (1986); Pa. PUC v. Pennsylvania Gas & Water Co., 68 PaPUC 191, 195-96 (1988). It follows that a utility must be doing more than providing efficient and reasonable service in order to receive more than the indicated rate of return pursuant to 66 Pa. C.S. Section 523.

As the statute provides, a primary piece of evidence most useful to this type of review would be the Company's latest audit, findings from such an audit and what the Company has done in regards to the recommendations contained therein. 66 Pa. C.S. § 523 (b)(1). As the ALJ found, however, PPL has not introduced such evidence in this case. R.D. at 84-85. The R.D. lists other evidence supplied by the Company such as enhanced storm response initiatives, although many of the claimed activities either occurred long ago (implementation of universal service programs, circa 1980) or are currently only in the "testing and evaluating" stage. R.D. at 85-88. The OCA, however, has produced evidence that counsels against the award of a management performance bonus.

OCA Cross Exhibit 1 lists 5 separate dockets where the Commission's Prosecutory Staff has investigated PPL for potential violations of the Public Utility Code. OCA Cross Exh. 1. In at least one of those dockets, the Commission stated that "PPL's alleged conduct was of a serious nature." Pa. PUC v. PPL Electric Utilities Corp., Docket No. M-2008-2057562, Order at 11 (May 31, 2009). The OCA submits that the types of actions and inactions that are contained in those dockets do not support the award of a management performance bonus. The OCA also agrees with I&E's conclusions on this issue, as succinctly set out in the R.D.:

> I&E argues that the 12 points sought translates into an additional $3 million in rate revenues. I&E argues further that there is considerable room for improvement in several areas, including preventable major outages, customer service calls answered within 30 seconds, the number and percentage of bills not rendered to residential customers and small businesses, and number of disputes with no response within 30 days. In addition, there is little evidence that the level of shopping in this Company's service territory was due to any action on PPL Electric's part, and education funding is provided elsewhere.

R.D. at 88 (internal citations omitted). The OCA submits that evidence supplied by I&E and the OCA tends to negate any management performance award in this matter.

In The Columbia Water Company case, the Commission reviewed a 25 basis point ROE adder request for management performance under 66 Pa. C.S. Section 523. Pa. PUC v. The Columbia Water Co., Dock. No. R-2008-2045157 (order entered June 10, 2009) (Columbia). In Columbia, the Commission rejected the Company's request for a management performance bonus. Columbia at 93. In the Columbia Order, the Commission cited ALJ Salapa's Recommended Decision on this issue, as follows:

> The ALJ noted in his Recommended Decision that the statute at 66 Pa. C.S. § 523(b)(1) provides that the Commission shall consider management effectiveness as measured by an audit pursuant to 66 Pa. C.S. § 516, regarding audits of utilities. The ALJ pointed out that in this case, the report by the Commission's Bureau of Audits only states that Columbia made "notable improvements" in management effectiveness. The ALJ noted that, out of twelve recommendations made by the Bureau of Audits in a June 2005 report, Columbia has implemented five recommendations and taken some action on the remaining seven recommendations. The ALJ agreed with the OCA this is not sufficient to warrant a rate of return premium of 0.25%.
>
> The ALJ stated Columbia is in compliance with all existing State and Federal primary and secondary drinking water standards, including lead and copper requirements. The ALJ pointed out that the system's pressure and unaccounted-for water meet all Commission regulations. In addition, the ALJ noted that there were no complaints filed with BCS against Columbia in either the historic or future test years. The ALJ pointed out that these all point to adequate, reasonable service, and this is not sufficient to warrant a rate of return premium of 0.25%.

Columbia at 91. As the Commission found in Columbia, reasonable and efficient service is not a basis for a rate of return premium. Based on the record here – no audit report in evidence, numerous Commission investigations into PPL's compliance with the Public Utility Code and the substantial evidence put on by I&E – the ALJ erred by recommending that PPL should receive a rate of return premium, in any amount.

OCA Exception 7: The ALJ Erred By Recommending The Use Of PPL's Cost Of Service Study To Allocate The Revenue Increase In This Proceeding. (R.D. at 104-108; OCA M.B. at 68-91; OCA R.B. at 32-53).

A. Introduction.

The Commission should reject the ALJ's recommendation to accept PPL's flawed cost of service study (COSS). The OCA submits that, based on the substantial evidence of record, the Commission should adopt the OCA's recommended COSS as a reasonable guide to set rates in this proceeding. PPL's cost of service study is flawed because it does not accurately reflect cost causation, is inconsistent with the 1992 NARUC Manual and the updated 2000 NARUC Report, and is inconsistent with the historical method that PPL used prior to 2010.

