BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

MAIN BRIEF OF VALLEY ENERGY, INC.

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I. INTRODUCTION

On July 1, 2019, Valley Energy, Inc. ("Valley" or "Company") filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") Supplement No. 49 to Tariff Gas-Pa. PUC No. 2 ("Original Supplement No. 49"), proposing an annual increase in revenue of $1,034,186. In support of this filing, Valley submitted a Statement of Reasons, the supporting information required by 52 Pa. Code § 53.52(a), (b), and (c), and various other information.

On July 29, 2019, Valley filed a revised Supplement No. 49 ("Supplement No. 49") modifying the proposed revenue increase to $834,497. *See* Valley Statement No. 1 – Direct Testimony of Howard S. Gorman ("Valley Statement No. 1"), Exhibit__(HSG-1), Schedule C1 (R).

In its Rebuttal Testimony, Valley subsequently revised its proposed revenue increase to approximately $745,000, reflecting rate of return, expense, and rate base adjustments to the as-filed request. Valley Statement No. 1-R – Rebuttal Testimony of Howard S. Gorman ("Valley Statement No. 1-R"), Exhibit__(HSG-1R2), Schedule C1 (R) [1]

A. VALLEY ENERGY, INC.

Valley is a small, for-profit, investor-owned natural gas distribution company ("NGDC") that provides natural gas service in Sayre and surrounding communities in Bradford County, which is in the northern tier of Pennsylvania. C&T Enterprises, Inc. ("C&T"), of which Valley is a wholly-owned subsidiary, formed Valley to purchase the assets of Valley Cities Gas Service, ("Valley Cities") and Waverly Gas Service from NUI Corporation. The two public utilities operate

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[1] In its Rebuttal Testimony, Valley provided an updated Schedule C1 showing adjustments to present and proposed revenue, rate base and rate of return. *See* Valley Statement No. 1-R, (Exhibit__HSG-1R2), Schedule C1 (R). At this time, all other schedules remain unchanged from the July 29, 2019 filing.

as an integrated system, receiving all-natural gas supplies through a single city gate located in Pennsylvania. Valley became the owner of the system in November 2002.

Valley's service territory is predominantly concentrated in Sayre and Athens Pennsylvania, and surrounding areas of Bradford County. As of December 31, 2018, Valley served 6,942 customers, of which 6,058 were residential, 812 were commercial and Industrial, and 72 were transportation customers. Schedule B3 (R), shows the total customers served by Valley on December 31, 2018, and the number of customers projected to be served as of December 31, 2019 and 2020. Valley Statement No. 1, Exhibit__(HSG-1), Schedule B3 (R). Valley anticipates a modest increase in customers due in part to an expansion project to the East Athens portion of Valley's territory ("East Athens Expansion") which was approved by the Commission on May 9, 2019, at Docket No. P-2018-3006500.

Through the instant proceeding, Valley requests from the Commission approval of an increase in annual delivery revenues. Valley conducted an analysis of whether the Company's base rates are sufficient to compensate the Company for the costs that it incurs to provide natural gas delivery and transportation service to its customers. In 2018, the Company earned a rate of return (distribution only) of 9.24%. *See* Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). However, without rate relief, Valley projected a rate of return for 2020 of only 4.64%. *See id.* Such a return is insufficient to support the continuation of the Company's efforts to provide safe, reliable, and quality service to customers and sufficient to satisfy the *Bluefield* standard.[2] If the full request is granted, Valley projects that it would earn a return of approximately 7.72%. *See id*. Valley believes that this is an appropriate return for its investment in the system under the *Bluefield* standard.

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[2] *See* Section VII.A., *infra.*

Valley last filed a distribution rate case in 2010, with the new rates taking effect in December 2010. As in 2010, the Company continues to undertake projects to improve reliability and safety of the pipeline system. Since filing the last base rate case, Valley has performed upgrades to its City Gate facility; upgraded transmission mains; replaced or upgraded 17 district regulator stations; installed over 17 miles of new or replacement plastic gas mains; installed 1,905 new or replacement services; relocated 100 meters from indoors to outdoors; and added or replaced 31 large commercial metering facilities. The Company also upgraded buildings and structures, including HVAC systems, computer equipment (servers and cables), and a generator. In addition, Valley has successfully replaced all bare steel mains and service lines. Valley has also begun replacing vintage plastic (Aldyl-A) mains that were installed in the early- to mid-1970s. These vintage plastic mains are budgeted to be completely replaced by 2023. Since the settlement in Valley's 2010 base rate case, Valley's rate base has increased from $11,412,287 to $17,398,606 — a $5,986,319 increase. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-7 (R).

Valley was able to maintain stable transportation rates for the last nine years despite very dramatic and substantial increases in operations and maintenance ("O&M") costs that are not within the Company's control. Comparing Valley's 2010 base rate case settlement to the Fully Projected Future Test Year in Valley's current base rate case, O&M expenses have increased by $1,018,113. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-7 (R). For example, since the Company's last rate case in 2010, Valley's labor costs have increased by 63%. Valley's employee team has increased from 24 full time employees in 2010 to 30 in 2020. The Company has added an Operations Technician, Field Service Technician, Operations Manager, Part-Time Customer Service Representative, a Geographic Information Systems Analyst, a Corrosion Technician, and anticipates adding a Full Time Customer Service Representative (replacing the part time position). Travel and training expenses, respectively, have increased from approximately

$6,000 annually to $54,000 annually to support the new hires and meet the increased expectations of federal and state regulators for training and operator qualifications.

In addition to labor costs, from 2010 to 2020 overhead increased by 77%; transportation expenses by 110%; and material, supplies and miscellaneous expenses by 34%. Additionally, the Company invested in billing software. Although Valley has taken steps to reduce expenses where possible, these continued cost increases and the substantial investment in new or replacement utility plant that has not yet been reflected in rate base, make it necessary for the Company to increase its rates so it can earn an adequate rate of return to support continued maintenance and upgrades of the system and the provision of safe and reliable service.

A reasonable rate of return is also particularly important for a company such as Valley due to the nature of its natural gas supply agreements. Valley is required to demonstrate its creditworthiness to the wholesale natural gas suppliers from which the Company purchases supply. Valley is constantly under credit review by its suppliers. In the event that Valley's financial situation would reach an unacceptable level, the Company may be asked for additional credit guarantees, such as to prepay for its natural gas, to post asset-backed guarantees, or other undesirable credit obligations. This situation would negatively impact Valley by limiting both the number of suppliers willing to serve the Company, as well as impairing the Company's liquidity. Enabling a fair and reasonable rate of return, such as Valley proposes in this proceeding, will prevent such undue harm.

For all rate schedules, Valley proposes to increase the monthly customer charge. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule B5 (R). A very large portion of the revenues for most utilities are collected through variable charges, while the actual cost-to-serve for most customers is largely fixed. Valley's revenues and costs are similar to those utilities. To better align rates with the cost of providing service, Valley proposes to reflect a portion of the overall

increase in its fixed charges to customers. These changes are needed to ensure that the rates better reflect the costs that the Company incurs to serve each customer class.

B. HISTORY OF THE PROCEEDINGS

This proceeding was initiated on July 1, 2019, when Valley filed Supplement No. 49 with the Commission. The Office of Consumer Advocate ("OCA") filed a Formal Complaint against Valley's rate increase on July 30, 2019. On July 22, 2019, the Office of Small Business Advocate ("OSBA") submitted a Notice of Appearance in this proceeding. The Bureau of Investigation and Enforcement ("I&E") also filed a Notice of Appearance on July 19, 2019. Pursuant to 52 Pa. Code § 5.61(d), Valley elected not to file an answer to OCA's Complaint.

At its Public Meeting of August 29, 2019, the Commission suspended Valley's proposed tariff supplement by operation of law until March 30, 2020, and instituted an investigation into this proceeding. On September 9, 2019, Valley filed a tariff supplement voluntarily extending the suspension period through April 29, 2019. On October 2, 2019, Valley filed an updated tariff supplement voluntarily extending the suspension period until May 1, 2020. The Commission assigned Administrative Law Judges ("ALJs") Steven K. Haas and Benjamin Myers to this case.

The ALJs held a Prehearing Conference on September 13, 2019, at which time a litigation schedule was developed. The Prehearing Conference was held jointly with the rate cases filed by Citizens' and Wellsboro at Docket Nos. R-2019-3008212 and R-2019-3008208, respectively. Prior to the Prehearing Conference, on August 2, 2019, Valley provided the parties with its prepared Direct Testimony. In accordance with the schedule established at the Prehearing Conference, Valley received Direct Testimony from OCA, I&E, and OSBA on October 15, 2019. On November 14, 2019, Valley submitted Rebuttal Testimony and received Rebuttal Testimony from OCA and OSBA on that same date. Valley received Surrebuttal Testimony from OCA, I&E, and OSBA on December 4, 2019.

Pursuant to the litigation schedule developed at the Prehearing Conference, the ALJs presided over a telephonic public input hearing on November 4, 2019.

Evidentiary hearings were held on December 16 and 17, 2019, to establish the record; provide oral Rejoinder Testimony from Company witnesses; and to make witnesses available for cross-examination. As with the Prehearing Conference, the evidentiary hearings were held jointly for the Citizens', Wellsboro, and Valley rate proceedings. All prepared Statements and Exhibits were entered into the record by verification or by witness authentication. Company witnesses Gorman, D'Ascendis, Rogers, and Levering were sworn in and presented oral Rejoinder Testimony and submitted to cross-examination. I&E witnesses Grab and Cline and OCA witnesses Sherwood, Morgan, and Mierzwa were sworn in and submitted to cross-examination. The testimony of other witnesses was entered into the record by stipulation without cross-examination.

Despite good faith efforts to resolve disputed issues via settlement, the parties were unable to reach settlement. However, a number of proposals by various witnesses were agreed upon by witnesses to opposing parties. These resolved issues are set forth in Section III of this Main Brief. Valley files this Main Brief to address all remaining disputed issues. As set forth more fully in this Main Brief, Valley's proposed rate base, revenue, expenses, rate of return, rate design, and tariff changes are just and reasonable and should be approved by the Commission.

C. LEGAL STANDARDS

The Public Utility Code requires that a public utility's rates be just, reasonable, and do not result in unreasonable rate discrimination. 66 Pa. C.S. §§ 315(a), 1301, 1304. Where, as here, a public utility seeks a general rate increase, the utility has the burden of proving that each element of the rate increase request is just and reasonable. *Univ. of Pa. v. Pa. PUC*, 485 A.2d 1217, 1226 (Pa. Cmwlth. 1984). The Commonwealth Court has explained, however, that public utilities are not required to affirmatively defend claims that have gone unchallenged. *See Allegheny Ctr.*

Assoc.'s v. Pa. PUC, 570 A.2d 149, 153 (Pa. Cmwlth. 1990) (stating "[w]hile it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.").

The ultimate burden of proof does not shift from the utility seeking a rate increase, however, where a party proposes an adjustment to the utility's rate making claim, that party must present evidence or analysis that demonstrates the reasonableness of its proposed adjustment. *See e.g., Pa. PUC v. Philadelphia Electric Company*, Docket No. R-891364, *et al.*, 1990 Pa. PUC LEXIS 155 (Order dated May 16, 1990); *see also Pa. PUC v. Breezewood Tel. Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45, at *10 (Order dated Jan 31, 1991) (stating "the Commission has indicated that where a party proposes an adjustment to a ratemaking claim of a utility, the proposing party does bear the burden of presenting some evidence or analysis tending to demonstrate the reasonableness [sic] of the adjustment.").

Further, a party that raises an issue that is not included in a public utility's general rate case filing bears the burden of proof. *See, e.g., Pa. PUC. v. Metro. Edison Co., et al.,* Docket Nos. R-00061366, *et al.,* 2007 Pa. PUC LEXIS 5, at *111-12 (Order entered Jan.11, 2007) (holding that Section 315(a) of the Public Utility Code cannot reasonably be read to place burden of proof on utility with respect to issues the utility did not include in its general rate case filing and which, frequently, utility would oppose).

II. SUMMARY OF ARGUMENT

Valley requests approximately a $745,000 overall revenue increase in this proceeding. Since Valley's last base rate case, the Company has made significant system investments, which will have increased its rate base by nearly $6 million to over $17 million by the end of the Fully-Projected Future Test Year ("FPFTY").

As a small utility, Valley continues to excel in providing exceptional service to its customers. Despite anticipating declining system usage and delivery revenues, the Company continues to systematically replace its aging distribution infrastructure, including upgrading its City Gate facility; upgrading transmission mains; replacing or upgrading district regulator stations; installing over 17 miles of new or replacement plastic gas mains; installing 1,905 new or replacement services; relocating 100 meters from indoors to outdoors; and adding or replacing dozens of large commercial metering facilities. Valley has successfully replaced all bare steel mains and service lines and has begun replacing vintage plastic mains that were installed in the early- to mid-1970s. The Company also upgraded buildings and structures, including HVAC systems, computer equipment (servers and cables), and a generator.

Valley has presented extensive evidence to support its filing. This Main Brief addresses all major aspects of the Company's rate filing, including rate base, revenues, expenses, rate of return, and rate structure in Sections IV through IX. The issues upon which the parties have agreed through testimony are stated in Section III.

Throughout this proceeding, the Company has presented extensive evidence of management efficiency and effectiveness. In addition to the major upgrades and improvements listed above, the Company has continued its exceptional management track record, including the following accomplishments since the last base rate case: (1) completing the Company's main replacement program without assessing a Distribution System Improvement Charge ("DSIC") on customers or filing for a rate increase; (2) low number of customer complaints, including no formal complaints in the last three years; (3) fast emergency response; (4) favorable customer feedback; (5) technological improvements in customer service by offering Smarthub use to customers; and (6) obtained a grant for the East Athens main extension project. The bottom line in determining management effectiveness is quality of service and reasonable rates. As explained further in this

Main Brief, Valley provides top tier customer service and reliability with a small, dedicated team and, thus far, without the use of a DSIC. These efforts and results should be recognized in this proceeding, as required by Section 523 and good public policy.

Notably, the evidence demonstrating Valley's effective management and service is entirely unrebutted by the opposing parties. However, I&E and OCA have essentially ignored all of this evidence and propose a variety of adjustments that, if adopted, would deprive Valley of an opportunity to earn a fair return. These central disputes are summarized as follows:

A. RATE BASE

Consistent with long-standing Commission precedent and the Commission's recent holding in the UGI Order, the Company's rate base claim is based on projected balances at the end of the test year – in this case, the FPFTY. However, OCA argues that plant in service should not be calculated in this manner, instead proposing an approach that "averages" the beginning and end of FPFTY balances. OCA effectively seeks to disallow half of all plant added during the FPFTY and in conflict with the Commission's clear holding in the UGI Order. As described in Section IV, *infra*, this adjustment is fundamentally inconsistent with the plain language of the Act of Feb. 14, 2012, Pub. L. 72, No. 11 ("Act 11") and the Commission's holding in the UGI Order.

B. REVENUES

OCA opposes Valley's present rate revenue claims. OCA proposes to only use sales data from the 12 months ended October 2019 and only weather-normalized only Residential and Commercial Rate classes. OCA fails to provide any credible for its position and does not address the fact that Valley faces declining sales, adding to its need for rate relief. As further set forth in Section V, *infra*, the Company's revenue projections are reasonable and should be accepted by the Commission.

C. EXPENSES

OCA and I&E seek reductions to numerous Company accounts using a variety of methods to understate the Company's expenditures. However, Valley's FTY (2019) year-to-date data, provided up through September 30, 2019 in Rebuttal Testimony, shows that the Company is effectively managing to its budget. While there is some variation between accounts, the Company's expenses are tracking close to projections. This fact, combined with Company testimony explaining certain one-time events impacting FTY expenditures, demonstrates the Company's FPFTY expense projections are realistic and conservative. As further explained in Section VI, *infra*, I&E's and OCA's selective expense adjustments should be denied, and the Company's expense claims should be accepted.

D. RATE OF RETURN

The Company has presented extensive data and analyses fully supporting its proposed 10.6% return on common equity and demonstrating that the 8.46% and 8.34% proposals of I&E and OCA, respectively, are woefully deficient. Of note:

1. OCA and I&E's recommended costs of common equity are outside the zone of reasonableness and, if adopted, would place the Companies below the lowest ROE *in the entire United States* over the past 40 years, according to a leading utility research group.
2. I&E and OCA ignore evidence establishing that their reliance solely on one ROE model would understate a fair rate of return due to present market conditions.
3. The Company has provided extensive evidence of size risk that must be reflected in an opportunity to earn a fair rate of return.
4. In accordance with the requirements of Section 523 of the Code, 66 Pa. C.S. § 523, Valley's presented extensive evidence of excellent utility management. No party

challenged any aspect of the Company's evidence—but argued the Company has been merely taking actions it is required to take pursuant to the Public Utility Code. In essence, I&E and OCA have offered only general opposition to the principle of a performance adjustment—an inadequate argument that ignores Section 523 of the Code.

As further explained in Section VII, *infra*, the deficient proposals of I&E and OCA cannot be considered reasonable or reflective of the current market climate and should be rejected by the Commission.

E. REVENUE ALLOCATION AND RATE DESIGN

No party opposes Valley's proposed revenue allocation or rate design. As explained further in Section VIII, *infra*, the Company's proposal should be approved by the Commission.

F. TARIFF CHANGES

The Company proposed multiple tariff changes, including a modification to Valley's Facilities Extension Policy and an update to Valley's disconnection and reconnection fees, which were respectively opposed by OSBA and OCA. As described further Section IX, *infra*, OSBA's opposition to a third method for calculating the Company's portion of service line extension costs is not persuasive in light of the public interest benefits of the Company's proposal. As also explained in Section IX, OCA's opposition to Valley's proposed disconnection and reconnection fees is not supported. The Company's proposed tariff changes should be approved by the Commission.

G. CONCLUSION

The opposing parties' proposals deny meaningful rate relief to a Company that is experiencing modest to non-existent revenue growth, faces increased operating expenses, and continues to invest substantial capital in new plant and facilities necessary to provide safe and

reliable service to customers. The Company has presented unrebutted evidence of superior management, a fact acknowledged by neither I&E nor OCA. The opposing parties reach an unreasonable position by: (1) defying the plain language of the Public Utility Code; and (2) ignoring long-standing Commission precedent on fundamental ratemaking issues. Therefore, Valley's respectfully requests that the ALJs and the Commission deny the adjustments of the opposing parties and approve Valley's proposed rate increase.

III. ISSUES RESOLVED AMONG ALL PARTIES[3]

A. CONSTRUCTION WORK IN PROGRESS

The Company initially proposed to add a Construction Work in Progress ("CWIP") amount of $114,497 to its FPFTY rate base total. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). This amount was based on the balance sheets for the historic test year ("HTY"), future test year ("FTY"), and FPFTY. I&E and OCA opposed the addition of CWIP for the FPFTY to rate base. I&E Statement No. 3 – Direct Testimony of Ethan H. Cline ("I&E Statement No. 3") at 7; OCA Statement No. 2 – Direct Testimony of Lafayette Morgan ("OCA Statement No. 2") at 4-5.

Because Valley's CWIP projections were based on historic figures rather than specific identified projects projected to be under construction at the conclusion of the FPFTY, Valley accepted the removal of CWIP from rate base. Valley Statement No. 1-R at 7. However, Valley's acceptance of the removal of CWIP from rate base is conditioned on the premise that plant projected to be in service by the end of the FPFTY is included in rate base, consistent with Commission precedent. *Id.* If "average" rate base figures for the FPFTY are used, as argued by OCA, the Company believes retaining its CWIP claim is appropriate. *Id.*

[3] The rate case tables attached as Appendix A reflect any revisions Valley accepted in its Rebuttal Testimony.

B. CHARITABLE CONTRIBUTIONS

Valley prioritizes building goodwill with customers, maintaining a positive presence in the community, and creating a vibrant, community-oriented workplace for Company employees. To that end, Valley makes a variety of charitable contributions to different community organizations each year in support of the local community. *See* I&E Statement No. 1 – Direct Testimony of Brenton Grab ("I&E Statement No. 1"), I&E Exhibit No. 1, Schedule 3.

Due to an initial misunderstanding between the parties on whether charitable contributions were included in calculating the Company's revenue requirement, I&E proposed adjustments to Valley's revenue requirement to disallow the alleged claim for charitable contributions. I&E Statement No. 1 at 9. However, Valley clarified in Rebuttal Testimony that charitable contributions are charged to Account 426.1, which was not included in Valley's revenue requirement. Valley Statement No. 1-R at 6. I&E withdrew its proposed adjustments connected to this account. I&E Statement No. 1-SR – Surrebuttal Testimony of Brenton Grab ("I&E Statement No. 1-SR") at 13.

C. PENSION EXPENSE

In its Direct Testimony, I&E calculated a $773,767 pension claim based on information provided in Valley's response to Interrogatory I&E-RE-23-D. *See* I&E Statement No. 1 at 21. In the Rebuttal Testimony, Valley provided an initial updated response to I&E-RE-23-D explaining errors in the original response and clarifying that pensions costs were claimed as a component of overhead costs rather than as a separate claim. Valley Statement No. 5-R - Rebuttal Testimony of Jamie Levering ("Valley Statement No. 5-R") at 4. Valley also provided a further updated response to I&E-RE-23-D after serving its Rebuttal Testimony to address questions received during informal discussions with the intervenors. *See* I&E Statement No. 1-SR at 29.

Following review of the updated responses to I&E-RE-23-D, I&E withdrew is pension adjustment. *See id.*

D. RATE BASE – MATERIALS & SUPPLIES

In its initial filing, the Company proposed to add $161,817 to rate base for materials and supplies. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). OCA witness Morgan proposed to use an average of the most recent 13 months of actual inventories, which increases the Company's rate base by $11,096 to $172,913. OCA Statement No. 2, Schedule LKM-4.

On Rebuttal, the Company accepted the OCA's 13-month methodology. Valley Statement No. 1-R at 11.

E. RATE BASE – CUSTOMER DEPOSITS

In its filing, the Company proposed to deduct $362,607 from rate base for customer deposits. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). Instead of basing the customer deposits amount on the Company's end-of-year HTY balance, OCA proposed to use a 13-month average balance. OCA Statement No. 2 at 7. OCA proposed a $98,293 adjustment reducing the Company's deduction for customer deposits from $362,607 to $264,314. OCA Statement No. 2, Schedule LKM-5.

On Rebuttal, the Company accepted OCA's 13-month methodology. Valley Statement No. 1-R at 11.

IV. RATE BASE

A. COMPANY PROPOSAL

The Company's claim for rate relief in this case is based upon data for the FPFTY ending December 31, 2020. Valley Statement No. 1 at 2; Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). In keeping with Commission regulations, Valley has provided detailed data for the HTY ending December 31, 2018. Valley Statement No. 1 at 4.

Valley's final claimed rate base of $17,176,637 reflects all adjustments adopted by the Company in this proceeding. Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). The claimed rate base consists of:

- the original cost of its utility plant in service as of December 31, 2020
- less: accumulated depreciation; accumulated deferred income taxes ("ADIT"); excess deferred income taxes ("EDIT"); and customer deposits
- plus: CWIP; accrued pension / OBEP liability; materials and supplies; and Cash Working Capital ("CWC")

See Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). I&E proposed changes to CWIP but did not dispute any other rate base components. OCA proposed adjustments to plant in service, CWIP, Materials and Supplies, Customer Deposits, Depreciation Expense, and EDIT.

B. ORIGINAL COST UTILITY PLANT IN SERVICE

The Company's claim for original cost utility plant in service of $34,714,831 is based on projected plant in service at the end of the FPFTY. Valley Statement No. 1, Exhibit__(HSG-1), Schedules C1-6 (R), C2 (R), C3 (R). OCA witnesses allege that the Company's plant in service and accumulated depreciation calculations for the FPFTY do not appropriately reflect plant retirements. OCA Statement No. 2 at 4. OCA witnesses also oppose the Company's calculation of plant in service at the end of the FPFTY, instead proposing an average calculation of rate base throughout the FPFTY. *Id.* For the reasons articulated below, these proposed adjustments should be rejected.

1. Adjustments for Plant Retirements

OCA witness Morgan observes that the Company's calculation of Plant in Service did not reflect plant retirements. OCA Statement No. 2 at 4. Mr. Morgan added that any adjustment to

Plant in Service for retirements would require a parallel adjustment to accumulated depreciation. *Id.* In total, this proposal results in a $55,659 adjustment to Plant in Service and a $56,678 adjustment to accumulated depreciation. *Id.* at 5.

These parallel adjustments do not result in a material impact on the Company's rate base claim. The Company recommends approval of its Plant in Service and Accumulated Depreciation calculations without modification.

2. End-of-Year vs. Average Rate Base Methodology

The Company's claim for plant in service is based on plant projected to be in service at the end of the FPFTY – that is, December 31, 2020. The Company's approach is consistent with direction recently provided by the Commission for calculation of plant in service at the end of the FPFTY. *Pa. PUC v. UGI Utilities, Inc. – Electric Division,* Docket No. R.2017-2640058 (Order Entered October 25, 2018) ("UGI Order") at 23-26; *see also* 66 Pa. C.S. § 315(e). The Company's approach comports with other Commission precedent providing that rate base items should be calculated as of the end of the given test year.

OCA opposes this methodology. Instead of using an end-of-year plant in service figure, OCA proposes that the Commission calculate the Company's rate base by averaging the beginning of test year and end of test year plant balances. *See* OCA Statement No. 2, Schedule LKM-2. Specifically, OCA proposes to average the plant in service balance on December 31, 2019 ($33,129,952) with the plant in service balance at the end of the FPFTY on December 31, 2020 ($34,714,831). Id. The result is a $783,815 downward adjustment to Valley's claim for plant in service. *See Id.*[4]

[4] In addition to plant in service, OCA's proposed methodology also impacts other components of the Company's total claim in this proceeding, such as Accumulated Depreciation. *See* Valley Statement No. 1-R at 11. The arguments supporting the Company's calculation of the FPFTY with regard to plant in service, and those supporting rejection of the approach utilized by OCA, extend to those other components of the Company's claim, as well. *See* Id.

