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

IN REPLY PLEASE
REFER TO OUR FILE

November 8, 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) **Exceptions** in the above-captioned proceeding.

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

Sincerely,

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

Enclosure
RLM/edc

cc: Parties of Record
Hon. Susan D. Colwell
Robert F. Powelson, Chairman
John F. Coleman, Jr., Vice Chairman
Wayne E. Gardner, Commissioner
James H. Cawley, Commissioner
Pamela A. Witmer, Commissioner
Chief Counsel Pankiw, Law Bureau
Director Cheryl Walker Davis, OSA

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

EXCEPTIONS OF THE BUREAU OF INVESTIGATION AND ENFORCEMENT

Johnnie E. Simms
Chief Prosecutor
PA Attorney I.D. #33911

Richard A. Kanaskie
Deputy Chief Prosecutor
PA Attorney I.D. #80409

Regina L. Matz
Prosecutor
PA Attorney I.D. #42498

Bureau of Investigation & Enforcement
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265

Dated: November 8, 2012

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I. INTRODUCTION

On March 30, 2012, PPL Electric Utilities Corporation (PPL, PPL Electric, or Company) filed Supplement No. 118 to Tariff Electric - Pa. P.U.C. No. 201 (Supplement 118). Supplement 118 was designed to increase the Company's distribution rates by approximately $104.6 million, or an approximate 14% increase[1] over existing distribution rates.[2] Supplement 118 proposed an effective date of January 1, 2013, based on a future test year (FTY) ending December 31, 2012. On May 24, 2012, the Pennsylvania Public Utility Commission (Commission) suspended the filing and assigned it to the Office of Administrative Law Judge (OALJ) for the development of an evidentiary record and Recommended Decision.

No settlement discussions were entertained and full evidentiary hearings were held August 6, 7, and 9, 2012, in Harrisburg. The Bureau of Investigation and Enforcement (I&E) introduced the testimony and exhibits of its expert witnesses, including the testimony and exhibits of I&E witness Emily Sears,[3] who addressed the Company's requested rate of return; the testimony and exhibits of I&E witness Dorothy Morrissey,[4] who addressed the Company's revenue and expense proposals, including the Company's claims for cash working capital; the testimony and exhibits of I&E witness

[1] The Company characterized the increase as approximately 13%, a number repeated in the Recommended Decision (R.D.) at 2. However, the overall increase is 14.24%. See PPL Ex. JMK-2, Cost Allocation Study, Test Year Ending December 31, 2012, Section VI, at 124, line 2 ÷ line 1 (proposed revenue increase/distribution revenues = 14.24%).
[2] Although the increase is also couched as a 2.9% total bill increase when including distribution, transmission, and generation charges, in ruling on the appeal of PPL's 2004 base rate case, Commonwealth Court found that "using the total bill as a measure masked the true overall percentage increase sought[.]" *Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1015 (Pa. Cmwlth. 2006) ("*Lloyd*"). For this reason, I&E believes that in reviewing the proposed increase, the Commission should retain the focus on the actual 14% impact, not its minimized effect as reflected on a total bill basis.
[3] I&E Statement Nos. 1 and 1-SR and I&E Exhibit Nos. 1 and 1-SR.
[4] I&E Statement Nos. 2, 2-SR, and 2-SSR and I&E Exhibit Nos. 2, 2-SR, and 2-SSR.

Jeremy Hubert,[5] who addressed the Company's rate base and rate structure proposals; and the testimony of I&E witness Amanda Gordon,[6] who addressed funding of the Company's customer assistance programs. In addition, I&E also had admitted I&E Cross-Examination Exhibit Nos. 1-7, and 9-13. I&E filed its Main Brief on August 29, 2012, and its Reply Brief on September 14, 2012.

Under cover letter dated October 19, 2012, the Secretary's Bureau issued the Recommended Decision of ALJ Susan D. Colwell, which recommends the Company be granted an overall increase of $63.8 million allocated to customer classes and implemented within each class as proposed by the Company.[7]

While the ALJ's overall revenue recommendation is larger than that advocated by I&E, a substantial part of the Company's proposed revenue increase, and by far the largest adjustment proposed by I&E, centered on the Company's requested rate of return.[8] On that issue, the ALJ recommended adoption of an overall rate of return of 7.65%, using the Company's proposed capital structure and based upon a calculated return on equity (ROE) of 9.68%, to which the ALJ added six basis points to reflect her recognition of PPL's management effectiveness.[9]

I&E does not take exception to the ALJ's 9.68% calculated return on equity, which is based on I&E's DCF analysis consisting of a dividend yield of 4.89% and a growth rate of 4.79% (prior to I&E witness' Sears' log-linear adjustment).[10] In fact, I&E does not take exception to much of the ALJ's Recommended Decision. The record

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[5] I&E Statement Nos. 3 and 3-SR and I&E Exhibit Nos. 3 and 3-SR.
[6] I&E Statement No. 4-R.
[7] R.D. at 2.
[8] Of I&E's total recommended adjustments to the Company's $104.6 million filing, $73 million was derived from adjustments to PPL's requested rate of return.
[9] R.D. at 94.
[10] R.D. at 93.

developed before the ALJ with respect to resolution of all issues was substantial. Ultimately, I&E believes that within the larger context of the ALJ's overall Recommended Decision, the Judge's calculation of a 9.68% ROE, prior to the management booster, is acceptable, as are many other of her recommendations.

With the few exceptions noted below, I&E is satisfied that in her Recommended Decision to the Commission, ALJ Colwell has fundamentally addressed the gravamen of I&E's concerns, and that the Recommended Decision is well-balanced, reasonable, and fair in its proposed resolution of multiple issues affecting competing interests. Except for the few modifications requested in these limited Exceptions, I&E proposes that the Recommended Decision of ALJ Colwell should be adopted.

In these Exceptions, I&E requests the Commission to reconsider the ALJ's recommendation with respect to the following six limited issues: (1) the recommendation to approve PPL's classification of the regulatory assessment expense as a prepayment in the Company's cash working capital (CWC) calculation, which I&E asserts does not comport with the statutory scheme and leads to an overcollection of almost $2.8 million; (2) the recommendation to approve 100% allocation of PPL's incentive compensation expense to ratepayers, which I&E asserts lacks legal and evidentiary support and overcompensates PPL by $4.5 million; (3) the recommendation to adopt PPL's proposed capital structure, which when compared to the industry average, overcompensates the Company by $15 million; (4) the recommended adoption of six basis to reward PPL's management, which I&E asserts lacks sufficient factual or legal support and overcompensates the Company by about $1.5 million; (5) the recommendation to scale-back the implementation of the reduced revenue allowance without first mitigating the

impact on two rate structures; and (6) the recommended adoption of the Company's proposed residential and non-residential customer charges, neither of which conforms with well-established Commission precedent and the latter of which lacks the factual basis the ALJ accepted as reasonable for the residential customer charge.

II. EXCEPTIONS

A. Rate Base – Cash Working Capital – Prepayments

1. Regulatory Assessments – the ALJ Erred by recommending rejection of I&E's adjustment to remove PPL's inclusion of the regulatory assessment expense as a prepayment included under its cash working capital calculation rather than an O&M expense.