To be clear, prior to 2010, PPL classified primary distribution plant as 100% demand related and further classified secondary distribution plant as partially demand and partially customer related.[7] This method was approved by the Commission in the 2004 and 2007 PPL rate cases, and is the same COSS method that the OCA has proposed in the present case. Starting with the 2010 rate case, and continuing here, however, PPL has classified primary distribution plant as 63% customer related and 37% demand related. This sea change, starting in 2010, as to how PPL classifies primary distribution plant costs has caused over *$1 billion* of such costs to be shifted from a demand basis to a customer count basis. PPL has further classified secondary distribution plant as 62% customer and 38% demand related.

The Commission should recognize that accepting PPL's COSS here will serve to unfairly increase residential customers' rates due to the embedded bias against the residential class. As has now been shown – residential customers will always pay the lion's share of any PPL rate increase in a never ending, but futile attempt (under PPL's COSS) to reach "cost of service". Such inequitable results tend to show why over 30 other regulatory jurisdictions do not use the method that PPL proposes here, classifying a majority of its primary distribution plant on a customer basis.

The ALJ relied on the arguments of the Company and the other parties in adopting PPL's COSS. R.D. at 108. These arguments espouse the central theme that the Commission has already ruled against the OCA in PPL's 2010 rate case and should do the same here. See R.D. at 104-108. In 2010, the Commission specifically held as follows:

> We have reviewed the OCA's positions and Exceptions on this issue and find them to be contrary to prior Commission action in PPL's 2004 and 2007 base rate proceedings and inconsistent with recommended COSS principles as outlined in the NARUC Manual.

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7 The primary distribution system operates at higher voltage levels than the secondary system and generally consists of plant and equipment between the substations and transformers.

Pa. PUC v. PPL Electric Utilities Corporation, Docket No. R-2010-2161694, Order at 35-36 (Dec. 21, 2010) (PPL 2010).

In the present case, the OCA has presented substantial evidence to show that PPL's COSS method does not follow the 1992 NARUC Manual in many respects, and is inconsistent with the more recent 2000 NARUC Report. In the 2010 rate case, PPL's recommended allocation of the $77.5 million increase entirely to the residential class was adopted by the ALJ and the Commission, at least in part because the Commission found the OCA's approach did not accurately reflect the costs incurred to serve the residential class. PPL 2010 at 46. In the 2010 case, however, the OCA's approach was identical to PPL's own COSS method used in 2004 and 2007. In the present case, the OCA has provided substantial evidence that its recommended COSS is accurate, reasonable, in accord with the 1992 NARUC Manual and the 2000 NARUC Report, as well as PPL's prior methodology, which the Commission approved in PPL's 2004 and 2007 base rate proceedings. On the contrary, PPL's proposed COSS here contains bias to the residential class that negates any possibility of that class reaching "cost of service" anytime in the foreseeable future.

Mr. Watkins provided substantial evidence, in this case, to show that both primary and secondary distribution plant should be classified as 100% demand related, consistent with how regulatory bodies in over 30 states classify such plant. See e.g. OCA St. 3 at 20-21. Based on the facts of this case, however, Mr. Watkins recommended a reasonable and appropriate compromise COSS that maintains a customer/demand split for the secondary distribution plant, but allocates primary plant on demand only. Specifically, Mr. Watkins cost of service study (COSS) classifies primary distribution plant exactly how PPL did prior to 2010 – 100% demand related. Mr. Watkins then classifies secondary distribution plant as partially demand and partially customer related, just like PPL's current and prior COSSs, but Mr. Watkins uses a more appropriate customer component than PPL based on his revisions to Mr. Kleha's minimum size study and consistent with how such a study is to be performed as per the 1992 NARUC Manual.

The OCA submits that the ALJ and the other parties' reliance on PPL 2010 is misplaced. In the present case the Commission has substantial evidence that it did not have in 2010, specifically: (1) PPL's proposed COSS is an outlier in its classification of primary distribution plant as having a customer component; (2) to the extent that a customer component should be a part of distribution plant cost assignment – PPL's minimum size study fails to follow the 1992 NARUC Manual's specific instructions for performing such a study; and, (3) the fact that adhering to PPL's proposed COSS will always result in the residential class being allocated a substantial portion of future rate increases with little to no hope of ever achieving cost of service. Based on these facts, and the substantial record evidence before it, the OCA respectfully requests the Commission to review the entire record and adopt the OCA's COSS as a reasonable guide to set rates in this matter.

B. PPL's Proposal To Classify A Majority Of Its Primary Distribution Plant Investment Based On Customer Counts As Accepted By The ALJ Must Be Rejected.

OCA witness Watkins provided substantial evidence to show that primary and secondary distribution plant should be classified as 100% demand related, consistent with how regulatory bodies in over 30 states classify such plant. Mr. Watkins further testified that the portions of the 1992 NARUC Manual that the Company relied on in 2010, and relies on in this proceeding must be read in conjunction with the 2000 NARUC Report. OCA St. 3 at 20-21.

