BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	R-2019-3008209
Office of Consumer Advocate	:	C-2019-3011850
Athens Borough	:	C-2019-3012397
South Waverly Borough	:	C-2019-3012396
Larry E. Cole	:	C-2019-3012219
	:	
v.	:	
	:	
Valley Energy, Inc.	:	

RECOMMENDED DECISION

Before
Steven K. Haas
Benjamin J. Myers
Administrative Law Judges

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I. INTRODUCTION

This Recommended Decision recommends that the proposed tariff supplement filed by Valley Energy, Inc. to increase total annual operating revenues by $834,546.00, or approximately 16.6%, be denied because the Company has not met its burden of proving by a preponderance of the evidence the justness and reasonableness of every element of its requested increase. Instead, this decision recommends approval of an increase in total annual operating revenues in the amount of $497,080.00, or approximately 9.82%. The suspension date is May 1, 2020.

A. Valley Energy, Inc.

Valley Energy, Inc. (Valley or the Company) is an investor-owned natural gas distribution company (NGDC) providing service in the borough of Sayre and surrounding communities in Bradford County, Pennsylvania. Valley is wholly owned by C&T Enterprises, Inc. (C&T). C&T is a holding and management services company that also owns Wellsboro Electric Company (Wellsboro) and Citizens' Electric Company of Lewisburg (Citizens').

Valley's service territory is predominantly concentrated in the boroughs of Sayre and Athens, Pennsylvania and surrounding areas of Bradford County. As of December 31, 2018, Valley served 6,942 customers, of which approximately 6,058 were residential, 812 were commercial and industrial, and 72 were transportation customers.

Through the instant proceeding, Valley seeks approval from the Pennsylvania Public Utility Commission (Commission) for an increase in annual delivery revenues. The Company's original request, Supplement No. 49 Tariff Gas – Pa. PUC No. 2, filed on July 1, 2019, sought an increase in rates of approximately $1,034,186.00, or approximately 20.6%. Valley subsequently revised its requested increase downward to approximately $834,497.00. If granted in full, the total bill for an average residential customer would increase by approximately $6.50 per month, or approximately 13%, over existing rates. In 2018, the Company earned a rate of return (distribution) of 9.24%. Valley argues that, without rate relief, its projected rate of return for 2020 will be 4.64%, a return that it argues will not support the long-term health of the Company.

B. History of the Proceeding

This proceeding was initiated on July 1, 2019, when Valley filed Supplement No. 49 Tariff Gas – Pa. PUC No. 2 with the Commission. In Supplement No. 49 Tariff Gas – Pa. PUC No. 2, issued to be effective for service rendered on or after August 30, 2019, Valley proposed an annual distribution revenue increase of $1,034,186 (20.6%). On July 29, 2019, Valley filed replacement schedules and tariff pages that updated the annual distribution revenue increase to $834,546 or approximately 16.6%. The Office of Consumer Advocate (OCA) filed a formal complaint against Valley's rate increase on July 30, 2019. On July 19, 2019, the Bureau of Investigation and Enforcement (I&E) filed a Notice of Appearance. On July 22, 2019, the Office of Small Business Advocate (OSBA) filed a Notice of Appearance in this proceeding. On August 14, 2019, a formal complaint was filed by Larry E. Cole at Docket No. C-2019-3012219. On August 15, 2019, formal complaints were filed by South Waverly Borough (Docket No. C-2019-3012396) and Athens Borough (Docket No. C-2019-3012397).

By Order entered on August 29, 2019, the Commission instituted an investigation to determine the lawfulness, justness, and reasonableness of the proposed rate increase and the tariff was suspended until March 30, 2020.

On September 9, 2019, Valley filed a tariff supplement voluntarily extending the suspension period until April 29, 2020. 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 J. Myers to preside over this proceeding.

A Prehearing Conference was held on September 13, 2019, at which time a litigation schedule was developed. The Prehearing Conference was held jointly with rate cases filed by Wellsboro and Citizens' at Docket Nos. R-2019-3008208 and R-2019-3008212, respectively. Prior to the Prehearing Conference, on August 2, 2019, Valley provided the parties with its direct testimony. In accordance with the procedural schedule established at the Prehearing Conference, OCA, I&E, and OSBA submitted direct testimony and associated exhibits on October 15, 2019. On November 14, 2019, Valley, OCA and OSBA submitted rebuttal testimony and associated exhibits. On December 4, 2019, the parties submitted surrebuttal testimony.

A telephonic public input hearing was held on November 4, 2019. Two witnesses testified during the public input hearing. Valorie Huckabee, Borough Manager, testified on behalf of South Waverly Borough and Mark Burgess, Borough Manager, testified on behalf of Athens Borough. Both witnesses argued against Valley's proposed rate increase.

Evidentiary hearings were held on December 16 and 17, 2019, during which rejoinder testimony was presented by Company witnesses and certain witnesses were made available for cross-examination. As with the Prehearing Conference, the evidentiary hearings were held jointly for the Valley, Citizens' and Wellsboro rate proceedings. All prepared Statements and Exhibits were entered into the record by verification or by witness authentication. Company witnesses Gorman, D'Ascendis and Kelchner were sworn in and presented oral rejoinder testimony and were submitted to cross-examination. I&E witnesses Patel 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. No prepared written testimony was submitted by Larry Cole, South Waverly Borough or Athens Borough.

Main Briefs were filed on January 8, 2020, and Reply Briefs were filed by the parties on January 22, 2020. Larry Cole, South Waverly Borough and Athens Borough did not file briefs. The record closed on January 22, 2020.

C. Burden of Proof

A public utility has the burden of proof to establish the justness and reasonableness of every element of its rate increase request in all proceedings under 66 Pa. C.S. § 1308(d). The standard to be met by the public utility is set forth at 66 Pa. C.S. § 315(a):

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

66 Pa. C.S. § 315(a).

The Commonwealth Court of Pennsylvania set forth the utility's burden of proof in a rate proceeding pursuant to 66 Pa. C.S. § 315(a) as follows:

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

Lower Frederick Twp. Water Co. v. Pa. Pub. Util. Comm'n., 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980) (emphasis added). *See also*, *Brockway Glass Co. v. Pa. Pub. Util. Comm'n*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

In general rate increase proceedings, the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility's burden of proof to establish the justness and reasonableness of every component of its rate request is an affirmative one and that burden of proof remains with the public utility throughout the course of the rate proceeding. There is no similar burden placed on other parties to justify a proposed adjustment to the public utility's filing. The Pennsylvania Supreme Court has held:

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

Berner v. Pa. Pub. Util. Comm'n, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955).

However, a public utility does not need to affirmatively defend every claim it has made in its filing, even those which no other party has questioned, in proving that its proposed rates are just and reasonable. The Pennsylvania Commonwealth Court has held:

> While 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.

Allegheny Center Assocs. v. Pa. Pub. Util. Comm'n, 131 Pa. Cmwlth. 352, 359, 570 A.2d 149, 153 (1990) (citation omitted). *See also, Pa. Pub. Util. Comm'n v. Equitable Gas Co*., 73 Pa. PUC 310, 359-60 (1990).

Additionally, 66 Pa. C.S. § 315(a) does not place the burden of proof on the utility with respect to an issue the utility did not include in its general rate case filing and which, frequently, the utility would oppose. The burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility. *Pa. Pub. Util. Comm'n v. Metropolitan Edison Company,* Docket No. R-00061366, 2007 Pa. PUC LEXIS 5 (Order entered January 11, 2007).

II. PUBLIC INPUT HEARING TESTIMONY

A "smart" public input hearing was held in this proceeding on November 4, 2019, at 1:00 p.m. in Harrisburg, Pennsylvania. Present during the hearing were counsel for the Company, I&E and OCA. A total of two witnesses testified during the hearing, both telephonically. Witness Valorie Huckabee is the Borough Manager of South Waverly Borough and testified on behalf of the citizens of South Waverly Borough. Mark Burgess is the Borough Manager of Athens Borough and testified on behalf of the citizens of Athens Borough.

Ms. Huckabee testified that the proposed increase would place an excessive burden on South Waverly residents, particularly elderly residents who are on fixed incomes. Tr. at 14. She testified that South Waverly residents are already faced with a number of other rising costs, such as school taxes, sewer authority facilities upgrades and Borough road and maintenance equipment enhancements, that impose financial hardships on the residents. Tr. at 14-16. Ms. Huckabee requested that the rate increase sought by Valley in this proceeding be substantially reduced by the Commission.

Mr. Burgess also testified about the rising costs that impose financial hardships on Athens Borough residents, including costs associated with recovery from flooding in 2011, school taxes, sewer authority facilities upgrades and Athens road enhancement projects. Tr. at 20-22. Mr. Burgess also requested that the rate increase sought by Valley in this proceeding be substantially reduced by the Commission.

We have reviewed and fully considered the testimony of the two public input hearing witnesses in reaching the recommendations contained in this Recommended Decision.

III. RATE BASE

The Company states that its claim for a new rate base is based upon data for the fully projected future test year (FPFTY) ending December 31, 2020. Valley Main Brief at 14; Valley Stmt. No. 1 at 2; Valley Stmt. No. 1-R, Exhibit__(HSG-1R2), Schedule C1 (R). The Company has provided data for the historic test year (HTY) ending December 31, 2018. Valley Stmt. No. 1 at 4.

According to the Company, its final claimed rate base of $17,179,542 reflects all adjustments adopted by the Company in this proceeding. Valley Main Brief at 15; Valley Stmt. 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")

Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). The Company notes that I&E proposed changes to CWIP but did not dispute any other rate base components, while OCA proposed adjustments to plant in service, CWIP, Materials and Supplies, Customer Deposits, Depreciation Expense, and EDIT. Valley Main Brief at 15. For the reasons explained, the Company asserts that its claimed rate base is reasonable and should be approved.

A. Utility Plant in Service and FPFTY

Positions of the Parties

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 Stmt. No. 1, Exhibit__(HSG-1), Schedules C1-6 (R), C2 (R), C3 (R). The Company notes that OCA witnesses allege that the Company's plant in service and accumulated depreciation calculations for the FPFTY do not appropriately reflect plant retirements, and that any adjustment to Plant in Service for retirements would require a parallel adjustment to accumulated depreciation. Valley Main Brief at 15, 16; OCA Stmt. No. 2 at 4. 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. The Company responds to OCA by stating that these parallel adjustments do not result in a material impact on the Company's rate base claim. The Company, therefore, recommends approval of its Plant in Service and Accumulated Depreciation calculations without modification. Valley Main Brief at 16.

The Company states that its rate claim based on plant projected to be in service at the end of the FPFTY is consistent with direction recently provided by the Commission for calculation of plant in service at the end of the FPFTY. Valley Main Briefat 16, 17 (citing *Pa. Pub. Util. Comm'n v. UGI Utilities, Inc. – Electric Division,* Docket No. R-2017-2640058 (Order Entered October 25, 2018) (*UGI Order*) at 23-26; 66 Pa. C.S. § 315(e); *Pa. Pub. Util. Comm'n v. PPL Electric Utilities Corp.*, Docket No. R-2012-2290597 at 12). The Company contends that, in the *UGI Order*, the Commission rejected arguments from OCA 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 follows:

> 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.

Valley Main Brief at 18 (citing *UGI Order* at 23). The Company also asserts that the Commission 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." *Id*. (citing *UGI Order* at 24).

