COMMONWEALTH OF PENNSYLVANIA

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November 19, 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 Reply 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	:	

REPLY EXCEPTIONS OF THE OFFICE OF CONSUMER ADVOCATE

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DATED: November 19, 2012

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I. INTRODUCTION

On October 19, 2012, the Office of Administrative Law Judge issued the Recommended Decision (R.D.) of Administrative Law Judge (ALJ) Susan D. Colwell. Exceptions were filed to the R.D. on November 8, 2012. Of particular importance to the Office of Consumer Advocate (OCA), Exceptions were filed by PPL Electric Utilities Corporation (PPL or the Company) to ALJ Colwell's recommendations for a 32-month normalization period for rate case expense and ALJ Colwell's recommendation that a reasonable return on equity (ROE) for PPL is 9.74%. Exceptions were also filed by the Office of Small Business Advocate (OSBA) and the PPL Industrial Customer Alliance (PPLICA) to ALJ Colwell's scaleback recommendation. The OCA files these Reply Exceptions to address PPL's Exceptions to the ALJ's rate case expense normalization and ROE recommendation, and to address OSBA's and PPLICA's Exceptions to the ALJ's scaleback recommendation.

The OCA has provided extensive discussion of these three issues in its Main Brief and Reply Brief in this proceeding. The OCA submits that the ALJ has reached the right conclusions on these issues in her R.D. The evidence and Commission precedent supports the ALJ's recommendation of a 32-month normalization period for rate case expense. R.D. at 42-44. As to the ROE issue, the ALJ correctly concluded that the Discounted Cash Flow (DCF) studies, coupled with the use of other ROE estimation methods, provide substantial support for a 9.68% ROE. R.D. at 60-84.[1] The ALJ also correctly concluded that a proportional scaleback mechanism, as recommended by PPL and OCA, is consistent with Commission precedent, fair, reasonable and represents sound ratemaking principles. R.D. at 110-112. In these Reply

[1] The ALJ also recommended a 6-basis-point ROE adder as a Management Performance Bonus to arrive at the recommended 9.74% ROE. The OCA opposes the Management Performance Bonus, as addressed in the OCA's Main and Reply Briefs, its Exceptions and as further addressed herein. See OCA M.B. at 64-66; OCA R.B. at 28-30; OCA Exc. at 15-18.

Exceptions, the OCA will summarize its arguments on these issues. A full discussion is presented in the OCA's Briefs.

II. REPLY EXCEPTIONS

OCA Reply to PPL Exception No. 7: The ALJ Was Correct In Relying On The Company's Rate Case Filing History In Recommending A 32-Month Normalization Of PPL's Rate Case Expense. (PPL Exceptions at 34-35; R.D. at 42-44; OCA M.B. at 25-27; OCA R.B. at 8-9).

In its Exceptions, PPL argued that the Company's proposed rate case expense normalization period of 24 months should be adopted because PPL plans to file base rate cases more frequently than it has in the past. See PPL Exc. at 34-35. In the R.D., the ALJ recommended that I&E's proposed 32-month normalization period be adopted because it was based on PPL's actual rate case filing history.[2] See R.D. at 44.

As discussed in detail in OCA's Main and Reply Briefs, it is well settled that the normalization period for rate case expense is based on a company's historic filing of base rate cases. See OCA M.B. at 25-27 and OCA R.B. at 8-9, citing Pa. PUC v. Columbia Water Co., 2009 Pa. PUC LEXIS 1423 (2009); Pa. PUC v. City of Lancaster Sewer, 2005 Pa. PUC LEXIS 44 (2005); Popowsky v. Pa. PUC, 674 A.2d 1149, 1154 (Pa. Commw. Ct. 1996); Pa. PUC v. Roaring Creek Water Co., 73 Pa. PUC 373, 400 (1990); Pa. PUC v. National Fuel Gas Dist. Corp., 84 Pa. PUC 134, 175 (1995); Pa. PUC v. West Penn Power Co., 119 P.U.R. 4th 110, 149 (Pa. PUC 1990). PPL's prior rate cases were filed as follows: March 2004, March 2007, March 2010 and March 2012. The evidence supports the ALJ's recommendation of a 32-month normalization period for rate case expense, and therefore, it should be adopted in this matter.

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[2] In its Main and Reply Briefs, the OCA proposed a 36-month normalization period for PPL's rate case expense based on the Company's base rate case filing history of March 2004, March 2007 and March 2010. See OCA M.B. at 25-27; OCA R.B. at 8-9. The OCA did not except to the ALJ's recommendation to adopt I&E's proposed normalization period of 32 months for PPL's rate case expense.

The ALJ's recommendation results in a downward adjustment to expenses of $258,000. See I&E M.B. at 26; R.D. at 44.