OCA's primary argument is that Valley's new rates will go into effect before some of the costs will be incurred. OCA Statement No. 1 – Direct Testimony of Stacy L. Sherwood ("OCA Statement No. 1") at 4; OCA Statement No. 2-SR – Surrebuttal Testimony of Lafayette K. Morgan ("OCA Statement No. 2-SR") at 2. OCA appears to propose this alternative methodology based on the assumption that customers will be paying for plant that is not yet in service. Specifically, OCA witness Sherwood argues that Valley will earn a 12-month return for calendar year 2020 "on the level of plant that will not be in service until December 31, 2020." OCA Statement No. 1 at 4. OCA asks the Commission to contradict its own decision in the UGI Order, stating that OCA appealed the Commission's holding. OCA Statement No. 2-SR at 2.

As noted above, the Company's claimed plant in service, based on plant projected to be in service at the end of the FPFTY, is consistent with both the Commission's holding in the UGI Order and long-standing Commission precedent, which has uniformly approved the calculation of plant in service at a point in time, i.e. the end of the relevant test year. *See*, e.g., *Pa. PUC, et al. v. PPL Electric Utilities Corporation*, Docket Nos. R-2012-2290597, et al., at 12. ("We agree with PPL that rate base items...are balances to be in effect at the end of the test year.").

For the reasons set forth below, OCA's arguments explicitly contradict the Commission's holding in the UGI Order; ignore the plain language of the Act of February 14, 2012, Pub. L. 72, No. 11 ("Act 11"); and frustrate the General Assembly's goals in enacting Act 11. OCA's position should be rejected.

a. <u>OCA's Argument Contradicts the Commission's Decision in the UGI Order.</u>

In the UGI Order, the Commission addressed the question of whether plant in service should be calculated on the basis of an end-of-year figure or an average figure as proposed by OCA and I&E in that proceeding. The Commission held that an end-of-year plant in service

number is appropriate. UGI Order at 23. In its Order, the Commission rejected arguments from the Advocates based on Section 1315 of the Code, which requires electric utility projects to be "used and useful" before being included in the rate base. As explained by the Commission:

> Section 315(e) of the Code specifically exempts application of 66 Pa. C.S. § 1315, which, for electric utilities, requires projects to be "used and useful" before being included in the rate base. The ALJs properly determined that the "used and useful" standard in Section 1315 *is not a bar to including all plant added during the FPFTY.*

UGI Order at 23 (emphasis added). The Commission further stated that by using an FPFTY, "a utility is essentially permitted to require ratepayers to pre-pay a return on its projected investment in future facilities." UGI Order at 24. The Commission evaluated the statute and explicitly noted that, with the FPFTY, the future facilities are not in place and providing service at the time the new rates will take effect. However, the Commission affirmed that use of an end-of-year FPFTY plant balance is appropriate under Section 315(e).

b. <u>The Plain Language of Act 11 Supports an End-of-Year Plant in Service Calculation for Both the FTY and the FPFTY.</u>

In 2012, the legislature Act 11. Among other things, Act 11 provided for the use of an FPFTY as a new ratemaking tool in Pennsylvania, amending Section 315(e) of the Public Utility Code to state as follows:

> (e) Use of future test year.--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) (relating to voluntary changes in rates). The commission shall promptly adopt rules and regulations regarding the information and data to be submitted when and if a future test period or a fully projected future test year is to be utilized. Whenever a utility utilizes a future test year or a fully projected future test year in any rate proceeding and such future test year or a fully projected test year forms a substantive basis for the final rate determination of the commission, the utility shall provide, as specified by the commission in its final order, appropriate data evidencing the accuracy of the estimates contained in the future test year or a fully projected future test year, and the commission may after reasonable notice and hearing, in its discretion, adjust the utility's rates on the basis of such data.

> 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 base.

66 Pa. C.S. § 315(e). The language of Act 11 fully supports use of end of test year balances. *See* id. The Act does not contain a separate provision for the FPFTY; rather, it simply adds the FPFTY to the existing statute authorizing use of an FTY. *See* id. For the FTY, it is standard ratemaking practice to use end of test year balances for determining plant in service. Act 11 provides no indication that the FPFTY plant balances should be calculated differently. In fact, as explained above, the Legislature (1) expressly indicated that the FPFTY may include plant projected to be in service *during* the FPFTY; and (2) specifically noted that Section 1315, which codified the "used and useful" standard, provides no bar to including in rate base all plant added during the FPFTY. *See id*. Thus, the General Assembly clearly allowed for the FPFTY to be treated the same as the FTY in calculating plant in service. OCA's arguments should be rejected.

c. The Use of End of Test Year Plant Balances Is Consistent with the Policy Underlying Act 11.

As affirmed in the UGI Order, one of the policies underlying Act 11 is to address regulatory lag. UGI Order at 23; *see also* Implementation of Act 11 of 2012, Docket No. M-2012-2293611, 2012 Pa. PUC LEXIS 1223 at *4-5, 7, 90 (Order entered Aug. 2, 2012) ("Act 11 Implementation Order"). It is well-known that many Pennsylvania utilities have aging infrastructure and must complete substantial capital investments to maintain safe and reliable service to ratepayers. Regulatory lag, where rate case inputs "are outdated by the time new base rates become effective," presents a challenge to fulfilling this need. Act 11 Implementation Order at *4. This problem is explicitly addressed by Act 11.

Act 11 addressed the problem of regulatory lag by establishing the FPFTY and authorizing utilities to file for a Distribution System Improvement Charge ("DSIC") under certain conditions.

See 66 Pa. C.S. § 1358(b)(1). The FPFTY allows utilities to develop rate filings on a *fully projected* future test year rather than a test year that will be mostly or entirely in the past at the conclusion of the rate case. The DSIC, meanwhile, is designed to recover approved and qualifying infrastructure improvements between rate cases, reducing regulatory lag and the need to file frequent base rate cases. *See, e.g.,* Act 11 Implementation Order at *90.

OCA's proposal to use an average rate base would dramatically weaken the benefits provided by the legislature in adopting Act 11. First, OCA would effectively deny half of the rate recovery by disallowing half of the additions budgeted between the end of the FTY and the end of the FPFTY. Specifically, OCA would eliminate half of the benefits of using the FPFTY by only allowing $783,815 in plant additions in 2020, where Valley has planned for $1,623,288 of plant additions for the FPFTY. *See* OCA Statement No. 2, Schedule LKM-2; *see* also Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

Second, under OCA's proposal, at some point during the first-year rates are in effect, rates will become insufficient to cover the used and useful plant placed into service during that year. In effect, this policy, if adopted, would convert a fully projected future test year to a "partially projected half test year." *See* Valley Statement No. 1-R at 11.

This approach is inconsistent with the purpose and policy underlying Act 11. OCA has provided no factual or legal basis for its average proposal, except that OCA is challenging the Commission's current position. OCA's position should be rejected.

d. <u>The Company's Approach Is Internally Consistent.</u>

In this case, the Company's approach for the FPFTY aligns with the Company's approach to the HTY and FTY. For all three test years, the Company provides rate base as of the last day of the annual period. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). This is

consistent with Act 11, which mandates that all plant placed in service during the test year be used and useful in providing service in that test year.

Adopting OCA's proposed methodology would result in one approach for 2018 and 2019 data and a distinct (and incomplete) approach for 2020 – in effect treating 2020 as a partial year for rate base. The OCA's approach to ratemaking is internally inconsistent and disjointed with no precedential basis. OCA's proposal should be rejected by the Commission.

e. Current Commission Policy Should Control Unless and Until It Is Overturned by a Reviewing Court.

OCA acknowledges that the Commission decided against the use of average rate base in the UGI Order but points out that the Commission decision is currently under legal challenge by OCA. OCA Statement No. 2 at 2. Regardless of the status of this issue on appeal, the Commission's current position is clear. The Company has appropriately used year end balances, consistent with the UGI Order. The OCA's proposed adjustment must be rejected.

C. ACCUMULATED DEPRECIATION

The Company's claim for rate base included an accumulated depreciation of $16,499,533 for FPFTY. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). As described by Valley witness Gorman, accumulated depreciation is calculated by adding annual depreciation expense at each year-end and subtracting retirements to the previous year-end balance. Valley Statement No. 1 at 16.

I&E did not oppose the Company's accumulated depreciation claim. I&E Statement No. 3, Exhibit No. 3, Schedule 1. However, OCA proposed an adjustment to accumulated depreciation based on its arguments that original cost utility plant in service should be based on an average of the beginning-of-year and end-of-year FPFTY plant balances. OCA Statement No. 2 at 4. OCA's FPFTY average balance calculation of $33,875,358 resulted in a $544,153 reduction in

accumulated depreciation amount, for a total accumulated depreciation of $16,442,855. OCA Statement No. 2, Schedule LKM-2.

The distinction between OCA's position and the Company's position on accumulated depreciation is a direct result of the two parties' different approaches to calculating the original cost plant in service. As stated above, the Company contends that original cost plant in service should be calculated based on the FPFTY year-end balance, consistent with the Commission's holding in the UGI Order.[5]

D. ADDITIONS TO RATE BASE

Valley's additions to rate base include: Materials and Supplies; Accrued Pension / OPEB Liability (negative amount); and CWC. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

1. Materials & Supplies

As stated above, the Company agreed to a small Materials and Supplies adjustment proposed by OCA increasing its claim by $11,096 from $161,817 to $172,913. Valley Statement No. 1-R at 11; *see also* OCA Statement No. 2, Schedule LKM-4.

2. Accrued Pension/OPEB Liability

In its filing, the Company proposed a reduction to rate base for Accrued Pension / OPEB liability. This reduction reflects the excess of amounts charged to expense over amounts paid. Valley Statement No. 1 at 18. Neither OCA nor I&E proposed any adjustments to the Company's claim. OCA Statement No. 1, Schedule SLS-3; I&E Statement No. 3 at 3-8.

[5] On this basis, the OCA's adjustment to Accumulated Depreciation also must be rejected. However, if the Commission reduces the Company's claim for original cost plant in service, there should be a commensurate reduction in accumulated depreciation as well.

3. Cash Working Capital

Regarding CWC, the Company claimed an increase of $402,100 to rate base. Valley Statement No. 1, Exhibit__(HSG-1) Schedule C1-6 (R). The Company derived the CWC by using the widely accepted formula of 1/8 of non-fuel cash operating costs. Valley Statement No. 1 at 18.

I&E and OCA do not oppose the 1/8 method proposed by the Company. Valley Statement No. 1-R at 7, 9. However, I&E and OCA each propose to reduce the CWC claim to reflect the respective party's proposed O&M expense adjustments and remove non-cash items (uncollectible expense, taxes other than income, and depreciation) from computation of CWC. I&E Statement No. 1 at 24; OCA Statement No. 1 at 19.

While the Company opposes several O&M expense adjustments proposed by I&E and OCA, the Company agrees that CWC should be recalculated if the Commission orders any changes to the Company's claimed O&M expenses. *See* Valley Statement No. 1-R at 7, 10. If O&M expenses are adjusted, the Commission should use the same 1/8 method utilized by the Company, with removal of non-cash items as proposed by I&E, and OCA, to adjust CWC.

E. DEDUCTIONS FROM RATE BASE

As outlined above, the Company deducted the following from plant in service in its calculation of rate base: Customer Deposits; ADIT; and EDIT. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

1. Customer Deposits

As stated above, OCA proposed a $98,293 adjustment to Customer Deposits, which the Company accepted. *See* OCA Statement No. 2 at 7; *see also* Valley Statement No. 1-R, at 11.

2. ADIT and EDIT

ADIT addresses the difference between actual tax liability for accumulated depreciation paid by Valley and the amount of tax expense for accumulated depreciation paid by ratepayers in

the revenue requirement. Valley Statement No. 1 at 17-18. Federal tax expense for ratemaking purposes is calculated using straight line depreciation, while for tax purposes the Company could use the double declining balance depreciation method. EDIT, on the other hand, directly addresses the benefit the Company received by taking depreciation expense for tax purposes while the Federal corporate tax rate was 34% and the revaluation of EDIT as of December 31, 2017, when the corporate tax rate changed from 34% to 21%. Valley Statement No. 1 at 18. Because the EDIT is due to the one-time change in the tax rate established through the Tax Cuts and Jobs Act ("TCJA"), it will not change over time.

The Company's claimed rate base includes a reduction for ADIT of $165,352 for the end of the FPFTY. *See* Valley Statement No. 1. Exhibit__ (HSG-1), Schedule C1-6 (R). This amount is equal to the difference between accumulated depreciation based on Federal tax expense borne by ratepayers (i.e., based on straight line method) and accumulated depreciation based on Valley's actual tax Federal tax expense (i.e., based on double declining balance method), times the current Federal income tax rate. Valley Statement No. 1 at 17; *see also* Valley Statement No. 1, Schedule C1-6, lines 28-33 and line 6.

The EDIT is calculated by taking the ADIT at December 31, 2017 (the initial effective date of Federal income tax rates under the TCJA), times the reduction in Federal income rates due to the TCJA. Valley Statement No. 1 at 17-18. The EDIT is computed on Schedule C1-6 (R), lines 36-41 and carried up to Schedule C1-6 (R), line 7. Id. The Company is amortizing the balance over the estimated remaining book life of the assets – ten years. Id. The EDIT balance included in rate base declines each year during this ten-year period. Id. The annual EDIT accretion (Schedule C1-6 (R), line 40) is carried forward to reduce Income tax expense (Schedule C1-4 (R), line 28). *Id.*

No party challenged the Company's calculation of ADIT or the proposal to amortize the EDIT balance over ten years; however, OCA claims the calculation of the EDIT balance should be modified to reflect the fact that EDIT will not accrue until new rates go into effect because the Commission has not required Valley to implement a credit flowing tax savings back to customers. *See* OCA Statement No. 2 at 11; *see also* Joint Statement No. 3 at 12 (confirming Valley was not required to implement rate adjustments to reflect impacts of the TCJA). As stated in Mr. Gorman's Rebuttal Testimony, Valley accepts OCA's adjustment, which increases the EDIT balance by $27,443 and reduces rate base by the same amount. *See* Valley Statement No. 1-R at 12; *see also* OCA Statement No. 2 at 11.

3. Natural Gas Inventories

As detailed in Section VI.B.9 below, the Company proposed to unbundle certain natural gas inventory costs in the amount of $650,909 from delivery rates and recover those costs for this asset through its Gas Cost Rate ("GCR"). *See* Valley Statement No. 1 at 17; *see* Valley Statement No. 1, Exhibit __ (HSG-1), Schedule C1-6 (R). No party opposed the Company's proposal.

F. CONCLUSION FOR RATE BASE CALCULATION

For the reasons fully explained above, the Company's final claimed rate base of $17,167,637 is reasonable and, therefore, should be approved.

V. REVENUES

Valley calculated projected FPFTY sales and revenue for tariff rate schedules Rate R, Rate C, Rate L, Rate IS, Rate SI, Rate Transport DDQ, and Rate Transport Interruptible based on a regression analysis using monthly number of customers and Heating Degree Data ("HDD") for 2016 – 2018. Valley Statement No. 1 at 9-11. For the Rate Schedule Rate Transportation Firm sales and revenue projection, Valley applied the same calculation, except using only 2018 HDD because changes in the customer configuration rendered data from prior periods inapplicable. *See*

Valley Statement No. 1 at 10. Importantly, Valley witness. Gorman also clarified that the "Company's projection of sales is based on a regression analysis for weather sensitive classes." Valley Statement No. 1-R at 12. Mr. Gorman additionally elaborated on the regression analysis in the manner below:

> What we did for the Valley revenue forecast of the sales projection at present rates is we did a statistical regression analysis. We did for each major component, each major rate class and we regressed actual sales by month for a period of time, using Heating Degree Days for these months.

Tr. 83.

As calculated by Mr. Gorman, Valley's anticipated system usage is expected to decline from 28,757,694 ccf in 2018 to 26,569,046 ccf in 2020. Valley Statement No. 1 at 11-12. Under present rates, this will reduce delivery revenues from $5,306,089 in 2018 to $5,059,370 in 2020. Valley Statement No. 1, Exhibit__(HSG-1), Schedule B (R).

Only OCA proposed adjustments to Valley's FPFTY sales and revenue projections. In Direct Testimony, OCA proposed an alternative revenue calculation that increases Valley's projected revenue at present rates (thus decreasing the revenue increase in this proceeding), but failed to credibly support or even fully explain its methodology. OCA witness Mierzwa proposes to increase Valley's FPFTY revenues at present rates to reflect only sales data from the 12 months ended October 2019. OCA Statement No. 4-SR, Surrebuttal Testimony of Jerome D. Mierzwa ("OCA Statement No. 4-SR"), Schedule JDM-6S. Mr. Mierzwa also adds that he weather-normalized sales for only Residential and Commercial rate classes, but does not explain why he did not weather-normalize other classes, or even present any evidence to support this decision. *See* OCA Statement No. 4 – Direct Testimony of Jerome D. Mierzwa ("OCA Statement No. 4") at 31; *see also* OCA Statement No. 4-SR, Schedule JDM-6S.

In his oral rejoinder testimony, Mr. Gorman discussed the many flaws in OCA's analysis, including: 1) relying on a single year of sales data; 2) taking the usage over the full year instead of

the well-supported approach of taking usage by month; and 3) inexplicably omitting certain classes from weather normalization. Mr. Gorman explained:

> There were no flaws identified in [the Company's] analysis, which in my experience is a kind of typical regression analysis that you would do for a sales forecast. Mr. Mierzwa substituted his own forecast and what he did was he took only one year of data, the most recent year of data, so that's a significant shortcoming of his work. He only used one year of data. He used it only on an annual basis… people that work in the industry know or should know the annual number really doesn't mean that much. It means that if you get a variation in September or the coldest day of the year, it doesn't mean that much. What matters is, what affects the regression, is the shorter periods, the swing months, the months in between, where people actually do vary their usage.
>
> So that's the second flaw, that he only – he did on an annual basis as opposed to – an annual basis as opposed to a monthly basis. And the third significant error was that the regression analyses that I did show that all of the heating classes except for the interruptible class have significant slopes to them. That means there's a correlation between the – between the heating degree days and the gas used by the customer. And Mr. Mierzwa ignored that for all but two of the classes.
>
> So again, he didn't find that anything was actually wrong with the way I did my forecast. And his forecast would - I would not accept that forecast. If somebody presented that to me, I would say we need to do a better job than that.

Tr. 84. As explained by Mr. Gorman, Mr. Mierzwa's alternative revenue forecast relies on limited data and fails to apply a monthly regression. Id. Perhaps even more significantly, Mr. Mierzwa provides no explanation for rejecting Mr. Gorman's prudent and supported weather normalization adjustments for customers other than Residential or Commercial customers. *See* id. Where Mr. Gorman extensively described the correlation between HDD days and gas usage for all non-Interruptible gas schedules, Mr. Mierzwa simply omits this adjustment and makes no attempt to explain the change in methodology.

Mr. Mierzwa has failed to support his proposed sales and revenue projections. As a result, the Commission should deny the adjustment and approve the Company's proposal.

VI. EXPENSES

In this proceeding, the Company has proposed to include expenses reasonably necessary to provide safe and reliable service to its customers in the FPFTY. *See* 66 PA. C.S. § 1501. Under Pennsylvania law, public utilities are entitled to recover all reasonable expenses incurred in furnishing public utility service. The Commonwealth Court has stated: "The general rule is that a public utility is entitled to recover in rates those expenses reasonably necessary to provide service to its customers and to earn a fair rate of return on the investment and plant used and useful in providing service." *Butler Township Water Co. v. Pa. PUC,* 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984) *("Butler Township"). See also T.W. Phillips Gas and Oil Co. v. Pa. PUC,* 81 Pa. Cmwlth. 205, 474 A.2d 355 (1984).

In reviewing the Company's proposals and the oppositional arguments from I&E and OCA, the Commission should also consider its responsibility to preserve the appropriate managerial discretion to make decisions based on the circumstances at hand. The Commission has cautioned against the tendency to weigh the prudency of managerial discretion based on information discovered after the fact. The Commission has concluded that "[t]he prudence standard enunciated by the courts requires that the Commission assess the reasonableness of utility management's decision-making based on the state of information available at the time decision had to be made without reliance upon after-discovered facts." *Pa. PUC v. Philadelphia Suburban Water Company*, 1991 Pa. PUC LEXIS 206, *9-10 (Pa. PUC October 18, 1991). Similarly, the prudence standard directly rejects the undue reliance on outcomes or results-oriented review of managerial decisions, which would find imprudence merely because an intended result was not achieved. *See Pa. PUC v. Duquesne Light Co.,* 63 Pa. PUC 337, 351 (1987).

The relevant question in a base rate proceeding is whether the proposed expenses are reasonable and appropriate for the furnishing of service to customers. The range of these expenses

is reflected in the Company's initial filing. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedules C1 (R) – C1-1 (R). A subset of the expenses included in the Company's original filing has been challenged by I&E and OCA and are described in this Section of the Company's Main Brief. As demonstrated herein, the expenses Valley has included in this proceeding are reasonable and appropriate for provision of safe and reliable service to its customers. Therefore, the Company's expense claims should be approved.

A. COMPANY PROPOSAL

1. The Company's Expense Claims Are Reasonable and Should Be Approved.

To develop its expense claims, the Company analyzed HTY actual costs and the FTY budget and developed projected costs for the FPFTY. Company expenses are comprised of the following components:

- Operations & Maintenance ("O&M") costs: including Purchased gas, Distribution expenses; Customer accounting and collection expenses; and Administrative and general expenses.
- Non-operating costs: including Depreciation, Taxes other than Income; Rate case expense normalization; and Income tax Expense.

Valley Statement No. 1 at 12; *see also* Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). Schedule C1 (R) provides an overview of the Company's expenses in summary format. *See* Valley Statement No. 1-R, Exhibit__(HSG-1R), Schedule C1(R). Schedule C1-1 (R) shows historical O&M costs on a more detailed basis, with projected changes for the FTY and the FPFTY.

The Company's O&M expenses for the HTY, including Purchased Gas, totaled $6,150,692. Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). Subtracting purchased gas, the distribution-only O&M total was $2,801,234. Id. The Company's total distribution-only O&M

expense claim for the FPFTY is $3,062,076. Id. Total distribution-only expenses for the HTY (including depreciation and taxes other than income) were $7,016,406. Id. Total distribution-only expense for the FPFTY (including depreciation and taxes other than income) are projected to be $4,158,118. *Id.*

The Company developed its FPFTY claim by adding a 3% wage, salary, and benefit inflation adjustment and other known adjustments to the O&M accounts in its FTY budget. *See* Valley Statement No. 1, Exhibit—(HSG-1), Schedule C1-1 (R), at 3-4 (showing adjustments to the FTY revenues). The Company's approach to budgeting recognizes that many individual accounts fluctuate on a year-to-year basis, and during the year, as different operational requirements arise. The FTY budget makes various assumptions regarding the projects and duties that various employees will have during the FTY, and whether any internal employees will work on projects that are capitalized rather than expensed. Those projections cannot account for all contingencies, especially not on an account-by-account basis, as work may need to shift between accounts, such as Account No. 878 - Meters and House Regulators and Account No. 902 – Meter Reading Expense. On a total expense basis; however, the Companies strive to operate within the budgeted total expenses.

In estimating costs for the FPFTY, the Company's management relied on its years of experience evaluating year-to-year changes in labor, benefits, materials, and outside contractor costs. Tr. 199. Based on that experience, Company management advised Mr. Gorman to incorporate a conservative 3% inflation factor to the FTY budget to arrive at the FPFTY costs. This was reasonable since the 2020 budget would not be developed until late 2019, which was after the rate case was filed.

The Company believes its method of carefully developing the FTY budget, then basing its FPFTY O&M expenses on the FTY budget plus an inflation factor and other known changes is an appropriate and reasonable basis to support its FPFTY claim.

As demonstrated below, the adjustments for the FPFTY are conservative expense adjustments that reasonably project expense growth and comport with both available FTY data and long-term historic cost trends for the Company. The Company's FPFTY expense claims are reasonable, well-grounded, and are supported. The FPFTY inflation adjustment is also supported by the Company's recently developed 2020 budget.

2. Actual 9-Month FTY Expense Data Supports the Company's Full Expense Claim.

Since filing the proposed rate increase, the Company tracked expenses throughout the FTY and provided updates to the other parties. In responses to discovery and in testimony, total O&M costs for the FTY were updated – both at the 6-month mark (as of June 30, 2019) and the 9-month mark (as of September 30, 2019). Because evidentiary hearings occurred near the end of the FTY, the Company was able to provide actual data to support its FTY expenses, and explain expense increases that will occur in the FPFTY (as reflected in the Company's 2020 Budget).

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a. Annualized FTY Expense and FPFTY Claim

Based on most recent YTD data (through September 30), the Company is tracking very close to its planned expenditures for 2019 as reflected in the FTY in the filing. In fact, as described in Mr. Gorman's Rebuttal Testimony, the 9-month expenses result in a projection that is $30,096 lower than the projection based on annualizing the YTD figures and adding the 3% adder that was applied across the board in developing the Company's FPFTY projections. Valley' Statement No. 1-R at 5. Further, as described in Mr. Gorman's Rebuttal Testimony, the projected FPFTY expenses based on annualizing FTY expenses based on actual costs as of September 30, 2019, must be adjusted to reflect to additional labor and overhead costs associated with a Corrosion Technician hired on October 7, 2019, and the return of an employee from prolonged medical leave. *See* Valley Statement No. 1-R at 6. When those adjustments are included, the Company's currently projected O&M expenses for 2020 exceeds the amount in the original filing.

