COMMONWEALTH OF PENNSYLVANIA

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September 13, 2018

Rosemary Chiavetta, Secretary
PA Public Utility Commission
Commonwealth Keystone Bldg.
400 North Street
Harrisburg, PA 17120

Re: Pa. Public Utility Commission
v.
UGI Utilities, Inc. – Electric Division
Docket No. R-2017-2640058

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Exceptions in the above-referenced proceeding.

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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cc: Honorable Andrew Calvelli, ALJ
Honorable Steven K. Haas, ALJ
Office of Special Assistants (e-mail only: ra-OSA@pa.gov)
Certificate of Service

*258563

CERTIFICATE OF SERVICE

Pennsylvania Public Utility Commission	:	
v.	:	Docket No. R-2017-2640058
UGI Utilities, Inc. – Electric Division	:	

I hereby certify that I have this day served a true copy of the following documents, the Office of Consumer Advocate's Exceptions, 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 13th day of September 2018.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-2017-2640058
	:	
UGI Utilities, Inc. – Electric Division	:	

EXCEPTIONS OF THE OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

On August 24, 2018, Administrative Law Judges (ALJs) Steven K. Haas and Andrew M. Calvelli issued a Recommended Decision (R.D.) dated August 20, 2018, setting forth their recommendations in UGI Utilities, Inc. – Electric Division's (UGI) base rate case. The R.D. addressed the parties' Partial Stipulation Resolving Certain Contested Issues (Partial Stipulation) as well as remaining contested issues addressed in Briefs.

The ALJs recommended that UGI's end of year rate base proposal be accepted and, consequently, the ALJs recommended approval of the Company's employee additions and depreciation expense claims based on end of year numbers and recommended that end of year numbers be used to calculate excess Accumulated Deferred Income Taxes (ADIT). The ALJs also recommended accepting UGI's storm damage expense claim. In addition, the ALJs recommended a 9.8% return on equity and a 20 basis point adder for management effectiveness. The ALJs also recommended approval of UGI's Act 40 proposal. Additionally, the ALJs recommended that UGI's cost of service study be used to allocate the revenue increase in this proceeding. The ALJs further recommended an $8.50 increase in the Residential customer charge, from $5.50 to $14.00.

For the reasons set forth in these Exceptions and in the OCA's Main and Reply Briefs, the OCA respectfully submits that the ALJs erred by recommending acceptance of the various UGI proposals as set out above. Therefore, the OCA requests that the Commission grant these Exceptions and adopt the modifications and recommendations herein and in the OCA's Main and Reply Briefs on these issues.

II. EXCEPTIONS

OCA Exception No. 1: The ALJs Erred By Recommending That UGI's End Of Year Rate Base Proposal Be Accepted. (R.D. at 12-22; OCA M.B. at 13-19; OCA R.B. at 5-8)

In the R.D., the ALJs recommended that the OCA's average rate base proposal should not be adopted. R.D. at 19-22. Instead, the ALJs recommended that UGI's end of year rate base proposal be accepted. Id. The OCA submits that the ALJs erred by accepting UGI's proposal on this issue.

Significantly, the ALJs found that the plain language of Act 11 is determinative; persuasive, relevant evidence from other jurisdictions should be disregarded; and, that – even if UGI's projections turn out to be overstated – a potential after-the-fact audit and possible later Commission action are sufficient ratepayer protections. R.D. at 19-22. The OCA addresses each of these contentions here.

The OCA submits that the plain language of Act 11 does not directly address this issue, leaving its fair and reasonable implementation to the Commission consistent with just and reasonable ratemaking standards. The OCA submits that in order to comply with the just and reasonable standard, rates must be set based on the average rate base projected to be used and useful in the fully projected future test year. The average rate base measures the net investment in facilities to provide utility service over the course of the year, rather than a single point in time at the end of the year. It is internally consistent with the measurement of expenses, billing determinants, and income over the course of the year to use an average rate base. Using an average rate base properly matches the calculation of rate base with the other elements of the Company's revenue requirement and income in a given year. As OCA witness Morgan explained:

> As noted previously, the use of a FPFTY is intended to allow rates to be set to recover the costs that will be incurred *during* the first year the rates are in effect. Accordingly, rate base should reflect the average balances of plant in service, accumulated depreciation, accumulated deferred income taxes and other elements. Similarly, the amounts included for depreciation, wages and other expenses should be based on the costs that will be incurred *during* the rate year. Wages, for example, should reflect the wage rates in effect each month of the year, not the wage rates that will be in effect at the end of the year. Depreciation expense should reflect average levels of plant in service *during* the rate year.

OCA St. 1 at 8 (emphasis added).

The rates in this case will go into effect on October 27, 2018. Under the Company's proposal, the rates that go into effect at that time will reflect an estimated rate base as of September 31, 2019, almost one year later. Throughout the whole rate year, customers would be paying rates that include a full return on a rate base larger than the actual investment in facilities being used to provide service. The OCA's proposal more closely reflects the actual revenue requirement needs of the Company *during* the year based on the average of rate base serving customers.

Under Act 11, past procedures for including end of year balances when using a Future Test Year should no longer apply. As OCA witness Morgan testified:

> While reflecting costs at end of year levels may have been appropriate when revenue requirements were being established to reflect costs for a future test year that ended at the time rates would go into effect, adjusting costs to year end levels is not appropriate now that a FPFTY is being used to establish rates. Adjusting costs to end of rate year levels and beyond would result in UGI-E recovering costs from ratepayers that are in excess of the costs that will be incurred during the rate year.

OCA St. 1 at 7-8.

Act 11 was meant, in part, to address concerns over regulatory lag. In finding for UGI on this issue, the ALJs quote the Commission as "the risks associated with regulatory lag will be substantially reduced because the new rates will be consistent with the test year used to establish

those rates for at least the first year." R.D. at 19. Accepting the OCA's proposed average rate base for the FPFTY will "substantially reduce" regulatory lag. Accepting UGI's end of year rate base will eliminate regulatory lag. The ALJs recommendation to accept UGI's proposal on this issue should not be adopted at this time.

In its Main Brief, the OCA pointed to the Illinois Commerce Commission decision that had recently addressed the average versus end of year rate base issue, and found as follows:

> The Commission finds that an average rate base methodology is more appropriate than a year end based calculation on the facts of the particular cases before us. The selection of an average rate base calculation take [sic] into account that investments are made throughout the test year, rather than the Companies' method of a year-end rate base **which inappropriately assumes, for rate setting purposes, that all investments are made at the beginning of the test year.**

OCA M.B. at 16, citing Re North Shore Gas Company, ICC Docket Nos. 12-0511/0512 (cons.), pp. 26 (Order entered June 18, 2013). The ALJs dismissed this sound reasoning, in part, by holding that:

> Further, it is not persuasive to cite to one provision of another jurisdiction's ratemaking practice without looking at other issues and aspects of that jurisdiction's overall ratemaking policy. Different jurisdictions adopt different approaches and mechanisms to various ratemaking issues, including capital structure, cost of equity, normalization, annualization and amortization, automatic adjustment clauses and post-test year adjustments.

R.D. At 21. The OCA submits that the Commission has a history of looking to other jurisdictions for guidance, especially when new laws, policies or practices are being considered. For example, the Commission is currently in the process of reviewing alternative ratemaking methods that might be employed in Pennsylvania. To that end, the Commission recently issued a Proposed Policy Statement Order wherein the Commission actively endorsed the idea of looking to other jurisdictions for guidance, as follows:

> Revenue per customer adjustments have already been implemented in other states such as Ohio, Maryland, Massachusetts and Virginia, therefore, there is a history

of experience from which to draw if proposing effective revenue per customer adjustments to benefit both customers and utilities.

Proposed Policy Statement Order, Fixed Utility Distribution Rates Policy Statement, Docket No. M-2015-2518883 at 30, n. 72 (Order entered May 23, 2018).[1] The OCA submits that the decision of the Illinois Commerce Commission is directly relevant to this issue and should be reviewed by the Commission here in reaching its determination on this matter.

Finally, as to the OCA's and I&E's concerns over the fact that UGI's projected end of year rate base could be substantially overstated, the ALJs relied on the arguments of UGI and the language of Section 315(e) to hold that "[w]e also agree with UGI Electric that the legislature addressed this issue in Section 315(e), which also provides that the Commission may audit FPFTY results after the fact to determine whether they were accurate and authorizes the Commission to adjust rates to reflect material differences." R.D. at 22. Notwithstanding this potential check on the accuracy of UGI's projections, the ALJs also note that the Commission has recognized that no retroactive adjustments to a utility's rates as part of any after the fact audit or review will occur. R.D. at 21-22. As such, the OCA submits that there is a real potential for ratepayers to be paying well in advance for UGI's proposed rate base additions that are never actually placed in service during the FPFTY.

I&E witness Cline also expressed this same concern, as follows:

> As discussed above, UGI Electric is requiring ratepayers, in essence, to pre-pay a return on its projected investment in future facilities that are not only not in place and providing service at the time the new rates take effect, but also that are not subject to any guarantee of being completed and placed into service. As a result, ratepayers will begin paying for expenses and plant when new rates become effective on October 27, 2018, but those projected expenses and plant may not be incurred or placed into service until September 30, 2019 or even later.