The Company also contends that the language of Act 11 (66 Pa. C.S.A. § 315) fully supports use of end of test year balances, stating that the Act does not contain a separate provision for the FPFTY, but instead adds the FPFTY to the existing statute authorizing use of a future test year (FTY). Valley Main Brief at 19. Moreover, according to the Company, 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. *Id.*

Given the above, the Company contends that OCA's proposal to use an average rate base would dramatically weaken the benefits provided by the legislature in adopting Act 11, because 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 Main Brief at 20. Specifically, the Company states that 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. *Id.* (citing OCA Stmt. No. 2, Schedule LKM-2; Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule C1-6 (R). The Company also notes that, 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, effectively converting a fully projected future test year to a "partially projected half test year." *Id.*; Valley Stmt. No. 1-R at 11. The Company argues that this approach is inconsistent with the purpose and policy underlying Act 11, and that OCA has provided no factual or legal basis for its average proposal, except that OCA is challenging the Commission's current position. *Id.* Therefore, according to the Company, OCA's position should be rejected. *Id.*

Regarding the Company's proposed use of FPFTY, OCA opposes this methodology, contending that although Section 315 of the Code permits capital investments that are not used and useful on the first day of new rates to be included in an electric utility's rate base during the FPFTY period, Act 11 does not remove the requirement under Section 1301 of the Public Utility Code that rates be just and reasonable under 66 Pa. C.S. § 1301. OCA Main Brief at 11, 12. OCA contends that the use of the FPFTY allows for levels of costs that will be experienced at the end of the rate year rather than the levels of costs incurred during the rate year, and that the use of a year-end rate base would result in Valley earning a 12-month return, beginning on January 1, 2020, on the level of plant that will not be in service until December 31, 2020. OCA Main Brief at 12.

OCA states that 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 Stmt. 1 at 4. OCA submits that the Company has not met its burden to demonstrate that the use of the end of the test year methodology for rate base results in just and reasonable rates. Therefore, according to OCA, the Company's proposed end-of-year method results in rates that are unjust and unreasonable. OCA Main Brief at 16. Accordingly, OCA submits that the Commission should utilize the average rate base method for determining its rate base, resulting in a proposed change from the Company's filed end of test year rate base to OCA's proposed average which would decrease the Company's proposed rate base by $839,474 from $34,714,831 to $33,875,357. OCA St. 1 at Sch. SLS-3.

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

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

OCA Stmt. 2 at 4, Sch. LKM-1. The OCA notes that in rebuttal testimony, OCA witness Gorman did not specifically address Mr. Morgan's recommendations with respect to plant retirements. Valley Stmt. 1-R at 11-12.

I&E and OSBA did not specifically address the issue of Valley's use of a FPFTY or OCA's recommendation that the Commission should utilize the average rate base method for determining Valley's rate base. I&E and OSBA also did not specifically address the issue of plant retirements.

Disposition

Regarding the issue of the Company's use of a Fully Projected Future Test Year, we agree with the Company that using the FPFTY is appropriate and is supported by law. The Company correctly cites to the recent Commission decision in the *UGI Order*, wherein the Commission allowed the use of an FPFTY even though some of the utility plant in service might not be operational until the latter part of the FPFTY. We note here that the Commonwealth Court recently upheld the Commission's *UGI Order* on this issue on January 15, 2020. *See, McCloskey v. Pa. Pub. Util. Comm'n,* 1549 C.D. 2018 (Pa.Cmwlth. Jan. 25, 2020). Accordingly, the parties to this proceeding, and subsequent rate proceedings, are bound by the Commission's holding in the *UGI Order*.

In addition, although OCA contends that the Section 1301 of the Public Utilities Code (mandating that rates be just and reasonable) should override the Company's rate claims because those claims are unjust and unreasonable, we do not agree. In that regard, assuming that the Commission's *UGI Order* does not otherwise override the provisions of Section 1301, we see no record evidence to show that the proposed rate base or rates are unjust or unreasonable. Most importantly, we note that OCA made no specific factual arguments in support of its contention that use of an FPFTY results in unjust or unreasonable rates; instead, OCA merely sets forth the proposition that, since the Company will be earning interest for the whole FPFTY on an asset that is not put in service until the end of that year, the Company will by definition be "overearning" on its investment. Given the clear holding of the Commission in the *UGI Order*, and the Commonwealth Court's decision affirming the Commission, this particular argument has already been considered and rejected by the Commission. Therefore, we also reject this argument.

We also note that none of the other parties to the proceeding have objected to the Company's use of an FPFTY. Given that fact, and the factors discussed above, we conclude that the Company is permitted to use an FPFTY in this proceeding.

B. Accumulated Depreciation

Positions of the Parties

Regarding the issue of accumulated depreciation, the Company's claim for rate base included an accumulated depreciation of $16,499,533 for the FPFTY. Valley Stmt. 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 Stmt. No. 1 at 16.

The Company notes that I&E did not oppose the Company's accumulated depreciation claim. Valley Main Brief at 21; I&E Stmt. No. 3, Exhibit No. 3, Schedule 1. The Company also notes that 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. *Id.*; OCA Stmt. No. 2 at 4. 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*. Valley Main Brief at 22. Therefore, the Company argues that OCA's position regarding accumulated depreciation should be rejected based on the UGI holding. *Id.*

OCA alleges that the Company's plant in service and accumulated depreciation calculations for the FPFTY do not appropriately reflect plant retirements, and that any adjustment to Plant in Service for retirements would require a parallel adjustment to accumulated depreciation. In total, OCA's proposal results in a $55,659 adjustment to Plant in Service and a $56,678 adjustment to accumulated depreciation. The Company responds to OCA by stating that these parallel adjustments do not result in a material impact on the Company's rate base claim. The Company, therefore, recommends approval of its Plant in Service and Accumulated Depreciation calculations without modification.

OSBA took no position on the issue of accumulated depreciation.

<u>Disposition</u>

Regarding the issue of accumulated depreciation, we do not find adequate record evidence to support OCA's recommended downward adjustment, which is a net figure of $1,019 as reflected in OCA Stmt. No. 2, Schedule LKM-2. 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*. Valley Main Brief at 22. Therefore, the Company argues that OCA's position regarding accumulated depreciation should be rejected based on the UGI holding. *Id*. As we have previously agreed with the Company on this point (use of FPFTY), we find for the Company on this particular issue as well. Therefore, the Company's claim for accumulated depreciation is recommended for approval by the Commission.

C. Materials and Supplies

Positions of the Parties and Disposition

Regarding the issue of materials and supplies, 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 Main Brief at 22; Valley Stmt. No. 1-Rat 11; OCA Stmt. No. 2, Schedule LKM-4. As no other parties raised any objection or counterproposal, we conclude that the small adjustment is reasonable; therefore, we recommend it be approved.

D. Accrued Pension/OPEB Liability

Positions of the Parties and Disposition

Regarding the issue of Accrued Pension / Other Post-Employment Benefits (OPEB) liability, 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 Main Brief at 22; Valley Stmt. No. 1 at 18. Neither OCA nor I&E proposed any adjustments to the Company's claim. *Id.*; OCA Stmt. No. 1, Schedule SLS-3; I&E Stmt. No. 3 at 3-8.

As no other parties raised any objection or counterproposal, we conclude that the small adjustment is reasonable; therefore, we recommend it be approved.

E. Cash Working Capital and Construction Work in Progress

Positions of the Parties

Regarding the issue of Cash Working Capital (CWC), the Company claimed an increase of $402,100 to rate base. Valley Stmt. No. 1, Exhibit__(HSG-1) Schedule C1-6 (R). The Company derived the CWC by using the formula of 1/8 of non-fuel cash operating costs. Valley Stmt. No. 1 at 18. The Company notes that I&E and OCA do not oppose the 1/8 method proposed by the Company, but that I&E and OCA each proposed to reduce the CWC claim to reflect the respective party's proposed operating and maintenance (O&M) expense adjustments and remove non-cash items (uncollectible expense, taxes other than income, and depreciation) from computation of CWC. Valley Main Brief at 23; I&E Stmt. No. 1 at 24; OCA Stmt. No. 1 at 19. The Company agrees that CWC should be recalculated if the Commission orders any changes to the Company's claimed O&M expenses. Valley Main Brief at 23; Valley Stmt. 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. *Id*.

Disposition

The Company agrees that CWC should be recalculated if the Commission orders any changes to the Company's claimed O&M expenses. I&E noted that the Company's rate base claim includes $114,497 of Construction Work in Progress (CWIP) based on the December 31, 2018 financial statements and estimated to be the same in the FTY and FPFTY. I&E also noted that, although CWIP allows a utility to recover costs for plant additions that will be completed and in service within six months of the end of the test year, the Company elected to use a FPFTY ending December 31, 2020, which includes projections of plant in service and depreciation that will be recovered in rates during that twelve-month period. Accordingly, I&E stated there is no reason to include a CWIP claim given that the plant should be included in the Company's FPFTY plant claim. The Company accepted I&E's recommended adjustment in rebuttal testimony "because it is using an end-of-year rate base for the FPFTY, and because it did not include specific projects in CWIP"; therefore, the $114,497 CWIP claim should be removed from the FPFTY rate base as originally filed.

I&E also noted that the Company claimed $402,100 for CWC, which was later revised to $399,027. I&E Exhibit No. 1-SR, Schedule 4 at 3. Because CWC covers the lag between the payment of operating expenses and the receipt of revenues from ratepayers, I&E argued that all non-cash items, such as uncollectible accounts expense and taxes, must be removed from the Company's CWC claim. The Company agreed with this recommendation in rebuttal testimony and updated its CWC claim to $399,027 to reflect the removal of the non-cash items identified in I&E's testimony. Additionally, because all cash-based expenses are included in the Company's overall CWC claim, any adjustments to the Company's O&M expense claims impact the CWC allowance. I&E recommended that the Company's O&M expense claims be reduced by $103,405, which reduces the Company's CWC allowance by $12,925.

I&E recommends a total $127,422 deduction from Valley's claimed rate base in its original filing. This deduction to rate base reflects I&E's recommended disallowance of $114,497 CWIP and a $12,295 reduction to CWC allowance. I&E notes that the tables attached to I&E's Appendix A only reflect a recommended reduction to rate base of $12,295 for CWC because Valley's rebuttal position accepted I&E's CWIP recommendation.

We note OSBA did not take positions on the above issues. OCA asserted that it is not appropriate to include CWIP in rate base either using an end of test year or the average rate base test year method because in either case, the plant item will not be completed and placed in service during the FPFTY. According to OCA, the Commission has historically disallowed the inclusion of CWIP in rate base. We also note that the Company has agreed to I&E and OCA's recommended adjustment regarding CWIP.

We conclude that the CWC adjustment is also reasonable; therefore, we recommend that it be approved.

F. Other Reductions from Rate Base

Positions of the Parties and Disposition

Regarding the issue of other reductions from rate base, the Company notes that OCA proposed a $98,293 adjustment to Customer Deposits, which the Company accepted. Valley Main Brief at 23; OCA Stmt. No. 2 at 7; Valley Stmt. No. 1-R at 11. The Company further notes that 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. Valley Main Brief at 22, 23; OCA Stmt. No. 2 at 11.; Joint Stmt. No. 3 at 12 (confirming Valley was not required to implement rate adjustments to reflect impacts of the Tax Cuts and Jobs Act of 2017 (TCJA). The Company accepts OCA's adjustment, which increases the EDIT balance by $27,443 and reduces rate base by the same amount. Valley Stmt. No. 1-R at 12; OCA Stmt. No. 2 at 11. Finally, 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"). Valley Stmt. No. 1 at 17; Valley Stmt. No. 1, Exhibit __ (HSG-1), Schedule C1-6 (R). No party opposed the Company's proposal. OSBA took no position on these issues.

As the parties are in agreement on the above reductions from rate base, we conclude that those adjustments are reasonable and should, therefore, be approved.

G. Summary

In sum, the following adjustments to the Company's claimed rate base have been agreed upon by all parties:

1) A Materials and Supplies adjustment increasing the Company's claim by $11,096 from $161,817 to $172,913;

2) A reduction to rate base for Accrued Pension / OPEB liability. This reduction reflects the excess of amounts charged to expense over amounts paid. The deduction amount is $899,115;

3) A total $117,570 deduction from the Company's claimed rate base in its original filing, reflecting a disallowance of $114,497 CWIP and a $3,073 reduction to CWC allowance;

4) A $98,293 increase to Customer Deposits, which decreases rate base by a similar amount;

5) An EDIT balance of $91,477 and a reduction of the rate base by the same amount; and

6) A reduction to rate base of $650,909 due to the unbundling of certain gas costs of the Company which the Company intends to recover through its Gas Cost Rate ("GCR").