Recommended Decision: Pages 22-23
I&E Main Brief: Pages 15-16
I&E Reply Brief: Pages 11-14

Prepayments are payments for and in advance of the receipt of actual goods or services rendered. I&E recommended removal of the Company's claimed regulatory assessments from the prepayments component of its CWC claim. The removal of regulatory assessments from prepayments resulted in a reduction of $2,780,000 to the Company's working capital prepayment claim.[11]

Briefly describing the timing of the assessment process and noting the fact that PPL, as one of the Commission's larger utilities, is requested by the Commission to pay its assessment in advance of the August due date, the ALJ concluded that "[t]here is no question that the assessment is based on a prior year's revenues but that the application period is the following fiscal year."[12]

[11] I&E M.B. at 15; I&E R. B. at 11.
[12] R.D. at 23.

The ALJ's conclusion that the regulatory assessment is a prepayment because of the time period in which the actual funds are spent is erroneous. The expense is calculated based upon the percentage of the utility's prior year's revenues directly allocable to regulation of each particular utility in that same time period. The fact that it is paid after-the-fact by the regulated entities at the commencement of the subsequent fiscal year does not render the regulatory expense a prepayment.

By analogy, the assessment can be readily compared to the computation and payment of the personal income tax. Personal income tax for calendar year 2012 will be paid in April of calendar year 2013. However, it will be computed based upon the personal income accrued in and the tax rate applicable to calendar year 2012. The fact that the government will spend the 2012 income tax after it is received in 2013 does not render the individual's 2012 tax liability a "prepayment" of the 2013 tax liability. It is an after-the-fact payment of the 2012 tax liability due and payable after that calendar year's total income is known.

The regulatory assessment process provided in the Public Utility Code works in a similar fashion. Under Section 510 of the Code,[13] the Commission "shall determine *for the preceding calendar year* the amount of its expenditures directly attributable to the regulation of each group of utilities . . . . and debit the amount so determined to such group."[14] In other words, based upon employee time records for the calendar year, the Commission determines the applicable "tax rate" for that *same year* for each utility group based upon each utility's intrastate operating revenues *for that year*. After determining allocation factors for all expenditures based upon each utility group's proportionate

[13] 66 Pa.C.S. §510.
[14] 66 Pa.C.S. §510(b)(1) (emphasis added).

responsibility for total regulatory expenses "*for that year*,"[15] the Commission allocates that proportionate responsibility among the groups.[16] "Each public utility within a group shall then be assessed for . . . . such proportion of the amount allocated to its group as the gross intrastate operating revenues of the public utility *for the preceding calendar year* bear to the total gross intrastate operating revenues of its group *for that year*."[17] Both the tax rate (the assessment) and the tax due (the payment) for that "tax year" are developed at the end of the year just like the personal income tax is developed.

Though paid in the subsequent fiscal year, the assessment covers the regulatory expense incurred *in the prior* year based on an assessment developed from regulatory activities for and intrastate revenues earned in *the prior year*. It is not a prepayment for the next year's expenses. It should be treated as an expense with an associated lag.[18]

Also unlike prepayments, which are paid in advance of a service and may be refunded if provision of the service is terminated before the end of the applicable service period, a utility's regulatory assessments are representative of the proportion of agency services rendered to that utility type in the prior year and are not subject to refund should the utility cease operation in the following year. Similarly, if a new utility begins operating in Pennsylvania in 2012, it will not be assessed by the Commission until the following year, or 2013. Accordingly, that new utility's assessment and payment made in 2013, though actually applied to spending in the Commission's operating fiscal year that spans July 1, 2013 through June 30, 2014, did not make a prepayment, but was levied as

[15] 66 Pa.C.S. §510(b)(2) (emphasis added).
[16] 66 Pa.C.S. §510(b)(3).
[17] 66 Pa.C.S. §510(b)(4) (emphasis added).
[18] I&E's CWC adjustment does not require any further O&M expense adjustment. I&E St. 2 at 57-59.

assessment on its 2012 earnings based upon the level of regulatory activities devoted to it (or its utility group) in the preceding year.[19]

While the regulatory assessment revenues may be spent in the following fiscal year, as tax revenues are spent in the following calendar year, the billed expense (assessment) for ratemaking purposes should be matched against the revenue generation time period on which the expense was based, namely, the prior year's jurisdictional revenue. This comports not only with the actual manner in which the assessment is made, but also with the accrual accounting concept of matching expense with the revenue earning period that manifested that expense, or vice versa, matching revenues with the expenses that result from the production of those revenues.[20] When these regulatory agencies *spend* the assessment, a fact apparently influential to the ALJ, is irrelevant and does not convert the expense to a prepayment.

PPL's citation to the Commission's June assessment letter, which uses the word "prepayment" as was noted by the ALJ,[21] does not support the ALJ's recommendation. The Commission's use of the word "prepayment" in the June assessment letter refers to the timing of the payment with respect to commencement of the fiscal year; it has no relevance to the assessment for purposes of developing the Company's ratemaking CWC needs.

As described above, 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. Actual assessments are made in August of a fiscal year. In June, however, the Commission issues letters prior to the beginning of the fiscal year, an example being

[19] I&E St. 2-SR at 64.
[20] I&E St. 2-SR at 63.
[21] R.D. at 23.

the one provided by PPL, 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[.]"[22] It asks these larger 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 have a continuous flow of funds at the beginning of the fiscal year. The assessment letter notes that the utility will receive the traditional August invoice which will reflect any remaining balance or credit of its annual assessment.

Thus, the Commission's use of the word "prepayment" in the June assessment letter is merely the Commission's request of an "early payment" to assure continuous funding of the regulatory agencies. It is not determinative of the status of that payment for the purposes of the appropriate calculation of PPL's CWC requirements.

In brief, PPL also cited to a *1995 NFGDC*[23] case as further evidence of this Commission's regulatory practice. This case is also not dispositive of the issue. In *1995 NFGDC*, no party contested whether regulatory assessments were appropriately characterized as "prepayments" for cash working capital purposes.[24] Notable also is the fact that NFGDC's entire CWC prepayment balance was $428,000, much closer to I&E's adjusted prepayment balance for PPL of $394,000 than the Company's original claim of over $3 million. Absent a challenge coupled with Commission discussion, analysis, and conclusion regarding the treatment of regulatory assessments in that case, the case alone is insufficient to controvert the statutory mechanism described above. If PPL pays its

[22] PPL Ex. BLJ-1 (emphasis added); I&E R.B. at 13.
[23] *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*").
[24] *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.")

assessment in June 2013 for its 2012 operations, as it will, but then in September 2013 ceases operations, it will not receive any refund of that payment because it is not a prepayment for the July 2013 to June 2014 fiscal year. It is, rather, an expense for the prior year's operations. Including it as a prepayment in PPL's CWC claim overstates the expense by $2.8 million, allowing the Company to earn both a return of and return on the expense. I&E's exception should be accepted.

B. Expenses

1. Incentive Compensation – Neither the evidence nor the case relied on supports the ALJ's recommendation that PPL be allowed 100% recovery from ratepayers of an almost $9 million incentive compensation expense.

