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January 8, 2020

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Re: Pennsylvania Public Utility Commission
v.
Valley Energy, Inc. – Supplement No. 49
to Tariff Electric – Pa. P.U.C. No. 2
Docket No. R-2019-3008209

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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Enclosures:
cc: The Honorable Steve K. Haas, ALJ
The Honorable Benjamin J. Myers, ALJ
Certificate of Service
*282057

CERTIFICATE OF SERVICE

Re:	Pennsylvania Public Utility Commission v. Valley Energy, Inc. – Supplement No. 49 to Tariff Electric – Pa. P.U.C. No. 2	: : : :	Docket No. R-2019-3008209

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

Dated this 8th day of January 2020.

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Dated: January 8, 2020
*282053

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-2019-3008209
	:	
Valley Energy Company	:	

MAIN BRIEF
OF THE
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Dated: January 8, 2020

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Administrative Decisions

Statutes

Regulations

Other Authorities

I. INTRODUCTION

A. Valley Energy Company

In its revised Supplement No. 49 to Tariff Gas Pa. P.U.C. No. 2 (Supplement No. 49), Valley Energy Company (Valley or the Company) proposed a requested increase of approximately $834,497 in annual distribution revenues. In Rebuttal Testimony, the Company revised its request to $744,000 in annual distribution revenues. Valley proposes to increase the residential customer charge from $10.50 to $12.79, or by 21.8 percent, including a demand charge component. The effective date of the proposed rates is May 1, 2020.[1]

The Office of Consumer Advocate (OCA) recommends an increase of no more than $227,888 in annual distribution revenues rather than Valley's proposed increase of $744,000 in annual distribution revenues. For Valley's residential customer class, R, the OCA recommends an increase of the customer charge from $10.50 per month to $12.79 per month at the Company's full request. OCA St. 4 at 28. If the Commission approves less than the Company's full request, the customer charge should be increased by a percentage that reflects the Commission's final determination. OCA St. 4 at 23, 28.

As discussed in greater detail below, the OCA proposes adjustments to the Company's proposed cost of equity, rate base including the Company's use of an end of test year rate base of the Fully Projected Future Test Year including the corresponding depreciation adjustments, use of an across-the-board 3.0 percent inflation factor, cash working capital and net operating income items, including industrial/commercial meters and regulators, meters and house regulators, customer installations, mains, meter reading, customer records and collection, uncollectible

[1] The Company agreed to a voluntary extension of the proposed effective date of rates from March 31, 2020 until May 1, 2020.

accounts. Miscellaneous customer expenses, administrative & general salaries, office supplies and expenses, general advertising expense, and rate case expense. These adjustments result in the OCA's recommended increase for the annual distribution revenues. The OCA respectfully submits this Main Brief in support of the individual adjustments that underlie the recommended revenue increase.

The OCA also proposes adjustments to the Company's cost of service study and proposed allocation of revenue. The OCA also opposes the Company's proposal to include demand charges in its customer charge. If the Commission grants the Company less than its full proposed revenue request, the OCA has recommended a methodology for the scale back of a Commission-authorized rate increase. The OCA opposes the Company's proposed reconnection/disconnection fee increases.

The Company has also proposed changes to its Main Extension program. The OCA supports the Company's proposed changes its Main Extension proposal.

B. History of the Proceedings

The Office of Consumer Advocate (OCA) hereby submits this Main Brief regarding the rate increase proposed by Valley Energy, Inc.'s ("Valley"). On July 1, 2019, Valley filed Tariff Supplement No. 49 to Tariff Gas – Pa. PUC No. 2, with the Public Utility Commission (PUC or Commission) to become effective August 30, 2019 at Docket No. R-2019-3008209. In its original filing, Valley proposed an annual increase in base rate revenues of $1,034,186 per year, or a distribution base rate increase of 20.60%. Additionally, the Company proposes to increase the residential fixed monthly charge from $10.50 to $12.79. Valley's service territory is predominantly rural within the area of Bradford County and is serving approximately 6,900 customers.

Pursuant to Section 1.91 of the Commission's regulations, on July 1, 2019, Valley filed a Petition for Waiver of Filing Requirements under 52 Pa. Code Section 53.53 for the Company's Rate Increase Request Exceeding $1,000,000. On July 22, 2019, the OCA, the Office of Small Business Advocate (OSBA), and the Bureau of Investigation & Enforcement (I&E) jointly filed an answer to the petition for waiver, requesting the Commission deny the waiver. On July 29, 2019, Valley withdrew its Petition for Waiver of Filing Requirements and revised its schedules reducing its requested increase to distribution revenues from $1,034,000 to $834,497.

On July 30, 2019, the OCA filed a Formal Complaint and Public Statement. On July 19, 2019, I&E filed a Notice of Appearance. On July 22, 2019, OSBA filed a Notice of Appearance. On August 29, 2019, the OSBA filed a Formal Complaint and Public Statement.

Pursuant to the Commission's Order entered August 29, 2019, the Commission suspended Tariff Supplement No. 49 until March 30, 2020, pursuant to Section 1308(d) of the Public Utility Code, 66 Pa. C.S. § 1308(d), and initiated an investigation into the lawfulness, justness, and reasonableness of the rates, rules, and regulations proposed in Supplement No. 49 and existing rates. Subsequently, the matter was assigned to Administrative Law Judges (ALJs) Steven Haas and Benjamin Myers.

. On September 13, 2019, a Prehearing Conference was held and, on September 16, 2019, the ALJs issued a Scheduling Order. On October 2, 2019, Valley filed a Tariff Supplement to voluntarily suspend the effective date of rates until May 1, 2020.

On November 4, 2019, in accordance with the procedural schedule, a "smart" Public Input Hearing was held. At the Public Input Hearing, the borough manager from South Waverly Borough and the borough manager from Athens Borough, Bradford County Pennsylvania both testified under oath opposing future rate increases. The Company's revised suspension date adjusted the procedural schedule resulting in Hearings which were to be concluded on December 17, 2019 and Main and Reply Briefs to be filed on January 6 and January 17, 2020, respectively.[2]

On October 15, 2019, the OCA filed the Direct Testimony of its witnesses: Lafayette K. Morgan,[3] Jerome D. Mierzwa,[4] David S. Habr,[5] and Stacy L. Sherwood.[6] On November 14, 2019, the OCA filed the Rebuttal Testimony of its witness Jerome D. Mierzwa. On December 4, 2019, the OCA filed the Surrebuttal Testimony of its witnesses: Lafayette K. Morgan, Jerome D. Mierzwa, David S. Habr, and Stacy L. Sherwood. On December 13, 2019, the OCA filed the Revised Surrebuttal Testimony of its witness Stacy L. Sherwood. Evidentiary Hearings were held

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[2] Due to technical issues delaying the delivery of the transcripts, the ALJ's granted a request to extend the filing deadlines for the Main Briefs and the Reply Briefs to January 8, and January 22, respectively.

[3] OCA witness Lafayette Morgan is an independent regulatory consultant focusing in the analysis of public utility operations, with particular emphasis on rate regulation. He has reviewed and analyzed utility rate filings, focusing primarily on revenue requirements, accounting, regulatory policy and cost recovery mechanisms throughout the country. Mr. Morgan was a Senior Regulatory Analyst with Exeter Associates from 1993 through 2010. Prior to his work with Exeter Associates, Mr. Morgan was a Senior Financial Analyst with Potomac Electric Power Company. Prior to that, Mr. Morgan was a Staff Accountant with the North Carolina Utilities Commission. OCA St. 1, Appendix A.

[4] OCA witness Jerome Mierzwa specializes in utility-related consulting services. Mr. Mierzwa worked for National Fuel Gas Distribution Corporation, where he conducted financial and statistical analyses related to market activity and state regulatory affairs. He later joined National Fuel Gas Supply Corporations' rate department, where he conducted utility cost of service and rate design analysis, expense and revenue requirement forecasting, and participated in federal regulation activities. Mr. Mierzwa also prepared the Purchased Gas Adjustment filing and developed interstate pipeline and spot market gas projections. OCA witness Mierzwa joined Exeter Associates, Inc. in 1990, became a principal in 1996, and later became Vice President. He specializes in evaluating gas purchasing practices of natural gas utilities, utility class cost of service and rate design analysis, the unbundling of utility services, and evaluation of customer choice natural gas transportation programs. OCA St. 4 at 1-2.

[5] OCA witness Dr. David Habr is the owner of Habr Economics, a consulting firm founded in January 2009 that focuses on cost of capital and mergers and acquisitions. Dr. Habr received a Bachelor of Arts and a Master of Arts degree in economics from the University of Nebraska- Lincoln and a Ph.D. degree in Economics from Washington State University. Dr. Habr's professional background and qualifications are described in OCA St. 3, Exh. DSH-1.

[6] Ms. Sherwood is an Economist with Exeter Associates, Inc. At Exeter, Ms. Sherwood addresses utility revenue requirement, develops utility service assessments, provides bill and rate analysis, and assesses and evaluates the effectiveness of energy conservation and efficiency programs. Prior to joining Exeter, Ms. Sherwood served as a Regulatory Economist with the Maryland Public Service Commission (PSC). At the PSC, she performed analysis on the EmPOWER Maryland energy efficiency and demand response programs, the Exelon Customer Investment Fund, and served as lead analyst for the EmPOWER Maryland limited income programs. OCA St. 1 at 1-2, App. A.

in Harrisburg on December 16, and 17, 2019. On December 16, 2019, at the Evidentiary Hearing, the Company orally entered its rejoinder testimony into the record with an accompanying Exhibit.

As discussed herein, the OCA proposes adjustments pertaining to the Company's proposed rate base, including plant additions and cash working capital; cost of capital, including the cost of equity; operations and maintenance expenses, and revenues and taxes. The OCA's adjustments to the Company's position result in the OCA's recommended revenue requirement of no more than $227,888.

The OCA respectfully submits this Main Brief in support of its specific adjustments and recommendations.

C. Legal Standards

The Company bears the burden of proof to establish the justness and reasonableness of every element of its requested rate increase. In this regard, Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a), provides as follows:

> Reasonableness of rates – In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceedings upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa. C.S. § 315(a). The Commonwealth Court has interpreted this principle in stating that:

> Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial.

Lower Frederick Twp. v. Pa. P.U.C., 409 A.2d 505, 507 (1980) (citations omitted); see also, Brockway Glass v. Pa. P.U.C., 437 A.2d 1067 (1981).

The "term 'burden of proof" is comprised of two distinct burdens, the burden of production and the burden of persuasion." Hurley v. Hurley, 754 A.2d 1283, 1285 (Pa. Super. 2000). The burden of production dictates which party has the duty to introduce enough evidence to support a cause of action. Id. at 1286. The burden of persuasion determines which party has the duty to convince the finder-of-fact that a fact has been established. Id. "The burden of persuasion never leaves the party on whom it is originally cast." Hurley at 1286; see also Pa. PUC v. Equitable Gas Co., 57 Pa. PUC 423, 471 (1983).

The Pennsylvania Supreme Court has stated that the party with the burden of proof has a formidable task to show that the Commission may lawfully adopt its position. Even where a party has established a prima facie case, the party with the burden must establish "the elements of that cause of action to prevail, precluding all reasonable inferences to the contrary." Burleson v. Pa. P.UC., 461 A.2d 1234, 1236 (Pa. 1983) (Burleson). Thus, a utility has an affirmative burden to establish the justness and reasonableness of every component of its rate request.

The OCA notes that Pennsylvania law is clear that there is no similar burden for a party proposing an adjustment to a utility base rate filing. See e.g., Berner v. Pa. P.U.C., 116 A.2d 738 (1955). In Berner, the Pennsylvania Supreme Court stated:

> [T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations, and that is the burden which the utility patently failed to carry.

Id. at 744. The Commission recognizes this standard in rate determinations. Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C., 423, 471 (1983); see also, University of Pennsylvania v. Pa. P.U.C., 485 A.2d 1217 (1984); Pa. P.U.C. v. PPL Elec. Corp., 237 P.U.R. 4th 419 (2004). Thus, it is unnecessary for the OCA, or any challenger, to prove that the Company's proposed rates are unjust, unreasonable, or not in the public interest. To prevail in its challenge, Pennsylvania law requires only that the OCA show how the Company failed to meet its burden of proof.

Therefore, the Company must affirmatively establish the reasonableness of every element of its claims and demonstrate that its proposed rates are just, reasonable, and in the public interest. In this Main Brief, the OCA will show that the Company has failed to satisfy its statutory burden in the manner set forth below.

II. SUMMARY OF ARGUMENT

As identified in the revised Surrebuttal Testimony of OCA witness Stacy Sherwood, the OCA recommends an increase of no more than $227,888 in annual distribution revenues rather than Valley's proposed increase of $744,000 in annual distribution revenues (as revised in the Errata to the Rebuttal Testimony of Company witness Gorman). In the Company's initial filing, the Company requested an increase of $834,497 in annual distribution revenues.

As discussed herein, the OCA proposes adjustments to the Company's proposed cost of equity, rate base including the Company's use of an end of test year rate base of the Fully Projected Future Test Year including the corresponding depreciation adjustments, use of an across-the-board 3.0 percent inflation factor, cash working capital and net operating income items, including industrial/commercial meters and regulators, meters and house regulators, customer installations, mains, meter reading, customer records and collection, uncollectible accounts, miscellaneous customer expenses, administrative & general salaries, office supplies and expenses, general advertising expense, and rate case expense. These adjustments result in the OCA's recommended increase for the annual distribution revenues. The OCA respectfully submits this Main Brief in support of the individual adjustments that underlie the recommended revenue increase.

The OCA also proposes adjustments to the Company's cost of service study and proposed allocation of revenue. The OCA also opposes the Company's proposal to include demand charges in its customer charge. If the Commission grants the Company less than its full proposed revenue request, the OCA has recommended a methodology for the scale back of a Commission-authorized rate increase. The OCA opposes the Company's proposed reconnection/disconnection fee increases.

The Company has also proposed changes to its Main Extension program. The OCA supports the Company's proposed changes its Main Extension proposal.

Based on the evidence the Company has provided to support its revenue claim and the applicable law, it is clear that the Company's annual distribution revenues should increase by no more than $359,459. The Tables reflecting the OCA's adjustments and a complete set of schedules supporting the OCA's recommendations are attached to this Brief as Appendix A.

The OCA now submits this Main Brief in support of the positions set forth in the testimony of its witnesses in this case.

III. ISSUES RESOLVED AMONG THE PARTIES

Valley and the OCA have resolved issues related to treatment of Excess Deferred Income Taxes (EDIT); rate base, including use of a 13-month average for Materials and Supplies and Customer Deposits; and two expense issues raised in Rebuttal Testimony relating to a corrosion technician and indirect labor costs.

A. <u>Treatment of EDIT</u>

In Rebuttal Testimony, Company witness Gorman agreed the Company would commence Excess Deferred Income Taxes (EDIT) accretion when new rates are effective. Valley St. 1-R at 12. Mr. Gorman agreed that rates were not changed to reflect EDIT, and the Company's rebuttal Exhibit HSG-1R, Schedule C1(RE) reflects this adjustment. Valley St. 1-R at 12. The OCA agrees that the issue raised in the Direct Testimony of Lafayette Morgan has been resolved.

B. Rate Base

The rate base adjustments adopted by the Company include changes to a 13-month average for Materials and Supplies and Customer Deposit balances. In the Direct Testimony of OCA witness Morgan, the OCA adjusted Valley's Materials and Supplies balances to reflect a 13-month average instead of the Company's proposed Historic Test Year end amount. OCA St. 2 at 6. In Rebuttal Testimony, Company witness Gorman accepted the use of a 13-month average for Materials and Supplies. Valley St. 1-R at 11. The adjustment reduces the Company's rate base by $11,096. OCA St. 2 at 6, Sch. LKM-4; see, OCA witness Sherwood's flow-through of OCA witness Morgan's rate base adjustments, OCA St. 1 at 3, Sch. SLS-3; OCA St. 1-SR(Revised) at Sch. SLS-3 C; App. A, Table II.

Also, in the Direct Testimony of OCA witness Morgan, the OCA adjusted Valley's Customer Deposits balance to reflect $82,925 of Customer Deposits being held by the Company. OCA St. 2 at 7. Similar to the adjustment for Materials and Supplies, Mr. Morgan adjusted the balance to reflect a 13-month average instead of the use of the Historic Test Year end amount. OCA St 2 at 7. In Rebuttal Testimony, Company witness Gorman accepted the use of a 13-month average. Valley St. 1-R at 11. The adjustment reduces the Company's rate base by $98,293. OCA St. 2 at 6, Sch. LKM-5; see, OCA witness Sherwood's flow-through of OCA witness Morgan's rate base adjustments, OCA St. 1 at 3, Sch. SLS-3; OCA St. 1-SR (Revised) at Sch. SLS-3 C; App. A, Table II.

C. Expense Issues

In Rebuttal Testimony, Company witnesses Gorman and Levering raise a new expense issue and an adjustment to the 2019 expenses. The OCA accepts these two proposed expense adjustments. First, the Company indicates that it hired a Corrosion Technician in October 2019 and, therefore, increased direct labor and overhead in Account 887- Mains and Account 892-Services. OCA witness Sherwood testified:

> Witness Levering indicates this increase for 2019 is expected to be $45,828 in direct labor costs but does not provide an amount for the increase is expected to be $45,828 in direct labor costs but does not provide an amount for the increase in overhead expenses. Additionally, this position will impact the direct labor and overhead expenses for the FPFTY. Witness Gorman provides the impact of the hiring of this position combined with the second expense adjustment; therefore, it is unclear what the full adjustment should be for only the Corrosion Technician.

OCA St. 1-SR (Revised) at 4. Ms. Sherwood surmised that "based upon Witness Levering's adjustment for the medical leave [discussed below], it would appear that the adjustment for the Corrosion Technician would be Witness Gorman's adjustment of $96,000, less the $14,720, which would be $81,280." OCA St. 1-SR (Revised) at 4.

Second, the Company has made an adjustment to increase direct labor costs for 2019 due to the return of an employee that was on medical leave from January 19, 2019 to May 12, 2019. OCA St. 1-SR (Revised) at 4. The adjustment increases FTY expenses to mirror the employee's medical leave time as labor expenses under various accounts, as assigned by Valley witness Levering. OCA St. 1-SR (Revised) at 4. Company witness Levering indicates that the direct labor cost impact would be $14,720. OCA St. 1-SR (Revised) at 4.

IV. RATE BASE

In testimony, the OCA recommended adjustments to rate base including plant in service, construction work in progress, materials and supplies, customer deposits, and depreciation expense. These adjustments are reflected in OCA witness Morgan's Schedules LKM-1 through LKM-6 and have been reflected in OCA witness Sherwood's testimony and schedules as well as in Tables I and II attached to the Brief. OCA St. 2 at Sch. LKM-1 through LKM-6; see, OCA witness Sherwood's flow-through of OCA witness Morgan's rate base adjustments, OCA St. 1 at

3, Sch. SLS-3; OCA St. 1-SR (Revised) at Sch. SLS-1 3 C; App. A, Table II. The OCA notes that as discussed *supra* in Section III, the Company has accepted the OCA's rate base adjustments related to Materials and Supplies and Customer Deposits. OCA witness Morgan also addressed the level of depreciation expense to reflect the use of the average rate base. OCA St. 2 at 8, Sch. LKM-2. The changes to the depreciation expense as a result of the change to the average rate base method is discussed in Section VI below.

Under the Pennsylvania Code, "Rate Base" is defined as: "The value of the whole or any part of the property of a public utility which is used and useful in the public service." 66 Pa. C.S. § 102. The U.S. Supreme Court has held that a "state scheme of utility regulation does not 'take' property simply because it disallows recovery of capital investments that are not 'used and useful in service to the public.'" Duquesne Light v. Barasch, 488 U.S. 299, 301-302 (1989) (Duquesne Light).