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[1] The OCA notes that in reaching a final determination on the authorized ROE of 9.8%, the ALJs appeared to rely in part on the average authorized returns of electric utilities from other jurisdictions. R.D. at 89.

I&E St. 3 at 6.

Act 11 authorizes the use of a FPFTY but does not provide specific ratemaking details associated with its use. The Commission must ensure that rates are just and reasonable, and accepting an average rate base method will ensure an appropriate balancing of interests between the Company and its customers. Accordingly, the OCA submits that the ALJs' end of year rate base recommendation should not be adopted.

OCA Exception No. 2: The ALJs Erred By Recommending That UGI's Storm Damage Expense Claim Be Accepted. (R.D. at 36-38; OCA M.B. at 30-31; OCA R.B. at 14-15)

In the R.D., the ALJs improperly recommended that the OCA's proposal to reduce UGI's storm damage expense claim to $114,000 be rejected and that UGI's full storm damage expense claim of $301,000 be approved. R.D. at 38. The OCA submits that the ALJs' findings are in error and that the Commission should not adopt the ALJs' recommendation as to the Company's storm damage expense claim.

UGI initially proposed to normalize its storm damage expense from 2013 to 2017 over a 5-year period, resulting in an annual expense of $275,000. OCA M.B. at 30. Subsequently, in Rebuttal Testimony, the Company proposed to instead normalize its storm damage expense from 2014 to 2018 over a 5-year period, resulting in an annual expense of $301,000. UGI St. 2R at 4; UGI St. 8R at 22; OCA M.B. at 30, n. 6. The Company averred that its proposed storm damage expense claim is based on the costs of "qualifying expenses from major storm events" during those periods. UGI St. 2 at 17; OCA M.B. at 30.

The OCA proposed to remove the 2014 storm cost and reduce the Company's storm damage expense claim to an annualized level of $114,000. OCA St. 1 at 20; OCA M.B. at 31; OCA R.B. at 14-15. As OCA witness Morgan explained, the Company's claim is flawed in that

"data presented by the Company on which the adjustment is based show that qualified storms or storms of this magnitude are infrequent." OCA St. 1 at 19. Mr. Morgan further explained:

> During that time there were only two storms – one in 2014 and the other in 2017. It should be noted that there are two years between with no activity. Typically, a multi-year average is used to normalize storm expenses that occur infrequently and have a high degree of variability from one year to the next. The normalization is used to smooth out spikes and dips that occur from year to year.

OCA St. 1 at 19-20. I&E also argued that the Company's storm damage expense claim should be reduced as it is not sufficiently supported. I&E M.B. at 43-44.

Nonetheless, the ALJ found that "UGI Electric's arguments in favor of normalization of the five-year period from 2014 to 2018 is persuasive" and recommended "that the Commission accept UGI Electric's storm damage expense claim of $301,000." R.D. at 38. As OCA witness Morgan explained, however:

> [T]he Company's attempt to include the 2014 storm cost should not be accepted by the Commission because (1) it serves to skew costs upward; and (2) it has the effect of retroactive recovery of 2014 storm costs since there are no other storm costs besides 2017 because of infrequent storm occurrence.

OCA St. 1 at 19-20; OCA M.B. at 30-32; OCA R.B. at 14-15. Accordingly, OCA witness Morgan properly proposed to remove the 2014 storm cost and reduced the claimed storm damage expense to an annualized level of $114,000. OCA St. 1, Schedule LKM-13. The OCA submits that the Commission should reject the ALJs' recommendation as to the Company's storm damage expense claim and adopt the OCA's proposal to reduce the amount of this claim.

OCA Exception No. 3: <u>The ALJs Erred By Recommending That UGI's Employee Additions Expense Claim Be Accepted.</u> (R.D. at 42-43: OCA M.B. at 32-34; OCA R.B. at 16)

In the R.D., the ALJs improperly recommended that the OCA's proposal to adjust UGI's employee additions expense claim to reflect the date of employment be rejected and that UGI's full claim of $382,000 be approved. R.D. at 42-43. The OCA submits that the ALJs' findings

are in error and that the Commission should not adopt the ALJs' recommendation as to the Company's employee additions expense claim.

UGI initially proposed a $494,000 claim for three additional personnel that were not factored into the FPFTY budget, including a General Manager, New Business Engineer, and Business Support Engineer. UGI St. 2 at 15; UGI St. 3 at 13-14; OCA M.B. at 32-33. Subsequently, in Rebuttal Testimony, the Company modified its claim for these three additional personnel to $382,000. OCA St. 1 at 17: OCA M.B. at 33. The Company based its employee additions expense claim on end of test year conditions. UGI St. 2R at 9; OCA M.B. at 33.

The OCA proposed to prorate the amount claimed by UGI to reflect the number of months that the positions will be in place during the FPFTY based on the expected date of employment. OCA St. 1 at 17; OCA M.B. at 33; OCA R.B. at 16. OCA witness Morgan explained that UGI's claim is flawed in that "the Company indicates that these positions are not expected to be filled until December 1, 2018" and, "under the FPFTY concept, the rate should be set to reflect the costs to be incurred during the rate year or the first year of the rate effective period." OCA St. 1 at 17. I&E echoed this position stating, "The Company assumes the positions will be filled *by* December 1, 2018; but, its claim is based on a full year's worth of expense . . . for the positions." I&E M.B. at 48 (emphasis in original); OCA R.B. at 16.

Nonetheless, the ALJs accepted UGI Electric's end of year methodology whereby the FPFTY reflects end-of-the year conditions and recommended "that the Commission accept UGI Electric's claim of expenses for employee additions in the amount of $382,000." R.D. at 43. This, despite the fact that UGI will **not** insure $382,000 of expense in the FPFTY because it does not intend to hire these employees for a full 12-months. As I&E noted, "the FPFTY expense allowance [should] be based on the actual amounts incurred . . . not an annualization of the end-

of-year inflated projections." I&E M.B. at 48; OCA R.B. at 16. Accordingly, OCA witness Morgan properly proposed to adjust the employee additions expense claim to reflect the December 1, 2018 date of employment. OCA St. 1, Schedule LKM-9. The OCA submits that the Commission should reject the ALJs' recommendation as to the Company's employee additions expense claim and adopt the OCA' or I&E's s proposal to adjust this claim.

OCA Exception No. 4: The ALJs Erred By Recommending That UGI's Depreciation Expense Claim Be Accepted. (R.D. at 51-52; OCA M.B. at 21; OCA R.B. at 9-10)

In the R.D., the ALJs improperly recommended that the OCA's proposal to adjust UGI's depreciation expense claim based on the average rate base methodology be rejected and that UGI's full depreciation expense claim of $5,333,752 be approved. R.D. at 51. The OCA submits that the ALJs' findings are in error and that the Commission should not adopt the ALJs' recommendation as to the Company's depreciation expense claim.

UGI initially proposed a depreciation expense claim of $4,265,854. I&E St. 3-SR at 13. Subsequently, in Rebuttal Testimony, the Company modified this claim to $5,333,752. I&E St. 3SR at 13. UGI proposed to base its rate year depreciation expense on the projected balance of plant at the end of the FPFTY. OCA St. 1 at 20; OCA M.B. at 21.

The OCA proposed to adjust the UGI's depreciation expense claim to reflect the average plant in service during the FPFTY. OCA St. 1 at 20-21: OCA M.B. at 21; OCA R.B. at 9-10. OCA witness Morgan explained that UGI's claim is flawed in that "the use of the end of rate year plant to calculate depreciation expense . . . significantly overstates the depreciation expense that will be recognized during the rate year, and results in UGI-E earning in excess of its allowed rate of return." OCA St. 1 at 21. I&E also proposed to adjust UGI's depreciation expense claim based on the average rate base methodology. I&E M.B. at 25. I&E recommended determining

this amount by "taking the average of the company's accumulated depreciation for the FTY ending September 30, 2018 and the Company's rebuttal accumulated depreciation for the FPFTY ending September 30, 2019." Id.

As discussed in OCA Exception No. 1, the ALJs recommendation to accept the end of year methodology is in error. In particular, with regard to the depreciation expense claim, OCA witness Morgan explained:

> By determining the annualized depreciation expense on the balance of plant in service as of the end of the fully projected test year, UGI-E has reflected a level of depreciation expense that will not begin to be incurred until after October 1, 2019 instead of the depreciation expense that will be incurred during the rate year ending September 30, 2019. When companies used a future test year that ended before rates went into effect, the use of end of FTY plant to calculate depreciation expense was appropriate in order to reflect the depreciation expense that would be recognized at the time rates went into effect. However, in this case, where UGI-E is now allowed to use a fully projected future test year, the use of end of rate year plant to calculate depreciation expense is no longer appropriate because doing so significantly overstates the depreciation expense that will be recognized during the rate year, and results in UGI-E earning in excess of its allowed rate of return.

OCA St. 1 at 20-21. Therefore, OCA witness Morgan properly proposed to adjust the depreciation expense claim to reflect the average plant in service in the FPFTY. The OCA submits that the Commission should reject the ALJs' recommendation as to the Company's depreciation expense claim and adopt the OCA's proposal to adjust the amount of this claim.