Additionally, CWC will be reduced by $20,509 which reflects our adjustment to operating expenses of $164,072.

Given the above adjustments, we conclude that the final rate base that we recommend for Commission approval is $17,159,033.

IV. REVENUE

A. FPFTY Sales and Revenue

As explained by Valley in its Main Brief, the Company " . . . calculated projected FPFTY sales and revenue for its tariff rate schedules Rate R, Rate C, Rate L, Rate IS, Rate Transport DDQ and Rate Transport Interruptible based on a regression analysis using monthly number of customers and Heating Degree Days ("HDD") for 2016-2018." Valley Stmt. No. 1 at 9-11. It further explained that, "[f]or the Rate Schedule 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." Valley Stmt. No. 1 at 10. Valley witness Gorman noted that Valley's ". . . projection of sales is based on a regression analysis for weather sensitive classes." Valley Stmt. 1-R at 12. Mr. Gorman calculated a decline in system usage from 28,757,694 ccf in 2018 to 26,569,046 ccf in 2020 resulting in an expected decrease in delivery revenues, under present rates, from $5,306,089 in 2018 to $5,059,370 in 2020. Valley Stmt. 1 at 11-12.

OCA, the only party to propose an adjustment to Valley's calculations, recommends an alternative analysis that results in an expected increase in Valley's projected revenue at present rates. In his direct testimony, OCA witness Mierzwa proposed to adjust Valley's FPFTY revenues to reflect the most recent available annual usage of the Company's customers. He used the 12-month period ending August 2019. OCA Stmt. 4 at 31; Sch. JDM-6, Sch. JDM 6S. Mr. Mierzwa testified that his proposed adjustment would increase revenues by $164,857. OCA Stmt. 4 at 31, Sch. JDM-1. In his surrebuttal testimony, Mr. Mierzwa updated his adjustment to reflect the most recent data available and included more localized weather information than the information originally used. OCA Stmt. 4-SR at 16. His updated FPFTY revenue projection is an increase of $141,561.00. OCA Stmt. 4-SR. OCA, therefore, recommends that Valley's projected revenue figure be adjusted upward by $141,561. OCA Stmt. 4-SR at 16, Sch. JDM-6S.

Valley criticizes OCA's analysis on the grounds that (1) it relies on just a single year of sales data, and (2) its failure to apply a monthly regression will not capture the customer usage variation necessary to generate reliable data. Valley Reply Brief at 7. It further criticizes OCA's analysis on the basis that it weather-normalized sales only for the Residential and Commercial customer classes yet offers no reason for using unadjusted data for the remaining customer classes. Valley Reply Brief at 7.

We recommend that Valley's revenue calculation be accepted, and that OCA's proposed adjustment be denied. We believe that Valley's analysis represents a reasonable approach and do not believe that OCA presented valid reasons to reject that approach or adjust its results. We generally agree with Valley witness Gorman's explanation as to the validity of Valley's approach versus that put forth by OCA:

> 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. at 84.

We do not believe that OCA presented sufficient reasons to reject Valley's results and accept OCA's proposed adjustment. We agree with the use by Valley's witness of a regression analysis as an appropriate method to forecast future sales. We also agree with Valley's use of several years of data in its analysis as being more appropriate than using only the most recent year of data, as employed by OCA. We believe this will more accurately correct for any abnormal weather conditions that occur in any one year's time period.

In consideration of the various adjustments adopted in this RD, we recommend an overall revenue requirement in this proceeding of $5,556,450.00.

V. EXPENSES

As a matter of constitutional law, a utility is entitled to recover in its rates all legitimate expenses incurred in the rendition of its public utility service. *UGI Corp. v. Pa. Pub. Util. Comm'n,* 410 A.2d 923, 932 (Pa. Cmwlth. 1980). Thus, the general rule is that utilities are permitted to set rates which will recover those operating expenses reasonably necessary to provide service to customers, while earning a fair rate of return on the investment in plant used and useful in providing adequate utility service. *Western Pennsylvania Water Company v. Pa. Pub. Util. Comm'n*, 422 A.2d 906 (Pa. Cmwlth. 1980); *Butler Township Water Co. v. Pa. Pub. Util. Comm'n,* 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984). The objective evaluation of reasonableness is whether the record provides sufficient detail to objectively determine whether the expense is prudently incurred. *Popowsky v. Pa. Pub. Util. Comm'n,* 674 A.2d 1149, 1153-54 (Pa. Cmwlth. 1996). With respect to operating and maintenance expenses, those expenses, if properly incurred, are allowed as part of the overall rate computation. To the extent that expenses are not incurred, imprudently incurred, or abnormally overstated during the test year, they should be disallowed and found not recoverable through rates.

A. Inflation Adjustment

In developing its expense claims, the Company analyzed HTY actual costs and the FTY budget and developed projected costs for the FPFTY. The Company additionally added a 3% wage, salary, and benefit inflation adjustment and other known adjustments to the O&M accounts in its FTY budget. Valley Main Brief at 30. I&E does not object to the inflation adjustment; however, OCA strongly objects to the inflation adjustment. The respective parties' positions will be analyzed below.

Position of the Parties

Valley contends that the Company's use of an inflation adjustment is a realistic approach to projecting expenses for the FPFTY. Company Witness Gorman testified that growth in costs cannot be "known with certainty but can be reasonably estimated." Valley Stmt. No. 1-R at 8.

The Company used the Producer Price Index (PPI) as a guideline in forming its 3% inflation projection. Valley Main Brief at 37. Valley believes that this percentage is reasonable based on Valley's historic trends. That is, Valley claims that historical O&M data indicates that the Company's selection of a 3% escalator is not only appropriate, but conservative. Valley notes that actual historic O&M expenses show a greater than 3% increase every year from 2016 to 2018. Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2. Therefore, Valley believes that 3% is a reasonable and conservative projection of the Company's FPFTY increase in O&M costs.

Valley expects 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 Stmt. No. 4-R at 5.

Valley cites to *Pa. Pub. Util. Comm'n v. Pennsylvania-American Water Co.*, Docket No. R-00038304 at 35 (Order entered Jan. 29, 2004); *Pa. Pub. Util. Comm'n v. Pennsylvania-American Water Co.,* Docket No. R-880916 at 54 (Order entered Oct. 21, 1988), for the proposition that the Commission has recognized the use of inflation factors in projecting costs. Valley also contends that its use of a 3% inflation rate aligns with the Commission's purposes as set forth in Act 11 in establishing the FPFTY as a ratemaking tool. Valley argues that to accept the OCA's position and remove the inflation adjustment would be to assume no cost increases from the FTY to the FPFTY. Valley Main Brief at 38-40.

OCA strongly objects to the use of a 3% inflation adjustment. OCA submits that the proposed 3% inflation factor applied to all expenses is not known and measurable or consistent with the law. OCA's Main Brief at 21. OCA argues that inflationary adjustments are not actually known and measurable because they do not reflect the true cost of expenses in that 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. OCA Stmt. 2 at 9.

OCA cites to a number of cases for the proposition that across-the-board inflation factors, or attrition adjustments, should not be used to establish rates because they are speculative in nature. *See*, *Pa. Pub. Util. Comm'n v. Philadelphia Gas Works*, 2007 Pa. PUC LEXIS 45 (Sept. 28, 2007); *Pa. Pub. Util. Comm'n v. Philadelphia Electric Co.*, 1990 Pa. PUC LEXIS 155 (May 16, 1990); *Pa. Pub. Util. Comm'n v. Philadelphia Electric Co.*, 58 Pa. PUC 7, 11-12 (1983). OCA also argues that a utility cannot meet its burden of proof, per 66 Pa. C.S. § 315(a), by applying the inflation to all its costs because there is no way to assess the reasonableness of the FPFTY expenses relative to HTY or the FTY expenses. OCA states that when utilities file a FPFTY, the utilities 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. OCA argues that no such detail or causes can be provided by Valley because the only explanation is the choice of the inflation escalation rate. OCA Main Brief at 22-23.

OCA additionally opposes the use of the PPI in forming the inflation adjustment and argues that a better measure of inflation for ratemaking purposes would be the forecasted Gross Domestic Product-Price Index (GDP-PI). Witness Morgan argued that if the Commission allows the use of an inflation adjustment, it should be based on the GDP-PI at 2.1%[1], instead of the PPI the Company used. Witness Morgan testified that use of projected GDP-PI is more reasonable for three reasons: (1) past history is not a good predictor of future inflation, therefore, relying on past inflation is not reasonable, (2) the 3% used by the Company was judgmental and did not rely upon an objective quantitative approach for determination, (3) it is a misuse of the PPI to forecast operating costs, especially for projecting expenses for ratemaking purposes. OCA Stmt. 2 at 9-10. OCA notes that the PPI is a family of indexes that measures the average change over time in the selling prices received by domestic producers of goods and services, and claims that the cost changes that the Company is attempting to project are not its price changes but rather the cost changes are those Citizens' is projecting for prices or costs it will pay in

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[1] The forecasted GDP-PI of 2.1% for calendar year 2020 was obtained from the August 2019, Volume 44, No. 8 Blue Chip Financial Forecast.

obtaining goods and services. Thus, OCA believes that the PPI is not an appropriate tool to measure the change in costs. *Id.*

Disposition

We agree with OCA on this issue. Based on the arguments presented above, we find it improper to use an inflation escalation in projecting FPFTY expenses.

Both OCA and Valley have cited to cases to support their positions concerning the inflation adjustment; however, the cases that the parties have cited were decided prior to Act 11, which authorized electric distribution companies to use a FPFTY in their Section 1308(d) base rate proceedings. Although Act 11 allowed for utilities to use the FPFTY to project expenses for the FPFTY, it did not eliminate the "known and measurable" standard. We believe that if a company claims that an expense will increase in the FPFTY, then such a claim must be supported through some known and measurable change in the FPFTY, in order for the company to meet its burden of proof under 66 Pa. C.S. § 315(a).

We agree with OCA's argument that inflation adjustments are not actually known and measurable because they do not reflect the true cost of expenses in that the adjustments are blanket adjustments which do not directly relate to the actual costs expected to be incurred. As discussed more below, we reject the Company's position that the Commission should accept the Company's total FPFTY claim derived from annualization of the Company's FTY YTD data as of September 30, 2019 plus a 3% inflation factor. Assuming that all expenses will increase by 3% is not supported in the record. Given the Company's burden of proof in this proceeding, if the Company alleges that an individual expense will increase in the FPFTY, then such a claim must be supported in the record. Claiming that an individual expense will increase by a blanket percentage does not meet the requisite burden of proof.

Accepting OCA's position is not assuming that there are no cost increases from the FTY to the FPFTY. As indicated in the individual adjustments to the expense sections below, we recommend that the Commission accept FPFTY projections consisting of cost increases from the FTY to the FPFTY that the Company can demonstrate and explain in the record.

Furthermore, we accept OCA's argument that an inflation adjustment of 3% was based on judgment and not a real quantitative approach. Valley argues that a 3% inflation adjustment is appropriate due to historical O&M expense increases of greater than 3%; however, as noted, we do recommend the Company's FPFTY projections that the Company has sufficiency proven in the record. It is not known how the Company specifically came to its 3% inflation adjustment figure. It is a speculative figure that should not be used to set rates.

We recommend Valley not be permitted to apply a blanket 3% inflation adjustment to all of its O&M accounts in its FTY budget.

B. Resolved Expense Issues

In rebuttal testimony, Valley raised two expense adjustments that were accepted by OCA (and not challenged by I&E).

