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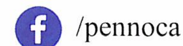

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January 22, 2020

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

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

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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cc: The Honorable Steve K. Haas, ALJ
The Honorable Benjamin J. Myers, ALJ
Certificate of Service
*282829

CERTIFICATE OF SERVICE

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

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

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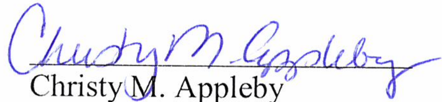

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

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I. INTRODUCTION

A. Valley Energy Company

The Office of Consumer Advocate (OCA) submits this Reply Brief primarily in response to the Main Brief of Valley Energy Company (Valley or Company). The OCA also addresses arguments raised in the Main Briefs of the Commission's Bureau of Investigation and Enforcement (I&E) and the Office of Small Business Advocate (OSBA). The OCA's Main Brief contains a comprehensive discussion of the evidence and its position on all issues, thus the OCA will respond only to those matters raised by other parties that were not previously addressed or require further clarification. Nevertheless, the OCA does not waive its opposition on contested issues because it does not repeat arguments here. Accordingly, the OCA incorporates the arguments and analysis contained in its Main Brief herein by reference.

In its Introduction, Valley states that it conducted an analysis that determined that an overall distribution rate increase of the as-filed $834,497 per year is necessary using the Fully Projected Future Test Year (FPFTY) ending December 31, 2020. Valley M.B. at 2. The Company states that it accepted certain adjustments of the parties and has reduced its request to $745,000. The Company argues that its return will decrease from 9.24 percent in 2018 to 4.64 percent in 2020 without an increase. Valley M.B. at 2. In support of its arguments that the full request is warranted, the Company also includes a list of activities planned and completed since 2010 when its last rate case was filed. See, Valley M.B. at 3-5.

The OCA submits that after a thorough review of its filing, the Company has not met its burden of proof to justify an increase of $745,000. As detailed by the OCA witnesses in their proposed adjustments, the OCA has considered all of the factors identified in the Company's introduction as part of the OCA's recommended revenue requirement. Based on the evidence the

Company has provided to support its claim and the applicable law, it is clear that the Company's annual distribution revenues should increase by no more than the OCA's recommended $227,888.

B. History of the Proceedings

The procedural history is set forth in the OCA Main's Brief. See, OCA M.B. at 2-5. On January 8, 2020, the OCA, I&E, OSBA, and Citizens' filed separate Main Briefs.

C. Legal Standards

The OCA discusses the legal standard at pages 4 to 6 of its Main Brief. OCA M.B. at 5-7.

II. SUMMARY OF ARGUMENT

In this Reply Brief, the OCA responds primarily to the arguments raised in the Main Brief of Valley. The OCA notes that many of the arguments raised by the Company were fully addressed in the OCA's Main Brief and will not be repeated here. The OCA further notes that no averments in any of the parties' Main Briefs alter the OCA's position in this proceeding. The OCA continues to submit that Valley has not met its burden of proof for its claims set forth in support of its revenue request. The OCA has proposed adjustments to the Company's proposed cost of equity; rate base including the Company's use of an end of test year rate base for the Fully Projected Future Test Year and the corresponding depreciation adjustments; use of an across-the-board 3.0 percent inflation factor; cash working capital; taxes; and net operating income items, including industrial/commercial meters and regulators, meters and house regulators, customer installations, mains, meter reading, customer records and collection, uncollectible accounts, miscellaneous customer expenses, administrative & general salaries, office supplies and expenses, general advertising expense, and rate case expense.

Based upon the OCA expert witnesses' testimony, the OCA submits that an overall distribution revenue increase of $227,888 is justified based on a 6.75% overall rate of return. This

amount reflects necessary adjustments as well as a return on equity of 8.34%. The OCA's recommended increase allocated to customers in the manner discussed in this Reply Brief and the OCA's Main Brief results in just and reasonable rates. A summary of the OCA's adjustments are provided in its Table II attached to the OCA's Main Brief. See, OCA M.B. at App. A, Table II. Based on the evidence the Company has provided to support its revenue claim and the applicable law, the Company's annual distribution revenues should increase by no more than $227,888.

III. ISSUES RESOLVED AMONG THE PARTIES

As discussed more fully in the OCA's Main Brief, the following issues have been resolved: (1) Rate Base- Materials & Supplies; (2) Rate Base- Customer Deposits; (3) expenses related to direct labor and an expense related to the hiring of a Corrosion Technician; and (4) the treatment of Excess Deferred Income Taxes (EDIT) accretion when new rates are effective and Accumulated Deferred Income Taxes (ADIT). OCA M.B. at 9-10; see also, Valley M.B. at 14. Valley also identified that I&E accepted the Company's pension expense claim and that the Company had not included charitable contributions in its revenue requirement. Valley M.B. at 13.

The OCA also made an adjustment to the Company's inclusion of Construction Work in Program (CWIP), and the Company partially agreed with OCA's and I&E's adjustment. See, OCA M.B. at 17-19; Valley St. 1-R at 7. Company witness Gorman agreed in Rebuttal Testimony to remove the CWIP for purposes of the use of an end-of-test year rate base. Valley St. 1-R at 7. For the reasons set forth below in Section IV and on pages 17 through 19 of the OCA's Main Brief, the OCA does not agree that it is appropriate to include CWIP in rate base either using an end of test year or the average rate base test year method. See, OCA M.B. at 17-19.

IV. RATE BASE

A. Plant in Service

1. Fully Projected Future Test Year

As discussed in the OCA's Main Brief, prior to the passage of Act 11 and the utilization of a Fully Projected Future Test Year, the test year upon which rates were established ended at approximately the same time that new rates became effective. See, OCA M.B. at 11-16. Act 11 of 2012 permits, *inter alia,* utilities to use a Fully Projected Future Test Year (FPFTY) when applying for a general rate increase under Section 1308(d) of the Public Utility Code. 66 Pa. C.S. § 1308(d). The OCA submits that under the Company's approach, "the end-of-year method will allow the Company to over-earn on its investment in the FPFTY while annual average method recognizes that capital investments will be made throughout the first year that new rates are in effect." OCA M.B. at 13; OCA St. 1 at 4; see, Valley M.B. at 17-18. To remedy this problem, the OCA submits that rates must be set based on the average rate base projected to be used and useful in the Fully Projected Future Test Year.

The Company argues that OCA's position contradicts the Commission's determination in the UGI Order; ignores the plain language of Act 11; and frustrates the goals of enacting Act 11. Valley M.B. at 17-18, citing Pa. PUC v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058, Order (Oct. 25, 2018)(UGI). In Rebuttal Testimony, Company witness Gorman argued that using the FPFTY average balances would "blunt the purpose of using FPFTY" and identified that the Commission had already addressed this issue in UGI. Valley St. 1-R at 8. Beyond those arguments, the Company did not provide any further justification for use of the end of test year instead of average rate base.

For its use of the end of test year, the Company relies upon the Commission's determination in UGI and also cites to the Commission's decision in Pa. PUC, *et al.* v. PPL Electric Utility Corporation, Docket No. R-2012-2290597 (Order entered Dec. 28, 2012)(PPL 2012). The Company's reliance on the PPL 2012 case is misplaced. The PPL 2012 case did not use a fully projected future test year. PPL 2012 at *9. The PPL 2012 case used a Historic Test Year and Future Test Year. The FPFTY issue presented here did not exist in the PPL 2012 case. In the PPL 2012 case, the identified issue involved the OCA's proposed use of an annualized level of depreciation reserve with a non-annualized end of test year. PPL 2012 at *12. In this case, the concern that the OCA has identified is that the use of the FPFTY with an end-of-test-year method means that customers will be paying for plant that is not used and useful at the effective date of rates. Generally, the future test year in cases prior to Act 11, like PPL 2012, coincided with the effective date of rates.

As to UGI, the OCA appealed the Commission's decision in UGI. See, Tanya J. McCloskey, Acting Consumer Advocate v. Pa. PUC, Case No.1529 C.D. 2018 (McCloskey). On January 15, 2020, the Commonwealth Court issued an Order affirming the Commission's Order in UGI. The OCA is reviewing the Court's Order at this time. The Court stated that this was a matter within the Commission's discretion, not clearly erroneous, and that it would not disturb the Commission's decision based on the record before it. McCloskey at 24-29. As a matter of discretion, the OCA would urge the Commission to consider the record and arguments here which clearly shows that the Company's earnings will be overstated if the end-of-year method is used.