OCA Exception No. 5: The ALJs Erred By Recommending A 9.8% Base Return On Equity For UGI. (R.D. at 57-89; OCA M.B. at 53-69; OCA R.B. at 24-28)

In the R.D., the ALJs recommended that the OCA's proposed Return on Common Equity (ROE) of 8.5% be rejected. R.D. at 89. Instead, the ALJs recommended that UGI be awarded an ROE of 9.8%. Id. The OCA submits that the recommendation to award UGI an ROE of 9.8% is inconsistent with the evidence in this case, inconsistent with the low-cost capital environment and should not be adopted.

A. Introduction

The ALJs held that the DCF should be the primary method used to determine the ROE in this matter, with the use of the CAPM as a check on the reasonableness of the DCF result. R.D. at 60. Company witness Moul's unadjusted DCF, even using his excessive growth rate, is 9.48%. OCA witness Rothschild calculated a DCF range of 7.93% – 8.31%, and I&E witness Spadaccio calculated a DCF of 8.62%. OCA M.B. at 53. It is clear that Mr. Moul's unadjusted DCF result at 9.48% is the highest in the record. To test the reasonableness of the DCF results, the ALJs concluded that a CAPM of 9.83% was correct, and in so doing, attempted to validate that an ROE of 9.8%[2] was reasonable. R.D. at 88. The OCA submits that the conclusions reached on these issues in the R.D. are in error, on several grounds.

First, the growth factor chosen by the ALJs to calculate the DCF result is extraordinarily high and unsupported by the record. Second, the CAPM of 9.83% as chosen by the ALJs as a check is substantially inflated by the ALJs' decision to accept Mr. Moul's arithmetic versus geometric mean argument, and is inconsistent with the evidence in this matter. The current and sustained low-cost capital environment, coupled with the evidence in this case clearly illustrates that the cost of common equity for UGI is consistent with the OCA's proposed 8.50%.

B. The Growth Rate Chosen By The ALJs To Calculate The DCF Is Well Overstated And Unsupported By The Record Evidence.

Mr. Moul relied on analysts' projections to calculate his growth rates, initially leading to a range of 4.33% – 6.06%.[3] R.D. at 70. From that range, Mr. Moul asserted that due to "improved economic growth" the growth rate should be set at the high end, 5.75%. Id. As the ALJs had excluded two of the companies from the original proxy group, a new range was

[2] The 9.8% does not reflect the 20 basis point "Management Effectiveness" adder that will be discussed in OCA Exception No. 6.

[3] Based on the original proxy group of ten companies that the ALJs then reduced to eight companies as the "Altered Proxy Group."

calculated as 5.2% – 6.5%, with an average of 5.85%. Id. The OCA submits that Mr. Moul's reliance on analysts' projections is an unreliable method to establish a growth rate.

OCA witness Rothschild testified as to the shortcomings in Mr. Moul's approach to establishing a growth rate based on the projection of analysts, as follows:

> Mr. Moul uses analyst five-year earnings per share growth without attempting to reconcile the retention rate used for computing growth with the retention rate he used to compute the dividend yield. This is analogous to failing to reconcile the money you are taking out of your checking account with your future balance, i.e. the basic balancing of a checkbook.

OCA St. 3 at 48. Mr. Rothschild goes on to explain further why using projections as to earnings per share is not a reliable method to actually arrive at a sustainable growth rate. Mr. Rothschild testified that:

> The primary cause of sustainable earnings growth is the retention of earnings. A company is able to create higher future earnings by retaining a portion of the prior year's earnings in the business and purchasing new business assets with those retained earnings. There are many factors that can cause short-term swings in earnings growth rates, but the long-term sustainable growth is caused by retaining earnings and reinvesting those earnings.
>
> . . .
>
> [C]hanges in earnings per share growth rates that are caused by non-recurring changes in the earned return on book equity are inconsistent with long-term sustainable growth, but changes in earnings per share because of the reinvestment of additional assets is a cause of sustainable earnings growth.

OCA St. 3 at 49. As Mr. Rothschild explained, Mr. Moul's method to arrive at a growth rate does not take into account the retention rate, in other words, the level of retained earnings that are kept by the company and directly reinvested.

These shortcomings in Mr. Moul's method for establishing a growth rate only serve to highlight the more reasonable and sustainable method employed by Mr. Rothschild, as he testified:

> The "b x r" term in the DCF equation computes sustainable growth because it measures only the growth which a company can expect to achieve when its earned

> return on book equity "r" remains in equilibrium. If analysts have sufficient data to be able to forecast varying values of "r" in future years, then a complex, or multi-stage DCF method must be used to accurately quantify the effect. Averaging growth rates over sub-periods, such as averaging growth over the first five years with a growth rate expected over the subsequent period, will not provide an appropriate representation of the cash flows expected by investors in the future and, therefore, will not provide an acceptable method of quantifying the cost of equity using the DCF method. The choices are either a constant growth DCF, in which one "b x r" derived growth rate should be used, or a complex DCF method in which the cash flow anticipated in each future year is separately estimated. Mr. Moul has done neither.

OCA St. 3 at 50. The 5.75% or 5.85% as indicated by Mr. Moul is well overstated and not representative of a growth rate for UGI that is sustainable, as required by the DCF method.

In the R.D., however, the ALJs accepted the rebuttal of Mr. Moul on this issue. R.D. at 72-73. In his Surrebuttal Testimony, Mr. Rothschild adequately defended his method in arriving at a reasonable, sustainable growth rate. Mr. Rothschild testified that:

> The five-year growth rates Mr. Moul uses are not the sustainable growth rates required by the constant growth DCF. Furthermore, a study conducted by McKinsey & Company in 2010 found that "analysts have been persistently over optimistic for the past 25 years with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth." Even if equity analysts' forecasts are not upwardly biased, as discussed in my Direct Testimony, adding earnings per share growth forecasts to a dividend yield without considering the retention rate produces a flawed result.

OCA St. 3S at 3 (footnote omitted). The key point here is that the DCF model, if it is to produce reliable results, must be based on a growth rate that is sustainable. The ALJs have not adopted a sustainable growth rate. Accordingly, the OCA submits that the OCA's ROE recommendation of 8.50%, based on a growth rate range of 4.20% -4.31%,[4] should be accepted in this matter.

C. <u>The 9.83% CAPM Result Used By The ALJs As A Check On The DCF Results Is Well Overstated.</u>

OCA witness Rothschild calculated the CAPM numbers for UGI and arrived at a CAPM cost of equity for UGI of 7.08%. OCA St. 3 at 3. Importantly, Mr. Rothschild does not use a

[4] <u>See</u> R.D. at 72.

historic arithmetic mean to calculate the total market return for use in his CAPM. His CAPM is based upon the option-implied betas for each of the companies in the Electric Group, the option implied betas for two Black Rock Bond Funds and yields on Black Rock Bond Funds. OCA St. 3 at 57-58. I&E witness Spadaccio also performed CAPM studies, for both the historic and forecasted periods. I&E St. 2 at 26-28. Mr. Spadaccio used the geometric mean for his calculations and arrived at a CAPM cost of equity for UGI of 8.98% Historic, and 8.00% Forecasted. Id. In rebuttal, Mr. Moul argued that Mr. Spadaccio's forecasted numbers were in error as they were based on outdated information. R.D. at 79. These alleged errors were accepted by the ALJs and the corrected forecasted CAPM result was found to be 9.83%.

Mr. Moul also argued that Mr. Spadaccio's historic return should be adjusted by using the arithmetic mean as opposed to the geometric mean. R.D. at 80. This argument was accepted by the ALJs and the resulting historic CAPM result was found to be 10.18%. Missing from the R.D., however, were the countervailing arguments put on by both OCA and I&E witnesses as to why the arithmetic mean should not be used for this purpose.

In his Direct Testimony, OCA witness Rothschild explained that:

> I do not agree with the results of Mr. Moul's CAPM analysis because I believe that they significantly and inaccurately overstate the Company's cost of equity.
>
> The arithmetic average return that Mr. Moul uses overstates the historical risk premium by *300 basis points*. The 2016 SBBI Yearbook shows that investors actually earned a compounded annual return of 10.0% between 1926 and 2015. The arithmetic mean return of 12.0% is possibly valuable to stock brokers and fund managers attempting to predict future bonuses, but not for calculating the cost of equity. A Dow Jones Newswire article stated, "Some financial advisers rely too heavily on a formula known as the arithmetic average, which can be misleading when investing for the long term. Financial advisors who use this formula may be overstating your potential profit and leading you to take risks you might otherwise avoid..."

His prospective risk premium calculation is based on a DCF analysis that is not based on sustainable growth. His DCF analysis for the S&P 500 has a growth component of an astounding 9.90%.

OCA St. 3 at 57-58 (emphasis added, footnotes omitted).

Similarly, I&E witness Spadaccio responded in Surrebuttal Testimony to this issue, as follows:

> I have used the geometric mean to find a *historical* return; the Ibbotson Yearbook is arguing against the use of a geometric mean in a *forecasted* CAPM and discusses the use of the arithmetic mean in a forward looking CAPM. I have only used the geometric mean in my historic CAPM; therefore, the Ibbotson quotes used by Mr. Moul do not apply. As stated by Ibbotson, "The geometric mean is backward-looking."