OCA Reply to PPL Exception No. 1: The ALJ Was Correct In Primarily Relying On The DCF Results To Arrive At A Reasonable ROE For PPL. (PPL Exceptions at 4-20; R.D. at 60-94; OCA M.B. at 47-66; OCA R.B. at 22-31).

A. Introduction.

The OCA accepts the ALJ's recommendations as to a reasonable ROE for PPL. The ALJ found that a ROE of 9.68%, primarily based on the results of the DCF studies in evidence, is reasonable for PPL considering the results of other ROE estimating methods and the overall economic climate. In its Exceptions, PPL argues that the ALJ erred by placing sole reliance on the DCF, by not adopting PPL witness Moul's leverage adjustment, by relying on recent ROE decisions in other jurisdictions and by not granting PPL its requested 12-basis-point ROE adder for management performance as the ALJ recommended a 6-basis-point adder was appropriate. The OCA addresses each of these contentions in these Reply Exceptions and submits that substantial, credible evidence supports the ALJ's decisions on each of these issues as they relate to the 9.68% base ROE recommendation. The OCA, however, continues to oppose any additional ROE adder for management performance.

The crux of the ROE issue is plain from the substantial evidence of record – the current economic climate is one where the cost of capital is low. As the R.D. provides:

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

R.D. at 93-94. As just one example of the low cost capital environment, after the close of the record PPL issued $250 million of new debt at a 2.61% interest rate. This large debt issuance with an interest rate for this new debt that is almost 300 basis points lower than PPL's average, embedded long-term debt cost of 5.56%, illustrates the favorable climate that exists for the acquisition of capital at low rates. See PPL M.B. at 91, fn 16. As one further example, even the Company's DCF study, which OCA witness Hill testified as being well overstated, comes in at a ROE level of 9.67%. See OCA St. 2 at 69-71; PPL Exc. at 6, fn 2.

As discussed below, PPL's attempts to increase its own flawed DCF results by inviting the Commission to place undue reliance on other ROE estimating methods, such as the Risk Premium, Capital Asset Pricing Model and Comparable Earnings, and to accept Mr. Moul's unsupported leverage adjustment should be rejected. The ALJ correctly reviewed the substantial evidence as to the cost of common equity in this matter and came to the right conclusion. Accordingly, the ALJ's recommendation to set the ROE for PPL at 9.68% should be upheld.

B. PPL's Argument That The ALJ Solely Relied On The DCF Results In Arriving At A Reasonable ROE Determination Are Misplaced And Should Be Rejected.

In its Exceptions, the Company argues that the ALJ erred by relying on "an unadjusted DCF result without any check on its validity." PPL Exc. at 6. The Company's argument is misplaced and unsupported by the facts. The ALJ spent considerable time in the R.D. reviewing and discussing the results of the parties' various ROE estimating studies, other than the DCF. R.D. at 60-94. After this in-depth review, the ALJ concluded that:

> As OCA points out, the Commission has indicated a preference for using the DCF method to establish reasonable common equity costs.
>
> > Historically, we have primarily relied on the DCF methodology in arriving at our determination of the proper cost of common equity. We have, in many recent decisions, determined the cost of common equity primarily based upon the DCF method and informed judgment. *See Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company*, 71 Pa. PUC 593, 623-632 (1989); *Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company*, 67 Pa. PUC 529, 559-570 (1988);

> *Pennsylvania Public Utility Commission v. Roaring Creek Water Company*, 150 PUR4th 449, 483-488 (1994); *Pennsylvania Public Utility Commission v. York Water Company,* 75 Pa. PUC 134, 153-167 (1991); *Pennsylvania Public Utility Commission v. Equitable Company*, 73 Pa. PUC 345-346 (1990). We determine that the DCF method is the preferred method of analysis to determine a market based common equity cost rate.

Pa. PUC v. Pennsylvania American Water Company, 99 Pa. PUC 38, 42 (2004) (PAWC 2004), aff'd on other grounds, Popowsky v. Pa. PUC, 868 A.2d 606 (Pa. Commw. Ct. 2004); accord Pa. PUC v. Aqua Pa, Inc., 99 Pa. PUC 204, 233 (2004).

R.D. at 91 (citations in original). The ALJ went on to conclude that "[t]he Commission's preferred method of determining a utility's ROE is the DCF model." R.D. at 93.

The ALJ correctly concluded that the Commission primarily relies on the DCF method to establish a reasonable ROE. The ALJ held that "As noted above, there are four methods of determining the cost of equity: Discounted Cash Flow (DCF), Risk Premium (RP), Capital Asset Pricing Model (CAPM), and Comparable Earnings (CE)." R.D. at 89. The ALJ then went on to review each method. R.D. at 63-81. The extensive discussion and analysis of these various methods in the R.D. provide no support for PPL's assertion that the ALJ relied solely on the DCF method.