The Company also argues that the use of the average rate base conflicts with Section 315(e) of Act 11 and would "weaken" the benefits provided by Act 11. Valley M.B. at 18-19. The plain language of Section 315(e) does not support the argument that the General Assembly intended that

the last day of the FPFTY be used to calculate a utility's rate base and expenses. Section 315(e) defines FPFTY simply as "the 12-month period beginning with the first month that the new rates will be placed in effect…" 66 Pa. C.S. § 315(e). This language certainly specifies the timeline involved with a FPFTY but does not support the conclusion that rate base and other expenses should be calculated at the end of the 12-month period.

As pointed out in the OCA's Main Brief, the year-end method would be the equivalent of an individual making a deposit into an interest-bearing savings account on Day 365, but requiring the bank to pay interest beginning on Day 1. OCA M.B. at 13-14. The bank would likely deny such a request because interest is paid from the time of deposit, not one year in advance. See, OCA St. 1 at 4-5. The Company argues that the 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. Valley M.B. at 20. The annual average method, however, will not cut Valley's earnings or eliminate half of its rate recovery. Rather, the annual average method calculates the rate base by properly reflecting investments as they are made throughout the entire time of the FPFTY and reflecting the return requirements as projects are placed in service throughout the FPFTY. Moreover, the Company has provided no support in its testimony for the Company's argument other than Mr. Gorman's statement that the use of the annual average method would "blunt the purpose of using FPFTY." Valley St. 1-R at 8. Indeed, the purpose of the FPFTY is to mitigate regulatory lag, not eliminate it, which is exactly what the average rate base method does.

The Company also argues that the OCA's approach would be internally inconsistent because the Company has used an end-of-test year method for the HTY and the FTY. Valley M.B. at 20-21. The OCA submits that the Company has misunderstood the purpose of using the average

rate base for the FPFTY. OCA witness Morgan explained the difference between using the end of test year plant in a FTY versus with the FPFTY:

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

OCA St. 2-SR at 2.

The Company's proposed end-of-test year method will result in rates that are unjust and unreasonable in direct contradiction to Section 1301 of the Public Utility. Section 1301 of the Public Utility Code requires that "[e]very rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or order of the commission." 66 Pa. C.S. § 1301. By law, a utility is only provided with a "rate that allows it to recover those expenses that are reasonably necessary to provide service to its customers as well as a reasonable rate of return on its investment." City of Lancaster (Sewer Fund) v. Pa. PUC, 793 A.2d 978, 982 (Pa. Commw. 2002). The utility bears the burden of "proving the reasonableness of its rates" and proving the "reasonableness of those expenses which form the basis for its rates." Carnegie Nat'l Gas Co. v. Pa. PUC, 433 A.2d 938, 942 (Pa. Commw. 1981); see also, Keystone Water Co., White Deer Dist. v. Pa. PUC, 477 Pa. 495, 609-610 (1978)(addressing the inclusion of a specific plant in rate base). Allowing a company to recover more than its necessary costs cannot be found to be just and reasonable.

The OCA submits that the reasons offered by the Company in support of utilizing an end of year rate base in the FPFTY do not justify requiring ratepayers to overpay the revenue requirement. The OCA submits that, for the reasons set forth above and those detailed in the OCA's Main Brief at pages 11 through 16, the average rate base should be used to establish a level of just and reasonable rates.

2. Retirements

OCA witness Morgan modified the Company's proposed retirements and contributions of plant in service in the FTY and the FPFTY. OCA M.B. at 16-17; OCA St. 2 at 4, Sch. LKM-1. In its calculation, the Company failed to exclude retirements, which caused the balances to be overstated. OCA M.B. at 16; OCA St. 2 at 4. Mr. Morgan also identified a corresponding effect on accumulated depreciation. OCA M.B. at 17; OCA St. 2 at 4, Sch. LKM-1. OCA witness Gorman did not specifically address Mr. Morgan's recommendations with respect to the plant retirements or related accumulated depreciation. See, Valley St. 1-R at 11-12 (Gorman discussion of response to OCA witness Morgan's plant in service, Materials and Supplies, Customer Deposits, removal of CWIP, use of average rate base in the FPFTY, and EDIT recommendations). In its Main Brief, the Company only state that "these parallel adjustments do not result in a material impact on the Company's rate base." Valley M.B. at 16. Without any further justification or argument, Valley concludes that the Company's calculations of its Plant in Service and Accumulated Depreciation should be adopted without modification. Valley M.B. at 16.

The Company has not addressed Mr. Morgan's concerns that the exclusion of retirements causes the year end balances to be overstated or denied that the balances are, in fact, overstated. OCA St. 4 at 2, Sch. LKM-1. Whether the Company considers the impact to be minimal or significant, the Company cannot justify including overstated balances in rates. The OCA submits

that the Company has failed to meet its burden of proof to demonstrate that its proposed calculation of Plant in Service and Accumulated Depreciation are accurate. As discussed in the OCA's Main Brief, the year-end Plant in Service and Accumulated Depreciation should be adjusted to reflect the average FPFTY amounts for inclusion in rate base. OCA M.B at 17; OCA St. 2 at 5, SCh. LKM-2; see also, OCA St. 1 at Sch. SLS-3.

B. Deductions

The Company included the Construction Work in Progress (CWIP) balance as of the end of the HTY in rate base. OCA St. 2 at 5; OCA M.B. at 17-19. The OCA and I&E proposed to remove the Company's inclusion of CWIP. OCA M.B. at 17-20; see also, OCA St. 2 at 6, Sch. LKM-3; I&E St. 3 at 6-8. The Company partially agrees with the OCA and I&E's adjustment, but states that if average rate base data for the FPFTY is used, the Company believes that retaining its CWIP claim is appropriate. Valley M.B. at 12.

For the reasons set forth in its Main Brief, the OCA submits that it is not appropriate to include CWIP in rate base either using an end of test year or average rate base test year method. OCA M.B. at 17-19. In either case, the plant item will not be completed and placed in service during the FPFTY. See, OCA St. 2 at 6. Moreover, CWIP balance as of the end of the HTY is likely to already be included as part of the plant in service during the FTY and FPFTY. OCA St. 2 at 6. Inclusion of CWIP in rate base would result in a double count. OCA St. 2 at 6.

V. REVENUES

OCA witness Mierzwa proposed to adjust Valley's FPFTY revenues to reflect the most recent available annual usage of Valley's customers. Mr. Mierzwa utilized the 12-month period ending August 2019 and proposed an adjustment to increase projected revenues by $164,857. OCA St. 4 at 31, Sch. JDM-6. In Surrebuttal Testimony, OCA witness Mierzwa updated his

adjustment to reflect the most recent data available and included the more localized weather information provided in response to OCA-VI-2 rather than the State College, Pa. data he had originally used. OCA St. 4-SR at 16. Mr. Mirezwa updated his FPFTY revenues projection to $141,561 in Surrebuttal Testimony. OCA St. 4-SR at 16, Sch. JDM-6S. As Mr. Mierzwa testified, the Company's methodology does not align with Valley's actual annual revenues. OCA witness Mierzwa's projected revenue adjustment more accurately reflects anticipated revenues. See, OCA St. 4-SR at 15.

In its Main Brief, the Company argues that the OCA failed to support or explain its methodology. Citizens' M.B. at 26-27. OCA witness Mierzwa does explain his methodology. OCA witness Mierzwa testified:

> In developing my adjustment, I have weather normalized sales for the Residential and Commercial rate classes to account for differences between actual and normal heating degree days ("HDDs") for the location closest to Valley's service territory for which I was able to obtain applicable HDD information. (State College, PA). During the 12-month ended August 2019, weather was 2.57 percent colder than normal in State College, Pa.

OCA St. 4 at 31. As Mr. Mierzwa explained, last winter was significantly colder than normal, a result that should be accounted for when projecting future revenues. OCA witness Mierzwa attached his supporting schedule which describes the OCA's adjustment to the Company's revenues. OCA St. 4 at Sch. JDM-6.

The issue that Company witness Gorman's analysis ignores is that his projections significantly understate the FPFTY revenues. OCA St. 4-SR at 15. As OCA witness Mierzwa testified:

> The flaw in the analysis supporting the Company's projections is that the results produced by the analysis significantly understate FPFTY revenues. With the exception of immaterial changes in the number of customers served, the analysis supporting the Company's revenue projections result in the same projections for Calendar 2019 and 2020.