A. Plant in Service

1. Fully Projected Future Test Year

Act 11 of 2012 took effect on April 14, 2012 and permits, *inter alia*, utilities to use a Fully Projected Future Test Year (FPFTY) when applying for a general rate increase under Section 1308(d) of the Public Utility Code. 66 Pa. C.S. § 315(e). Act 11 provides in pertinent part:

> In discharging its burden of proof the utility may utilize a future test year or a fully projected future test year, which shall be the 12-month period beginning with the first month that the new rates will be placed in effect after application of the full suspension period permitted under section 1308(d)…Notwithstanding section 1315 (relating to limitation on consideration of certain costs for electric utilities), the commission may permit facilities which are projected to be in service during the fully projected future test year to be included in the rate case.

66 Pa. C.S. § 315(e). Although the "notwithstanding" clause of Section 315 permits capital investments that are not used and useful on the first day of new rates to be included in an electric

utility's rate base during the Fully Projected Future Test Year period, Act 11 does not remove the requirement under Section 1301 of the Public Utility Code that rates be just and reasonable. 66 Pa. C.S. § 1301.

Prior to Act 11, utilities were permitted to use an Historic Test Year and a Future Test Year. An Historic Test Year (HTY) includes all of the utility's revenues, expenses, and other rate base eligible investments from an historic period defined as the prior twelve months. A Future Test Year (FTY) allows utilities to project out their anticipated revenues, expenses, and other rate base eligible investments to approximately the time that new rates became effective. Projections made under a FTY are "projected when filed, but historic at the time rates become effective." James H. Cawley & Norman J. Kennard, A Guide to Utility Ratemaking, Pa. PUC, at 86 (2018 ed.). The FPFTY, in contrast, allows for a utility to project out its revenues, expenses, and other rate base eligible investments a full twelve months past the date that new rates become effective. 66 Pa. C.S. § 315(e). Thus, unlike the FTY, projections made under the FPFTY remain projections until one year after the new rates take effective. [7]

In its July 1, 2019 filing, the Company relied upon Act 11 and used a FPFTY period ending December 31, 2020 to determine its proposed revenue increase. OCA St. 1 at 4. Valley used an end-of-year methodology for determining its rate base which assumes that on Day 1 of new rates, all projected rate base investments have already been incurred, similar to the methodology used

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[7] The Company filing and OCA witness Sherwood have utilized an historic test year ending December 31, 2018; a future test year ending December 31, 2019; and a fully projected future test year ending December 31, 2020 as the basis for determining the Company's revenue requirements and the revenue increase necessary to recover those requirements. OCA St. 1 at 2-3. The Commission's regulations require that a rate case be filed within 120 days of the Company's historic test year (HTY). 52 Pa. Code § 53.52(b)(2). On February 28, 2019, Wellsboro, Citizens' Electric of Lewisburg, and Valley Energy collectively requested a waiver of the Commission's filing requirements that requires the Companies to file within 120 days of the Company's HTY. In this case, the waiver received extended until July 1, 2019, at which time the Companies filed the instant rate cases. On March 25, 2019, at the respective rate case dockets, the Commission issued a Secretarial Letter granting the waiver.

for a FTY claim. The OCA recommends that the Company use an annual average method for determining rate base to more accurately reflect the costs as they are incurred *during* the FPFTY. In support of its position, the OCA submitted testimony from its expert witnesses, Stacy L. Sherwood and Lafayette K. Morgan. Ms. Sherwood testified that Valley's use of an end-of-year method to determine its investments and expenses during the FPFTY period failed to properly reflect costs actually incurred throughout the FPFTY period, which resulted in the Company overstating its cost of service during the first year. OCA St. 1 at 4. As OCA witness Sherwood explained, when using a FPFTY, rates must reflect costs as they are incurred throughout the year. OCA St. 1 at 4. Otherwise, rates will be set higher than the level of expenses and return that is required.

OCA witness Sherwood explained the impact of the use of the end of test year methodology instead of the average rate base methodology:

> The use of the FPFTY allows for the rate year to reflect costs incurred during the first year that the rates are in effect; however, Valley's FPFTY reflects the costs that will be incurred by year end December 31, 2020. Therefore, Valley has overstated its revenue requirement in the FPFTY by reflecting levels of costs that will be experienced at the end of the rate year rather than the levels of costs incurred during the rate year. The use of a year-end rate base would result in Valley earning a 12-month return, beginning on January 1, 2020, on the level of plant that will not be in service until December 31, 2020. The Company should not expect ratepayers to pay a return on investments not yet made by the Company.

OCA St. 1 at 4.

Simply put, the end-of-year method will allow the Company to over-earn on its investment in the FPFTY while annual average method recognizes that capital investments will be made throughout the first year that new rates are in effect. OCA St. 1 at 4. The end-of-year method is analogous to an individual telling a bank that the individual will be making an interest bearing deposit on Day 365, but the individual would like to begin receiving interest on Day 1. The bank would likely, and correctly, deny such a request because interest is only paid from the point of investment, not one year in advance. OCA witness Sherwood explained this example:

> For example, if a bank requested on December 31, 2019 to begin to pay interest on a deposit made on December 30, 2020, the bank would not agree to those terms and would not pay interest on the deposit until it was made. If the ending account balance on December 31, 2020 was $500, but the average account balance during the year was only $250, the bank would only pay interest on the average account balance and not the year-end balance.

OCA St. 1 at 4-5.

The OCA submits that the Company has not met its burden to demonstrate that the use of the end of the test year methodology for rate base results in just and reasonable rates. OCA witness Morgan explained the difference between using the end of test year plant in a FTY versus with the FPFTY:

> I continue to believe that average test year plant is appropriate to use for the FPFTY. In rate cases that predated Act 11, the revenue requirements of utilities were established based on FTY costs. Because the FTY ended at approximately the same time that new rates were scheduled to take effect, it was appropriate to make adjustments to reflect the end of the test year because those costs would have been incurred before the new rates went into effect. Adjusting plant balances to year end levels is not appropriate now that a FPFTY is being used to establish rates because those costs will not be incurred when new rates go into effect. Adjusting costs to end of rate year levels and beyond would result in the Company recovering costs from ratepayers that are in excess of the costs that will be incurred during the rate year. Therefore, the use of the end of period balance should be rejected.

OCA St. 2-SR at 2. Mr. Morgan then calculated the average rate base to be used by Ms. Sherwood. See, OCA St. 2 at Sch. LKM-1 through LKM-2; see, OCA witness Sherwood's flow-through of OCA witness Morgan's rate base adjustments, OCA St. 1 at 3, Sch. SLS-3; OCA St. 1-SR (Revised) at Sch. SLS-1 3 C; App. A, Table II.

In Rebuttal Testimony, Company witness Gorman argued that using the FPFTY average balances would "blunt the purpose of using FPFTY" and identified that the Commission had addressed this issue recently in the UGI Utilities-Electric Division rate proceeding. Valley St. 1-R at 8, citing Pa. PUC v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058, Order (Oct. 25, 2018). The Company did not provide any further justification for use of the end of test year instead of the average rate base. The OCA notes that it has challenged the Commission's determination in the UGI case at the Commonwealth Court, and oral argument in the matter was held in December 2019. See, Tanya J, McCloskey, Acting Consumer Advocate v. Pa. PUC, Case No. 1529 C.D. 2018.

The Company's proposed end-of-year method results in rates are unjust and unreasonable. Section 1301 of the Public Utility Code requires that "[e]very rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or order of the commission." 66 Pa. C.S. § 1301. Under the just and reasonable standard, a utility is provided only with "a rate that allows it to recover those expenses that are reasonably necessary to provide service to its customers as well as a reasonable rate of return on its investment." City of Lancaster (Sewer Fund) v. Pa. PUC, 793 A.2d 978, 982 (Pa. Commw. 2002). The utility bears the burden of "proving the reasonableness of its rates" and proving "the reasonableness of those expenses which form the basis for its rates." Carnegie Nat'l Gas Co. v. Pa. PUC, 433 A.2d 938, 942 (Pa. Commw. 1981); see also, Keystone Water Co., White Deer Dist. v. Pa. PUC, 477 Pa. 594, 609-610 (1978)(addressing the inclusion of a specific plant in rate base). Allowing a company to recover more than its necessary costs cannot be found to be just and reasonable.

The OCA notes that in a 2013 general rate increase case, the Illinois Commerce Commission reached the conclusion that the average rate base method was the appropriate method to use with a FPFTY:

> 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.

Re North Shore Gas Company, ICC Docket Nos. 12-0511/0512, at 38 (Order entered June 18, 2013).

The Company's proposed end-of-year method will result in rates that are unjust and unreasonable. The end-of-year method allows the Company to over-earn on its investments by collecting through rates more than the actual costs the Company incurred during the test year. 66 Pa. C.S. §§ 315(e), 1301. The proposed change from the Company's filed end of test year rate base to the OCA's proposed average rate base would decrease the Company's proposed rate base by $839,474 from $34,714,831 to $33,875,357. OCA St. 1 at Sch. SLS-3. For the reasons set forth above, the OCA submits that the Commission should utilize the average rate base method for determining its rate base.

2. Retirements

OCA witness Morgan also modified the Company's proposed retirements and contributions of plant in service in the FTY and FPFTY. OCA witness Morgan testified:

> As presented on Exhibit (HSG-1) Schedule C3, during the historical periods, the activity for each year includes plant additions and retirements in the determination of the year end balances for the FTY or the FPFTY. The exclusion of retirements causes the year end balances to be overstated. Therefore, I have determined that it is necessary to adjust plant retirements and contributions in 2019 and 2020.

OCA St. 2 at 4, Sch. LKM-1. The OCA notes that in Rebuttal Testimony, OCA witness Gorman did not specifically address Mr. Morgan's recommendations with respect to plant retirements. See, Valley St. 1-R at 11-12 (Gorman discussion of response to OCA witness Morgan's plant in service, Materials and Supplies, Customer Deposits, removal of CWIP, use of average rate base in the FPFTY, and EDIT recommendations)

The OCA submits that there is also be a corresponding effect on accumulated depreciation. OCA witness Morgan, therefore, made a corresponding adjustment to the Accumulated Depreciation Balance to remove the effect of the retired plant in service. OCA St. 2 at 4. OCA witness Morgan testified:

> On Schedule LKM-1, I have adjusted the year-end Plant in Service and Accumulated Depreciation to reflect the removal of the plant retirement amounts for 2019 and 2020 of $38,410 and $17,250 respectively. These amounts were provided by the Company in response to data requests. After reflecting these reductions, the total adjustment to Plant in Service and Accumulated Depreciation is $55,659 and $56,678, respectively.

OCA St. 2 at 5, Sch. LKM-1. Given that Mr. Morgan recalculated the plant in service to reflect the plant retirements, OCA witness Morgan provided OCA witness Sherwood with the revised information contained in Schedule LKM-2 to allow Ms. Sherwood to reflect the average plant-related balances for inclusion in rate base. OCA St. 2 at 5, Sch. LKM-2; see, OCA St. 1 at Sch. SLS-3; OCA St. 1-SR(Revised) at Sch. SLS-3 C. On Schedule LKM-2, OCA witness Morgan adjusted the year-end Plant in Service and Accumulated Depreciation to reflect the average FPFTY amounts for inclusion in rate base by $783,815 and $544,153, respectively. OCA St. 2 at 5, Sch. LKM-2; see OCA St. 1 at Sch. SLS-3; OCA St. 1-SR(Revised) at Sch. SLS-3 C.

B. Deductions from Rate Base

The Company included the Construction Work in Progress (CWIP) balance as of the end of the HTY in rate base. OCA St. 2 at 5. In the Company's response to OCA-Valley-Set-II-20, the Company stated that the reason for including CWIP in rate base is that CWIP represents funds the Company has invested in order to serve customers. OCA St. 2 at 5. The Company stated that it does not capitalize construction period interest, therefore including CWIP in rate base is the mechanism for the Company to earn a return on these assets. OCA St. 2 at 5.

OCA witness Morgan recommends that an adjustment be made to remove the CWIP balance of $114,497 from rate base. OCA St. 2 at 6, Sch. LKM-3. OCA witness Morgan testified:

> In order to qualify for inclusion in rate base, a plant item should be completed and placed in service. Moreover, the CWIP balance as of the end of the HTY is likely to already be a part of the plant that is placed in service during the FTY and the FPFTY. Therefore, the inclusion of the CWIP balance in rate base would result in a double count of those costs. For these reasons, on Schedule LKM-3, I am recommending an adjustment that removes the CWIP balance of $114,497 from rate base.

OCA St. 2 at 6, Sch. LKM-3. I&E witness Cline also testified that it is not appropriate to include CWIP in rate base and removed the Company's proposed inclusion of CWIP in rate base. I&E St. 3 at 6-8.

Company witness Gorman partially agreed with the OCA's and I&E's adjustment stating that "[i]f the Company uses the end-of-year Plant balances, then it is acceptable to remove CWIP." Valley St. 1-R at 7; <u>see</u> <u>also</u>, OCA St. 2-SR at 7. Mr. Gorman acknowledges that specific projects were not identified by the Company in this proceeding, but states that if specific projects had been identified, they would have been included. Valley St. 1-R at 7; <u>see</u> <u>also</u>, OCA St. 2-SR at 7. Company witness Gorman states that it is "notable that Mr. Morgan proposes to reject *both* projects in process during the year (CWIP) and projects completed during the year (end of year Plant), which seems self-contradictory." Valley St. 1-R at 7 (emphasis in original); <u>see also</u>, OCA St. 2-SR at 7. In Surrebuttal Testimony, OCA witness Morgan states "the relevance of that statement is unclear because he does not indicate what should be done." OCA St. 2-SR at 7.

The OCA submits that it is not appropriate to include CWIP in rate base either using an end of test year or the average rate base test year method because in either case, the plant item will not be completed and placed in service during the FPFTY. See, OCA St. 2 at 6. Moreover, CWIP balance as of the end of the HTY is likely to already be part of the plant placed in service during the FTY and the FPFTY. OCA St. 2 at 6. Inclusion of the CWIP in rate base would result in a double count. OCA St. 2 at 6.

The Commission has historically disallowed the inclusion of CWIP in rate base. See, Pa. PUC v. Emporium Water Co., 2001 Pa. PUC LEXIS *7, Order at *41 (March 8, 2001). As the Commission stated in Pa. PUC v. West Penn Power:

> [t]he inclusion in rate base of such CWIP would create a mismatch of revenues, expenses, and plant invest during the test period. It would distort the relationship among costs and revenues by preventing a proper analysis of the company's revenue requirements.

Pa. PUC v. West Penn Power, 53 Pa. PUC 410, Order at 423-424 (Aug. 27, 1979).

The OCA submits that under either the average rate base and year-end rate base approaches, it is improper to include CWIP in rate base. The Commission has been consistent on the exclusion of CWIP in rate base. The OCA submits that the Company's proposed modification to exclude CWIP only with the use of end of test year plant is without merit and should be denied.

V. REVENUES

OCA witness Mierzwa proposed to adjust Valley's FPFTY revenues to reflect the most recent available annual usage of Valley's customers. Mr. Mierzwa utilized the 12-month period ending August 2019. OCA St. 4 at 31, Sch. JDM-6, Sch. JDM-6S. In Direct Testimony, OCA witness Mierzwa's proposed adjustment would increase revenues by $164,857. Mr. Mierzwa relied upon weather data from State College, Pa. for his projections. OCA St. 4 at 31, Sch. JDM-1. In Surrebuttal Testimony, OCA witness Mierzwa updated his adjustment to reflect the most recent data available and included the more localized weather information provided in response to OCA-VI-2 rather than the State College, Pa. data he had originally used. OCA St. 4-SR at 16.

Based upon this information, OCA witness Mierzwa's updated FPFTY revenues projection is $141,561. OCA St. 4-SR at 16, Sch. JDM-6S.

In Rebuttal Testimony, Company witness Gorman testified that the Company's projection is based on a regression analysis for weather-sensitive classes. Valley St. 1 at 12. He argued that Mr. Mierzwa had not found a flaw in that analysis and recommends that Mr. Mierzwa's revenue adjustment be rejected. Valley St. 1 at 12. The OCA does not agree. The issue with Company witness Gorman's analysis is that a comparison of the Company's most recent annual revenues demonstrate that Mr. Gorman's projections will significantly understate the FPFTY revenues. OCA St. 4-SR at 15. As OCA witness Mierzwa testified:

> The flaw in the analysis supporting the Company's projections is that the results produced by the analysis significantly understate FPFTY revenues. With the exception of immaterial changes in the number of customer served, the analysis supporting the Company's revenue projections result in the same projections for Calendar 2019 and 2020. A comparison of Valley's most recent annual revenues with FPFTY provides an indication of the reasonableness of Valley's FPFTY projections. Therefore, Valley's most recent annual revenues provide for a reasonable estimate of FPFTY revenues.

OCA St. 4-SR at 15.

The OCA submits that the Company's projections significantly understate the FPFTY projections. The Company's revenues should be adjusted by $141,561 as presented in Mr. Mierzwa's Schedule JDM-6S. OCA St. 4-SR at 16, Sch. JDM-6S.

VI. EXPENSES

A. Summary

The expenses at issue in this case include expenses associated with: 1) the across-the-board 3.0 percent inflation factor applied to all expenses; 2) industrial/commercial meters and regulators, 3) meters and house regulators, 4) customer installations, 5) mains, 6) meter reading, 7) customer records and collection, 8) uncollectible accounts, 9) miscellaneous customer expenses, 10) administrative & general salaries, 11) office supplies and expenses, 12) general advertising expense, 13) rate case expense, and 14) depreciation expense.

B. Inflation Factor

The Company projected in its FPFTY Operations & Maintenance (O&M) expenses to recognize a general level of rising costs of 3.0 percent. OCA St. 2 at 8.[8] The Company identified in response to a discovery request that the 3.0 percent was determined based on judgment rather than a quantitative method and referenced Producer Price Index (PPI) data sourced from the Bureau of Labor Statistics (BLS) that suggest an historical PPI inflation rate higher than 3.0 percent. OCA St. 2 at 8. The Company has used the 3.00 percent inflation rate as a proxy for determining the FPFTY O&M expenses rather than using forecasted data. OCA St. 2 at 9. The OCA submits that the Company's proposed across-the-board 3.0 percent growth rate for determining the FPFTY expenses is unreasonable and must be rejected.

A proposed across-the-board 3.0 percent growth or inflation rate is not known and measurable and is not consistent with the law. As OCA witness Lafayette Morgan testified:

> These inflationary adjustments are not actually known and measurable because they do not reflect the true cost of expenses. Inflation adjustments are typically blanket adjustments or increases which do not directly relate to actual costs expected to be incurred by the Company in the period in which rates are set. Costs should be based upon evidence or documentation that supports the Company's adjustments. I do not believe the determination of expenses for the FPFTY was envisioned to be simply applying an inflation rate to expenses. Therefore, my recommendation to Ms. Sherwood is to remove the inflation adjustment from the revenue requirement determination.

OCA St. 2 at 9.

[8] The OCA notes that the Company did amend its proposal for the FPFTY to annualize 9 months of actual data and then to apply the 3% inflation factor across-the-board to the annualization. Valley St. 1-R at 8-9; see, OCA St. 1-SR (Revised) at 7. The OCA submits that the Company's determination to annualize the actual data does not impact the OCA's arguments regarding why an across-the-board inflation factor is not appropriate.

OCA witness Sherwood then flowed through this adjustment to remove the inflation factor for all expenses for the FPFTY. As Ms. Sherwood testified, this adjustment impacts all expenses for the FPFTY as the inflation factor was applied to all FTY expenses. OCA St. 1 at 3-4. Ms. Sherwood testified:

> To reflect this adjustment, for accounts that I do not recommend specific adjustments, I used the Company's proposed FTY budget for FPFTY. These adjustments are reflected on Schedule SLS-1. By not using the Company's proposed inflation factor, I reduced these accounts by $77,164. For the accounts which I have recommended specific adjustments, I have not utilized an inflation factor to determine the FPFTY.

OCA St. 1 at 4.