First, the Company explained that its annualized 2019 expense data based on actual expenses incurred as of September 30, 2019 do not reflect that Valley hired a Corrosion Technician on October 7, 2019. Valley Stmt. No. 5-R at 4-5. 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. *Id.* Adjusting the Company's FPFTY claim to reflect the unanticipated 2019 Corrosion Technician hire increases the FPFTY expense by $81,280. *See* Valley Stmt. No. 1-R at 2; *See also* OCA Stmt. No. 1-SR at 4.

Second, the Company also explained that its annualized 2019 expense data based on actual expenses incurred as of September 30, 2019 do not reflect that Valley had an employee take a prolonged medical leave from January 19, 2019 through May 12, 2019. Valley Stmt. 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. *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. *Id.* at 5.

These accepted expense adjustments will be added to the total FPFTY claim determined in this proceeding.

C. Individual Adjustments

I&E and OCA have proposed individual adjustments to Valley's expense claims, an approach that Valley takes exception. While Valley seeks to have its entire FPFTY expense claim ($3,137,541) accepted, it proposes to accept an adjusted FPFTY claim, based on its most recent year-to-date (YTD) data as of September 30, 2019, annualized and adding a 3% inflation factor. As a result, Valley would accept a total expense claim of $3,107,445 (not factoring in the two expense adjustments, noted above), approximately $30,000 less than its total FPFTY claim. In other words, Valley proposed to accept an across-the-board adjustment to expenses based on the annualized FTY expense as of September 30, 2019, plus the 3% inflation adjustment. Additionally, Valley claims that making adjustments to individual expense accounts presents unique challenges for a smaller utility such as Valley, that moves expense amounts between General Ledger accounts based on the operational needs of the Company. Valley Main Brief at 34-36. Valley claims that making individual adjustments to its expense claims ignores the Company's success in managing overall costs very close to its budgeted costs. *Id.*

Valley's argument here will be rejected. A public utility has the burden of proof to establish the justness and reasonableness of every element of its rate increase request in all proceedings under 66 Pa. C.S. § 1308(d). The standard to be met is set forth at 66 Pa.C.S.A. § 315(a), which states "[i]n any proceeding upon the motion of the commission, involving any proposed or existing rate of any public utility, or in any proceedings upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility." 66 Pa.C.S.A. § 315(a). As a result, individual expense claim will be analyzed below to determine the justness and reasonableness of each claim.

1. Rate Case Expense

Position of the Parties

Valley 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.

Valley acknowledges that the filing intervals for its last three rate cases have been 33 months, 36 months, and 110 months, which averages out to 60 months. Regarding the fact that Valley has last filed a rate case in 2010, Valley stated that abnormal circumstances caused the stay out since the 2010 filing, stating the following:

> 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 Stmt. No. 4-R at 5.

In summary, Valley claimed that the long period following the 2010 rate case is an outlier, claiming that it is unlikely that another similarly sized large customer will enter the service territory. Valley Main Brief at 41-43.

Valley cited to cases for the proposition that, while historic filing frequency is a factor considered in determining the time period for rate case normalization, it is not the only factor the Commission considers, citing to *Butler Township Water Co. v. Pa. Pub. Util. Comm'n,* 473 A.2d 219 (Pa. Cmwlth. 1984) and *Pa. Pub. Util. Comm'n. v. UGI Utilities, Inc. – Electric Division*, R-2017-2640058 (Order entered October 25, 2018).

I&E recommends that the rate case expense claim of $271,000 be normalized over 60 months, based on the average number of months between the Company's rate case filings. I&E argues that the factors Valley raises in support of a three-year normalization period do not warrant deviation from Commission precedent of looking towards the average number of months between a Company's rate case filings to determine the normalization period. I&E Main Brief at 20-21.

OCA recommends that the rate case expense claim of $271,000 be normalized over 60 months as well, stating the following:

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

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

<u>Disposition</u>

We agree with Valley on this issue. The total rate case expense claim of $271,000 is not disputed between the parties. At issue is the length of the normalization period for recovery of the rate case expense. Valley requested a 36-month normalization period while I&E and OCA both requested a 60-month normalization period. The filing intervals for its last three rate cases have been 33 months, 36 months, and 110 months, which averages out to 60 months.

It is the Commission's practice to recognize all prudently-incurred rate case expense and set a normalization period based upon historic filing frequency. *City of Lancaster v. Pa. Pub. Util. Comm'n*, 793 A.2d 978 (Pa.Cmwlth. 2002). However, the Commission has also recognized that there are exceptions to the general principle that the history of rate filings represents the best evidence for normalization of rate case expense. In *Pa. Pub. Util. Comm'n v. PPL Electric Utilities Corporation,* Docket No. R-2012-2290597 (Order entered December 28, 2012), PPL's request for a two-year period for normalization of rate case expense was granted despite PPL's historic filing frequency of three years. The Commission was persuaded that PPL's major capital improvement program addressing aging infrastructure warranted an accelerated normalization period for the rate case expense. In the *UGI Order*, UGI's request for a three-year period for normalization of rate case expense was granted despite UGI not having filed for a base rate increase for 22 years. The Commission was persuaded that UGI's ongoing capital improvement costs warranted establishing an amortization period without regard to historic frequency of the Company's base rate filings.

We find that the record supports deviation from the general principle that history of rate filings represents the best evidence for normalization of rate case expense. The record supports a finding that the Company's proposed use of a three-year normalization period for rate case expense is appropriate and that a longer period between rate proceedings is unlikely. We are persuaded by Valley's evidence that shows that the length period of time since the last rate case filing in 2010 is an outlier due to the entry of a large contract customer into Valley's service territory following its 2010 rate case filing. We are persuaded by Valley's claim that it is unlikely that another similarly sized large customer will enter the service territory.

As the Commission noted in the *UGI Order*, the normalization period for rate case expense is an expense that can be based on future expectations. *UGI Order* at 60. Notably, in the *UGI Order*, UGI had not filed a rate case for 22 years. The Commission did not look at UGI's historic filing frequency but instead based its determination to grant UGI's three-year normalization request based off of UGI's future expectations that it would be more likely to file its next rate case within a three-year period.

Looking at Valley's future expectations, Valley does not anticipate another large contract customer entering into its service territory. It is accepted that Valley will likely file its next rate case with three years as compared to a longer period. The historic filing frequency of 60 months is inflated by Valley forgoing a rate case filing for approximately nine years due to the large contract customer. It is also agreed that accepting either I&E or OCA's proposal would likely result in an under collection in the likely event that Valley files a rate case within the next three years. It is more likely that Valley will file a rate case within the next three years as opposed to the next five years, given the history of Valley's filings once the 110-month outlier is removed.

We recommend that the Commission accept Valley's expense claim for rate case expense, to be normalized over three years ($90,333).

2. Industrial / Commercial Meters and Regulators Operations Expense (Account 876)

Position of the Parties

Valley made an original claim of $73,475 for industrial / commercial meters and regulators operations expense for the FPFTY. Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $48,034. The FTY data annualized shows an amount of $64,046. Applying a 3% inflation adjustment to the FTY annualized amount would show an amount of $65,967 for the FPFTY. Valley Stmt. No. 1-R at 6.

Initially, OCA recommended an adjustment of $15,730 to the Company's claim, based off a three-year average of the Account 876 expenses for 2016 through 2018, 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 Main Brief at 43. OCA now recommends an adjustment of $9,429 to Valley's claim, based off the Company's annualized FTY costs as of September 30, 2019. OCA Main Brief at 25-26.

In support of its FPFTY claim, Valley states that it typically incurs approximately 30% of its expense for Account 876 in the 4th quarter of each year, which means that even if the Company annualizes the actual FTY costs incurred as of September 30, 2019, the Company's expense would be understated. Valley Main Brief at 43.

OCA notes that its adjustment did in fact account for the Company's position that approximately 30% of the annual expenses are incurred in the 4th quarter. OCA Stmt. 1-SR at 9-10.

Disposition

We agree with OCA on this issue. In support of its FPFTY claim, Valley notes that it incurs approximately 30% of its expense for this Account in the 4th quarter, and therefore, annualizing the FTY costs incurred as of September 30, 2019 would understate the Company's expense. However, if the FTY costs incurred as of September 30, 2019 were to be annualized by 30%, the figure would increase from $48,034 to $62,444 – less than Valley's FPFTY claim and almost equal to OCA's adjustment claim. Given Valley's original claim of $73,475 for the FPFTY, Valley did not provide sufficient evidence that it would meet or exceed the FTY projections. Therefore, given that OCA's recommendation accounts for the Company's position that approximately 30% of the annual expenses are incurred in the 4th quarter, OCA's position should be excepted. We believe annualizing the FTY costs is the appropriate method here for determining the Company's FPFTY claim, in the light of the lack of justification for the Company's proposed claim.

We recommend that the Commission approve OCA's adjustment for industrial / commercial meters and regulators operations expense and reduce the Company's claim by $9,429. This results in an allowance of $64,046 for Account 876.

3. Meters and House Regulators Operating Expense (Account 878) / Meter Reading Expense (Account 902)

Position of the Parties

Valley made an original claim of $172,563 for meters and house regulators operating expense for the FPFTY and $99,668 for meter reading expense for the FPFTY.

For Account 878, 9-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $135,855. The FTY data annualized shows an amount of $181,140. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $186,574 for the FPFTY. Valley Stmt. No. 1-R at 6.

For Account 902, 9-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $61,453. The FTY data annualized shows an amount of $81,937. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $84,396 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA recommended an adjustment of $33,746 to the Company's original claim for Account 878, based on a three-year average of the Account, on grounds that the Company has not provided a basis for the increase from HTY expense. OCA Stmt. No. 1 at 6. OCA additionally recommends an adjustment of $12,847 to the Company's claim for Account 902, on the basis that the Company's overhead costs incurred through the first 6 months of the FTY (June 30, 2019) for Account 902 are tracking below projected levels. OCA Stmt. No. 1-SR at 11.

Valley argues that OCA's adjustments do not recognize the relationship between the two Accounts. Valley states that work shifted from Account 878 to Account 902 and that accepting OCA's adjustments for both accounts would result in a double disallowance. Valley notes that, as of September 30, 2019, Account 902 was tracking $15,272 below FTY projections, which closely parallels the increased costs observed for Account 878, which was tracking $14,010 above FTY projections as of September 30, 2019. Read together, Valley argues that both accounts are tracking closely to the Company's projected FTY expenses. Valley Main Brief at 44-45; Valley Stmt. No. 1-R at 5.

Disposition

We agree with Valley on this issue. We find Valley's arguments in support of its FPFTY claims for both Accounts persuasive. We find it persuasive that the accounts should be read together and that Account 902 tracking below Valley's FTY projections parallels the increased costs observed for Account 878 due to the shifting of work between both accounts.

We recommend that the Commission approve the Company's claim for meters and house regulators operating expense and meter reading expense.

4. Customer Installations (Account 879)

Position of the Parties

Valley made an original claim of $132,269 for customer installations for the FPFTY. Valley notes that the actual expenses for Account 879 are tracking ahead of projections for the FTY, based on FTY costs as of September 30, 2019. Valley Main Brief at 33.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $102,199. The FTY data annualized shows an amount of $136,265. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $140,353 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA argues that the Company's claim is 16% higher than the expense in the HTY, and that even though overhead costs can vary from year to year, the Company provides no explanation for an increase of this magnitude. OCA Stmt. 1 at 7. As a result, OCA recommends that the Company use a three-year average of the Account 879 expenses for 2016 through 2018, which OCA claims will take into account the increased maintenance cost that may occur. OCA Stmt. 1 at 7-8. Thus, OCA recommends an allowance of $117,396, or an adjustment of $14,873.

Valley argues that the vast majority of the HTY to FTY increase – $13,352 – is due to a 3% increase in wages effective January 1, 2019. Valley Reply Brief at 14.

Disposition

We agree with Valley on this issue. We find that Valley has provided sufficient evidence to justify its projected FPFTY costs, particularly given its explanation that the increase is due mostly due the increase in wages effective January 1, 2019. Thus, Valley did explain the increase in the expense's overhead costs, and we do not feel as a result that reduction to Valley's claim is justified. It is particularly persuasive that actual expenses for the Account are tracking ahead of projections, based on annualization of the FTY costs as of September 30, 2019.