On the contrary, the ALJ reviewed the results of PPL's Risk Premium (RP) analysis in the R.D. and concluded that the RP method should not be relied upon as PPL suggests. R.D. at 77-78. This conclusion is consistent with OCA witness Hill's testimony as to why PPL's RP estimate should not be relied upon here, in relevant part:

In reaching his Risk Premium estimate, Mr. Moul adds the 79-year return difference between utility stocks and bonds to projected utility bond yields. To his credit, Mr. Moul has considered both arithmetic and geometric return differentials. However, Mr. Moul also considers what he calls "median" or middle-value return information, which is improper and leads to an overstatement of his risk premium.

> The reason that Mr. Moul's "median" risk premium estimates should not be included in his analysis is that the "median" values come from different years—different eras, in fact—and cannot be said to be representative of any risk premium which might have existed in actual economic environment. For example, the S&P Public Utility median return is a mid-point between returns that occurred in 1981 and 1963, while the Utility Bond return median a mid-point between returns that occurred in 1961 and 1940. Clearly, the difference between those two values from two different years does not represent a meaningful or usable relationship between utility equity returns and utility debt returns in the same year.
>
> In every time period studied by Mr. Moul the "median" risk premium substantially overstates either the geometric or arithmetic average of the actual annual risk premiums. Nevertheless, Mr. Moul averages that "median" number in his calculation of the historical risk premiums and, in so doing, substantially overstates his result. Mr. Moul's data presented on page 2 of his Schedule 12 indicate that over the long-term, the return on the S&P Utilities exceeded bond returns by 3.47% to 5.52% (the geometric and arithmetic means).

OCA St. 2 at 73-74. Mr. Hill's testimony on this issue illustrates why PPL's RP result of 10.75% is well overstated, and, in fact, a more reasonable RP result would be in the range of 6.50% to 8.55% ROE. OCA St. 2 at 74. I&E witness Sears expressed similar concerns over the use of the RP method, as the ALJ cited. R.D. at 77-78. The record is clear that the ALJ did not ignore the results of PPL's Risk Premium method, but rather chose not to place reliance on it in arriving at an ROE recommendation due to its many flaws.

The R.D. also provided a discussion and review of the Capital Asset Pricing Model (CAPM) studies performed by PPL witness Moul, I&E witness Sears and OCA witness Hill. R.D. at 78-80. PPL's CAPM results indicated a roughly 12.0% ROE was appropriate for PPL, whereas I&E's CAPM result was 8.68% and OCA witness Hill's CAPM study provided an ROE of 8.14%. Id. The R.D. provided that:

> Both Mr. Hill and Ms. Sears used a CAPM as a check of reasonableness for their DCF calculations. However, both also believe there are shortcomings to this model, express concerns regarding its use and note their preference for using the DCF model to determine the cost of equity capital.

R.D. at 80. The ALJ reviewed the CAPM results as part of her ROE recommendation. It should be apparent that the ALJ considered this evidence, but concluded that the DCF method should be primarily relied upon in determining the ROE. R.D. at 93.

PPL witness Moul also performed a Comparable Earnings (CE) study. R.D. at 80. The R.D. provides that

> OCA witness Hill and I&E witness Sears did not perform a comparable earnings analysis. Ms. Sears notes:
>
> The CE methodology is subjective in terms of the selection of comparable companies, has generally been rejected by the Commission, and, in Mr. Moul's particular analysis, compares projected returns of companies of dissimilar business and financial risks.

R.D. at 81 (footnotes and citations omitted). OCA witness Hill expressed similar concerns as I&E witness Sears as to the CE method, as Mr. Hill testified:

> [E]ven though Mr. Moul's sample selection process purports to consider companies of similar risk, one key risk element omitted from his Comparable Earnings sample selection process is the level of competition to which the firms are exposed. For example, it is difficult to believe that investors consider regulated electric distribution utility operations to be similar in risk to that of a drug company (Bristol-Meyers; see Moul Schedule 15, page 1). For example, when a PPL ratepayers flips on a light there are no choices as to who will deliver the electricity to light that light, but when a customer is in the checkout line of the local pharmacy store there are many different types of medicines to choose from—not just the ones manufactured by Bristol-Meyers. It is reasonable to believe, therefore, that the sample group on which Mr. Moul's Comparable Earnings results are based has a risk profile that is greater than that of PPL's electric utility operations, and the results of that analysis substantially overstate the Company's actual cost of equity.
>
> Mr. Moul's Comparable Earnings analysis does not identify the market-based cost of equity capital, is based on a sample group of firms that are unlikely to be similar in overall investment risk to PPL. This Commission should place little, if any, reliance on Mr. Moul's Comparable earnings results.

OCA St. 2 at 82-83; see also OCA St. 2-SR at 22-23 (Mr. Hill discussing the inclusion of Weis Markets in Mr. Moul's CE similar company profile).