As Mr. Watkins explained, not only does the more recent 2000 NARUC Report not indicate that distribution plant must be classified as partially demand-related and partially customer-related, but the 2000 NARUC Report indicates that the majority of states use a basic customer method in which all distribution costs, except for service and meters, are classified as demand related. Specifically, Mr. Watkins testified that the 2000 NARUC Report provides:

> There are a number of methods for differentiating between the customer and demand components of embedded distribution plant. <u>The most common method used is the basic customer method, which classifies all poles, wires, and transformers as demand-related and meters, meter-reading, and billing as customer-related</u>. <u>This general approach is used in more than thirty states</u>. A variation is to treat poles, wires, and transformers as energy-related driven by kilowatt-hour sales but, though it has obvious appeal, only a small number of jurisdictions have gone this route.

OCA St. 3 at 20-21. (Emphasis added). As Mr. Watkins testified, the 2000 NARUC Report provides that the practice of classifying <u>primary</u> and <u>secondary</u> distribution plant costs as wholly demand related is the norm in the industry. PPL's proposed COSS in the present case, which assigns the majority of primary distribution plant costs based on customer counts, is contrary to the industry norm and completely inapposite to how PPL assigned primary plant costs prior to 2010.

In addition, OCA witness Watkins testified that the only reason to classify a portion of primary or secondary distribution plant expenses based on customer counts as PPL did in this proceeding, rather than based on demands placed on the system, would be due to the customer mix and density in the service territory. OCA St. 3 at 8-9. OCA witness Watkins' testimony regarding customer densities and class customer mixes is supported in the field of academia by Professor James Bonbright. Mr. Watkins testified that Professor Bonbright, in his treatise <u>Principles of Public Utility Rates</u>, states:

> [there] is the very weak correlation between the area (or the mileage) of a distribution system and the number of customers served by this system. For it makes no allowance for the density factor (customers per linear mile or per square mile). Our casual empiricism is supported by a more systematic regression

> analysis in (Lessels, 1980) where no statistical association was found between distribution costs and number of customers. Thus, if the company's entire service area stays fixed, an increase in number of customers does not necessarily betoken any increase whatever in the costs of a minimum-sized distribution system.

OCA St. 3 at 14; James Bonbright, Principles of Public Utility Rates, at 491 (2d ed. 1988). OCA witness Watkins conducted an analysis of the mix of PPL's customers across the service territory in order to assess whether an allocation based on customer counts is supported by PPL's actual distribution system. Mr. Watkins testified as to the results of his customer density analysis, in relevant part as follows:

> In summary, each customer class is represented in a reasonably proportional manner in both rural and urban areas within PPL's service area. As a result, it cannot be said that the less populated portions of PPL's service area (which require significant investment to serve few customers) are dedicated to any one class of customers. As such, PPL's distribution plant and expenses should be assigned to classes based only on utilization and any consideration of customer counts is improper for the allocation of distribution plant, as such, this study indicates that PPL's distribution plant should be classified as 100% demand-related.

OCA St. 3 at 18. As the record evidence provides, the 2000 NARUC Report and Mr. Watkins' density study supports an assignment of all distribution plant costs, primary and secondary, based on demand only. To be conservative, however, Mr. Watkins recommended assigning all primary plant costs based only on demand but including a customer component for secondary plant costs.

As Mr. Watkins provided in his testimony, PPL's choice to completely alter its COSS methodology starting with the 2010 base rate case has a profound impact on the residential class. Using the method that has been accepted in over 30 other states, where primary and secondary distribution plant is classified as 100% demand related, the indexed rate of return for the RS class, at present rates, would be 124%. OCA St. 3 at 36, Table 14. Using the method that PPL proposes in this proceeding, where primary and secondary distribution plant is classified substantially as customer related and only partially as demand related, the indexed rate of return for the residential class return would only be 63%. Id. Based on the specific facts of this case, however, Mr. Watkins has recommended a compromise COSS that maintains a customer/demand split for the secondary distribution plant. Mr. Watkins' COSS, with an appropriate customer/demand split for secondary distribution plant and a demand only for primary plant costs shows the RS class at an indexed rate of return of 112% *at present rates*. OCA St. 3 at 37, Table 16. At current rates, under an accurate and reasonable COSS as recommended by Mr. Watkins, the RS class is paying more than its cost to serve.

The OCA submits that the Commission's holding in PPL 2010 should not be controlling here. The OCA has presented substantial, additional evidence that the Commission did not have in 2010, such as the 2000 NARUC Report, Mr. Watkins' revised density study and the fact that under PPL's flawed COSS the residential class will likely never achieve cost of service, to show that PPL's proposal to assign the majority of its primary distribution plant costs based on customer counts is unsound and should be rejected.

C. Even If A Partial Customer Classification Is Appropriate, The Company's Minimum System Study Used To Determine The Customer Percentage Is Flawed, And In Many Respects, Inconsistent With The 1992 NARUC Manual.