Recommended Decision: Pages 26-28
I&E Main Brief: Pages 28-31
I&E Reply Brief: Pages 19-24

PPL is entitled to recover all reasonably incurred expenses necessary for the provision of safe, reliable and adequate utility service[25] if it satisfies its burden of proof.[26] PPL's evidence in this proceeding does not support a 100% allocation to ratepayers of PPL's claimed $9 million incentive compensation expense.

Incentive compensation comprises payments to eligible employees in addition to their base salaries and wages usually based on the attainment of key performance indicators established by the company or an affiliate. In this proceeding, PPL claimed a total incentive compensation expense of $10.088 million, of which $8.918 million was jurisdictional. The basis for the Company's claim was its assumption of attaining the

[25] *UGI Corp. v. Pa. P.U.C.*, 410 A.2d 923, 932 (Pa. Cmwlth. 1980); *Western Pennsylvania Water Company v. Pa. P.U.C.*, 422 A.2d 906 (Pa. Cmwlth. 1980).
[26] 66 Pa.C.S. § 315(a); *See also Cup v. Pa. P.U.C.*, 556 A.2d 470 (Pa. Cmwlth. 1989).

general goals of stock earnings per share (EPS) performance, financial objectives, and operation goals.

The Company declined in response to I&E discovery to identify the specific targeted incentive parameters that were assumed in developing its historic test year (HTY) and FTY claims by the Company to its affiliate PPL Services or the targets that had to be met to qualify for the compensation. Accordingly, I&E recommended an equal sharing of the claimed FTY incentive compensation expense between shareholders and ratepayers, resulting in a jurisdictional allowance of $4.459 million and a reduction of an equal $4.459 million from the Company's claim.[27] As PPL's own evidence proved, PPL Corp's strategic goals include "best-in-the-sector returns" through "increase[d] shareowner value."[28] Since the Company's stock EPS performance and other financial measures directly impact shareholder value, absent sufficient data to determine the relative ratepayer and shareholder values, I&E's proposed equal sharing of the expense was fair.

PPL's incentive compensation expense is substantial. At almost $9 million, this one expense comprised almost 10% of the Company's proposed rate increase, and almost 15% of the ALJ's recommended revenue allowance. Notwithstanding both the size of the claim and this Commission's history of analyzing the factual basis underlying each claim, PPL declined to provide evidence to allow either I&E or the Commission to analyze the extent to which this expense was necessary for the provision of safe and reliable service at just and reasonable rates.

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[27] I&E M.B. at 28-30; I&E St. 2 at 16-17; I&E Ex. 2, Sch. 8.
[28] PPL Exhibit DAC-2, Schedule.

The ALJ concluded that no party challenged the reasonableness of the total compensation expense, and thus the only challenge was to the "method of delivering it."[29] Noting cases cited by PPL in which the Commission had allowed recovery, including one involving PPL's prior affiliate *PPL Gas*,[30] the Judge concluded that "the law does not support [the] concept" that shareholders should share in the funding of the expense because they directly benefit from it. As support for her legal conclusion, the Judge cited *Butler*[31] as precedent that prohibits the sharing of the incentive compensation expense.[32]

I&E respectfully submits that the ALJ applied an erroneous legal standard of review. This, in turn, led to an incomplete evidentiary analysis, resulting in a recommendation that is not supported by substantial evidence. Finally, by challenging one-half of the expense, I&E did challenge the reasonableness of the total expense *as it relates to ratepayers*. Therefore, on all three grounds, the ALJ's recommendation is erroneous.

The ALJ erroneously concluded that *Butler* prohibited, as a matter of law, adoption of I&E's proposal to disallow 50% of the incentive compensation expense as a legitimate ratepayer expense. As this Commission itself ruled in *PPL Gas*, "we do not agree with the Company that the adjustment urged by the OTS [regarding the sharing of the variable pay expense] would be prohibited as a matter of law under *Butler*[,]" which involved the proposed sharing of *rate case* expense and is therefore inapposite.[33] Further,

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[29] R.D. at 27.
[30] *Pa. P.U.C. v. PPL Gas Utilities Corporation*, Docket No. R-00061398 (Order entered February 8, 2007) ("*PPL Gas*").
[31] *Butler Township Water Co. v. Pa. P.U.C.*, 473 A.2d 219 (Pa. Cmwlth. 1984) ("*Butler*").
[32] R.D. at 28.
[33] *PPL Gas*, Slip Opinion at 40.

while in *PPL Gas* the Commission did allow 100% ratepayer recovery of the expense, it did so only after specific review "of the facts of [that] case[.]"[34]

This leads to the second point of error in the ALJ's recommendation. Because the Commission's determination regarding PPL's ability to recover this expense is heavily dependent upon a fact-specific review of the relative costs and benefits of the expense to ratepayers, as part of its evidentiary burden PPL was required to provide substantial evidence of the specific details of its incentive compensation package. Despite I&E's request, PPL chose not to do so. The Company's refusal to disclose the underlying specifics of PPL's claimed $9 million incentive compensation expense left the Commission no ability to "scrutinize the plan's prudence and priorities as they affect ratepayers."[35]

In *PPL Gas*, the Commission specifically identified that "several considerations lead us to this conclusion [to allow full ratepayer recovery of the expense]."[36] 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. In fact, in distinguishing its incentive program from others for which the Commission had disallowed the expense, the utility in that case, PPL Gas specifically noted as follows:

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[34] *Id.*
[35] I&E St. 2-SR at 11.
[36] *PPL Gas,* Slip Opinion at 40.

> PPL Gas distinguishes *Roaring Creek* as a case that addressed a bonus program tied to the financial goals of the corporate parent. PPL Gas reiterates that *the goals of its program are balanced and unrelated to the financial performance of any corporate affiliate*.[37]

Clearly the same distinction cannot be made in the current proceeding where affiliate shareholder value is a specific program goal.

On this same basis of a factually intensive review of the underlying specifics of the program the Commission distinguished another case in which it had disallowed the claim. In that case,[38] 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."[39]

PPL's program clearly is tied to earnings targets for its parent. However it also encompasses ratepayer operational interests.[40] Notwithstanding PPL's obvious understanding of the import of the factual scrutiny undertaken by the Commission, having distinguished similar programs in the past, the Company refused to provide I&E's requested information. While this may or may not have supported a 100% allocation of the expense to ratepayers, it is now a fact this Commission cannot find on this record.

PPL controlled what facts it would and would not reveal to support its claim. I&E 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. As PPL steadfastly maintained even before the Judge, however, "the detailed analysis desired by I&E is not

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[37] *PPL Gas*, Slip Opinion at 38 (emphasis added).
[38] *Pa. P.U.C. v. Roaring Creek Water Co.*, 81 Pa. P.U.C. 285 (1994).
[39] *PPL Gas*, Slip Opinion at 40. *See also Pa. P.U.C. v. Consumers Pennsylvania Water Company - Roaring Creek Division*, 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.")
[40] As PPL's evidence showed, and as PPL agreed in brief, "the incentive compensation benefits ratepayers **and** shareholders[.]" PPL M.B. at 35 (emphasis added); I&E M.B. at 29-30.

necessary."[41] Apparently preferring to "roll the dice" before the Commission, the Company chose not to disclose the underlying specifics to support its claim, leaving I&E essentially to "take it or leave it."