The OCA submits that similar to the Risk Premium and Capital Asset Pricing Models, the ALJ reviewed PPL's Comparable Earnings method but chose not to place reliance on it. The ALJ's conclusion to rely primarily on the DCF method to arrive at an ROE recommendation here is consistent with well-established Commission precedent and should be accepted.

C. The ALJ Was Correct In Rejecting PPL's Leverage Adjustment.

PPL argues in its Exceptions that Mr. Moul's proposed leverage adjustment (a 70 basis point adder to ROE) should have been accepted by the ALJ. PPL Exc. at 11. PPL goes on to state that the "RD rejected all other methods of determining the cost of equity and thereby effectively precludes any meaningful check on the DCF result and any possibility of upward adjustment." Id. As discussed above, PPL's claims that the ALJ "rejected" all other ROE estimation methods except for the DCF are simply not in accord with the facts. The ALJ reviewed and discussed each of the other methods presented in this proceeding, and, correctly, chose not to place those alternative methods on the same level as the DCF. The OCA submits that the ALJ was correct to reject the leverage adjustment, as the R.D. provides "for the reasons developed by the OCA and I&E, the Company's leverage adjustment should be denied." R.D. at 76. Substantial evidence supports the ALJ's recommendation.

First, as OCA witness Hill testified:

> While there are certainly many aspects of rate of return analysis that are subject to judgment and, thus, debate regarding the proper application of a particular technique, Mr. Moul's use of an imaginary risk difference between a market-based capital structure and a book value capital structure is not one of them. There is no evidence available in the literature of financial economics to support any risk difference between market-value and book-value capital structures. Miller and Modigliani (supposedly the source of Mr. Moul's "leverage" adjustment) do *not* compare market-value and book value capital structures.

OCA St. 2-SR at 4 (emphasis in original). The ALJ accepted the fact that artificially increasing the ROE based on a technique that finds no support in the financial literature, considering the evidence of record here, does not represent sound ratemaking. PPL's attempt to substantially increase its ROE was correctly rejected by the ALJ and should be upheld.

Second, Mr. Moul's leverage adjustment has been thoroughly reviewed and appropriately rejected in virtually every regulatory jurisdiction where it has been proposed. Mr. Hill testified on this issue, in relevant part as follows:

> [E]ven though Mr. Moul began to employ his leverage/risk adjustment in 1997, and this Commission, for a period of time, utilized that adjustment, Mr. Moul notes in his testimony (Moul Direct, p. 37) that the last time this Commission utilized that adjustment was 2007. As I noted above, since that time this Commission has rejected that adjustment. Moreover, since 2007 Mr. Moul has testified in 24 regulatory jurisdictions, and no regulatory jurisdiction (including Pennsylvania) has specifically accepted and utilized Mr. Moul's "leverage/risk" adjustment.

OCA St. 2 at 59. During the cross-examination of Mr. Moul, it was confirmed that the only regulatory jurisdiction to accept Mr. Moul's leverage adjustment proposal has been Pennsylvania. Tr. at 251; see also R.D. at 74-76; OCA M.B. at 61-63. As the R.D. specifically provided:

> The "leverage" adjustment recommended by Mr. Moul has been presented in dozens of regulatory jurisdictions. It has been rejected by all of those jurisdictions (including, recently, Pennsylvania).

R.D. at 76, citing OCA St. 2-SR at 11.

As to these other jurisdictions where PPL's proposed leverage adjustment has been rejected, Mr. Hill explained that:

> When investors are unable to earn their required returns, utilities will not be able to attract capital. However, the Company has not made the case, or provided any evidence to show that in all the jurisdictions in which Mr. Moul's leverage/risk adjustment has been rejected, utilities are unable to attract the capital necessary to fulfill their regulatory obligation to serve. Absent such a showing, it is reasonable to believe that the standard regulatory practice (applying cost of equity estimates to book value capital structures) enables investors to realize the returns they require and, concomitantly, enables regulated utilities to attract capital. Standard

> regulatory practice should be applied here in Pennsylvania as well—Mr. Moul's financial/risk adjustment, a "financial risk adder" should be rejected.

OCA St. 2 at 59. Consistent with Mr. Hill's testimony, the evidence of record and the ALJ's conclusion on this issue – there is no need for a leverage adjustment within the confines of standard regulatory practice or a need for such a mechanism in the Commonwealth.

The OCA has provided substantial evidence in this proceeding to show that the Commission, like every other regulatory body before it, should reject this unnecessary and unsupported leverage adjustment. I&E also provided substantial evidence to refute the Company's claims that its leverage adjustment should be accepted. R.D. at 71-72. Specifically, the R.D. provides that:

> I&E calculates that there are six cases in which the Commission accepted the leverage adjustment, most recently in 2007. The adjustment has been proposed in 68 cases over a 23 year period yielding 6 successful results. Finally, I&E charges that Mr. Moul's formulae for the adjustment are flawed as he uses formulae which do not appear in the research cited to support it.