These data demonstrate that the Company's projections not only comport with actual O&M expenses on an aggregate basis, but that the Company's expense projections for the FPFTY, as reflected in its rate filing, are conservative. While some accounts are high and some are low because operational priorities shifted during the year, the Company has effectively managed its resources to its budget. As seen in Table 1 below, the Company's expenses in the FPFTY based on annualized YTD data are projected to be just below the Company's claim, before accounting for the necessary adjustments described below.

Main Brief Table 1

Account	Actual 9 months	Annualized	FPFTY	Claim	Difference
842	16,497	21,996	22,656	32,904	(10,248)
870	116,548	155,398	160,060	153,703	6,357
871	5,838	7,784	8,017	5,590	2,428
874	360,871	481,161	495,596	514,698	(19,102)
875	50,284	67,046	69,057	67,081	1,976
876	48,034	64,046	65,967	73,475	(7,508)
877	30,199	40,265	41,473	47,351	(5,878)
878	135,855	181,140	186,574	172,563	14,010
879	102,199	136,265	140,353	132,269	8,084
880	3,958	5,277	5,436	4,130	1,306
881	2,575	3,433	3,536	1,969	1,567
885	18,913	25,218	25,975	29,056	(3,081)
886	56,055	74,739	76,982	41,191	35,790
887	29,976	39,968	41,167	36,742	4,425
889	22,904	30,539	31,455	18,231	13,224
890	20,945	27,926	28,764	17,284	11,479
891	4,984	6,646	6,845	11,765	(4,920)
892	46,095	61,460	63,304	61,261	2,043
893	47,661	63,547	65,454	59,542	5,911
902	61,453	81,937	84,396	99,668	(15,272)
903	349,623	466,164	480,149	513,237	(33,088)
904	31,855	42,473	43,748	100,799	(57,052)
905	18,177	24,236	24,963	24,449	515
909	8,395	11,193	11,529	1,236	10,293
913	6,129	8,172	8,417	4,141	4,276
920	349,820	466,427	480,420	536,697	(56,277)
921	44,951	59,934	61,732	74,701	(12,969)
923	125,475	167,299	172,318	87,699	84,619
924	9,167	12,222	12,589	12,051	538
925	44,957	59,943	61,741	59,893	1,848
926	449	598	616	3,168	(2,552)
928	26,805	35,740	36,813	38,524	(1,711)
930	48,074	64,099	66,022	73,373	(7,352)
932	16,982	22,643	23,322	27,098	(3,776)
	2,262,703	3,016,937	3,107,445	3,137,541	(30,096)

Valley Statement No. 1-R at 6.

As seen on the table, total 2019 O&M costs are, when annualized, are projected to be $3,016,937. Id. After adding the 3% inflation factor, this results in an annualized projection of $3,107,445. Id. While this total is $30,096 below the Company's FPFTY claim of $3,137,541, it

does not account for the FTY and FPFTY adjustments detailed in the Direct Testimony of witness Jamie Levering. *See* Valley Statement No. 1-R at 6.

b. FTY and FPFTY Adjustments

Ms. Levering explains that the Company's annualized 2019 expense data based on actual expenses incurred as of September 30, 2019 do not reflect that Valley: (1) hired a Corrosion Technician on October 7, 2019 and (2) had an employee take a prolonged medical leave from January 19, 2019 through May 12, 2019. Valley Statement No. 5-R at 4-5.

As a result of the extended medical leave, labor costs recorded to Account Nos. 878, 879, 893, and 932 were reduced. *See id.* at 4-5. The additional FTY expense to correct for the non-recurring reduction in labor costs resulting from the prolonged employee medical leave increases Valley's FTY overhead expense by $14,720. *See id.* at 5.

Additionally, Ms. Levering confirmed that Valley hired a Corrosion Technician on October 7, 2019. *Id.* at 6. The labor and overhead costs associated with this employee hire were not included in the Company's 2019 budget or its FTY labor and overhead calculations. *See id.* Adjusting the Company's FPFTY claim to reflect the unanticipated 2019 Corrosion Technician hire increases the FPFTY expense by $81,280. *See* Valley Statement No. 1-R at 2; *see* OCA Statement No. 1-SR at 4.

As discussed below, OCA and I&E contest the Company's proposal relying on annualized FTY expenses for the FPFTY expense claim. As explained below, the Company's expense claim based on the annualization of actual O&M costs as of September 30, 2019 is reasonable and should be approved. However, any approved FTY expense and FPFTY projection should be adjusted to account for the above-referenced employee medical leave and hiring of the Corrosion Technician. *See* Valley Statement No. 1-R at 2.

c. <u>The OCA and I&E Objections to the Company's Expense Claim Ignore the Operation Reality of Smaller Public Utilities and Fail to Appropriately Account for the Company's Actual Expenses as Evidenced by the FTY Data</u>

OCA and I&E take a "mix and match" approach to adjusting accounts that results in penalizing the Company for its effective budget management. As stated by Mr. Gorman, OCA "proposed adjustments for accounts using a variety of methods, sometimes using a 3-year average, sometimes using a 2-year average, sometimes using only 2018, sometimes using the entire account, and sometimes using portions of accounts." Valley Statement No. 1-R at 9. Similarly, I&E made selective adjustments. Id. at 3-4. Mr. Rogers explained his disagreement with the approach taken by OCA and I&E as follows:

> I think the approach is overly granular in that individual accounts are evaluated without consideration of the overall Company operations, and it ignores the Company's success in managing overall costs very close to its budgeted costs. For example, if the Company's actual expense for mains tracks below budgeted costs in the Future Test Year ("FTY"), then OCA and/or I&E would propose a downward adjustment to the FPFTY. But on the other hand, if actual expenses for another account, such as miscellaneous customer expenses, runs above budgeted costs for the FTY, this would not likely be considered in conjunction with the lower mains expense.

Valley Statement No. 4-R at 4. Mr. Rogers explained how this granular approach raises unique challenges for Valley:

> For a smaller utility like Valley, this approach presents particular challenges because the Company shifts resources and priorities during the year as operational needs arise. The approach of OCA and I&E actually penalizes the Company for being responsive and for applying resources where most needed.

Id. at 4. As seen by the YTD data provided by the Company for the FTY, and the testimony of Mr. Gorman and Mr. Rogers, the Company has effectively managed its resources and conservatively projected its expenses, consistent with its managerial discretion and the needs of a smaller public utility to nimbly reallocate resources as issues arise. Consequently, the Commission

should deny I&E's and OCA's expense adjustments and approve the Company's FPFTY expense claim.

3. The Company's Inflation Adjustment is Reasonable, Conservative, and Consistent with Historic Cost Increases.

To develop its FPFTY expense projection, the Company considered historical expense increases and determined that generally increasing its FTY O&M estimates by 3% would reasonably and conservatively account for anticipated FPFTY expense increases, primarily for wage, benefits, and salaries and for materials. While I&E did not object to the inflation adjustment, OCA fervently opposed the Company's approach. OCA criticized both the concept of a general inflation adjustment and the amount selected by the Company for its 2020 projections, claiming that general inflation adjustments should not be used because they are not "known and measurable." OCA Statement No. 2 at 9. Mr. Morgan also argued that if the Commission allows the use of an inflation adjustment, it should be based on the Gross Domestic Product-Price Index ("GDP-PI") at 2%, instead of the Producer Price Index ("PPI") the Company used. *Id.*

As discussed below, the Company's use of an inflation adjustment is a realistic approach to projecting expenses for the FPFTY. This approach is consistent with the Company's historical experience and with the increases in Valley's 2020 budget. While fluctuations may occur on an account-by-account basis, developing FPFTY O&M expenses for this rate case filing on a general inflation basis from a carefully crafted FTY budget is appropriate and comports with historical cost increases.

a. <u>The Company's proposed inflation adjustment for FPFTY expenses is a conservative estimate developed to reflect both past experience and now confirmed by the Company's 2020 budget.</u>

Valley witness Gorman explained in his Rebuttal Testimony that growth in costs cannot be "known with certainty, but can be reasonably estimated." Valley Statement No. 1-R at 8. As

further discussed by Mr. Gorman, the Company developed its rate case filing over the first half of 2019, well in advance of commencing its budgeting process for the FPFTY, *i.e.* 2020. Tr. at 77. In order to develop reasonable FPFTY claims for purposes of compiling the rate filing, the Company reviewed both inflation data and historical expense increases. Further, per the below transcript excerpt, the Company's subsequent development of its 2020 budget lends additional supports to the inclusion of a 3% inflation adjustment for the FPFTY expenses.

The Company used the PPI as a guideline in forming its 3% inflation projection. Valley Statement No. 1-R at 8. This percentage selected by the Company is reasonable and, as detailed below, comports with Valley historic trends.

Historical O&M data indicates that the Company's selection of a 3% escalator is not only appropriate, but conservative. As seen in Schedule C1-1 (R) at 2, actual historic O&M expenses show a greater than 3% increase every year from 2016 to 2018 (the last year full expense data is available). Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2. In other words, regardless of which year is used as a baseline, the Company's O&M expenses have increased over 3% year-over-year through 2018. It is clear that, historically, 3% is a reasonable and conservative projection of the Company's FPFTY increase in O&M costs.

Mr. Rogers in Rebuttal Testimony affirmed the reasonableness of the 3% inflation adjustment:

> **Q. Does Valley expect its overall expenses to remain the same in 2020?**
>
> A. No. We are in the process of preparing our fiscal year 2020 budget. On an overall basis, we expect expenses to increase by over 3% from 2019 to 2020, with significantly higher increases in some areas (e.g. health insurance costs) being offset by management's efforts to manage costs.

Valley Statement No. 4-R at 5. Company witness Mr. Gorman further testified on rejoinder that the 3% inflation adjustment was developed to be a conservative estimation of future costs, knowing

that costs such as healthcare would increase more than 3%. Tr. 78. Mr. Rogers also addressed the inflation adjustment in rejoinder, explaining:

> …it would be extremely improper not to include inflationary costs of inflation. On the operation and maintenance side 65 percent historically has been for labor and overhead.

Tr. 201.

Finally, to further validate the proposed 3% inflation adjustment for the Company' FPFTY expenses, Mr. Rogers confirmed through the following Q&A on rejoinder that the Company's 2020 budget also reflects inflation:

> Q. And so would you agree that the company did reflect inflation in its 2020 budget?
>
> A. Yes, we do. We include that in our 2020 budget and all budgets.

Tr. 201. Accordingly, the 3% inflation adjustment is supported both by the Company's historical experience, specific indicators of cost increases for the FPFTY, and the Company's development of its 2020 budget.

b. <u>An inflation adjustment is a reasonable and appropriate means of projecting FPFTY expenses.</u>

OCA's position opposing the Company's inflation adjustment should be summarily rejected. The Commission has long recognized the use of inflation factors in projecting costs. *See, e.g.,* Opinion and Order, *Pa. PUC v. Pennsylvania-American Water Co.*, Docket No. R-00038304 (Order entered Jan. 29, 2004) at 35; Opinion and Order, *Pa. PUC v. Pennsylvania-American Water Co., et al,* Docket No. R-880916 (Order entered Oct. 21, 1988) at 54. To accept OCA's position would be to assume no cost increases from the FTY to the FPFTY. This is not only inaccurate and unrealistic; it is contrary to the purpose of the FPFTY as established in Act 11.

Act 11 established the FPFTY as a ratemaking tool. By its fully "projected future" nature, the FPFTY requires utilities to propose estimates. 66 Pa. C.S. § 315(e). Because a significant

portion of the Company's distribution O&M expenses is for employees, wage, benefits and salary expense is the most significant expense for many of the accounts. Schedule C1-1 (R) at 3-4 show the escalation of wages and materials that was assumed in the FPFTY. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 3-4. Knowing that expenses fluctuate on an account-by-account basis, Valley's approach is realistic, conservative, and grounded in the Company's experience.

OCA argues that the Commission has rejected use of inflation or "attrition" factors but cites only to cases entirely inapplicable to the Company's proposal. OCA witness Morgan cites to a Philadelphia Gas Works ("PGW") rate case at Docket No. R-00061931 and a PECO Energy Company ("PECO") rate case at Docket No. R-822291 to support his claim that the PUC categorically rejects inflation adjustments of the manner proposed by Valley. OCA Statement No. 2-R – Rebuttal Testimony of Lafayette K. Morgan ("OCA Statement No. 2-R") at 6. However, each of these cases is demonstrably distinct from the current circumstances. PGW, in the referenced case, was proposing to recover a 2% attrition escalator over a five-year forecast period. *Pa. PUC v. Philadelphia Gas Works,* Docket Nos. R-00061931 *et al.* (Order Entered Nov. 28, 2007), at 13-14. PECO proposed not solely an inflation adjustment to expenses, but an overall 2% increase to expense, revenue, and rate base. *Pa. PUC v. Philadelphia Electric Company,* Docket No. R-822291 (Order Entered Nov. 22, 1983), at 5. Moreover, as emphasized in the Order addressing the proposed PECO attrition factor, both of these cases pre-date Act 11, meaning the Commission's decision to deny an inflation adjustment for any forecast period would have been consistent with the Public Utility Code at the time. *See* id.

OCA's position also undercuts the purpose of the FPFTY authorized by Act 11. As explained above, one of the policies underlying Act 11 was the reduction of regulatory lag. To that end, it is appropriate for a utility to make a "fully projected future" projection for the FPFTY.

In Valley's case, the 2020 projections will be used to form the rates that must meet Valley's expenses in 2020, 2021, and each year until Valley files its next rate case. To insist that the Company use 2019 data in its projections for 2020 denies Valley the benefits of a *fully projected* future test year. OCA's arguments should be rejected, and the Company's inflation adjustment should be approved for each O&M expense.

c. 3% is a reasonable escalator to project FPFTY expenses.

In Direct Testimony, Mr. Morgan opposes the use of the PPI and argues that a better measure of inflation for ratemaking purposes would be the forecasted GDP-PI. OCA Statement No. 2 at 8. Mr. Morgan states that "past history is not a good predictor of future inflation" and argues that the PPI is not appropriate to forecasting operating costs for ratemaking purposes. *Id.*

Mr. Morgan's arguments on this issue miss the mark. His contention that past history is not a good predictor of future inflation conflicts with fundamental ratemaking, is entirely unsupported, and cannot be reconciled with OCA's general reliance on historical data as a predictor of the Company's future expenses. *Id.*; *see also* OCA Statement No. 1-SR at 5. Further, Mr. Morgan provides no evidence to rebut the data showing that normally, the Company's historical O&M expenses annually increase by at least 3%.

In summary, the Company's use of the 3% inflation rate aligns with the Commission's purposes as set forth in Act 11. It is supported by both Company testimony, long-term historical trends, 2019 annualized numbers and the 2020 Valley budget. In the alternative, if the Company's 3% inflation adjustment is not accepted by the Commission, the OCA's alternative measure of inflation should be adopted (i.e., 2.1%).

B. ADJUSTMENTS PROPOSED BY ADVOCATES

As explained above, the Company's annualized FTY data, plus adjustments for 3% inflation, employee medical leave, and Corrosion Technical hire, fully support the Company's

expense claim. While the Advocates have proposed a variety of adjustments, they have disputed neither the fact that Valley has managed its expenses close to budget, nor the fact that Valley's adjusted FTY expenses are tracking approximately very close to projections for 2019. For these reasons, it is appropriate to approve Valley expense claim based on annualized FTY data as set forth in Mr. Gorman's Rebuttal Testimony. Valley Statement No. 1-R at 5.

However, to the extent the Commission does not accept the Company's primary proposal, the Company addresses specific adjustments proposed by I&E and OCA below. Any resolution of a dispute, except rate case expense and C&T Allocation Expense, should be grossed up by the inflation adjustment per Section VI.A.3 above.

1. **Rate Case Expense – Normalization Period**

As part of its direct case in this proceeding, the Company proposed a total rate case expense claim of $271,000 and proposed to normalize this amount over three years consistent with the anticipated frequency of base rate proceedings going forward, and with numerous prior Commission proceedings. This resulted in a normalized claim of $90,333. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-3 (R).

Neither I&E nor OCA opposed the Company's total rate case expense amount. However, both parties opposed the Company's proposal to normalize rate case expense over three years (36 months). I&E witness Grab proposed a normalization period of 48 months based on the Company's last three base rate case filings. I&E Statement No. 1 at 5. OCA witness Sherwood proposed 60 months, based on the average time between the "Company's last four rate case filings, including this case." OCA Statement No. 1 at 18.

While historic filing frequency is a factor considered in determining the normalization for rate case expense, it is not the only factor the Commission considers. *See, e.g., Butler Township* 81 Pa. Cmwlth. 40, 47-48 (affirming that historic practice need not be the exclusive factor relied

upon by the Commission). Ratemaking is prospective, and the goal of ratemaking is to reasonably reflect future conditions when new rates are in effect. *See, e.g., Columbia Gas v. Pa. PUC,* 613 A.2d 74, 76 (Pa. Cmwlth. 1992), *aff'd,* 636 A.2d 627 (Pa. 1994). In the UGI Order, UGI Electric had not filed a base rate case for 22 years. UGI proposed a three-year normalization period. In that case, I&E did not propose the average length between UGI's base rate cases, which would have been over eight years, but instead proposed a five-year normalization period. UGI Order at 58. However, the Commission rejected I&E's approach, stating that UGI had shown its increased capital spending would require the Company to seek relief in a base rate case. The Commission found that "a long period between rate base proceedings is highly unlikely and that the Company's proposed use of a three-year normalization period for rate case expense is appropriate." UGI Order at 60.

In the UGI Order, the Commission stated: "This proceeding is premised on the FPFTY and the recognition that certain expenses may be based on future expectations. Consistent with our determination in the *PPL 2012 Order,* the normalization period for rate case expense is one of those expenses." UGI Order at 59-60.[6]

Similarly, the instant proceeding is based on reasonable future expectations. In Rebuttal, Company witness Gorman acknowledged that the average filing intervals for the last three rate cases have been "33 months, 36 months, and 110 months." Valley Statement No. 1-R at 7. Valley witness Rogers explained the abnormal circumstances contributing to the extended stay out since the 2010 rate case as follows:

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[6] *See Pa. Pub. Util. Comm'n., v. PPL Electric Utilities Corporation,* Docket No. R-2012-2290597, *et al*., (Order entered December 28, 2012 (*PPL 2012 Order*) at p. 49. In the *PPL 2012 Order,* PPL Electric sought a two-year normalization of rate case expense. I&E and OCA, based on a rate filing history, proposed a three-year period. *Id.* at 44-45. The Commission approved PPL Electric's two-year normalization of rate case expense. The Commission acknowledged PPL Electric's three-year filing history, but also noted its major capital improvement program to address aging infrastructure. *Id.* at 47-48.

> The circumstances allowing Valley to avoid a rate increase since 2010 are not likely to recur following this rate case. Valley was fortunate to connect a very large new contract customer shortly after the 2010 rate case. The additional contract revenues helped the company offset rising operational costs that otherwise would have resulted in a request for a rate increase. The Company should not be penalized for effectively managing the additional revenues to avoid burdening customers with rate increases. The fact is, there is no anticipated scenario where Valley would avoid filing a rate increase for a 60-month period.

Valley Statement No. 4-R at 5.

The Company has demonstrated that the long period following the 2010 rate case amounts to be an outlier in comparison to the prior 33-month and 36-month intervals between rate cases. Accordingly, the Company's three-year proposal reflects a reasonable normalization period and should be approved.

2. Industrial/Commercial Meters and Regulators Operations Expense (Account No. 876)

In its Direct Testimony, Valley included a claim for Industrial/Commercial Meters and Regulators of $74,475 for the FPFTY. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2. OCA initially proposed a $15,730 adjustment claiming that Valley provided no evidence showing that higher materials and labor expenses occurring over the HTY would recur in the FTY of FPFTY. Valley Statement No. 4 at 6. Following review of Valley's Rebuttal Testimony, OCA revised its proposed adjustment to $9,429 based on the Company's annualized FTY costs as of September 30, 2019.

OCA's adjustment should be denied as Valley witness Rogers testified that the Company generally incurs approximately 30% of its expense for Account No. 876 in the 4th quarter of each year. *See* Valley Statement No. 4-R at 7. Accordingly, even annualizing the actual FTY costs incurred as of September 30, 2019 would understate the Company's expense. The Company's claim should be approved without modification.

3. **Regulatory Commission Expense (Account No. 928)**

Valley's rate filing included a $38,524 claim for Regulatory Commission Expense. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 4. I&E opposes this claim, averring that Valley claims the Regulatory Commission Expense both as expense and taxes other than income taxes. *See* I&E Statement No. 1-SR at 16.

Any consideration of this adjustment should also address the expense adjustments described in Ms. Levering's testimony. Valley Statement No. 5-R at 4-5.

4. **Meters and House Regulators Operating Expense (Account No. 878)/Meter Reading Expense (Account No. 902)**

Valley's rate filing included a $172,563 claim for Meters and House Regulators and a $99,668 claim for Meter Reading Expense. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2, 4. OCA proposed to adjust the Company's claim for Account No. 878 by $33,746 on grounds that the Company has not provided a basis for the increase from HTY expense. *See* OCA Statement No. 1 at 6. OCA additionally proposes to reduce the Company's claim for Account No. 902 by $12,847 on the basis that the Company's overhead costs incurred through the first 6 months of the FTY for Account No. 902 are tracking below projected levels. OCA Statement No. 1-SR at 11.

Valley witness Rogers provided an explanation for both the increased expense for Account No. 878 and the lower expense for Account No. 902, noting that the Company shifted work from Account No. 902 (Meter Reading) to Account No. 878. *See* Valley Statement No. 4-R at 8. OCA declined to accept this adjustment, noting that Account No. 902 "should have decreased" if there was a shift in expenses. *See* OCA Statement No. 1-SR at 9. OCA failed to acknowledge that Account No. 902 did decrease consistent with Mr. Rogers' testimony. As of September 30, 2019, Account No. 902 was tracking $15,272 below FTY projections. Valley Statement No. 1-R at 5.

This very closely parallels the increased costs observed for Account No. 878, which was tracking $14,010 above FTY projections as of September 30, 2019. *See* id.

Notably, OCA proposed adjustments to both Account No. 878 ($33,746) and Account No. 902 ($12,847). *See* OCA Statement No. 1 at 7, 10. Approving both of these adjustments would result in a double count, given the Company's explanation that work shifted from Account No. 878 to Account No. 902. Accordingly, the Commission should deny the OCA's proposed adjustment to Account No. 878, particularly as the FTY expenses are tracking above the projected amount.

5. **Mains Operating Expense (Account No. 887)**

The Company's filing included a claim of $98,308 for Mains expense. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2. OCA proposed a $19,998 adjustment alleging that the Company's claim included non-recurring costs associated with a one-time project. OCA Statement No. 1 at 8. Valley confirmed in Rebuttal that OCA has overstated the proportion of mains costs associated with the one-time project. Valley Statement No. 4-R at 8. OCA subsequently reduced its adjustment to $1,219. OCA Statement No. 1-S at 10.

If the Commission declines to accept Valley's expense claim based on annualized the FTY total O&M expense based on September 30, 2019 data, Valley would accept this adjustment.

6. **Office Supplies and Expense (Account No. 921)**

The Company's filing included a claim for Office Supplies and Expense of $74,701. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 4. OCA proposes a $19,510 adjustment based on a claim that the travel and training component of total Account No. 921 costs are projected to increase by 54% from the HTY and that the actual costs incurred through the first 6 months of the FTY. OCA thus proposes that the travel and training costs within Account No. 921 should be adjusted based on HTY costs and the remainder of the costs should be adjusted based on FTY levels (although OCA's proposal reflects only FTY expense as of June 30, 2019, with no

recognition of the Company's update FTY expenses as of September 30, 2019. *See* OCA Statement No. 1 at 16-17.

OCA's adjustment should be denied. Valley witness Rogers explained that the Company would be incurring ongoing training costs both to onboard new employees and "to address increasing regulatory obligations for certified Operators and employee training for continually evolving human resources issues." *See* Valley Statement No. 4-R at 9. Additionally, actual FTY expenses for Account No. 921 as of September 30, 2019, are tracking below projections by $12,969, which OCA witness Sherwood fails to reflect in her adjustment. *See* Valley Statement No. 1-R at 5. Ms. Sherwood unfortunately trivializes this omitted update, stating that "Gorman accepted as part of his O&M adjustment that the account will be approximately $13,000 lower than the FPFTY. That is not significantly lower than my proposed adjustment." *See* OCA Statement No. 1-SR at 10.

Ms. Sherwood is mistaken. The difference between a $19,988 adjustment and a $12,969 adjustment is meaningful. Accordingly, OCA's proposed adjustment should be denied, and the Commission should accept Mr. Gorman's proposal to adjust the Account No. 921 expenses based on the annualized FTY expenses.

7. **General Advertising Expense (Account No. 930)**

Valley's filing included a proposal for General Advertising Expense of $73,373. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 4. OCA initially proposed an adjustment of $11,165 to Account No. 930 on grounds that Valley's claimed expense improperly included both volunteer labor costs and director travel/training costs that appeared to be non-recurring. OCA Statement No. 1 at 8.

Valley witness Rogers responded in Rebuttal and clarified that Valley recently began participating in an annual Beyond the Boardroom leadership training program organized by the

American Gas Association. Valley Statement No. 4 at 9. Mr. Rogers confirmed that one director attended the training in October 2019, but another had to cancel due to scheduling conflicts. *Id.* However, Valley will continue to budget for two attendees every year. *Id.* at 10. Mr. Rogers also addressed Valley's volunteer labor expenses, noting that the programs "foster happy, healthy, and fulfilled employees, which helps to reduce turnover and to increase employee productivity. Increased productivity benefits ratepayers through better service." Valley Statement No. 4 at 10.