Recognizing some ratepayer value, I&E did not recommend rejection. Most definitely recognizing shareholder value as well, however, I&E concluded that a 50/50 sharing of this expense between PPL Electric's ratepayers and the PPL corporate family which benefitted from the mandated increase in shareholder value was reasonable. As I&E witness Morrissey summarized:

> [PPL witness] 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.[42]

Accordingly, I&E's adjustment appropriately recognized both the appropriate legal standard of review and the requisite evidentiary burden.

Unfortunately, due to her erroneous legal conclusion that *Butler* forbade the type of adjustment I&E proposed, the ALJ undertook no evidentiary analysis. Based upon the limited evidence provided, however, PPL cannot adequately distinguish its proposal in this case from other cases in which the Commission disallowed the claim, as PPL did that

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[41] PPL M.B. at 40, note 6.
[42] I&E St. 2-SR at 10-11.

with respect to its prior affiliate in *PPL Gas*. Unlike *PPL Gas* in which the Commission specifically noted that "variable pay is *unrelated* to the performance of a PPL Gas holding company or affiliate[,]"[43] the corporate parent's shareholder returns *are a specific component* in the cost of PPL's incentive compensation expense. And also unlike *PPL Gas,* in which the goals were not only unrelated to the financial goals of an affiliate but also "balanced," because of PPL's stance that "the detailed analysis desired by I&E is not necessary,"[44] the Commission cannot determine the relative shareholder/ratepayer "balance" of PPL's program compared to its expense.

These factors, I&E submits, require at least some allocation of the cost outside the rate-regulated entity PPL. A single expense item that comprises such a significant portion of PPL's overall request should not be so readily accepted as reasonable and necessary for ratepayer operations when the Company picks and chooses what details to disclose to support it. In choosing not to provide more information, PPL allowed its sense of entitlement to cloud its judgment and as a result has not met its burden of proving that an $8.9 million expense is reasonable and necessary for the provision of regulated utility service. I&E's proposal to reduce PPL's expense by $4.459 million is appropriate and should be adopted.

C. Rate of Return

1. Capital Structure – The ALJ erred in not applying a more cost-efficient capital structure for PPL, using I&E's calculated industry average, particularly because PPL's more expensive equity ratio is assigned by its affiliate.

Recommended Decision: Pages 56-60
I&E Main Brief: Pages 82-83
I&E Reply Brief: Pages 60-67

[43] *PPL Gas*, Slip Opinion at 40 (emphasis added).
[44] PPL M.B. at 40, note 6.

A utility's capital structure should be both representative of the industry norm and an efficient use of capital. A hypothetical capital structure based upon an industry average should be used for ratemaking purposes if use of the utility's actual capital structure has the potential to overstate the overall cost of capital. I&E witness Sears recommended a hypothetical capital structure based upon her industry average of 54.89% long-term debt and 45.11% equity for the FTY (or 55% debt and 45% equity).[45]

PPL's proposed capital structure, at essentially 49% debt and 51% equity, is neither representative of the industry norm nor an efficient use of capital.[46] PPL's stock is not publicly traded and its capitalization is determined by its parent. Therefore, in analyzing PPL's proposed capital structure, I&E witness Sears reviewed the capital structures of her similarly-situated barometer group of companies and recommended use of a hypothetical capital structure for PPL based on the average of her barometer group. I&E's recommended industry average structure best represents the industry norm and the most cost-efficient capitalization. Thereby, I&E's recommendation best balances the needs of the Company with the interests of its ratepayers.

In analyzing I&E's, OCA's, and PPL's barometer groups of companies, the ALJ noted that all three include companies that have equity ratios that are both higher and lower than PPL's capital structure.[47] While acknowledging I&E's claim that PPL's proposed capital structure overstates the Company's capital needs by $15 million, the ALJ also acknowledged PPL's argument that "[t]he law permits the use of a hypothetical

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[45] I&E St. 1 at 12-13.
[46] PPL St. 11 at 22; I&E M.B. at 82-83.
[47] R.D. at 57.

[structure] when the Company's actual capital structure is atypical, not when it is inconvenient."[48]

Ultimately the ALJ concluded that "[t]he appropriate capital structure is the Company's actual capital structure of 49.22% long-term debt and 50.78% common equity."[49] I&E respectfully submits that while the differences between PPL's and I&E's proposed capital structures are nuanced, PPL's actual capital structure includes sufficiently more expensive equity than less expensive debt such that I&E's proposed adjustment is appropriate. Imposing upon PPL the industry average capital structure saves ratepayers an annual $15 million while still providing the Company competitive and effective means to finance its capital needs. This is particularly true given today's economic environment where debt rates have been and remain at all-time lows, and where PPL's capitalization is controlled by its affiliate, which is financially accountable to PPL's corporate parent not PPL's ratepayers. If the corporate family is unwilling to take advantage of historically low interest rates to benefit its affiliated rate-regulated entity's ratepayers, then it is incumbent upon this Commission to do so.

While not expressly stated, it appears the ALJ was persuaded by the fact that PPL's proposed equity ratio fell within the range of those presented in the Company's, I&E's, and OCA's barometer groups. However, an equity ratio that falls within a range is not necessarily an efficient equity ratio. Particularly in a case of this size, where an affiliate controls the capital structure and where a difference of 5% between debt and

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[48] R.D. at 60.
[49] R.D. at 60.

equity equates to an additional annual $15 million ratepayer expense,[50] the determination of the most efficient capital structure requires more scrutiny.

Contrary to PPL's characterization, the legal standard for employment of a hypothetical capital structure is not that the actual capital structure is "atypical." Rather, I&E employed a capital structure that was representative of the industry average because it presented a better option for PPL's efficient capitalization than the capital structure assigned to PPL by its corporate family.

Use of a barometer group average is more reliable than comparing data from individual companies because individual company data may be subject to short-term anomalies that distort its return on equity. The average smooths out those anomalies. Further, as I&E witness Sears noted, not only her industry average, but also the common equity ratio industry averages from PPL'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 approximated and supported I&E's recommended capital structure of 45% equity and 55% debt.[51] Finally, as I&E witness Sears also demonstrated, a range is not always indicative of an industry norm.[52] A range could be from 0% to 100% equity, and have an average of 30% showing where the majority of companies fell. A 99% equity ratio would still be within the "range," but nonetheless grossly outside the norm and failing to provide evidence of an appropriate ratio.[53]

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[50] Tr. at 364.

[51] I&E St. 1 at 14. As the ALJ noted, PPL witness Moul's proposed barometer group of companies violated several of Mr. Moul's own criteria and thus failed to satisfy even Mr. Moul's own standards. Therefore, although ALJ Colwell did not expressly exclude from consideration Mr. Moul's barometer group of companies, for the reasons stated in I&E's Main and Reply Briefs, I&E contends that the Commission's use of Mr. Moul's barometer groups should be limited. I&E M.B. at 79-83; I&E R.B. at 60-65, 70.

[52] 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.")

[53] I&E St. 1-SR at 8; I&E R.B. at 65-66.