We recommend that the Commission approve the Company's claim for customer installations.

5. Mains Operating Expense (Account 887)

Position of the Parties

Valley made an original claim of $98,308 for mains operating expense in the FPFTY. This expense is $41,499, or 73%, higher than the expense in the HTY. Valley reasoned the increase is due to "additional purchases for an ongoing project to update signage, pipeline markers, and corrosion studies." OCA Stmt. 1 at 8.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $29,976. The FTY data annualized shows an amount of $39,968. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $41,167 for the FPFTY. Valley Stmt. No. 1-R at 6.

Initially, OCA proposed a $19,998 adjustment alleging that the Company's claim included non-recurring costs associated with a one-time project. OCA Stmt. No. 1 at 8. Valley in rebuttal testimony alleged that OCA overstated the proportion of mains costs associated with the one-time project. Valley Stmt. No. 4-R at 8. As such, OCA lowered its adjustment to $1,219. OCA Main Brief at 29.

Disposition

We agree with OCA on this issue. We find that Valley justified the majority of this expense, given that the Company indicated that it has not completed an ongoing project and will likely continue to experience similar levels of expense going forward (in the FPFTY) due to ongoing maintenance to address its aging infrastructure. However, Valley's claim should be adjusted by $1,219, which the Company admits was a one-time expense related to signage purchase. OCA Reply Brief at 18. Expenses that are imprudently incurred should be disallowed and found not recoverable through rates.

We recommend that the Commission approve OCA's adjustment for mains operating expense and reduce the Company's claim by $1,219.

6. Customer Records & Collection Expense (Account 903)

Position of the Parties

Valley made an original claim of $513,237 for customer records and collection expense in the FPFTY. The claim represents a 10% increase over the two years from the HTY to the FPFTY. Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 4. Valley cites increasing benefits and payroll expenses as the basis for this increase. OCA Main Brief at 31. Specifically, Valley claims that Company-wide overhead expenses will increase during 2019 and particularly in 2020 due to the Corrosion Technician hired in October 2019, as that position was not accounted for in the FTY budget. Valley Main Brief at 3, 32, 34.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $349,623. The FTY data annualized shows an amount of $466,164. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $480,149 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA proposes to disallow $32,977 of this claimed expense by allowing 3% overhead cost increases from the HTY to the FTY and removing the 3% inflation adjustment from FTY to FPFTY. OCA Main Brief at 31. OCA argues that YTD overhead data as of June 30, 2019 supports its adjustment because overhead YTD data within Account No. 903 is tracking lower than projected as of the first half of 2019. OCA argues that the level of overhead expenses that the Company is claiming for this claim has not been experienced by the Company through the first half of 2019. OCA Main Brief at 30.

Disposition

We agree with OCA on this issue. We find that Valley has not justified its projection that Company-wide overhead expenses will meet or exceed the FTY projections, given that overhead YTD as of June 30, 2019 is tracking lower than what the Company has projected. Using the more up to date figures provided by the company, the overhead YTD as of September 30, 2019 is still tracking lower than what the Company has projected. Regarding the addition of the Corrosion Technician that has not factored into the FTY budget, as mentioned previously, we have accepted the Company's expense adjustment of $81,280 for the Corrosion Technician. This adjustment will be reflected in the overall FPFTY claim in this proceeding.

We recommend that the Commission approve OCA's adjustment for customer records and collection expense. However, given that OCA recommendation of $480,260 ($513,237 - $32,977) is higher than the Company's YTD FTY data annualized, we recommend that the Commission accept an allowance of $466,164 for Account 903. $466,164 is the 9-month FTY data annualized without the inflation adjustment.

7. Miscellaneous Customer Expense (Account 905)

Position of the Parties

Valley made an original claim of $24,449 for miscellaneous customer expense in the FPFTY. The claim is a 17% reduction from the HTY to the FPFTY. OCA Main Brief at 32-33. The account has been adjusted for a decrease in transportation, materials, and supplies.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $18,177. The FTY data annualized shows an amount of $24,236. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $24,963 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA proposes to disallow $8,980 of this claimed expense. OCA argues that, although the account has been adjusted for a decrease in transportation, materials, and supplies, the Company did not adjust the account for the inclusion of $8,267 in 2018 for an IT backup system expense that should have been capitalized. OCA Stmt. 1 at 14. OCA recommends that the Account be lowered to account for the one-time expense and to eliminate the Company's inflation adjustment. OCA Main Brief at 33.

Valley claims that OCA has provided no evidence that the $8,267 expense is non-recurring in future years. Valley Reply Brief at 16.

Disposition

We agree with OCA on this issue. OCA's allowance reflects removal of a one-time expense and elimination of the Company's 3% inflation adjustment. Valley claims that OCA provided no evidence that the IT backup system expense was non-recurring, however, the burden of proof is on Valley in this proceeding. Valley did not provide sufficient evidence to show that the IT backup system expense would reoccur in future years, and not just one time in

2018. In light of the lack of justification, we recommend that the IT backup system be disallowed.

OCA's adjustment for miscellaneous customer expense is $8,980. Our calculations provide for an adjustment of $8,515. Our calculations provide for the removal of the IT backup system expense and elimination of the Company's 3% inflation adjustment ($8,267 * 1.03 = $8,515).

We recommend that the Commission approve an adjustment for miscellaneous customer expense and reduce the Company's claim by $8,515.

8. Administrative & General Salaries (Account 920)

Position of the Parties

Valley made an original claim of $536,697 for administrative and general salaries in the FPFTY. This projection is an increase to the overhead portion of this expense, as Valley cites increasing benefits costs for this increase. OCA Main Brief at 33.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $349,820. The FTY data annualized shows an amount of $466,427. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $480,420 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA proposes to disallow $76,645 of this claimed expense by allowing only 3% overhead cost increases from the HTY to the FTY and removing the 3% inflation adjustment from FTY to FPFTY. OCA argues that YTD overhead data as of June 30, 2019 supports its adjustment, stating that the Company actual costs are not trending towards its projections. OCA Main Brief at 33-34.

Valley notes that, even if the Company's claim is adjusted to reflect YTD FTY expenses, OCA's proposal would still understate the allowance for Account 920 because the YTD expense as of September 30, 2019 is tracking $56,277 below the Company's original projection (inclusive of the 3% inflation adjustment). Valley Main Brief at 33.

In addition, Valley claims that Company-wide overhead expenses are projected to increase beyond the annualized numbers due to the Corrosion Technician hired in October 2019, a position that was not in the FTY budget. Valley Main Brief at 3, 32, 34.

Disposition

We agree with OCA on this issue. In support of their FPFTY claim, Valley cited to the addition of the Corrosion Technician hired in October 2019, a position that was not factored into its FTY budget. Regarding the addition of the Corrosion Technician that has not factored into the FTY budget, as mentioned previously, we have accepted the Company's expense adjustment of $81,280 for the Corrosion Technician. This adjustment will be reflected in the overall FPFTY claim in this proceeding. Valley additionally cites to "increasing benefits costs" as the reason for the increase in this account; however, YTD data does not support this claim, as actual YTD data as of September 30, 2019 does not reflect this claimed increase.

We recommend that the Commission approve an allowance of $466,427, or a reduction of $70,270 to the Company's original claim. $466,427 is the annualized FTY YTD expense for administrative and general salaries as of September 30, 2019, with no inflation adjustment. Valley Stmt. 1-R at 6. We believe this figure more accurately reflects projected expenses for the FPFTY as Valley has not justified that the annualized FTY amount would increase in the FPFTY.

9. Office Supplies and Expense (Account 921)

Position of the Parties

Valley made an original claim of $74,701 for office supplies and expense in the FPFTY. This figure is $22,677, or 44 %, higher than the expense in HTY. OCA Stmt. 1 at 16. The most significant increase is noted from the HTY to the FTY, when the Company forecasts that travel and training expenses will increase by $18,961. *Id.* The Company cites the need for increased training for new hires and replacements as the reasons for these expenses. Specifically, Valley explained that the Company's claim is reasonable because Valley will incur 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." Valley Main Brief at 46; Valley Stmt. No. 4-R at 9.

Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $44,951. The FTY data annualized shows an amount of $59,934. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $61,732 for the FPFTY. Valley Stmt. No. 1-R at 6.

OCA posits that Valley is only anticipating one new hire in the FPFTY, indicating that the training expense should not increase from prior years. OCA Stmt. 1 at 16. In addition, OCA claims that it is unlikely that the Company will experience a significant increase in travel and training expenses, based upon its travel and training expenses recognized through the first half of 2019 (as of June 30, 2019). OCA Stmt. 1 at 16. Therefore, OCA 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 Stmt. 1 at 6. Using this methodology, OCA calculates the Account 921 travel and training expense to be $41,806 in the HTY, which would bring the Account 921 FPFTY total to $55,191. *Id.*

Disposition

We agree with OCA on this issue. Valley has provided no justification for its speculation that its travel and training expenses will significantly increase during the FPFTY. Specifically, Valley has not provided evidence that it would be experiencing an influx of new hires to justify increased travel and training expenses. As OCA noted, Valley is only anticipating one new hire in the FPFTY. Valley's comments that the increase in costs is for "increasing regulatory obligations for certified Operators and employee training for continually evolving human resources issues" is speculative in nature. Without justification that travel and training expenses will increase due to new hires, Valley's original FPFTY claim for this expense has not been justified and supported in the record.

However, we do agree with Valley, in that OCA's adjustment should be modified to reflect more recent YTD projections as of September 30, 2019. Valley's YTD projections as of September 30, 2019, annualized (and without an inflation adjustment), gives a figure of \$59,934. We believe this figure more accurately represents the projected costs for this expense for the FPFTY, as it reflects the travel and training expenses that Valley has experienced through the first 9 months of 2019.

We recommend that the Commission approve an allowance of \$59,934 for Account 921, the YTD projection as of September 30, 2019.

10. Regulatory Commission Expense (Account 928)

Position of the Parties

Valley made an original claim of \$38,524 for Regulatory Commission Expense in the FPFTY. Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of \$26,805. The FTY data annualized shows an amount of \$35,740. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of \$36,813 for the FPFTY. Valley Stmt. No. 1-R at 6.

I&E recommends that the entire claim for Regulatory Commission Expenses be denied because Valley failed to provide an adequate explanation or support for its claim where PUC assessment and Public Utility Realty Tax were double counted. I&E Main Brief at 14-15. More specifically, Valley identified regulatory Commission expenses as consisting of the Commission assessment and Public Utility Realty Tax (PURTA), and that Valley already claimed PURTA of $10,000 and PUC assessment expense of $24,296 on Valley Exhibit No. HSG-1, Schedule C1-3(R) as taxes other than income taxes. I&E Stmt. No. 1-SR (Errata Version) at 15.

Valley states that it accepts I&E's adjustment if the Commission denies the Company's primary proposal to accept its FPFTY expense claim based on the FTY annualized expense, the 3% inflation factor and the additional expense adjustments described in Ms. Levering's testimony (the adjustments relating to the Corrosion Technician hire and the employee prolonged employee absence due to medical leave). Valley Stmt. No. 5-R at 4-5.

Disposition

We agree with I&E on this issue. We are persuaded by I&E's argument that Valley already claimed PURTA of $10,000 and Commission assessment expense of $24,296 as taxes other than income taxes. Thus, allowing Valley to recover for these expenses here would be improper and would allow Valley to double count for the Commission assessment and PURTA. Furthermore, Valley did not oppose I&E's position. Also with respect to the expense adjustments, as noted previously in this Decision, the total FPFTY expense claim recommended in this proceeding will be adjusted to reflect inclusion of the expense adjustments.

We recommend that the Commission approve I&E's adjustment, which disallows the entirety of the Company's claim. This would be a reduction of $36,813 from the Company's FPFTY claim as of September 30, 2019.