In Rebuttal Testimony, Company witness Gorman argued that the Commission has historically recognized the use of inflation factors in projecting costs. Valley St. 1-R at 8-9. In support of his claim, Mr. Gorman cites to the Commission's Orders in two Pennsylvania-American Water Company rate cases, Docket No. R-00038304 (Order entered January 29, 2004) and Docket No. R-880916 (Order entered October 21, 1988). See, Valley St. 1-R at 10, citing Pa. PUC v. Pennsylvania-American Water Co., Docket No. R-00038304, Order at 35 (Jan. 29. 2004); Pa. PUC v. Pennsylvania-American Water Co., *et al.*, Docket No. R-880916, Order at 54 (Oct. 21, 1988).

The OCA submits that the Pennsylvania-American cases cited by Mr. Gorman are not applicable here. The basis of the cost of service in the cases he has cited differs substantially from the FPFTY filed in this matter. and the inflation factor was applied to a limited number of residual expenses. As OCA witness Morgan testified:

> First, it is important to recognize that the cases cited by Mr. Gorman pre-date Act 11. In other words, those cases were not based upon Fully Projected Future Test Years (FPFTY). The cases cited by Mr. Gorman were filed at a time when utilities were limited to the use of either a historical test year (HTY) or the partially projected future test year (FTY). When developing the FTY or the adjusted HTY, the cost of service was based upon costs that were known, measurable and certain. Act 11 amended Chapter 3 of the public utility code to allow jurisdictional utilities

> to make rate case claims based on a FPFTY. However, utilities are not restricted or required to use the FPFTY. The partially projected future test year (FTY) can still be used.
>
> Under the HTY and FTY approach, utilities are required to adjust their actual historical cost of service using the known and measurable principle. When the HTY and FTY approach is used, companies do not base their entire cost increases on an inflation escalation. Thus, in Pennsylvania-American Water Company (PAWC) rate cases, that company would typically adjust the various cost elements based on known and measurable cost increases, and only adjust residual expenses using an inflation factor. The residual expense adjustment generally turned out to be minor relative to the adjustments made and the total cost of service.
>
> I disagree with the Company's approach to developing the cost of service because it is extremely improper since the Company's projections are not based upon planned activities or normal Company operations. The Company's very simplified blanket inflation approach is not a projection as envisioned by Act 11.

OCA St. 2-SR at 3 (footnote omitted).

Escalation of the historical amounts by an inflation factor is not an appropriate method of cost projection consistent with Section 315 of the Public Utility Code because it bears no relationship to the activities planned for the rate year. OCA witness Morgan testified:

> In fact, the utility does not meet its burden of proof by applying the inflation to all its costs because there is no way to assess the reasonableness of the FPFTY expenses relative to HTY or the FTY expenses. In my experience with other utilities filing a FPFTY, the utilities have been able to demonstrate and explain reasons for FPFTY cost changes based upon specific causes such as unit price increases, planned activities, and abnormal activity in the HTY. For Valley, no such detail or causes can be provided because the only explanation is the choice of the inflation escalation rate.

OCA St. 2-SR at 5.

The Commission has often that found across-the-board inflation factors, or attrition adjustments, should not be used to establish rates because they are speculative in nature. <u>See</u>, <u>Pa. PUC v. Philadelphia Gas Works</u>, 2007 Pa. PUC LEXIS 45 (Sept. 28, 2007)(<u>PGW</u>); <u>Pa. PUC v. Philadelphia Electric Co.</u>, 1990 Pa. PUC LEXIS 155 (May 16, 1990)(<u>PECO 1990</u>)(rejection of attrition adjustment related to Limerick 2); <u>Pa. PUC v. Philadelphia Electric Co.</u>, 58 Pa. PUC 7, 11-12 (1983) (PECO 1983). For example, in a similar fashion as the Company proposes here, PGW sought to determine O&M expenses by increasing expenses across-the-board using a 2% inflation factor, and the Commission denied the proposed use of a five-year forecast with a 2% inflation factor. Similarly, in the PECO 1983 case, the Commission stated "however in the final analysis the company's proposed attrition adjustment must be rejected as speculative in nature." PECO 1983 at 12.

The OCA also submits that even if an inflation factor is considered, the calculation of the Company's proposed inflation factor is unreasonable. OCA witness Morgan testified:

> [a] better measure of inflation for ratemaking purposes would be the forecasted Gross Domestic Product-Price Index (GDP-PI) of 2.1 percent for calendar year 2020 instead of the Company's 3.0 percent. This forecasted GDP-PI of 2.1 percent for calendar year 2020 was obtained from the August 2019, Volume 44, No. 8 *Blue Chip Financial Forecast*. The Blue Chip Financial Forecast is a well-respected publication that is used as a source of economic data. I believe the use of projected GDP-PI is more reasonable than the Company's judgmental approach for three reasons. First, past history is not a good predictor of future inflation. Therefore, relying on past inflation is not reasonable. Second, the 3.0 percent used by the Company was judgmental and did not rely upon an objective quantitative approach for determination. Third, it is a misuse of the PPI to forecast operating costs, especially for projecting expenses for ratemaking purposes. According to the Bureau of Labor Statistics' website,
>
>> The Producer Price Index is a family of indexes that measures the average change over time in the selling prices received by domestic producers of goods and services. PPIs measure price change from the perspective of the seller. This contrasts with other measures, such as the Consumer Price Index (CPI), that measure price change from the purchaser's perspective.
>
> The cost changes that the Company is attempting to project are not its price changes. Rather, the cost changes are those [Valley] is projecting for prices or costs it (as a purchaser) will pay in obtaining goods and services. Thus, the PPI is not an appropriate tool to measure the change in costs.

OCA St. 2 at 9-10 (footnote omitted).

In Mr. Gorman's Rebuttal Testimony, he testifies that "[a]t a minimum, the OCA's alternative measure of inflation should be adopted (i.e., 2.1%)" Valley St. 1 at 9. By presenting the alternative inflation rate, the OCA is not suggesting that an across-the-board inflation factor is appropriate. The use of any inflation factor in the manner employed by the Company is improper. As the OCA points out, the Company has also utilized an overstated inflation factor that is not appropriate, and if the Commission disagrees with the OCA's recommendation, a more appropriate inflation factor should be used.

For the reasons set forth above, the OCA submits that the proposed 3.0 percent inflation factor applied to all expenses is not known and measurable or consistent with the law. Moreover, the Company's proposed calculation of the 3.0 percent factor is also flawed. The Commission should reject the Company's use of an inflation factor and adopt the OCA's adjustment.

C. Account 876 - Industrial/Commercial Meters and Regulators

The Company projects that the total cost of industrial/commercial meters and regulators will be $73,475. OCA St. 1 at 5. This expense is 12 percent, or $8,071, higher than the HTY. OCA St. 1 at 5. OCA witness Sherwood demonstrated that the Company experienced an increase in expense from 2017 to 2018 of $11,437, which the Company stated was due to increased material and labor costs associated with increased maintenance needs in 2018. Id. In Direct, Ms. Sherwood noted there was no evidence provided by the Company that the increased maintenance needs experienced in 2018 would continue to increase, which led to her initial recommendation that the Company use a three-year average of the Account 876 expenses for 2016 through 2018, as this takes into account the increased maintenance costs that my occur. OCA St. 1 at 5-6. Using the average expense for Account 876, Ms. Sherwood calculated the three-year average total expense to be $57,730. OCA St. 1 at 6.

In rebuttal, the Company responded stating that the increase in expenses from historical costs is due to aging infrastructure and a resulting increase in maintenance activities. Valley St. 4 at 6. Further, the Company demonstrated that approximately 30 percent of the annual expenses are incurred in the fourth quarter and as a result, the Company believes that no adjustment should be made because it will likely meet or exceed FTY budget projections. Valley St. 4 at 6-7. When asked if the Company's justification for their expenses increase changed her recommendation, OCA witness Sherwood responded:

> Yes, but I still do not agree with the Company's projections. It is evident that in the past two years, the fourth quarter expenses are equivalent to approximately 30 percent of the annual expenses. However, I do not agree that the Company will exceed or meet the FTY projections. The Company projected that the FTY expenses will be $71,587; however, if you annualize Account 876 by increasing the nine month expense by 30 percent, it only increases from $48,034 to $62,444, which is approximately $9,100 less than the Company's projection. Furthermore, witness Gorman accepts a lower claim of $7,508 as part of his adjustment to the FPFTY O&M claim. . . I am proposing to accept the Company's FTY annualized claim for Account 876. As a result, this decreases my adjustment from $15,730 to $9,429.

OCA St. 1-SR (Revised) at 7.

OCA witness Sherwood proposes to accept the Company's FTY annualized amount for Account 876, as a result, decreasing her adjustment from $15,730 to $9,429. OCA St. 1-SR (Revised) at 10; App. A, Table II. This amount more closely reflects the Company's maintenance costs.

D. <u>Account 878 – Meters and House Regulators</u>

The Company projects that the total cost of meters and house regulators will be $172,563. OCA St. 1 at 6. This expense is $28,488 or 20 percent, higher than the expense in HTY. OCA St. 1 at 6. OCA witness Sherwood disagreed with the Company's forecast. OCA St. 1 at 6. In rebuttal, the Company argued that the increase from 2018 to 2019 of $24,029, is related to its projected increase in meter reading expenses. Valley St. 4 at 7. Additionally, the Company states that an increase in one account may result in decreases in another account in the same year, as employee's hours are shifted to work on various projects as needed. Valley St. 4 at 7.

OCA witness Sherwood recommends the Company use a three-year average of the Account 878 expenses for 2016 through 2018, which will take into account the increased costs that may occur. OCA St. 1 at 7. Using the three-year average, Ms. Sherwood calculated a total expense of $138,827. OCA St. 1 at 7. Because of the three-year average, OCA witness Sherwood adjusted the Account 878 expense by $33,736, this adjustment is reflected in Schedule SLS-5. OCA St. 1 at 7, App. A, Table II..

E. Account 879 – Customer Installations

The Company projects that the total cost of customer installations will be $132,269, which is $17,933, or 16 percent, higher than the expense in the HTY. OCA St. 1 at 7. OCA witness Sherwood states that while overhead cost can vary from year to year, the Company provides no explanation for an increase of this magnitude. OCA St. 1 at 7. Ms. Sherwood therefore recommends that the Company use a three-year average of the Account 879 expenses for 2016 through 2018, which will take into account the increased maintenance cost that may occur. OCA St. 1 at 7-8.

In rebuttal the Company witnesses did not respond directly to the OCA's recommendations regarding Accounts 879 but made general comments about all line items of O&M expenses. Valley St. 1-R at 9. Company witness Gorman criticized OCA witness Sherwood's adjustments to O&M expense in general. Valley St. 1-R at 9. Specifically, Gorman disagrees with OCA witness Sherwood's methodology, for example, using a 3-year average. Valley St. 1-R at 9.

OCA witness Sherwood responded by stating:

> I recommended adjustments to accounts that appeared to have aberrations based upon historical trends and year-to-year comparisons. If the Company reasonably justified the expense increases, then I accepted the Company's proposed claim. . . . Mr. Gorman is incorrect about my methodology for proposing adjustments. My methodology did not vary by years, rather if the adjustment was not focused on labor and overhead expenses, I recommended that a three-year average be used to determine the expense for FTY. If the adjustments were for labor and overhead expenses, then I recommended that a three percent increase be applied to HTY labor and overhead expenses. My methodology for proposing the adjustments varied, it was done to provide a fair adjustment for the Company.
>
> Witness Gorman states that the entire year's expenses should be evaluated; however, I would argue that multiple years should be evaluated when considering the budget for the FPFTY. While expenses may be running close to the Company's overall FPFTY claim, it does not necessarily mean that the level of expenses incurred in FTY will be incurred in FPFTY due to one-time expenses and/or unexpected projects. Furthermore, there is potential for expenses in the FTY to be higher or lower in that year in comparison to other years. Therefore historical expense trends should be considered along with known and measurable increases when setting rates.

OCA St. 1-SR (Revised) at 8-10.

OCA witness Sherwood, using the average expense for Account 879, calculates the three-year average total expense to be $117,396. OCA St. 1 at 8. This methodology properly accounts for variations and aberrations in year-to-year expenses to develop a normal level of on-going expense. Ms. Sherwood's adjustment is reasonable and should be adopted. App. A, Table II..

F. Account 887 – Mains

The Company projected that the total cost of mains will be $98,308. OCA St. 1 at 8. This expense is $41,499, or 73 percent, higher than the expense in the HTY. Id. The Company reasoned the increase is due to "additional purchases for an ongoing project to update signage, pipeline markers, and corrosion studies." OCA St. 1 at 8. OCA witness Sherwood originally adjusted account 887 by $31,816 however after reviewing the Company's rebuttal amended her adjustments, stating:

> Q. WHY DID WITNESS ROGERS NOT ACCEPT YOUR ADJUSTMENT TO ACCOUNT 887 – MAINS?
>
> A. The Company indicated that it has not completed the updated project and will likely continue to experience similar levels of expense due to ongoing maintenance to address its aging infrastructure. Witness Rogers did state that the only one-time expense may be related to signage purchase, which was $1,219.
>
> Q. DOES THE COMPANY'S JUSTIFICATION FOR AN INCREASE IN EXPENSES FOR ACCOUNT 887 CHANGE YOUR RECOMMENDATION?
>
> A. Yes. As a result, I am lowering my adjustment from $19,988 to $1,219.

OCA St. 1-SR (Revised) at 10-11.

OCA witness Sherwood's adjustment for Account 887 is $1,219. OCA St. 1-SR (Revised) at 11; App. A, Table II.

G. Account 902 – Meter Reading Expense

The Company projects that the total meter reading expenses will be $99,668, which is $14,821, or 17 percent, higher than the expense in HTY. OCA St. 1 at 9. OCA witness Sherwood noted that the most significant increase is from the HTY to the FTY, when the Company forecasts that overhead expenses will increase by $11,195, or 31 percent. OCA St. 1 at 9-10. The Company cites overhead expenses of payroll taxes and estimated increases in benefits costs such as healthcare and retirement; however, the Company through the first half of 2019 has not experienced this level of overhead expenses. OCA St. 1 at 9-10.

In rebuttal the Company witnesses did not respond directly to the OCA's recommendations regarding Accounts 902 but made general comments about all line items of O&M expenses. Valley St. 1-R at 9. Company witness Gorman criticizes OCA witness Sherwood's adjustments to O&M expense in general. Valley St. 1-R at 9.

OCA witness Sherwood responded by stating:

> I recommended adjustments to accounts that appeared to have aberrations based upon historical trends and year-to-year comparisons. If the Company reasonably justified the expense increases, then I accepted the Company's proposed claim. . . . Mr. Gorman is incorrect about my methodology for proposing adjustments. My methodology did not vary by years, rather if the adjustment was not focused on labor and overhead expenses, I recommended that a three-year average be used to determine the expense for FTY. If the adjustments were for labor and overhead expenses, then I recommended that a three percent increase be applied to HTY labor and overhead expenses. My methodology for proposing the adjustments varied, it was done to provide a fair adjustment for the Company.

OCA St. 1-SR (Revised) at 8-10.

In this case, the Company has failed to justify the significant increase particularly as the actual cost in the first half of 2019 have not experienced such a level of increase. Therefore, Ms. Sherwood recommends that the Company increase the labor and overhead costs by three percent, coincident with the approved salary increase for FTY. OCA St. 1 at 9-10. Using this methodology, OCA witness Ms. Sherwood calculated the Account 902 expense be $86,821 in the FPFTY, leading to her adjusting the Account 902 by $12,847. OCA St. 1 at 10, Schedule SLS-8; App. A, Table II.

H. Account 903 – Customer Records & Collection

The Company projects that the total customer records and collection expenses will be $513,237. This expense is $45,272, or 10 percent, higher than the expense in HTY. OCA St. 1 at

10. OCA witness Ms. Sherwood does not agree with the Company's forecast for Account 903. OCA St. 1 at 10. OCA witness Sherwood demonstrates that while the Company cites increases from overhead expenses of payroll taxes and estimated increases in benefits, this level of overhead expenses has not been experienced by the Company through the first half of 2019. OCA St. 1 at 10-11. Therefore, Ms. Sherwood recommends that the Company increase the HTY overhead costs by three percent, coincident with the approved salary increase for FTY, which equates to $182,523 in FPFTY overhead costs. OCA St. 1 at 11. Then, after adjusting to remove the Company's inflation factor to calculate FPFTY expenses, OCA witness Sherwood calculated the Account 903 expense to be $480,261. Id. OCA witness Sherwood is adjusting the Account 903 expense by $32,977, this adjustment is reflected in Schedule SLS-9. OCA St. 1 at 11.

In rebuttal the Company witnesses did not respond directly to the OCA's recommendations regarding Accounts 903 but made general comments about all line items of O&M expenses. Valley St. 1-R at 9. For the same reason as meter reading expense, the Company does not directly respond to OCA witness Sherwood's adjustments which demonstrate the expenses are not trending in a way that supports the Company's forecast. App. A, Table II.

I. Account 904 – Uncollectible Accounts

The Company projects that the total expense for uncollectible accounts will be $100,799. This expense is $46,787, or 87 percent, higher than the expense in HTY. OCA St. 1 at 11. OCA witness Sherwood does not agree with the Company's forecast for Account 904. OCA St. 1 at 11. As explained by Ms. Sherwood:

> The Company states that the uncollectible accounts, or bad debt reserve, are based on monthly sales. Per Attachment I&E-RE-17-D, the Company has utilized a factor of 0.005 percent of monthly sales revenue to determine the bad debt reserve. Under the assumption that the Company used this factor for 2020, this would indicate that the Company is projecting over $20 million in gross revenue, which

> would be more than double the amount of the highest gross revenue recognized by Valley since 2014. It is highly unlikely that Valley will experience revenues of this magnitude even with its projected growth.
>
> To calculate the bad debt reserve using the same methodology that the Company has utilized in previous years, I calculated the percentage of annual gross revenues recognized in each month for the years 2016 through 2018. I then averaged the monthly percentage of gross revenue for each year to determine how to distribute the projected revenue for the FPFTY . . . Utilizing the Company's requested revenue requirement and its projected natural gas sales volume multiplied by $0.15 per one hundred cubic feet (ccf), the Company's bad debt reserve should only be $49,397 in the FPFTY.

OCA St. 1 at 12-13 (footnotes omitted). I&E witness Grab also recommended a reduction in Uncollectible Account expense. I&E St. 1-SR at 20. The Company did not specifically respond to OCA witness Sherwood's adjustments which demonstrate the expenses are not trending in a way that supports the Company's forecast.

OCA witness Sherwood recommends that the bad debt reserve be adjusted based upon the Company's approved revenue requirement and projected sales at the conclusion of this case, however because that is unknown, OCA witness Sherwood used the Company's requested revenue requirement as a placeholder and calculated an adjustment of $51,403 to Account 904. OCA St. 1 at 13. This adjustment is reflected in Schedule SLS-10. Id. App. A, Table II.

J. Account 905 – Miscellaneous Customer Expenses

The Company projects that the total cost of miscellaneous customer expenses will be $24,449, which is $4,628, or 17 percent, lower than the HTY. OCA St. 1 at 14. OCA witness Sherwood demonstrates that although the account has been adjusted for a decrease in transportation, materials, and supplies, the Company did not adjust the account for the inclusion of $8,267 in 2018 for an IT backup system expense that should have been capitalized. OCA St. 1

at 14. OCA witness Sherwood recommends that the Account be lowered $15,469 to account for the one-time expense and to eliminate the Company's inflation adjustment. This adjustment equals $8,980 and is reflected in Schedule SLS-11. OCA St. 1 at 14.

Company witness Gorman did not respond to the tax adjustment but responded generally by making general comments about all line items of O&M expenses. Valley St. 1-R at 9. OCA witness Sherwood's adjustment is reasonable, removes one-time expenses and should be adopted. App. A, Table II.