I&E's recommendation to use a hypothetical capital structure based on the average of I&E's industry barometer group also negates PPL Service Corporation's conflict of interest between maximizing returns to the corporate parent while also ensuring the rate-regulated entity provides utility service at rates that are simultaneously economical to ratepayers and compensatory to the parent. During cross-examination, OCA witness Hill accurately described the parent corporation's ability to affect the rate-regulated entity's capitalization:

> A. …[I]t's very simple for the parent company to transfer cash to the subsidiary and call it equity or call it debt.
>
> An accountant can sit at his keyboard and determine whether $125 million going to the subsidiary is equity or debt. The parent says, "We're going to loan this money to you, or we're going to invest it in the equity accounts." And that has a big impact on the subsidiary capital structure.
>
> In fact, that's what's happening here. Mr. Moul talks about the company making a $150 million equity infusion to the subsidiary. They could just as easily, which is my assumption, say that we're loaning this money to you instead of putting it into your equity account. That's simply a parent company decision, very simple to do.
>
> Q. But there's no evidence in this proceeding that the parent company is borrowing that money, is there, and then loaning it -- and then giving it to PPL?
>
> A. Doesn't matter –
>
> Q. PPL Electric, excuse me.
>
> A. Doesn't matter what the source is. They've got the money. They're contributing the money. The money can come out of operating earnings, it can come out of -- the parent company can decide, no, you don't have to pay dividends. Instead, we'll say that that money is recontributed back to you and we'll call it debt or we'll call it equity. There's lots of ways that the parent can move money around.

Q. So you think that the parent should assume that PPL Electric is paying dividends to the parent, which are earnings, and then refunding it back to PPL Electric as equity. In your mind, that should be characterized as debt?

A. No. In the example you just gave, it would be characterized however PPL chose to characterize it, PPL Corporation. My point is that the company -- this is a distribution company, let's remember this. Distribution companies are less risky than fully integrated electric companies.

The average equity ratio for a fully integrated electric company is about 46 percent in this country, 46 percent. The company is asking for a 51 percent equity ratio. This is a less risky company asking for more equity capital. I don't think that's fair for ratepayers.

So instead of contributing equity, I think they should contribute debt to the subsidiary. That's a reasonable thing to do and it's -- a reasonable ratemaking capital structure is the result.[54]

The Commission clearly has the authority to employ a hypothetical capital structure to impose a more efficient capital structure:

> 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:
>
> > ***The capital structure of a corporation may affect, sometimes drastically, the cost of capital***. The capital structure is, in reality, little more than those dollars represented by its common and preferred stock and its debt. In some cases where the public utility is a wholly-owned subsidiary, its capital structure may not be comparable to another public utility which 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.[55]

[54] Tr. at 325-27. *See also* OCA St. 2-SR at 12-13; I&E M.B. at 83; I&E R.B. at 61.

[55] *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).

While I&E agrees that PPL's actual capital structure does not deviate substantially from the industry range, the applicable legal standard is not that the capital structure must be "atypical" before a hypothetical structure should be considered. Commission decisions have specifically avoided setting numeric standards to define efficient capital structures. To the contrary, the Commission has set standards such as "in proper proportions," "on balance," not "too heavily weighted" one way or another. How much is "too much" is undefined and very case-specific. As the Commission stated:

> 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.[56]

This Commission has also clearly recognized that "there are no magic numbers for the proper percentage of debt and equity."[57] 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."[58] 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 unfair and unreasonable to ratepayers because it can be moderated without financial harm to PPL Electric through the minor adjustment to the rate-regulated entity's capital structure. Indeed, it is appropriate to do so if the record demonstrates, as it does here, that a hypothetical capital

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[56] *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).
[57] *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.
[58] *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).

structure would better "achieve a fair balance between the consumer and the stockholder interests."[59]

I&E submits than an annual $15 million expense, that is created or avoided at the exercise of an affiliate's conflicted judgment, requires adherence to a strict standard of scrutiny. As this Commission has recognized in the past:

> 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**.[60]

The nuanced difference between PPL's proposed capital structure and I&E's proposed capitalization is a textbook example of a proposal that while benign on its face can nonetheless insidiously produce unnecessarily inflated ratepayer costs. I&E's proposed capital structure should be adopted by the Commission to impartially achieve a fair balance of ratepayer and stockholder interests.

[59] *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).

[60] *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). ("1995 Pa. American")

2. Management Effectiveness Adder – the ALJ's recommended addition of six basis points to her calculated return on equity to reward PPL's management is not supported by the evidence.

Recommended Decision: Pages 84-89
I&E Main Brief: Pages 116-23
I&E Reply Brief: Pages 83-94

PPL sought the addition of 12 basis points, or almost $3 million in additional ratepayer revenues,[61] to its calculated return on equity to reward its shareholders.[62] According to the Company, "[t]he ultimate measure of an electric utility's management effectiveness is its ability to provide safe, reliable, and high-quality service at reasonable rates."[63] As evidence it earned a reward, PPL cited its advanced metering infrastructure, operating initiatives, customer contact center, performance in retail electric competition, customer education and energy efficiency programs, customer assistance programs, and industry awards.[64]

I&E's evidence countered each point: Smart meters were statutorily mandated specifically under Act 129 and generally under Section 1501 and were being implemented ubiquitously by electric utilities. PPL's operating initiatives such as its "smart grid" and work and asset management system were necessary costs of doing business to implement infrastructure improvements in today's technologically-advanced environment.[65] Costs associated with these initiatives were also already reflected in PPL's rates, where the Company was earning a return of and a return on its investment,

[61] Tr. at 335.
[62] PPL St. 11 at 6.
[63] PPL St. 1 at 6.
[64] PPL Exhibit Future 1, Statement of Reasons, at 8-17.
[65] Before Act 129 specifically mandated "smart meters," for example, Section 1501 of the Code already required utilities 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." 66 Pa.C.S. §1501 (emphasis added). To the extent technology improves service, PPL is mandated to pursue it.

and such cost recovery will only become more timely through use of the Distribution System Improvement Charge.[66]

PPL selectively presented evidence of "high quality" service. I&E's responsive evidence of "adequate, efficient, safe, and reasonable" service, the required statutory standard, however, was uncontroverted. PPL was cited by the Commission for its below average storm response and while some customer service metrics rose, others fell, presenting a mixed bag at best.[67] The Company's achievements under Act 129 were also mediocre compared to its peers.[68] In claiming excellence in the areas of competition, universal service support, and consumer education, PPL essentially sought investor reward for implementing statutorily-mandated programs that were purely ratepayer funded through Commission-mandated rates that guaranteed PPL dollar-for-dollar recovery with interest through separate surcharges and riders.

For example, while PPL held up its "family of universal service programs" as evidence of effective management, I&E's evidence demonstrated that it is PPL's ratepayers, not the Company, who provide $76 million annually in mandatory ratepayer funding. Already comprising 98.77% of the Company's universal service funding, this ratepayer funding is projected to grow while shareholder support remains stagnant. Similarly since 2008 PPL's ratepayers have been mandated to provide an annual $5.4 million in ratepayer funding for consumer education and program implementation regarding retail competition and energy efficiency, funding that PPL seeks to increase.[69] I&E understands these are statutory programs with statutory funding mechanisms. But

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[66] I&E M.B. at 117-18 I&E R.B. at 83-84.
[67] I&E M.B. at 118-22. For example, PPL had the highest percentage of bills not rendered to residential customers and ranked 5th out of 8 for satisfaction with its automated system.
[68] I&E R.B. at 85-86.
[69] I&E M.B. at 120-22; I&E R.B. at 83-87.

they should not be accepted as satisfactory evidence to justify compelling even more ratepayer funding. Yet PPL fails to see the either the irony or inequity of citing existing mandated ratepayer funding as evidence that ratepayers should compelled to reward shareholders with yet additional millions in pure shareholder premium.