Following review of Valley's Rebuttal, OCA modified its adjustment to remove the expenses associated with director travel and training. OCA thus propose to adjust Valley's claim for Account No. 930 by $3,889 to reflect address volunteer labor expenses. OCA Statement No. 1-S at 10. As described by Mr. Rogers, these expenses benefit Valley's customers by contributing to a productive and engaged workforce. OCA's adjustment should be denied.

8. **C&T Allocation Expense**

The Company's FPFTY expense claim includes $233,608 for allocated expenses for shared services from C&T. *See* I&E Statement No. 1, Exhibit No. 1, Schedule 9, at 1. Notably, the Company's C&T Allocation Expense claim for the FPFTY represents an exception from the Company's proposal to increase FTY expense by the 3% inflation adjustment, as Valley applied a 1% increase from FTY costs based on historical increases to its C&T allocation. *See* I&E Statement No. 1, Exhibit No. 1, Schedule 9 at 1.

I&E proposed to adjust the Company's FPFTY expense claim by $44,429 to $189,179 because the projected increase from the HTY to the FTY exceeds the historical annual increases for this expense item. *See* I&E Statement No. 1 at 18-19; *see also* I&E Statement No. 1-SR at 23. I&E also noted that the Company provided inconsistent YTD data for the C&T Allocation expense claim, indicating expense of $115,023 as of August 31, 2019 and $86,936 as of September 30, 2019. *See* I&E Statement No. 1-SR at 26.

On rejoinder, Company witness Jamie Levering clarified that the correct YTD expense for C&T Allocation Expense is $128,441.23 as of September 30, 2019. *See* Valley Rejoinder Exhibit No. 7. Annualizing the YTD FTY data and adding a 1% increase would result in a FPFTY claim of $172,967. *See id.* The Company's historical annual expense for C&T Allocation Expense exceeded the 2019 projections in 2016, 2017, and 2018, annualizing the YTD data would not produce a reasonable expense claim for the Company's C&T Allocation. *See* I&E Statement No. 1, I&E Exhibit No. 1, Schedule 9, at 1.

Anticipated future trends also support approval of the Company's claim for C&T Allocation Expense. As discussed by Company witness Levering, the C&T Allocation is based on the revenue and meter counts for Valley and its affiliated operating companies. *See* I&E Statement No. 1, Exhibit No. 1, Schedule at 1. As revenue and meter counts determine the C&T Allocation Expense, the Commission should consider that the first phase of the East Athens Main Extension project was not scheduled for completion until November 2019. *See* I&E Statement No. 3, Exhibit No. 3, Schedule 2 at 4 (showing 2019 East Athens Main Extension projects to be completed between November 2019 and June 2020). Accordingly, the YTD numbers as of September 30, 2019 for C&T Allocation Expense do not reflect additional customers in East Athens anticipated to begin service before the end of the FTY and throughout the FPFTY.

In light of the Company's historical C&T Allocation Expense and the anticipated increased allocation due to connecting customers in East Athens, it is clear that a claim based on the Company's annualized FTY expense or the I&E claim based solely on the Company's historical expense level would understate the FPFTY expense. As a result, the Company's claim should be approved.

9. **Uncollectible Expense**

Valley's filing included a FPFTY claim of $55,430 for Uncollectible Expense, which reflects the Company's total projected Uncollectible Expense for the FPFTY of $100,799 minus the commodity portion of Uncollectible Expense ($45,369) to be unbundled for recovery through the GCR. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C4 (R). I&E proposed to adjust Valley's claim by $24,201. I&E Statement No. 1 at 15. To derive this adjustment, I&E calculated the three-year average of Valley's write-off percentage (0.62%) and multiplied by the FPFTY present rate revenues. *Id.* I&E recommends that the Commission determine the final Uncollectible Accounts Expense by applying the 0.62% write-off ratio to any the final base rate increase approved in this proceeding. *See id.*

The Company is concerned that I&E's proposal would understate Uncollectible Expense following the 0.83% write-off percentage experienced in the HTY. *See* Valley Statement No. 1-R at 4. While I&E looks only at the prior 3 years, it is notable that the I&E's recommended Uncollectible Accounts Expense would be lower than the Company's actually experienced Uncollectible Accounts Expense in 2014 and 2015. *See* I&E Statement No. 1, Exhibit No. 1, Schedule 6 at 1.

The Company's Uncollectible Expense claim is prudent and should be approved.

C. CONCLUSION

For the reasons identified in the previous discussion, the various disallowances to the Company's expenses proposed by the other parties in this proceeding should be rejected, and the Company's total expenses should be approved and included in the base rate.

VII. FAIR RATE OF RETURN

A. RATE OF RETURN STANDARDS

The United States Supreme Court outlined the principal benchmarks for a fair rate of return in *Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia*, 262 U.S. 679 (1923) (*"Bluefield"*). In this seminal Order, the Court defined a fair rate of return as follows:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings *which are attended by corresponding risks and uncertainties*; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. 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 maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Bluefield, at 679 (Emphasis added). As referenced by Company Witness Dylan W. D'Ascendis, *Bluefield* established three tenets defining a fair rate of return. Under *Bluefield*, a fair rate of return must be: (1) equal to the return on investments in other business undertakings with the same level of risks (comparable earnings standard); (2) sufficient to assure confidence in the financial soundness of a utility (financial integrity standard); and (3) adequate to permit a public utility to maintain and support its credit, enabling the utility to raise or attract additional capital necessary to provide reliable service (the capital attraction standard). *See* Joint Statement No. 2 at 6. The Court later reaffirmed the *Bluefield* standard in *Federal Power Commission v. Hope Natural Gas.,* 320 U.S. 591, 603 (1944) (*"Hope")* and *Duquesne Light Co. v. Barasch,* 488 U.S. 299 (1989).

In developing a rate of return for any regulated public utility, the Commission must ensure all public utilities have an opportunity to earn a rate of return sufficient to meet the enumerated criteria. Importantly for the Company, this includes consideration of the specific risks faced by smaller utilities pursuant to the comparable earnings standard. Accordingly, the Commission

should approve only a rate of return consistent with the *Bluefield* standards. Mr. D'Ascendis' rate of return is the only proposal in this proceeding that meets these standards.

B. GAS PROXY GROUP

Mr. D'Ascendis selected a 7-company proxy group based on selection criteria set forth in his Direct Testimony. Joint Statement No. 2, at 12. The proxy group was updated in Mr. D'Ascendis' Rebuttal Testimony to exclude one company after re-running the selection criteria based on updated data. The remaining 6 company proxy group ("Gas Utility Proxy Group") is set forth on page 4 of Mr. D'Ascendis' Rebuttal Testimony. Joint Statement No. 2-R, at 4.

C. CAPITAL STRUCTURE

Mr. D'Ascendis proposed to use a hypothetical capital structure for Valley consistent with the average capital structure ratios in his Gas Utility Proxy Group. *See* Joint Statement No. 2 at 13. As a result, Mr. D'Ascendis recommended a capital structure of 47.45% long-term debt and 52.55% common equity for Valley. *See id.* at 13-14. No party disputes the proposed capital structure set forth in Mr. D'Ascendis' Direct Testimony. *See* OCA Statement No. 3 at 3; *see also* I&E Statement No. 2 at 12.

D. COST OF LONG-TERM DEBT

Mr. D'Ascendis originally proposed to use the Company's actual cost rate of 4.98% for long-term debt. Joint Statement No. 2 at 15. OCA did not dispute the principle of using Valley's actual long-term debt rate, but I&E claimed Mr. D'Ascendis relied on a forecasted rate rather than Valley's effective cost of long-term debt during the FPFTY of 4.54%. *See* OCA Statement No. 3 at 3; *see* I&E Statement No. 2 at 14. Mr. D'Ascendis accepted I&E's proposal and updated the recommended debt cost rate to 4.54% in his Rebuttal Testimony. *See* Joint Statement No. 2-R at 5.

E. COST OF COMMON EQUITY

1. **Introduction**

The principal disputes concerning the appropriate rate of return for the Company relate to the determination of the Company's cost rate for common equity capital, referenced as the Return on Equity ("ROE"). In reviewing the proposal from the Company and the other parties, the Commission should consider the *Bluefield* standards within the context of the investment marketplace and the investor concerns that will drive or discourage purchases of utility common stocks.

Specifically, the Commission should adopt an ROE that reflects actual market conditions. While the Commission has primarily relied on the Discounted Cash Flow ("DCF") model to set ROE cost rates, the Commission has also observed that DCF-only results may understate the appropriate ROE. UGI Order at 105. Because DCF results may understate ROE, considering results of other models is consistent with the fundamental purpose of the Commission's regulation of public utility Rate of Return ("ROR") where "regulation must act as a substitute for marketplace competition." Joint Statement No. 2-R at 6. Public utilities compete with other firms of comparable risk for investor capital. *See id.* In order to attract the capital necessary to serve the public, public utilities in Pennsylvania rely on the Commission to authorize ROEs that can generate sufficient earnings for investors. *See id.* at 16.

Consistent with the *Bluefield* and *Hope* standards, and as detailed below, Valley witness D'Ascendis conducted a thorough analysis of multiple ROE models to develop an ROE based on his Gas Utility Proxy Group of 9.35%. Mr. D'Ascendis then adjusts the Gas Utility Proxy Group's ROE upward by 1.00% to reflect the Company's smaller relative size to the Gas Utility Proxy Group and 0.25% to reflect management performance. As a result of his adjustments to the Gas

Utility Proxy Group's ROE to reflect the unique risk of the Company, Mr. D'Ascendis recommends a 10.60% ROE. *See* Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2.

Given the critical role of the authorized ROE in attracting capital necessary to meet the Company's public utility obligations, the Commission should be cognizant of the stark disparity between the ROE recommendations from I&E and OCA and actual market conditions. As discussed by Mr. D'Ascendis, the I&E and OCA recommended ROEs for Valley of 8.46% and 8.34% "are all below the lowest ROE authorized for any major natural gas utility followed by Regulatory Research Associates ("RRA"), a division of Standard and Poor's ("S&P") Global Intelligence since at least 1980." Joint Statement No. 2-R at 5. None of the witnesses dispute this fact. Similarly, no witness disputes that the I&E and OCA recommended ROEs for Valley are significantly below the 10.00% ROE calculated by the Commission for natural gas utility Distribution System improvement Charges ("DSICs") as of November 14, 2019. Tr. 45. Their DCF-only results understate the appropriate ROE for Pennsylvania natural gas utilities, as the UGI Order noted can occur.

The Commission should also consider that the above-referenced benchmarks only account for the disparity between the OCA and I&E recommended ROEs and the market-reflective ROEs for natural gas utilities multiple times larger than the Company. For example, the RRA only evaluates rate cases with a proposed rate increase over $5 million or an authorized rate increase over $3 million. Joint Statement No. 2-R at 6. The Company's requested increase is only approximately $745,000. As observed by Mr. D'Ascendis, "RRA's data would understate ROE's authorized for smaller utilities, like the Companies relative to those companies covered by RRA." *Id.* at 6. Similarly, the proxy group of public utilities used to develop the Commission's DSIC ROE includes Companies many times larger than Valley. Tr. 55-56 (noting DSIC ROE could be adequate for Companies after adjusting for size and performance). Accordingly, even the ROEs

supported by these marketplace benchmarks like RRA would still understate the appropriate ROE for Valley, due to its smaller size. Thus, OCA and I&E's positions based on DCF become farther away from the appropriate ROE for Valley.

Additionally, despite the contrary positions of the Advocates, the Commission is required to consider utility management effectiveness and efficiency in setting rates. 66 Pa. C.S. § 523. The Company has demonstrated a high level of performance and customer satisfaction supporting approval of the proposed 25 basis performance adjustment to the ROE.

Finally, and consistent with the *Bluefield* standard, the Commission should adjust the Companies ROEs to account for company size, even if the OCA or I&E DCF results are adopted. The Company has provided extensive evidence showing company size to be a risk factor for public utilities. Mr. D'Ascendis' analysis demonstrates that a 437 basis point size adjustment is justified due to Valley's size difference in comparison to the proxy group. The Commission should approve the Company's more modest 100 basis point size adjustment in this proceeding.

All of the above considerations provide the context through which the Commission should evaluate the ROE proposals in this proceeding. Any reasonable evaluation of the relevant market conditions reveals the inadequacy of the ROE proposals advanced by I&E and OCA. To enable Valley to attract capital and continue furnishing safe and reliable service to its customers, the Commission should adopt the 10.60% ROE proposed by Mr. D'Ascendis.

2. **Valley's Return on Common Equity Should Be Adopted.**

a. <u>Summary of Valley's ROE proposal</u>

Company witness Mr. D'Ascendis described his methodology for developing a recommended ROE for Valley in his Direct Testimony as follows:

> My recommendation results from applying several cost of common equity models, specifically the Discounted Cash Flow ("DCF") model, the Risk Premium Model ("RPM"), and the Capital Asset Pricing Model ("CAPM"), to the market data of the

> Electric and Gas Utility Proxy Group whose selection criteria will be discussed below. In addition, I applied the DCF model, RPM, and CAPM to proxy groups of domestic, non-price regulated companies comparable in total risk to the Electric and Gas Utility Proxy Groups ("Non-Price Regulated Proxy Groups"). The results derived from each are as follows:
>
> [Table Omitted]
>
> The indicated common equity cost rates were 9.90% and 10.10%, respectively, for the Electric and Gas Utility Proxy Groups, respectively, before any company-specific adjustments. I then adjusted the indicated common equity cost rate upward by 1.00% to reflect the Companies' smaller relative size, as compared to the Electric and Gas Utility Proxy Groups, and by 0.25% to reflect a performance factor adjustment, based on guidance from Pennsylvania Code 66 Pa.C.S. § 523. These adjustments resulted in company-specific indicated common equity cost rates of 11.15% for Citizens' and Wellsboro, and 11.35% for Valley, which are my recommendations.

Joint Statement No. 2 at 4-5. In Rebuttal Testimony, Mr. D'Ascendis updated his original recommended ROE to replicate the same analysis reflecting current market conditions as of September 30, 2019. This update produced the following final ROE recommendation:

Main Brief Table 2

Citizens' Electric Company / Wellsboro Electric Company / Valley Energy, Inc.
Brief Summary of Common Equity Cost Rate

Line No.	Principal Methods	Proxy Group of Seventeen Electric Companies	Proxy Group of Six Natural Gas Distribution Companies
1.	Discounted Cash Flow Model (DCF)	8.27 %	9.02 %
2.	Risk Premium Model (RPM)	9.57	9.26
3.	Capital Asset Pricing Model (CAPM)	8.82	9.22
4.	Market Models Applied to Comparable Risk, Non-Price Regulated Companies	9.43	10.26
5.	Indicated Common Equity Cost Rate before Adjustment for Business Risks	9.05 %	9.35 %
6.	Size Adjustment	1.00	1.00
7.	Performance Factor Adjustment	0.25	0.25
8.	Recommended Common Equity Cost Rate	10.30 %	10.60 %

Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2. As indicated in the above table, the Rebuttal update reduced the recommended ROE for Valley from 11.35% to 10.60%.

As summarized by Mr. D'Ascendis, his ROE reflects the results of his DCF, Risk Premium and CAPM models, plus his application of each model to a proxy group of non-regulated entities.

As further discussed below, this approach incorporates multiple models consistent with best practices supported by academic literature and the Commission's policy of relying primarily on the DCF but referencing other models to ensure the reasonableness of the overall ROE recommendation.

b. Company DCF Model

Mr. D'Ascendis uses a single-stage constant growth DCF model. The DCF model relies on the theory that the "present value of an expected future stream on net cash flows during the investment holding period can be determined by discounting those cash flows at the cost of capital, or the investors' capitalization rate." Joint Statement No. 2 at 16. The capitalization rate is the anticipated common equity return rate and consists of the dividend yield on market price plus a growth rate. *Id.* at 16-17. The calculation of Mr. D'Ascendis' dividend yield and growth rate are detailed below.

i. Dividend yield

To derive the dividend yield for his DCF model, Mr. D'Ascendis calculated each proxy company's dividends as of September 30, 2019 and divided by the average closing market price for the 60 trading days ending September 30, 2019. *See* Statement No. 2 at 17; *see also* Statement No. 2-R, Exhibit __ (DWD-1R), Schedule 1R at 3, fn. 1 (showing updated dividend yield reflecting data available as of September 30, 2019). Mr. D'Ascendis applied a conservative adjustment to reflect prospective increases to the dividend yield, in accordance with the Gordon Periodic version of the DCF model. Mr. D'Ascendis describes the necessary adjustment in his Direct Testimony as follows:

> Because the companies in the Electric and Gas Utility Proxy Groups increase their quarterly dividends at various times during the year, a reasonable assumption is to reflect one-half the annual dividend growth rate in the dividend yield component, or $D_{1/2}$. Because the dividend should be representative of the next twelve-month

> period, this achievement is a conservative approach that does not overstate the dividend yield.

Joint Statement No. 2 at 18. Both the unadjusted dividend yields and the adjusted dividend yields are reflected in columns 1 and 6, respectively, of page 3 to Mr. D'Ascendis' Exhibit __ (DWD-1R), Schedule DWD-1R.

ii. Growth rate

To calculate the growth rate for his DCF, Mr. D'Ascendis utilized the same published earnings growth rates relied upon by investors in the marketplace. Mr. D'Ascendis explained the importance of utilizing earnings growth rates in the below excerpt from his Direct Testimony:

> Investors with more limited resources than institutional investors are likely to rely on widely available financial information services, such as *Value Line*, Reuters, Zacks, and Yahoo! Finance. Investors realize that analysts have significant insight into the dynamics of the industries and individual companies they analyze, as well as companies' abilities to effectively manage the effects of changing laws and regulations, and ever-changing economic and market conditions. For these reasons, I used analysts' five-year forecasts of EPS growth in my DCF analysis.

Id. Subsequently to submitting Direct Testimony, Mr. D'Ascendis eliminated Reuters' growth rates from his calculation because the organization stopped publishing projected earnings growth rates on its website. Joint Statement No. 2-R at 4. Accordingly, as reflected in Mr. D'Ascendis' Exhibit __ (DWD-1R), he developed a growth rate for each proxy group company by averaging the five-year projected growth rates published by Value Line, Zacks, and Yahoo! Finance.

c. Company Risk Premium Model

Mr. D'Ascendis also conducted a risk premium analysis as part of his ROE recommendation. A risk premium analysis seeks to quantify the additional ROE demanded by investors to account for the greater equity investment risk as compared to debt capital. Under a risk premium analysis, "the cost of common equity equals the expected cost rate for long-term capital, plus a risk premium over that cost rate, to compensate common shareholders for the added

risk of being unsecured and last-in-line for any claim on the corporation's assets and earnings upon liquidation." Joint Statement No. 2 at 19.

Importantly, Mr. D'Ascendis' risk premium analyses averages the results of two analyses. The first, the Predictive Risk Premium Model ("PRPM") directly estimates the risk premium for equity capital investment based on an evaluation of the actual variance between historical equity risk premiums. *Id.* at 20. The second analysis, the total market approach, relies on known metrics to develop prospective RPM cost rates. *Id.* at 22.

i. PRPM

As referenced above, the inputs to Mr. D'Ascendis' PRPM analysis are historical risk premiums. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule 1R at 28, fn. 1. Starting with these historical returns, Mr. D'Ascendis develops the PRPM cost rate through the following analysis:

> Using a generalized form of ARCH, known as GARCH, I calculated each Utility Proxy Group company's projected equity risk premium using Eviews© statistical software. When the GARCH model is applied to the historical return data, it produces a predicted GARCH variance series and a GARCH coefficient. Multiplying the predicted monthly variance by the GARCH coefficient and then annualizing it produces the predicted annual equity risk premium. I then added the forecasted 30-year U.S. Treasury bond yield of 3.36% to each company's PRPM-derived equity risk premium to arrive at an indicated cost of common equity.

As set forth in Mr. D'Ascendis' Exhibit No. __ (DWD-1R), applying the PRPM to each Gas Utility Proxy Group produces a risk premium cost rate of 9.08%, which Mr. D'Ascendis averages with the results of his total market approach risk premium for a final risk premium ROE. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule 1R at 28.

ii. Total Market Risk Premium

To conduct his total market approach analysis, Mr. D'Ascendis develops a prospective bond yield and applies it to an average of three equity risk premium rates. The three risk premium rates incorporated into the total market approach are: 1) a beta-adjusted total market equity risk

premium; 2) an S&P Utilities Index equity risk premium; and 3) and an equity risk premium based on authorized ROEs for natural gas distribution utilities. *See* Joint Statement No. 2 at 23, 28-29. Page 29 of Mr. D'Ascendis' Exhibit No. __ (DWD-1R) presents the results of his total market risk premium analysis, showing an ROE of 9.43% for the Gas Utility Proxy Group. This result is then averaged with the 9.08% PRPM ROE for a combined risk premium ROE of 9.26%. *See* Joint Statement No. 2-R Exhibit _ (DWD-1R), Schedule DWD-1R at 27.

d. <u>CAPM</u>

Mr. D'Ascendis also conducts a CAPM ROE analysis. The traditional CAPM "is applied by adding a risk-free rate of return to a market risk premium, which is adjusted proportionately to reflect the systemic risk of the individual security relative to the total market as measured by the beta coefficient." *See* Joint Statement No. 2 at 32. Mr. D'Ascendis uses the traditional CAPM and averages these results with an Empirical CAPM ("ECAPM") analysis, which generally reflects the same analysis, but incorporates a more gently sloping Security Market Line to reflect the results of analysis showing that the steeper slope of the predicted Security Market Line (as used in the traditional CAPM) is not borne out by analysis of the empirical Security Market Line. *See* Joint Statement No. 2 at 32; *see also* Joint Statement No. 2-SR at 27.

i. <u>CAPM Risk-Free Rate</u>

For the CAPM risk-free rate, Mr. D'Ascendis used the yield on 30-year U.S. Treasury bonds as set forth on page 42 of Exhibit __ (DWD-1R). Joint Statement No 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 42, fn. 2. As explained in his Direct Testimony, Mr. D'Ascendis selected the 30-year U.S. Treasury bond yields for the risk-free rate because "[t]he yield on long-term U.S. Treasury bonds is almost risk-free and its term is consistent with the long-term cost of capital to public utilities measured by the yield's on Moody's A-rate public utility bonds; the long-term investment horizon inherent in utilities' common stocks; and the long-term life of the

jurisdictional rate base to which the allowed fair rate of return (*i.e.,* cost of capital) will be applied." Joint Statement No. 2 at 33-34. Mr. D'Ascendis' Rebuttal Testimony presents the results of the analysis supporting the risk-free rate of 2.64%.[7]

ii. CAPM Market Risk Premium

To develop the CAPM market risk premium, Mr. D'Ascendis calculated "an average of three historical data-based market risk premiums, two Value Line data-based market risk premiums, and one Bloomberg data-based market risk premium." Joint Statement No. 2 at 34. A detailed description of each of the six data-based market risk premiums is presented in Mr. D'Ascendis' Direct Testimony. Joint Statement No. 2 at 34; *see also* Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 42. Mr. D'Ascendis' Exhibit __ (DWD-1R) shows the derivation of his 10.05% market risk premium based on the updated average of the aforementioned six data-based market risk premiums. As reflected on page 41 of Mr. D'Ascendis' Exhibit __ (DWD-1R), applying the above-referenced risk-free rate and market risk premium to the traditional CAPM and the ECAPM for the Gas Utility Proxy Group results in a CAPM equity cost rate of 8.72% and an ECAPM equity cost rate of 9.71%. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 41. Mr. D'Ascendis then averages these outputs to arrive at a CAPM/ECAPM equity cost rate of 9.22%.

e. Cost of Equity Models Applied to Comparable Risk, Non-Price Regulated Companies.

As a final indicated equity cost rate, Mr. D'Ascendis calculated equity cost rates based on the application of the above-referenced DCF, RPM, and CAPM models to a proxy group of

[7] Mr. D'Ascendis' Direct Testimony set forth his originally proposed risk-free rate 3.36% based on: 1) the expected yields of 30-year U.S. Treasury bonds for the six quarters ending with the third quarter of 2020; and 2) long term projections for the years 2020 -2024 and 2025 – 2029. *See* Joint Statement No. 2 at 33. Mr. D'Ascendis' Rebuttal Testimony updated the risk-free rate to 2.64% based on: 1) the expected yields of 30-year U.S. Treasury bonds for the six quarters ending with the first quarter of 2021; and 2) long term projections for the years 2021 -2025 and 2026 – 2030. *See* Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 42, fn. 2.

domestic, non-price regulated companies. This methodology provides a valuable indicator of anticipated investor returns for public utilities. As explained by Mr. D'Ascendis, "[b]ecause the purpose of rate regulation is to be a substitute for marketplace competition, non-price regulated firms operating in the competitive marketplace make an excellent proxy *if they are comparable in total risk to the Electric and Gas Utility Proxy Groups* being used to estimate the cost of common equity." Joint Statement No. 2 at 36. In other words, Mr. D'Ascendis' modeling of equity cost rates for non-price regulated companies includes only non-price regulated companies meeting criteria developed to mirror the total risk of the Gas Utility Proxy Group.