11. General Advertising Expense (or Miscellaneous General Expenses) (Account 930)[2]

Position of the Parties

Valley made an original claim of $73,373 for general advertising expense in the FPFTY. Nine-month data for the FTY (as of September 30, 2019), provided by the Company shows a FTY amount of $48,074. The FTY data annualized shows an amount of $64,099. Applying a 3% inflation adjustment to the FTY annualized amount would show a new claim of $66,022 for the FPFTY. Valley Stmt. No. 1-R at 6.

I&E recommends an adjustment of $14,415 to the Company's original claim. The first component of I&E's recommended $14,415 downward adjustment reflects the $7,351 downward adjustment ($73,373 – $66,022) from Valley's original claim to the FTY annualized amount with a 3% inflation adjustment. The second component of $7,064 comprises $6,603 for volunteer labor and $461 for volunteer expense. I&E Exhibit No. 1-SR, Schedule 1 at 1. I&E argues that the Company has not provided adequate analysis, support, or documentation that volunteer labor provides direct benefits to ratepayers and is an operational cost necessary to provide safe and reliable natural gas service. I&E Main Brief at 16. I&E additionally argues that ratepayers should not be required to finance the Company's decision to pay its employees to provide volunteer labor as some of this volunteer labor may be for organizations that ratepayers would choose not to support. I&E Stmt. No. 1-SR (Errata Version) at 19.

OCA recommends an adjustment of $3,889 to the Company's original claim, removing the Company's inclusion of off-site volunteering labor.

Valley posits that volunteer expenses benefit Valley's customers by contributing to a productive and engaged workforce. Valley Main Brief at 47; Valley Stmt. No. 4 at 10. Valley claims the volunteer programs foster happy, healthy, and fulfilled employees, which helps

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

to reduce turnover and to increase employee productivity. Valley claims that this increased productivity benefits ratepayers through better service. *Id.*

Disposition

We agree with OCA on this issue. The primary point of contention between the position of the three parties is whether or not expenses that the Company undertook relating to volunteer labor were expenses necessary for Valley to provide gas service to its customers. As cited, utilities are permitted to recover operating expenses reasonably necessary to provide service to customers. *Western Pennsylvania Water Company v. Pa. Pub. Util. Comm'n*, 422 A.2d 906 (Pa. Cmwlth. 1980); *Butler Township Water Co. v. Pa. Pub. Util. Comm'n,* 81 Pa. Cmwlth. 40, 43-44, 473 A.2d 219, 221 (1984). We find that Valley has not provided sufficient evidence that off-site volunteer work expenses are necessary in the provision of its gas service to its customers. As a result, we believe a reduction to the Company's claim to remove these unnecessary expenses is needed.

We recommend that the Commission approve OCA's adjustment of $3,889 to the Company's claim.

12. C&T Allocation Expense

Position of the Parties

Valley's FPFTY expense claim includes $233,608 for allocated expenses for shared services from C&T. Valley applied a 1% increase from FTY costs based on historical increases to its C&T allocation to come to this figure, instead applying the 3% inflation adjustment. I&E Stmt. No. 1, Exhibit No. 1, Schedule 9 at 1.

I&E recommended an adjustment of $44,429 to the Company's claim. I&E makes this adjustment because the projected increase from the HTY to the FTY exceeds the historical annual increases for this expense item. I&E Stmt. No. 1 at 18-19. I&E's figure is based on the Company's average annual percentage increase of the C&T Allocation to Valley from 2016 to the HTY. I&E Main Brief at 18-19. I&E claims that the current FTY data confirms that its recommendation is reasonable.

Valley provided YTD data that shows that the expense for C&T Allocation Expense is $128,441.23 as of September 30, 2019. Valley Rejoinder Exhibit No. 7. Annualizing the YTD FTY data and adding a 1% increase would result in a FPFTY claim of $172,967. *Id.* Valley claims that the Company's historical annual expense for C&T Allocation Expense exceeded the 2019 projections in 2016, 2017, and 2018, thus annualizing the YTD data would not produce a reasonable expense claim for the Company's C&T Allocation. *See* I&E Stmt. No. 1, I&E Exhibit No. 1, Schedule 9 at 1.

In that regard, Valley states that anticipated future trends support approval of the Company's claim for C&T Allocation Expense. Valley notes that the C&T Allocation is based on the revenue and meter counts for Valley and its affiliated operating companies. *See* I&E Stmt. No. 1, Exhibit No. 1, Schedule 9 at 1. As revenue and meter counts determine the C&T Allocation Expense, Valley asks that the Commission consider that the first phase of the East Athens Main Extension project was not scheduled for completion until November 2019. *See* I&E Stmt. 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, Valley claims that 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. Valley Main Brief at 47-48.

Disposition

We agree with Valley on this issue. Valley provided sufficient evidence to justify its FPFTY claim, specifically by connecting its claim to the East Athens Main Extension project. We agree that the YTD numbers as of September 30, 2019 do not reflect additional customers in East Athens anticipated to begin service beginning late in the FTY and throughout the FPFTY because the East Athens Mains Extension project had not yet been completed as of the YTD numbers. Use of the FPFTY allows Companies to base expenses on future expectations. Thus, we find that Valley's FPFTY projections are justified. Valley's FPFTY projection will account for the additional customers who will begin service as a result of the completed East Athens Main Extension project.

We recommend that the Commission approve an allowance of $233,608 for this claim. As this recommendation recommends approval of estimated projected expenses that will be included in the Company's base rates, we also believe that it would be in the public interest that the Company's future actual expenditures related to the allowed expense be monitored to ensure the accuracy of projected expenses. *See* 66 Pa. C.S. § 315(e).

13. Uncollectible Expense

Position of the Parties

Valley made a claim of $55,430 for uncollectible expense in the FPFTY. Valley's claim 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 Stmt. No. 1, Exhibit__(HSG-1), Schedule C4 (R).

I&E recommends a $24,201 adjustment to Valley's claim. I&E also recommends that the Commission use the write-off ratio of 0.62% to determine the additional uncollectible accounts expense attributable to any final base rate increase to be determined in this proceeding. I&E Stmt. No. 1 at 16. I&E's recommendation and the 0.62% write-off ratio is based on three years of historic gross revenues and net write-offs. I&E Stmt. No. 1 at 15-16.

Valley opposes I&E's recommendation and states the Company's calculation for uncollectible accounts expense is based on the most recent Company experience and is more appropriate than I&E's recommendation, which uses three years of data. Valley Errata Stmt. No. 1-R at 4. Valley also states that it is concerned that I&E's proposal would understate uncollectible expense following the 0.84% write-off percentage experienced in the HTY. *See*

Valley Stmt. No. 1-R at 4. Valley also notes 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 Stmt. No. 1, Exhibit No. 1, Schedule 6 at 1.

I&E argues that the Company's use of the most recent information to determine its uncollectible accounts expense ignores the fact that this expense fluctuates from year to year. I&E Stmt. No. 1-SR (Errata Version) at 22. The Company's three-year net write-off history is 0.49% for 2016, 0.52% for 2017, and 0.84% for the HTY. I&E Stmt. No. 1 at 16. Since the HTY indicates a much larger net-write off ratio than the previous two years, I&E argues that the Company would be overstating its claim by using only the most recent experience.

<u>Disposition</u>

We agree with I&E on this issue. We agree that the Company has overstated its claim by only using the 0.84% write-off percentage experienced in the HTY to determine uncollectible expense, when its write-off percentage experienced in the HTY is greater than the write-off percentages experienced in previous two years. The Company's three-year net write-off history of 0.49% for 2016, 0.52% for 2017, and 0.84% for the HTY shows that this expense fluctuates from year to year and is generally lower than the write-off percentage experienced in 2018. As a result, it would be imprudent to simply look at the 2018 HTY write-off percentage to determine uncollectible expense. We find that I&E's suggestion to use a write-off ratio of 0.62% to determine additional uncollectible accounts expense attributable to any final base rate increase to be reasonable, given that the ratio was derived from the average of the last three-year net write-off histories ((0.49% + 0.52% + 0.84%) / 3 = 0.62%). Using the three-year averages normalizes the write-off percentage and prevents over recovery of this expense.

We recommend that the Commission approve an allowance of $31,229, or a reduction of $24,201 to the Company's claim. We also recommend that the Commission use the write-off ratio of 0.62% to determine the additional uncollectible accounts expense attributable to any final base rate increase to be determined in this proceeding.

14. Cash Working Capital

As noted previously in this Decision, Valley's cash working capital claim is based on one-eighth (12.5%) of its O&M expenses. Thus, the adjustment to cash working capital will be made in accordance with the total O&M adjustments adopted in this proceeding.

Based on the total O&M expense adjustments ($164,072), cash working capital will be adjusted downwards by $20,509 ($164,072 * 12.5%).

15. Depreciation Expense

Position of the Parties

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 Stmt. 2 at 7; OCA Main Brief at 38.

OCA recommends an adjustment to the depreciation expense in order 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 submits that the Company should base its depreciation expense on average plant in service in the FPFTY. Thus, OCA recommends that the Company use an average test year rate base, and therefore, claims the accumulated depreciation expense should be reduced by $33,805. OCA Main Brief at 38; OCA Stmt. 2 at 8.

Disposition

We agree with Valley on this issue. A utility seeking to recover a depreciation deficiency from rates has the burden of proving that the deficiency is genuine. *Pa. Power & Light Co. v. Pa. Pub. Util. Comm'n,* 10 Pa.Cmwlth. 328, 339 (Pa. Cmwlth. 1973). The genuineness of a deficiency is proved by the utility's demonstrating that it has not received revenues sufficient to pay all of its operating expenses together with a fair return on its rate base during the years when the deficiency was created. See generally, *U.S. Steel Corp. v. Pa. Pub. Util. Comm'n,* 37 Pa.Cmwlth. at 212-19 (Pa. Cmwlth 1978); *Pa. Power & Light Co*. at 339-42. The issue between Valley and OCA with respect to depreciation expense is the question of what methodology should be used to base the depreciation expense on. Valley proposed an end-of-year methodology while OCA proposed an average rate base methodology.

In the *UGI Order* the Commission permitted UGI Electric to use the end-of-year methodology in its FPFTY, so that its depreciation expense claim reflected end-of-the year conditions. *UGI Order* at 74-76. We note that the Commission's order on this issue was upheld by the Pennsylvania Commonwealth Court on January 15, 2020. See, *McCloskey v. Pa. Pub. Util. Comm'n.,* 1549 C.D. 2018 (Pa.Cmwlth. Jan. 15, 2020). As to remain consistent with the Commission's decision in *UGI Order,* Valley should be permitted to utilize end-of-year methodology in the FPFTY. Thus, it is proper for Valley to base its test year depreciation expense on the projected balance of plant in service as of the end of the FPFTY. We recommend that the Commission reject OCA's recommendation to reduce the accumulated depreciation expense.

D. Conclusion

Consistent with the above discussion, we recommend an adjustment of total claimed expenses for the FPFTY in the amount of $164,072, which makes the total O&M expenses $3,083,575 prior to the increase in revenue requirement and $3,086,657 after the revenue requirement increase.[3] We have accepted Valley's end-of-year methodology for calculating the FPFTY in this proceeding, so no reductions were made based on the use of an average rate-based methodology.

[3] Expenses will increase with the increase in revenues, due to accounting for an increase in uncollectibles at 0.62%.

VI. FAIR RATE OF RETURN

Valley is seeking in this proceeding an overall rate of return of 7.72%, including a cost of long-term debt of 4.54% and a cost of common equity of 10.60%. Valley Main Brief at 91. As more fully explained below, we recommend an overall rate of return of 7.37%, including a cost of long-term debt of 4.54% and a return on common equity of 9.93%. The return on common equity rate of 9.93% includes the 25-basis point addition requested by the company for management effectiveness.