R.D. at 72, citing I&E MB at 100.

The OCA submits that the ALJ's recommendation to reject PPL's leverage adjustment is supported by substantial evidence and Commission precedent and should be accepted.

D. PPL's Attempt To Differentiate The PEPCO Decision Or To Rebut The Substantial Evidence As To The Current Low Cost Capital Environment Are Without Merit.

In its Exceptions, PPL argues that the ALJ erred by relying on the PEPCO[3] case as support for an ROE recommendation of 9.68%. PPL Exc. at 16-17. PPL argues that there are circumstances in PEPCO, a "revenue stabilization mechanism" and "substandard reliability" issues which are not present in this case. PPL Exc. at 17. The OCA submits, however, that the quoted portions of the PEPCO Order only serve to reinforce the fact that the ALJ's

[3] In re PEPCO, Order No. 85028 (MD PSC, July 20, 2012) (PEPCO).

recommendation of a 9.68% ROE is adequate and reasonable. In addition, the OCA provided a thorough discussion and examples of other similar, recent cases where regulatory jurisdictions have recognized and discussed the current low cost capital environment for regulated utilities. The ALJ correctly reviewed the entire body of evidence as to the cost of equity issue, and came to a reasoned and fair decision which should be upheld.

As to PEPCO, the Maryland Public Service Commission (MD PSC) provided that it was lowering the utility's return by 50 basis points due to the revenue stabilizing mechanism, and then adding 6 basis points back for flotation costs (not present here), to arrive at its 9.31% ROE conclusion. PPL Exc. at 17. Accordingly, without the 50 basis point reduction, and the 6 basis points added back, Pepco's ROE would have been set at 9.75%. Importantly, the MD PSC provided that:

> The final ROE of 9.31% recognizes the less risky nature of Pepco's operations, is based on a wide and varied range of methodologies, and balances the interests of Pepco's ratepayers and shareholders.

PPL Exc. at 17. It should be apparent from a careful reading of PEPCO that the MD PSC did not make a separate ROE adjustment for reliability issues, but rather reduced the ROE by 50 basis points based on a combination of the reliability and the revenue stabilizing factors.

Further, as the R.D. provided:

> OCA cites numerous other jurisdictions which have awarded less than 10%, in particular, PEPCO:
>
>> We conclude that the 8.43% - 9.85% ROE range recommended by the other parties represents a reasonable range of potential returns for Pepco. In determining Pepco's actual ROE within that range, we note that Pepco owns no generation, being only a distribution company, has no competition, and serves a heavily residential customer base. Its customer base is not subject to closing or wholesale relocation, thus significantly reducing the level of Pepco's economic risk.
>>
>> . . .

> The final ROE of 9.31% recognizes the less risky nature of Pepco's operations, is based on a wide and varied range of methodologies, and balances the interests of Pepco's ratepayers and shareholders. The return Pepco's investors will be allowed to earn in this case is appropriate, particularly under the present economic climate. <u>We have no doubt that a monopoly company in a stable service territory with the potential of earning 9.31% on its equity will be able to attract the necessary capital in the current low interest rate environment to meet its statutory requirements to provide safe and reliable service to its customers.</u>

R.D. at 62 (citation omitted, emphasis added). As with Pepco, PPL owns no generation, has no competition for distribution service and serves a heavily residential customer base. And on these facts, the MD PSC had no reservation with setting an ROE of 9.31% and had "no doubt" that the utility could attract capital and provide safe and reliable service. PPL's attempt to distance itself from Pepco is without merit and should be rejected.

Moreover, PPL argues that the Commission should take a prospective stance on the ROE issue, as "the economy is improving" and the cost of capital is likely to rise at some future time. PPL Exc. at 19. The OCA submits that the Commission should reject PPL's invitation to "peer into the future". The evidence of record continues to show that the current and near-term future economic outlook is one that includes a low cost of capital. <u>See</u> R.D. at 62; OCA St. 2 at 11-19; OCA M.B. at 35-38. PPL does cite some cases where other jurisdictions have allowed ROEs greater than 10%, but there is no description of the specific facts or why such decisions were made. On the contrary, along with the <u>PEPCO</u> case the OCA has provided recent cases from other jurisdictions with relevant discussions as to the low cost of capital environment.

For example, in approving a 9.25% return on equity in a July 2012 decision, the South Dakota Public Service Commission recognized the current economic climate by providing:

> The Commission finds that, especially in the current turbulent economic environment, the four indicator average projected growth input employed by Staff

> in its DCF model is a more conservative and reliable methodology for projecting probable growth rates at this point in time, and the Commission adopts Staff's DCF model approach and its conclusions for purposes of its decision on ROE in this case. The Commission finds that use of this more conservative approach in this case is a proper application of the principle that regulatory commissions are to effect a "balancing of the investor and the consumer interests." Hope, *supra*, at 603. There is no evidence in the record that Xcel will be unable to raise capital through equity issuances as a result of a return on equity at the rate recommended by Staff.