OCA St. 4-SR at 15.

Mr. Mierzwa reviewed Valley's most recent annual revenues and found them a reasonable estimate of FPFTY revenues. Mr. Mierzwa utilized the most recent sales data along with the localized weather data provided by the Company. His updated adjustment is $141,561 as shown at OCA St. 4-SR, Sch. JDM-6S.

VI. EXPENSES

A. Summary

In its Main Brief, the OCA has addressed the following expense issues: 1) the across-the-board 3.0 percent inflation factor applied to all expenses; 2) industrial/commercial meters and regulators, 3) meters and house regulators, 4) customer installations, 5) mains, 6) meter reading, 7) customer records and collection, 8) uncollectible accounts, 9) miscellaneous customer expenses, 10) administrative & general salaries, 11) office supplies and expenses, 12) general advertising expense, 13) rate case expense, and 14) depreciation expense. OCA M.B. at 20-38. For the reasons detailed in the OCA's Main Brief and Reply Brief, the following adjustments should be made to the Company's claim. See, OCA M.B. at 20-38.

B. Inflation Factor

In its Main Brief, the Company argues that the proposed 3 percent inflation adjustment for FPFTY expenses is "conservative" and reflects the Company's experience and budget. Valley M.B. at 36-40. The OCA submits that the proposed inflation factor is not conservative nor is it appropriate. As explained in the OCA's Main Brief, the proposed across-the-board 3.0 percent growth or inflation rate does not relate to actual costs. See, OCA M.B. at 21-25. OCA witness Morgan testified:

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

OCA St. 2 at 9.

The Company argues that the OCA's position is to assume no cost increases from the FTY to the FPFTY as established in Act 11. Valley M.B. at 38-39. The Company's argument is an inaccurate characterization of the OCA's position regarding the proposed inflation factor. The OCA has accepted many of the Company's proposed cost increases from FTY to the FPFTY; the OCA, however, does not accept a blanket inflation factor for the Company's expenses that were documented by the Company. Escalation of the historical amounts by an inflation factor is more accurately characterized as a proxy for anticipated (but not provable) increased costs. It is not an appropriate method of cost projection or consistent with Section 315 of the Public Utility. 66 Pa. C.S. § 315. As OCA witness Morgan testified:

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

OCA St. 2-SR at 5.

In its Main Brief, the Company argues that the Commission has long recognized the use of inflation factors in projecting costs. See, Valley M.B. at 38, citing Pa. PUC v. Pennsylvania-American Water Co., Docket No. R-00038304, Order at 35 (Jan. 29, 2004); Pa. PUC v.

Pennsylvania-American Water Co., *et al.*, Docket No. R-880916, Order at 54 (Oct. 21, 1988). As the OCA discussed in its Main Brief, the cases cited by Valley are not applicable here. See, OCA M.B. at 22-23.

The basis of the cost of service in the Pennsylvania-American cases that the Company has cited differ substantially from the FPFTY filed in this matter. The inflation factor, in those cases, was applied to only a limited number of residual expenses. As OCA witness Morgan testified:

> First, it is important to recognize that the cases cited by Mr. Gorman pre-date Act 11. In other words, those cases were not based upon Fully Projected Future Test Years (FPFTY). The cases cited by Mr. Gorman were filed at a time when utilities were limited to the use of either a historical (HTY) or the partially projected future test year (FTY). When developing the FTY or the adjusted HTY, the cost of service was based upon costs that were known, measurable and certain. Act 11 amended Chapter 3 of the public utility code to allow jurisdictional utilities to make rate case claims based on a FPFTY. However, utilities are not restricted or required to use the FPFTY. The partially projected future test year (FTY) can still be used.
>
> Under the HTY and FTY approach, utilities are required to adjust their actual historical cost of service using the known and measurable principle. When the HTY and FTY approach is used, companies do not based their entire cost increases on an inflation escalation. Thus, in Pennsylvania-American Water Company (PAWC) rate cases, that company would typically adjust the various cost elements based on known and measurable cost increases, and only adjust residual expenses using an inflation factor. The residual expense adjustment generally turned out to be minor relative to the adjustments made and the total cost of service.
>
> I disagree with the Company's approach to developing the cost of service because it is extremely improper since the Company's projections are not based upon planned activities or normal operations. The Company's very simplified blanket inflation approach is not a projection as envisioned by Act 11.

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

The Commission has found that across-the-board inflation factors, or attrition adjustments, should not be used to establish rates because they are speculative in nature. See, Pa. PUC v. Philadelphia Gas Works, 2007 Pa. PUC LEXIS 45 (Sept. 28, 2007)(PGW); Pa. PUC v. Philadelphia Electric Co., 1990 Pa. PUC LEXIS 155 (May 16, 1990)(rejection of attrition

adjustment related to Limerick 2); Pa. PUC v. Philadelphia Electric Co., 58 Pa. PUC 7, 11-12 (1983)(PECO 1983).

In its Brief, the Company argues that the PGW and PECO 1983 cases are not applicable to the Company's proposal. Valley M.B. at 39. The Company argues that the cases pre-date Act 11 and that the inflation adjustment denial would have been consistent with the Public Utility Code at that time. As noted above, the two Pennsylvania-American cases cited by the Company also pre-date Act 11. Contrary to the Company's arguments in its Main Brief, there is a strong similarity between the instant case and the PGW case. The Company draws a distinction between the instant case and PGW because the PGW proposed to use a 2% inflation adjustor over a five year budget period instead of only across the 2020 FPFTY. Valley M.B. at 39. The OCA submits, however, that the PGW proposed inflation factor is very similar to the inflation factor proposed in this case. The primary difference is that PGW proposed to use the inflation factor across its five year budget and Valley proposes to use the inflation factor only in the FPFTY. PGW at *26-*28.

The Company argues that the PECO 1983 case is inapplicable because PECO proposed an overall increase of 2% to expense, revenue, and rate base. Valley M.B. at 39. The fact that PECO applied the inflation factor as an attrition adjustment to expenses, revenues and rate base does not change the Commission's conclusion that the "proposed attrition adjustment must be rejected as speculative in nature." PECO 1983 at 12. The concern here is the same. The proposed across-the-board inflation factor is speculative and not a known and measurable change.

The Company argues that the OCA's position undercuts the purpose of the FPFTY authorized by Act 11. Valley M.B. at 38-39, citing to 66 Pa. C.S. § 315(e). The OCA submits that Act 11 may have allowed for a FPFTY, it did not eliminate the "known and measurable" standard. An "across-the-board" approach does not meet the known and measurable standard.

In further support of its argument, the Company cites to the example raised in Rejoinder Testimony that "healthcare would increase more than 3%." Valley M.B. at 37-38; Tr. 78. The OCA submits, however, that the individual expense cannot be viewed in isolation. Other expenses may also decrease. The Company has not limited its proposed inflation adjustment to expenses that it reasonably anticipates will increase. The Company's inflation adjustment assumes that all expense will increase by a 3.0 percent inflation factor without providing evidentiary support for those proposed increases. As OCA witness Morgan explained, "[I]n this proceeding the Company is attempting to use an inflation escalation as the sole determinant of virtually all of the FPFTY expenses." OCA St. 2-SR at 5. Mr. Morgan concluded:

> It is not possible for the Company's FPFTY expense projection to be accurate when it uses a blanket inflation rate that was determined based upon judgement and without regard to the planned activities during the FPFTY.
>
> ***
>
> To be clear, in my recommendation, I am not claiming that the use of an inflation escalation has not been accepted by the Commission. Neither am I claiming that an inflation escalation cannot be used to project certain future year expenses. Instead, I am recommending that the Company's use of an inflation escalation as the sole basis for determining the FPFTY expenses is not appropriate. Therefore, it should be rejected by the Commission.

OCA St. 2-SR at 5-6.