K. Account 920 – Administrative & General Salaries

The Company projects that the total administrative and general salaries expenses will be $536,697. OCA ST. 1 at 14. This expense is $94,081, or 21 percent, higher than expense in HTY. OCA St. 1 at 14. OCA witness Sherwood does not agree with the Company's forecast for Account 920, noting that the most significant increase is noted from the HTY to the FTY, when the Company forecasts that overhead expenses will increase by $69,965, or 30 percent. OCA St. 1 at 15. The Company cites overhead expenses for payroll taxes and estimated increases in benefits costs such as healthcare and retirement, however, this level overhead expenses has not been experienced by the Company through the first half of 2019. Id. Ms. Sherwood shows that from January 1 through June 30, 2019, Valley recognizes $122,968 in overhead expenses and $233,316 in total expenses for Account 920 and if overhead costs were doubled, this would be approximately $55,100 below the Company's projections for FTY overhead expenses. OCA St. 1 at 15. OCA witness Sherwood recommends that the Company increase the HTY overhead expenses by three percent, coincident with the approved salary increase for FTY, which equates to $238,024 in FPFTY overhead costs. OCA St. 1 at 15. Adjusting to remove the Company's inflation factor to calculate FPFTY expenses, Ms. Sherwood calculates the Account 920 expense to be $460,052 in the FPFTY. OCA St. 1 at 15.

In rebuttal the Company witnesses did not respond directly to the OCA's recommendations regarding Accounts 920 but made general comments about all line items of O&M expenses. Valley St. 1-R at 9. Company witness Gorman criticizes OCA witness Sherwood's adjustments to O&M expense in general. Valley St. 1-R at 9. Mr. Gorman however, does not respond to or address the fact that the Company's actual costs are not trending toward these projections. As such, the OCA's adjustments are reasonable, reflect the experience of past rate base cases and should be adopted.

OCA witness Sherwood is adjusting the Account 920 by $76,645, this adjustment is reflected in SLS-12. App. A, Table II.

L. Account 921 – Office Supplies and Expenses

The Company projects that the total administrative and general salaries expense will be $74,701, this expense is $22,677, or 44 percent, higher than the expense in HTY. OCA St. 1 at 16. The most significant increase is noted from the HTY to the FTY, when the Company forecasts that travel and training expenses will increase by $18,961, or 54 percent. OCA St. 1 at 16. The Company cites the need for increased training for new hires and replacements as the reasons for these expenses, however, Ms. Sherwood noted that Valley is only anticipating one new hire in the FPFTY, indicating that the training expense should not increase from prior years. OCA St. 1 at 16.

In addition, OCA witness Sherwood demonstrated that it is unlikely that the Company will experience such an increase based upon its travel and training expenses recognized through the first half of 2019. If doubled, the 2019 expenses would be approximately $20,000 below the Company's projections for the FTY. OCA St. 1 at 16. Therefore, Ms. Sherwood recommends that the FPFTY reflect the HTY travel and training expenses and that the remainder of the Account

921 expenses reflect the FTY levels to eliminate the use of the Company's inflation factor used to determine FPFTY. OCA St. 1 at 16. Using this methodology, Ms. Sherwood calculates the Account 921 travel and training expense to be $41,806 in the FPFTY, which would bring the Account 921 FPFTY total to $55,191. Id.

Company witness Rogers responded that the increase is due to new employee and existing employee training and relies on Mr. Gorman's testimony. Valley St. 4 at 8-9. Mr. Gorman responded generally to Ms. Sherwood's Account 904 adjustment, making general comments about all line items of O&M expenses, rather than addressing the specific reasons for her adjustment and presenting no evidence such as extensive training demonstrating the actual expenses are not trending toward the forecasts. Valley St. 1-R at 9.

MS. Sherwood adjusted the Account 921 expense by $19,510, this adjustment is reflected in Schedule SLS-13. OCA St. 1 at 16-17; App. A, Table II.

M. Account 930 – General Advertising Expense

The Company noted in response to I&E-RE-31-D that this account should be titled "Miscellaneous General Expenses" and not "General Advertising." OCA St. 1 at 17. The Company projects that the miscellaneous general expenses will be $73,373, which is almost the same as the level experienced in the HTY. It is approximately $20,000 higher than it was in 2017, however, after accepting the known and measurable adjustments offered by the Company, OCA witness Sherwood continues to challenge the inclusion of off-site volunteering labor. OCA St. 1-SR (Revised) at 12.

OCA witness Sherwood recommends adjusting the Account 930 by $3,889. OCA St. 1-SR (Revised) at 12. App. A, Table II.

N. Rate Case Expense

The Company claims $271,000 of rate case expense normalized over 36 months, for an annual expense of $90,333. OCA St. 1-SR (Revised) at 13. The OCA has not recommended any adjustment to the level of expense claimed, but does recommend an adjustment to the 36-month normalization period proposed by the Company. OCA St. 1 at 18. The OCA submits that a 60-month normalization period is appropriate. OCA St. 1 at 18, see also OCA St. 1-SR (Revised) at 13.[9]

Company witness Gorman stated that the 3-year normalization period is appropriate, as that is the time period since its last rate case filing. OCA St. 1-SR (Revised) at 13. Additionally, the Company cites increased revenues shortly after 2010 allowing them to delay filing a rate case for nine years. Id.

OCA witness Sherwood recommends a 60 month normalization period stating:

> There is Commission precedent to utilize the average period between rate cases to determine the normalization of the rate case expense, as I have done to calculate the normalization period in this case. This method does not penalize or discourage the Company from filing a rate case as needed, rather it is a way to match the expense recovery over the average period of time of when cases are filed. Therefore, I maintain my recommendation to utilize a 60 month normalization period. Additionally, as with the Company's concern regarding under-recovery, there is concern for over-recovery of rate case expense if the Company does not file within the time period.

OCA St. 1-SR (Revised) at 13.

The Company's rate case expense must be adjusted to reflect a proper normalization period that is consistent with Commission precedent. The Commission has consistently held that rate case expenses are normal operating expenses, and normalization should, therefore, be based on the

[9] I&E witness Grab recommends a normalization period of 60 months and disagrees with the Company's proposal because "the Company's proposed 36-month normalization period is based on mere speculation." I&E St. 1-SR at 11-12.

historical frequency of the utility's rate filings. Popowsky v. Pa. PUC, 674 A.2d 1149, 1154 (Pa. Commw. 1996); Pa. PUC v. Columbia Water Co., 2009 Pa. PUC LEXIS 1423 (2009); Lancaster Sewer, 2005 Pa. PUC LEXIS *84; Pa. PUC v. National Fuel Gas Distriburtion Corp., 84 Pa. PUC 134, 175 (1995); Pa. PUC v. Roaring Creek Water Co., 73 Pa. PUC 373, 400 (1990); Pa. PUC v. West Penn Power Co., 119 PUR4th 110, 149 (Pa. PUC 1990). In recent cases the Commission reiterated that the normalization period is determined, "by examining the utility's actual historical rate filings, not upon the utility's intentions." Pa. PUC v. City of Lancater – Bureau of Water, 2011 Pa. PUC LEXIS 1685, *56-57 (Lancaster 2011); Pa. PUC v. Metropolitan Edison Co., 2007 Pa. PUC LEXIS 5 (2007); Lancaster Sewer, 2005 Pa. PUC LEXIS *84; Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 (Order entered May 18, 2017, at 65) (City of Dubois).

By changing the normalization period, OCA witness Sherwood is recommending an adjustment of $36,133. This adjustment is reflected in SLS-15. OCA St. 1 at 18; App. A, Table II.

O. Cash Working Capital

The Company calculated its cash working capital based upon 12.5 percent or one-eighth of the operations and maintenance ("O&M") expense, excluding depreciation expense, uncollectible expense and taxes. OCA St. 1 at 19. OCA witness Sherwood as well as I&E witness Grab adopted the Company's methodology. OCA St. 1 at 19, I&E St. 1 at 22-24. OCA witness Sherwood states:

> Valley calculated its cash working capital based upon 12.5 percent or one-eighth of the operations and maintenance ("O&M") expense, excluding depreciation expense, uncollectible accounts, and taxes other than income. I have adopted this methodology, except that, as shown on Schedule SLS-16, I have adjusted the cash working capital to $349,226, accounting for my recommended adjusted O&M expenses.

OCA St. 1 at 9.

OCA witness Sherwood is recommending adjusting working capital based on the final level of O&M expense. OCA St. 1 at 19; App. A, Table II.

P. Depreciation Expense

As a result of Valley's use of the end of test year rate base, Valley has also based its rate year depreciation expense on the projected balance of plant in service as of the end of the FPFTY. OCA St. 2 at 7. For the reasons set forth in Section IV(A)(1) above, the OCA recommends that the Company use an average test year rate base instead of the Company's proposed end of test year rate base. The OCA submits that as a result of the OCA's proposed modification to use the average rate base, the related depreciation expense would also change. OCA witness Morgan explained the impact of the change:

> [t]he plant in service amount included in rate base was adjusted to reflect the average plant in service during the FPFTY instead of the end of period plant balance used by the Company. In my derivation of the level of depreciation expense that will be incurred during the rate year, I have calculated depreciation expense based on the average balance of plant in service after reflecting the retirements and plant contributions. I have based this calculation on the depreciation rates for the categories of plant accounts proposed by Valley in this case. Hence, the depreciation adjustment only reflects changes in the depreciable balances. As shown on Schedule LKM-2, my adjustment to reflect the depreciation expense that will be incurred during the rate year ending December 31, 2016 reduces depreciation expense by $33,805.

OCA St. 2 at 8.

VII. FAIR RATE OF RETURN

A. Introduction

Valley seeks a 7.72% overall rate of return, including a 10.60% return on common equity.[10] Valley St. 2-R at 2. The Company's proposed capital structure is 52.55% equity/ 47.45% debt. Exhibit HSG-1, Schedule C1-2. The Company's proposed cost of capital is excessive as both the testimony of OCA witness David S. Habr, I&E witness Christopher M. Henkel, and the following discussion demonstrate. Dr. Habr's testimony demonstrates that a fair cost of common equity is 8.34% and a fair overall rate of return is 6.75%. OCA St. 3 at 3. The OCA submits that Dr. Habr has presented a reasonable cost of capital proposal that accurately portrays the current low cost capital environment and reflects reasonable returns for investors. The Company, OCA, and I&E proposals presented in this matter are summarized below.

Valley presented the testimony of Dylan W. D'Ascendis to support its rate of return request. The following table summarizes the Company's request:

Capital Type	**Percent of Total (%)**	**Cost Rate (%)**	**Weighted Cost (%)**
Debt	47.45	4.54[11]	2.15
Common Equity	52.55	10.60	5.57
Total	100		7.72

Exhibit HSG-1, Schedule C1-2, Valley St. 1-R at 2. To reach his recommendation, Mr. D'Ascendis has included adjustments that increase his cost of common equity determination in this matter. Valley St. 2 at 5. The first adjustment is a proposed "size adjustment" that adds 1.00%

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[10] The Company's original return on equity claim was 11.35%, which was revised to 10.60% in witness D'Ascendis' rebuttal. The revised overall return based on this updated ROE is 7.72%. Valley St. 2-R at 2.

[11] The Company's original cost rate of debt was 4.98%, which was revised to 4.54% in witness D'Ascendis' rebuttal.

to the proposed cost of common equity. The second is a "performance factor adjustment" that adds an additional 0.25% to the cost of equity. Valley St. 2 at 5.

The OCA presented the testimony of Dr. David S. Habr, an expert economic consultant specializing in utility regulation, to support its rate of return allowance. In determining an appropriate cost of capital OCA witness Habr accepted the Company's capital structure.[12] OCA St. 3 at 2-3. Adopting the Company's capital structure, the OCA recommends an 8.34% return common equity and a return on rate base of 6.75%:

Capital Type	**Percent of Total (%)**	**Cost Rate (%)**	**Weighted Cost (%)**
Long-term Debt	47.45	4.98	2.36
Common Equity	52.55	8.34	4.39
Total	100		6.75

OCA St. 3 at 2-3. The 8.34% cost of equity recommended by Dr. Habr is the result of his Discounted Cash Flow (DCF) analysis and is the median value "of all the DCF and [Federal Energy Regulatory Commission (FERC)] 2-Step cost rates." OCA St. 3 at 28-29.

I&E presented the testimony of Christopher M. Henkel, Fixed Utility Financial Analyst with I&E to support its rate of return recommendation. The recommendation of Cost of Capital by I&E is as follows:

Capital Type	**Percent of Total (%)**	**Cost Rate (%)**	**Weighted Cost (%)**
Long-term Debt	47.45	4.54	2.15
Common Equity	52.55	8.46	4.45

12 As originally proposed in Valley St. 2 at 3.

Total	100		6.60

I&E St. 2 at 6.

The OCA submits that the Company's 11.35%, as updated to 10.60%, cost of common equity request is well in excess of an objective assessment of investor market requirements in the current economic environment and should be rejected. The Company's recommendation is based on a flawed DCF analysis. In addition, both OCA witness Dr. Habr and I&E witness Henkel testified the return on equity (ROE) adjustments proposed by Mr. D'Ascendis are inappropriate, unnecessary and only serve to inflate the Company's equity cost estimate. If included in the cost of equity determination, these adders will substantially and unreasonably increase costs for ratepayers. See OCA St. 3 at 30; see also I&E St. 2 at 42-44. The OCA opposes the inclusion of these adjustments.

The OCA recommends the Company be given the opportunity to earn 8.34% on their common equity, resulting in an overall allowed return on rate base of 6.75%. OCA St. 3 at 2-3. When applied to the OCA's recommended rate base, this will provide the Company an opportunity to earn a fair rate of return while benefiting consumers with public utility service at reasonable rates, consistent with Pennsylvania law and public policy as set forth in the Public Utility Code. The Commission should adopt the recommendations of the OCA as to rate of return and cost of capital.

B. The Legal Framework for Determining What Rate of Return is Fair to Valley Consumers and the Company

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 "[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.

Typically, cost of capital is the basis for determining a fair rate of return. Pa. PUC v. Philadelphia Suburban Water Co., 71 Pa. PUC 593, 623 (1989) (PSWC 1989). The Commission has defined an appropriate rate of return as:

> [T]he amount of money a utility earns, over and above operating expenses, depreciation expense and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the 'return' are interest on long-term debt, dividends on preferred stock, and earnings on common stock equity. In other words, the return is the money earned from operations which is available for distribution among the capital. In the case of common stockholders, part of their share may be retained as surplus.

Pa. PUC v. Emporium Water Co., 95 Pa. PUC 191, 196, 208 PUR4th 502, 507 (2001) (EWC 2001) (quoting Public Utility Economics, Garfield and Lovejoy, 116 (1964)). Further, "[t]he return authorized must not be confiscatory, and must be based upon the evidence presented." PSWC 1989, 71 Pa. PUC at 623 (citing Pittsburgh v. Pa. PUC, 165 Pa. Super. 519, 69 A.2d 844 (1949) (Pittsburgh)).

A public utility with facilities and assets used and useful in the public service is entitled to no more than a reasonable opportunity to earn a fair rate of return on its investment. Pa. PUC v. Roaring Creek Water Co., 87 Pa. PUC 826, 844 (1997) (Roaring Creek 1997). The United States Supreme Court established the standard with which to evaluate whether a rate of return is fair in Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679 (1923) (Bluefield), stating:

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management. . .to raise the money necessary for the proper discharge of public duties.

Bluefield, 262 U.S. at 693. The Court also said that allowed rates of return should reflect the following:

> [A] return on the value of the [utility's] property which it employs for the convenience of the public equal to that. . .being made at the same time… on investments in other business undertakings which are attended by corresponding risks and uncertainties.

Bluefield, 262 U.S. at 692. Twenty-one years later, the Court reviewed the issue of fair rate of return in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) (Hope). In Hope, the Court held that a fair rate of return "should be commensurate with returns on investments in other enterprises having corresponding risks" while being sufficient "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." Hope, 320 U.S. at 603. The Court noted that "[t]he rate-making process under the Act, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and consumer interests . . . and does not insure that the business shall produce revenues." Id. More recently, the Court stated that consumers are obliged to rely upon regulatory commissions to protect them from excessive rates and charges. See Permian Basin Area Rate Cases, 390 U.S. 747, 794-95 (1968) (*citing* Atlantic Refining Co. v. Public Service Comm'n, 360 U.S. 378, 388 (1959)).

Finally, in Duquesne Light Co. v. Barasch, the Court stated

> whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular rate setting, and on the amount of capital upon which the investors are entitled to earn on that return.

Duquesne Light Co., 488 U.S. at 310. In determining a fair rate of return this Commission has described its task as follows:

> A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. It requires the exercise of informed judgment based upon an evaluation of the particular facts presented in each proceeding. There is no one precise answer to the question as to what constitutes the proper rate of return. The interests of the Company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility.

Pa. PUC v. Pennsylvania Power Co., 55 Pa. PUC 552, 579 (1982) (emphasis added). See Pa. PUC v. National Fuel Gas Distribution Corp., 73 Pa. PUC 552, 603-605 (1990).

In the present matter, the OCA's recommended rate of return, including its 8.34% cost of common equity, represents a fair rate of return for the Company. The OCA's proposed rate of return will provide the Company's shareholders with a reasonable opportunity to earn a market-based return on their investment, will provide for the financial integrity of the Company and will protect ratepayers from excessive and unjustified rates as case law dictates.

C. Capital Structure

The OCA accepted the Company's Capital Structure. OCA St. 3 at 2-3. Additionally, I&E witness Henkel also accepted the Company's Capital Structure. I&E St. 2 at 12.

D. Cost of Debt

The OCA accepted the Company's long-term cost of debt of 4.98%. OCA St. 3 at 3.

E. Cost of Common Equity

1. Introduction

The OCA submits that the Company's proposal for a common equity rate of 11.35%, as updated to 10.60%, is excessive and results in a shareholder windfall at the expense of ratepayers, further leading to rates that are unjust and unreasonable. As OCA witness Dr. Habr testified, profits for the provision of utility services are regulated because the services tend to be produced under conditions that approximate a natural monopoly. OCA St. 3 at 3. The current economic conditions and outlook produce a favorable cost of equity environment for the Company. As will be discussed in the following sections, however, Company witness D'Ascendis' DCF analysis is flawed, and he has artificially inflated his ROE recommendation in this matter through a variety of methods and adjustments. The OCA submits that such unnecessary and unsupported "adjustments" should not be considered.

The following table summarizes the parties' findings based on the DCF methodology and the parties' subsequent ROE recommendations.

Party	**DCF Results**	**Recommended ROE**
Valley	9.35%[13]	10.60%
OCA	7.67-10.02%	8.34%
I&E	8..46%	8.46%

Dr. Habr explained that he used the DCF method to estimate the cost of equity for the Company. OCA St. 3 at 9. As explained in more detail below, the OCA's recommended 8.34% common equity cost rate is the median value "of all the DCF and FERC 2-Step cost rates shown on Table – 4 [in OCA St. 3 at. 25-26,]; half of the observations lie above this value and half lie below it . . . this middle-of-the-pack value is appropriate for" the Company. Id at 28-29.

The OCA submits that its 8.34% cost of common equity recommendation is reasonable. The Commission should adopt an 8.34% cost of equity over the Company's recommendation of 11.35%, as updated to 10.60%, because an 8.34% cost is in line with results of the DCF analyses and with current economic conditions. Considering these facts, it would be unreasonable to burden Valley's ratepayers with higher costs based on the Company's 11.35%, as updated to 10.60%,

[13] Mr. D'Ascendis DCF result is 9.35% before adding 1.25% for size and performance adjustments. Exhibit DWD-1R, Schedule DWD-1R at 2.

ROE proposal. The Company's 11.35%, as updated to 10.60%, cost of equity recommendation is considerably higher than DCF results return expectations published by major consulting firms, brokerage houses and market data publications. See OCA St. 3 at 25-26. OCA witness Habr properly applied a DCF analysis checked by the Capital Asset Pricing Model (CAPM) in this proceeding to arrive at a reasonable rate of return that should be adopted here.

2. OCA Witness Habr Has Derived His Common Equity Cost Recommendations From The Commission's Preferred Method of Setting Common Equity Cost Rates – The Discounted Cash Flow Model

The Testimony of OCA witness Habr clearly indicates that he developed a market-based cost of common equity recommendation using the DCF model, which is the method primarily relied upon by this Commission. In January 2004 in its Opinion and Order in Pa. PUC v. Pennsylvania American Water Company, the Commission wrote:

> 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).