As discussed above, the OCA has submitted substantial evidence to show that primary and secondary distribution plant costs should be assigned based solely on demand. Based on the specific facts here, however, Mr. Watkins has presented a COSS that does include a customer component for the assignment of secondary distribution plant costs. In determining how much of the distribution plant to classify as customer related, the Company performed a minimum system study. Mr. Watkins performed a systematic analysis of PPL's minimum system study, completely consistent with Commission precedent and the specific instruction contained in the

1992 NARUC Manual and found PPL's proposed customer/demand split suffers from several, serious shortcomings. As discussed below, these serious errors in PPL's minimum system study make it unsuitable for use in determining a customer/demand split. Accordingly, PPL's COSS should be rejected and the OCA's COSS should be used as a guide to set rates in this proceeding. Alternatively, and at a minimum, the Commission should act to correct the errors in PPL's proposed customer/demand split consistent with Mr. Watkins' testimony on this issue. See OCA St. 3 at 25-38; OCA St. 3 at 35, Table 13; OCA M.B. at 85-91; OCA R.B. at 45-53.

As OCA witness Watkins testified, PPL witness Mr. Kleha's minimum system plant components "serve significant load requirements of consumers and are universally considered to be demand-related, such that the customer portion of a distribution system should reflect only those costs required to connect a customer with no load placed on the system." OCA St. 3 at 26. Mr. Watkins' testimony as to the selection of plant for conducting a minimum size study is directly on point with the precedent of the Pennsylvania Public Utility Commission. The Commission has stated that:

> [t]he customer component of distribution plant is a theoretical minimum size system that is required to serve a customer with infinitely small load and represents the costs of just being a customer. This system can be represented as a wet thread supported by long tooth picks to serve a Christmas tree light.

Pa. PUC v. Duquesne Light Co., 59 Pa. PUC 67, 160-61 (1985); OCA St. 3 at 26. PPL's minimum size study is thus seriously flawed in this respect as the components chosen for the study have significant load carrying capability. Such a minimum size system is not the "wet thread" that the Commission referred to in the Duquesne Light case.

To further compound the problem of creating a minimum size system with significant load carrying capability, Mr. Kleha failed to follow the specific instructions contained in the 1992 NARUC Manual for dealing with this situation. As Mr. Watkins explained:

> [T]he NARUC Electric Utility Cost Allocation Manual also recognizes the load carrying capability of the minimum-size equipment installed in a distribution system as follows:
>
>> When using this [minimum-size] distribution method, the analyst must be aware that the minimum-size distribution equipment has a certain load-carrying capability, which then can be viewed as a demand-related cost (page 95).
>
> With the exception of Line Transformers (which represents less than 10% of PPL's gross investment in distribution plant), Mr. Kleha's classification studies make no attempt in correcting for, or adjusting this bias.

OCA St. 3 at 26. PPL's minimum size study, the basis for its proposed COSS, not only fails to conform to Commission precedent on the structure of a minimum size system but also fails to adequately account for the significant load carrying capability of such a system – in direct contravention of specific instruction contained in the 1992 NARUC Manual.

Mr. Watkins systematically went through PPL's minimum size study and made adjustments to PPL's minimum size system calculations to recognize the 1992 NARUC Manual's prescription for circuits and circuit meters, Account No. 364 (poles), Account No. 365 (overhead conductors), Account No. 366 (underground conduit), Account No. 367 (underground conductors and Account No. 368 (line transformers). OCA St. 3 at 28-36. The adjustments, which did not reflect any modification to account for the load carrying capability of conductors, resulted in a substantial difference in class rates of return, as Mr. Watkins testified:

> When these adjusted plant classifications are utilized, the following class ROR's at current rates are produced:

Table 13

	ROR At Current Rates			
	Kleha CCOSS Results		OCA Adjusted Classification CCOSS Results	
Class	ROR	Indexed ROR	ROR	Indexed ROR
RS	3.87%	63%	4.93%	80%
RTS	-4.01%	-65%	-4.85%	-79%
GS-1	8.20%	134%	9.32%	152%
GS-3	17.51%	285%	11.49%	187%
LP-4	10.03%	163%	4.15%	68%
LP-5	-5.57%	-91%	-5.37%	-88%
LPEP	21.68%	353%	24.22%	394%
GH-2	5.32%	87%	3.72%	61%
SL/AL	6.17%	100%	5.92%	96%
Total Jurisdictional	6.14%	100%	6.14%	100%

OCA St. 3 at 35, Table 13.

As shown by Table 13, the serious errors in PPL's minimum size study cast a negative light on the RS class' movement to full cost of service at present rates. Even accepting PPL's proposal to classify a majority of primary distribution plant as customer related, Mr. Watkins' adjustments to PPL's study shows significant movement to cost of service for the RS class. The R.D. does not address the substantial evidence supplied by the OCA on this issue, and on the serious errors contained in PPL's minimum size study which makes the Company's COSS wholly unsuitable as a guide to set rates in this proceeding. The OCA requests that the Commission review the entire body of evidence on this issue, PPL's failure to adhere to Commission precedent, PPL's failure to adhere to specific instruction contained in the 1992 NARUC Manual, and reject the ALJ's recommendation to adopt PPL's COSS.