If the Commission decides, however, to adopt an across-the-board inflation adjustment, the OCA opposes the Company's calculation of the proposed 3.0 percent inflation factor. OCA M.B. at 24-25; OCA St. 2 at 9-10. Mr. Morgan testified that a better measure of inflation for ratemaking purposes would be the forecasted Gross Domestic Product-Price Index (GDP-PI) of 2.1 percent for calendar year 2020. OCA St. 2 at 9. To be clear, the OCA is not suggesting that an across-the-board inflation factor is appropriate. The use of any inflation factor in the manner employed

by the Company is not appropriate. If the Commission disagrees, however, a more appropriate inflation factor should be used.[1]

For the reasons set forth above and in its Main Brief, the OCA submits that the proposed 3.0 inflation factor applied to all expenses is not known and measurable nor consistent with the law. Moreover, the Company's proposed calculation of the 3.0 percent factor is flawed. The Commission should reject the Company's use of an inflation factor and adopt the OCA's adjustment.

C. Account 876: Industrial/Commercial Meters and Regulators

In its Main Brief, the Company challenged the OCA's approach and adjustment to Account 876 stating, "OCA's adjustment should be denied as Valley witness Rogers testified that the Company generally incurs approximately 30% of its expense for Account 876 in the 4th quarter of each year." Valley M.B. at 43. The OCA adjustment did in fact account for the Company's position that approximately 30 percent of the annual expenses are incurred in the fourth quarter. OCA St. 1-SR at 9-10; OCA M.B. at 25-26.

As detailed more fully in the OCA's Main Brief, Ms. Sherwood demonstrated that the projected FTY expense will be $71,587; however, if you annualize Account 876 by increasing the nine-month expense by 30 percent, it only increases from $48,034 to $62,444, which is approximately $9,100 less than the Company's projection. Furthermore, witness Gorman accepts a lower claim of $7,508 as part of his adjustment to the FPFTY O&M claim. Based off the FTY

[1] In its Main Brief, the Company also mischaracterizes OCA witness Morgan's testimony regarding the calculation of the inflation factor as being in conflict with "fundamental ratemaking." Valley M.B. at 40. The Company attempts to utilize a quotation regarding the calculation of an appropriate inflation factor out of context. In Surrebuttal Testimony, OCA witness Morgan discussed why an across-the-board inflation adjustment is not known and measurable, but Mr. Morgan's discussion is not applicable to ratemaking in general. OCA St. 2-SR at 3. What Mr. Morgan stated is that in the cases identified by the Company, the utilities were limited to the use of a historical or partially projected future test year, and in those cases, the cost of service was based upon costs that were known and measurable. See, OCA St. 2-SR at 3.

annualized claim for Account 876, the OCA submits an adjustment of $9,429 is appropriate.[2] OCA St. 1-SR (Revised)

D. Account No 878: Meters and House Regulators/Account 902: Meter Reading Expense

The Company argues that expenses for Account 878 equal $172,563 and expenses for Account 902 equal $99,668. Valley M.B. at 44. As explained in OCA's Main Brief, OCA witness Sherwood disagrees with the Company's forecast. OCA M.B. at 26-27. The Company argues that the increase in Account 878's forecasted expenses is due to a shift in expenses from Account 902 to Account 878. Valley M.B. at 44; OCA M.B. at 26-24. However, in Surrebuttal, Ms. Sherwood explained that Account 902's forecast does not accurately reflect the supposed shift in expenses. OCA St. 1-SR (Revised) at 10-11.

Specifically, regarding Account 902's increase in expenses, the Company cites increases in overhead expenses of payroll taxes and estimated increases in benefits costs such as healthcare and retirement; however, the Company through the first half of 2019 has not experienced this level of forecasted expenses. OCA M.B. at 29. The Company has failed to justify the significant increase particularly as the actual costs in the first half of 2019 have not experienced such a level of increase. OCA M.B. at 30.

As discussed in the OCA's Main Brief, the OCA submits a three-year average of the Account 878 expenses for 2016 through 2018 is reasonable. OCA M.B. at 27. Additionally, the OCA accepts the Company's increase to the labor and overhead costs by three percent, to reflect with the approved salary increases for FTY, which leads to an adjustment of Account 902 by $12,847. OCA ST. 1 at 10; OCA M.B. at 30.

[2] Original adjustment equaled $15,730. OCA St. 1-SR (Revised) at 10.

E. Account No. 879: Customer Installations

The OCA's adjustment related to Account 879 is addressed in detail on pages 27 and 28 of the OCA's Main Brief. In its Main Brief, the Company does not specifically address the OCA's adjustments to Account 879.

F. Account No. 887: Mains

The Company's filing included a claim of $98,308 for Mains expense. Valley M.B. at 45. The OCA revised its original adjustment in surrebuttal to $1,219. OCA St. 1-SR (Revised) at 10-11. Company witness Rogers responded to OCA witness Sherwood that regarding Account 887, "the only one-time expense may be related to signage purchase, which was $1,219." OCA St. 1-SR (Revised) at 11; OCA M.B. at 28-29. In its Main Brief, the Company states if "the Commission declines to accept Valley's expense claim . . . Valley would accept this adjustment." Valley M.B. at 45.

G. Account 903: Customer Records & Collection

The OCA's adjustment related to Account 903 is addressed in detail on pages 30 and 31 of the OCA's Main Brief. In its Main Brief, the Company does not specifically address the OCA's adjustments to Account 903.

H. Account 904: Uncollectible Accounts

The Company argues in its Main Brief that its total expense for Uncollectible Accounts will be $100,799. Valley M.B. at 49. As explained in the OCA's Main Brief at pages 31 and 32, Ms. Sherwood explained the Company's claim does not match up with its traditional methodology as follows:

> The Company states that the uncollectible accounts, or bad debt reserve, are based on monthly sales. Per Attachment I&E-RE-17-D, the Company has utilized a factor of 0.005 percent of monthly sales revenue to determine the bad debt reserve. Under the assumption

> that the Company used this factor for 2020, this would indicate that the Company is projecting over $20 million in gross revenue, which would be more than double the amount of the highest gross revenue recognized by Valley since 2014. It is highly unlikely that Valley will experience revenues of this magnitude even with its projected growth.
>
> To calculate the bad debt reserve using the same methodology that the Company has utilized in previous years, I calculated the percentage of annual gross revenues recognized in each month for the years 2016 through 2018. I then averaged the monthly percentage of gross revenue for each year to determine how to distribute the projected revenue for the FPFTY . . . Utilizing the Company's requested revenue requirement and its projected natural gas sales volume multiplied by $0.15 per one hundred cubic feet (ccf), the Company's bad debt reserve should only be $49,397 in the FPFTY.

OCA St. 1 at 12-13; See, OCA M.B. at 31-32.

In its Main Brief, the Company does not respond to the OCA's adjustments to Account 904, but does respond to I&E's adjustment. Valley M.B. at 49. Therefore, the OCA submits Ms. Sherwood's recommendation as to the determination of the bad debt reserve be adopted. The final calculation will need to be based upon the Company's approved revenue requirement and projected sales at the conclusion of this case. Because that is unknown, OCA witness Sherwood used the Company's requested revenue requirement as a placeholder and calculated an adjustment of $51,403 to Account 904. OCA St. 1 at 13. This adjustment is reflected in Schedule SLS-10. Id. App. A, Table II; OCA M.B. at 32.

I. Account 905: Miscellaneous Customer Expenses

The OCA's adjustment related to Account 905 is addressed in detail on pages 32 and 33 of the OCA's Main Brief. In its Main Brief, the Company does not specifically address the OCA's adjustments to Account 905.

J. Account 920: Administrative & General Salaries

The OCA's adjustment related to Account 920 is addressed in detail on pages 33 and 34 of the OCA's Main Brief. In its Main Brief, the Company does not specifically address the OCA's adjustments to Account 920.

K. <u>Account 921: Office Supplies and Expenses</u>

The Company's claim for Office Supplies and Expense is $74,701. Valley M.B. at 45. As described more thoroughly in the OCA Main Brief, the OCA recommends adjusting Account 921 by $19,510. The Company in its Main Brief objects to OCA's adjustment relying on Company witness Rogers' explanation of the increased costs. Valley M.B. at 46. Specifically, Company witness Rogers argues the increased budget is for training purposes, for new and existing employees. Valley M.B. at 46. OCA witness Sherwood responded to this argument in Surrebuttal by demonstrating there is no indication that this level of expenses will continue beyond 2020. OCA St. 1-SR (Revised) at 11; OCA M.B. at 34, 35.