OCA M.B. at 35, <u>citing</u>, <u>in part</u>, <u>In re Xcel Energy</u>, 2012 S.D. PUC Lexis 137, *18-19 (S.D. PUC 2012). And further, <u>In re Puget Sound Energy, Inc.</u>, where in June 2012, granting an ROE of 9.8%, the Washington Commission stated:

> We are not persuaded by Dr. Olson and Mr. Gaines that PSE's authorized ROE should be set at a level above 10.1 percent, the level set in PSE's 2010 general rate case. We find two reasons. First, the Company has not provided persuasive evidence that market conditions and investor confidence have changed sufficiently, or in a manner, that requires any increase, much less the ROE it seeks. Rather, Treasury and utility bond yields have decreased, and interest rates are expected to remain low for some time. Utility stocks enjoy favorable market sentiment in such an environment. There is no apparent need to increase ROE in these circumstances.

OCA M.B. at 48, <u>citing</u> 2012 Wash. UTC LEXIS 423, *69.

Other jurisdictions have recognized the low cost capital environment, and the fact that it is forecast to continue into the foreseeable future. And as to Pennsylvania, specifically, Mr. Hill testified that:

> While financial markets have recovered from the difficulties of late 2008 and early 2009, the economy as a whole is staging a slow recovery, and economic conditions for PPL's ratepayers (and Pennsylvania's citizens in general) remain difficult. Even Mr. Dudkin recognizes that the Pennsylvania economy is "stagnant." The most recent data from the U.S. Bureau of Labor statistics puts Pennsylvania's unemployment level at 7.2% in December of 2011, roughly 60% higher than the average of 4.5% in 2006 and 2007. With the economy expected to continue a slow recovery (if international troubles do not derail such progress) and interest rates and inflation expected to continue at relatively low levels, the available returns on financial assets (from checking accounts to common stocks) are low.

OCA St. 2 at 6 (citations omitted).

The OCA submits that PPL has failed to carry its evidentiary burden that the current financial climate is not one where there are low costs of capital, especially for regulated utilities, and such a situation is not likely to dissipate rapidly. As such, the ALJ's comparisons to PEPCO and other cases cited by the OCA are instructive and appropriate.

E. PPL's Management Performance Bonus Should Be Denied In Its Entirety.

PPL proposed a 12-basis-point ROE adder for management performance. PPL Exc. at 19. ALJ Colwell held that PPL should receive a 6-basis-point ROE adder. R.D. at 84-89. In its Exceptions, PPL references its briefs as support for the 12 basis points. PPL Exc. at 19.

The OCA opposed the management performance bonus in its entirety. In its Exceptions, the OCA provided a review of the R.D. and a discussion as to why PPL should not receive a management performance bonus, based on the record of this case. OCA Exc. at 15-18. The OCA's position on this issue has not changed, and has been thoroughly set out in its Main and Reply Briefs, and in Exceptions. OCA M.B. at 64-66; OCA R.B. at 28-30. The OCA respectfully requests the Commission to modify the ALJ's recommendation and remove the 6-basis-point ROE adder.

F. Conclusion.

The OCA submits that the ALJ was correct in finding that a 9.68% ROE for PPL is fair and reasonable based on the entire body of evidence. The Company's Exceptions, for all the reasons discussed in these Reply Exceptions and in the OCA's Main and Reply Briefs, should be rejected. The ALJ's recommendation on the 9.68% ROE should be upheld.

OCA Reply to OSBA and PPLICA Exception Nos. 1: The ALJ Was Correct In Recommending The Use Of A Proportional Scaleback. (OSBA Exceptions at 5-12; PPLICA Exceptions at 3-6; R.D. at 110-112; OCA M.B. at 101-105; OCA R.B. at 58-60).

A. Introduction.

At the start of the scaleback discussion, the R.D. provides that:

> The Commonwealth Court has recognized that, although the cost of service is the "polestar" of establishing rates:
>
> > Rate structure, which is an essential, integral component of rate-making, is not merely a mathematical exercise applying theoretical principles. Rate structure must be based on the hard economic facts of life and a complete and thorough knowledge and understanding of all the facts and circumstances which affect rates and services; and the rates must be designed to furnish the most efficient and satisfactory service at the lowest reasonable price for the greatest number of customers, i.e., the public generally. While cost to serve is important, other relevant factors may also be considered.
> > *Lloyd* at 1016.