I&E St. 2SR at 18. Mr. Spadaccio went on to explain further why the arithmetic mean should not be used for historic CAPM purposes, as follows:

> Suppose a hypothetical investor has \$100 to invest over a two-year period. The first year the investor earns a 100% return so that his ending wealth at the end of period 1 is \$200. The second year the investor has a -50% return (loses \$100) so that his ending wealth at the end of period 2 is \$100. It is quite clear that the investor has not earned a return since he ends the two-year period with the same \$100 that he started with. The calculated geometric return is 0% = $(\$100/\$100)^{\wedge 1/2}$, which shows the lack of increased wealth. However, the calculated arithmetic return is 25% = (100% - 50%)/2. This means an investor relying on the arithmetic mean would expect to have an ending wealth of \$125, but instead would only have an ending wealth of \$100. This illustrates the inherent bias of using the arithmetic mean to calculate period results. As a result, it is quite clear that the use of the arithmetic mean for cost of capital purposes in a regulatory setting will produce biased results and that the geometric mean is more accurate and appropriate.

I&E St. 2SR at 19.

In the R.D., it is clear that the ALJs agreed in large part with the CAPM proposed by I&E witness Spadaccio, with the exception as to the arithmetic mean issue just discussed and the update to the forecasted numbers. As to the arithmetic versus geometric mean, it should be clear from the additional discussion here that Mr. Moul's proposed adjustment to the historic CAPM

numbers should not have been made. As such, the CAPM range here should actually be 7.08% to 9.83%, with an average CAPM cost of equity of 8.46%.

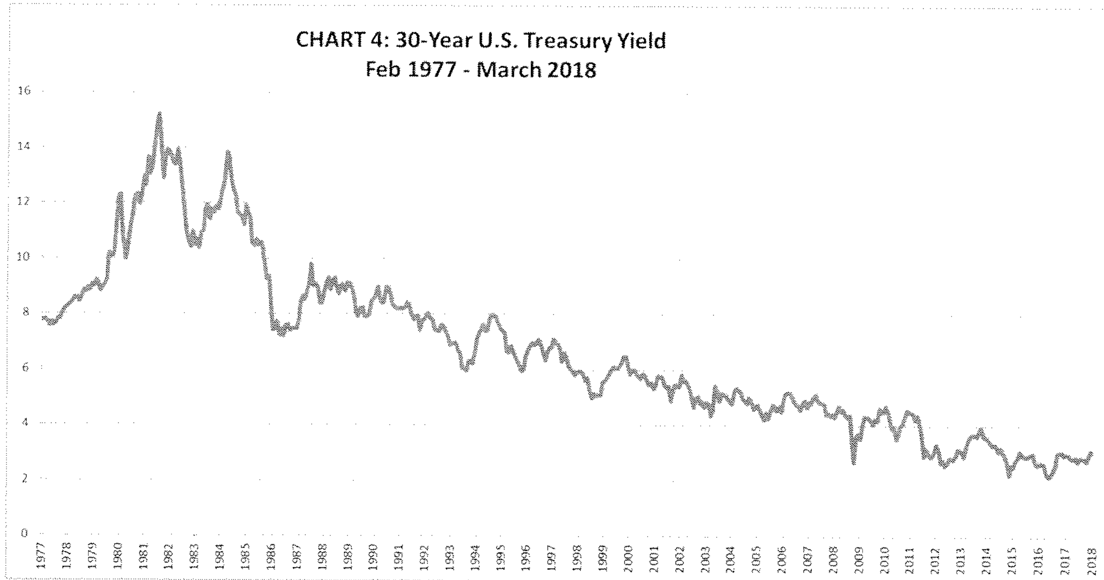
Accordingly, the additional evidence put on by both OCA and I&E witnesses should be thoroughly evaluated here and the CAPM results adjusted accordingly. Once those corrections are made, it should be clear that the CAPM range does not support an ROE of 9.8%.

D. The Long-Term, Sustained Low Cost Of Capital Environment Should Be Adequately Reflected In Cost Of Capital Decisions.

The law charges the Commission with the duty of protecting the rights of the public. City of Pittsburgh v. Pa. PUC, 126 A.2d 777, 785 (Pa. Super. 1956) (City of Pittsburgh II). As a general rule, a public utility, whose facilities and assets have been dedicated to public service, is entitled to *no more than* a reasonable opportunity to earn a fair rate of return on shareholder investment. Discussing rate of return, the City of Pittsburgh II court wrote that "[i]t is the function of the commission in fixing a fair rate of return to consider not only the interest of the utility but that of the general public as well. The commission stands between the public and the utility." Id.

As OCA witness Rothschild testified, we are in a long-term period of low costs for capital:

> As of March 31, 2018 the yield on the 30-Year U.S. Treasury bond is at 3.03%. As shown in Chart 4 below, yields on 30-year U.S. treasuries remain low by historical measures:



OCA St. 3 at 14-15. There are no "anomalous" market conditions at this time. The current environment for access to capital and the costs thereof should more appropriately be viewed as the "new normal." The current environment represents investors' expectations because the prices they pay for securities today is based on the returns they expect to receive in the future. When investors' expectations change, it will be revealed in current market conditions and rates should be adjusted accordingly at that time. With that, it is clear from the record in this case that the quantum of numbers, whether they be from the DCF or the CAPM are decidedly lower than the 9.8% ROE arrived at in the R.D..

The OCA submits that the 9.8% ROE recommended by the ALJs should not be adopted. The evidence in this matter shows that by all reasonable measures the cost of common equity for UGI is well below 9.8%. The OCA recommends that this Commission adopt the cost of capital recommendations of Mr. Rothschild, and allow UGI the opportunity to earn an 8.5% return on common equity and a 6.75% overall return on its rate base.

OCA Exception No. 6: The ALJs Erred By Recommending A Management Effectiveness Adjustment Adder Of 20 Basis Points To UGI's Return On Equity. (R.D. at 83-89; OCA M.B. at 66-67; OCA R.B. at 24-28)

In the R.D., the ALJs recommended that the OCA's proposal to reject UGI's 20 basis point management effectiveness adder not be adopted. R.D. at 86-87. Instead, the ALJs recommended that UGI be awarded the full 20 basis point adder. Id. The OCA submits that the 20 basis point adder is unsupported and should not be granted.

The Commission should expect our regulated utilities to provide safe, adequate, efficient and reasonable service in accordance with the utilities' public service obligation. Accordingly, proposals such as UGI's "Management Effectiveness Adjustment" should be carefully scrutinized and only awarded in truly exceptional circumstances. The OCA submits that the record in this matter does not support the ALJs' recommended 20 basis point adder.

As discussed elsewhere in these Exceptions, the ALJs' recommended 9.8% base ROE award is well above what the record here should support. Adding another 20 basis points on top of that already overinflated ROE is neither reasonable nor fair to the ratepayers, and is certainly not required to attract capital. OCA witness Rothschild explained that a management bonus is not a factor for reasonable investment decision making, as follows:

> The cost of equity for UGI Electric should be based only on the return equity investors demand to invest in companies with similar risk to UGI Electric. Mr. Moul claims that his proposed return fulfills the standards established by the landmark *Hope* and *Bluefield* cases. However, charging consumers an additional return for management performance is inconsistent with the *Hope* and *Bluefield* cases. Furthermore, Mr. Moul presented no analysis on how he valued UGI Electric's claimed superior performance to be 20 basis points, nor is there any indication that Mr. Moul evaluated whether UGI Electric's performance is superior to, or more efficient, than those companies in the Electric Group.

OCA St. 3 at 45 (footnote omitted).

In addition, I&E witness Spadaccio argued against granting UGI a 20-basis-point adder based on the Company's touted achievements, as follows:

> First, many of the programs presented, such as the EE&C Plan as well as the new Customer Information System are funded by ratepayers. Next, topics such as

> electric reliability, customer satisfaction and a focus on safety are required of every public utility under 66 Pa. C.S.A. §1501. Finally, while the Company may have voluntarily filed an LTIIP, it is important to acknowledge that it is required for utilization of a DSIC mechanism, which may have a significant benefit to the Company in the form of immediate recovery of eligible property to be repaired, improved, or replaced.

I&E St. 2 at 47-48.

The OCA submits that the record in this matter does not support the award of an additional financial adder based on management performance. Accordingly, the Commission should reject UGI's request for an additional 20 basis point ROE adder.

OCA Exception No. 7: <u>The ALJs Erred By Recommending The Use of End Of Year Numbers to Determine The Amount of Excess ADIT (EDIT).</u> (R.D. at 105-107; OCA M.B. at 40-44; OCA R.B. at 19-21)

In the R.D., the ALJs improperly recommended that the amount of EDIT to be deducted from UGI's rate base be determined based upon end of year numbers. R.D. at 107. The OCA agrees with the decision of the ALJs that EDIT should be recognized as an offset to rate base. R.D. at 105. The OCA submits, however, that the ALJs finding as to the use of end of year numbers to calculate EDIT is in error and must be rejected.