The Company cites the need for increased training for new hires and replacements as the reasons for these expenses, however, Ms. Sherwood noted that Valley is only anticipating one new hire in the FPFTY, indicating that the training expense should not increase from prior years. OCA St. 1 at 16; OCA M.B. at 34-35. In addition, OCA witness Sherwood demonstrated that it is unlikely that the Company will experience such an increase based upon its travel and training expenses recognized through the first half of 2019. If doubled, the 2019 expenses would be approximately $20,000 below the Company's projections for the FTY. OCA St. 1 at 16. Therefore, Ms. Sherwood recommends that the FPFTY reflect the HTY travel and training expenses and that the remainder of the Account 921 expenses reflect the FTY levels to eliminate the use of the Company's inflation factor used to determine FPFTY. OCA St. 1 at 16. Using this methodology, Ms. Sherwood calculates the Account 921 travel and training expense to be $41,806 in the FPFTY,

which would bring the Account 921 FPFTY total to $55,191. OCA St. 1 at 16; OCA M.B. at 34-35.[3]

L. Account 930: General Advertising Expense

In its Main Brief, the Company supports their original filing for Account 930 equaling $73,373. Initially, the OCA's adjustment equaled $10,400, however through Company witness Rogers' clarifications in rebuttal, OCA witness Sherwood decreased her adjustment to $3,889. OCA St. 1-SR (Revised) at 11-12. Ms. Sherwood's reduction to her adjustment is a result of her accepting the Company's known and measurable expenses as proposed by the Company. OCA St. 1-SR (Revised) at 11-12. Ms. Sherwood continues to challenge the Company's inclusion of off-site volunteering labor, therefore OCA submits an adjustment of $3,889 to Account 930.

M. Rate Case Expense

In its Main Brief, the Company asserted that its rate case normalization period of 36 months should be accepted because that would be consistent with its anticipated frequency going forward. Valley M.B. at 41. According to the Company, "three years [is] consistent with the anticipated frequency of base rate proceedings going forward, and with numerous prior Commission proceedings." Valley M.B. at 41. The OCA submits that the Company's speculation regarding the filing of future base rate cases is not determinative of this issue and that precedent guides this Commission, and not the Company's suggestion of "anticipated frequency." Valley M.B. at 41.

The Company claims $271,000 of rate case expense normalized over a 3 year period, for an annual expense of $90,333. OCA M.B. at 35. The OCA has not recommended any adjustment to the level of expense claimed, but does recommend an adjustment to the 3 year normalization

[3] Additionally, the Company's Main Brief on page 46 states the OCA's adjustment to Account 921 equals $19,988, this is incorrect. OCA's reported adjustment to Account 921 equals $19,510. App. A, Table II; OCA M.B. at 34-35.

period proposed by the Company. OCA M.B. at 35-36. The OCA submits that a 60 month normalization period is appropriate.

As discussed in detail in OCA's Main Brief, it is well settled that the normalization period for rate case expense is based on a company's historic filing of base rate cases. See, OCA M.B. at 25-27, citing Pa. PUC v. Columbia Water Co., 2009 Pa. PUC LEXIS 1423 (2009); Pa. PUC v. City of Lancaster Sewer, 2005 Pa. PUC LEXIS 44 (2005); Popowsky v. Pa. PUC, 674 A.2d 1149, 1154 (Pa. Commw. Ct. 1996); Pa. PUC v. Roaring Creek Water Co., 73 Pa. PUC 373, 400 (1990); Pa. PUC v. National Fuel Gas Dist. Corp., 84 Pa. PUC 134, 175 (1995); Pa. PUC v. West Penn Power Co., 119 P.U.R. 4th 110, 149 (Pa. PUC 1990). Valley's prior three rate cases have been 33 months, 36 months, and 110 months. Valley M.B. at 42. As such, OCA witness Sherwood's recommendation to normalize Valley's rate case expense for this proceeding over 60 months should be adopted. This normalization period resulted in a downward expense adjustment of $36,133. OCA St. 1-SR (Revised) at 13; OCA M.B. at 36-37.

The Company cites to Pa. PUC v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058, (Order Entered October 25, 2018) (UGI Electric) in defense of its position for an anticipated frequency 36 month normalization period. The Commission's determination in the UGI Electric case, however, was distinguishable from the facts presented in this proceeding. In UGI Electric, the Commission weighed the lengthy 8-year average and increased capital spending to create a specific equitable solution. See, Order at 58. UGI Electric does not support the Company's contention that rate case expense should be based on the Company's speculative intention to file a rate case rather than the historical average interval between rate filings.

N. Cash Working Capital

As discussed at page 37 of the OCA's Main Brief, the Company's cash working capital claim is based on one-eighth (12.5%) of its operating and maintenance expenses (O&M). The Commission should ultimately modify the adjustment to cash working capital in accordance with the total operations and maintenance adjustments adopted in this proceeding. See, OCA App. A, Table II. The Company did not address this issue in its Main Brief except to revise its own cash working capital adjustment based on its revised O&M expense claim. Valley M.B. at 23.

O. Depreciation Expense

As a result of Valley's use of the end of test year rate base, Valley has based its test year depreciation expense on the projected balance of plant in service as of the end of the FPFTY. OCA St. 2 at 7; OCA M.B. at 38. OCA witness Morgan recommends an adjustment to the depreciation expense in order to reflect the OCA's proposed use of an average test year rate base instead of the Company's proposed end of test year rate base. OCA M.B. at 38; OCA St. 2 at 8. The OCA submits that the Company should base its depreciation expense on average plant in service in the FPFTY. For the reasons set forth at Section IV(A)(1) above and in the OCA's Main Brief, the OCA continues to recommend that the Company use an average test year rate case, and therefore, the accumulated depreciation expense should be reduced by $33,805. OCA St. 2 at 8.

VII. RATE OF RETURN

A. Introduction

As explained in the OCA's Main Brief at 39 and 40, the appropriate overall rate of return is 6.75%, which is calculated using the Company's capital structure[4] and an 8.34% equity cost rate. OCA St. 3 at 3; OCA M.B. at 39-40. Contrary to the arguments made by the Company, this is not an unreasonable rate of return for the Company. Rather, it reflects the most accurate estimate

[4] The OCA's witness Dr. Habr adopted the Company's capital structure as filed in Direct Testimony. OCA St. 3 at 3.

using the Commission's preferred Discounted Cash Flow (DCF) methodology. The OCA submits that its rate of return recommendation based on current market conditions is appropriate for ratemaking, and will ensure that customers do not pay more than is reasonable. The Company's request for a higher than necessary return should be rejected. There is no evidence that the Company will not be able to continue to attract capital.

The discussion below will address the main areas of disagreement; however, the OCA's Main Brief contains a full discussion of the OCA's position.

B. Capital Structure

The OCA accepted the Company's Capital Structure.[5] OCA St. 3 at 2-3; OCA M.B. at 39-40.

C. Cost of Long Term Debt

The OCA accepted the Company's long-term cost of debt of 4.98%. OCA St. 3 at 3; OCA M.B. at 39-40.[6]

D. Cost of Common Equity

1. Introduction

The OCA's recommended cost of equity is 8.34%, which is the median value of all the DCF and FERC 2-Step cost rates presented by Dr. Habr. OCA St. 3 at 28-29; OCA M.B. at 39-40. Half of the observations lie above 8.34% and half lie below it. OCA St. 3 at 28-29; OCA M.B. at 39-40. This middle-of-the-pack value is appropriate for Valley. For the reasons discussed in OCA Statement 3 and 3-SR and the OCA's Main Brief, the OCA's recommended cost of equity of 8.34% should be adopted for ratemaking purposes.

[5] The Company's proposed capital structure is 52.55% equity/ 47.45% debt. Valley' St. 2-R at 3.
[6] The Company's original cost rate of debt was 4.98%, which was revised to 4.54% in witness D'Ascendis' rebuttal.