In its recent UGI-Electric decision, the Commission affirmed its primary reliance on the DCF method, stating that it has "found no reason to deviate from the use of this method in the instant case." Pa PUC v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058, et al, slip op. at 106 (Order entered October 25, 2018) (UGI-E). This Commission has stated that determining a fair rate of return is an exercise of informed judgment, based upon the facts of each case. Pa. PUC v. Pennsylvania Power Co., 55 Pa. PUC 552, 579 (1982). "The interests of the Company and its investors are to be considered along with those of the customer, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved." Pa. PUC v. Pennsylvania Power Co., 55 Pa. PUC at 579.

In coming to this informed judgment, the Commission has stated on numerous occasions its preference to rely upon the DCF methodology over other methods such as the Risk Premium (RP) and Capital Asset Pricing Model (CAPM) in determining the rate of return. In PPL's 2012 and 2004 base rate case, the Commission reaffirmed its reliance upon the DCF method. Pa. PUC v. PPL Electric Utilities Corp., Docket No. R-2012-2290597 (Order entered December 28, 2012) (PPL 2012); Pa. PUC v. PPL Electric Utilities Corp., 237 P.U.R. 4th 419, 2004 Pa. PUC LEXIS 40 (December 2, 2004) (PPL 2004). The Commission additionally noted, however, that while it is not required, other methodologies can be used to check DCF results. PPL 2012 at 80.

Considering the DCF results of OCA witness Dr. Habr as checked by his CAPM and current financial market conditions, the OCA submits that a review of the evidence in this proceeding supports an ROE of 8.38%.

3. Dr. Habr's Analysis of the Cost of Common Equity for Similar Risk Utility Operations Supports a Cost of Equity 8.34%

In this case, Dr. Habr conducted DCF and Capital Asset Pricing Model (CAPM) analyses. OCA St. 3 at 14. Dr. Habr primarily relied on the DCF method, using the CAPM method as a check, and has recommended an 8.34% return on common equity.

Dr. Habr explained why it is appropriate to rely on the DCF model in this proceeding. Dr. Habr testified as follows:

> I rely primarily on the Discounted Cash Flow (DCF) model. This model is straight forward and provides reliable results when the growth rate used in the model is consistent with the model's assumptions.
>
> The model begins with the proposition that the market price for a share of common stock that an investor is *willing to pay under any market conditions* is equal to the present value of the stock's expected dividend stream. The present value of an expected income stream is determined by discounting the stream with a rate that reflects, among other items, the investor's perception of the asset's inherent and relative riskiness compared to similar or other companies the investor may be considering. In this manner, the economic principle of opportunity cost finds expression in the DCF method.
>
> The discount rate will also tend to track general capital market conditions. That is, the discount rate will tend to move up when interest rates in general rise and it will tend to move down when interest rates in general decline.
>
> From the investor's point of view, *this discount rate reflects the rate of return the investor expects to earn on his or her investment in the asset*. For an asset like a utility company common stock that is freely traded in the market, the market price conceptually represents the present value of the expected income stream for investors who are willing and able to buy that asset instead of another asset.

OCA St. 3 at 9-10 (emphasis in original).

In the PAWC 2004 case, the ALJ quoted the following description of the DCF model from a leading treatise on public utility rate making:

> The DCF method is derived from valuation theory, and rests on the premise that the market price of a stock is the present value of the

> future benefits of holding a stock. Those benefits are the future cash flows provided by holding the stock. They are, quite simply, the dividends paid and the proceeds from the ultimate sale of the stock. Since dollars to be received in the future are not worth as much as dollars received today, the cash flows must be discounted back to the present at the investor's required rate of return. The most basic form of this model assumes that dividends grow at a constant rate each year (g), and that the stock is held "forever". Since the stock is not sold, the only relevant contribution to its value is the dividends to be received. The basic theoretic difficulties are the assumption of a constant or fixed retention or payout rate and the assumption that dividends will grow at a constant "g" rate in perpetuity.
>
> The first point to remember in evaluating the growth rate is that it is not what a witness thinks the growth rate should be that matters. What matters is what investors expect the growth rate to be. The rate of return analyst is really trying to (or should be trying to) replicate the thinking of investors in developing their expectations regarding the growth in dividends. In all, the DCF method takes into account several factors important in the determination of the fair rate of return: (1) preferences of investors; (2) equity financing; (3) risk, and (4) inflation.

PAWC 2004, Docket No. R-00038304, R.D. at 65 (Nov. 26, 2003) quoting J. Bonbright, A. Danielsen & D. Kamerschen, Principles of Public Utility Rates 318 - 319 (2d ed. 1988).

Based on the results of his analysis, Dr. Habr made the following recommendation:

> Based on my DCF analysis, I am recommending Valley Energy be given the opportunity to earn 8.34% on its common equity . . . My recommended 8.34% common equity cost rate is the median value of all the DCF and FERC 2-Step cost rates shown on Table – 4 above; half of the observations lie above this value and half lie below it. Like Citizens' and Wellsboro, this middle-of-the-pack value is appropriate for Valley Energy.

OCA St. 3 at 28-29.

a. Dr. Habr's Adjusted Proxy Group

To estimate the cost of equity, a proxy group of similar companies is needed. A proxy group is generally preferred over the use of data exclusively from any one company because it has the effect of smoothing out potential anomalies associated with a similar company and is therefore a more reliable measure. See UGI-E at 82. In developing his recommendation, Dr. Habr accepted and utilized Mr. D'Ascendis' chosen gas proxy group.[14] OCA St. 3 at 9.

4. The Commission Should Adopt The 8.34% Equity Cost Rate Proposed By The OCA As Appropriate For The Company

a. DCF

Dr. Habr relied primarily on the Discounted Cash Flow model, "[t]his model is straight forward and provides reliable results when the growth rate used in the model is consistent with the model's assumptions." OCA St. 3 at 9. The model begins with the proposition that the market price for a share of common stock that an investor is willing to pay under any market conditions is equal to the present value of the stock's expected dividend stream. The present value of an expected income stream is determined by discounting the stream with a rate that reflects, among other items, the investor's perception of the asset's inherent and relative riskiness compared to similar or other companies the investor may be considering. In this manner, the economic principle of opportunity cost finds expression in the DCF method. Dr. Habr explained the DCF equations as follows:

> If the expected dividend growth remains unchanged, the price an investor would be willing to pay for the stock is given by equation (1). The numerator reflects a perpetual dividend stream growing at the rate "g" and the denominator reflects the cost of equity (discount rate) "k" used to determine the present value of the dividend stream. This equation only has a finite solution if "k" is greater than "g." A value of "g" greater than "k" would imply a share price that is infinitely large.
>
> $$P_0 = \int_0^\infty \frac{D_0 e^{(g)t}}{e^{(k)t}} dt \qquad (1)$$
>
> P_0 = the current market price of the stock.
> D_0 = the current indicated annual dividend.

14 As discussed in Section E-2 below, Mr. D'Ascendis' non-price regulated proxy group should be disregarded.

> k = the cost of common equity.
> g = the long-term sustainable growth rate.
> e = the base for natural logarithms.
> t = time.
> dt = the differential of time
>
> The solution to equation (1) is:
>
> $$P_0 = \frac{D_0}{k - g} \qquad (2)$$
>
> Equation (2) can be rearranged to the familiar dividend yield plus growth format used to find the implied value of k based on observed values of D_0, P_0, and g:
>
> $$k = \frac{D_o}{P_o} + g \qquad (3)$$
>
> In the constant growth version of the model, the expected growth rate is a rate that could be economically/financially sustained by the company "forever" (or infinitely from the mathematical point of view). This constant growth assumption puts an implicit upper limit on the magnitude of the dividend growth rate.

OCA St. 3 at 10-11.

The DCF is used to assess the value of an investment based on its future cash flows. This method, essentially attempts to gauge the value of a company today, based on projections of how much money it will generate in the future.

b. OCA Witness Dr. Habr's Application of the DCF

As seen above, the DCF equation calls for a company's growth rate and annual dividend yield to produce its result. Valley is not a publically traded company with a dividend yield and therefore, lacks the necessary data to run a unique DCF analysis. Because the DCF cannot be applied directly to Valley, OCA witness Dr. Habr instead conducted multiple DCF analyses for each company within his gas proxy group. See OCA St. 3 at 25-26. Specifically, Dr. Habr calculated 3 constant growth DCFs for each of the 7 companies in his proxy group. OCA St. 3 at

25-26. Dr. Habr calculated 3 separate constant growth DCFs for each company because he used three separate growth rates, one DCF calculation for each source, Yahoo!, Value Line, and Zack's. OCA St. 3 at 25-26. Calculating a DCF for each company in the proxy group provided for more accurate results as Dr. Habr was able to utilize each company's actual dividend yield and growth rate in his calculation. OCA St. 3 at 25-26. In the same format, Dr. Habr conducted 3 sets of FERC 2-Step DCF and Two-Stage DCF for each company as well. OCA St. 3 at 25-26.

Dr. Habr explained that in the DCF model, the expected growth rate is a rate that could be economically/financially sustained by the company "forever (or infinitely from the mathematical point of view)." OCA St. 3 at 11. This constant growth assumption puts an implicit upper limit on the magnitude of the dividend growth rate. Id. Dr. Habr went on to explain that if the magnitude of the dividend growth rate used exceeds the magnitude of the expected long-term growth in Gross Domestic Product (GDP), the results of the model become confounded. Id.

> **Q: WHAT UPPER LIMIT IS IMPOSED ON THE DIVIDEND GROWTH RATE?**
>
> A: The upper limit is the expected long-term GDP growth rate. If the magnitude of the dividend growth rate used exceeds the magnitude of the expected long-term growth in Gross Domestic Product (GDP), the results of the model become confounded. A company with a perpetual, sustainable growth rate greater than the economy as a whole will eventually exceed the economy as a whole in size. That is, the company would become the economy, a quite unlikely real world outcome. For this reason one must be very careful when using analysts' growth forecasts that exceed GDP growth forecasts because the use of these forecasts results in an overestimate of a given utility's cost of common equity.

OCA St. 3 at 11.

A company with a perpetual, sustainable growth rate greater than the economy as a whole (GDP) will eventually exceed the economy as a whole in size, "[t]hat is, the company would become the economy, a quite unlikely real world outcome." OCA St. 3 at 11. For this reason one must be very careful when using analysts' growth forecasts that exceed GDP growth forecasts because the use of these forecasts results in an overestimate of a given utility's cost of common equity.

The DCF can be modified to take into account the fact that an individual company cannot grow faster than the economy as a whole in perpetuity by using a weighted average of the analysts' growth forecasts and the long-term GDP growth rate forecast to establish "g" in the equation.

Therefore, Dr. Habr employed a 2 step, weighted average of the analysts' growth forecasts, which is the same approach as is done at FERC. OCA St. 3 at 12. Dr. Habr explained:

> A weighted average of the analysts' growth forecasts and the long-term GDP growth rate forecast can be used for "g" in the standard dividend yield plus growth DCF model to temper the impact of short-term growth rate forecasts that are not sustainable in the long-run.
>
> FERC has been using a weighted average growth rate in the DCF model in natural gas and oil pipeline cases since the mid-1990's and recently adopted the same methodology in regulated utility cases. (See FERC Opinions 531, 531-A, and 531-B). FERC gives two-thirds weight to the earnings growth forecasts and one-third weight to the GDP growth forecast. This tempers the impact of unsustainably high earnings growth forecasts on DCF cost estimates. A DCF model with two growth periods or stages can also be used to estimate a weighted average growth rate.

Id.

Dr. Habr's ultimate recommendation was then based on the median of his combined DCF and FERC 2-Step DCF. Table 4 summarized Dr. Habr's findings:

TABLE 4 -- GAS PROXY GROUP DCF COST OF COMMON EQUITY RESULTS

	DCF			FERC 2-Step DCF			Two-Stage DCF				
Company	Yahoo! Growth Rates	Zacks Growth Rates	*Value Line* Growth Rates	Yahoo! Growth Rates	Zacks Growth Rates	*Value Line* Growth Rates	Yahoo! Growth Rates	Zacks Growth Rates	*Value Line* Growth Rates	Individual Company Average	Individual Company Median
Atmos Energy Corporation	8.56%	8.77%	9.57%	8.07%	8.20%	8.74%	7.17%	7.19%	7.26%	**8.17%**	**8.20%**
New Jersey Resources	8.46%	9.47%	5.93%	8.13%	8.81%	6.44%	7.56%	7.67%	7.35%	**7.76%**	**7.67%**
Northwest Natural Holding	6.84%	7.35%	N.R.	7.19%	7.53%	N.R	7.77%	7.82%		**7.42%**	**7.44%**
One Gas Inc.	7.30%	8.21%	10.33%	7.31%	7.91%	9.33%	7.53%	7.61%	8.12%	**8.18%**	**7.91%**

South Jersey Industries, Inc.	8.26%	10.29%	14.26%	8.40%	9.76%	12.40%	8.62%	9.08%	10.23%	**10.14%**	**9.76%**
Southwest Gas Holdings, Inc.	8.67%	8.77%	11.61%	8.31%	8.37%	10.26%	7.73%	7.73%	8.14%	**8.84%**	**8.37%**
Spire, Inc.	5.60%	7.32%	8.43%	6.38%	7.53%	8.27%	7.72%	7.88%	8.00%	**7.46%**	**7.72%**
Proxy Group Average	**7.67%**	**8.60%**	**10.02%**	**7.68%**	**8.30%**	**9.24%**	**7.73%**	**7.85%**	**8.18%**		
Proxy Group Median	**8.26%**	**8.77%**	**9.95%**	**8.07%**	**8.20%**	**9.03%**	**7.72%**	**7.73%**	**8.06%**		

	Combined Proxy Group DCF		**Combined Proxy Group FERC 2-Step DCF**		**Combined Proxy Group Two-Stage DCF**		**Overall Proxy Group Descriptive Statistics**	
	Median:	**8.51%**	**Median:**	**8.24%**	**Median:**	**7.73%**	**Maximum:**	**14.26%**
	Average:	**8.70%**	**Average:**	**8.37%**	**Average:**	**7.91%**	**Median:**	**8.13%**
Combined DCF/FERC 2-Step Median:	**8.34%**						**Average:**	**8.33%**
Combined DCF/FERC 2-Step Average:	**8.53%**						**Minimum:**	**5.60%**

OCA St. 3 at 25-26; see also OCA St. 3, Exh. DSH-6.

Dr. Habr then summarized his recommendation from this data:

> **Q: HOW DID YOU ARRIVE AT YOUR 8.34% COMMON EQUITY COST RATE?**
>
> A: My recommended 8.34% common equity cost rate is the median value of all the DCF and FERC 2-Step cost rates shown on Table – 4 above; half of the observations lie above this value and half lie below it. Like Citizens' and Wellsboro, this middle-of-the-pack value is appropriate for Valley Energy.

OCA St. 3 at 28-29.

c. OCA Witness Habr's Capital Asset Pricing Model/Risk Premium Method Analysis Provides a Reasonable Check on his Recommendations

To check his DCF results, Dr. Habr conducted both a CAPM and a risk premium method analysis. OCA St. 3 at 14. The CAPM is a theory about how expected return of stocks and capital assets are related. The biggest problem with the basic CAPM is that the closest measure there is for a true risk free rate, the rate on short duration T-bills, is highly influenced by Federal Reserve monetary policy and thus does not reflect a market determined risk free rate. OCA St. 3 at 15.

While the Commission does not favor the CAPM approach, it is reasonable to conduct such an analysis as a check on DCF results.

Dr. Habr testified as to the CAPM/Risk Premium model that he uses:

> I use the Capital Asset Pricing Model (CAPM) and a risk premium method that is based on the CAPM as checks to my DCF analysis. The basic CAPM is represented by the equation:
>
> $$k_e = R_f + \beta_e(R_m - R_f)$$
>
> where:
>
> k_e = company's market cost of common equity.
> R_f = risk free rate of return.
> R_m = market rate of return.
> β_e = the company's common stock beta.
>
> The core problem with the basic CAPM is that the closest measure there is for a "true" risk free rate,[15] the rate on short duration T-bills, is highly influenced by Federal Reserve monetary policy and thus does not reflect a market determined risk free rate.
>
> The basic risk premium model consists of a bond yield plus a risk premium, that is:
>
> $$k_e = k_b + (k_e - k_b)$$
>
> The core problem with the risk premium model is pretty obvious; the cost of common equity has to be estimated somehow to come up with the risk premium to be added to the bond yield, k_b, to determine the cost of common equity. Going through this process adds nothing to the information already contained in the original common equity cost estimate.
>
> These two problems can be solved recognizing that it is conceptually possible to estimate bond yields using the CAPM. That is:
>
> $$k_b = R_f + \beta_b\left(R_m - R_f\right)$$
>
> where k_b is the bond yield and β_b is the company's bond beta. A risk premium that can be added to the company's bond yield can now be calculated as:
>
> $$k_e - k_b = (\beta_e - \beta_b)(R_m - R_f)$$
>
> That is, the equity risk premium to be added to the company's bond yield is equal to difference between equity and bond betas times the market risk premium. The risk premium model now takes the form:
>
> $$k_e = k_b + (\beta_e - \beta_b)\left(R_m - R_f\right)$$
>
> Thus, we have a model that combines positive aspects of the risk premium model and the CAPM. From the risk premium model, we have the observable bond yield, k_b, and, from the CAPM we have

[15] The "true" risk free rate has neither default risk nor interest rate risk.

> empirically estimated values for the betas and the market risk premium. Even if bond betas are not available, this model can be used to estimate maximum values for CAPM common equity costs by assigning a value of zero to the bond beta. That is what I have done in the current analysis.

OCA St. 3 at 14-16.

Dr. Habr calculates his CAPM analysis by using a time frame that includes the time frame he used in his DCF analysis. OCA St. 3 at 16. Dr. Habr calculates bond betas for the gas Proxy Group companies based on the New York Stock Exchange Index using weekly holding period returns for the period September 1, 2014 through August 31, 2019. Id. The calculated betas were then adjusted using *Value Lines* adjusted formula. OCA St. 3 at 16.

Dr. Habr then discussed the market risk premium used in his CAPM/Risk Premium analysis:

> I used four different estimates of the market risk premium. The first, 7.12%, is a historical risk premium based on total return data for Large Capitalization Stocks and U.S. Treasury Bills found in Appendices B-1 and B-9 in the 2019 edition of the SBBI Yearbook. The second, 7.24%, is based on a DCF cost estimate for the S&P 500 index itself. The third and fourth estimates, 8.32% and 9.77% respectively, are based on forecast equity cost estimates for the dividend paying companies in S&P 500 index.

OCA St. 3 at 17.

Additionally, Dr. Habr discussed the historical risk premium included in his analysis:

> [m]y historical risk premium is the average of the annual difference between annual holding period returns (continuously compounded) for Large Capitalization Stock and the annual holding period returns (continuously compounded) for U.S. Treasury Bills. For the period 1983 through 2018, that average is 6.87%, which I converted to the annual compounding equivalent, 7.12%, for use in the CAPM models. (See Exhibit DSH-3.)

OCA St. 3 at 18. The reason Dr. Habr saw fit to include a historical risk premium in his analysis is because:

> Whether making a hiring decision or a decision to buy a common stock, the rational decision maker will look at past accomplishments as well as current and future potentials. Past performance provides a reality check; it tells us what the experience has been relative to the future expectations.

OCA St. 3 at 18.

Dr. Habr calculated 8.32% and 9.77% risk premiums. OCA St. 3 at 17. He explained:

> Two different data sets were used to calculate these risk premiums, a Bloomberg data set and a Value Line data set. The Bloomberg data set produced the 8.32% risk premium while the Value Line data set produced the 9.77% risk premium. Each of these data sets contained market capitalization, dividend yields, and 5-year earnings growth forecasts for the companies in the S&P 500.
>
> Because many of the companies had 5-year growth rates that exceeded 20%, the FERC 2-Step method was used to calculate the individual firm's cost of common equity. Relative market capitalization was used to weight the individual cost of equity estimates to arrive at a weighted average cost of common equity for each data set. The average cost of common equity for the Bloomberg data set is 10.99% and 12.44% for the Value Line data set. Subtracting the March 1, 2019 – August 31, 2019 average 2.67% 30-year constant maturity yield from these cost rates produces the 8.32% and 9.77% risk premiums.