To compile a group of domestic, non-price regulated companies comparable in total risk to the companies in the Gas Utility Proxy Group, Mr. D'Ascendis included only companies meeting the following criteria:

(i) They must be covered by Value Line Investment Survey (Standard Edition);

(ii) They must be domestic, non-price regulated companies, i.e., not utilities;

(iii) Their beta coefficients must lie within plus or minus two standard deviations of the average unadjusted beta coefficients of the Utility Proxy Group; and

(iv) The residual standard errors of the *Value Line* regressions which gave rise to the unadjusted beta coefficients must lie within plus or minus two standard deviations of the average residual standard error of the Utility Proxy Group.

Joint Statement No. 2 at 37. In particular, the criteria measuring both beta coefficients and residual standard errors ensure that companies included on the non-price regulated proxy group have similar total risk to the companies in the Gas Utility Proxy Group. Mr. D'Ascendis explains the importance of these two criteria in measuring comparable risks as follows:

> Beta coefficients measure market, or systemic, risk, which is not diversifiable. The residual standard errors of the regressions measure each firm's company-specific, diversifiable risk. Companies that have similar beta coefficients *and* similar residual standard errors resulting from the same regression analyses have similar total investment risk.

Id. Mr. D'Ascendis selection criteria yielded a non-price regulated proxy group of seven companies with total investment risk comparable to the Gas Utility Proxy Group. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD 1R at 49. Mr. D'Ascendis then applied the DCF and CAPM analyses in the same manner as the Gas Utility Proxy Group. He also applied the RPM analysis but modified this model slightly to omit utility-specific risk premiums and the PRPM. *Id.* at 38.

As set forth below, Mr. D'Ascendis' application of the DCF, RPM, and CAPM analyses to the non-price regulated proxy group produced the following common equity cost rates:

Main Brief Table 3

Citizens' Electric Company / Wellsboro Electric Company / Valley Energy, Inc.
Summary of Cost of Equity Models Applied to
Proxy Groups of Non-Price Regulated Companies
Comparable in Total Risk to the Proxy Group of Nineteen Electric Companies
and Proxy Group of Seven Natural Gas Distribution Companies

Principal Methods		Proxy Group of Six Non-Price Regulated Companies	Proxy Group of Twenty Non-Price Regulated Companies
Discounted Cash Flow Model (DCF) (1)		8.21 %	10.00 %
Risk Premium Model (RPM) (2)		10.10	10.82
Capital Asset Pricing Model (CAPM) (3)		9.56	10.18
	Mean	9.29 %	10.33 %
	Median	9.56 %	10.18 %
	Average of Mean and Median	9.43 %	10.26 %

Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule 1R at 46.

Per the above discussion, these equity cost rates provide an indication of the returns investors expect from companies exhibiting risk and uncertainties comparable to the public utilities in the Gas Utility Proxy Group. Consistent with the *Bluefield* standard, this information is relevant to the Commission's consideration of an appropriate ROE for the Company.

f. Importance of reflecting multiple methods in Company ROE

By applying the multiple cost of equity models to the Gas Utility Proxy Group and the non-price regulated proxy group, Mr. D'Ascendis develops an unadjusted indicated ROE for the Company of 9.35%. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 2. Before addressing the appropriate adjustments to determine the recommended ROE for the Company, the importance of Mr. D'Ascendis' reliance on multiple models should be reviewed.

Mr. D'Ascendis discussed the impact of using multiple ROE models in his Rebuttal Testimony. The following excerpt summarizes the rationale and support for his methods:

> As discussed in my direct testimony, the use of multiple models adds reliability to the estimation of the common equity cost rate, with the prudence of using multiple cost of common equity models supported in both the financial literature and regulatory precedent.

Joint Statement No. 2-R at 6. Mr. D'Ascendis proceeds to identify financial literature supporting his application of multiple ROE models to determine a recommended ROE for the Company. The financial literature cited by Mr. D'Ascendis consists of a study of Roger A. Morin in which Dr. Morin references the below findings from Professor Eugene Brigham:

> Three methods typically are used: (1) the Capital Asset Pricing Model (CAPM), (2) the discounted cash flow (DCF) method, and (3) the bond-yield-plus-risk-premium approach. *These methods are not mutually exclusive – no method dominates the others*, and all are subject to error when used in practice. Therefore, when faced with the task of estimating a company's cost of equity, we generally use all three methods and then choose among them on the basis of our confidence in the data used for each in the specific case at hand.

Id. at 7 (emphasis added). The same study also quotes from a similar analysis of Professor Stewart Myers in which he more directly addresses the use of multiple ROE models for regulatory purposes:

> While it is certainly appropriate to use the DCF methodology to estimate the cost of equity, there is no proof that the DCF produces a more accurate estimate of the cost of equity than other methodologies. Sole reliance on the DCF model ignores the capital market evidence and financial theory formalized in the CAPM and other

> risk premium methods. *The DCF model is one of many tools to be employed in conjunction with other methods to estimate the cost of equity.* It is not a superior methodology that supplants other financial theory and market evidence. The broad usage of the DCF methodology in regulatory proceedings in contrast to its virtual disappearance in academic textbooks does not make it superior to other methods. The same is true of the Risk Premium and CAPM methodologies.

Id. at 8 (emphasis added). The referenced financial literature clearly reinforces Mr. D'Ascendis' reliance on multiple ROE models to derive a recommended ROE for Valley.

Mr. D'Ascendis also notes that the financial literature supporting use of multiple ROE models is consistent with the Commission's historical review of recommended public utility ROEs. While the Commission has a history of applying the DCF model as the foundation when determining an appropriate ROE for public utility ratemaking, the Commission has also incorporated the results of other models in finalizing the ROE component of an overall authorized ROR for ratemaking purposes. *See id. citing Pa. PUC v. Columbia Water Company*, Docket No. R-2013-2360798 (Order entered January 23, 2014) ("*Columbia Water"*) and *Pa. PUC v. Emporium Water Company*, Docket No. R-2014-2402324 (Order entered January 28, 2015) ("*Emporium"*). Additionally, in the most recent litigated public utility rate determination, the Commission reinforced the importance of using other models in recognizing the potential shortcomings of undue reliance on a single model:

> Initially, we note that UGI has presented a valid argument that sole reliance on one methodology without checking the validity of the results of that methodology with other cost of equity analyses does not always lend itself to responsible ratemaking. As such, where evidence based on other cost of equity methods indicates that the DCF-only results may understate the utility's current cost of equity capital, we will consider those other methods, to some degree, in evaluating the appropriate range of reasonableness for our equity return determination.

UGI Order at 104 – 105. Importantly, Mr. D'Ascendis conducted a critical market analysis explaining why reliance solely on the DCF in the current market environment would likely understate the appropriate ROE for the Company. In his Rebuttal Testimony, Mr. D'Ascendis

presents the below chart tracking the market-to-book ratio for the combined I&E and OCA gas utility proxy groups compared to the ten-year average:

Main Brief Table 4

M/B Ratios of the Combined Gas Utility Proxy Group Compared with Ten-Year Average

See Joint Statement No. 2-R at 13.

As indicated in Table 3, market-to-book value for the combined proxy group has been higher than the 1.75 ten-year average, particularly since 2018. This trend has significant implications for the reliability of the DCF model. As discussed by Mr. D'Ascendis:

> DCF models assume an M/B ratio of 1.0 and therefore under-or-over-states investors' required return when market value exceeds or is less than book value, respectively. It does so because equity investors evaluate and receive their returns on the market value of a utility's common equity, whereas regulators authorize returns on the book value of common equity. This means that the market-based DCF will produce the total annual dollar return expected by investors, only when market and book values of common equity are equal, a very rare and unlikely situation.

Id. at 11. Importantly, Mr. D'Ascendis' observations of the susceptibility of the DCF model to distortion where market-to-book ratios exceed unity (*i.e.* a 1.0 ratio) are supported both by financial literature and empirical analysis.

In addition to his own summary of the relationship between the DCF model and market-to-book ratios, Mr. D'Ascendis again cites to research from Dr. Morin in which Dr. Morin also asserts that "application of the standard DCF model to utility stocks understates the investor's expected return when the market to-book (M/B) ratio of a given stock exceeds unity." Joint Statement No. 2-R at 10.

Mr. D'Ascendis additionally develops an empirical quantification of the understated return that would result from approval of the I&E and OCA DCF equity cost rates. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-2R. This analysis indicates that I&E's 8.46% equity cost rate would produce 5.75% growth at market value but would result in just 0.98% growth if applied to book value. *Id.* Similarly, OCA's 8.34% equity cost rate would produce 5.65% growth at market value but would result in just 0.99% growth at book value. *Id.*

Finally, Mr. D'Ascendis further demonstrates the inaccuracy of the DCF model when market-to-book ratios exceed unity by applying the I&E and OCA DCF models to a book value capital structure. This involves de-leveraging the DCF ROE and then applying the de-levered ROE to the book value capital structure. *Id.* at 1. As detailed in Exhibit __ (DWD-1R), Schedule DWD-3R adjusting the I&E and DCF model to reflect the book capital structure of its proxy group would increase I&E's DCF ROE from 8.46% to 9.49%. The same adjustment would increase OCA's DCF ROE from 8.34% to 9.52%. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-3R at 4.

g. **<u>Management Performance</u>**

As addressed later in this Main Brief, the Company has demonstrated effective and efficient management meriting a 25 basis point performance adjustment to the ROE. I&E and OCA have not provided any relevant or persuasive arguments in response to the evidence of management effectiveness furnished by the Company. As a result, the Commission should approve the proposed 25 basis point performance adjustment.

h. **<u>Size Adjustment</u>**

As further addressed later in this Main Brief, the Company has proposed a 100 basis point size adjustment to account for the additional risks associated with smaller public utilities. The size risk has been recognized in financial literature and further demonstrated by empirical analysis conducted by Company witness Mr. D'Ascendis. Mr. D'Ascendis demonstrated that a 437 basis point adjustment could be justified for Valley, but he recommends a more modest 100 basis point adjustment. Joint Statement No. 2 at 45. Accordingly, the Commission should approve the proposed 100 basis point performance adjustment.

3. **The Opposing Parties' Unprecedented and Unreasonable Common Equity Recommendations Must Be Rejected.**

In this proceeding, I&E and OCA have advanced ROE recommendations that starkly contrast with the financial and operational reality facing the Company. I&E recommends an ROE of 8.46%, while OCA recommends an ROE of 8.34%. These recommended ROEs are outside the scope of reasonableness and significantly below the lowest ROEs approved for natural gas utilities anywhere in the country over the past 40 years (as tracked by RRA). *See* Joint Statement No. 2-R at 5.

Not surprisingly, the ROEs recommended by I&E and OCA also depart from ROEs approved by this Commission in fully-litigated rate proceedings for investor-owned public

utilities. In late October 2018, the Commission approved an ROE of 9.85% for UGI Utilities, Inc. – Electric Division. UGI Order at 119. Additionally, the Commission approved an ROE of 10.40% for PPL Electric Utilities Corporation in 2012 and an ROE of 11.00% for Aqua Pennsylvania, Inc. in 2008. Joint Statement No. 2-R at 5. Although market conditions may change, no empirical evidence supports adoption of ROE's that are 139 and 151 basis points lower than the UGI result, which was decided a mere 18 months before this case. When considering that the current market demands higher rates of return for natural gas utilities versus their electric counterparts, the fact that both I&E and OCA are proposing ROE results significantly lower than that awarded to UGI is concerning. *See* Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 1. As indicated by the above background and detailed in the below analysis of the opposing ROE recommendations, the Commission should reject the proposals from I&E and OCA and approve the thoroughly developed and supported ROE recommendation from Mr. D'Ascendis.

a. I&E Arguments

In contrast to Mr. D'Ascendis' detailed analysis addressing the necessity to evaluate the DCF results in conjunction with other models for purposes of this proceeding, I&E maintains an unreasonably narrow focus on relying primarily on the DCF and considering only the CAPM as a check. Generally, I&E's testimony critiques the CAPM and RPM analyses while entirely ignoring similar shortcomings associated with the DCF analysis. I&E's methodology and specific criticisms of Mr. D'Ascendis' recommendations are addressed below.

i. I&E fails to recognize importance of other models.

I&E applies a DCF model and uses the CAPM as a "check" on the DCF results. I&E Statement No. 2 at 20. As discussed by Mr. D'Ascendis, unfortunately, I&E's application of the CAPM suffers from numerous flaws, which renders the "check" useless. Additionally, I&E entirely omits consideration of additional models despite Mr. D'Ascendis providing compelling

testimony establishing that market conditions favor reference to other models to correct for inaccuracies embedded in the DCF model.

ii. I&E's CAPM analysis is flawed.

First, I&E identifies the CAPM analysis as subject to manipulation based on the inputs and proceeds to use different inputs than Mr. D'Ascendis. *See* I&E Statement No. 2 at 21-22, 37. I&E's criticism of the CAPM analysis in general as subject to "manipulation" should be given no weight. As noted by Mr. D'Ascendis, I&E's criticism of the CAPM would apply equally to any ROE model as "[a]ll ROE models are only as good as their inputs, and all ROE models can be easily manipulated by changing those inputs." *See* Joint Statement No. 2-R at 38. To illustrate this point, Mr. D'Ascendis compiled the below table reflecting the various data inputs to the DCF that can each alter the results of any individual DCF analysis:

Main Brief Table 5

Various Inputs to DCF Models

Input	Variations of Inputs
Cash Flow Stream	Constant-Growth, Blended Growth, Multi-Stage Growth
Dividend Yield	Spot Dividend Yield, average dividend yield
Adjusted Dividend Yield	No adjustment, ½ g adjustment, full g adjustment, projected dividend
Growth Rates	Historical v. Projected v. Sustainable
Growth Measure	EPS, DPS, BVPS
Sources of Growth Rates	Value Line, Zacks, Yahoo, MorningStar, etc.

Joint Statement No. 2 at 39. CAPM should not be disregarded simply because it requires the analyst to make reasonable judgments regarding the model inputs.

In addition to the general critique of the CAPM as subject to manipulation, I&E specifically challenges Mr. D'Ascendis' selection of the 30-year Treasury Bonds as the risk-free rate, his forecast period, and his use of the ECAPM.

Regarding the applicable risk-free rate, I&E claims the 10-year Treasury Note represents the appropriate risk-free rate for a CAPM analysis. I&E bases this assertion on its claim that the 10-year Treasury Note balances short-term volatility risk and long-term inflation risk. *See* I&E Statement No. 2 at 37. I&E also relies on the Commission's decision to adopt its proposal to use the 10-year Treasury Note as the risk-free rate in the 2018 UGI Order. Notwithstanding the prior determination in the UGI rate case, the Company urges the Commission to consider the matching principle explained by Mr. D'Ascendis. Mr. D'Ascendis presents multiple financial analyses from notable scholars confirming that the "risk-free rate used in the CAPM should match the life (or duration) of the underlying investment." *See* Joint Statement No. 2-R at 23. Morningstar, Inc. further explains this matching principle as follows:

> The traditional thinking regarding the time horizon of the chosen Treasury security is that it should match the time horizon of whatever is being valued. When valuing a business that is being treated as a going concern, the appropriate Treasury yield should be that of a long-term Treasury bond. Note that the horizon is a function of the investment, not the investor. If an investor plans to hold stock in a company for only five years, the yield on a five-year Treasury note would not be appropriate since the company will continue to exist beyond those five years.

Id. Mr. D'Ascendis additionally references the below passage from Dr. Morin affirming the same matching principle and directly recommending the use of 30-year Treasury Bonds as the appropriate risk-free rate for CAPM analysis:

> [b]ecause common stock is a long-term investment and because the cash flows to investors in the form of dividends last indefinitely, the yield on very long-term government bonds, namely, the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM… The expected common stock return is based on long-term cash flows, regardless of an individual's holding time period.

Id. Based on this well-founded matching principle and the useful life of public utility assets ranging from 21-31 years (or more), Mr. D'Ascendis concludes that "the I&E Witnesses' use of a medium-term Treasury bond does not match the life of the assets being valued." *Id.* at 24. I&E provided no credible academic or financial authority to rebut the multiple studies referenced by Mr. D'Ascendis. Accordingly, the Commission should approve Mr. D'Ascendis' proposed risk-free rate based on the 30-year U.S. Treasury Bonds.

I&E further criticizes Mr. D'Ascendis' forecast period for the risk-free rate. As set forth above, Mr. D'Ascendis' CAPM analysis included a projection of the risk-free rate over the period 2021-2025 and 2026-2030. *See supra* at VII.E.3. I&E claims any projection exceeding five years would include unreliable data. I&E Statement No. 2 at 37. Notably, I&E provides no analysis or citation to any authority to support the assertion that projecting a risk-free rate over a ten-year period would result in unreliable data. To the contrary, Mr. D'Ascendis identifies two significant flaws in the I&E recommendation.

First, he confirms that the Blue Chip Financial Forecasts, the source relied upon by both Mr. D'Ascendis and I&E, projects interest rates out to 2030. Joint Statement No. 2 at 24. Thus, because the DCF model is precipitated on an assumption that the projected growth is constant into perpetuity, I&E contradicts the model by not incorporating the longest projection available. *Id.* Second, Mr. D'Ascendis also observes that investors are generally presumed to act in accordance with the semi-strong form of the Efficient Market Hypothesis, which assumes that "all information (including long-term forecasts of interest rates) are available to the investor, which means the 2026-2030 forecasted interest rate would be considered by investors when making investment decisions and, therefore, should be included in the I&E ROE Witnesses' CAPM analysis." *Id.* at 25. Mr. D'Ascendis has provided ample support for the proposed forecast period, which I&E has

failed to credibly rebut. The Commission should therefore approve the Company's proposed forecast period for the risk-free rate.

Finally, I&E fails to include an ECAPM analysis. I&E opposes Mr. D'Ascendis use of the ECAPM claiming that it only exacerbates the subjectivity of the traditional CAPM. I&E's argument eschews substance in favor of conclusive and thus unreliable assertions. In Surrebuttal Testimony, I&E references unspecified flaws in the ECAPM, alleging "[a]s I explained in my direct testimony, the ECAPM has the same problems as the CAPM." I&E Statement No. 2-SR at 18. However, I&E cites back to pages 38 and 39 of its Direct Testimony, which contain no further articulation of the purported flaws in the CAPM that are not addressed by the ECAPM. *See* I&E Statement No. 2 at 37-38. To the contrary, Mr. D'Ascendis references multiple studies affirming that the ECAPM addresses criticism of the overly steep predicted Security Market Line resulting from the traditional CAPM. For example, Dr. Morin concluded that "[w]ith few exceptions, the empirical studies agree that… low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted." *See* Joint Statement No. 2-R at 28. The ECAPM directly responds to this concern by relaxing the slope of the predicted Security Market Line to reflect the empirical (i.e. actual) Security Market Line.

iii. I&E Unreasonably Excludes Consideration of the Company's Risk Premium Analyses.

I&E also rejects Mr. D'Ascendis' use of the RPM and PRPM analyses on grounds that both rely on indirect ROE measures and the PRPM is an uncommon methodology requiring purchase of proprietary software at a "substantial fee." I&E Statement No. 2 at 33. These allegations are unfounded. Mr. D'Ascendis confirmed in his Direct Testimony that he adjusted the RPM results "by the beta coefficient to account *for the risk of the Electric and Gas Utility Proxy Groups*." Joint Statement No. 2 at 28 (emphasis added). As Mr. D'Ascendis adjusted for the specific risks of the

Gas Utility Proxy Group, the RPM is not based on indirect measure of ROE. Similarly, Mr. D'Ascendis clarified in his Rebuttal Testimony that "[t]he PRPM model used in my RPM analysis measures the risk-return relationship directly using the same company-specific market prices used to derive company-specific beta coefficients." Joint Statement No. 2-R at 39. Mr. D'Ascendis further cites to a *Journal of Regulatory Economics* article by the authors of the model affirming that the PRPM estimates risk *directly* from asset pricing data. *Id.* at 39. Similarly, Mr. D'Ascendis also confirmed in his Direct Testimony that he adjusted the RPM results "by the beta coefficient to account for the risk of the Electric and Gas Utility Proxy Groups." Joint Statement No. 2 at 28. Finally, with regard to the claims that the PRPM is not a commonly used method, Mr. D'Ascendis provided extensive evidence of its use in the industry, including three publications in academic peer-reviewed journals and a recent adoption of the model by the South Carolina Public Service Commission. Joint Statement No. 2-R at 41. Mr. D'Ascendis also addressed I&E's claim that the PROM is a proprietary model available only through substantial fees by clarifying that he made his workpapers available to all parties in this proceeding and that free versions of software necessary to run the PRPM model are available. *See id.* at 42. While the PRPM analysis has not been commonly adopted by this Commission, Mr. D'Ascendis has provided substantial and unrebutted support for his reliance on the model.

iv. I&E Fails to Incorporate Results of the Company's Analysis of Non-Price Regulated Companies.

I&E also contests Mr. D'Ascendis use of market data from domestic, non-price regulated companies in determining a recommended ROE for the Company. I&E objects to this method principally based on the Commission's observation in the UGI Order that "determining which companies are comparable is entirely subjective." I&E Statement No. 2 at 35. I&E also avers that

consideration of non-price regulated companies runs contrary to the *Bluefield* standard. Both arguments should be rejected.

In reviewing Mr. D'Ascendis' reliance on data from non-price regulated companies, the Commission should consider that its decision in the UGI Order was based on the Comparable Earnings analysis proposed in that proceeding. Notably, the Commission observed in that Order that UGI considered returns on book equity rather than returns on common equity. UGI Order at 105. To the contrary, no party disputes that Mr. D'Ascendis applied the DCF, CAPM, and RPM models to the non-price regulated proxy group. Additionally, as previously observed by Mr. D'Ascendis, there is a measure of subjectivity involved in all ROE models. *See* Joint Statement No. 2-R, at 38. Here, Mr. D'Ascendis developed specific selection criteria limiting the non-price regulated proxy group to companies with beta coefficients *and* residual standard errors within plus or minus two standard deviations of the Gas Utility Proxy Group. Joint Statement No. 2 at 37. I&E's criticisms of Mr. D'Ascendis' non-price regulated proxy group would apply with equal force to any ROE model in that the projected risk is never a guarantee of future risk.

Additionally, I&E errs in asserting that consideration of non-price regulated companies violates the *Bluefield* standard. As noted above, the non-price regulated companies meet selection criteria indicating they face similar, albeit not exact, risks as the Gas Utility Proxy Group. I&E's assertion that the companies in the non-price regulated proxy group are "highly profitable or speculative ventures" cannot be reconciled with the selection criteria applied by Mr. D'Ascendis.

I&E failure to consider the multiple ROE models conflicts with Mr. D'Ascendis' testimony demonstrating that the DCF is subject to distortion during periods where market value exceeds book value, which is a situation that currently exists as shown on Table 3. I&E purports to rebut Mr. D'Ascendis' arguments by claiming that any difference between market and book value for natural gas utilities is reflected in the forecasted growth rates used in the DCF. *See* I&E Statement

No. 2-SR at 12. However, I&E's assessment is flatly contradicted by the financial literature cited by Mr. D'Ascendis, which corroborates his observation that "application of the standard DCF model to utility stocks understates the investor's expected return when the market to-book (M/B) ratio of a given stock exceeds unity." Joint Statement No. 2-R at 10.

b. <u>Consideration of DCF-Only Results Still Invalidates I&E's ROE Recommendation.</u>

Although Mr. D'Ascendis provides ample support for his reliance on multiple methods, the Commission should consider that even the DCF-only results support an ROE higher than the recommendations from I&E. The Commission's determination of the ROE for natural gas utility DSICs indicates that an appropriate ROE should be set at the higher range of DCF results. As discussed by Mr. D'Ascendis in his rejoinder testimony, the Commission does not set the DSIC ROE at the median or mean of its DCF analysis, but rather sets the DSIC ROE at some point within a standard deviation of the results. *See* Tr. 45. Despite arguments from I&E that the DSIC ROE is not relevant to this proceeding, the DSIC ROE is a market indicated cost of common equity developed by the Commission concurrently with this rate case. It applies to utilities that settled their most recent rate cases without a litigated ROE. If ROE was litigated, then the PUC's determination from the rate case is applied. 66 Pa. C.S. § 1357(b)(2). Accordingly, it serves as a meaningful check on the results in this proceeding, although the DSIC results would be conservative as it omits consideration of the specific risks faced by small public utilities like Valley and any recognition of a performance adjustment for management effectiveness.

4. OCA Arguments

Like I&E, OCA's ROE analysis relies narrowly on the DCF and gives no weight to the results of other models. Interestingly, OCA alleges that it considered other models; however, its 8.38% recommended ROE (or I&E's ROE) remains solely based on the median point of its DCF

analysis. As noted above, OCA's ROE would be the lowest ROE approved for a natural gas utility in the country. *See* Joint Statement No. 2-R at 5. While the below discussion will address specific faults with OCA's analysis, the Commission should consider the drastic departure from market realities sufficient reason to summarily reject OCA's recommended ROE.

a. <u>OCA fails to recognize importance of other models.</u>

Although Mr. D'Ascendis provided evidence demonstrating that current market conditions render the DCF subject to distortion, OCA continues to recommend an 8.34% ROE for the Company based solely on a combination of a constant growth DCF and the Federal Energy Regulatory Commission ("FERC") two-step DCF analysis. Joint Statement No. 2-R at 46. In addition to the combined DCF/two-step DCF model, OCA conducts a two-stage DCF analysis, a CAPM analysis, and a CAPM/Risk Premium analysis, but places no weight on these analyses. Joint Statement No. 2-R at 46. Therefore, OCA's recommended ROE is based solely on the DCF. OCA Statement No. 3 at 25.

b. <u>OCA's Non-Constant DCF Results Have No Merit.</u>

The constant growth DCF model applied by OCA substantially duplicates Mr. D'Ascendis' DCF model. The OCA errs by also considering non-constant DCF results. Specifically, the OCA's alternative non-constant FERC two-step DCF and the two-stage DCF are predicated on false premises and should be rejected as invalid ROE models. As described by Mr. D'Ascendis, both the FERC two-step DCF and the two-stage DCF alternative growth rates are intended to reflect the dual premises: "(1) that growth is limited by the long-term growth in gross domestic product ("GDP") and (2) utility companies are not in the 'steady state' stage in the company/industry life cycle." Joint Statement No. 2-R at 49. However, neither premise holds true.