The OCA's DCF derived cost of common equity is 8.34% for the proxy group. The OCA's recommended return on equity relies on the results of Dr. Habr's DCF analysis, because the DCF model provides the best measure of equity cost rates. See, OCA M.B. at 47. This approach is consistent with this Commission's long-standing utilization of the DCF methodology when establishing the cost of common equity for utilities. OCA M.B. at 46-47; see, UGI Electric at 104. The Company argues that its use of multiple valuation models is consistent with Commission precedent. Valley M.B. at 66. The Commission rejected the same argument in Pa. PUC v. City of Lancaster – Bureau of Water, 2011 Pa. PUC LEXIS 1685, *56-57 (Lancaster 2011). The use of additional models, which have flaws, does not lead to a better result, contrary to the Company's position. The UGI Electric case states as follows:

> [W]e shall adopt the positions of I&E and the OCA and shall base our determination of the appropriate cost of equity on the results of the DCF method and shall use the CAPM results as a comparison thereto. As both Parties noted, the use of the DCF model has historically been our preferred methodology. This was recently affirmed in *Pa. PUC, et. al v. City of Dubois-Bureau of Water*, Docket No. R 2016 2554150, et. al. (Order entered March 28, 2017). Like the ALJs, we find no reason to deviate from the use of this method in the instant case.

UGI Electric at 106; see, Pa. PUC v. Emporium Water Co., Docket No. R-00061297, Order at 55-56 (Dec. 28, 2006), Pa. PUC v. Emporium Water Co., 95 Pa. PUC 191, 208 PUR4th 502 (2001); Pa. PUC v. Roaring Creek Water Co., 81 Pa. PUC 285, 150 PUR4th 449 (1994); Pa. PUC v. York Water Co., 75 Pa. PUC 134, 159-69 (1991); Pa. PUC v. Philadelphia Suburban Water Co., 71 Pa. PUC 593 (1989); Pa. PUC v. Pennsylvania-American Water Co., 71 Pa. PUC 210, 279-82 (1989); Pa. PUC v. The Peoples Natural Gas Co., 69 Pa. PUC 1, 167-68 (1989); Pa. PUC v. Pennsylvania Power, 67 Pa. PUC 91, 164, 93 PUR4th 189, 266 (1988) (Penn Power 1988); Pa. PUC v. National Fuel Gas Distribution Corp., 67 Pa. PUC 264, 332 (1988).

The Company cites to Pa. PUC v. Emporium Water Co., Docket No. R-2014-2402324 (Jan. 28, 2015) (Emporium 2014) to support its position that multiple ROE models must be used to set an appropriate return on equity in this proceeding. Valley M.B. at 66. The Company claims that the Commission approved a cost of equity developed from multiple models as used by Company witness D'Ascendis in this case. Valley M.B. at 66. A review of the Commission Order in Emporium 2014 shows that the Commission did not adopt the return on equity recommendation of any specific party in that proceeding. Order at 35. Thus, the Company's argument is without merit. As discussed in the OCA's Main Brief, the Commission relies on the DCF and informed judgment. OCA M.B. at 46.

2. Proxy Group

As explained in OCA's Main Brief, Dr. Habr's proxy group is appropriate and should be adopted because it contains companies of similar risk to Valley. OCA M.B. at 46-47. Dr. Habr's proxy group, unlike Mr. D'Ascendis' proxy group does not include non-price regulated results, which should not be given any weight. OCA M.B. at 46-47.

The Company argues in their Main Brief, that the "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." Valley M.B. at 62 (emphasis removed).

Mr. D'Ascendis' claim that his non-price regulated proxy firms are similar in risk to the gas proxy group he uses in his analysis is without merit. See, OCA St. 3 at 32. The OCA submits, that as explained in the OCA's Main Brief, Dr. Habr opposed Mr. D'Ascendis' proxy group which is comprised of companies that are not regulated gas utilities. OCA M.B. at 61. Dr. Habr demonstrated that Mr. D'Ascendis' use of non-price regulated firm results in establishing his

recommended allowed rate of returns invalidates his conclusions. OCA St. 3 at 31-32; OCA M.B. at 61. Table – 7 of Dr. Habr's testimony shows that the common equity cost estimates for the non-price regulated proxy groups are systematically higher than his utility common equity cost estimates by 66 to 208 basis points.

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

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

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

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

3. OCA's Cost of Equity Models

a. OCA's Consideration of Multiple Cost of Equity Models

As explained in more detail in the OCA's Main Brief, Dr. Habr employs multiple DCF models in his calculations. OCA M.B. at 52-54. Dr. Habr conducted 3 sets of DCF analyses -- a Constant Growth DCF, the FERC-2-Step DCF, and the Two-Stage DCF -- for each Company in his Gas Proxy Group. OCA M.B. at 52-54. Additionally, Dr. Habr employed a CAPM analysis, and a CAPM/Risk Premium analysis as a check. OCA 3-SR at 5-6.

The Company incorrectly argues that Dr. Habr placed no weight on his two-stage DCF model, CAPM model, and CAPM/Risk Premium Model and instead only considers his DCF model. Valley M.B. at 78. However, the Company is plainly mistaken, because as stated in both the OCA's Main Brief and Dr. Habr's Surrebuttal (OCA St. 3-SR), the combined results of the CAPM/Risk Premium model results were used to establish the common equity cost upper limits for the gas proxy group. OCA St. 3-SR at 5-6. Moreover, the combined results of the Two-Stage DCF model (Table 4, OCA St. 3 at 25-26), along with the combined results of the CAPM (Table 5, OCA St. 3 at 27-28), provided lower boundaries for the proxy group's common equity costs. OCA St. 3-SR at 5-6; See, OCA M.B. at 57-58.

Dr. Habr utilized the results of these additional models to establish reasonable upper and lower limits and provided a check on the results of his DCF analysis. The Company's claim that Dr. Habr "places no weight on these analyses" is incorrect and should be given no weight. Wellsboro M.B. at 80.

b. OCA's Non-Constant DCF Results

As explained in the OCA's Main Brief, Dr. Habr employed the use of additional DCF methods to temper the impact of an unsustainable 5-year analyst forecasts used in the constant growth DCF model. OCA St. 3-SR at 6-7; OCA M.B. at 52-53. Specifically, Dr. Habr explained that although multistage DCF models are generally used on firms early in their development to capture the different stages of growth, the use of these models "has nothing to do with the utility's current growth stage." OCA St. 3-SR at 7. Instead, Dr. Habr used these models because the constant growth DCF model used in utility regulation requires a sustainable long-term growth rate, analyst 5-year forecasts are just that, 5-year forecasts, they are not prepared for use in a utility regulatory framework OCA St. 3-SR at 7; OCA M.B. at 52-53.

The Company criticizes Dr. Habr's use of the additional model, and suggest that the non-constant DCF should be rejected as an invalid ROE model. Wellsboro M.B. at 80. As Dr. Habr explained and as discussed in OCA's Main Brief, these additional methods were used to temper the impact of unsustainable 5-year analyst forecasts on the constant growth DCF model. OCA St. 3-SR at 6- 7; OCA M.B. at 52-54. As Dr. Habr explains, his use of this model tempers the impact of unsustainable 5-year analyst forecasts on the constant growth DCF model. OCA St. 3 at 7; OCA M.B. at 52-54. Each method uses a weighted average of the analyst forecast growth rates and the forecast long-term GDP growth. OCA St. 3-SR at 6-7; OCA M.B. at 52-54. The Two-Stage DCF model was used to determine an implicit average long-term growth based on the assumption that the analyst forecasts were achieved for the first 20 years with the GDP growth applying to the years thereafter. OCA St. 3-SR at 6-7; OCA M.B. at 52-54. Both of these growth rates were then used in the standard dividend yield plus growth DCF. OCA St. 3-SR at 6-7.

The Company is incorrect to argue that Dr. Habr's application of this DCF model has no merit as Dr. Habr has demonstrated its intricate role in balancing the unsustainable 5-year growth assumption. Valley M.B. at 78.

c. <u>OCA's CAPM Analysis is not Flawed and OCA's CAPM/Risk Premium Analysis is Proper in this Context.</u>

The Company claims to have identified flaws in OCA's CAPM analysis, thereby "invalidating" it. Valley M.B. at 79. Specifically, Mr. D'Ascendis claims that the OCA's CAPM analysis "fails to utilize a risk-free rate based on a forecast period. . ." Valley M.B. at 79. Additionally, Mr. D'Ascendis claims that this model departs from the CAPM's theoretical basis, because "it assumes no risk-free asset." Valley M.B. at 80.

As more fully detailed in the OCA's Main Brief, Dr. Habr has addressed the Company's arguments in his Surrebuttal testimony:

Q: ON PAGE 65, LINES 10-12, OF HIS REBUTTAL TESTIMONY, MR. D'ASCENDIS OPINES THAT YOUR RISK PREMIUM APPROACH "IS A SUBSTANTIAL DEPARTURE FROM THE CAPM'S THEORETICAL BASIS SIMPLY BECAUSE IT ASSUMES NO RISK FREE ASSET." DO YOU AGREE WITH THIS STATEMENT?