OCA St. 3 at 19-20.

Dr. Habr applied his CAPM/Risk Premium model to the proxy group and summarized the results:

> **Q: WHAT DO THE RESULTS OF YOUR GAS CAPM ANALYSIS SHOW?**
>
> A: The CAPM/Risk Premium model yields maximum common equity estimates when it is applied assuming the bond betas equal zero as done in this case. Thus, the combined CAPM/Risk Premium median 9.54% and 9.61% average provide an upper limit for common equity cost rates. All of the measures of central tendency (medians and averages) for my DCF analysis fall well below these values.

OCA St. 3 at 28; <u>see also</u> OCA St. 3, Exh. DSH-7.

The OCA submits that Dr. Habr's CAPM/Risk Premium median 9.54% and 9.61% confirms the validity of his DCF results because they provide upper limits not to be exceeded.

5. The Commission Should Reject the Company's Overstated 11.35%, as updated to 10.60% Equity Cost Rate Which is Based on Multiple Costing Methods with Biased Inputs

a. Introduction

Company witness D'Ascendis applied three cost rate models to a nine company proxy group. Mr. D'Ascendis used the DCF model, the Risk Premium Model and the Capital Asset Pricing Model (CAPM). Valley St. 2 at 16. From the results of all of these models, Company witness D'Ascendis identified an indicated equity cost range of 8.63%-10.21%. Id at 5. He selected 10.10% as the indicated cost of common equity before adjustments and then added 100 basis points to reflect a Size Adjustment and then added 25 basis points to reflect a Performance Factor Adjustment. Id.

As explained below, the Company's risk adjusted return of 11.35%, as updated to 10.60%, overstates the appropriate cost of equity for the Company through the blending of results of flawed valuation analyses plus improper adjustments. In addition, an inflated equity return cannot be justified as necessary to generate a higher overall return. Established rate making principles, the law of Hope, Bluefield, Barasch and established Commission practice do not support the Company's claim.

b. Mr. D'Ascendis' Cost of Equity Analyses are Not Reasonable for Ratemaking Purposes

Dr. Habr demonstrated that Mr. D'Ascendis' DCF model is flawed in that he does not consider making any adjustment to his DCF analysis to take into account the impact on his results of analysts' short-term forecasts that exceed the expected long-term GDP growth. Because these growth rates are not sustainable, their use results in the DCF cost rates being over estimated. OCA St. 3 at 33.

OCA witness Dr. Habr similarly refuted Mr. D'Ascendis' CAPM analysis. OCA St. 3 at 34. Mr. D'Ascendis relied on an average 3.36% 30-year treasury yield based on a period covering the second quarter of 2019 through 2029. Id. He also uses this same forecast in part of his risk premium analysis. Id. The purpose of a test-year in utility regulation is to match the costs incurred that year with the services provided during that year. Test-year costs are not based on costs that may exist during some period in the future. Id. To rectify this problem, Dr. Habr substituted the 2.66% 30-year treasury yield that was used in Dr. Habr's CAPM/Risk Premium analysis. The columns in the Table below representing the Gas Company proxy group (Table – 8 from OCA St. 3 at 34) demonstrate the impact of this change in the 30-year treasury rate as well as the impacts of making the appropriate modifications of the Gas Proxy Group and removing the allowed returns risk premiums from the Risk Premium Model results:

Table – 8 Citizens' Electric Company / Wellsboro Electric Company / Valley Energy, Inc.
Brief Summary of Common Equity Cost Rate
HABR ADJUSTED

Line No.	Principal Methods	Proxy Group of Nineteen Electric Companies		Proxy Group of Seven Natural Gas Distribution Companies	
1.	Discounted Cash Flow Model (DCF) (1)	8.86	%	8.63	%
2.	Risk Premium Model (RPM) (2)	9.62		9.60	
3.	Capital Asset Pricing Model (CAPM) (3)	8.72		9.45	
4.	Market Models Applied to Comparable Risk, Non-Price Regulated Companies (4)	~~10.61~~		~~11.05~~	
5.	**DCF, Risk Premium, CAPM Average**	**9.07**	**%**	**9.23**	%
6.	~~Size Adjustment (5)~~	~~1.00~~		~~1.00~~	
7.	~~Performance Factor Adjustment (6)~~	~~0.25~~		~~0.25~~	
8.	~~Recommended Common Equity Cost Rate~~	~~10.32~~	~~%~~	~~10.48~~	%

Notes: (1) From page 1 of Schedule DWD-3.
(2) From page 1 of Schedule DWD-4.
(3) From page 1 of Schedule DWD-5.
(4) From page 1 of Schedule DWD-7.

OCA St. 3 at 34-35.

The 9.60% Risk Premium and 9.45% CAPM for the Gas Proxy Group are lower than Mr. D'Ascendis' 10.21%, and 10.15% for the same categories OCA St. 3 at 35. This clearly validates that Mr. D'Ascendis' results should not be relied upon to establish the proper allowed return on common equity in these proceedings.

Furthermore, OCA witness Dr. Habr and I&E witness Henkel also opposed Mr. D'Ascendis' use of an improper proxy group that was comprised of companies that are not regulated gas utilities. I&E St. 2 at 30. Dr. Habr confirmed that Mr. D'Ascendis' use of non-price regulated firm results in establishing his recommended allowed rate of returns invalidates his conclusions. OCA St. 3 at 31-32. Mr. D'Ascendis claims his non-price regulated proxy groups are similar in risk to the gas proxy groups he uses in his analysis. This is not the case. OCA St. 3 at 32. Table – 7 of Dr. Habr's testimony shows that the common equity cost estimates for the non-price regulated proxy groups are systematically higher than his utility common equity cost estimates by 66 to 208 basis points.

Table -- 7 Comparison of Mr. D'Asendis' Utility v. Non-Price Regulated Cost of Common Equity Results

Estimation Method	Proxy Group 19 Electric Companies	Proxy Group of 6 Non-Price Regulated Companies	Proxy Group of 7 Natural Gas Distribution Companies	Proxy Group of 6 Non-Price Regulated Companies
DCF	9.03%	9.74%	8.63%	10.71%
Risk Premium	10.39%	11.05%	10.21%	11.53%
CAPM	9.42%	10.71%	10.15%	11.01%
Average	9.61%	10.50%	9.66%	11.08%

Source: Schedules DWD-1, page 2 and DWD-7, page 1.

OCA St. 3 at 32. The non-price regulated proxy group results should be given no weight in these proceedings.

c. <u>The Company's Proposed Adders Should Be Rejected</u>

i. <u>Size</u>

Regarding the 100-basis point size adjustment made by Mr. D'Ascendis, both OCA and I&E witness explained why the Company should not be awarded a size premium. Dr. Habr testified:

> **Q: TURNING TO MR. D'ASCENDES' TESTIMONY, DO YOU AGREE WITH HIS 100 BASIS POINT SIZE ADJUSTMENT ADDITION TO HIS RECOMMENDED RETURN ON COMMON EQUITY FOR CITIZENS' ELECTRIC, WELLSBORO ELECTRIC, AND VALLEY ENERGY?**
>
> A: No, I do not. The size premiums on Schedule DWD-8, page 1 do not tell the whole story. Duff & Phelps also provides the OLS (ordinary least squares) betas associated with each of the size deciles shown on this page. Table -6 below shows the size premium and OLS beta for each size decile from an earlier Duff & Phelps study.

Table -- 6 Duff & Phelps Size Premium and Associated OLS Betas

	Market Capitalization ($Mil)			
Decile	Low	High	Size Premium	OLS Beta
1	$24,361.659	$609,163.498	-0.35%	0.92
2	$10,784.101	$24,233.747	0.61%	1.04
3	$5,683.991	$10,711.194	0.89%	1.11
4	$3,520.556	$5,676.716	0.98%	1.13
5	$2,392.689	$3,512.913	1.51%	1.17
6	$1,571.193	$2,390.899	1.66%	1.17
7	$1,033.341	$1,569.984	1.72%	1.25
8	$569.279	$1,030.426	2.08%	1.30
9	$263.715	$567.843	2.68%	1.34
10	$2.516	$262.891	5.59%	1.39

Source: Duff & Phelps, Valuation Handbook, 2017, p. 7-11 and Appendix 3.

> When the OLS betas and size premiums for all ten deciles are taken into account, it is clear that regulated utility companies have more in common with the first decile.
>
> What this table shows is that positive size premiums are associated with OLS betas that are greater than one. All of the utility holding companies in the proxy groups in this proceeding have betas that were calculated using ordinary least squares and have values

> less than one. This suggests that if any adjustment is made for size, it should be negative rather than positive.

OCA St 3 at 29-30 (footnote omitted).

Dr. Habr further commented on the proposed size adjustment with an additional basis:

> Yes. Utility customers should not be required to pay higher costs associated with inefficient utility operations. If a utility company chooses to operate at such a small scale that its cost of common equity is truly increased, there is no reason for the utility's captive customers to pay any increased costs resulting from the utility's inefficient size.

Id.

ii. Performance

In a similar way, Company witness D'Ascendis added a 25 basis point adjustment based on performance. Both OCA and I&E refute this adder. Dr. Habr testified:

> I found descriptions of management doing the job they are expected to do. That is, they are taking actions any successful company has to take to efficiently maintain its operations and provide satisfactory customer service. Regulated utilities are expected to operate efficiently and should not be given a rewarded for doing what is expected.

OCA St. 3 at 31.

Additionally, I&E witness Henkel testified:

> Ultimately, for any company, true management effectiveness is earning a higher return through its efficient use of resources and cost cutting measures. The greater net income resulting from growth, cost savings, and true efficiency in management and operations is available to be passed on to shareholders. I do not believe that Valley should be granted additional basis points for doing what they are required to do in order to provide adequate, efficient, safe, and reasonable service.

I&E St. 2 at 44.

Both adders proposed by the company are misplaced and unsupported and would only have the effect of unreasonably inflating rates.

iii. Leverage

Company witness D'Ascendis states "one must de-leverage the implied cost of common equity based on DCF. This is derived using the Modigliani / Miller equation as illustrated in Schedule DWD-3R . . ." Valley Statement No. 2-R at 15 (footnote omitted).

Dr. Habr also responded to the leverage adjustments Mr. D'Ascendis describes in schedule DWD-3R. OCA St. 3-SR at 3.

> **Q: ARE THE LEVERAGE ADJUSTMENTS MR. D'ASCENDIS DESCRIBES IN SCHEDULE DWD-3R PROPER FOR REGULATED UTILITY COMPANIES?**
>
> A: No, they are not. In fact, their use in the regulated utility industry results in double counting regulatory risk. As I noted in the previous answer, M/B ratios greater than one are indicative of expected earned returns exceeding the cost of common equity. In the regulatory arena, sustained earned returns that exceed the cost of common equity can be reduced at any time through regulatory action. The regulatory risk of this action is already reflected in the price investors are willing to pay for the utility company's common stock.
>
> **Q: DO YOU HAVE ANY OTHER COMMENTS CONCERNING MR. D'ASCENDIS' LEVERAGE ADJUSTMENT?**
>
> A: Yes. Mr. D'Ascendis' market value capital structure is essentially a fair value capital structure whose components: common equity, preferred equity, and debt are all valued at current market prices instead of the actual dollars the company received for the common stock, preferred stock, and various debt instruments issued. Utilizing a market value capital structure effectively allows common shareholders to earn a return on funds they did not contribute to the utility. Original cost rate making assures that investors are only allowed to earn a return on funds that have actually been provided to the utility.

OCA St. 3-SR at 3.

Importantly, in 2012 PPL filed a rate case with proposed adders, to which the Commission rejected. Pa. PUC v. PPL Electric Utilities Corp., Docket No. R-2012-2290597 at 91 (Order entered December 28, 2012) (PPL 2012). In rejecting the adders the Commission stated:

> Based upon our analysis of the evidence of record, we are persuaded by the arguments of the OCA and I&E that PPL's requested leverage adjustment is not reasonable and should be denied. The fact that we have granted leverage adjustments in a few select cases in the past as noted by PPL does not mean that such adjustments are warranted in all cases. The award of such an adjustment is not precedential but discretionary with the Commission. In fact, the Commission has rejected leverage/financial risk adjustments that are similar to the one proposed by PPL in this proceeding. *See, e.g., Pa. PUC v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, at 38-39 (Order entered July 31, 2008). Moreover, in the context of our determination, *supra*, of a reasonable return on equity for PPL of 10.28%, **we conclude that there is no need to have an artificial upwards adjustment to compensate for any perceived risk related to PPL's market-to-book ratio.** Accordingly, we shall deny the Exceptions of PPL and adopt the ALJ's recommendation to reject PPL's requested leverage adjustment.

PPL 2012 at 91 (emphasis added).

Other state commissions have uniformly recognized this type of adjustment as unwarranted in their decisions. The D.C. Commission rejected such adjustment, reasoning as follows:

> [t]he record in this proceeding does not support WGL's prediction that, without such an adjustment, investors will sell their stocks. Investors know that the returns allowed by public service commissions are applied to book value/rate base. An adjustment of the type witness Olson recommends would provide excessive returns to the Company's shareholders at the expense of ratepayers.

In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Increase Existing Rates and Charges for Gas Service, 2003 D.C. PUC LEXIS 220, *72 (2003); see also, West Virginia Public Service Comm'n v. West Virginia-American Water Works, 2004 W. Va. PUC LEXIS 6, *18 (2004). The Public Service Commission of the State of Missouri rejected a utility's argument for a market-to-book adjustment to the DCF-derived return on equity. In the Matter of St. Louis, Missouri, for Authority to File Tariffs to Increase Water Service Provided to Customers in the Missouri Service Area of the Company, 1998 Mo. PSC LEXIS 13, *17 (1988). In rejecting the adjustment, the Missouri Commission concluded that investors are aware that returns on equity for regulated utilities are "based on assets valued at original cost, and they take this factor into account in their investment decisions." Id. Finally, the Michigan Public Service Commission also rejected a market-to-book adjustment in excess of DCF results. See gen'ly In the Matter of the Application of Wisconsin Electric Power Company for Authority to Increase its Rates for the Sale of Electricity in Michigan, 2002 Mich. PSC LEXIS 294, *37-38 (2002).

The OCA submits that for the reasons just discussed, and taking the record as a whole, such adjustments should not be considered in this matter.

F. Summary

For all the foregoing reasons, the OCA submits that the Company has failed to meet its burden of proof in support of its requested 11.35%, as updated to 10.60%, return on equity. The Commission should adopt the OCA's recommended rate of return of 8.34% on common equity and an overall allowed return on rate base of 6.75%.

VIII. TAXES

The taxes issue raised by OCA witness Morgan has been resolved as discussed in Section III above.

IX. RATE STRUCTURE

A. Allocated Class Cost of Service Study (if applicable)

Valley did not have a requirement to file an ACCOSS under the regulations as the regulations only require that an ACCOSS be filed if the rate request is in excess of $1 million. 52 Pa. Code § 53.53. In addition, Valley was not a party to the Citizens' and Wellsboro prior rate cases that resulted in a settlement imposing an obligation on Citizens' and Wellsboro to file an ACCOSS. As such, this section is not applicable to Valley.[16]

B. Revenue Allocation

For Valley, Company witness Gorman proposed to increase the tariff rates for each class by the same percentage (as rounded). OCA St. 4 at 22. The Company excluded from the proposed rate increase Valley's three Firm Fixed and Firm Volumetric customers whose rates are set by contract. OCA St. 4 at 22; see also, OCA St. 4 at 22, Table 7. OCA witness Mierzwa found Valley's proposed across-the-board increase for tariff customers to be reasonable. OCA witness Mierzwa also reviewed the Company's proposal for contract customers and found the proposal to be reasonable. OCA St. 4 at 23. No party disputed the Company's proposed revenue allocation.

C. Rate Design

Valley has one residential customer rate class, Schedule R. Schedule R consists of a $10.50 per month customer charge and $2.5628/Mcf usage charge. Valley proposes to increase the customer charge from $10.50 per month to $12.79 per month, or by 21.8 percent and proposes to increase the volumetric distribution charge by approximately 21.5 percent to $3.1142/Mcf. OCA St. 4 at 23. Although Mr. Gorman did not prepare a class cost of service study for Valley, Mr. Gorman did present an analysis of the direct residential customer costs. See, Valley St. 1 at Exh. HSG-1, Sch. C1-8(R). As OCA witness Mierzwa testified:

---

[16] An ACCOSS was presented for Wellsboro and Citizens' pursuant to the settlement of the Companies' last base rate proceedings in 2016. Pa. PUC v. Citizens' Electric Company of Lewisburg, Pa. and Pa. PUC v. Wellsboro Electric Co., Docket Nos. R-2016-2531550, R02916-2531551, Order (April 6, 2017).

> a customer charge should only include those direct costs associated with serving customers, regardless of their usage or demand characteristics. Customer costs would include the expenses and capital costs related to meters, regulators, and services, as well as expenses related to meter reading and billing.

OCA St. 4 at 28. Mr. Mierzwa determined that only these costs have been included in Mr. Gorman's customer charge analysis.

Mr. Mierzwa testified that a proposed increase to the residential customer charge equal to the system average increase authorized by the Commission in this proceeding to be reasonable and cost-justified. OCA St. 4 at 28. As such, rather than adopt the Company's 21.8% increase to the customer charge, the customer charge should be increased by a percentage that reflects the Commission's final rate determination. OCA St. 4 at 23, 28. The volumetric distribution charge should be adjusted accordingly.

D. Scale Back

If a rate increase less than the Company's requested revenue requirement is approved, the Company's proposed across-the-board allocation should be applied to the approved increase. As discussed above, the OCA recommends that the customer charge should also only be increased by the system average increase authorized by the Commission in this proceeding.

E. Summary

Valley did not have a requirement to file an Allocated Class Cost of Service Study (ACCOSS) under the regulations as the regulations only require that an ACCOSS be filed if the rate request is in excess of $1 million. 52 Pa. Code § 53.53. The OCA submits that the Company's proposed across-the-board increase for tariff customers and the costs of serving customers be adopted. OCA St. 4 at 22-23. If a rate increase less than the Company's requested revenue requirement is approved, the applicable across-the-board tariff revenue increase should apply.

Valley proposes to increase the customer charge from $10.50 per month to $12.79 per month, or by 21.8 percent and proposes to increase the volumetric distribution charge by approximately 21.5 percent to $3.1142/Mcf. OCA St. 4 at 23. Although Mr. Gorman did not prepare a class cost of service study for Valley, Mr. Gorman did present an analysis of the direct residential customer costs. See, Valley St. 1 at Exh. HSG-1, Sch. C1-8(R). After review of the analysis, OCA witness Mierzwa concluded that the Company had appropriately allocated residential customer costs. OCA St. 4 at 28. The OCA recommends that a proposed increase to the residential customer charge equal to the system average increase authorized by the Commission in this proceeding is reasonable and cost-justified. OCA St. 4 at 28. As such, rather than adopt the Company's 21.8% increase to the customer charge, the customer charge should be increased by a percentage that reflects the Commission's final rate determination. OCA St. 4 at 23, 28. The volumetric distribution charge should also be adjusted accordingly.

IX. MISCELLANEOUS ISSUES

A. Reconnection/disconnection fee

Under its existing tariff, Valley's disconnection and reconnection fees are respectively $25 and $30. Here, Valley proposes to increase its disconnection and reconnection fees to $35 for services completed during working hours. For service completed outside of working hours, Valley proposes to increase the disconnection and reconnection fees to $40. OCA St. 4 at 29. The only testimony presented by Company witness Rogers in support of the requested increase states that the "Company has not increased this fee since 2007, therefore an update is necessary to reflect the reconnection cost in today's dollars." Valley St. 4 at 15. In Direct Testimony, OCA witness Mierzwa opposed the proposed increase and stated that "such fees should be cost based. Valley has presented no evidence demonstrating that its proposed increases are cost based." OCA St. 4

at 29; OCA St. 4-SR at 16. Valley did not present any Rebuttal or Rejoinder testimony in response to OCA witness Mierzwa's Direct Testimony or Surrebuttal Testimony. OCA St. 4-SR at 16.