D. <u>PPL's COSS Is Fatally Flawed In That It Contains Inherent and Perpetual Bias To The Residential Class.</u>

PPL agreed to bring all rate classes at or near cost of service over a period of three rate cases, starting in 2004, including the 2007 rate case and concluding with <u>PPL 2010</u>. Tr. at 396-

401. Although the RS class was closing in on that objective in PPL 2010, the Company changed the rules of the game by switching to a COSS method where primary distribution plant costs are now substantially allocated based on the number of customers, and not based solely on demand, as had been PPL's practice for decades. OCA witness Watkins provided an example of how unfair this approach is to residential customers, as follows:

> Therefore, because customer counts do not recognize relative customer size difference or differences in utilization or demand, a small residential apartment customer is allocated the same level of costs as a major industrial factory.

OCA St. 3-SR at 2. During cross examination, PPL witness Kleha acknowledged that Mr. Watkins' example is, in fact, accurate:

> Q. When distribution plant costs are based on number of customers, a small apartment customer would be allocated the same level of costs as a major industrial factory or a large office building complex; is that correct?
>
> A. Approximately, yes.

Tr. at 389-390. The OCA submits that PPL's proposed COSS, where a single residential customer living in an apartment can be assigned the same level of costs as a major industrial factory, flies in the face of cost-causation and simple common sense. As further evidence of the major flaws in PPL's method, one only needs to review the results by comparing the class' rates of return from the PPL 2010 case to the proposed class returns here.

Rate Classes	Relative Return at Present Rates	Relative Return at Proposed Rates
Total PA Jurisdictional	100.00%	100.00%
RS	53.10%	78.61%
RTS	-59.94%	-2.65%
GS-1	163.91%	113.17%
GS-3	360.73%	250.06%
LP-4	212.88%	145.20%
ISP	140.06%	135.83%
LP-5	-372.02%	-237.33%
LP-6	-1064.39%	-831.53%
LPEP	237.36%	163.51%
GH	217.81%	150.94%
SL/AL	145.47%	100.77%

Source: PPL 2010, Recommended Decision at 49-50 (Entered Oct. 15, 2010).

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

Source: 2012 PPL M.B. at 154.

As the charts show, even though the residential class absorbed the entire $77.5 million revenue increase in PPL 2010, the RS class never produced the 78.61% return projected from PPL 2010 and the RTS class went backwards under PPL's flawed COSS. In order to put the trend in PPL's rates into perspective, the following table provides a history of PPL increases to residential distribution rates since rates were unbundled:[8]

Summary of PPL Residential Distribution Rate Increases

Rate Case	Increase ($000) Amount	Percent	Cumulative Percent
2004 Case (Authorized)	$68,340	23.9%	23.9%
2007 Case (Authorized)	$47,830	13.5%	40.7%
2010 Case (Authorized)	$77,500	19.3%	67.8%
2012 Case (PPL Proposed)	$104,656	21.8%	104.5%

OCA St. 3-SR at 8.

As can be seen above, if PPL's proposed rate increase is granted in this case, residential distribution rates will have increased by 104% since January 2004 (pre-2004 case). Further, even though the residential class is once again being asked to shoulder almost the entire burden of PPL's requested increase, the RS class under PPL's flawed COSS still appears to fall short. The OCA submits that continuing to follow this path, using PPL's flawed COSS, the residential class will indefinitely bear the vast majority of rate increases. It is unreasonable and unfair to rely on such a flawed study.

E. Conclusion.

PPL's cost of service study is seriously flawed because it does not accurately reflect cost causation, is inconsistent with the 1992 NARUC Manual, the updated 2000 NARUC Report, the historical method that PPL used prior to 2010 and contains bias to the residential class that will perpetuate unfair and unreasonable cost allocation to that class. OCA witness Watkins' study properly allocates costs in a more accurate and reasonable manner that is reflective of cost

8 The increases to non-residential rates cannot be determined on a rate by rate basis due to commercial/industrial rate consolidations since 2004.

causation on the PPL system. For these reasons, the OCA proposes that the Commission reject the ALJ's recommendation to adopt the Company's study and rely primarily on OCA witness Watkins' cost analysis as a guide to set rates in this matter.

OCA Exception 8: The ALJ Erred By Accepting PPL's Proposed Revenue Allocation. (R.D. at 108-110; OCA M.B. at 91-101; OCA R.B. at 53-57).