A: No. My CAPM/Risk Premium does not assume no risk free asset. Mr. D'Ascendis' has apparently forgot that the risk free asset appears in two different places in the basic CAPM equation shown below, first as a "free standing"

$$k_e=R_f+ \beta_e (R_m-R_f)$$

variable and second as part of the risk premium calculation. The arithmetic in the development of the CAPM/Risk Premium formula eliminates the "free standing" risk free asset, Rf, while still including the risk free asset, Rf, in the market risk premium calculation.

OCA St. 3-SR at 8-9; See, OCA M.B. at 55-57. Dr. Habr explained further that he uses the CAPM/Risk Premium Model as a check on his DCF analysis. The core problem with the basic CAPM is that the closest measure there is for a true risk free rate, is the rate on a short duration T-bill which is highly influenced by the Federal Reserve monetary policy and thus does not reflect a market determined risk free rate. OCA St. 3 at 15; OCA M.B. at 54-55. Following, the core problem with the risk premium model is the cost of common equity has to be estimated somehow to come up with the risk premium to be added to the bond yield to determine the cost of equity. OCA St. 3 at 14-16; OCA M.B. at 54-55. Due to core problems with both models individually, combined they produce more accurate and useful results. OCA St. 3 at 14-16; OCA M.B. at 54-55.

As explained more thoroughly in OCA's Main Brief, Dr. Habr's CAPM/Risk Premium model yields maximum common equity estimates when it is applied assuming the bond betas equal zero as done in Dr. Habr's analysis. OCA St. 3 at 27-28; OCA M.B. at 57. The combined CAPM/Risk Premium median 9.54% and 9.61% average provide an upper limit for common

equity cost rates. OCA St. 3 at 27-28; OCA M.B. at 57; see also OCA Exhibit DSH-5 at 1-4. Furthermore, the Company again incorrectly asserts that the OCA develops its recommended ROE solely on its constant growth DCF and FERC two-step DCF models, however as plainly stated by Dr. Habr, the CAPM/Risk Premium provided important limits that were used in analyzing the DCF results consistent with Commission precedent. OCA St. 3 at 27-28; OCA M.B. at 61-62.

4. Management Performance Adder

The Company has reqested that the Commission adopt a cost of equity for Valley that includes an additional 25 basis points for what has been described as "effective management of operations and costs which warrants a performance adjustment." Valley M.B. at 81. The OCA opposes the Company's request for a higher equity return rate on this basis. The Company's ratepayers have a right to receive safe and adequate service at rates which are just and reasonable, and to expect utility management to operate in an effective manner. 66 Pa. C.S. §§ 1301, 1501. The OCA recognizes that the Public Utility Code allows the Commission to "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." 66 Pa. C.S. § 523(a). The evidence of record here, however, does not support the Company's request.

In its Main Brief the Company opines that OCA, has "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." Valley M.B. at 84. OCA witness Dr. Habr did testify that an additional 25-basis point adjustment to ROE would be unduly burdensome for ratepayers. OCA St. 3 at 30-31. After review of all company testimony as it related to the performance factor adjustment, Dr. Habr found "descriptions of management doing the job they are expected to do." OCA St. 3 at 30-

31. Moreover, what the Company describes as going beyond what it is required to do, Dr. Habr describes as "taking actions any successful company has to take to efficiently maintain its operations and provide satisfactory customer service." See, Valley M.B. at 81; OCA St. 3 at 31. This is evident in the fact that Valley's purported evidence for this adder includes replacing mains, low number of customer complaints, fast emergency response, technological improvments, and grants for main extenstion projects. Valley M.B. at 82.

Accordingly, the OCA submits that the evidence of record, taken as a whole, does not support the Company's request for a 25-basis point ROE adder. See, OCA M.B. at 63.

5. Size Performance Adder

The Company has also reqested that the Commission adopt a cost of equity for Valley that includes an additional 100 basis points for what has been described as "size adjustment to account for the greater risk faced by smaller public utilities. . ." Valley M.B. at 85. Both I&E and the OCA oppose the Company's request for a higher equity return rate on this basis.

In its Main Brief the Company states that OCA contests the proposed size adjustment based on misunderstanding Compnay testimony and "irrelevant condemnations of small utility operations." Valley M.B. at 88. OCA witness Dr. Habr testifes that an additional 100-basis point adjustment to ROE would be unduly burdensome for ratepayers. OCA St. 3 at 29-30. After review of all Company testimony as it related to the size adjustment, Dr. Habr found that the economic literature would, in fact, support a downward adjustment if any. As Dr. Habr explained:

> The size premiums on Schedule DWD-8, page 1 do not tell the whole story. Duff & Phelps also provides the OLS (ordinary least squares) betas associated with each of the size deciles shown on this page. Table -6 below shows the size premium and OLS beta for each size decile from an earlier Duff & Phelps study.

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

Market Capitalization ($Mil)

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

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

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

OCA St. 3 at 29-30. (Footnote omitted). Accordingly, the OCA submits that the evidence of record, taken as a whole, does not support the Company's request for a 100-basis point ROE adder. As Dr. Habr states the Company's ratepayers "should not be required to pay higher costs associated with inefficient utility operations. OCA St. 3 at 29-30; OCA M.B. at 63. If a utility company chooses to operate at such a small scale that its cost of common equity is truly increased, there is no reason for the utility's captive customers to pay any increased costs resulting from the utility's inefficient size." OCA St. 3 at 30; OCA M.B. at 63.

VIII. TAXES

The taxes issue raised by OCA witness Morgan has been resolved as discussed in Section III above. See also, OCA M.B. at 66.

IX. RATE STRUCTURE

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

The OCA addressed this issue at pages 66 to 67 of the OCA's Main Brief. No reply is necessary.

B. Revenue Allocation

The OCA addressed this issue at page 67 of the OCA's Main Brief. No reply is necessary.

C. Rate Design

The OCA addressed this issue at pages 67 to 68 of the OCA's Main Brief. No reply is necessary.

D. Scale Back

The OCA addressed this issue at page 68 of the OCA's Main Brief. No reply is necessary.

E. Summary

The OCA addressed this issue at pages 68 to 69 of the OCA's Main Brief. No reply is necessary.

X. MISCELLANEOUS ISSUES

A. Reconnection/Disconnection Fee

The Company proposes to increase the fee for reconnections/disconnections completed during working hours from $25 to $35 and increase the fees for reconnections/disconnections completed outside of working hours from $30 to $40. Valley St. 4 at 16. In its Main Brief, Valley states that "the record reflects, however, that Valley's testimony explained that the fees were increased to account for 13 years of inflation." Valley M.B. at 98. Company witness Rogers' Direct Testimony only stated that "the Company has not increased this fee since 2007, therefore an update is necessary to reflect the reconnection cost in today's dollars." Valley St. 4 at 15. Mr.

Rogers did not provide any exhibits reflecting the calculation or show how that calculation of "today's dollars" was achieved and resulted in a $10 increase. The Company has not provided a single schedule or exhibit in the filing reflecting the calculation of the proposed disconnection/reconnection fee or the actual cost of reconnections and disconnections.

OCA witness Mierzwa appropriately raised this issue in his Direct Testimony when he stated that he opposed the increase. In Direct Testimony, Mr. Mierzwa stated that "such fees should be cost based. Valley has presented no evidence demonstrating that its proposed increases are cost based." OCA St. 4 at 29; OCA St. 4-SR at 16. The Company had two opportunities, in Rebuttal Testimony or in Rejoinder Testimony to address Mr. Mierzwa's concerns and to identify the cost-based calculation for its reconnection/disconnection fees. The Company did not present any Rebuttal or Rejoinder Testimony and did not present any evidence. There is no evidence in the record to explain how it calculated "today's dollars" and why the Company considers "today's dollars" to be equivalent to "cost-based."