The ALJ correctly recognized that "the provision of safe, reliable, adequate and reasonable service is the minimum required by the Public Utility Code, and simply meeting that standard does not warrant excessive rewards."[70] The ALJ determined, however, that "PPL presented substantial evidence of management effectiveness in a number of areas."[71] While acknowledging PPL's service was imperfect, the ALJ recommended a management effectiveness equity reward of six basis points apparently abiding the standard espoused by PPL:

> The principal issue is not whether PPL Electric's various practices, processes, or programs are superior to other electric utilities, or whether the programs and initiatives are funded by ratepayers. Rather, the principal issue is the broad scope of PPL Electric's efforts to improve its operations in ways that strengthen reliability, enhance customer satisfaction, respond to customer needs, and reinforce public and employee safety. It involves a commitment to customer services, effective leadership, operational excellence, and a culture of continuous improvement.[72]

I&E believes the ALJ's recommendation is not only unsupported by substantial evidence as described above, but also fails to establish or abide by any measurable standard.

While the Commission has the discretion to reward management, because such action essentially sanctions approval of a ratepayer premium, the Commission should exercise that discretion circumspectly. Circumstances warranting investor rewards should be the exception not the norm. As the evidence showed, however, PPL's service is not

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[70] R.D. at 89.
[71] *Id.*
[72] *Id.*

exceptional. PPL complies with its obligations under the Public Utility Code to provide adequate, efficient, safe, and reasonable service at just and reasonable rates. PPL's service was at times above average, at other times below average, and sometimes just average. PPL's evidence, however, did not exemplify a superior standard. Moreover, there was no clear evidence of any particular shareholder commitment that justifies gratuitous ratepayer funding.

Indeed, PPL eschews any notion that it should demonstrate superiority of service or shareholder commitment in order to receive a management reward. In discovery I&E sought elaboration from PPL how the Company distinguished itself from others since absent some distinction, compliance with the Public Utility Code reward opens the door for all utilities to seek this bonus. In each instance, PPL's response was a well-rehearsed refrain, repeated in briefing and again in the Recommended Decision:

> 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.[73]

I&E further 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 responded that "[t]he two concepts are related, but quite different" with the statutory requirements establishing a "minimum standard."[74] With the exception

[73] I&E Cross-Examination Ex. 9 (quoting from PPL's response to I&E-RR-69); Tr. at 298-301; I&E R.B. at 89-90; R.D. at 122.
[74] I&E Cross-Examination Ex. 9 (I&E RR-75); Tr. at 303.

of Act 129, however, PPL was at a loss to identify any other statutory or regulatory standard that was clearly established as a "minimum."[75]

PPL argued that nothing in Section 523 required the utility to perform better than others. Moreover, according to PPL, the notion that shareholders should contribute to the "operational excellence" was "nonsensical."[76] Again, however, since an equity reward represents a rate premium, 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 excellence other than PPL's own self-image.

The Commission is aware of the vagaries involved when asked to set rates that exceed reasonable compensation and instead reward investors. Before Section 523 was enacted, the Commission held that "good management is amply rewarded by decreased operating costs and thus greater return."[77] Although authorizing consideration of management effectiveness, Section 523 likewise provides no clear standard for rewarding effective management. All but two of the seven statutory criteria[78] have been effectively rendered moot by subsequent legislative enactments. Of the two potentially remaining factors, subsection (b)(1), "management effectiveness and operating efficiency *as measured by an audit* pursuant to section 516"[79] that is properly introduced into evidence, is inapplicable because, as the ALJ noted, no audit was presented. Subsection (b)(7), "any other relevant and material evidence of efficiency, effectiveness and adequacy of service,"[80] is so broad as to constitute essentially no standard. This is particularly true in

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[75] Tr. at 303-04.
[76] PPL M.B. at 121-22.
[77] *Pa. P.U.C. v. Blue Mountain Consolidated Water Co.*, 1982 WL 213115 (Pa. P.U.C.) ("*Blue Mountain*"), Slip Opinion at 2.
[78] 66 Pa. C.S. §523(b).
[79] 66 Pa. C.S. §523(b)(1)(emphasis added).
[80] 66 Pa. C.S. §523(b)(7).

light of Sections 1501 and 1301 of the Code, which mandate PPL to provide adequate, efficient, safe, and reasonable service and facilities at just and reasonable rates.[81]

Existing Commission cases are equally vague. In *1994 West Penn Power,*[82] 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."[83] In *2008 Aqua Pennsylvania,*[84] the Commission found that "Aqua has done much to improve the quality of service throughout its growing service territory"[85] while acknowledging that Aqua had undertaken a course of acquiring small troubled water systems.

The lack of a measureable and objective standard is troubling. All utilities are subject to and comply with the same statutory standards. But as I&E noted, PPL dismissed 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,[86] it is not unreasonable to consider an element of superiority or shareholder contribution to the rate-regulated entity in order to give some definition to an otherwise amorphous standard. In each regard, however, PPL's evidence fails.

I&E submits that while the Commission clearly has the authority to reward investors, PPL's evidence does not support it. I&E also submits that it would be a particularly unwarranted exercise of discretion by the Commission because PPL's

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[81] 66 Pa. C.S. §§1501, 1301.
[82] *Pa. P.U.C. v. West Penn Power Company*, Docket Nos. R-00942986 et al. (Order entered December 29, 1994) ("*1994 West Penn Power*").
[83] *1994 West Penn Power*, Slip Opinion at 52.
[84] *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, (Order entered July 31, 2008) ("*2008 Aqua Pennsylvania*").
[85] *2008 Aqua Pennsylvania*, Slip Opinion at 50.
[86] PPL M.B. at 122.

ratepayers have compensated PPL handsomely under deregulation, paying $2.8 billion in Competitive Transition Charges since 1998 to compensate PPL for stranded generation assets and $269 million in rate increases since 2004. And by all PPL's projections, ratepayers will continue to face the financial effects of not only unrelenting rate case increases but also intervening DSIC filings.[87]

PPL has not exceeded its statutory and regulatory requirements under the Public Utility Code. All utilities share the same obligations under the Public Utility Code and all are meeting those, some better than PPL. The ALJ's recommendation to grant PPL six basis points in addition to her calculated return on equity is neither warranted nor supported under the facts or the law. Service industry workers who earn below minimum wage while expecting to be made whole 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.[88] 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.