Based on its flawed COSS that shows the residential class with a rate of return of 3.87% at current rates (compared to a 6.14% system average rate of return), the Company proposed to place virtually the entire revenue increase on residential customers, for the second time in two years. The OCA recommended an alternative revenue allocation that reflects the results of a properly conducted, reasonable and equitable COSS. In addition, the OCA submits that while cost of service should guide the Commission when setting rates in this proceeding, other ratemaking principles such as gradualism, avoidance of rate shock and basic fairness must not be abandoned. The R.D. provided that the OCA's revenue allocation proposal should be rejected because it is based on the OCA's COSS, and that PPL's revenue allocation proposal should be adopted. R.D. at 110. The OCA submits that for all the reasons given above, the OCA's COSS should be adopted as a guide to set rates in this proceeding and for purposes of establishing a fair and reasonable allocation of the revenue increase.

PPL's cost of service study is unduly discriminatory against Residential customers, and because PPL's proposed revenue allocation is based on that study, OCA witness Watkins developed a revenue allocation that relies on his reasonable cost of service results and recognizes gradualism and fairness. OCA St. 3 at 39. In explaining his revenue allocation method, Mr. Watkins testified as follows:

> [G]iven the magnitude of PPL's proposed overall increase, I recommend no revenue decreases such that there will be no change in revenue for the GS-1 and LPEP classes even though their ROR's at current rates exceed those of PPL's

> proposed 8.46% cost of capital. Next, consistent with gradualism, I recommend that no class sustain an increase greater than 150% of the system-wide percentage increase in distribution base rates; i.e., no more than 21.45% (150% of 14.30%). These capped increases are applied to those classes that are significantly deficient in terms of ROR at current rates and include rates RTS, LP-4, LP-5 and GH-2. The remaining classes (rates RS, GS-3 and SL/AL) are then first brought up to full cost of service; i.e., ROR equals 8.46%. The remaining required increase is then distributed to rates RS, GS-3 and SL/AL based on current rate revenues.

OCA St. 3 at 39-40. OCA witness Watkins provided the following table of his allocation at the Company's full request:

Table 20

Comparison of OCA and PPL Proposed Increases ($000)

	OCA Increase		PPL Increase	
Class	$	Percent	$	Percent
RS	$65,854	13.96%	$101,088	21.42%
RTS	$961	21.45%	$3,568	79.61%
GS-1	$0	0.00%	$815	1.13%
GS-3	$25,045	20.29%	-$4,674	-3.79%
LP-4	$7,266	21.45%	$7	0.02%
LP-5	$258	21.45%	$712	59.28%
LPEP	$0	0.00%	$0	0.00%
GH-2	$290	21.45%	$323	23.86%
SL/AL	$4,943	21.45%	$2,779	12.06%
Total	$104,617	14.30%	$104,618	14.30%

OCA St. 3 at 41. As to the indexed rate of return at present rates (Table 16) and under the proposed increase (Table 21), using Mr. Watkins' COSS and allocation provides the following results:

Table 16

Class	OCA CCOSS Results At Current Rates ROR	Indexed ROR
RS	6.90%	112%
RTS	-5.71%	-93%
GS-1	11.05%	180%
GS-3	6.38%	104%
LP-4	-0.81%	-13%
LP-5	-5.37%	-88%
LPEP	24.48%	399%
GH-2	1.86%	30%
SL/AL	5.58%	91%
Total Jurisdictional	6.14%	100%

Table 21

Class	OCA Revenue Allocation ROR	Relative ROR
RS	9.42%	111%
RTS	-4.51%	-53%
GS-1	11.05%	131%
GS-3	9.20%	109%
LP-4	0.93%	11%
LP-5	-0.34%	-4%
LPEP	24.48%	289%
GH-2	4.24%	50%
SL/AL	9.36%	111%
Total	8.46%	100%

OCA St. 3 at 37, 41. As the Tables above show, using Mr. Watkins COSS and revenue allocation method results in a reasonable movement of all classes to cost of service at PPL's proposed revenue increase, while also recognizing the need for gradualism.

The OCA submits that the revenue allocation proposed herein by Mr. Watkins meets the legal requirements for determination of revenue allocation. The Commonwealth Court of Pennsylvania provided that the "polestar"[9] for determining the level of revenue for the different rate classes should be the cost of providing service to those different rate classes. Lloyd v. Pa. PUC, 904 A.2d 1010, 1020 (Pa. Commw. Ct. 2004) (Lloyd). As the Commission has found, a COSS is to serve as a guide in setting rates. Pa. PUC v. Pennsylvania Gas & Water Co., 1993 Pa. PUC LEXIS 61, *161 (1993).

As Table 16 of Mr. Watkins' testimony, shown above, from the perspective of the COSS that formed the basis for the 2004 Lloyd decision and consistent with the COSS recommended

9 "Polestar" is a literary reference meaning "directing principle" or a "guide." The American Heritage Dictionary, Houghton Mifflin Co. (1985).

by Mr. Watkins in this proceeding, the Rate RS class has achieved unity. See OCA St. 3 at 37. As such, PPL's proposal to allocate virtually the entire rate increase to the residential class, for the second time in two years, cannot be supported. Rather, the OCA submits that this substantial movement to unity for the Rate RS class should be preserved here, while respecting other principles such as gradualism and fairness, as Mr. Watkins' revenue allocation accomplishes. Based on the substantial record evidence in the present case, the ALJ's recommendation to accept PPL's revenue allocation should be rejected.