A. Legal Standards

A public utility seeking a general rate increase is entitled to an opportunity to earn a fair rate of return on the value of the property dedicated to public service. *Pa. Gas and Water Co. v. Pa. Pub. Util. Comm'n*, 341 A.2d 239 (Pa. Cmwlth. 1975) In determining what constitutes a fair rate of return, the Commission is guided by the criteria set forth in *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Comm'n v. Hope Natural Gas Co*., 320 U.S. 591 (1944). In *Bluefield* the United States Supreme Court stated:

> 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. A rate of return may reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-23 (1923).

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,* 262 U.S. at 693. These principles have been adopted and applied by the Appellate Courts of Pennsylvania in numerous cases. *Riverton Consolidated Water Co. v. Pa. Pub. Util. Comm'n*, 140 A.2d 114 (Pa. Super. 1958); *Pittsburgh v. Pa. Pub. Util. Comm'n*, 126 A.2d 777 (Pa. Super. 1956); *Lower Paxton Twp. v. Pa. Pub. Util. Comm'n*, 317 A.2d 917 (Pa. Cmwlth. 1974).

The return allowed to investors must be commensurate with the risk assumed, as the Supreme Court has stated in three landmark opinions. *Bluefield*, *supra*, requires that the rate of return reflect:

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

262 U.S. at 692.

The Supreme Court reiterated that standard in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), as follows:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 603.

Later, in reaffirming *Hope*, the Supreme Court, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989) observed that "[o]ne of the elements always relevant to setting the rate under *Hope* is the return investors expect given the risk of the enterprise."

The determination of a fair rate of return thus requires the review of many factors, including: (1) the earnings which are necessary to assure confidence in the financial integrity of the company and to maintain its credit standing; (2) the need to pay dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development and operation. *Pa. Pub. Util. Comm'n. v. Pa. Gas and Water Co. - Water Division*, 341 A.2d 239 (Pa. Cmwlth. 1975); *Lower Paxton Twp.*, supra. Moreover, the Commission's findings must be based upon substantial and competent evidence on the record before it, not upon speculation or hypothesis. *Ohio Bell Telephone Co. v. Pub. Util. Comm'n of Ohio*, 301 U.S. 292 (1937); *United States Steel Corp. v. Pa. Pub. Util. Comm'n*, 390 A.2d 849 (Pa. Cmwlth. 1978); *Octoraro Water Co. v. Pa. Pub. Util. Comm'n*, 391 A.2d 1129 (Pa. Cmwlth. 1978).

In analyzing a proposed general rate increase, the Commission determines a rate of return to be applied to a rate base measured by the aggregate value of all the utility's property used and useful in the public service. In determining a proper rate of return, the Commission calculates the utility's capital structure and the cost of the different types of capital during the period in issue. The Commission has wide discretion, because of its administrative expertise, in determining the cost of capital. *Equitable Gas Co. v. Pa. Pub. Util. Comm'n*, 405 A.2d 1055 (Pa. Cmwlth. 1979).

B. Capital Structure

Valley is proposing in this proceeding a capital structure of 47.45% debt and 52.55% equity. Valley Joint Stmt. 2at 13. No parties dispute Valley's proposal. OCA Stmt. 3 at 3; I&E Stmt. 2 at 12. We recommend adoption of Valley's proposed capital structure.

C. Cost of Long-Term Debt

Valley is proposing in this proceeding a cost of long-term debt rate of 4.54%. No parties dispute Valley's proposal. OCA Stmt. 3 at 3; I&E Stmt. 2 at 14. We recommend adoption of Valley's proposed cost of long-term debt rate.

D. Cost of Common Equity

Valley seeks a 10.60% return on common equity, which results in an 7.72% overall rate of return. Valley Main Brief at 91. This is based on its proposed capital structure of 47.45% long-term debt and 52.55% common equity.

Description	**Capitalization Ratio**	**Embedded Cost**	**Return-%**
Long-Term Debt	47.45%	4.54%	2.15%
Common Equity	52.55%	10.60%	5.57%
Total	100.00%		7.72%

OCA states that the Company's request for a return on equity of 10.60% is well in excess of an objective assessment of investor market requirements in the current economic environment and should be rejected. OCA Main Brief at 41. OCA recommends a fair overall rate of return of 6.75%, including a cost of common equity of 8.34%. OCA Main Brief at 40. OCA developed the following chart:

Description	**Capitalization Ratio**	**Embedded Cost**	**Return-%**
Long-Term Debt	47.45%	4.98%	2.36%
Common Equity	52.55%	8.38%	4.39%
Total	100.00%		6.75%

OCA Main Brief at 40.

I&E used the DCF model and the CAPM as a comparison to the DCF results. I&E recommends a 6.60% overall rate of return and an 8.46% return on equity.

Description	Capitalization Ratio	Embedded Cost	Return-%
Long-Term Debt	49.33%	4.86%	2.40%
Common Equity	50.67%	8.10%	4.10%
Total	100.00%		6.50%

I&E Main Brief at 24-25.

Valley witness D'Ascendis conducted an analysis of multiple ROE models to develop an ROE of 9.35%, based on his Gas Utility Proxy Group. 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 effective 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 Stmt. No. 2-R, Exhibit __(DWD-1R), Schedule 1R at 2.; Valley Main Brief at 52-53.

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").

Valley Joint Stmt. 2 at 4-5; Valley Main brief at 54-55.

The results derived from each are as follows:

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	%

Valley Joint Stmt. 2-R, Exhibit __(DWD-1R), Sch. 1R at 2; Valley Main Brief at 56.

As indicated in the above table, the company's recommended ROE is 10.30%. Valley Main Brief at 56.

Both I&E and OCA recommend using the Discounted Cash Flow (DCF) method as the primary method to determine the cost of common equity, with the results of the Capital

Asset Pricing Model (CAPM) used as a comparison to the DCF results. OCA Main Brief at 46-47; I&E Main Brief at 28-29.

In addressing this issue is prior decisions, the Commission has stated:

> Although there are various models used to estimate the cost of equity, the Discounted Cash Flow (DCF) method applied to a barometer group of similar utilities, has historically been the primary determinant by the Commission. *Pa. PUC v. City of Lancaster – Water Bureau,* Docket No. R-2010-2179103, at 56 (Order entered July 14, 2011); *Pa. PUC v. PPL electric Utilities, Corp.,* Docket No. R-00049255, at 59 (Order entered December 22, 2004). The DCF model assumes that the market price of a stock is the present value of the future benefits of holding the stock. These benefits are the future cash flows of holding the stock, *i.e.*, the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than dollars received today, the cash flow must be "discounted" back to the present value at the investor's rate of return.

2012 PPL Order at 69-70.

More recently, the Commission affirmed reliance primarily on the DCF and rejected giving equal weight to the other methodologies. In *City of Dubois – Bureau of Water*, the Commission stated:

> [T]he City's cost of equity in this proceeding should be based upon the use of the DCF methodology, with the other methodology results used as a check on the reasonableness of the DCF results. We note that we have primarily relied upon the DCF methodology in arriving at previous determinations of the proper cost of equity and utilized the results of methods other than the DCF, such as the CAPM and RP methods, as a check upon the reasonableness of the DCF derived equity return calculation, tempered by informed judgement. We are not persuaded by the arguments of the City that we should assign equal weight to the multiple methodologies.

Pa. Pub. Util. Comm'n v. City of DuBois – Bureau of Water, Docket No. R-2016-2554150at 96-97 (Order entered March 28 2017).

In *UGI Utilities, Inc. – Electric Division*, the Commission stated:

> The ALJs adopted the positions of I&E and the OCA that the DCF method should be the primary method used to determine the cost of common equity, and that the results of the CAPM should be used as a comparison to the DCF results. The ALJs found no reason to deviate from these preferred methods in this proceeding. Therefore, the ALJs recommended against the use of the RP and CE methods proffered by UGI. Further, the ALJs noted that the companies analyzed under the CE model are too dissimilar to a regulated public utility company. R.D. at 60, 76, 81-82….[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. Accordingly, we shall deny UGI's Exceptions on this issue.

Pa. Pub. Util. Comm'n v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058 at 103-06 (Order entered October 25, 2018).

We agree with I&E and OCA, based on Commission precedent, in the use of the DCF and CAPM models as the preferred methods to determine an appropriate cost of common equity and see no reason to deviate from these preferred methods in this proceeding.

1. Barometer Groups

As explained by I&E witness Henkel, a proxy (or barometer) group is a group of companies that act as a benchmark for determining the utility's rate of return. A proxy group is also typically used because using data exclusively from one company may be less reliable than using a group of companies because the data for one company may be subject to short-term anomalies that distort its return on equity. Use of a proxy group smooths these potential anomalies. Use of a proxy group also satisfies the long-established principle of utility regulation that seeks to provide the utility the opportunity to earn a return equal to that of similar risk enterprises. I&E Stmt. 2 at 6.

Valley witness D'Ascendis initially proposed a gas utility proxy group based on the following criteria:

1. The company must be included in the Natural Gas Utility Group of *Value Line's Standard Edition* (March 1, 2019);

2. The company must have 60% or greater of fiscal year 2017 total operating income derived from, and 60% or greater of fiscal year 2017 total assets attributable to, regulated gas distribution operations;

3. At the time of preparation of Mr. D'Ascendis' testimony, the company must not have publicly announced that they were involved in any major merger or acquisition activity (i.e., one publicly-traded utility merging with or acquiring another);

4. The company must not have cut or omitted their common dividends during the five years ended 2017 or through the time of preparation of Mr. D'Ascendis' testimony;

5. The company must have *Value Line* and Bloomberg Professional Services ("Bloomberg") adjusted betas;

6. The company must have positive *Value Line* five-year dividends per share ("DPS") growth rate projections; and

7. The company must have *Value* Line, Reuters, Zacks, or Yahoo! Finance consensus five-year earnings per share ("EPS") growth rate projections.

Valley Stmt. 2 at 12.

I&E witness Henkel applied the following criteria to produce a proxy group that resembles the natural gas utility industry.

1. Fifty percent or more of the company's revenues must be generated from the regulated natural gas utility industry;

2. The company's stock must be publicly traded;

3. Investment information for the company must be available from more than one source, including Value Line;

4. The company must not be involved in an announced merger or the target of an announced acquisition at the time of this analysis;

5. The company must have five consecutive years of historic earnings data; and

6. The company must be operating in a state that has a deregulated gas utility.

I&E Stmt. 2 at 7.

OCA witness Habr generally accepted and utilized Mr. D'Ascendis' chosen gas proxy group. OCA Stmt. 3 at 9.

I&E argues in its Main Brief:

> I&E witness Henkel disputes Valley witness D'Ascendis's proxy group. In direct testimony, I&E witness Henkel excludes two of the companies Valley witness D'Ascendis originally uses and includes one company that Valley witness D'Ascendis does not use.[4] The two excluded companies are New Jersey Resources Corp. and South Jersey Industries, Inc. Both companies did not meet I&E witness Henkel's first criterion that fifty percent or more of the company's revenues must be generated from the regulated gas utility industry. If Valley witness D'Ascendis' second criterion[5] for selecting proxy group companies was based upon fiscal year 2018 data, both New Jersey Resources Corp. and South Jersey Industries, Inc. would not have qualified for his Gas Utility Proxy Group. Stated differently, I&E witness Henkel's proxy group criteria are based upon more current information.[6]
>
> In rebuttal testimony, Valley witness D'Ascendis removed New Jersey Resources Corporation after re-running his selection criteria.[7] However, South Jersey Industries, Inc. remains part of Valley's proxy group.

I&E Main Brief at 33-34.

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4 I&E witness Henkel included Nisource, Inc. in his proxy group while Valley witness D'Ascendis did not include Nisource, Inc. in his Gas Utility Proxy Group. I&E Stmt. No. 2 at 11.