D. Rate Structure

1. Scale-back – The ALJ's recommended proportionate scale-back should be adjusted.

Recommended Decision: Pages 110-12
I&E Main Brief: Pages 126-28
I&E Reply Brief: Pages 99-101

The ALJ recommended adoption of the Company's proposed proportional scale-back in the event the Commission approved an increase less than $104.6 million.[89] I&E

[87] I&E R.B. at 4.
[88] I&E R.B. at 57-58.
[89] R.D. at 112.

agrees with the ALJ, but believes the Commission should moderate the increases proposed for the Rate RTS usage rate and the LP-5 customer charge, if that is not reduced based upon Mr. Hubert's customer cost analysis, before the proportionate scale-back is applied.[90]

2. Customer Charges – The ALJ's recommendation to adopt the Company's compromise residential customer charge lacks legal support and the recommendation to adopt the Company's non-residential customer charges to be consistent with the recommendation regarding the residential customer charge lacks factual support.

Recommended Decision: Pages 116-21
I&E Main Brief: Pages 129-38
I&E Reply Brief: Pages 101-14

As originally proposed, PPL's entire residential increase was to be recovered from an 82% increase to its RS customer charge. PPL also proposed increases to its non-residential customer charges. In support of these proposals, PPL presented no direct customer cost analysis. It provided only a cost of service study, which is an entirely different cost analysis.[91] PPL found "very few, if any, distribution system-related costs that are a function of usage[,]"[92] and proposed to recover essentially all fixed costs in the customer charge. The Company classified all costs as either demand or customer related, then used those classifications to drive its proposed customer charges, including within its calculation of a customer charge all fixed costs that are customer, as opposed to demand, related,[93] and making no distinction between direct and indirect costs.

[90] I&E M.B. at 126-28; I&E R.B. at 99-101.
[91] I&E St. 3 at 9-10.
[92] PPL St. 5 at 12.
[93] For the residential class alone, approximately 80% of the class revenues were classified as customer related, and the remainder demand related. I&E M.B. at 132-33.

I&E opposed PPL's proposals. As I&E witness Hubert explained, fixed costs and customer costs are not synonymous.

> Once an investment is made, it may be considered a fixed cost. However, that alone does not dictate the manner in which the fixed cost should be recovered. Fixed costs assigned to the customer charge are limited to those fixed costs for which there is a direct impact from an individual customer. For example, each individual customer requires a meter and a bill. Therefore, fixed costs associated with meters and billing are properly attributable to the fixed customer charge. On the other hand, there is no direct relationship between the number of customers and the size or the cost of poles, conductors or transformers. Accordingly, those costs are not properly attributable to the customer charge. Instead, those items are common costs that should be billed to the customer class through volumetric rates.[94]

Mr. Hubert continued that "[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."[95] Using data from the Company's cost of service study, Mr. Hubert conducted a customer cost analysis according to Commission precedent, the results of which are replicated in the Recommended Decision.[96]

Although PPL moderated its Rate RS proposal in rebuttal, it still failed to conduct an appropriate customer cost analysis. Rather, PPL presented a "study" that included both direct and indirect costs that it claimed authorized a $36.70 RS customer charge, but under which PPL only claimed only a "compromise" RS charge of $14.09.[97] Further, PPL

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

[95] I&E St. 3 at 10.

[96] R.D. at 117. 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. Also, I&E did not distinguish between residential and non-residential classes, but was guided solely by the results of the properly constructed direct customer cost analysis. I&E M.B. at 129-38.

[97] PPL St. 8-R at 30; PPL St. 8RJ (part 2) at 5. PPL witness Krall identifies $10.75 as the minimum customer charge required to ensure the relative percentage of fixed costs recovered in the customer charge does not decrease. PPL St. No. 5-R at 14-15. However, the Company did not reduce its second proposal, as confirmed by Mr. Krall on page 14 of his rebuttal testimony based upon the costs identified by PPL witness Kleha on page 30 of his rebuttal testimony his Exhibit JMK 5. *See also* I&E R.B. at 107-14.

produced no such "study" and made no such "compromise" offer with respect to its originally proposed non-residential customer charges.

In the Recommended Decision, the ALJ recommended approval of all PPL's proposed customer charges. The ALJ recommended PPL's "compromise" rebuttal proposal for the residential class because "it is based on an approved cost of service study, which clearly illustrates that customer-related costs for the residential class include elements that I&E ignores in its own analysis and determination of a proper residential customer charge. It is reasonable to include some of these additional elements in calculating the residential customer charge, as the Commission allowed in the *Aqua* case.[98] For the non-residential customer charges, the ALJ concluded that "[a]s I have accepted the Company's cost of service-based evaluation for residentials, it is consistent to accept it for the commercial and industrial customers as well."[99]

Relying on one aberrant Commission order from 2004, I&E submits that the ALJ's Rate RS customer charge recommendation lacks adequate legal support. Moreover, although the ALJ recommended adoption of PPL's non-residential customer charges to be consistent with her residential recommendation, since PPL did not present a "study" nor revise its non-residential customer charges in rebuttal as it did for the Rate RS class, the ALJ's non-residential recommendation is actually inconsistent since the proposed non-residential customer charges lack any supporting cost analysis.

PPL and the ALJ both rely on *2004 Aqua*[100] as support for the Rate RS customer charge. PPL, recognizing that its initial proposal far exceeded any reasonable bounds of

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[98] R.D. at 120.
[99] R.D. at 121.
[100] *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*").

Commission precedent, presented in rebuttal what it called an "alternative compromise customer charge" based on its interpretation of *2004 Aqua*. However, that case is not controlling.

The holding of that case, with respect to the inclusion of indirect costs in the calculation of a customer charge, has not been reaffirmed or reapplied since 2004. Since 1985 and most recently 2011, with the *one exception being 2004 Aqua*, the Commission affirmed the basic customer cost analysis it originally articulated in 1985.

In *1985 West Penn Power,*[101] the Commission adopted the standard that defined "basic customer cost" as expenses for those items a company must have in place each month for each customer including meters, service drops, meter reading, and billing, and specifically excluded "assertedly 'customer-related' costs of transformation and distribution plant" which were 'better recovered through energy charges to avoid subsidies from low usage customers to high usage customers."[102] A decade later the Commission affirmed its basic customer cost analysis to exclude indirect customer and administrative costs for the gas industry, finding that National Fuel Gas's proposed customer charges improperly "include more than the direct customer costs relating to these classes as defined earlier."[103] The Commission also adopted this approach to water utilities as well.[104]

I&E's customer cost analysis also adhered to recent Commission rulings, applying the same principles adopted by the Commission in the 2004 PPL base rate

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[101] *Pa. P.U.C. v. West Penn Power Company*, 59 Pa. P.U.C. 552 (1985) ("*1985 West Penn Power*").
[102] *Id*., Slip Opinion at 42.
[103] *1995 NFGDC at* **108-10 (citations omitted).
[104] *1995 Pa. American* at ** 55.

proceeding[105] and in the 2007 *PPL Gas* case involving PPL's former affiliate. Finally, I&E's analysis was most recently confirmed by the Commission just last year in the *2011 Columbia Gas* decision,[106] in which I&E conducted the identical customer cost analysis as presented here, including for recovery in a fixed customer charge the costs of meters and house regulators, customer installations, services, meter reading, customer records and collection and customer assistance costs, which analysis the Commission adopted.[107]

While the Company attempted 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 mechanisms,"[108] that precaution is not substantively different from the Commission's precaution in *2004 Aqua*, in which the Commission articulated that "[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."[109] Moreover, when reviewed within the context of the charge at issue in *2011 Columbia Gas*, the Commission's reservation clearly applies to Columbia's proposal to implement a fixed, flat monthly rate with no usage component and not the customer cost analysis. 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. Thus, both the overwhelming majority as well as the most recent of Commission decisions, including those decided

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[105] *Pa. P.U.C. v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (Order entered December 22, 2004) ("*2004 PPL*").