OCA Exception 9: The OCA's Scaleback Proposal Should Be Accepted. (R.D. at 110-112; OCA M.B. at 101-104; OCA R.B. at 58-60).

The ALJ recommended adoption of PPL's scaleback method. R.D. at 111-112. As a general principle, the OCA has no disagreement with PPL's proportional scaleback approach. The OCA does disagree, however, with using PPL's revenue allocation as a starting point for a proportional scaleback. Accordingly, the OCA submits that Mr. Watkins' revenue allocation be used as a starting point for a proportional scale back in this proceeding. See OCA St. 3 at 41, Table 20.

OCA Exception 10: The ALJ Erred By Accepting PPL's Alternative Residential Customer Charge Proposal. (R.D. at 116-120; OCA M.B. at 106-111; OCA R.B. at 60-65).

PPL proposed to significantly increase its customer charge for Rate RS customers from its current level of \$8.75 to \$16.00, an 83% increase. The OCA argued that PPL's proposed customer charge is based on its flawed COSS results, does not represent the results of a direct customer cost analysis, would disproportionally impact low-income, low-usage customers, and would result in a significant disincentive for customers to engage in conservation activities. The OCA recommended, consistent with Mr. Watkins' Direct cost study that the Rate RS customer charge continue to be set at its correct level of \$8.75. In rebuttal testimony, PPL witness Krall proposed an alternative customer charge of $14.09 for the RS class. PPL argued that such a customer charge derivation, which includes direct and indirect costs is appropriate. The ALJ accepted PPL's alternative $14.09 customer charge for the RS class.

The OCA submits that the ALJ erred by relying on PPL's flawed COSS results as a reasonable basis for setting the RS customer charge. The OCA has previously set out and discussed the many flaws in PPL's proposed COSS, and will not repeat those arguments here. Additionally, however, the ALJ also erred by accepting PPL's alternative RS customer charge without a direct cost study as support for such a charge. The OCA submits that this Commission has repeatedly expressed its preference for a direct cost study, which includes only direct costs and not indirect costs as PPL has done in its alternative proposal, as a basis to set customer charges. As OCA witness Watkins testified:

> Over the past decade or so, I have participated in several dozen rate cases in Pennsylvania involving electric distribution, natural gas distribution and water utilities. It has been my experience that this Commission's policies and practices regarding those costs considered in developing residential customer charges has been clear and consistent in that only those "direct" customer-related costs are included such that indirect and overhead costs are appropriately collected from variable usage or energy charges.

OCA St. 3-SR at 6. A number of cases support Mr. Watkins' testimony that the Commission has a decided preference for, and relies on direct cost studies to calculate customer charges.

The Commission has clearly defined what is included in the basic customer costs for determining the customer charge – (only) those costs which directly relate to the Company's investment in services and meters as well as the operating expenses associated with meter reading, customer service, accounting and customer records and collections. See Pa. PUC v. Metropolitan Edison Co., 60 Pa. PUC 349 (1985); Pa. PUC v. West Penn Power Co., 59 Pa. PUC 552 (1985); Pa. PUC v. West Penn Power Co., 1994 Pa. PUC LEXIS 144, *154 (1994). In a

1994 National Fuel Gas Distribution Company base rate proceeding, the Commission provided further guidance as follows:

> Commission precedent is clear that indirect customer costs are not properly included in the customer charge. Only those costs which represent items that the utility must have in place each month for each customer are 'basic customer costs" which are properly recovered in the customer charge.

Pa. PUC v. National Fuel Gas Dist. Corp., 83 Pa. PUC 262, 371 (1994). More recently, the Commission has continued to support only the inclusion of direct customer costs when arriving at a reasonable customer charge. See Pa. PUC v. PPL Gas Utilities Corp., Docket No. R-00061398 at 137 (Order entered Feb. 8, 2007); Pa. PUC v. PPL Electric Utilities Corp., Dock. No. R-00049255 at 82-84 (Order entered Dec. 22, 2004). By contrast to the decades of Commission precedent on this issue, PPL supports its alternative customer charge with the lone case of Aqua Pennsylvania in 2004. Pa. PUC v. Aqua Pennsylvania, Inc., 236 P.U.R. 4th 218 (2004) (Aqua). The OCA submits that the Aqua decision was fact specific and provides no support for PPL's current proposal.