R.D. at 110 (citation in original). The ALJ noted that the OCA and PPL support a proportional scaleback, "with no change in revenues for classes that do not receive a rate increase." R.D. at 110. After review of the OSBA and PPLICA position as to the use of a revenue-based scaleback, the ALJ recommended approval of the proportional scaleback approach recommended by PPL and OCA. R.D. at 111-112. The OSBA and PPLICA except on this issue, and continue to support a revenue-based scaleback.

The OCA supports the ALJ's recommendation to use a proportional scaleback.[4] The OSBA, through its witness Mr. Knecht, has advocated throughout this proceeding for a revenue-based scaleback and this proposition is carried forward in its Exceptions. PPLICA supports the

[4] 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 M.B. at 91-105; OCA R.B. at 53-60; OCA Exc. at 31-34.

OSBA scaleback mechanism, and continues to argue for its adoption in its Exceptions. In these Reply Exceptions the OCA will principally address the OSBA's arguments on this issue, as OSBA witness Knecht is the witness supporting the revenue-based scaleback.

Principally, the OCA notes that the OSBA's recommendations for how to allocate any revenue increase that is less than the total amount requested by PPL were directly addressed in PPL 2010. In that case, the ALJ concluded that "a reduced amount of a rate increase does not provide a source of funding as OSBA assumes." Pa. PUC v. PPL Electric Utilities Corporation, Docket No. R-2010-2161694, Order at 43 (Dec. 21, 2010) (PPL 2010). The Commission agreed with the ALJ on this issue and provided that:

> to ask one class to shoulder more of an increase than the final total increase in revenue would constitute unjust and unreasonable rates.

PPL 2010 at 46-47. The OSBA's proposed scaleback method here, if accepted, would also impose additional costs on certain rate classes, over and above the total revenue increase authorized, in order to provide additional rate decreases to other rate classes. In discussing the OSBA scaleback proposal, the ALJ provided that:

> However, this concept, applied blindly, would result in reductions to customers who were not expecting an increase, or greater reductions to some customers than were originally proposed, to the detriment of those whose rates will rise more than necessary. The Company's proposal to apply any scaleback on a proportional basis to only those rate schedules which receive increases is recommended.

R.D. at 112.

In their Exceptions, neither the OSBA nor PPLICA provide any additional arguments or evidence to support the idea that what constituted "unjust and unreasonable rates" in 2010, is now acceptable. Further, and as discussed in detail below, neither the OSBA nor PPLICA have rebutted the testimony of OCA witness Glenn Watkins as to the serious shortcomings of the revenue-based scaleback approach. Accordingly, the OCA submits that the ALJ's recommendation on this issue should be upheld.

B. The ALJ's Was Correct In Recommending That OSBA's Proposed Scaleback Mechanism Should Be Rejected.

OCA witness Watkins described OSBA witness Knecht's "scale-back" proposal as follows:

> He then recommends that any reduction to this \$104.6 million amount be shared in proportion to the Company's proposed distribution revenues. In other words, Mr. Knecht's scale-back recommendation is not based on the relative proportions of the Company's requested increase, but rather on the level of PPL's proposed revenues after the increase. Because Mr. Knecht's scale-back proposal is based on total distribution revenues, his recommendation produces further rate reductions (beyond those proposed by PPL) to the GS-3 class and also results in ultimate rate reductions to other commercial/industrial classes depending on the final authorized overall increase. As an illustration, Mr. Knecht provided an example of his scale-back proposal assuming an overall authorized increase of \$74.6 million (\$30.0 million scale-back) on page 14 of his direct testimony. As can be seen in this example, although the total jurisdictional increase is \$74.6 million, Mr. Knecht's recommended scale-back would result in a residential revenue increase (RS, RTD and RTS) of \$84.773 million (\$80.497 + \$3.276). At the same time, the GS-1, GS-3, and LP-4 classes would enjoy rate reductions of \$1.793, \$8.914, and \$1.199 million, respectively.

OCA St. 3-R at 2-3. As Mr. Watkins explained, the OSBA scaleback proposal would result in residential customers paying a far greater revenue increase than the total increase authorized for PPL. This additional revenue, in this example approximately \$10 million, would then be used as a source of funding to further *decrease* the rates of the GS-3 class and to provide *rate reductions* for the GS-1 and LP-4 classes. To show the full effects of the OSBA proposal, it should be viewed within the context of PPL's proposed allocation at the full request of \$104.6 million.

OCA witness Watkins provided the following table of PPL's allocation (right side of the chart) 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. At a total revenue increase of $104.6 million, the GS-3 class was slated for a revenue reduction of $4,674,000, but under the OSBA's scaleback approach at a total revenue increase of $74.6 million the GS-3 class would receive a revenue reduction of $8,914,000. The GS-1 and LP-4 classes, both scheduled for rate increases at the full rate increase amount, would under the OSBA approach receive *reductions* of $1,793,000 and $1,199,000 million, respectively. See OCA St. 3-R at 2-3. This is the exact scenario that ALJ Colwell rejected in PPL 2010 by stating "a reduced amount of a rate increase does not provide a source of funding as OSBA assumes", which the Commission upheld. See PPL 2010 at 43.