UGI proposed to exclude EDIT funds from rate base, thus increasing the rate base upon which depreciation expense and return is calculated for revenue requirement purposes. OCA St. 1 at 12, OCA M.B. at 42. The OCA proposed to include EDIT funds in rate base as a reduction. OCA witness Morgan explained that, based on Federal tax policy, "just because the name of the account in which these funds are held has changed, ratepayers should not be penalized by not including the funds in the rate base given the funds are still restricted as if they were protected ADIT." OCA St. 1 at 13, OCA M.B. at 43. Accordingly, the OCA proposed to reduce the Company's rate base by the amount of EDIT based on the average balance of $10.876 million. OCA St. 1, Schedule LKM-5.

The ALJs agreed that "excess ADIT should be recognized as an offset to UGI Electric's rate base" and recommended "that the Commission order these funds to be deducted from the rate base." R.D. at 105, 107. The ALJs, however, recommended that "the amount of excess ADIT will be based upon the ending balance adjustment which is the company's number of $11,213,000." R.D. at 107. As discussed in OCA Exception No. 1, the ALJs recommendation to accept the end of year methodology is in error.

As demonstrated by OCA witness Morgan, the amount of EDIT to be deducted from rate base should be based on the average balance, $10.876 million, which is calculated by averaging the balance at September 30, 2019 ($11.213 million) and the balance at September 30, 2018 ($10.538 million). OCA St. 1, Schedule LKM-5. Therefore, the OCA submits that the Commission should reject the ALJs' recommendation as to the calculation of the amount of EDIT to be reduced from rate based and adopt the OCA's proposed amount of $10.876 million. OCA St. 1 at 13.

OCA Exception No. 8: <u>The ALJs Erred By Recommending Adoption Of UGI's Act 40 Proposal.</u> (R.D. at 107-111; OCA M.B. at 44-47; OCA R.B. at 21-23)

In the R.D., the ALJs recommended that the OCA's proposals as to the treatment of consolidated tax savings from Act 40 be rejected. R.D. at 111. Instead, the ALJs recommended that UGI's proposed handling of the consolidated tax savings should be adopted. <u>Id</u>. The OCA submits that the findings on this issue in the R.D. are in error and should not be adopted.

Prior to Act 40, ratepayers were only required to pay the actual taxes paid by UGI, not hypothetical taxes. <u>City of Pittsburgh v. Pa. PUC</u>, 128 A.2d 372, 387 (Pa. Super. 1956); <u>Western Pennsylvania Water v. Pa. PUC</u>, 422 A.2d 906, 909 (Pa. Commw. 1980); <u>Barasch v. Pa. PUC</u>,

493 A.2d 653, 656 (1985). Act 40 has changed the way in which consolidated tax savings are treated for ratemaking purposes. Under Act 40:

> If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates. If an expense or investment is not allowed to be included in a public utility's rates, the related income tax deductions and credits, including tax losses of the public utility's parent or affiliated companies, shall not be included in the computation of income tax expense to reduce rates.

Act 40, however, includes requirements that must be followed until December 31, 2025.

In a rate case, the utility is still required to perform a consolidated tax savings calculation in order to determine whether a "differential accrues" as a result thereof. See Act 40 of 2016, 66 Pa. C.S § 1301.1. Here, UGI performed the required calculation and the Act 40 savings amount is $75,400. UGI St. 2-R at 13. Act 40 then further provides, "for ratemaking purposes", these savings are to be used as follows:

> Revenue Use – If a differential accrues to public utility resulting from applying the ratemaking methods employed by the commission prior to the effective date of subsection (a) for ratemaking purposes, the differential shall be used as follows:
>
> (1) fifty percent to support reliability or infrastructure related to the rate-base eligible capital investment as determined by the commission; and
>
> (2) fifty percent for general corporate purposes.

66 Pa.C.S. § 1301.1(b).

Part (b) of Act 40 specifically requires that the company account for these funds when determining rates. Part (b) is in effect until December 31, 2025, indicating that the General Assembly included this provision as a means to mitigate the rate impacts of Act 40 for ratepayers, at least for a period of time. The OCA's proposals as set out in Mr. Morgan's

Testimony would accomplish these important objectives. Alternatively, accepting UGI's proposed use and treatment of these savings would ignore the explicit requirements of Act 40.

OCA witness Morgan testified that the Company's approach to calculating the use of consolidated tax savings did not comply with Act 40. Mr. Morgan testified as follows:

> Q. DID THE COMPANY COMPLY WITH ACT 40 OF 2016?
>
> A. No. With regard to the portion of Act 40 that requires the 50 percent of the calculated consolidated tax savings be earmarked to support reliability or infrastructure related to the rate-base eligible capital investment, the Company simply states that its rate base claim in this case exceeds the 50% of the consolidated tax savings. This does not show how it is used or benefit[s] ratepayers.

OCA St. 1 at 23. Here, consistent with Act 40, Mr. Morgan is relating that there are several, separate and distinct showings that are required by Act 40. These separate and distinct obligations under Act 40 do not appear to be accurately captured in the R.D., as the ALJs held that:

> The statute merely requires 50% of the Act 40 savings be used for reliability or infrastructure purposes, while the other 50% of the Act 40 savings be used for general corporate purposes. Nowhere does the statute state any particular requirements within the subcategories listed. Therefore, the OCA's position that UGI Electric did not sufficiently specify where the Act 40 savings would be spent is without merit.

R.D. At 110. The ALJs focused on whether UGI identified the uses of these savings with specificity, and finding that such was not required, the ALJs recommended that UGI's Act 40 proposal was sufficient. R.D. at 110-111. Such an interpretation renders Section (b) meaningless and would violate the rules of statutory construction, which dictate that all provisions of a statute should be given effect. 1 Pa. C.S. § 1921(a). The OCA submits that a showing in this rate case as to how and where each 50% of the savings is to be applied to the benefit of ratepayers is necessary and consistent with the clear language of Act 40.

Moreover, and perhaps more importantly, is the lack of any recognition that ratepayer benefits must be shown, at least through December 31, 2025. Act 40 is clear that during this time period, Act 40 savings are to provide ratepayer benefits. To address the use of funds consistent with Act 40's infrastructure requirement, OCA witness Morgan recommended as follows:

> Q. WHAT DO YOU CONCLUDE REGARDING THE 50% OF THE DIFFERENTIAL THAT ACT 40 REQUIRES BE USED TO SUPPORT RELIABILITY OF INFRASTRUCTURE RELATED TO RATE BASE ELIGIBLE CAPITAL INVESTMENT?
>
> A. The 50% of the differential should be used to offset rate base in this case. The rate base reduction supports infrastructure and reliability investment and reduces the burden of rate-base eligible capital investment on ratepayers.

OCA St. 1 at 24.

As to the other required 50% of the Act 40 savings, the OCA submits that UGI's "general corporate purpose" is to provide regulated electric utility distribution service in the Commonwealth of Pennsylvania. The Act 40 savings for "general corporate purposes" should be directed to such uses as supporting capital expenditures necessary to execute utility business plans, paying off debt, funding construction projects, paying dividends, paying for maintenance and operating expenses, investing in utility plant in Pennsylvania, and providing a source of working capital, etc. Many of these uses for "general corporate purposes" would have a quantifiable benefit to Pennsylvania ratepayers, rather than just resulting in a windfall to the Company. In keeping with this purpose, OCA witness Morgan recommended that the 50 percent differential for general corporate purposes be reflected as a source of non-investor-supplied funding for utility working capital. OCA St. 1 at 25.

Finally, UGI has the burden of proof in this rate case. <u>See</u> 66 Pa. C.S. § 315(a). Under Act 40, UGI has the burden to (1) calculate the Act 40 savings, (2) identify where and how each

50% of such savings will be applied, and (3) show how such application provides a benefit to ratepayers. These Act 40 savings are undeniably ratepayer-supplied capital. Act 40 has in no way superseded the overall requirement that rates must be just and reasonable.

In conclusion, UGI has failed to correctly implement the requirements of Act 40 in this matter, and as such, has failed to carry its burden of proof. In order to apply Act 40 as the General Assembly intended, the OCA's proposals on this issue should be accepted and the findings in the R.D. should not be adopted.

OCA Exception No. 9: The ALJs Erred By Recommending The Use Of UGI's Cost Of Service Study To Allocate The Revenue Increase In This Proceeding. (R.D. at 111-120; OCA M.B. at 70-79; OCA R.B. at 28-34)

In the R.D., the ALJs recommended that the OCA's proposed Class Cost of Service Study (COSS) not be adopted in this matter. R.D. at 120. Instead, the ALJs recommended that UGI's COSS should be accepted and used as a guide to set rates in this matter. Id. The OCA submits that the ALJs erred by recommending the adoption of UGI's COSS in this matter and that that the Commission should consider the OCA's alternative study as a guide when setting rates in this proceeding.

A. Introduction

OCA witness Mierzwa explained the purposes and the reasons why a COSS is submitted in a rate case, as follows:

> Such studies are referred to as average, embedded, ACCOSS because they attempt to directly assign or allocate to each customer class, actual book plant and related costs, adjusted to test year levels as authorized by the Commission. These ACCOSS are also referred to as "fully allocated" because they require that 100 percent of the allowed total jurisdictional costs of service be allocated among the various classes. This is done by determining the average costs of the various components of service (the total cost of the component divided by the units of service for that component), and then by allocating these component costs to each of the classes based on each class' service units that have caused, or benefit from, that cost.