Mr. D'Ascendis provided an analysis illustrating the fallacy of referencing GDP as a limit on long-term growth, showing that even the highest growth rate industry (Educational Services,

Healthcare, and Social Assistance) would need 3,467 years of compound annual growth to comprise 100% of GDP. Joint Statement No. 2-R at 50. In addition, Mr. D'Ascendis further cited to financial literature evidencing that natural gas utilities are mature (i.e. steady state) firms. *Id.* at 51-52. In other words, both premises cited above do not apply in this context.

In response, OCA further argues that use of the non-constant FERC two-step DCF and two-stage DCF are unrelated to the underlying firm's growth stage and applied to serve as a check on unsustainable analyst growth rates used in the constant growth DCF model. OCA Statement No. 3-SR at 7. However, OCA's reasoning is circular as OCA recognizes that the non-constant DCF models are generally reserved for growth-stage firms rather than mature steady stage firms like natural gas utilities. *Id.* at 7. OCA provides no basis for applying these models to steady stage firms other than an unsubstantiated allegation that the otherwise applicable 5-year forecasts are "unsustainable." *Id.* at 7.

c. <u>OCA's CAPM Analysis is Flawed.</u>

As stated above, OCA also performs a CAPM analysis as a check on its DCF results, which results in a range of 6.86% to 11.49% for his electric proxy group. OCA Statement No. 3 at 28. However, Mr. D'Ascendis identified numerous flaws invalidating OCA's CAPM analysis. In principle, and as discussed in detail in Mr. D'Ascendis' Rebuttal Testimony, OCA's CAPM analysis: 1) fails to utilize a risk-free rate based on a forecast period, despite common knowledge that investors are aware of and rely on interest rate forecasts; 2) relies on four flawed market risk premium calculations; and 3) similar to I&E, fails to incorporate an ECAPM analysis. Joint Statement No. 2-R at 55-63. As indicated by Mr. D'Ascendis, correcting OCA's CAPM to incorporate a projected risk-free rate and corrected market risk premiums would result in an adjusted range of 6.79% to 12.25% for his gas proxy group.

d. OCA's CAPM/Risk Premium Analysis Is Not a Generally Accepted Model.

OCA compounds the ineffectiveness of its CAPM analysis by applying a purported "risk premium" analysis that simply replaces the risk-free rate in the CAPM with a six-month average utility bond yield. Joint Statement No. 2-R at 64. As discussed in Mr. D'Ascendis' Rebuttal Testimony, this model is "a substantial departure from the CAPM's theoretical basis, simply because it assumes no risk-free asset." *Id.* at 65. While OCA argues that its risk premium analysis preserves a risk-free asset in the market risk premium calculation, it concedes that the "free-standing" risk free asset component of the CAPM is eliminated. OCA Statement No. 3-SR at 9. As OCA provides neither financial literature nor other support for this departure from the widely accepted CAPM or risk premium analyses, the Commission should dismiss OCA's unsupported risk premium analysis.

As referenced above, OCA conducted multiple analyses, but developed its recommended ROE of 8.34% based solely on the results of its constant growth and FERC two-step DCF models. While OCA claims to have considered various other models, it used the results of its two-stage DCF model, CAPM model, and CAPM/Risk Premium model OCA only to set the upper and lower limits for its gas proxy group. *Id.* at 5. Accordingly, OCA omits consideration of multiple ROE models in the same manner as I&E. In response to Mr. D'Ascendis' presentation of evidence establishing the susceptibility of DCF models to distortion during periods where market-to-book ratios exceed unity, OCA offers parallel arguments to those advanced by I&E, each of which fails to overcome the empirical evidence advanced by Mr. D'Ascendis in favor of using other models to counter unreliable DCF results.

e. Consideration of DCF-Only Results Still Invalidates OCA's ROE Recommendation.

Finally, as detailed above in response to I&E's ROE analysis, OCA's ROE recommendation remains unsupported even if considered solely on the basis of its DCF results, as both the Commission's practice in setting the DSIC ROEs and the policy initiatives necessitating significant capital expenditures for reliability improvements would favor awarding an ROE closer to the high end of the DCF results, subject to further adjustments.

F. MANAGEMENT PERFORMANCE

Valley has demonstrated effective management of operations and costs which warrants a performance adjustment. OCA and I&E are incorrect in their assertions that Valley's successes in providing effective management of operations and costs merely achieve what the Public Utility Code requires all utilities to do—*i.e.*, provide adequate, efficient, safe, and reasonable service.[8] *See* OCA Statement No. 3 at 31. I&E Statement No. 2 at 44.

Section 523 of the Public Utility Code, 66 Pa. C.S. § 523, requires that the Commission to consider management effectiveness in setting rates and states, in relevant part:

> (a) Considerations. — The commission *shall consider*, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.

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[8] Section 1501 of the Public Utility Code, 66 Pa. C.S. § 1501 provides, in relevant part: "Every public utility shall furnish and maintain adequate, efficient, safe, and reasonable service and facilities."

66 Pa. C.S. § 523. (Emphasis added.) In order to be rewarded with a rate of return premium, the utility must provide specific evidence to support the adjustment. *Pa. PUC v. Columbia Water Co.*, 2013 Pa. PUC LEXIS 763, *82.

Valley has listed a number of performance metrics that constitute specific evidence in support of a performance adjustment. The performance metrics demonstrate Valley effective management of costs and operations and, therefore, warrants a performance adjustment.

1. Valley's Effective Management of Operations and Costs Warrants a Performance Adjustment.

In managing operations and costs, Valley has gone above and beyond what it is required to do by improving the quality of public utility service for customers in multiple respects. As Company Chief Executive Officer Edward Rogers described in his direct testimony, Valley has accomplished the following: (1) replaced mains without assessing a DSIC to customers; (2) low number of customer complaints; (3) fast emergency response; (4) favorable customer feedback; (5) technological improvements in customer service by offering Smarthub use to customers; and (6) obtainment of a grant for East Athens main extension project. Valley's Statement No. 4 at 6-8.

In order to highlight the importance of Valley's accomplishments, a few of these achievements will be explained in more detail. Concerning Valley's low number of customer complaints, during the past three years, Valley has received 2 informal complaints but no formal complaints. Valley's Statement No. 4 at 6. The two informal complaints were subsequently resolved with the Commission finding that Valley did not violate the Commission's rules or regulations. *Id.* Valley has also demonstrated quick response times to emergency calls during the 2016-2018 period with a response time of sixty minutes or less. *Id.* at 7. In order to improve the overall customer experience, Valley implemented the use of Smarthub, which allows customers to

review and pay bills, and track their usage electronically. *Id.* Valley has also replaced all cast iron mains, bare steel mains and services, which will ultimately help the Company to continue providing excellent and reliable service to its customers. *Id.* at 6. Notably, Valley implemented this system improvements through effective management of base rate revenues, without employing a DSIC. *Id.* at 6. Lastly, Valley applied for and received grant funding from the Pennsylvania Department of Community and Economic Development's Pipeline Investment Program in order to extend the East Athens main at reduced cost to customers. *Id.* at 8. The Commission's Chairman recognized this step as demonstration of Valley's "practical commitment to extending natural gas service." Valley Statement No. 4, Exhibit _ (ER-3).

All the above discussed performance metrics show Valley's commitment to improve its operations to increase reliability, increase attention to customer needs and customer satisfaction, and increase the overall effectiveness of the Company's service. These accomplishments achieve more than just mere compliance with Commission requirements and policies but demonstrate Valley's commitment to providing reliable and quality service to its customers above and beyond what is required by the Public Utility Code. Based on Valley's effective cost and operations management, a performance adjustment is warranted.

2. I&E and OCA's Disallowance of Any Allowance for Management Effectiveness Should Be Rejected.

Witnesses Habr and Henkel, in their direct testimonies on behalf of OCA and I&E respectively, contend that Valley has not earned a performance adjustment because the Company is merely taking actions it is required to take pursuant to the Public Utility Code. *See* OCA Statement No. 3 at 31; I&E Statement No. 2 at 44. As discussed above, however, Section 523 of the Public Utility Code requires the Commission to consider evidence concerning a utility's efficiency, effectiveness, and adequacy of service in determining whether a utility has earned a

performance adjustment. 66 Pa. C.S. § 523(a); *Pa. PUC v. Columbia Water Co.*, 2013 Pa. PUC LEXIS 763 at *82-83. The Public Utility Code, in very general terms, requires utilities to "furnish and maintain adequate, efficient, safe, and reasonable service and facilities." 66 Pa. C.S. § 1501. In support of Valley's efficiency, effectiveness, and adequacy of service, the Company has listed numerous performance metrics and provided evidence in support thereof. The Commission did not require Valley to develop and implement innovative and progressive solutions such as optimizing the customer service experience through Smarthub, rather, Valley took this step on its own initiative. The Advocates have failed to address whether Valley has provided evidence of effective and efficient management consistent with Section 523(a) of the Public Utility Code and have instead offered only general opposition to the principle of a performance adjustment. If the contentions of OCA and I&E are accepted, there would never be in instance in which the Commission could grant a performance adjustment to a utility.

Certainly, the Commission has stated that utilities who meet the bare requirements of the Public Utility Code have not proven that their performance warrants a performance adjustment. *See Pa. PUC v. Columbia Water Co.*, 2013 Pa. PUC LEXIS 763 at *84 ("In this case, the evidence provided by Columbia shows compliance with Commission requirements and policies, *i.e.* reasonable and adequate service, but it does not even support a rate adjustment in the amount requested. Columbia provided testimony regarding its compliance with state and federal drinking water standards. The evidence regarding Columbia's adequacy of service and water quality is not sufficient to warrant a rate of return premium of 0.25%."). Here, however, Valley has provided evidence of performing above and beyond the its compliance obligations under the Public Utility Code in greatly increasing the efficiency, reliability, and quality of service through the many listed performance metrics.

G. SIZE ADJUSTMENT

In considering the appropriate ROE for Valley, the Commission must include a size adjustment to account for the greater risk faced by smaller public utilities in comparison to the Gas Utility Proxy Group. By any measure, Valley is a smaller public utility compared to the companies in the Gas Utility Proxy Group and most of the other natural gas utilities regulated by the Commission. While application of a size adjustment may not be necessary or appropriate in every utility base rate proceeding, the Company has provided evidence demonstrating that a size adjustment is necessary to reflect the difference in scale and size between Valley and the companies in the Gas Utility Proxy Group. I&E and OCA oppose the size adjustment based on allegations that utilities are immune from size risk, but these assertions are unpersuasive considering the body of evidence to the contrary. Accordingly, the Commission should approve the 100 basis point size adjustment proposed by Mr. D'Ascendis.

1. The Proposed Size Adjustment is Necessary to Ensure Valley's ROE Meets the *Bluefield* Standard.

The Company's proposed size adjustment is a corollary to the *Bluefield* standard determining that public utilities are entitled to earn a rate of return on property placed into public service commensurate with other business undertakings "which are attended by corresponding risks and uncertainties." *Bluefield* at 79. As detailed below, company size is a risk factor. Accordingly, an ROE developed using proxy groups differing substantially in size from the public utility requesting a rate increase will understate the appropriate ROE unless the result is adjusted to account for size risk.

Notably, the Commission has previously recognized the validity of a size adjustment. In a 2007 Order, the Commission awarded a size adjustment to PPL Gas Corp. *Pa. PUC v. PPL Gas Corp.*, 2007 Pa. LEXIS 779, *105. Additionally, while the Commission denied the size adjustment

proposed by UGI Electric in 2018, the Commission preserved the validity of the size effect and found only that UGI failed to present sufficient evidence to warrant an adjustment in that proceeding. UGI Order at 100. To the contrary, and as addressed below, the Company has provided compelling evidence supporting its proposed size adjustment.

2. **The Evidentiary Record Supports the Proposed Size Adjustment.**

Mr. D'Ascendis discussed the inverse relationship between company size and risk in his Direct Testimony, as set forth below:

> The Companies' smaller size relative to the Electric and Gas Utility Proxy Groups indicates greater relative business risk for the Companies because, all else being equal, size has a material bearing on risk.
>
> Size affects business risk because smaller companies generally are less able to cope with significant events that affect sales, revenues and earnings. For example, smaller companies face more risk exposure to business cycles and economic conditions, both nationally and locally. Additionally, the loss of revenues from a few larger customers would have a greater effect on a small company than on a bigger company with a larger, more diverse, customer base.

Joint Statement No. 2 at 42. Per Mr. D'Ascendis' explanation, failure to reflect the increased risk faced by smaller public utilities such as Valley would understate the ROE demanded by investors.

The reality that investors demand greater returns to account for size risk is further evidenced through review of the relevant financial literature. In his Direct Testimony, Mr. D'Ascendis references a Duff & Phelps 2019 Valuation Handbook Guide to Cost of Capital - Market Results through 2018 ("D&P - 2019"), which discusses the nature of the small-size phenomenon in detail as follows:

> The size effect is based on the empirical observation that companies of smaller size are associated with greater risk and, therefore, have greater cost of capital [sic]. The "size" of a company is one of the most important risk elements to consider when developing cost of equity capital estimates for use in valuing a business simply because size has been shown to be a *predictor* of equity returns. In other words, there is a significant (negative) relationship between size and historical equity returns - as size *decreases*, returns tend to *increase*, and vice versa. (emphasis in original)

Id. Mr. D'Ascendis additionally cites to the "The Capital Asset Pricing Model: Theory and Evidence," in which Fama and French observe that:

> . . . the higher average returns on small stocks and high book-to-market stocks reflect unidentified state variables that produce undiversifiable risks (covariances) in returns not captured in the market return and are priced separately from market betas.

Joint Statement No. 2 at 42. Finally, Mr. D'Ascendis references noted scholar Eugene Brigham's research identifying the "small-firm effect" as a hindrance to small firm operations:

> A number of researchers have observed that portfolios of small-firms (sic) have earned consistently higher average returns than those of large-firm stocks; this is called the "small-firm effect." On the surface, it would seem to be advantageous to the small firms to provide average returns in a stock market that are higher than those of larger firms. In reality, it is bad news for the small firm; *what the small-firm effect means is that the capital market demands higher returns on stocks of small firms than on otherwise similar stocks of the large firms*. (emphasis added)

Joint Statement No. 2 at 43. Mr. D'Ascendis' review of financial literature establishes the inverse relationship between Company size and risk. The question relevant to whether a size adjustment is necessary to appropriately reflect Valley's risk factors turns to whether Valley is considerably smaller than the companies in the Gas Utility Proxy Group.

To determine whether a size adjustment should be incorporated, Mr. D'Ascendis conducted a market capitalization analysis to quantify the relative size risk. Joint Statement No. 2 at 44. Mr. D'Ascendis' study observed that, as of March 29, 2019, Valley had a market capitalization of $19.24 million compared with an average company market capitalization of $4,600.41 million for the Gas Utility Proxy Group. *Id.* at 45. This amounts to a size difference of 239x.[9] Id.

In order to quantify the appropriate size adjustment, Mr. D'Ascendis relied on "size premiums for portfolios of New York Stock Exchange, American Stock Exchange, and NASDAQ

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[9] Notably, Mr. D'Ascendis also pointed to Valley's rate base as an indicator of size, observing that even the combined $45 million rate base of Citizens', Valley, and Wellsboro are multiple time smaller than the $4.6 billion rate base of the average natural gas utility granted an ROE of approximately 9.70%. *See* Tr. 44.

listed companies ranked by deciles for the 1926 to 2018 period." Joint Statement No. 2 at 45. The Gas Utility Group $4.6 billion market capitalization ranked in the 4th decile, while Valley's $26.8 million market capitalization ranked in the 10th decile, resulting in a size premium spread of 4.37%. Joint Statement No. 2 at 45. Following review of the proxy groups compiled by I&E and OCA, Mr. D'Ascendis refined this market capitalization analysis to include the average market capitalizations of the I&E and OCA proxy groups and finds similar results. *See* Joint Statement No. 2-R at 32; *see also id.,* Exhibit No.__ (DWD-1R), Schedule DWD-5R. Accordingly, although his analysis supports a 437 basis point adjustment, Mr. D'Ascendis recommends a conservative size adjustment of 1.00% or 100 basis points to the Company's ROE.

3. **The Advocates Arguments in Opposition to the Size Adjustment are Unsupported.**

I&E does not contest the general applicability of size risk but allege that the studies referenced by the Company are irrelevant because they are not specific to the utility industry. While the Company does not concede that only financial authorities specific to public utilities are relevant to its ROE determination, Mr. D'Ascendis rebutted the I&E claims with reference to a utility-specific study and his own utility specific analysis demonstrating that size risk impacts public utilities. Joint Statement No. 2-R at 32-26. OCA also contests the proposed size adjustment but bases its opposition on a misunderstanding of Mr. D'Ascendis' size premium and irrelevant condemnations of small utility operations. As OCA and I&E have not credibly responded to Mr. D'Ascendis' proffered utility-specific evidence, their arguments should be dismissed.

In opposing the Company's proposed size adjustment, I&E places exclusive weight on a single study by Dr. Annie Wong concluding that there is "no need to adjust for the firm size in utility rate regulation." *See* I&E Statement No. 2 at 42. In response, Mr. D'Ascendis notes that Dr. Wong's study erroneously equates "a change in size to beta coefficients, which accounts for

only a small percentage of diversifiable company-specific risk." Joint Statement No. 2-R at 33. By analyzing only the risk captured in beta, Dr. Wong understates the total impact of size risk. Joint Statement No. 2-R at 33.

In addition to critiquing Dr. Wong's methods, Mr. D'Ascendis cited to a more recent article by Thomas M. Zepp which also criticized Dr. Wong's study and observed "[t]wo other studies discussed here support a conclusion that smaller water utility stocks are more risky than larger ones. To the extent that water utilities are representative of all utilities, there is support for smaller utilities being more risky than larger ones." Joint Statement No. 2-R at 34. While I&E attempts to invalidate Dr. Zepp's observations by critiquing his methods, the indisputable fact remains that Dr. Zepp presented an authoritative analysis disputing Dr. Wong's findings and was not rebutted in the financial literature by Dr. Wong or her advocates. Particularly considering Mr. D'Ascendis' pointed critique of Dr. Wong's study and the abundance of financial literature supporting the size effect, Dr. Wong's findings that the size effect impacts every industry except utilities should be met with skepticism.

To definitively test Dr. Wong's finding, Mr. D'Ascendis conducted a study to whether size effect is applicable to utilities. Mr. D'Ascendis' methodology and the results are presented below:

> My study included the universe of electric, gas, and water companies included in *Value Line Standard Edition.* From each of the utilities' *Value Line Ratings & Reports*, I calculated the 10-year coefficient of variation ("CoV") of net profit (a measure of risk) and current market capitalization (a measure of size) for each company. After ranking the companies by size (largest to smallest) and risk (least risky to most risky), I made a scatter plot of the data, as shown on Chart 3, below:

Main Brief Table 6

<u>Relationship between Size and Risk for the *Value Line* Universe of Utility Companies</u>

Joint Statement No. 2-R at 35. In assessing the results, Mr. D'Ascendis concluded that the study shows an R-Squared of 0.09, meaning that approximately 9% of the change in risk is explained by size. Mr. D'Ascendis further clarified that a 0.09 R-Squared would not generally be considered to have strong explanatory power, but in this case, it exceeds the average R-Squared of each of the I&E and OCA proxy group companies' beta coefficients, which is a common measure of market risk. *See* Joint Statement No. 2-R at 36.

OCA's opposition to the size adjustment also lacks merit. OCA contests Mr. D'Ascendis' calculation of the applicable size premium, arguing that Mr. D'Ascendis should asses the Duff & Phelps size premium decile based on the proxy group's Ordinary Least Squares ("OLS") beta rather than company market capitalization. OCA Statement No. 2 at 29. Importantly, OCA offers no explanation to support its contention that OLS beta is more relevant that market capitalization to assess size risk. Further, even accepting OCA's premise, the size premium calculated by Mr. D'Ascendis represents the *spread* between the Company decile size premium and average proxy

group decile size premium. *See* Joint Statement No. 2 at 45. As demonstrated by the Duff & Phelps size premiums chart provided in OCA's testimony, the spread between decile 10 and decile 1 remains consistent with Mr. D'Ascendis' proposed size adjustment of 100 basis points. *See* OCA Statement No. 3 at 29.

Finally, OCA also generally contends that public utility customers should not be required to pay higher costs via a size adjustment for "inefficient utility operations." *See* OCA Statement No. 3 at 30. This argument runs contrary to the *Bluefield* standard and should be given no weight. OCA's characterization of the Company's operations as "inefficient" makes no effort to quantify the customer benefits of being served by a smaller public utility such as the Company and should be disregarded.

For the reasons stated above, the I&E and OCA arguments in opposition to the Company's proposed size adjustment should be denied.

H. CONCLUSION AS TO RATE OF RETURN

As detailed above, the Company is entitled to the opportunity to earn a fair and reasonable return consistent with *Bluefield*. Investors expect to earn increased returns on common equity sufficient to justify the risks of equity investment in smaller companies. The Commission must consider the market signals that would result from a decision approving the unprecedented cost of common equity proposals advanced by I&E and OCA and instead support the goals of accelerating replacement of aging infrastructure and continued provision of safe and adequate public utility service. To that end, the Commission should adopt the Company's proposed cost of common equity of 10.60%, which results in an overall rate of return of 7.72% after adjusting for the Company's unopposed capital structure and debt cost rate. *See* Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule DWD-1R at 1.

VIII. RATE STRUCTURE

A. REVENUE ALLOCATION

Valley proposed an across-the-board increase to all tariff rate schedules. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule B5 (R). The across the board increase reflects the unbundling of certain GCR-related costs discussed in Section IX.C below.

No party opposes Valley's proposed revenue allocation. *See* OCA Statement No. 4 at 23, I&E Statement No. 3 at 12; *see also* OSBA Statement No. 1 at 4. Therefore, Valley requests that the Commission approve the Company's revenue allocation.

B. RATE DESIGN

Valley's proposed rate design reflects the across-the-board revenue allocation. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule B5 (R). Although Valley did not conduct a Cost of Service Study, Valley provided a customer charge analysis supporting the proposed increases. *See* Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-8 (R). As with the revenue allocation, no party opposes Valley's proposed rate design. *See* OCA Statement No. 4 at 28, I&E Statement No. 3 at 12; *see also* OSBA Statement No. 1 at 4. Therefore, Valley requests that the Commission approve the Company's revenue allocation.

C. SCALE BACK

I&E and OSBA proposed proportional scalebacks, meaning that if the Commission approves a revenue requirement for Valley that is less than Valley's full requested increase, Valley's rates for each class shall be scaled back in a proportional manner proposed by the Company. *See* I&E Statement No. 3 at 12; *see also* OSBA Statement No. 1 at 4.

The I&E and OSBA proposed scalebacks are consistent with the Company's proposed revenue allocation and should approved in the event the Commission awards less than the Company's requested revenue increase.

IX. MISCELLANEOUS ISSUES

A. REPORTING REPORTS

In Direct Testimony, I&E witness Cline accepts the Company's plant in service projections for the FTY and FPFTY, but adds a request for the Company to submit updates to Schedule C3 by April 1, 2020 (for the year ended December 31, 2019) and by April 1, 2021 (for the year ended December 31, 2020). Valley Statement No. 4-R at 11; *see also* I&E Statement No. 3 at 10.

The Company respectfully opposes the imposition of additional requirements not required by statute or regulation. The Company submits numerous filings to the Commission each year, including Annual Reports required by the Commission's Regulations. 52 Pa. Code § 59.48. These Annual Reports include detailed plant, expense, and sales data that the Commission and I&E can review. In addition, Commission regulations require quarterly updates while the filing is pending. 52 Pa. Code § 53.56. Thus, year-end balances will be provided through other means. The Company urges the Commission to mitigate the regulatory burden on small utilities by denying I&E's request.

The Commission has not adopted rules or regulations comprehensively addressing the requirements for public utilities utilizing the FPFTY. As stated by Mr. Rogers, "[t]he Company should not be required to comply with additional filing requirements unless those requirements are part of the regulations applicable to all NGDCs. I&E and other interested parties will have the opportunities to review this information when the Company files a subsequent base rate case." Valley' Statement No. 4-R at 11. *See, e.g., Pa. PUC v. Pennsylvania-American Water Co.*, Docket No. R-00932670 et al., 1994 Pa. PUC LEXIS 120 at *158 (Final Order entered July 26, 1994) (adopting the ALJ's conclusion that the issues raised by OCA were outside the scope of rate case and would be better addressed in a statewide rulemaking proceeding). Presumably, the ongoing FPFTY stakeholder process will result in a clear set of reporting standards to which the Company

(and all NGDCs) will be subject. Meanwhile, the Company already has continual reporting requirements in a highly regulated context. Until the Commission makes a broad determination on reporting requirements applicable to all NGDCs, the Company should not be required to provide the reports recommended by Mr. Cline.

B. PROPOSED TARIFF CHANGES

In addition to the rate modifications, Valley proposed the following changes to its tariff:

1. Clarify existing defined terms consistent with Company practices;
2. Clarify the Company's Natural Gas Shortage and Emergency Conditions Policy;
3. Revise the Company's Facilities Expansion Policy to ensure recovery of reasonable facility expansion costs;
4. Update fees for disconnection and reconnection due to customer violations or seasonal service; and
5. Update the Automatic Meter Reading Equipment language to reflect current technologies.