In addition, Mr. Knecht's scaleback approach violates fundamental principles of gradualism and avoidance of rate shock. OCA witness Watkins provided an example of the impact of the OSBA's recommended revenue allocation at $74.6 million, as follows:

Table 1-R

Class	OSBA Scale-Back At $74.6 Million Increase	
	Percent Increase (Decrease)	Percent Of System Average
RS	17.0%	167%
RTS	71.4%	700%
GS-1	-2.5%	-24%
GS-3	-7.3%	-71%
LP-4	-3.6%	-35%
LP-5	53.4%	524%
LPEP	-3.6%	-35%
GH-2	19.0%	186%
SL/AL	8.1%	80%
Total	10.2%	100%

Id. at 3. As the chart shows, the OSBA scaleback mechanism would impose substantial increases on certain rate classes. Mr. Watkins also calculated the relative class revenue changes, using Mr. Knecht's proposed scale-back method, under authorized increases of $52.3 million and $21 million, as follows:

Table 2-R
OSBA Scale-Back Under Alternative Overall Authorized Increases

Class	Overall $52.3 Million Increase			Overall $21.0 Million Increase		
	Revenue Change $ (Million)	% Change	% Of System Average	Revenue Change $ (Million)	% Change	% Of System Average
RS	$62.5	13.8%	193%	$43.7	9.2%	322%
RTS	$3.1	66.7%	933%	$2.8	60.0%	2,090%
GS-1	-$3.7	-5.2%	-73%	-$6.5	-9.0%	-312%
GS-3	-$12.1	-9.8%	-137%	-$16.5	-13.4%	-467%
LP-4	-$2.1	-6.2%	-87%	-$3.3	-10.0%	-347%
LP-5	$0.6	49.1%	688%	$0.5	43.2%	1,504%
LPEP	$0.0	-6.3%	-87%	$0.0	-10.0%	-348%
GH-2	$0.2	15.7%	219%	$0.2	11.0%	385%
SL/AL	$1.2	5.1%	72%	$0.2	0.9%	33%
Total	$52.3	7.2%	100%	$21.0	2.9%	100%

OCA St. 3-R at 4. As the charts show, following the OSBA's scaleback mechanism would produce extraordinary increases for some classes and windfall reductions for others.

OCA witness Watkins concluded his analysis of OSBA's scale-back proposal as follows:

> I conclude that Mr. Knecht's recommendation is unreasonable and should not be considered regardless of any overall revenue increase authorized in this case. However, when Mr. Knecht's scale-back mechanism is applied to more likely final outcomes of an overall jurisdictional authorized increase, it is apparent that his approach violates the majority of the recognized ratemaking principles discussed earlier in this testimony. As examples, and notwithstanding other criteria, consider the gradualism principle and a class limit of 150% of the system average percentage increase discussed by Mr. Knecht in his direct testimony under lower overall revenue requirement increases. We can see that under his scale-back mechanism, some classes would receive increases of upwards of 1,000% of the system average percentage increase, while other classes would enjoy rate reductions of several hundred percent of the system average. In my opinion, such results are well beyond any reasonable definition of gradualism and clearly are at odds with Mr. Knecht's acknowledgement of limiting class increases to 150% of the system-wide percentage increase.

OCA St. 3-R at 4-5. As Mr. Watkins testified, the OSBA's scaleback proposal is unworkable when applied against the full range of possible revenue increase outcomes, and accordingly does not represent sound ratemaking policy. PPL arrived at the same conclusion, as the Company states in its Main Brief that the OSBA scale back could result in customer classes who were originally slated for an increase receiving decreases, and even classes proposed for a rate decrease seeing an even larger decrease. PPL M.B. at 156.

C. Conclusion.

The ALJ was correct to recommend a proportional scaleback mechanism. The OCA submits that OSBA's scaleback methodology is not reasonable and thus does not represent sound ratemaking. In addition, the OSBA and PPLICA have failed to provide any new or additional evidence in this case that should persuade the Commission to depart from its decision in PPL 2010 on the exact same issue. Accordingly, the OCA submits that the ALJ's recommendation to use a proportional scaleback mechanism is reasonable and should be upheld.

III. CONCLUSION

For the reasons set forth above, and for the reasons set forth in the OCA's Briefs and Exceptions, the OCA submits that the ALJ's Recommended Decision should be adopted, subject to the modifications set forth in the OCA's Exceptions.

Respectfully Submitted,

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Dated: November 19, 2012

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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 Reply 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 19th day of November 2012.

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