OCA St. 4 at 4-5. UGI last filed a base rate case approximately 22 years ago. In this intervening period, the Company has undoubtedly made capital additions, alterations, improvements and continued necessary maintenance of its systems for the benefit of all of its customers who take electric service. Yet, here in this rate case, the Company's proposed COSS would indicate that almost 100% of its current revenue increase claim should be collected solely from the Residential class. The OCA submits that such an outcome is not only unreasonable, but also unsupported by a properly conducted COSS.

UGI's COSS contains several flaws that make it unsuitable to rely upon as a guide to setting rates in this matter. The OCA's proposed COSS more accurately follows the principles of cost causation and is consistent with noted treatises on this issue and consistent with the common practice of more than 30 other states. Further, even if the general parameters of UGI's COSS are accepted here, there are adjustments that must be made as UGI has failed to reasonably account for the load carrying capability of its "minimum system" and has also failed to reasonably account for the discrepancies in the actual length of facilities used to serve its customers.

B. <u>The OCA's COSS Should Be Accepted As A Guide To Set Rates In This Matter.</u>

The major difference between the OCA and UGI as to its COSSs is that UGI includes a customer component to its upstream primary and secondary distribution plant, and OCA witness Mierzwa testified that such distribution plant should be classified as 100% demand related. As Mr. Mierzwa explained:

> I recommend that the Commission require the Company to classify 100 percent of its upstream primary and secondary distribution plant as demand-related. This approach is used in more than 30 states. This classification will best reflect the factors that have caused this plant to be constructed—the need to meet local neighborhood peak demands and the need to deliver energy at usable voltages

> during all the hours of the year. The Company's proposal to classify a portion of upstream primary and secondary distribution plant as customer-related is unsupported and should be rejected because it fails to account for class differences between the distance between small and large customers and the [Peak Load Carrying Capability] PLCC of the minimum system.

OCA St. 4 at 16-17. Mr. Mierzwa's recommendation here is sound and directly in accord with the findings of more than 30 other states. Mr. Mierzwa testified to additional authoritative material on this issue, as follows:

> The 2000 NARUC Report identified in my direct testimony provides:
>
> > There are a number of methods for differentiating between the customer and demand components of embedded distribution plant. <u>The most common method used is the basic customer method, which classifies all poles, wires, and transformers as demand-related and meters, meter-reading, and billing as customer-related. This general approach issued in more than thirty states</u>. A variation is to treat poles, wires, and transformers as energy-related driven by kilowatt-hour sales but, though it has obvious appeal, only a small number of jurisdictions have gone this route.
> >
> > ...
> >
> > Any approach to classifying costs has virtues and vices. The first potential pitfall lies in the assumptions, explicit and implicit, that a method is built upon. In the basic customer method, it is the *a priori* classification of expenditures (which may or may not be reasonable). In the case of the minimum-size and zero-intercept methods, the threshold assumption is that there is some portion of the system whose costs are unrelated to demand (or to energy for that matter). From one perspective, this notion has a certain intuitive appeal [sic] these are the lowest costs that must be incurred before any or some minimal amount of power can be delivered but from another viewpoint it seems absurd, since in the absence of any demand no such system would be built at all. Moreover, firms in competitive markets do not indeed, cannot price their products according to such methods: they recover their costs through the sale of goods and services, not merely by charging for the ability to consume, or access. (Pages 29 & 30).

OCA St. 4S at 2-3. Mr. Mierzwa testified on this matter further, as follows:

> These costs are not, in any meaningful way, directly related to the number of customers served. The cost of upstream distribution plant is incurred in order to meet the coincident loads of the customers that it serves. The size and costs of the required plant are a function of the diversity of customers' loads that must be served from this plant, as well as the expected future coincident loads that may have to be served from these facilities as growth occurs on the system. There is no direct relationship between the number of customers and the size or the cost of

> poles or conductors, and Mr. Taylor has presented no evidence of a direct relationship.

OCA St. 4 at 9. Poles, wires and transformers are designed in order to meet the loads placed on them. To assign any of the costs for these facilities based on the number of customers is inconsistent with how the system was designed or operated in everyday use.

Further, when asked as to whether this Commission has ever addressed the allocation of upstream distribution plant based on the number of customers, Mr. Mierzwa testified as follows:

> Yes. In Philadelphia Gas Works, Docket No. R-00061931, 2007 PAPUC Lexis 46 (2007), this Commission found that allocations of upstream distribution plant based on the number of customers are not acceptable.

OCA St. 4 at 16.

The ALJs appear to rely quite heavily on the 2012 PPL case as support for their decision here. Yet, this Commission has and continues to recognize that there is no customer component for upstream distribution facilities in natural gas matters. Further, as OCA witness Mierzwa testified, Former Commissioner Cawley provided the following in the 2012 PPL case:

> [I]n a partial dissent, former Commissioner James H. Cawley stated:
>
> Both parties further debate the "minimum size" parameters at great detail. But the company never really fundamentally addresses why its model is appropriate, when other states have rejected this model. In fact, OCA presents valid arguments that this model is not well suited for the PPL service area. If, for example, a disproportionate number of residential customers lived in rural or suburban areas, the higher, less-dense costs of serving these customers might justify allocating more costs to residential customers. However, the density studies provided by PPL showed just the opposite, that various classes of customers were very evenly distributed across its service areas. Thus, there was no clear justification for why the "minimum size" model should be used in this instance to allocate more costs to the residential class. (Partial Dissent of Commissioner Cawley, PPL Docket No. R-2012-2290597, page 3.)

OCA St. 4 at 11. In this matter, Mr. Mierzwa testified that:

As indicated in Table 3 Residential customers comprise a consistent percentage of the number of customers in each zip code served by UGI regardless of population density and, therefore, *evenly distributed* across UGI's service territory.

OCA St. 4 at 12 (emphasis added). Accordingly, as set forth here the OCA's COSS should be used as a guide to set rates in this matter:

Table 1-S. Comparison of Allocated Cost of Service Study Results				
	Company		**OCA**	
Rate Class	**Rate of Return**	**Index**	**Rate of Return**	**Index**
Residential	(0.54%)	(0.14)	0.97%	0.26
General Service-1	(0.59)	(0.16)	3.78	1.01
General Service-4	23.23	6.19	13.87	3.70
Large Power	16.20	4.32	5.56	1.48
Lighting	21.02	5.61	17.33	4.62
Total:	**3.75%**	**1.00**	**3.75%**	**1.00**

OCA St. 4S at 9, Sch. JDM 1-S.

C. <u>UGI Has Failed To Reasonably Account For The Load Carrying Capability Of Its Minimum System</u>.

In determining that there is a customer component to primary and secondary distribution plant, UGI used a "minimum system" approach. Even if it is determined that some portion of primary and secondary distribution plant is customer related, UGI's minimum system is flawed. UGI's alleged "minimum system" is a hypothetical construct – it does not actually exist beyond the realm of theory, and it does not represent the way that the system is actually used in the day-to-day operations of the electric grid. Here, the fallacy in UGI's minimum system approach is that it does indeed have load carrying capability, in direct contravention of the very reason that such a hypothetical construct would be employed – in order to show a customer component through connection only to the grid with no actual usage or load placed on the system.

As Mr. Mierzwa testified, failing to recognize the load carrying capability (referred to as the Peak Load Carrying Capability, or PLCC) inherent in the hypothetical minimum system results in a double allocation of primary and secondary upstream distribution costs to Residential and other small customers. OCA St. 4 at 14. The Company argues that the fact that the minimum system has load carrying capability does not hinder its study from providing a reasonable approximation of the costs relating to the demand portion and customer portion of the distribution system. UGI St. 6R at13. The Company has not, however, conducted any assessment of the load carrying capability in its minimum system and its impacts on allocated costs upon which it can justify this claim. OCA St. 4-S at 7.

In his Rebuttal Testimony, UGI witness Mr. Taylor explained that as part of his minimum system study he made an adjustment to remove the load carrying portion of transformers, thereby, allegedly addressing Mr. Mierzwa's criticism that the Company had not accounted for the load carrying capability of the minimum system. UGI St. 6-R at 13-14. Mr. Taylor also made the statement that "minimum size poles do not have load carrying capacity." In the R.D., the ALJs appeared to rely on these statements to find UGI's minimum system study reasonable. R.D. at 117.

First, the OCA notes that transformers and poles are only functional if there are actual conductors (wires) connecting them. It does not appear that the load carrying capacity of the conductors was adjusted or otherwise taken into account by Mr. Taylor. Further, for Mr. Taylor to be correct that minimum size poles have no ability to carry load, the OCA would note that such poles would likely have to be as those described by the Commission in Pa. PUC v. Duquesne Light Co., 1985 Pa. PUC LEXIS 68, 231 (1985), where the Commission noted that the "theoretical minimum size system" "can be represented as a wet thread supported by long tooth

picks to serve a Christmas tree light." The OCA is doubtful that the minimum size poles that UGI approximated to conduct its minimum system study would meet the Commission's prior description of same.