See Valley Statement No. 4 at 11-12. No party opposed Valley's proposals to clarify existing defined terms, clarify the Company's Natural Gas Shortage and Emergency Conditions Policy, and Update the Automatic Meter Reading Equipment language to reflect current technologies. Accordingly, these proposed changes should be approved for the reasons set forth in the Direct Testimony of Valley witness Rogers. *See* Valley Statement No. 4 at 12-13, 15.

OSBA and OCA respectively opposed Valley's proposals to revise the Company's Facilities Expansion Policy and update fees for disconnection and reconnection due to customer violations or seasonal service. OSBA Statement No. 1 at 9; OCA Statement No. 4 at 29. As discussed below, both tariff changes are reasonable and should be approved.

1. **Unopposed Tariff Changes**

As noted above, Valley proposed five changes to its tariff. The two contested changes are addressed below. This section summarizes the unopposed proposed tariff changes.

a. Proposal to Clarify existing defined terms consistent with Company practices.

Valley proposes to modify certain defined terms in its tariff to clarify current Company practices, eliminate duplicative language, alphabetize the definitions section, and conform the definitions to reflect proposed changes to other tariff sections. In his Direct Testimony, Valley witness Rogers reviews modifications to or additions of the following defined terms: "Daily Quantity;" "Service;" "Service Pipe;" and "System Maintenance Order." *See* Statement No. 4 at 12-13. Mr. Rogers adds that other defined terms are re-ordered to alphabetize the defined terms section in the tariff. *Id.* at 13.

b. Proposal to Clarify the Company's Natural Gas Shortage and Emergency Conditions Policy.

Valley proposes changes to its Natural Gas Shortage and Emergency Conditions Policy to add additional detail concerning the Company's curtailment process. The modifications also correct a typographical error and inserts a definition of "unauthorized use". *See* Statement No. 4 at 13.

c. Proposal to Update the Automatic Meter Reading Equipment language to reflect current technologies.

Valley proposes to modify its Automatic Meter Reading Equipment language for Rate Schedules Large Industrial (I), Industrial Interruptible (IL), and Transportation Service (T) to clarify the costs associated with automatic meter reading equipment to include ethernet connections and/or wireless communication devices and wireless communication subscription plans. *See* Statement No. 4 at 15.

d. Conclusion

Each of the unopposed changes is consistent with the public interest and will enable Valley to continue providing safe and reliable public utility service to its customers. As a result, Valley requests Commission approval of the unopposed tariff changes.

2. Valley's Proposed Modification to its Facilities Extension Policy Benefits Customers and Should Be Approved as Consistent with the Public Interest.

As part of the rate filing, Valley proposed to modify its Facilities Expansion Policy to clarify its right to adjust cost estimates, implement a third method for calculating the Company's portion of service line extension costs, and allow customers to request a review of Company records to determine whether a refund is necessary to account for customer connection in excess of the number used to calculate the Company and customer investment in service and/or main extensions. Valley Statement No. 4 at 14-15. OSBA opposed only Valley's proposal to implement a third method for calculating the Company's portion of service line extension costs. OSBA Statement No. 1 at 9. As detailed below, OSBA's arguments are not persuasive when weighed against the public interest benefits derived from the Company's proposal.

Currently, Valley's tariff offers two options for customers seeking a Company contribution for a service line extension. Customers are entitled to a Company contribution for service line extensions of: 1) up to $6 per each additional dollar of anticipated annual revenues; or 2) the costs of 200 feet of service or main extensions. Valley Statement No. 4 at 14. As detailed in the Company's response to Interrogatory OSBA-Valley-II-1, the current method creates an unnecessary inequity. *See* OSBA Statement No. 1, Exhibit BK-1(V) (attaching Valley's response to OSBA-Valley-II-1). As stated therein, the average cost for 200 feet of service line or main extension for new installations over the 12-month period ending September 30, 2018 is $6,557. *See id.* Under the current rule, a customer requiring a 200 foot extension costing $6,557 is entitled to a Company contribution, while a customer requiring a 300 foot extension that costs a total of $6,400 is not entitled to receive a full allocated contribution amount for the footage over 200 feet. *See id.* Valley proposes to add a third option allowing for Company contributions for a main or

service line extensions up to the average cost of 200 feet of service and/or main extensions for new installations over the most recent 12-month period ending September 30. *See id.*

OSBA witness Brain Kalcic opposes the Company's proposal on grounds that there is no inequity under the current tariff rule and that Valley's proposal would raise the Estimated Base Annual Revenue (EBAR) for which the 200-foot cap allegedly serves as a proxy. *See* OSBA Statement No. 1 at 5, 9. OSBA additionally argues that Valley's proposal does not protect customers against uneconomic main or service line extensions. *See* OSBA Statement No. 1 at 10; *see also* OSBA Statement No. 1-SR at 5. Finally, OSBA proposes that Valley alternatively propose to replace its current 200 feet allowance rule with a cost-justified fixed dollar allowance applicable to all customers in a given rate class in its next base rate proceeding. *See* OSBA Statement No. 1-SR at 7-8.

OSBA's arguments should be disregarded. OSBA offers no empirical analysis supporting the association between the 200 feet of service line or main extension and the EBAR from customers. Particularly as the Company's proposal preserves the average cost of a 200-foot extension as the upper limit on Company contributions under the proposed methodology, OSBA's concerns regarding uneconomic line extension are unfounded. *See* Company Statement No. 4-R at 12. As stated by Valley witness Rogers "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." *See id.* at 13.

In reviewing the Company's proposal, the Commission should consider that OCA witness Mierzwa also addressed the Company's proposed change to the Facilities Extension Policy and observed that "… it is unclear how Valley's proposal would effectively raise its existing EBAR credit and Mr. Kalcic has presented no evidence to indicate that the additional facility extension projects would not be cost-justified or uneconomic." OCA Statement No. 4-R at 9. To the

contrary, Mr. Mierzwa concurs that Valley's proposal is consistent with the efforts of other NGDCs to promote the availability of natural gas to unserved and underserved areas and that OSBA's recommendation could serve as a deterrence to completion of economic extension projects. *See id.* at 9-10. Finally, Mr. Mierzwa criticizes OSBA's proposal for Valley to develop a fixed fee maximum contribution available to each customer class, noting that it would not address the issue of expanding Company contributions to customers with varying costs of facilities extensions. *See id.* at 10. As noted by OCA's witness, only Valley's proposal solves the issue by recognizing that cost differences for service line or main extensions should not preclude a Company contribution as long as the customer's extension costs fall below what the Company must pay under the current 200-foot method. *See id.*

For the reasons set forth above, the Commission should approve Valley's proposed changes to its Facilities Extension Policy.

3. Valley's Proposed Disconnection and Reconnection Fees Are Reasonable and Should be Approved.

Valley proposed changes to its tariff to update its disconnection and reconnection fees by increasing the current fees by $10. The Company proposes to increase the fee for reconnections/disconnections completed during working hours from $25 to $35 and increase the fee for reconnections/disconnections completed outside of working hours from $30 to $40. *See* Valley Statement No. 4 at 16.

OCA witness Mierzwa opposed Valley's proposed change on grounds that Valley had not provided a cost basis for the proposal. OCA Statement No. 4-SR at 16. The record reflects, however, that Valley's testimony explained that the fees were increased to account for 13 years of inflation. *See* Valley Statement No. 4 at 15. OCA conducted no investigation into Valley's claim and OCA witness Mierzwa responded at the evidentiary hearing that he could not recall the

explanation for the increased fee provided in Valley Witness Rogers' Direct Testimony. *See* Tr. 312.

In support of its proposed fee adjustment, Valley presented more convincing evidence than OCA. Ten dollars is a modest increase to fees that were last increased in Valley's 2007 rate case, which was almost thirteen years ago. Accordingly, the proposed increases to Valley's reconnection and disconnection fees should be approved.

C. UNBUNDLED PROCUREMENT COSTS TO BE RECOVERED IN VALLEY'S GCR

As detailed in the Direct Testimony of Valley witness Levering, the Company proposed to unbundle procurement costs from delivery rates pursuant to the Commission's Order of June 23, 2011 at Docket No. L-2008-2069114. Ms. Levering's testimony also recounted the waiver granted to Valley by Commission Order entered on December 5, 2012 at Docket No. P-2012-2321937, which exempted Valley from compliance with the unbundling requirement until its next base rates.

Consistent with the Commission's directive and waiver, Valley's rate filing proposes to unbundle the Company's natural gas inventory and the proportion of uncollectible expense derived from gas supply shall be recovered through Valley's GCR. Accordingly, Valley Statement No. 1, Exhibit__(HSG-1) Schedule C4 (R) shows the reallocation of $121,529 from Valley's fully-projected future test year revenue requirement to the GCR. To claim the $121,529 reallocated revenues in the GCR, Valley will update its GCR concurrent with the effective date of the new rates established in this proceeding. *See* Valley Statement No. 1 at 19.

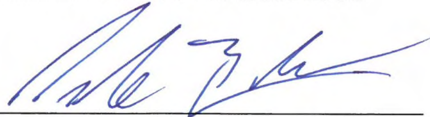
No party opposed Valley's proposed unbundling adjustment.

X. CONCLUSION

WHEREFORE, Valley Energy, Inc. respectfully requests that the Pennsylvania Public Utility Commission approve the rate increase and other proposals set forth in Tariff-Gas PA. PUC No. 2.

Respectfully submitted,

McNEES WALLACE & NURICK LLC

By 

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Counsel to Valley Energy, Inc.

Dated: January 8, 2020

TABLE I
Valley Energy Company (PA)
INCOME SUMMARY
R-2019-3008209

	Pro Forma Present Rates (1)	Company Adjustments (1)	Pro Forma Present Rates (Revised) (1)	ALJ Adjustments	ALJ Pro Forma Present Rates	ALJ Revenue Increase	Total Allowable Revenues
	$	$	$	$	$	$	$
Operating Revenue	5,059,370	0	5,059,370	0	5,059,370	745,079	5,804,449
Expenses:							
O & M Expense	3,247,647	0	3,247,647	0	3,247,647	0	3,247,647
Depreciation	971,413	0	971,413	0	971,413	0	971,413
Taxes, Other	34,296	0	34,296	0	34,296	0	34,296
Income Taxes:							
State	(16,477)	0	(16,477)	(73)	(16,550)	74,433	57,883
Federal	25,473	0	25,473	(137)	25,336	140,836	166,172
Total Expenses	4,262,351	0	4,262,351	(210)	4,262,141	215,269	4,477,410
Net Inc. Available for Return	797,019	0	797,019	210	797,229	529,810	1,327,039
Rate Base	17,179,542	0	17,179,542	0	17,179,542		17,179,542
Rate of Return	4.64%		4.64%				7.72453000%
Source:	C1 (R)						

(1) Company Main Brief

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TABLE I(A)
Valley Energy Company (PA)
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			2.15423000%		
Long-term Debt	47.45%	4.54%	2.15423000%		2.15%
Short-term Debt			0.00000000%		
Preferred Stock			0.00000000%	0.711079	0.00%
Common Equity	52.55%	10.60%	5.57030000%	0.711079	7.83%
	100.00%		7.72453000%		9.98%
Pre-Tax Interest Coverage	4.63				
After-Tax Interest Coverage	3.59				
Source:	C1-2 (R)	C1-2 (R)			

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TABLE I(B)
Valley Energy Company (PA)
REVENUE FACTOR
R-2019-3008209

100%	1.00000000
Less:	
Uncollectible Accounts Factor (*)	0.00000000
PUC, OCA, OSBA Assessment Factors (*)	0.00000000
Gross Receipts Tax	
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
	1.40631350

(*) Company Main Brief
Source: C1-3 (R)

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Appendix A
Rate Case Tables

TABLE II
Valley Energy Company (PA)
SUMMARY OF ADJUSTMENTS
R-2019-3008209

Adjustments	Rate Base	Revenues	Expenses	Depreciation	Taxes-Other	State Income Tax	Federal Income Tax
	$	$	$	$	$	$	$
RATE BASE:							
CWC:							
Int. & Div. (Table IV)	(IV!B38)						
Taxes (Table V)	(V!P34)						
O & M (Table VI)	(VI!B42)						
REVENUES:							
		0				0	0
EXPENSES:							
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
			0			0	0
TAXES:							
Interest Synchronization (Table III)						(73)	(137)
TOTALS	0	0	0	0	0	(73)	(137)

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TABLE III
Valley Energy Company (PA)
INTEREST SYNCHRONIZATION
R-2019-3008209

	Amount $
Company Rate Base Claim	17,179,542
ALJ Rate Base Adjustments	0
ALJ Rate Base	17,179,542
Weighted Cost of Debt	2.15423000%
ALJ Interest Expense	370,087
Company Claim (1)	369,360
Total ALJ Adjustment	(727)
Company Adjustment	0
Net ALJ Interest Adjustment	(727)
State Income Tax Rate	9.99%
State Income Tax Adjustment	(73)
Net ALJ Interest Adjustment	(727)
State Income Tax Adjustment	(73)
Net ALJ Adjustment for F.I.T.	(654)
Federal Income Tax Rate	21.00%
Federal Income Tax Adjustment	(137)

(1) Company Main Brief
Source: C1-4 (R)

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TABLE IV
Valley Energy Company (PA)
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
ALJ Rate Base Adjustments	$0	$0	ALJ Rate Base Adjustments	$0
ALJ Rate Base	$17,179,542	$17,179,542	ALJ Rate Base	$17,179,542
Weighted Cost of Debt	2.15423000%	0.00%	Weighted Cost Pref. Stock	0.00000000%
ALJ Annual Interest Exp.	$370,087	$0	ALJ 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				
ALJ Daily Interest Exp.	$1,014	$0	ALJ Daily Dividends	$0
Net Lag Days	-45.0	0.0	Net Lag Days	0.0
ALJ Working Capital	($45,630)	$0		$0
Company Claim (1)	$0	$0	Company Claim (1)	$0
ALJ Adjustment	($45,630)	$0		$0
Total Interest & Dividend Adj.	($45,630)			

(1) Company Main Brief.

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TABLE V
Valley Energy Company (PA)
CASH WORKING CAPITAL -TAXES
R-2019-3008209

Description	Company Proforma Tax Expense Present Rates	ALJ Adjustments	ALJ Pro forma Tax Expense Present Rates	ALJ Allowance	ALJ 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		$10,000	$27.40	0.00	$0
Capital Stock Tax	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
	$0	$0	$0		$0	$0.00	0.00	$0
State Income Tax	($16,477)	($73)	($16,550)	$74,433	$57,883	$158.58	0.00	$0
Federal Income Tax	$25,473	($137)	$25,336	$140,836	$166,172	$455.27	0.00	$0
	$43,291	($210)	$43,081	$215,269	$258,350			

Source: C1-3 (R)

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

(1) Company Main Brief

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TABLE VI
Valley Energy Company (PA)
CASH WORKING CAPITAL -- O & M EXPENSE
R-2019-3008209

Description	Company Pro forma F.T.Y. Expense	ALJ	ALJ Pro forma Expenses	Lag Days	Lag Dollars
O&M	$3,247,647	$0	$3,247,647	45.00	$146,144,115
Less: Uncollectibles (net of GCR)	($55,430)	$0	($55,430)	45.00	($2,494,370)
Group Insurance	$0	$0	$0	45.00	$0
Insurance, Other	$0	$0	$0	45.00	$0
Labor	$0	$0	$0	45.00	$0
Leased Equip./Rent	$0	$0	$0	45.00	$0
Leased Vehicles	$0	$0	$0	45.00	$0
Miscellaneous	$0	$0	$0	45.00	$0
Natural Gas	$0	$0	$0	45.00	$0
Power	$0	$0	$0	45.00	$0
Purchased Water	$0	$0	$0	45.00	$0
Telephone	$0	$0	$0	45.00	$0
Waste Disposal	$0	$0	$0	45.00	$0
Post Retirement Benefits	$0	$0	$0	45.00	$0
Pensions	$0	$0	$0	45.00	$0
	$3,192,217	$0	$3,192,217	45.00	$143,649,745

ALJ Average Revenue Lag	0.0	
Less: ALJ Avg. Expense Lag	45.0	
Net Difference	-45.0	Days
ALJ Pro forma O & M Expense per Day	$8,746	
ALJ CWC for O & M	($393,570)	
Less: Company Claim (1)	($399,027)	C1-6 (R)
ALJ Adjustment	$5,457	

(1) Company Main Brief

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APPENDIX B

PROPOSED FINDINGS OF FACT

RESOLVED ISSUES

1. The Company initially proposed to add a Construction Work in Progress ("CWIP") amount of $114,497 to its FPFTY rate base total. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

2. Because Valley's CWIP projections were based on historic figures rather than specific identified projects projected to be under construction at the conclusion of the FPFTY, Valley accepted the removal of CWIP from rate base. Valley Statement No. 1-R – Rebuttal Testimony of Howard S. Gorman ("Valley Statement No. 1-R") at 7.

3. Valley's acceptance of the removal of CWIP from rate base is conditioned on the premise that plant projected to be in service by the end of the FPFTY is included in rate base, consistent with Commission precedent; if "average" rate base figures for the FPFTY are used, as argued by OCA, the Company believes retaining its CWIP claim is appropriate. Valley Statement No. 1-R at 7.

4. Valley makes a variety of charitable contributions to different community organizations each year in support of the local community. See I&E Statement No. 1, I&E Exhibit No. 1, Schedule 3.

5. Valley clarified in Rebuttal Testimony that charitable contributions are charged to Account 426.1, which was not included in Valley's revenue requirement. Valley Statement No. 1-R at 6.

6. I&E withdrew its proposed adjustments connected to Account 426.1. I&E Statement No. 1-SR at 13.

7. In its Direct Testimony, I&E calculated a $773,767 pension claim based on information provided in Valley's response to Interrogatory I&E-RE-23-D. See I&E Statement No. 1 at 21.

8. Valley provided an initial updated response to I&E-RE-23-D explaining errors in the original response and clarifying that pensions costs were claimed as a component of overhead costs rather than as a separate claim; Valley also provided a further updated response to I&E-RE-23-D after serving its Rebuttal Testimony to address questions received during informal discussions with the intervenors. See Valley Statement No. 5-R at 4; see I&E Statement No. 1-SR at 29.

9. Following review of the updated responses to I&E-RE-23-D, I&E withdrew is pension adjustment. See I&E Statement No. 1 at 21.

10. The Company proposed to add $161,817 to rate base for materials and supplies. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

11. OCA witness Morgan proposed to use an average of the most recent 13 months of actual inventories, which increases the Company's rate base by $11,096 to $172,913. OCA Statement No. 2, Schedule LKM-4

12. The Company accepted the OCA's 13-month methodology. Valley Statement No. 1-R at 11.

13. The Company proposed to deduct $362,607 from rate base for customer deposits. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

14. Instead of basing the customer deposits amount on the Company's end-of-year HTY balance, OCA proposed to use a 13-month average balance. OCA Statement No. 2 at 7.

15. The Company accepted OCA's 13-month methodology. Valley Statement No. 1-R at 11.

RATE BASE

16. Valley's final claimed rate base of $17,176,637 reflects all adjustments adopted by the Company in this proceeding. Valley Statement No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R).

17. The Company's claim for original cost utility plant in service of $34,714,831 is based on projected plant in service at the end of the FPFTY. Valley Statement No. 1, Exhibit__(HSG-1), Schedules C1-6 (R), C2 (R), C3 (R).

18. OCA witnesses allege that the Company's plant in service and accumulated depreciation calculations for the FPFTY do not appropriately reflect plant retirements. OCA Statement No. 2 at 4.

19. OCA witness Morgan observes that the Company's calculation of Plant in Service did not reflect plant retirements. OCA Statement No. 2 at 4.

20. In total, this proposal results in a $55,659 adjustment to Plant in Service and a $56,678 adjustment to accumulated depreciation; these parallel adjustments do not result in a material impact on the Company's rate base claim. See OCA Statement No. 2 at 5.

21. OCA witnesses oppose the Company's calculation of plant in service at the end of the FPFTY, instead proposing an average calculation of rate base throughout the FPFTY. OCA Statement No. 2 at 4.

22. OCA proposes to average the plant in service balance on December 31, 2019 ($33,129,952) with the plant in service balance at the end of the FPFTY on December 31, 2020 ($34,714,831); the result is a $783,815 downward adjustment to Valley's claim for plant in service. See OCA Statement No. 2, Schedule LKM-2.

23. The Company's claimed plant in service, based on plant projected to be in service at the end of the FPFTY, is consistent with both the Commission's holding in the UGI Order and long-standing Commission precedent, which has uniformly approved the calculation of

plant in service at a point in time, i.e. the end of the relevant test year. See, e.g., Pa. PUC, et al. v. PPL Electric Utilities Corporation, Docket Nos. R-2012-2290597, et al., at 12.

24. OCA's proposal would eliminate half of benefits of using the FPFTY by only allowing $783,815 in plant additions in 2020, where Valley has planned for $1,623,288 of plant additions for the FPFTY. See OCA Statement No. 2, Schedule LKM-2; see also Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-6 (R).

25. OCA proposed an adjustment to accumulated depreciation based on its arguments that original cost utility plant in service should be based on an average of the beginning-of-year and end-of-year FPFTY plant balances. OCA Statement No. 2 at 4.

26. OCA's FPFTY average balance calculation of $33,875,358 resulted in a $544,153 reduction in accumulated depreciation amount, for a total accumulated depreciation of $16,442,855. OCA Statement No. 2, Schedule LKM-2.

27. The Company agreed to a small Materials and Supplies adjustment proposed by OCA increasing its claim by $11,096 from $161,817 to $172,913. Valley Statement No. 1-R at 11; see also OCA Statement No. 2, Schedule LKM-4.

28. The Company proposed a reduction to rate base for Accrued Pension / OPEB liability; this reduction reflects the excess of amounts charged to expense over amounts paid. Valley Statement No. 1 at 18.

29. Neither OCA nor I&E proposed any adjustments to the Company's Accrued Pension/OPEB claim. OCA Statement No. 1, Schedule SLS-3; I&E Statement No. 3 at 3-8.

30. Regarding Cash Working Capital ("CWC"), the Company claimed an increase of $402,100 to rate base. Valley Statement No. 1, Exhibit__(HSG-1) Schedule C1-6 (R).

31. I&E and OCA do not oppose the 1/8 method for CWC proposed by the Company. Valley Statement No. 1-R at 7, 9.

32. I&E and OCA each propose to reduce the CWC claim to reflect the respective party's proposed O&M expense adjustments and remove non-cash items (uncollectible expense, taxes other than income, and depreciation) from computation of CWC. I&E Statement No. 1 at 24; OCA Statement No. 1 at 19.

33. While the Company opposes several O&M expense adjustments proposed by I&E and OCA, the Company agrees that CWC should be recalculated if the Commission orders any changes to the Company's claimed O&M expenses. See Valley Statement No. 1-R at 7,10.

34. As stated above, OCA proposed a $98,293 adjustment to Customer Deposits, which the Company accepted. See OCA Statement No. 2 at 7; see also Valley Statement No. 1-R, at 11.

35. ADIT addresses the difference between actual tax liability for accumulated depreciation paid by Valley and the amount of tax expense for accumulated depreciation paid by ratepayers in the revenue requirement. Valley Statement No. 1 at 17-18.

36. EDIT, on the other hand, directly addresses the benefit the Company received by taking depreciation expense for tax purposes while the Federal corporate tax rate was 34% and the revaluation of EDIT as of December 31, 2017, when the corporate tax rate changed from 34% to 21%. Valley Statement No. 1 at 17-18.

37. No party challenged the Company's calculation of ADIT or the proposal to amortize the EDIT balance over ten years; however, OCA claims the calculation of the EDIT balance should be modified to reflect the fact that EDIT will not accrue until new rates go into effect because the Commission has not required Valley to implement a credit flowing tax savings back to customers. See OCA Statement No. 2 at 11; see also Joint Statement No. 3 at 12.

38. Valley accepts OCA's adjustment, which increases the EDIT balance by $27,443 and reduces rate base by the same amount. See Valley Statement No. 1-R at 12; see also OCA Statement No. 2 at 11.

39. The Company proposed to unbundle certain natural gas inventory costs in the amount of $650,909 from delivery rates and recover those costs for this asset through its Gas Cost Rate ("GCR"). See Valley Statement No. 1 at 17; see Valley Statement No. 1, Exhibit __ (HSG-1), Schedule C1-6 (R).

40. The Company's final claimed rate base of $17,167,637 is reasonable and, therefore, should be approved.

REVENUE

41. Valley calculated projected FPFTY sales and revenue for tariff rate schedules Rate R, Rate C, Rate L, Rate IS, Rate SI, Rate Transport DDQ, and Rate Transport Interruptible based on a regression analysis using monthly number of customers and Heating Degree Data ("HDD") for 2016 – 2018. Valley Statement No. 1 at 9-11.

42. Company witness Gorman did a statistical regression analysis for each major component, each major rate class and regressed actual sales by month for a period of time, using Heating Degree Days for these months. Tr. 83.

43. As calculated by Mr. Gorman, Valley's anticipated system usage is expected to decline from 28,757,694 ccf in 2018 to 26,569,046 ccf in 2020. Valley Statement No. 1 at 11-12.

44. Under present rates, this will reduce delivery revenues from $5,306,089 in 2018 to $5,059,370 in 2020. Valley Statement No. 1, Exhibit__(HSG-1), Schedule B (R).

45. OCA witness Mierzwa proposes to increase Valley's FPFTY revenues at present rates to reflect only sales data from the 12 months ended October 2019. OCA Statement No. 4-SR, Schedule JDM-6S.