Section 1407(a) of the Public Utility Code provides that "a public utility may require a reconnection fee <u>based upon the public utility's cost</u> as approved by the commission prior to reconnection of service following lawful termination of the service." 66 Pa. C.S. § 1407(a)(emphasis added). The Company has not provided any evidence of its costs for the reconnection or disconnection of service. The fact that the fees have not changed since 2007 does not automatically mean that the Company's costs for reconnection and disconnection have increased or that they have increased by $10. The OCA submits that the Company's proposal should be denied because the Company has not met its burden of proof to demonstrate that the proposed increases to the reconnection and disconnection fees are cost-based, reasonable, or justified. The Company has the burden of proving that each and every component of its rate request is just and reasonable. <u>Burleson</u> at 1236. The Company has provided no calculations or evidence in support of its requested reconnection fee increase. Valley has failed to meet its burden of proof with respect to the proposed increases to the disconnection and reconnection fees and its request should be denied.

B. <u>Main Extension Proposal</u>

Valley has proposed to add a third option to its existing service and main extension policy in order to provide customers with additional opportunities to obtain natural gas service from Valley. Mr. Mierzwa explained the Company's current service and main extension policy:

> Under the Company's current Tariff Rule 4(1), Valley will make a net capital investment in new or upgraded facilities for a residential applicant (1) not to exceed 6 times the customer's estimated base annual revenue ("EBAR"), or (2) up to the cost of 200 feet of service and/or main extension. In the case of a non-residential applicant, Valley will undertake a net capital investment in new or upgraded facilities (1) not to exceed 4.5 times the customer's EBAR or (2) up to the cost of

> 200 feet of service and/or main extension. If the cost of an applicant's main extension and service line exceeds the Company's allowable investment amount, Valley requires the applicant to make an upfront payment of that difference in the form of a contribution in aid of construction ("CIAC"), before the Company will undertake the facility extension project.

OCA St. 4-R at 6; see also, Valley St. 4 at 14-15. Valley proposes a third option for determining the amount of net capital investment the Company will contribute toward a facility extension project. Mr. Mierzwa explained:

> Under the Company's proposed third method, Valley would contribute "up to the Company's average cost of 200 feet of service and/or main extension of new installations for the 12 months ended September 30 of the previous year. That is, this additional option would allow the Company to install facilities in excess of 200 feet in circumstances where the total installation cost is less than or equal to the Company's average allowable investment amount for a 200-foot extension from the previous year.

OCA St. 4-R at 6-7; see also, Valley St. 4 at 14-15; Supplement No. 49 to Gas – Pa. P.U.C. No. 2, Fourth Revised Page No. 27 of Valley's proposed tariff.

Valley proposes to modify its extension policy in order to address the fact that under the current extension policy, customers with different unit installation costs are not treated equitably. Company witness Rogers stated that it is Valley's position that "there is no reason to deprive any individual customer of the level of investment the Company offers, on average, to any customer for a 200-foot extension." Valley St. 4-R at 12. Mr. Rogers further testified that the proposal would be "more equitable for customers" and would "continue to facilitate expansion of gas service, which benefits all customers." Valley St. 4-R at 13.

OSBA witness Kalcic opposes the proposed main extension change, arguing that a remedy is not necessary. Mr. Kalcic argues that the inequity is to be expected as long as the Company's unit installation costs vary across installations. OSBA St. at 9-10. Mr. Kalcic also argues that the proposal would effectively increase Valley's Estimated Base Annual Revenue (EBAR) credit above the cost of 200 feet of service and/or the main extension. OSBA St. 1 at 9. OSBA witness Kalcic recommends the rejection of Valley's proposal to modify its current facility expansion as uneconomic. OSBA St. 1 at 9-10.

In Rebuttal Testimony, Company witness Rogers responded that OSBA's concerns were unfounded. Valley's proposal would not raise the maximum amount the Company can spend on any individual customer. Valley St. 4-R at 12. In fact, as Valley witness Rogers testified:

> The Tariff already allows Valley to provide 200 feet of service and/or main extension, without a specific maximum cost. Rather, Valley's proposal would ensure each customer could access an across-the-board *minimum* dollar investment from the Company. Mr. Kalcic's argument that Valley's proposal would result in the Company effectively exceeding the cost of 200 feet of service and/or main extension is unfounded.

Valley St. 4-R at 12.

The proposed third option is intended to address the potential inequity created in the existing policy. Mr. Rogers states that "Valley's position is that there is no reason to deprive any individual customer of the level of investment the Company offers, on average, to any customer for a 200-foot extension." Valley St. 4-R at 12. Mr. Rogers explains the flaws in OSBA's analysis:

> First, many customer line extensions will still cost less than the average amount of a 200-foot extension because some line extensions are for shorter distances. Second, the Tariff already provides two options to choose from in calculating the Company's allowable investment. Valley is proposing a third method that merely allows all customers to access, if needed, the same minimum dollar investment available to any customer with an average 200-foot extension.

Valley St. 4-R at 13. Mr. Rogers explains how the Company calculated the average cost and its impact on ratepayers and new customers. Company witness Roger testified:

> This figure is based on the average cost of 200 feet of service and/or main extension during a recent defined 12-month period. Clearly, some customers will need far less than this. (For example, adding a 30-foot service extension across unpaved yard will likely cost far less than $6,557.) Valley's proposal is more equitable for customers because it allows each customers to access the same *minimum* dollar amount, if needed. This benefit would be available to all customers across all rate

> classes. From a cost perspective, it does not "raise" the maximum benefit for any individual customer.

Valley St. 4-R at 12-13.

The OCA agrees with the Company's position. OCA witness Mierzwa explained how the current main extension policy can provide unreasonable results, using the following example:

> Customer A, with a lower than average (unit cost) of installation, may require a total of 250 feet of mains/service line investment as a cost of, say, $6,500, or $26 per foot. Customer B, with a greater than average (unit cost) of installation, may require a total of 200 feet of main/service line investment at a cost of, say, $6,800, or $34 per foot. Under the Company's existing service extension policy, Customer B would not be required to pay a CIAC since the service extension does not exceed 200 feet. On the other hand, Customer A would be required to provide a CIAC equal to the cost to install facilities beyond 200 feet. Valley deems this outcome inequitable since Customer A is required to pay a CIAC even though Customer A's total cost of installation ($6,500) is less than the total cost to extend service to Customer B.

OCA St. 4-R at 7-8. As described by Company witness Rogers and OCA witness Mierzwa, the Company's proposal would address these inequities in a manner that would benefit new customers.

OSBA witness Kalcic, however, recommends rejection of Valley's proposal, or in the alternative, replacing the fixed footage allowance with a fixed dollar allowance. OCA St. 4-R at 9. Mr. Mierzwa first explained that rejecting the proposal would not facilitate extending natural gas service into the unserved and underserved areas because "a CIAC can act as a deterrent to customers pursuing natural gas service. Rejecting Valley's proposal as Mr. Kalcic recommends could result in facility extension projects which are economic not being pursued." OCA St. 4-R at 10. OCA witness Mierzwa further explained why Mr. Kalcic's alternative was inequitable:

> Because Mr. Kalcic's recommendation would provide for the same fixed investment amount for each new customer within a class, it fails to address the cost differences which may exist in extending facilities to new customers. Valley's proposal to modify its existing facilities extension policy would appropriately recognize these cost difference.

OCA St. 4-R at 10.

Recognizing the benefit that low-cost natural gas can provide to residential ratepayers, other utilities have sought – and had approved—modifications to main extension policies that will facilitate the expansion of service. See, Pa. PUC v. Peoples Natural Gas Company, LLC, Docket No. R-2018-3006818, Order at 35 (October 3, 2019); Pa. PUC v. Columbia Gas of Pa., Docket No. R-2015-2468056, Order at 14, 22 (June 19, 2015); see also, Pa. PUC v. Columbia Gas of Pa., Docket No. R-2015-2468056, Order at 21-22 (Dec. 3, 2015)(Order approving subsequent Partial Settlement on issue). Valley's proposal also recognizes these benefits and enables the extension of natural gas service to unserved and underserved areas.

Considering the record as a whole, the OCA submits that Valley has met its burden of proof in this case that the modification to its Extension Policy will provide a benefit to customers seeking to obtain access to low-cost natural gas in unserved and underserved areas within the Commonwealth. The OCA supports the Company's proposed main extension modifications and agrees that the proposed modification would provide a necessary fix to address a customer inequity problem in its current main extension policy. See, OCA St. 4-R at 7. For the reasons set forth above, the OCA submits that the Company's proposed main extension and services option should be approved.

XI. CONCLUSION

For the reasons set forth in this Main Brief, the OCA respectfully submits that the Commission should adopt the OCA's adjustments and modifications to the Company's rate increase request. The Company's as-proposed rate increase will not result in just and reasonable rates and will not reflect sound ratemaking policy or Pennsylvania law. In particular, a fair revenue allocation, monthly Residential customer charge, and return on equity must be adopted in this proceeding.

Respectfully Submitted,

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APPENDIX A

TABLE I
VALLEY ENERGY SERVICES, INC
INCOME SUMMARY
R-2019-3008209

	Pro Forma Present Rates (1)	Company Adjustments (1)	Pro Forma Present Rates (Revised) (1)	OCA Adjustments	OCA Pro Forma Present Rates	OCA Revenue Increase	Total Allowable Revenues (2)
	$	$	$	$	$	$	$
Operating Revenue	5,059,370	0	5,059,370	141,561	5,200,931	227,888	5,428,819
Expenses:							
O & M Expense	3,247,647	0	3,247,647	(212,794)	3,034,853	0	3,034,853
Depreciation	971,413	0	971,413	(34,824)	936,589	0	936,589
Taxes, Other	34,296	0	34,296	0	34,296	0	34,296
Income Taxes:							
State	(16,477)	0	(16,477)	86,018	69,541	0	69,541
Federal	(31,177)	0	25,473	162,756	188,229	0	188,229
Deferred Income Tax	56,649	0	56,649	(56,649)	0	0	0
Total Expenses	4,262,351	0	4,262,352	1,156	4,263,508	0	4,263,508
Net Inc. Available for Return	797,019	0	797,018	140,405	937,423	227,888	1,165,311
Rate Base	17,179,542	0	17,179,542	(17,380)	17,162,162		17,162,162
Rate of Return	4.64%		4.64%				6.79%

(1) Company Main Brief

TABLE I(A)
VALLEY ENERGY SERVICES, INC
RATE OF RETURN
R-2019-3008209

	Structure	Cost	After-Tax Weighted Cost	Effective Tax Rate Complement	Pre-Tax Weighted Cost Rate
Total Cost of Debt			2.36301000%		
Long-term Debt	47.45%	4.98%	2.36301000%		2.36%
Short-term Debt	0.00%	0.00%	0.00000000%		
Preferred Stock	0.00%	0.00%	0.00000000%	0.711079	0.00%
Common Equity	52.55%	8.42%	4.42471000%	0.711079	6.22%
	100.00%		6.78772000%		8.58%
Pre-Tax Interest Coverage	3.63				
After-Tax Interest Coverage	2.87				

TABLE I(B)
VALLEY ENERGY SERVICES, INC
REVENUE FACTOR
R-2019-3008209

100%	1.00000000
Less:	
Uncollectible Accounts Factor (*)	0.00000000
PUC, OCA, OSBA Assessment Factors (*)	0.00000000
Gross Receipts Tax	0.00000000
Other Tax Factors	0.00000000
	1.00000000
State Income Tax Rate (*)	0.09990000
Effective State Income Tax Rate	0.09990000
Factor After Local and State Taxes	0.90010000
Federal Income Tax Rate (*)	0.21000000
Effective Federal Income Tax Rate	0.18902100
Revenue Factor (100% - Effective Tax Rates)	0.71107900

(*) Company Main Brief

TABLE II
VALLEY ENERGY SERVICES, INC
SUMMARY OF ADJUSTMENTS
R-2019-3008209

Adjustments	Rate Base	Revenues	Expenses	Depreciation	Taxes-Other	State Income Tax	Federal Income Tax
	$	$	$	$	$	$	$
RATE BASE:							
Reflect Average Balance for Plant in Service and Accumulated Depreciation	(239,643)						
CWC (1)	222,263						
CWC:							
Int. & Div. (Table IV)							
Taxes (Table V)							
O & M (Table VI)							
REVENUES:							
Adjust Residential Revenues		18,094					
Adjust Commercial and Industrial Revenues		50,152					
Adjust Transportation Revenues		73,315					
EXPENSES:							
Eliminate for 3% Inflation Factor Used for 2020			(35,608)				
Normalize I&C Meters and Regulators			(9,444)				
Normalize Meter and House Regulators			(33,736)				
Normalize Customer Install			(14,873)				
Normalize Mains			(13,047)				
Adjust Admin/General Service Overhead (Healthcare)			(76,645)				
Adjust Office Supplies and Expenses for One Time Expense			(19,510)				
Removed Volunteer Labor and One Time Expenses from General Advertising Expense			(4,654)				
Normalize Rate Case Expense over 5 Years			(36,133)				
Adjust for Corrison Technican Position and Medical Leave			96,000				
Adjust to Company's Rebuttal Position (2)			(65,144)				
Adjust Depreciation Expense to Reflect Average Plant				(34,824)			
TAXES:							
EDIT					(56,649)		
State						86,018	
Federal							162,756
Interest Synchronization (Table III)							
TOTALS	(17,380)	141,561	(212,794)	(34,824)	(56,649)	86,018	162,756

(1) CWC adjustment will not match OCA schedules to adjust for the difference between the Company's rebuttal position and OCA's surrebuttal position
(2) OCA recommended adjustments are based upon the Company's Direct position. OCA did not accept the Company's rebuttal expense projections except where noted in Surrebuttal.

TABLE III
VALLEY ENERGY SERVICES, INC
INTEREST SYNCHRONIZATION
R-2019-3008209

	Amount $
Company Rate Base Claim	17,179,542
OCA Rate Base Adjustments	(17,380)
OCA Rate Base	17,162,162
Weighted Cost of Debt	2.36301000%
OCA Interest Expense	405,544
Company Claim (1)	369,360
Total OCA Adjustment	(36,184)
Company Adjustment	0
Net OCA Interest Adjustment	(36,184)
State Income Tax Rate	9.99%
State Income Tax Adjustment	(3,615)
Net OCA Interest Adjustment	(36,184)
State Income Tax Adjustment	(3,615)
Net OCA Adjustment for F.I.T.	(32,569)
Federal Income Tax Rate	21.00%
Federal Income Tax Adjustment	(6,839)

(1) Company Main Brief

TABLE IV
VALLEY ENERGY SERVICES, INC
CASH WORKING CAPITAL - Interest and Dividends
R-2019-3008209

Accrued Interest	Long-Term Debt	Short-Term Debt	Preferred Stock Dividends	
Company Rate Base Claim	$17,179,542	$17,179,542	Company Rate Base Claim	$17,179,542
OCA Rate Base Adjustments	($17,380)	($17,380)	OCA Rate Base Adjustments	($17,380)
OCA Rate Base	$17,162,162	$17,162,162	OCA Rate Base	$17,162,162
Weighted Cost of Debt	2.36301000%	0.00%	Weighted Cost Pref. Stock	0.00000000%
OCA Annual Interest Exp.	$405,544	$0	OCA Preferred Dividends	$0
Average Revenue Lag Days	0.0	0.0	Average Revenue Lag Days	0.0
Average Expense Lag Days	45.0	0.0	Average Expense Lag Days	0.0
Net Lag Days	-45.0	0.0	Net Lag Days	0.0
Working Capital Adjustment				
OCA Daily Interest Exp.	$1,111	$0	OCA Daily Dividends	$0
Net Lag Days	-45.0	0.0	Net Lag Days	0.0
OCA Working Capital	($49,995)	$0		$0
Company Claim (1)	$0	$0	Company Claim (1)	$0
OCA Adjustment	($49,995)	$0		$0
Total Interest & Dividend Adj.	($49,995)			

(1) Company Main Brief.

TABLE V
VALLEY ENERGY SERVICES, INC
CASH WORKING CAPITAL -TAXES
R-2019-3008209

Description	Company Proforma Tax Expense Present Rates	OCA Adjustments	OCA Pro forma Tax Expense Present Rates	OCA Allowance	OCA Adjusted Taxes at Present Rates	Daily Expense	Net Lead/ Lag Days	Accrued Tax Adjustment
PUC Assessment	$24,296	$0	$24,296	$0	$24,296	$66.56	0.00	$0
Public Utility Realty	$10,000	$0	$10,000	$0	$10,000	$27.40	0.00	$0
State Income Tax	($16,477)	$86,018	$69,541	$0	$69,541	$190.52	0.00	$0
Federal Income Tax	$25,473	$162,756	$188,229	$0	$188,229	$515.70	0.00	$0
	$43,292	$248,774	$292,066	$0	$292,066			

OCA Allowance	0
Company Claim (1)	0
OCA Adjustment	0

(1) Company Main Brief

TABLE VI
VALLEY ENERGY SERVICES, INC
CASH WORKING CAPITAL -- O & M EXPENSE
R-2019-3008209

Description	Company Pro forma F.T.Y. Expense	OCA (2)	OCA Pro forma Expenses	Lag Days	Lag Dollars
O&M	$3,247,647	($308,794)	$2,938,853	45.00	$132,248,385
Less: Uncollectibles	(55,430)	6,034	(49,396)	45.00	($2,222,820)
			-	45.00	$0
Service Company			-	45.00	$0
Chemicals			-	45.00	$0
Group Insurance			-	45.00	$0
Insurance, Other			-	45.00	$0
Labor			-	45.00	$0
			-	45.00	$0
Leased Equip./Rent			-	45.00	$0
Leased Vehicles			-	45.00	$0
Miscellaneous			-	45.00	$0
Natural Gas			-	45.00	$0
Power			-	45.00	$0
Purchased Water			-	45.00	$0
Telephone			-	45.00	$0
Waste Disposal			-	45.00	$0
Post Retirement Benefits			-	45.00	$0
Pensions			-	45.00	$0
	$3,192,217	($302,760)	$2,889,457	45.00	$130,025,565

OCA Average Revenue Lag	0.0	
Less: OCA Avg. Expense Lag	45.0	
Net Difference	-45.0	Days
OCA Pro forma O & M Expense per Day	$7,916	
OCA CWC for O & M	($356,220)	
Less: Company Claim (1)	($399,027)	
OCA Adjustment	$42,807	

(1) Company Main Brief
(2) The adjustment will not match Table II due to the Company adjusting its inflation adjustment and levels of expenses in rebuttal. OCA did not accept the Company's rebuttal adjustments to expenses.

APPENDIX B

LIST OF OCA STATEMENTS AND EXHIBITS

DIRECT TESTIMONY

STATEMENT	EXHIBITS	SPONSORING WITNESS
OCA Statement No. 1	SLS-1 – SLS-16	Stacy L. Sherwood
OCA Statement No. 2	LKM-1 – LKM-4; App. A.	Lafayette K. Morgan
OCA Statement No. 3	DSH-1 – DSH-8	David S. Habr
OCA Statement No. 4	JDM-1 – JDM-6	Jerome D. Mierzwa

REBUTTAL TESTIMONY

STATEMENT	EXHIBITS	SPONSORING WITNESS
OCA Statement No. 4-R		Jerome D. Mierzwa

SURREBUTTAL TESTIMONY

STATEMENT	EXHIBITS	SPONSORING WITNESS
OCA Statement No. 1-SR (Revised)	SLS-1C (Revised), SLS-2C, SLS-3C, SLS-16C, SLS-1SR (Revised)	Stacy L Sherwood
OCA Statement No. 2-SR		Lafayette K. Morgan
OCA Statement No. 3-SR		David S. Habr
OCA Statement No. 4-SR	JDM-6S – JDM-7	Jerome D. Mierzwa

CROSS EXAMINATION EXHIBITS

OCA Valley Cross Exam Exh. 1 – OCA-Valley-II-4

PROPOSED FINDINGS OF FACT

III. Issues Agreed Upon Among the Parties

1. The Company will commence Excess Deferred Income Taxes accretion when new rates are effective. Valley St. 1-R at 12.

2. Materials and Supplies balances should be calculated to reflect a 13-month average. OCA St. 2 at 6; Valley St. 1-R at 11.