Although the Company has indicated that it has made some adjustments to its minimum system study to account for the inherent load carrying capability, it has not performed any study to sufficiently assure that the impacts on its proposed allocated costs are indeed reasonable. Accordingly, the recommendation of the ALJs to accept UGI's flawed COSS as a guide to set rates in this proceeding should not be adopted.

D. UGI's Minimum System COSS Misallocates Primary Distribution Conductors.

As part of its minimum system study, UGI allocated approximately 30 percent of its primary distribution system based on the number of customers connected to it. OCA St. 4 at 13. Mr. Mierzwa testified that such a process creates a misallocation of costs, as follows:

> That is, 375 miles (1,250 miles x 30 percent), or 1,980,000 feet of the primary distribution system was installed to connect customers to the UGI system. UGI's system services 62,000 customers and, therefore, under Mr. Taylor's approach, each customer is allocated 32 feet of primary distribution conductor line. As indicated in the response to OCA I-7, UGI extended its primary distribution facilities by an average of 1,350 feet to connect three of its largest customers to its distribution system. Of the 5 largest customers served by UGI, the Company extended its primary distribution facilities by an average of 820 feet. Clearly, Mr. Taylor's assumption that UGI extends its primary distribution system by the same number of feet to connect a large customer and a small customer results in a mis-allocation of costs.

OCA St. 4 at 13. As noted in the R.D., UGI argued that Mr. Mierzwa was incorrect that the Company actually assigns or allocates 32 feet of conductor to each customer, but rather that the theoretical costs of such conductors were allocated. R.D. at 118. The ALJs appear to have accepted this response from the Company as an adequate resolution of the issue, as no further

discussion on this topic occurred. Mr. Mierzwa, however, did supply additional evidence on this issue in his Surrebuttal Testimony.

First, Mr. Mierzwa directly responded to the allegations from UGI that he was incorrect about the allocation of conductors, as follows:

> Mr. Taylor contends he did not allocate footage to each class but rather a determination of costs. I find there to be no distinction between allocating the costs associated with 32 feet of primary conductor line to each customer and allocating 32 feet of primary conductor line to each customer for purposes of evaluating Mr. Taylor's proposals.

OCA St. 4S at 7. Mr. Mierzwa further explained the misallocation of the primary conductors, as follows:

> As indicated in my direct testimony, under Mr. Taylor's minimum system approach, each UGI customer is allocated 32 feet of primary distribution conductor line. As also indicated in my direct testimony, it was necessary for UGI to extend its distribution system by an average of 820 feet, or more than 25 times further, to connect its largest customers to its system. Mr. Taylor's minimum system customer component does not account for these significant differences in the upstream distribution facilities associated with serving larger customers.

OCA St. 4S at 6. As OCA witness Mierzwa explained, the allocation used by UGI is not consistent with how costs are incurred on the system or accurately assigned to the entity causing such costs.

The OCA submits that this misallocation of the primary conductors results in unfair treatment of the Residential Class, and does not comport with the theory of cost causation. The Commission should review all of the evidence provided on this issue and find that the recommendation from the ALJs to adopt UGI's COSS as a guide to set rates in this matter should not be adopted.

OCA Exception No. 10: The ALJs Erred By Recommending That The OCA's Revenue Allocation Be Denied. (R.D. at 120-122; OCA M.B. at 79-83; OCA R.B. at 34-38)

In the R.D., the ALJs improperly recommended that the OCA's revenue allocation be rejected and UGI's revenue allocation be approved. R.D. at 122. The OCA submits that the ALJs' findings are in error and that the Commission should not adopt the ALJs' recommendation as to revenue allocation.

UGI argued that the revenue allocation should be based on its COSS. UGI M.B. at 146. UGI further argued that the primary factor in revenue allocation is cost of service alone and that the cost of service trumps any consideration of gradualism concerns. UGI M.B. at 145-146, 150. The OCA proposed an alternative allocation based on its own COSS. See OCA M.B. at 79-83; OCA R.B. at 28-34. OCA witness Mierzwa explained that the OCA's revenue allocation moves classes toward the costs of service, while also accounting for gradualism concerns. OCA St. 4S at 10. Like the OCA, I&E argued that the revenue allocation adopted in this proceeding must reflect the concept of gradualism. I&E M.B. at 76-77.

The ALJs recommended that UGI's revenue allocation, which is based on a flawed COSS as discussed in OCA Exception No. 9 and fails to reflect gradualism, be adopted. R.D. at 122. In recommending that the Company's revenue allocation be adopted, the ALJs merely reasoned, "OCA has presented an alternative allocation proposal that is based on its COSS which, as noted above, we have rejected in favor of UGI Electric's ACOSS" and "[a]ccordingly, OCA's rate allocation alternative is denied." Id.

The ALJs cited Lloyd v. Pa. PUC, 904 A.2d 1010 (Pa. Commw. 2004) (Lloyd) noting that the "primary goal of revenue allocation is to have rates reflect the actual cost of service," but this is an inaccurate interpretation of Lloyd. R.D. at 120. Lloyd provides that the cost of service

is a "polestar" for revenue allocation, or merely a "guide."[5] Lloyd also provides that other factors, including gradualism, avoidance of rate shock, and fundamental fairness, may be taken into consideration. Lloyd at 1020-1021. In Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 (Order entered May 18, 2017) (City of Dubois), the Commission recognized this point. The Commission stated, "while Lloyd establishes cost of service rates as the polestar of ratemaking, it **does not preclude consideration of other factors**." City of Dubois at 26; see OCA M.B. at 81-83. Because cost of service studies are more of an art form rather than a science, it is appropriate to consider factors such as gradualism in assessing the reasonableness of a proposed revenue allocation.[6]

In addition, the ALJs noted that a "proposed revenue allocation will only be found to be reasonable if it moves distribution rates for each class closer to the full cost of providing service." R.D. at 120. As OCA witness Mierzwa explained, the OCA's proposed allocation **does** move classes toward the cost of service. OCA witness Mierzwa stated:

> I assigned a less-than-average system increase to [the General Service class] because it was generating a return that exceeded the system average return. For the Large Power customer class, I assigned an increase sufficient to move the return of this class to the system average return. I assigned no increase to the Lighting customer class because the return of this class was significantly in excess of the system return. The Residential customer class was assigned the remainder of the requested increase.

OCA St. 4 at 22. Therefore, the OCA's revenue allocation properly reflects movement toward the indicated cost of service, while reflecting gradualism. OCA M.B. at 81-83; OCA R.B. at 36-37. The OCA's revenue allocation at UGI's filed revenue increase is as follows:

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[5] Polestar is a literary reference meaning "guide." The American Heritage Dictionary, Houghton Mifflin Co. (1985).

[6] See Application of Met-Ed Approval of Restructuring Plan Under Section 2806 of the Public Utility Code, 1998 Pa. PUC LEXIS 160, *159 (1998); Pa. PUC v. Pa. Power & Light, 55 P.U.R. 4th 185, 249 (Pa. PUC 1983); Pa. PUC v. Aqua Pa. Inc., Docket No. R-00072711 (Order entered July 31, 2008).

Table 3-S. OCA Proposed Revenue Distribution ($000)				
Rate Class	**Present Rates**	**Proposed Rates**	**Increase**	**Percent**
Residential	$22,180	$29,660	$6,850	30%
General Service-1	1,548	1,879	331	21
General Service-4	5,753	5,753	0	0
Large Power	5,817	6,728	911	16
Lighting	993	993	0	0
Total:	**$36,921**	**$45,013**	**$8,092**	**22%**

OCA St. 4S at 10, Table 3S.

The OCA submits that while cost of service should guide the Commission when setting rates in this proceeding, other ratemaking principles such as gradualism, avoidance of rate shock, and basic fairness must not be abandoned. The OCA further submits that its proposed revenue allocation appropriately reflects movement toward the class of service and reflects gradualism. Therefore, the OCA requests that the Commission reject the ALJs' recommendation and adopt the OCA's revenue allocation.

OCA Exception No. 11: The ALJs Erred By Recommending An Increase In UGI's Residential Customer Charge from $5.50 to $14.00. (R.D. at 123-128; OCA M.B. at 83-93: OCA R.B. at 38-41)

In the R.D., the ALJs improperly recommended an increase in UGI's Residential customer charge from $5.50 to $14.00. R.D. at 123-128. The ALJs determined that an increase from $5.50 to $14.00 is not unreasonable, that the Company properly calculated its customer cost analysis, and that the proposed Residential customer charge will not disproptionately impact low-income customers. R.D. at 123-128. For the reasons set forth below, the OCA submits that the ALJs' findings are in error and the Commission should not adopt the ALJs recommendations as to rate design.