The Company argues that the OCA did not conduct sufficient investigation into the reconnection/disconnection fees. Valley M.B. at 98-99. The OCA appropriately raised the issue in its Direct Testimony and its investigation was to raise the issue to be addressed by the Company. The Company failed to provide any response. It is the Company, not the OCA, that has the burden to justify every rate it charges, including reconnection/disconnection fees. As the Company states in its own Legal Standards section, "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." Valley M.B. at 6, citing Univ. of Pa. v. Pa. PUC, 485 A.2d 1217, 1226 (Pa. Cmwlth. 1984); see also, Burleson v. Pa. P.U.C., 461 A.2d 1234, 1236 (Pa. 1983)

The Company's testimony regarding the reconnection/disconnection fee also does not meet the requirements of Section 1407(a) of the Public Utility Code. 66 Pa. C.S. § 1407(a). As discussed in the OCA's Main Brief, Section 1407(a) of the Public Utility Code provides that "a public utility may require a reconnection fee based upon the public utility's cost as approved by the commission prior to reconnection of service following lawful termination of service." 66 Pa. C.S. § 1407(a). The Company has not provided any evidence of its costs for the reconnection or disconnection of service consistent with the requirements of Section 1407(a) and that the increase in dollars to "today's costs" are equivalent to the Company's current costs of reconnection and disconnection of service. The fact that the fees have not changed since 2007 does not automatically mean that the Company's costs for reconnection and disconnection have increased or that they have increased by $10.

Finally, the Company also argues that the proposed increase is a "modest increase." Valley M.B. at 99. A $10 increase in the reconnection/disconnection fee for working hours from $25 to $35 is a 40 percent increase, and the $10 increase in the reconnection/disconnection for non-working hours from $30 to $40 is a 33 percent increase. The OCA submits that neither increase should be considered a "modest increase."

The Company has the burden of proving that each and every component of its rate request is just and reasonable. Burleson at 1236. The Company has provided no calculations or evidence in support of its requested reconnection fee increase. For the reasons set forth above and in the OCA's Main Brief, the OCA submits that the Company's proposal should be denied because the Company has not met its burden of proof to demonstrate that the proposed increases to the reconnection and disconnection fees are cost-based, reasonable, or justified.

B. Main Extension Proposal

1. The Main Extension Proposal Should Be Approved As In The Public Interest.

In its Main Brief, the OSBA opposes the Company's proposed third option to its existing service and main extension policy. OSBA M.B. at 7-11. As more fully discussed in the OCA's Main Brief and the Company's Main Brief, the purpose of the third option is to provide customers with additional opportunities to obtain natural gas service from Valley. See, OCA M.B. at 70-74; Valley M.B. at 96-98. Valley proposes to modify its extension policy in order to address the fact that under the current extension policy, customers with different unit installation costs are not treated equitably. See, Valley St. 4-R at 12-13.

In its Main Brief, OSBA argues that a remedy is not necessary and that the inequity is to be expected as long as the Company's unit installation costs vary across new installations. OSBA M.B. at 9, citing OSBA St. 1 at 9. OSBA also argues that the proposal would effectively increase Valley's Estimated Base Annual Revenue (EBAR) credit above the cost of 200 feet of service and/or main extension. OSBA M.B. at 9, citing OSBA St. 1 at 9.

In Rebuttal Testimony, Company witness Rogers responded that OSBA's concerns were unfounded. Valley's proposal would not raise the maximum amount the Company can spend on any individual customer. Valley St. 4-R at 12-13; see, OCA M.B. at 70-74.

As Company witness Rogers testified, "Valley's position is that there is no reason to deprive any individual customer of the level of investment the Company offers, on average, to any customer for a 200-foot extension." Valley St. 4-R at 12.

The OCA agrees with the Company's position. Mr. Mierzwa explained that rejecting the Company's proposal would not facilitate extending natural gas service into the unserved and underserved areas because "a CIAC can act as a deterrent to customers pursuing natural gas

service." OCA St. 4-R at 10. OCA witness Mierzwa further explained why OSBA's alternative would not provide the same benefits as the Company proposal as follows:

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

OCA St. 4-R at 10.

The OCA submits that the Company's proposed Extension Policy should be approved as in the public interest.

2. The OSBA's Argument That The Company's Proposed Change To The Extension Policy Is Discriminatory Ratemaking In Violation of 66 Pa. C.S. Section 1304 Is Misplaced.

The OSBA cites to 66 Pa. C.S. Section 1304 and Lloyd v. Pa. P.U.C., 904 A.2d 1010, 1020 (Pa. Commw. 2006) and argues that the modified Extension Policy is discriminatory. OSBA Main Brief at 10-11. According to the OSBA, the Extension Policy violates cost-causation principles by shifting "a portion of main extensions from individual customer applicants to any class of general ratepayers." OSBA Main Brief at 10.

The OCA submits that the OSBA's discrimination arguments are misplaced. Section 1304 of the Code provides, in relevant part, that:

> No public utility shall, as to rates, make or grant any *unreasonable* preference or advantage to any person, corporation, or municipal corporation, or subject any person, corporation, or municipal corporation to any unreasonable prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates, either as between localities or as between classes of service.

66 Pa. C.S. § 1304 (emphasis added). As the text of Section 1304 clearly indicates, preferences or advantages provided to a particular class are not *per se* discriminatory. The preference or advantage must be *unreasonable*. See id.

As explained by the Commonwealth Court of Pennsylvania:

> Before a rate can be declared unduly preferential and therefore unlawful, it is essential that there be not only an advantage to one, but a resulting injury to another. Such an injury may arise from collection from one more than a reasonable rate to him in order to make up for inadequate rates charged to another, or because of a lower rate to one of two patrons who are competitors in business. There must be an advantage to one at the expense of the other.

Phila. Elec. Co. v. Pa. PUC, 470 A.2d 654, 657 (Pa. Commw. 1984) (citing Alpha Portland Cement Co. v. Public Service Comm'n, 84 Pa. Super. 225 (1925).[7]

The purpose of the proposed Extension Policy is to resolve current inequities in the Company's existing Extension Policy. As the OCA discusses above in Section B(1), OSBA's perceived discrimination argument is unfounded. OCA witness Mierzwa testified "it is unclear how Valley's proposal would effectively raise its existing proxy 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 St. 4-R at 10. As a result, additional expansion may provide economic benefits to all customers. As the Company states in its Main Brief, the Company's proposal also "preserves the average cost of a 200-foot extension as the upper limit on Company contributions under the proposed methodology." Valley M.B. at 97. The Company similarly concludes that OSBA's concerns regarding uneconomic line extensions are unfounded. Valley M.B. at 97.

The OCA submits that the Company's proposal is consistent with the law and in line with the main extension policies of other NGDCs in the Commonwealth. See, OCA M.B. at 74. The

[7] See also Bldg. Owners & Managers Ass'n v. Pa. P.U.C., 79 Pa. Commw. 598, 605, 470 A.2d 1092, 1095-96 (1984) ("[W]e reiterate that mere variation in rates among classes of customers does not violate the Public Utility Code. The requirement is merely that rates of one class of service shall not be unreasonably prejudicial or disadvantageous to a patron in any other class of service."); Mill v. Pa. P.U.C., 67 Pa. Commw. 597, 601, 447 A.2d 1100, 1102 (1982) ("It is true that Section 1303 prohibits a public utility from demanding or receiving a rate less than that established in the applicable tariff, but Section 1304 modifies that prohibition by providing that a utility shall not grant any *unreasonable* preference or advantage to any person. The clear implication from this language is that a person may be given a rate preference so long as it is not unreasonable[.]" (emphasis in original)).

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

3. Conclusion

For the reasons set forth above and in the OCA's Main Brief, the OCA submits that Valley has met its burden of proof in this case that the modification to its Extension Policy will provide a benefit to customers seeking to obtain access to low-cost natural gas in unserved and under-served areas within the Commonwealth. See, OCA M.B. at 70-74. The OCA supports the Company's proposed main extension modifications and agrees that the proposed modifications would provide a necessary fix to address a customer inequity problem in its current main extension policy. See, OCA St. 4-R at 7. The OCA submits that the Company's proposed main extension and services option should be approved.

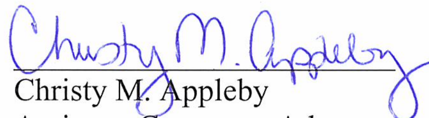
C. Unbundled Procurement Costs To Be Recovered In Valley's Gas Cost Rate (GCR)

As the Company's Main Brief indicates, the OCA did not raise any issues with the Company's proposal. Valley M.B. at 99.

XI. CONCLUSION

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

Respectfully Submitted,



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