Mr. Watkins performed a direct customer cost analysis, consistent with Commission precedent, and found the direct Residential customer costs range from $7.70 per month (OCA capital costs) to $8.24 per month (PPL capital costs). OCA St. 3 at 44. Accordingly, the OCA recommended that PPL's current $8.75 customer charge for the RS class is reasonable and should not be increased. See OCA M.B. at 106-111; OCA R.B. at 60-65. The OCA also presented the testimony of Roger Colton as to the impact on low-income and low-usage customers that would occur if PPL's proposed customer charge was authorized. See OCA St. 4. Mr. Colton concluded that:

> The level of the Company's proposed rate increase, exacerbated by its proposed change in its rate design, will disproportionately impose adverse impacts on the customers least able to afford those bill increases. It is critical for the

> recommendations of OCA witness Watkins to be adopted not only for the cost reasons articulated in his testimony, but also to mitigate these harms.

OCA St. 4 at 12. Mr. Colton's testimony and thorough analysis of the customer charge issue, combined with this Commission's prior Orders on this topic as discussed by Mr. Watkins support the OCA proposal to set the RS customer charge at $8.75.

I&E presented the testimony of Jeremy Hubert as to the customer charge issue. After conducting his own customer cost analysis, using only direct customer costs consistent with prior Commission decisions, Mr. Hubert concluded that the customer charge for the RS class should remain unchanged at $8.75. I&E St. 3 at 10-12.

The OCA submits that the record evidence in this matter, the OCA and I&E direct customer cost analyses, the avoidance of disparate impacts to low-income and low-usage customers weigh in favor of a customer charge for the RS class of $8.75 and not the $14.09 as the ALJ recommends.

OCA Exception 11: The ALJ Erred By Recommending The Adoption OF PPL's Competitive Enhancement Rider As Proposed By The Company. (R.D. at 126-128; OCA M.B. at 124-127; OCA R.B. at 70-73).

PPL submitted a Competitive Enhancement Rider (CER) for approval in this matter. OCA witness Watkins described the CER, as follows:

> PPL is proposing a reconcilable rider mechanism to reimburse the Company for expenses incurred relating to: (1) specific consumer education programs; (2) consumer mailings required by the Commission in the Retail Market Investigation ("RMI") and other non-capital operating costs that arise from the RMI; and, (3) any retail enhancement program costs not recovered from suppliers.

OCA St. 3 at 48. The Company proposed to structure its CER on a flat rate charge per customer, per month basis. In the R.D., the ALJ accepted PPL's proposal, stating that:

> I recommend that the CER be approved, and the costs incurred by the Company in implementing the retail market enhancement programs, including consumer education costs not recoverable from the EGSs, be recovered using the CER. As

> all customers benefit from the robust competitive market, then all customers should bear the costs involved in developing it, on a per customer basis.

R.D. at 128. The OCA opposes this recommendation regarding retail market enhancement programs, and submits that this type of cost recovery for retail market enhancement programs is inconsistent with the Commission's directives in this area. As Mr. Watkins testified:

> [T]here must be quantifiable assurances that there is no double recovery of these costs, such as through the CER and also included within the approved revenue requirement in this case.

OCA St. 3 at 49-50. Further, the Commission has recently held that competitive enhancement costs should not be collected from ratepayers. Indeed, in a recent FirstEnergy decision, the Commission held that EGSs should pay for retail market enhancement costs. Petition of FirstEnergy, Docket No. P-2011-2273650, Order at 136 (Aug. 16, 2012) (FirstEnergy Order). The FirstEnergy Order is consistent with the Commission's decision to require EGSs to pay for the costs of opt-in auction programs in Investigation of Pennsylvania's Retail Electricity Market: Intermediate Work Plan, Docket No. I-2011-2237952, Order at 79 (March 2, 2012). See also Petition of PECO Energy Company for Approval of its Default Service Program II, Dock. No. P-2012-2283641, Ordering Paragraph 14 (Order entered Oct. 12, 2010).

In addition, Mr. Watkins testified as to his disagreement with the structure of the CER as proposed, in relevant part:

> As indicated earlier, the Company proposes to structure its rider on a flat rate per customer per month. I recommend that if a rider is approved, it be structured on a class by class per KWH charge basis. Specifically, the costs associated with specific rate classes should be directly assigned to those classes.
>
> ...
>
> Consumers that use more energy clearly have much more potential to benefit from these customer education programs than consumers who use very little electricity. As such, a per KWH based rider better equates costs and benefits of these programs.

OCA St. 3 at 51-52.

Accordingly, the OCA submits that whatever consumer education costs are ultimately recovered from ratepayers should be done on a KWH basis, consistent with Mr. Watkins' testimony. OCA St. 3 at 51-52.

III. CONCLUSION

For the reasons set forth above, the Office of Consumer Advocate respectfully submits that the ALJ's recommendations as set out in the Recommended Decision should be reviewed and modified as recommended herein.

Respectfully Submitted,

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Dated: November 8, 2012

CERTIFICATE OF SERVICE

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

I hereby certify that I have this day served a true copy of the Office of Consumer Advocate's Exceptions to the Recommended Decision, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code §1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 8th day of November 2012.

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