A. The Company's Customer Cost Analysis Includes Costs That Are Not Appropriate To Include In A Customer Charge.

As discussed above, UGI Electric's cost of service study is significantly flawed. Thus, it is not a valid basis for calculating a customer charge. Moreover, as OCA witness Mierzwa explained, the Company's calculated charge of $19.01 is "based on the increase reflected in its initial application which has been subsequently reduced" and reflects costs not appropriately included in a customer charge. OCA St. 4 at 23-24. OCA witness Mierzwa explained:

> Adjusting the Company's calculated charge to reflect the Company's revised request results in a calculated charge of $17.70. However, the Company's calculated customer charge included costs not appropriately included in a customer charge: Universal Service Costs and Uncollectible Accounts. Only those costs that directly increase with the addition of a customer should be included in a customer charge. Removing these costs from the Company's calculated Residential monthly charge further reduces the charge to $12.22. Also included in the Company's calculated charge are miscellaneous customer service expenses associated with energy efficiency and conservation. These costs do not vary directly with the addition of a customer. Removing these costs reduces the calculated Residential customer charge to $10.29. Generally, all the Company Residential customer charge calculations just described are based on the Company's claimed requested increase. The calculated charge will likely be further reduced based on the increase authorized by the Commission in this proceeding.

OCA St. 4 at 23-24.

The ALJs determined that the Company "properly calculated and included relevant costs as part of its customer cost analysis." R.D. at 127. The ALJs stated that the Company's customer cost analysis is consistent with ratemaking precedent in Pennsylvania. Id.

It is well established that UGI Electric is permitted only to include costs in its customer charge calculation that are costs required to connect a customer and maintain a customer's account and that indirect customer costs should not be included in the customer charge.[7] UGI's

[7] See Pa. PUC v. Metropolitan Edison Co., 60 Pa. PUC 349 (1985); Pa. PUC v. West Penn Power Co., 59 Pa. PUC 552 (1985); Pa. PUC v. West Penn Power Co., 1994 Pa. PUC LEXIS 144, *154 (1994): Pa. PUC v. National Fuel Gas Dist. Corp., 83 Pa. PUC 262, 371 (1994).

customer charge analysis, however, includes costs that "do not vary directly with the addition of a customer." OCA St. 4 at 24. OCA witness Mierzwa properly removed "costs not appropriately included in a customer charge." OCA St. 4 at 23; See OCA M.B. at 84-87; OCA R.B. at 38-39.

Therefore, the OCA submits that UGI's cost analysis is improper and the Commission must reject the ALJs' recommendation. The OCA requests that the Commission modify the customer charge calculation to remove the above-mentioned costs. See OCA M.B. at 84-85.

B. An Increase In The Residential Customer Charge From $5.50 to $14.00 Is Unreasonable And Fails To Reflect Gradualism.

As OCA witness Mierzwa explained, the Company's proposed monthly Residential customer charge of $14.00 "reflects an increase that is 6.6 times the proposed increase for the average Residential class" and is "inconsistent with the principal of gradualism."[8] OCA St. 4 at 23. As such, the OCA recommended a $8.00 customer charge, which represents a 45 percent increase. OCA St. 4 at 25. Such an increase would typically not be reasonable, but would be acceptable in this case given the length of time since UGI's last customer charge increase. OCA St. 4 at 25. I&E likewise found that the Company's proposed increase "is excessive and violates the concept of gradualism" and recommended a lesser increase of $10.00, or 81%. OCA St. 4R at 3, 4. The OCA maintained that further gradualism is necessary. Id.

In the R.D., the ALJs determined that the increase in the customer charge is not unreasonable and that "cost of service considerations should outweigh gradualism considerations in this proceeding" and approved an increase from $5.50 to $14.00, or an increase of **250 percent**. R.D. at 126. The ALJs noted that it has been 22 years since the Company's last

[8] The ALJs refer to UGI's statement that a $14.00 charge "is less than the current charge of PPL Electric and all other Pennsylvania electric cooperatives." R.D. at 125. The customer charge of PPL and the customer charges of electric cooperatives are entirely irrelevant in this proceeding. PPL's customer charge is the highest EDC customer charge in Pennsylvania and electric cooperatives are not regulated by this Commission.

customer charge increase, but declined to apply gradualism to mitigate the impact of this dramatic increase on Residential customers.

Here, where the Company has not increased its Residential customer charge for 22 years, gradualism and avoidance of rate shock are particularly important. The Commission has stated:

> "Gradualism" is a principle of rate design that rates will be increased overtime to avoid "rate shock." *See*, Lloyd v. Pa. P.U.C., 904 A.2d 1010, 1018 (Pa Cmwlth 2006). Large rate increases have the potential to cause "rate shock" among customers. To mitigate rate shock, gradualism allows the phasing in of rates over a longer period of time and **can be considered as a factor in setting rates.**

Pa. PUC v. North Heidelberg Sewer Co., 2013 Pa. PUC LEXIS 356 (2013). An immediate increase of 250 percent has potential to result in rate shock and gradualism is a necessary consideration in this proceeding.

Therefore, the OCA submits that a monthly Residential customer charge of $14.00 violates the concept of gradualism. The OCA respectfully requests that the Commission reject the ALJs' recommendation to approve a 250 percent increase in the monthly Residential customer charge and adopt the OCA's proposed customer charge of $8.00.

C. The Residential Customer Charge Increase will Disproportionately Impact Low-Income Customers.

OCA witness Mierzwa pointed out that the Company's proposed 250 percent increase "will have a disproportionate impact on low income and lower usage customers," and OCA witness Colton provided data demonstrating that "a disproportionate number of low-income customers have electricity usage lower than the usage levels of residential customers generally." OCA St. 4 at 23, OCA St. 5 at 17; OCA St. 5S at 2.

The ALJs were persuaded by UGI's claims that "low income customers use more electricity than the average residential customer" and that the $14.00 monthly Residential customer charge will "benefit" low-income customers. UGI M.B. at 158, R.D. at 128. The ALJs

determined that "low income customers . . . will pay less under UGI Electric's proposed $14.00 customer" charge and will not be disproportionately harmed. R.D. at 128.

As OCA witness Colton explained, however, the Company's own data demonstrates that low-income customers are, in fact, low-use customers. OCA R.B. at 41-43. He stated:

> What Mr. Taylor does not acknowledge is that his Table 4 demonstrates, and supports, the very testimony which he is seeking to rebut. In *no* income range below $35,000 does the electricity usage within the range equal, let alone exceed, the residential average. In contrast, in all but three of the income ranges at or above $35,000, usage *does* exceed the residential average. In six of the thirteen income ranges above $35,000, annual usage does equal or exceed 10,000 kWh, more than 25% greater than the residential average ([10,000 – 7,815] / 7,815 = 0.2796).

OCA St. 5S at 2-3 (citations omitted) (emphasis in original). As OCA witness Colton further explained, for low-income/ low-use customers, "the customer charge is a higher overall percentage of total bills and . . . a change in the customer charge would be a larger proportionate change in the total bill." OCA St. 5 at 9.

In addition, the Company's claims that the ALJs rely on are based only on the usage of UGI Electric's CAP participants. UGI St. 6R at 33, 35; OCA St. 5S at 4. As OCA witness Colton explained, this is an inappropriate comparison that results in an invalid conclusion. UGI St. 6R at 33, 35; OCA St. 5S at 4. Mr. Colton stated:

> CAP customers are a very small percentage of UGI-Electric's overall low-income population and are not representative of the overall low-income population. CAP customers tend to be higher usage customers than are non-CAP customers. Two reasons exist for this. First, UGI Electric's CAP customers tend to be drawn from the Company's payment-troubled low-income population. There is a relationship between higher usage and nonpayment. Second, if low-income customers had lower consumption, they would choose not to participate in CAP because their bills would already be affordable even in the absence of additional assistance.

OCA St. 5S at 4. As such, CAP customers cannot be used as a surrogate for "low-income" customers generally. OCA St. 5S at 4.

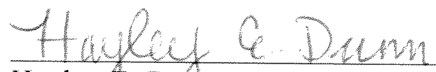
Further, the ALJs did not address the following harms of record resulting from an increased customer charge that will impact low-income customers: (1) increased CAP bills for customers who use the average monthly bill component of CAP, (2) reduced the buying power for LIHEAP customers, and (3) increased bills for low-income customers that do not participate in bill affordability programs. See OCA M.B. at 88-93; OCA R.B. at 43; OCA St. 5 at 8-16.

Therefore, the OCA submits that increasing the monthly Residential customer charge to $14.00 will disproportionately harm low-income customers. The OCA further submits that the Commission must reject the ALJs findings as to the impact of this significant increase.

III. CONCLUSION

For the reasons set forth above and in the OCA's Main and Reply Briefs, the OCA respectfully submits that the ALJs erred by recommending (1) that UGI's end of rate year rate base proposal be accepted, (2) that UGI's storm damage expense claim be accepted, (3) that UGI's employee additions expense claim be accepted, (4) that UGI's depreciation expense claim reflect end of year conditions, (5) that a 9.8% base return on equity for UGI be awarded, (6) that a management effectiveness adjustment adder of 20 basis points be awarded, (7) that end of year numbers be used to determine the amount of excess ADIT, (8) that UGI's Act 40 proposal be adopted, (9) that UGI's cost of service study be used to allocate the revenue increase, (10) that the OCA's rate allocation be denied, and (11) that an increase in UGI's Residential customer charge from \$5.50 to \$14.00 be approved. Therefore, the OCA requests that the Commission grant these Exceptions and adopt the modifications and recommendations herein and in the OCA's Main and Reply Briefs.

Respectfully Submitted,



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