46. Mr. Mierzwa adds that he weather-normalized sales for only Residential and Commercial rate classes, but does not explain why he did not weather-normalize other classes, or even present any evidence to support this decision. See OCA Statement No. 4 at 31.

47. In his oral rejoinder testimony, Mr. Gorman discussed the many flaws in OCA's analysis, including: 1) relying on a single year of sales data; 2) taking the usage over the full year instead of the well-supported approach of taking usage by month; and 3) inexplicably omitting certain classes from weather normalization. Tr. 84.

48. Mr. Mierzwa's alternative revenue forecast relies on limited data and fails to apply a monthly regression. Tr. 84.

49. Mr. Mierzwa provides no explanation for rejecting Mr. Gorman's prudent and supported weather normalization adjustments for customers other than Residential or Commercial customers. Tr. 84.

EXPENSES

50. The Company developed its FPFTY claim by adding a 3% wage, salary, and benefit inflation adjustment and other known adjustments to the O&M accounts in its FTY budget. See Valley Statement No. 1, Exhibit—(HSG-1), Schedule C1-1 (R).

51. In estimating costs for the FPFTY, the Company's management has years of experienced evaluating year-to-year changes in labor, benefits, materials, and outside contractor costs. Tr. 199.

52. Total 2019 O&M costs are, when annualized, projected to be $3,016,937. See Valley Statement No. 1-R at 6.

53. Adding the 3% inflation factor, this results in an annualized FTY projection of $3,107,445. See Valley Statement No. 1-R at 6.

54. While this annualized FTY total is $30,096 below the Company's FPFTY claim of $3,137,541, it does not account for the FTY and FPFTY adjustments detailed in the Direct Testimony of witness Jamie Levering. See Valley Statement No. 1-R at 6.

55. Ms. Levering explains that the Company's annualized 2019 expense data based on actual expenses incurred as of September 30, 2019 do not reflect that Valley: (1) hired a Corrosion Technician on October 7, 2019 and (2) had an employee take a prolonged medical leave from January 19, 2019 through May 12, 2019. Valley Statement No. 5-R at 4-5.

56. The additional FTY expense to correct for the non-recurring reduction in labor costs resulting from the prolonged employee medical leave increases Valley's FTY overhead expense by $14,720. Valley Statement No. 5-R at 5.

57. Adjusting the Company's FPFTY claim to reflect the unanticipated 2019 Corrosion Technician hire increases the FPFTY expense by $81,280. See Valley Statement No. 1-R at 2; see OCA Statement No. 1-SR at 4.

58. The Company has effectively managed its resources and conservatively projected its expenses, consistent with its managerial discretion and the needs of a smaller public utility to nimbly reallocate resources as issues arise. Valley Statement No. 4-R at 4.

59. Actual historic O&M expenses show a greater than 3% increase every year from 2016 to 2018 (the last year full expense data is available). Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2.

60. Mr. Rogers also testified on rejoinder that it would be "extremely improper" not to include inflation for O&M, particularly as the majority of O&M is labor and overhead. See Tr. 201.

61. The 3% inflation adjustment is supported both by the Company's historical experience, specific indicators of cost increases for the FPFTY, and the Company's development of its 2020 budget. Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2; Tr. 201.

62. The Company's annualized FTY data, plus adjustments for 3% inflation, employee medical leave, and Corrosion Technical hire, fully support the Company's expense claim based on annualized FTY data. Valley Statement No. 1-R at 5.

63. The Company generally incurs approximately 30% of its expense for Industrial/Commercial Meters and Regulators (Account No. 876) in the 4th quarter of each year. See Valley Statement No. 4-R at 7.

64. The Company shifted work from Account No. 902 (Meter Reading) to Account No. 878. See Valley Statement No. 4-R at 8.

65. As of September 30, 2019, Account No. 902 was tracking $15,272 below FTY projections; this very closely parallels the increased costs observed for Account No. 878, which was tracking $14,010 above FTY projections as of September 30, 2019. Valley Statement No. 1-R at 5; see OCA Statement No. 1 at 7, 10.

66. OCA proposed adjustments to both Account No. 878 ($33,746) and Account No. 902 ($12,847); approving both of these adjustments would result in a double count, given the Company's explanation that work shifted from Account No. 878 to Account No. 902.

67. YTD numbers as of September 30, 2019 for C&T Allocation Expense do not reflect additional customers in East Athens anticipated to begin service before the end of the FTY and throughout the FPFTY. I&E Statement No. 3, Exhibit No. 3, Schedule 2 at 4 (showing

2019 East Athens Main Extension projects to be completed between November 2019 and June 2020).

68. The Company's historical annual expense for C&T Allocation Expense exceeded the 2019 projections in 2016, 2017, and 2018, annualizing the YTD data would not produce a reasonable expense claim for the Company's C&T Allocation. See I&E Statement No. 1, I&E Exhibit No. 1, Schedule 9, at 1.

69. I&E's recommended Uncollectible Accounts Expense would be lower than the Company's actually experienced Uncollectible Accounts Expense in 2014 and 2015. See I&E Statement No. 1, Exhibit No. 1, Schedule 6 at 1.

RATE OF RETURN

70. Because DCF results may understate ROE, considering results of other models is consistent with the fundamental purpose of the Commission's regulation of public utility ROR where "regulation must act as a substitute for marketplace competition." Joint Statement No. 2-R at 6.

71. Valley witness D'Ascendis conducted a thorough analysis of multiple ROE models to develop an ROE based on his proxy group of 9.35%. See Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2.

72. Mr. D'Ascendis then adjusts the proxy group's ROE upward by 1.00% for the Company's smaller relative size to the proxy group and 0.25% to reflect management performance. See Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2.

73. As a result of his adjustments to the proxy group's ROE to reflect the unique risk of the Company, Mr. D'Ascendis recommends a 10.60% ROE. See Joint Statement No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2.

74. The I&E and OCA recommended ROEs for Valley of 8.46% and 8.34% "are all below the lowest ROE authorized for any major natural gas utility followed by Regulatory Research Associates ("RRA"), a division of Standard and Poor's ("S&P") Global Intelligence since at least 1980." Joint Statement No. 2-R at 5.

75. Mr. D'Ascendis' observations of the susceptibility of the DCF model to distortion where market-to-book ratios exceed unity (i.e. a 1.0 ratio) are supported both by financial literature and empirical analysis. Joint Statement No. 2-R at 10.

76. Application of the standard DCF model to utility stocks understates the investor's expected return when the market to-book (M/B) ratio of a given stock exceeds unity. Joint Statement No. 2-R at 10.

77. Market-to-book value for the combined proxy group has been significantly higher than the 1.75 ten-year average, particularly since 2018. See Joint Statement No. 2-R at 13.

78. Mr. D'Ascendis developed an empirical quantification of the understated return that would result from approval of the I&E or OCA DCF equity cost rates. Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-2R.

79. The Commission approved an ROE of 10.40% for PPL Electric Utilities Corporation in 2012 an ROE of 11.00% for Aqua Pennsylvania, Inc. in 2008 and an ROE of 9.85% for UGI in 2018. Joint Statement No. 2-12 at 5.

80. Although market conditions may change, no empirical evidence supports adoption of ROE's that are 139 and 151 basis points lower than the UGI result, which was decided a mere 18 months before this case. Joint Statement No. 2-R at 5.

81. As the current market demands higher rates of return for natural gas utilities versus their electric counterparts, the fact that both I&E and OCA are proposing ROE results significantly lower than that awarded to UGI is concerning. See Joint Statement No. 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 1.

82. I&E's criticism of the CAPM analysis in general as subject to "manipulation" should be given no weight; as noted by Mr. D'Ascendis, I&E's criticism of the CAPM would apply equally to any ROE model as "[a]ll ROE models are only as good as their inputs, and all ROE models can be easily manipulated by changing those inputs." See Joint Statement No. 2-R at 38.

83. Mr. D'Ascendis presents multiple financial analyses from notable scholars confirming that the "risk-free rate used in the CAPM should match the life (or duration) of the underlying investment." See Joint Statement No. 2-R at 23.

84. The I&E Witnesses' use of a medium-term Treasury bond does not match the life of the assets being valued. Joint Statement No. 2-R at 24.

85. I&E provides no analysis or citation to any authority to support the assertion that projecting a risk-free rate over a ten-year period would result in unreliable data. I&E Statement No. 2 at 37.

86. Mr. D'Ascendis has provided ample support for the proposed forecast period, which I&E has failed to credibly rebut. Joint Statement No. 2 at 24.

87. Mr. D'Ascendis references multiple studies affirming that the ECAPM addresses criticism of the overly steep predicted Security Market Line resulting from the traditional CAPM. See Joint Statement No. 2-R at 28.

88. The PRPM model used in Mr. D'Ascendis' RPM analysis measures the risk-return relationship directly using the same company-specific market prices used to derive company-specific beta coefficients. Joint Statement No. 2-R at 39.

89. Mr. D'Ascendis provided extensive evidence of the PRPM's use in the industry, including three publications in academic peer-reviewed journals and a recent adoption of the model by the South Carolina Public Service Commission. Joint Statement No. 2-R at 41.

90. Mr. D'Ascendis also addressed I&E's claim that the PRPM is a proprietary model available only through substantial fees by clarifying that he made his workpapers available to all parties in this proceeding and that free versions of software necessary to run the PRPM model are available. See Joint Statement No. 2-R at 42.

91. Mr. D'Ascendis developed specific selection criteria limiting the non-price regulated proxy group to companies with beta coefficients and residual standard errors within plus or minus two standard deviations of the Gas Utility Proxy Group. Joint Statement No. 2 at 37.

92. The Commission does not set the DSIC ROE at the median or mean of its DCF analysis, but rather sets the DSIC ROE at some point within a standard deviation of the results. See Tr. 45.

93. The Commission's determination of the ROE for electric utility DSICs indicates that an appropriate ROE should be set at the higher range of DCF results. See Tr. 45.

94. In addition to the combined DCF/two-step DCF model, OCA conducts a two-stage DCF analysis, a CAPM analysis, and a CAPM/Risk Premium analysis, but places no weight on these analyses. Joint Statement No. 2-R at 46.

95. Both the FERC two-step DCF and the two-stage DCF alternative growth rates are intended to reflect the dual premises: (1) that growth is limited by the long-term growth in gross domestic product ("GDP") and (2) utility companies are not in the 'steady state' stage in the company/industry life cycle; However, neither premise holds true. Joint Statement No. 2-R at 49.

96. OCA's CAPM analysis: 1) fails to utilize a risk-free rate based on a forecast period, despite common knowledge that investors are aware of and rely on interest rate forecasts; 2) relies on four flawed market risk premium calculations; and 3) similar to I&E, fails to incorporate an ECAPM analysis. Joint Statement No. 2-R at 55-63.

97. OCA applies a purported "risk premium" analysis that simply replaces the risk-free rate in the CAPM with a six-month average utility bond yield - this model is a substantial departure from the CAPM's theoretical basis, simply because it assumes no risk-free asset. Joint Statement No. 2-R at 64.

98. OCA argues that its risk premium analysis preserves a risk-free asset in the market risk premium calculation, but concedes that the "free-standing" risk free asset component of the CAPM is eliminated. OCA Statement No. 3-SR at 9.

99. OCA provides neither financial literature nor other support for this departure from the widely accepted CAPM or risk premium analyses. OCA Statement No. 3-SR at 9.

100. As Company Chief Executive Officer Edward Rogers described in his direct testimony, Valley has accomplished the following: (1) replaced mains without assessing a DSIC to customers; (2) low number of customer complaints; (3) fast emergency response; (4) favorable customer feedback; (5) technological improvements in customer service by offering Smarthub use to customers; and (6) obtainment of a grant for East Athens main extension project. Valley's Statement No. 4 at 6-8.

101. Valley's commitment to providing reliable and quality service to its customers above and beyond what is required by the Public Utility Code. Valley's Statement No. 4 at 6-8.

102. Mr. D'Ascendis' review of financial literature establishes the inverse relationship between Company size and risk. Joint Statement No. 2 at 42-43.

103. The question relevant to whether a size adjustment is necessary to appropriately reflect Valley's risk factors turns to whether Valley is considerably smaller than the companies in the Gas Utility Proxy Group. Joint Statement No. 2 at 42-43.

104. To determine whether a size adjustment should be incorporated, Mr. D'Ascendis conducted a market capitalization analysis to quantify the relative size risk. Joint Statement No. 2 at 44.

105. Mr. D'Ascendis' market capitalization study observed that, as of March 29, 2019, Valley had a market capitalization of $19.24 million compared with an average company market capitalization of $4.600.41 million for the Gas Utility Proxy Group; this amounts to a size difference of 239x. Joint Statement No. 2 at 45.

106. In order to quantify the appropriate size adjustment, Mr. D'Ascendis relied on "size premiums for portfolios of New York Stock Exchange, American Stock Exchange, and NASDAQ listed companies ranked by deciles for the 1926 to 2018 period." Joint Statement No. 2 at 45.

107. The Gas Utility Proxy Group $4.6 billion market capitalization ranked in the 4th decile, while Valley's $19.24 million market capitalization ranked in the 10th decile, resulting in a size premium spread of 4.37%. Joint Statement No. 2 at 45.

108. Although his analysis supports a 437 basis point adjustment, Mr. D'Ascendis recommends a conservative size adjustment of 1.00% or 100 basis points to the Company's ROE. Joint Statement No. 2 at 45.

109. In opposing the Company's proposed size adjustment, I&E places exclusive weight on a single study by Dr. Annie Wong concluding that there is "no need to adjust for the firm size in utility rate regulation." See I&E Statement No. 2 at 42.

110. Mr. D'Ascendis finds that Dr. Wong's study erroneously equates "a change in size to beta coefficients, which accounts for only a small percentage of diversifiable company-specific risk." Joint Statement No. 2-R at 33.

111. By analyzing only the risk captured in beta, Dr. Wong understates the total impact of size risk. Joint Statement No. 2-R at 33.

112. Mr. D'Ascendis cited to a more recent article by Thomas M. Zepp which also criticized Dr. Wong's study and observed "[t]wo other studies discussed here support a conclusion that smaller water utility stocks are more risky than larger ones. To the extent that water utilities are representative of all utilities, there is support for smaller utilities being more risky than larger ones." Joint Statement No. 2-R at 34.

113. Dr. Zepp presented an authoritative analysis disputing Dr. Wong's findings, and was not rebutted in the financial literature by Dr. Wong or her advocates. Joint Statement No. 2-R at 34.

114. To definitively test Dr. Wong's finding, Mr. D'Ascendis conducted a study to whether size effect is applicable to utilities. Joint Statement No. 2-R at 35.

115. In assessing the results, Mr. D'Ascendis concluded that the study shows an R-Squared of 0.09, meaning that approximately 9% of the change in risk is explained by size. Joint Statement No. 2-R at 35.

116. A 0.09 R-Squared would not generally be considered to have strong explanatory power, but in this case, it exceeds the average R-Squared of each of the I&E and OCA proxy group companies' beta coefficients, which is a common measure of market risk. See Joint Statement No. 2-R at 36.

TARIFF CHANGES

117. No party opposed Valley's proposals to clarify existing defined terms, clarify the Company's Natural Gas Shortage and Emergency Conditions Policy, and Update the Automatic Meter Reading Equipment language to reflect current technologies. See Valley Statement No. 4 at 12-13, 15.

118. Valley's tariff offers two options for customers seeking a Company contribution for a service line extension. Customers are entitled to a Company contribution for service line extensions of: 1) up to $6 per each additional dollar of anticipated annual revenues; or 2) the costs of 200 feet of service or main extensions. Valley Statement No. 4 at 14.

119. The average cost for 200 feet of service line or main extension for new installations over the 12-month period ending September 30, 2018 is $6,557. See OSBA Statement No. 1, Exhibit BK-1(V) (attaching Valley's response to OSBA-Valley-II-1).

120. Under the current rule, a customer requiring a 200 foot extension costing $6,557 is entitled to a Company contribution, while a customer requiring a 300 foot extension that costs a total of $6,400 is not entitled to receive a full allocated contribution amount for the footage over 200 feet. See OSBA Statement No. 1, Exhibit BK-1(V) (attaching Valley's response to OSBA-Valley-II-1).

121. Valley proposes to add a third option allowing for Company contributions for a main or service line extensions up to the average cost of 200 feet of service and/or main extensions for new installations over the most recent 12-month period ending September 30. See OSBA Statement No. 1, Exhibit BK-1(V) (attaching Valley's response to OSBA-Valley-II-1).

122. OCA Witness Mierzwa concurs that Valley's proposal is consistent with the efforts of other NGDCs to promote the availability of natural gas to unserved and underserved areas and that OSBA's recommendation could serve as a deterrence to completion of economic extension projects. OCA Statement No. 4-R at 9-10.

123. Valley's testimony explained that the fees were increased to account for 13 years of inflation. See Valley Statement No. 4 at 15.

UNBUNDLED GAS PROCUREMENT COSTS

124. Valley Statement No. 1, Exhibit__(HSG-1) Schedule C4 (R) shows the reallocation of $121,529 from Valley's fully-projected future test year revenue requirement to the GCR.

125. To claim the $121,529 reallocated revenues in the GCR, Valley will update its GCR concurrent with the effective date of the new rates established in this proceeding. See Valley Statement No. 1 at 19.

APPENDIX C

PROPOSED CONCLUSIONS OF LAW

BURDEN OF PROOF

1. Utilities have the burden of proving that each element of the rate increase request is just and reasonable. *Univ. of Pa. v. Pa. PUC*, 485 A.2d 1217, 1226 (Pa. Cmwlth. 1984).

2. Public utilities are not, however, required to affirmatively defend claims that have gone unchallenged. *See Allegheny Ctr. Assoc.'s v. Pa. PUC*, 570 A.2d 149, 153 (Pa. Cmwlth. 1990).

3. The ultimate burden of proof does not shift from the utility seeking a rate increase; however, where a party proposes an adjustment to the utility's rate making claim, that party must present evidence or analysis that demonstrates the reasonableness of its proposed adjustment. *See e.g., Pa. PUC v. Phila. Elec. Co.*, Docket No. R-891364, *et al.*, 1990 Pa. PUC LEXIS 155 (Order dated May 16, 1990); *see also Pa. PUC v. Breezewood Tel. Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45, at *10 (Order dated Jan 31, 1991).

4. A party that raises an issue that is not included in a public utility's general rate case filing bears the burden of proof. *See, e.g., Pa. PUC. v. Metro. Edison Co., et al.,* Docket Nos. R-00061366, *et al.,* 2007 Pa. PUC LEXIS 5, at *111-12 (Order entered Jan.11, 2007).

RATE BASE

5. The Company's claimed plant in service, based on plant projected to be in service at the end of the FPFTY, is consistent with both the Commission's holding in the UGI Order and long-standing Commission precedent, which has uniformly approved the calculation of plant in service at a point in time, *i.e.* the end of the relevant test year. *See, e.g.*, *Pa. PUC, et al. v. PPL Electric Utilities Corporation*, Docket Nos. R-2012-2290597, et al., at 12; *Pa. PUC v. UGI Utilities, Inc. – Electric Division* (*"UGI Utilities"*), Docket No. R-2017-2640058 (Order Entered October 25, 2018) ("UGI Order") at 23-26.

6. The language of Act 11 fully supports use of end of test year balances. 66 Pa. C.S. § 315(e).

7. The Legislature (1) expressly indicated that the FPFTY may include plant projected to be in service *during* the FPFTY; and (2) specifically noted that Section 1315, which codified the "used and useful" standard, provides no bar to including in rate base all plant added during the FPFTY. 66 Pa. C.S. § 315(e).

EXPENSES

8. The Company's proposed expenses are reasonably necessary to provide service to its customers and to earn a fair rate of return on the investment and plant used and useful

in providing service. *Butler Township Water Co. v. Pa. PUC,* 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984) *("Butler Township"). See also T.W. Phillips Gas and Oil Co. v. Pa. PUC,* 81 Pa. Cmwlth. 205, 474 A.2d 355 (1984).

9. The expense adjustments proposed by OCA and I&E would understate the revenue requirement necessary to provide the Company with an opportunity to earn a fair rate of return on the investment and plant used and useful in providing service. *Butler Township Water Co. v. Pa. PUC,* 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984) *("Butler Township"). See also T.W. Phillips Gas and Oil Co. v. Pa. PUC,* 81 Pa. Cmwlth. 205, 474 A.2d 355 (1984).

10. The Company's has exercised managerial discretion to prudently manage its HTY and FTY expenses. *See Pa. PUC v. Philadelphia Suburban Water Company*, 1991 Pa. PUC LEXIS 206, *9-10 (Pa. PUC October 18, 1991).

11. The expense adjustments proposed by OCA and I&E place undue reliance on outcomes or results-oriented review of managerial decisions, which would find imprudence merely because an intended result was not achieved. *Pa. PUC v. Duquesne Light Co.,* 63 Pa. PUC 337, 351 (1987).

12. The Company's proposal to apply a 3% inflation adjustment to various O&M expenses based on historical expenses, historical inflation, and 2020 budgeting proposals is consistent with Commission precedent authorizing the use of inflation factors in projecting costs. *See, e.g.,* Opinion and Order, *Pa. PUC v. Pennsylvania-American Water Co.*, Docket No. R-00038304 (Order entered Jan. 29, 2004) at 35; Opinion and Order, *Pa. PUC v. Pennsylvania-American Water Co., et al,* Docket No. R-880916 (Order entered Oct. 21, 1988) at 54.

13. The Company's proposal to apply a 3% inflation adjustment to various O&M expenses based on historical expenses, historical inflation, and 2020 budgeting proposals is consistent with Act 11. 66 Pa. C.S. § 315(e).

14. The Company's historic filing frequency is a factor considered in determining the normalization for rate case normalization, but is not the only factor the Commission considers. *See, e.g., Butler Township* 81 Pa. Cmwlth. 40, 47-48 (affirming that historic practice need not be the exclusive factor relied upon by the Commission).

15. Ratemaking is prospective, and the goal of ratemaking is to reasonably reflect future conditions when new rates are in effect. *See, e.g., Columbia Gas v. Pa. PUC,* 613 A.2d 74, 76 (Pa. Cmwlth. 1992), *aff'd,* 636 A.2d 627 (Pa. 1994).

RATE OF RETURN

16. A fair rate of return must be: (1) equal to the return on investments in other business undertakings with the same level of risks (comparable earnings standard); (2) sufficient to assure confidence in the financial soundness of a utility (financial integrity standard); and (3) adequate to permit a public utility to maintain and support its credit, enabling

the utility to raise or attract additional capital necessary to provide reliable service (the capital attraction standard). *Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia*, 262 U.S. 679 (1923) (*"Bluefield"*); *Federal Power Commission v. Hope Natural Gas.,* 320 U.S. 591, 603 (1944) (*"Hope");* and *Duquesne Light Co. v. Barasch,* 488 U.S. 299 (1989).

17. The Commission will rely on multiple return on equity models where evidence indicates the results from the DCF model would understate a utility cost of common equity. UGI Order at 104-105.

18. The Commission is required to consider utility management effectiveness and efficiency in setting rates. 66 Pa. C.S. § 523.

19. Utilities who only meet the bare requirements of the Public Utility Code have not, however, proven that their performance warrants a performance adjustment. *See Columbia Water Co.*, 2013 Pa. PUC LEXIS 763 at *84.

20. The Companies have provided specific evidence to support a rate of return premium for management effectiveness pursuant to Section 523 of the Public Utility Code. 66 Pa. C.S. § 523; *see also Pa. PUC v. Columbia Water Co.*, 2013 Pa. PUC LEXIS 763, *82.

21. The Company's proposed size adjustment is a corollary to the *Bluefield* standard determining that public utilities are entitled to earn a rate of return on property placed into public service commensurate with other business undertakings "which are attended by corresponding risks and uncertainties." *Bluefield* at 79.

REVENUE ALLOCATION

22. Where revenue allocation is concerned, it has long been established in Pennsylvania that cost-causation is the "polestar" of utility ratemaking. *Lloyd v. Pa. PUC,* 904 A.2d 1010, 1015 (Pa. Cmwlth. 2006).

APPENDIX D

PROPOSED ORDERING PARAGRAPHS

1. That Valley Energy, Inc. is authorized to file tariffs, tariff supplements and/or tariff revisions, on at least one day's notice, and pursuant to the provisions of 52 Pa. Code §§ 53.1, *et seq.,* and 53.101, designed to produce an annual distribution rate revenue increase of approximately $745,000 and otherwise reflecting the changes proposed to Tariff Gas – Pa. PUC No. 2, to become effective for service rendered on and after May 1, 2020.
2. That Valley Energy, Inc. shall file detailed calculations with its tariff filing, which shall demonstrate to the Commission's satisfaction that the filed tariff adjustments comply with the provisions of this final Opinion and Order.
3. That Valley Energy, Inc. shall allocate the authorized increase in operating distribution revenue to each customer class, and rate schedule within each customer class, in the manner prescribed in this Opinion and Order.
4. That, upon acceptance and approval by the Commission of the tariff supplements filed by Valley Energy, Inc. consistent with its Final Order, the investigation at Docket R-2019-3008209 be marked closed.
5. That Valley Energy, Inc. shall comply with all directives, conclusions, and recommendations contained in the body of this Opinion and Order, which are not the subject of an individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering paragraph.
6. That the complaint filed by the Office of Consumer Advocate in this proceeding at Docket Number C-2019-3011850 be dismissed and marked closed.
7. That the complaint filed by Athens Borough in this proceeding at Docket Number C-2019-3012397 be dismissed and marked closed.
8. That the complaint filed by South Waverly Borough in this proceeding at Docket Number C-2019-3012396 be dismissed and marked closed.
9. That the complaint filed by Larry E. Cole in this proceeding at Docket Number C-2019-3012219 be dismissed and marked closed.