[106] *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc.*, Docket No. R-2010-2251623 (Order entered October 14, 2011), 293 P.U.R. 4th 235, 2011 WL 5026079 (Pa.P.U.C.) ("*2011 Columbia Gas*").

[107] *2011 Columbia Gas*, 2011 WL 5026079 * 16; Tr.at 541-42.

[108] PPL M.B. at 169, note 34.

[109] *2004 Aqua*, Slip Opinion at 72.

after deregulation, support I&E's customer cost analysis and not the charges recommended for adoption in the Recommended Decision.

Further, even if the Commission is inclined to follow the *2004 Aqua* outlier, PPL admitted that it included in its "study" a $12.7 million customer service expense that was not addressed in *2004 Aqua*.[110] This one expense item not only does not vary with the addition or deletion of a customer, it also adds almost $1/month to each customer's bill.[111] Yet this distinction was not specifically considered in the Recommended Decision.

The Commission has 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 transmission or distribution related costs that a not a direct function of adding customers. While most challenges have involved increases in the residential customer charge, the Commission has clearly extended and applied its basic customer cost analysis to non-residential classes as well.[112] The *2004 Aqua* case relied on by PPL and the ALJ is an outlier that should not apply as controlling case law.[113]

As the sole basis presented in the Recommended Decision for adoption of the Rate RS customer charge, the ALJ's recommendation should be rejected. PPL's "compromise" RS customer charge fails to meet the parameters of a properly constructed

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[110] R.D.at 119, quoting PPL M.B. at 172-73.

[111] Dividing the $12.7 million expense by the 14.6 million annual customer bills of the 1.2 million residential customers renders an expense of almost $0.90/bill. *See* R.D., chart at 118-19, for all data.

[112] I&E R.B. at 108-11.

[113] In brief, PPL also asserted that its proposed customer charges were required by *Lloyd*. In *Lloyd*, however, Commonwealth Court did not address intra-class rate design or intra-class revenue allocation. Rather, the Court addressed the allocation of rates "among the various rate classes, i.e., the rate structure. *Lloyd*, 904 A.2d at 1015 The Court did not address the revenue allocation *within* a class. *Lloyd*, therefore, has no applicability at all.

customer cost analysis.[114] The ALJ's recommended residential customer charge is not supported by the overwhelming Commission precedent and, unless prepared to enunciate a new standard, the Commission should reject it.[115]

As for the non-residential customer charge, the ALJ recommended adoption of the Company's original proposals in order to be "consistent" with her Rate RS recommendation. However, the Company's proposed non-residential customer charges were based upon its initial construct that all fixed costs associated with permanent customer-related fixed infrastructure should be recovered through the customer charge. Unlike the Rate RS charge, for which the Company conducted a further compilation of direct and indirect costs, the Company's proposed non-residential charges have no supporting "compromise study" and therefore lack the factual support the ALJ found adequate for the Rate RS charge. On the basis of that error, the ALJ's non-residential recommendation should not be adopted.

III. CONCLUSION

In this fully litigated proceeding, the parties' adjustments presented a daunting task to the Administrative Law Judge to discern between substantial adjustments that at times presented diametrically opposed recommendations. On the basis of the record before her, I&E believes that Administrative Law Judge Colwell's Recommended

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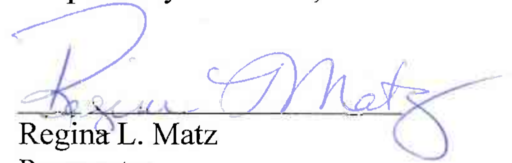
[114] While PPL maintained that there is a direct relationship between the number of customers and the size and cost of poles, conductors, and transformers, this contention overlooks the reality that the Company's service area remains fixed, thus an increase in the number of customers will not notably increase the costs of a minimum size distribution system.

[115] PPL also attempted to justify its proposed residential customer charge on the bases that if unchanged, it would recover fewer fixed costs than under present rates, and that conservation would not be negatively impacted because more revenues than not would still be collected under a usage-based component. I&E disputed the Company's calculation of the relative relationship between its customer and usage charges. *See* I&E R.B. at 105-06. Further, under any calculation, customers will lose control over a substantial part of their bill, very likely deterring conservation efforts despite the millions of dollars customers have invested in energy conservation efforts.

Decision presents a resolution that, with the minor exceptions discussed herein, best balances the competing interests at stake and recommends a resolution that advances the public interest. I&E urges the Commission to adopt these Exceptions.

Respectfully submitted,



Regina L. Matz
Prosecutor
PA Attorney I.D. #42498

Richard A. Kanaskie
Deputy Chief Prosecutor
PA Attorney I.D. #80409

Johnnie E. Simms
Chief Prosecutor
PA Attorney I.D. #33911

Bureau of Investigation and Enforcement
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265
(717) 783-6155

Dated: November 8, 2012

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

<u>CERTIFICATE OF SERVICE</u>

I hereby certify that I am serving the foregoing **Exceptions** of the Bureau of Investigation & Enforcement upon the persons and in the manner indicated below:

<u>Served via electronic and interoffice mail</u>

Steven C. Gray, Esquire
Sharon E. Webb, Esquire
Daniel G. Asmus, Esquire
Office of Small Business Advocate
300 North Second Street
Suite 1102
Harrisburg, PA 17101

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

<u>Served via electronic and first class mail</u>

David B. MacGregor, Esquire
John H. Isom, Esquire
Post & Schell, PC
17 North Second Street
12th Floor
Harrisburg, PA 17101-1601

Scott J. Rubin, Esquire
333 Oak Lane
Bloomsburg, PA 17815-2036

Todd S. Stewart, Esquire
Hawke McKeon & Sniscak LLP
P.O. Box 1778
100 N. Tenth Street
Harrisburg, PA 17105-1778

Paul E. Russell, Esquire
PPL Electric Utilities Corporation
2 North Ninth Street
Allentown, PA 18101

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

Kenneth L. Mickens, Esquire
316 Yorkshire Drive
Harrisburg, PA 17111

Daniel Clearfield, Esquire
Carl R. Shultz, Esquire
Deanne O'Dell, Esquire
213 Market Street, 8th Floor
PO Box 1248
Harrisburg, PA 17108-1248

Edmund Berger, Esquire
Berger Law Firm
2104 Market Street
Camp Hill, PA 17011

Eric Joseph Epstein
4100 Hillsdale Road
Harrisburg, PA 17112

Adeolu A. Bakare, Esquire
McNees Wallace & Nurick LLC
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108

Served via first class mail

Dave Kenney
577 Shane Drive
Effort, PA 18330

William Andrews
40 Gordon Avenue
Carbondale, PA 18407

John Lucas
112 Jessup Avenue
Jessup, PA 18434

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

Helen Schwika
1163 Lakeview Drive
White Haven, PA 18661

Regina L. Matz
Prosecutor
Bureau of Investigation & Enforcement

Dated: November 8, 2012