3. The Materials and Supplies adjustment reduces the Company's rate base by $11,096. OCA St. 2 at 6, Sch. LKM-4; OCA St. 1-SR (Revised) at Sch. SLS-3 C.

4. Customer Deposits should be calculated to reflect a 13-month average. OCA St. 2 at 7; Valley St. 1-R at 11.

5. The Customer Deposits adjustment reduces the Company's rate base by $98,293. OCA St. 2 at 7, Sch. LKM-5; OCA St. 1-SR (Revised) at Sch. SLS-3 C.

6. The Company hired a Corrosion Technician in October 2019, and therefore, increased direct labor and overhead in Account 887- Mains and Account 892-Services. OCA St. 1-SR (Revised) at 4.

7. The adjustment for the Corrosion Technician is $81,280. OCA St. 1-SR (Revised) at 4.

8. The Company made an adjustment to increase direct labor costs for 2019 due to the return of an employee that was on medical leave from January 19, 2019 to May 12, 2019. OCA St. 1-SR (Revised) at 4.

9. The direct labor cost impact is $14,720. OCA St. 1-SR (Revised) at 4.

IV. Rate Base

A. Plant in Service

Fully Projected Future Test Year

10. In its July 1, 2019 filing, the Company relied upon Act 11 and used a FPFTY period ending December 31, 2020 to determine its proposed revenue increase. OCA St. 1 at 4.

11. Valley used an end-of-year methodology for determining its rate base which assumes that on Day 1 of new rates, all projected rate base investments have already been incurred, similar to the methodology used for a FTY claim. OCA St. 1 at 4.

12. An annual average method for determining rate base more accurately reflects the costs as they are incurred during the FPFTY. OCA St. 1 at 4.

13. The end-of-year method will allow the Company to over-earn on its investment in the FPFTY while annual average method recognizes that capital investments will be made throughout the first year that new rates are in effect. OCA St. 1 at 4.

14. The proposed change from the Company's filed end-of-test year rate base to the OCA's proposed average rate base would decrease the Company's proposed rate base by $839,474 from $34,714,831 to $33,875,357. OCA St. 1 at Sch. SLS-3.

Retirements

15. As presented on Exhibit (HSG-1), Schedule C3, during the historical periods, the activity for each year includes plant additions and retirements in the determination of the year end balances for the FTY or the FPFTY. OCA St. 2 at 4, Sch. LMK-1.

16. Exclusion of retirements causes the year-end balances to be overstated. OCA St. 2 at 4, Sch. LMK-1.

17. The year-end Plant in Service and related Accumulated Depreciation should be adjusted to reflect the plant retirement amounts for 2019 and 2020 of $270,000 and $800,000, respectively. OCA St. 2 at 5, Sch. LKM-1.

18. After reflecting these reductions, the total adjustment to Plant in Service and Accumulated Depreciation is $55,659 and $56,678, respectively. OCA St. 2 at 5, Sch. LKM-1.

B. Deductions from Rate Base

Construction Work in Progress

19. In order to qualify for inclusion in rate base, a plant item should be completed and placed in service during the test year. OCA St. 2 at 6.

20. The CWIP balance as of the end of the HTY is likely to already be a part of the plant in service during the FTY and the FPFTY. OCA St. 2 at 6.

21. Inclusion of the CWIP in rate base would result in a double count of these costs. OCA St. 2 at 6.

22. An adjustment should be made to remove the Construction Work in Progress balance of $59,971 from rate base. OCA St. 2 at 6, Sch. LMK-3.

23. Specific projects were not identified by the Company in this proceeding. Valley St. 1-R at 7; OCA St. 2-SR at 7.

24. It is not appropriate to include CWIP in rate base either using an end of test year or average rate base test year method. OCA St. 2 at 6.

25. In either case, the plant item will not be completed and placed in service during the FPFTY. OCA St. 2 at 6.

V. Revenues

26. OCA witness Mierzwa proposed to adjust Valley's FPFTY revenues to reflect the most recent available annual usage of Valley's customers. OCA St. 4-SR at 16.

27. The Company's projections significantly understate FPFTY revenues. OCA St. 4-SR at 15.

28. Valley's revenues should be increased by $164,857. OCA St. 4 at 31, Sch. JDM-1.

VI. Expenses

A. Inflation Factor

29. The Company projected in its FPFTY Operations & Maintenance (O&M) expenses to recognize a general level of rising costs of 3.0 percent. OCA St. 2 at 8.

30. The 3.0 percent was determined based on judgment rather than a quantitative method. OCA St. 2 at 8.

31. The Company has used the 3.0 percent inflation rate as a proxy for determining the FPFTY O&M expenses rather than using forecasted data. OCA St. 2 at 9.

32. The proposed across-the-board 3.0 percent growth or inflation rate is not known and measurable. OCA St. 2 at 9.

33. Inflation adjustments do not directly relate to actual costs expected to be incurred by the Company in the period in which rates are set. OCA St. 2 at 9.

34. If the Commission determines to allow an inflation factor, the calculation of the inflation factor should be limited to 2.1 percent. OCA St. 2 at 9-10.

B. Account 876- Industrial/Commercial Meters and Regulators

35. The Company projects that the total cost of industrial/commercial meters and regulators will be $73,475, which is 12 percent, or $8,071 higher than the HTY. OCA St. 1 at 5.

36. Aannualizing Account 876 by increasing the nine month expenses by 30 percent (what the Company alleges to be incurred in the final quarter) results in a projected expense that is approximately $9,100 less than the Company's projections.

37. The OCA accepts the Company's FTY annualized claim for Account 876, and the OCA's resulting adjustment is $9,429.

C. Account 878- Meters and House Regulators

38. The Company projects that the total cost of meters and house regulators will be $172,563. This expense is $28,488 or 20 percent, higher than the expense in HTY. OCA St. 1 at 6.

39. The OCA recommends a three-year average of Account 878 for 2016 through 2018, which will take into account the increased cost that may occur. OCA St. 1 at 7.

D. Account 879- Customer Installations

40. The Company projects that the total cost of customer installations will be $132,269, which is $17,933, or 16 percent, higher than the expense in HTY. OCA St. 1 at 7.

41. To address the fluctuation and lack of explanation, the OCA recommends that the Company use a three-year average of the Account 879 expenses for 2016 through 2018. OCA St. 1 at 7-8.

E. Account 887- Mains

42. The Company projected that the total cost of mains will be $98,308, which is $41,499, or 73 percent, higher than the expense in HTY. OCA St. 1 at 8.

43. The Company included a one-time expense of $1,219 in Account 887. OCA St. 1-SR (Revised) at 10-11.

F. Account 902- Meter Reading Expense

44. The Company projects that the total meter reading expenses will be $99,668. This expense is $14,821, or 17 percent, higher than the expense in HTY. OCA St. 1 at 9.

45. The Company through the first half of 2019 had not experienced the projected level of overhead expenses. OCA St. 1 at 9-10.

46. The OCA recommends that the Company increase the labor and overhead costs by three percent, coincident with the approved salary increase for FTY. OCA St. 1 at 9-10.

G. Account 903- Customer Records & Collection

47. The Company projects that the total customer records and collection expenses will be $513,237, which is $45,272, or 10 percent, higher than the expense is HTY.

48. While the Company cites increases to this Account, the level of expenses they claim had not been experienced. OCA St. 1 at 10-11.

49. The OCA recommends that the Company increase the HTY overhead costs by three percent, coincident with the approved salary increase for FTY, which equates to $182,523 in FPFTY overhead costs. OCA St. 1 at 11.

H. Account 904- Uncollectible Accounts

50. The Company projects that the total expense for uncollectible accounts will be $100,799 which is $46,787, or 87 percent, higher than the expense in HTY. OCA St. 1 at 11.

51. The OCA calculated an uncollectibles adjustment of $51,403 to Account 904. OCA St. 1 at 12-13.

I. Account 905- Miscellaneous Customer Expenses

52. The Company projects that the total cost of miscellaneous customer expenses will be $24,449, which is $4,628, or 17 percent, lower than the HTY. OCA St. 1 at 14.

53. Although Account 905 has been adjusted for a decrease in certain areas, the Company did not adjust the account for the inclusion of $8,267 in 2018 for an IT backup system expense that should have been capitalized. OCA St. 1 at 14.

J. Account 920- Administrative & General Salaries

54. The Company projects that the total administrative and general salaries expenses will be $535,697, which is $94,081, or 21 percent, higher than expenses in HTY. OCA St. 1 at 14.

55. The level of overhead expenses for this Account has not been experienced by the Company through the first half of 2019. OCA St. 1 at 15.

56. The OCA recommends that the Company increase the HTY overhead expenses by three percent, coincident with the approved salary increase for FTY, which equates to $238,024 in FPFTY overhead costs. OCA St. 1 at 15.

K. Account 921- Office Supplies and Expenses

57. The Company projects that the total administrative and general salaires expense will be $74,701, which is $22,677, or 44 percent, higher than the expense in HTY. OCA St. 1 at 16.

58. The Company is not likely to experience such increase based upon its travel and training expenses recognized through the first half of 2019. If doubled, the expenses would be approximately $20,000 below the Company's projections for the FTY. OCA St. 1 at 16.

L. Account 930- General Advertising Expense

59. The Company noted in response to I&E-RE-31-D that this account should be titled "Miscellaneous General Expenses" and not "General Advertising." OCA St. 1 at 17.

60. The Company projects that the miscellaneous general expenses will be $73,373, which is almost the same level experienced in the HTY, however, it is approximately $20,000 higher than 2017. OCA St. 1 at 17.

61. Off-site volunteering labor should not be included. OCA St. 1-SR (Revised) at 12.

M. Rate Case Expense

62. The OCA has not recommended any adjustment to the level of expense claimed, but recommends an adjustment to the normalization period, the Company proposed a 3 year, 36 month period. OCA St. 1-SR (Revised) at 13.

63. The OCA recommends a normalization period of 60-months. OCA St. 1-SR (Revised) at 13.

64. The Company's 36 month suggested period is based off of the time only since their last rate case filing. OCA St. 1-SR (Revised) at 13.

N. Cash Working Capital

65. The Company calculated its cash working capital based on 12.5 percent or one-eighth of the operations and maintenance expense, excluding depreciation expense, uncollectible and taxes, which the OCA adopted. OCA St. 1 at 9.

O. Depreciation Expense

66. As a result of Valley's use of the end of test year rate base, Valley has also based its rate year depreciation expense on the projected balance of plant in service as of the end of the FPFTY. OCA St. 2 at 8.

67. The adjustment to reflect the depreciation expense that will be incurred during the rate year ending December 31, 2020 reduces depreciation expense by $33,805. OCA St. 2 at 8.

VII. Rate of Return

68. The OCA accepted the Company's Capital Structure and recommends and 8.34% return on common equity and a return on rate base of 6.75%. OCA St. 3 at 2-3.

69. Profits for the provision of utility services are regulated because the services tend to be produced under conditions that approximate a natural monopoly. OCA St. 3 at 3.

70. The Company's recommendation is based on a flawed DCF analysis. OCA St. 3 at 6-8.

71. The Commission primarily relies upon the DCF method.

72. Dr. Habr conducted DCF and Capital Asset Pricing Model (CAPM) analyses. OCA St. 3 at 14.

73. The DCF model is straight forward and provides reliable results when the growth rate used in the model is consistent with the model's assumptions. OCA St. 3 at 9-10.

74. Dr. Habr primarily relied on the DCF method, using the CAPM method as a check, and has recommended an 8.34% return on common equity. OCA St. 3 at 14.

75. Dr. Habr calculates his CAPM analysis by using a time frame that includes the time frame he used in his DCF analysis. OCA St. 3 at 16. OCA St. 3 at 16.

76. To estimate the cost of equity, a proxy group of similar companies is needed, a proxy group is generally preferred over the use of data exclusively from any one company because it has the effect of smoothing out potential anomalies associated with a similar company and is therefore a more reliable measure. OCA St. 3 at 14.

77. Dr. Habr confirmed that Mr. D'Ascendis' use of non-price regulated firm results in establishing his recommended allowed rate of returns invalidates his conclusions. OCA St. 3 at 31-32.

78. Both OCA and I&E witnesses explained why the Company should not be awarded a size premium. OCA St. 3 at 29-30; I&E St. 3 at 41-43.

79. Both OCA and I&E witness explained why the Company should not be awarded a performance premium. OCA St. 3 at 29-30; I&E St. 3 at 41-43.

80. OCA witness Dr. Habr refuted Mr. D'Ascendis' CAPM analysis because Mr. D'Ascendis relied on an average 3.36% 30-year treasury yield based on a period covering the second quarter of 2019 through 2029. OCA St. 3 at 34.

81. Dr. Habr's CAPM/Risk Premium median 9.54% and 9.61% confirms the validity of his DCF results because they provide upper limits not to be exceeded. OCA St. 3 at 28.

82. Dr. Habr demonstrated that Mr. D'Ascendis' DCF model is flawed in that he does not consider making any adjustment to his DCF analysis to take into account the impact on his results of analysts' short-term forecasts that exceed the expected long-term GDP growth because these growth rates are not sustainable, their use results in the DCF cost rates being over estimated. OCA St. 3 at 33.

IX. Customer Rate Structure

B. Revenue Allocation

83. Company witness Gorman proposed to increase the tariff rates for each class by the same percentage (as rounded). OCA St. 4 at 22.

84. The Company excluded from the proposed rate increase Valley's three Firm Fixed and Firm Volumetric customers whose rates are set by contract. OCA St. 4 at 22; see also, OCA St. 4 at 22, Table 7.

85. OCA witness Mierzwa found Valley's proposed across-the-board increase for tariff customers to be reasonable. OCA St. 4 at 23.

86. OCA witness Mierzwa also reviewed the Company's proposal for contract customers and found the proposal to be reasonable. OCA St. 4 at 23.

C. Rate Design

87. Valley has one residential customer rate class, Schedule R. OCA St. 4 at 23.

88. Schedule R consists of a $10.50 per month customer charge and $2.5628/Mcf usage charge. OCA St. 4 at 23.

89. Valley proposes to increase the customer charge from $10.50 per month to $12.79 per month, or by 21.8 percent and proposes to increase the volumetric distribution charge by approximately 21.5 percent to $3.1142/Mcf. OCA St. 4 at 23.

90. Although Mr. Gorman did not prepare a class cost of service study for Valley, Mr. Gorman did present an analysis of the direct residential customer costs. See, Valley St. 1 at Exh. HSG-1, Sch. C1-8(R).

91. A customer charge should only include those direct costs associated with serving customers, regardless of their usage or demand characteristics. OCA St. 4 at 23.

92. Customer costs would include the expenses and capital costs related to meters, regulators, and services, as well as expenses related to meter reading and billing. OCA St. 4 at 28.

93. Only these costs have been included in the proposed customer charge analysis. OCA St. 4 at 28.

X. Miscellaneous

A. Reconnection/Disconnection Fee

94. Under its existing tariff, Valley's disconnection and reconnection fees are respectively $25 and $35. OCA St. 4 at 29.

95. Valley proposes to increase its disconnection and reconnection fees to $35 for services completed during working hours. OCA St. 4 at 29.

96. For service completed outside of working hours, Valley proposes to increase the disconnection and reconnection fees to $40. OCA St. 4 at 29.

97. Reconnection fees and disconnection fees should be cost-based. OCA St. 4 at 29; OCA St. 4-SR at 16.

B. Main Extension Proposal

98. Valley has proposed a third option to its existing service and main extension policy in order to provide customers with additional opportunities to obtain natural gas service from Valley. OCA St. 4-R at 6; Valley St. 4 at 14-15.

99. Under the Company's current Tariff Rule 4(1), Valley will make a net capital investment in new or upgraded facilities for a residential applicant (1) not to exceed 6 times the customer's estimated base annual revenue ("EBAR"), or (2) up to the cost of 200 feet of service and/or main extension. OCA St. 4-R at 6.

100. Under the Company's current Tariff, in the case of a non-residential applicant, Valley will undertake a net capital investment in new or upgraded facilities (1) not to exceed 4.5 times the

customer's EBAR or (2) up to the cost of 200 feet of service and/or main extension. OCA St. 4-R at 6.

101. Under the Company's current Tariff, if the cost of an applicant's main extension and service line exceeds the Company's allowable investment amount, Valley requires the applicant to make an upfront payment of that difference in the form of a contribution in aid of construction ("CIAC"), before the Company will undertake the facility extension project. OCA St. 4-R at 6.

102. In its filing, Valley proposes a third option wherein Valley would contribute up to the Company's average cost of 200 feet of service and/or main extension of new installations for the 12 months ended September 30 the previous year. OCA St. 4-R at 6.; Valley St. 4 at 14-15.

103. The additional option would allow the Company to install facilities in excess of 200 feet in circumstances where the total installation cost is less than or equal to the Company's average allowable investment amount for a 200-foot extension from the previous year. OCA St. 4-R at 7; Valley St. 4 at 15.

104. The proposed third option is to address the potential inequity created in the existing policy. Valley St. 4-R at 12.

PROPOSED CONCLUSIONS OF LAW

1. The Public Utility Commission has jurisdiction over the parties and the subject matter of this proceeding by virtue of the Public Utility Code, 66 Pa. C.S. § 101, *et seq.*

2. Valley has the burden of establishing the justness and reasonableness of every element of its requested rate increase. 66 Pa. C.S. § 315(a); Lower Frederick Twp. v. Pa. PUC, 48 Commw. 222, 226-27 (1980).

3. Valley has the burden of proving that the rate involved is just and reasonable. 66 Pa. C.S. §§ 315(a), 1301, and 1308(e).

4. Valley may satisfy its burden of proof by a preponderance of the evidence. Samuel J. Lansberry, Inc. v. Pa. PUC, 134 Pa. Commw. 218, 221-22 (1989).

5. Valley has not met its burden of proof to establish that its cost of equity is reasonable and is otherwise supported by record evidence.

6. Valley has not met its burden of proof to establish that its rate of return is reasonable and is otherwise supported by record evidence.

7. Valley has not met its burden of proof that its proposed rates contained in Supplement 49 are just, reasonable and otherwise lawful.

8. Valley should be permitted to file a new tariff, proposing rates designed to recover no more than $227,888 in base revenues.

PROPOSED ORDERING PARAGRAPHS

It is hereby ORDERED THAT:

1. Valley Energy Company shall not place into effect the rates contained in Supplement 49, which have been found to be unjust, unreasonable and, therefore, unlawful.

2. Valley Energy Company is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings herein, to produce revenues not in excess of $227,888.

3. The tariffs, tariff supplements, or tariff revisions may be filed upon less than statutory notice, and pursuant to the provisions of 52 Pa. Code §§ 53.31 and 53.101, may be filed to be effective for service rendered on and after the date of entry of this Commission's Opinion and Order.

4. Valley Energy Company shall file detailed calculations with its tariff filing, which shall demonstrate to this Commission's satisfaction that the filed rates comply with the proof of revenue, in the form and manner customarily filed in support of compliance tariffs.

5. Valley Energy Company shall comply with all directives, conclusions and recommendations contained in this Commission's Opinion and Order that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

6. Valley Energy Company shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class in the manner set forth in this Order.

7. The Complaints filed by the various parties to this proceeding at Docket Number R-2019-3008209 are granted in part and denied in part, to the extent consistent with this Commission's Opinion and Order.

DATE:________________ ______________________________________

Administrative Law Judge Steven K. Haas
Administrative Law Judge Benjamin J. Myers