5 Valley Stmt. No. 2 at 12, lines 12-14.

6 I&E Stmt. No. 2 at 10.

7 Valley Stmt. No. 2-R at 3-4.

Valley argues in response:

> To support its proposed proxy group, I&E alleges in its Direct Testimony that it uses more current information than Mr. D'Ascendis. I&E Main Brief at 34. However, as noted in Valley's Main Brief, Mr. D'Ascendis updated his proxy group in Rebuttal testimony based on data available as of September 30, 2019. *See* Valley Main Brief at 51; *see also* Joint Statement No. 2, Exhibit__(HSG-1R), Schedule DWD-1R. Accordingly, Mr. D'Ascendis' proxy group is based on the most current data and should be accepted by the Commission.

Valley Reply Brief at 22.

The following chart illustrates the parties' positions:

Proxy Groups of the Parties

Valley	OCA	BIE
Atmos Energy Corporation	**Atmos Energy Corporation**	Atmos Energy Corporation
Northwest Natural Holding Co.	**New Jersey Resources**	NiSource Inc.
ONE Gas, Inc.	**Northwest Natural Holding Co.**	Northwest Natural Gas
South Jersey Industries, Inc.	**One Gas, Inc.**	ONE Gas Inc.
Southwest Gas Holdings, Inc.	**South Jersey Industries, Inc.**	Spire Inc.
Spire Inc.	**Southwest Gas Holdings, Inc.**	
	Spire Inc.	

Both Mr. Henkel and Mr. D'Ascendis state they have the most recent data and, thus, should be accepted by the Commission. Mr. D'Ascendis updated his proxy group based on data as of September 30, 2019. Mr. Henkel notes that if 2018 data was used for D'Ascendis' second criterion, South Jersey Industries would not have qualified for the Valley's gas proxy group. Ultimately, we cannot consider data fresh if it is based upon older criteria. Accordingly, we will utilize the proxy group of I&E here.

2. <u>Discounted Cash Flow (DCF)</u>

Valley witness D'Ascendis used four methods to determine the cost of equity: Discounted Cash Flow (DCF), Risk Premium (RP), Capital Asset Pricing Model (CAPM), and Comparable Earnings (CE). As discussed above, the Commission has traditionally utilized the

DCF method, with use of the CAPM method as a check. Accordingly, we will rely on those methods in this decision.

I&E witness Henkel explains the constant growth discounted cash flow model in his testimony as follows:

> First, the DCF provides the most direct measurement of return on equity. It facilitates the use of stock prices, dividend payments, and growth rate forecasts that are specific to companies such as those in my proxy group, which, as stated earlier, were selected to establish a benchmark of risk and corresponding rate of return in this proceeding. These inputs, which are easily accessible through public sources, directly capture the two components of return expected by investors: dividend yield and capital gains (growth). Second, the DCF recognizes the time value of money and is forward-looking, which is helpful since rate case proceedings often involve fully projected future test years. Finally, the DCF is commonly used and widely accepted by Public Utility Commissions across the United States. For these reasons, the DCF is the superior method for determining the required return on equity of a subject utility in a rate proceeding.

I&E Stmt. 2 at 17-18.

Mr. Henkels' analysis employs the constant growth DCF model as portrayed in the following formula:

$$K = D_1/P_0 + g$$

Where:

K	=	Cost of equity
D_1	=	Dividend expected during the year
P_0	=	Current price of the stock
g	=	Expected growth rate

I&E Stmt. 2 at 23.

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

Party	DCF Results	Recommended ROE
Valley	9.02%	10.60 %[8]
OCA	7.67-10.02%	8.34%[9]
BIE	8.46%	8.46%

We note that the OCA's recommended 8.34% ROE is based upon the median of two types of DCF calculations: a constant growth DCF and the FERC 2-Step DCF. As discussed herein, we will utilize the constant growth DCF model, which the three parties have utilized. As explained in Valley's Main Brief:

> Mr. D'Ascendis uses a single-state 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

---

8 Valley witness D'Ascendis averaged multiple ROE methods to determine a 9.35% cost of equity plus an additional 1.25% to reflect and size adjustment and management efficiency.

9 OCA's recommended ROE is the median value of all cost rates of the constant growth DCF and the FERC-two-step, an alternative model.

> 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 Stmt. 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. <u>Growth rate</u>

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.

Valley Main Brief at 57-58.

Mr. D'Ascendis' DCF results utilized the average of the mean and median of his results. The following table summarizes Valley's DCF results by Company:

Valley			
Company	Adj Div Yield	Average Growth Rate	DCF
Atmos Energy Corporation	1.99	7.17	9.16
Northwest Natural Holding Co.	2.74	4.50	7.24
ONE Gas, Inc.	2.26	6.37	8.63
South Jersey Industries, Inc.	3.67	7.87	11.54
Southwest Gas Holdings, Inc.	2.53	8.17	10.70
Spire Inc.	2.88	4.74	7.62
Mean (1)	9.15		
Median (2)	8.90		
Avg. (1+2)	9.02		

In response, OCA states in its Main Brief:

> Valley is not a publicly traded company with a dividend yield and therefore, lacks the necessary data to run a unique DCF analysis. Because the DCF cannot be applied directly to Valley, OCA witness Dr. Habr instead conducted multiple DCF analyses for each company within his gas proxy group. See OCA St. 3 at 25-26. Specifically, Dr. Habr calculated 3 constant growth DCFs for each of the 7 companies in his proxy group. OCA St. 3 at 25-26. Dr. Habr calculated 3 separate constant growth DCFs for each company because he used three separate growth rates, one DCF calculation for each source, Yahoo!, Value Line, and Zack's. OCA St. 3 at 25-26. Calculating a DCF for each company in the proxy group provided for more accurate results as Dr. Habr was able to utilize each company's actual dividend yield and growth rate in his calculation. OCA St. 3 at 25-26.

OCA Main Brief at 51-52.

OCA witness Habr utilized multiple DCF models. The following chart summarizes OCA's DCF result by company using a constant growth DCF model only:

OCA			
Company	Yahoo! Growth Rates	Zacks Growth Rates	*Value Line* Growth Rates
Atmos Energy Corporation	8.56%	8.77%	9.57%
New Jersey Resources	8.46%	9.47%	5.93%
Northwest Natural Holding	6.84%	7.35%	
ONE Gas, Inc.	7.30%	8.21%	10.33%
South Jesey Industries, Inc.	8.26%	10.29%	14.26%
Southwest Gas Holdings, Inc.	8.67%	8.77%	11.61%
Spire Inc.	5.60%	7.32%	8.43%
Mean (1)	**8.70%**		
Median (2)	**8.51%**		
Avg. (1+2)	**8.61%**		

I&E argues in its Main Brief:

I&E witness Henkel recommends a cost of common equity of 8.46%.[10] I&E witness Henkel's recommendation includes a dividend yield of 2.71% and a recommended growth rate of 5.75%.[11] I&E witness Henkel's analysis uses a spot dividend yield and a 52-week dividend yield, and earnings growth forecasts. I&E witness Henkel employs the standard DCF model formula, $K = D_1/P_0 + g$, where K = the cost of equity, D_1 = the dividend expected during the year; P_0 = the current price of the stock; and g = the expected growth rate. When a forecast of D_1 is not available, D_0 (the current dividend) must be adjusted by ½ the expected growth rate in order to account for changes in the dividend paid in period 1.[12]

a) Dividend yields

A representative yield must be calculated over a time frame sufficient to avoid short-term anomalies and stale data. I&E witness Henkel's dividend yield calculation places equal emphasis on the most recent spot (2.61%) and 52-week average (2.82%) dividend yields resulting in an average dividend yield of 2.71%.[13]

10 I&E Stmt. No. 2 at 22; I&E Exhibit No. 2, Schedule 6.
11 I&E Stmt. No. 2 at 27.
12 I&E Stmt. No. 1 at 23.
13 I&E Stmt. No. 2 at 24.

b) Growth rate

> I&E witness Henkel used earnings growth forecasts to calculate his expected growth rate. His earnings forecasts are developed from projected growth rates using 5-year estimates from established forecasting entities for his proxy group of companies, yielding an average 5-year growth forecast of 5.75%.[14]

I&E Main Brief at 29-30.

Mr. Henkel recommended an 8.46% ROE calculated from a constant growth DCF model. The recommendation was calculated by adding the average dividend yield of 2.71% and an average growth rate of 5.75%. The following chart summarizes I&E's DCF result methodology as well as a mean, median, and average of the two by company:

BIE			
Company	Average Dividend	Average Adjusted Growth	DCF
Atmos Energy Corp.	2.14	7.18	9.32
NiSource Inc.	3.04	6.82	9.86
Northwest Natural Gas	2.88	4.25	7.13
ONE Gas Inc.	2.47	6.30	8.77
Spire, Inc.	3.05	4.20	7.25
Average	**2.71**	**5.75**	**8.46**
Mean.(1)	8.47		
Median(2)	8.77		
Avg.(1+2)	8.62		

All Parties have provided a constant growth DCF model and we compare a calculation of the mean, median, and average of the two. As we have determined that I&E has presented a favored proxy group, we will utilize I&E's recommendation utilizing an 8.46% DCF. We note that I&E's average and Valley's mean are nearly 70 basis points apart which would appear to be attributable to the difference in proxy groups.

[14] I&E Stmt. No. 2 at 24.

3. Capital Asset Pricing Model (CAPM)

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." Valley Main Brief at 60.

The traditional CAPM is portrayed in the following formula:

$$K = R_f + \beta(R_m - R_f)$$

Where:

K	=	Cost of equity
R_f	=	Risk-free rate of return
R_m	=	Expected rate of return on the overall stock market
β	=	Beta measures the systematic risk of an asset

The three witnesses utilized the CAPM with various inputs and even some variation of the model. The precise validity or accuracy of the CAPM results will not be addressed here. Rather, a s noted above, the Commission has traditionally utilized the CAPM model largely as a check on DCF results. Accordingly, we will not determine the reasonableness of CAPM results. Instead, we will merely use the results to determine the reasonableness of each parties' DCF calculation.

I&E witness Henkel gave no specific weight to his CAPM results because of his concerns that, unlike the DCF, which measures the cost of equity directly by measuring the discounted present value of future cash flows, the CAPM measures the cost of equity indirectly and can be manipulated by the time period used.[15] However, I&E submits that for purposes of

[15] I&E Stmt. No. 2 at 34-35. I&E witness Henkel's presentation of a CAPM analysis serves as a check on his DCF analysis. For the reasons set forth in I&E witness Henkel's direct testimony, the DCF model should be used as the primary method in determining a fair return on equity.

providing another point of comparison, the 8.04% CAPM analysis confirms the reasonableness of I&E witness Henkel's 8.46% return under his DCF calculation.[16] (I&E Main Brief at 31).

Dr. Habr calculates his CAPM analysis by using a time frame that includes the time frame he used in his DCF analysis. OCA Stmt. 3 at 16. Dr. Habr calculates bond betas for the gas Proxy Group companies based on the New York Stock Exchange Index using weekly holding period returns for the period September 1, 2014 through August 31, 2019. *Id.* The calculated betas were then adjusted using *Value Lines* adjusted formula. OCA Stmt. 3 at 16. The OCA submits that Dr. Habr's CAPM/Risk Premium median 9.54% and 9.61% confirms the validity of his DCF results because they provide upper limits not to be exceeded. OCA Main Brief at 58.

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." Joint Stmt. No. 2 at 32; Valley Main Brief at 60. 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 Stmt. No 2-R, Exhibit __ (DWD-1R), Schedule DWD-1R at 42, fn. 2. (Valley Main Brief at 60).

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 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

[16] In rebuttal testimony, Valley witness D'Ascendis provided analysis disputing various data sources relied upon by I&E witness Henkel in his CAPM analysis. Valley Statement No. 2-R at 26-27. As I&E witness Henkel explains, even if Valley witness D'Ascendis' recommended return on the overall market rate was accepted by I&E, the CAPM result would only adjust from 8.04% to 8.59%, validating I&E's DCF result of 8.46%. I&E Stmt. No. 2-SR at 16.

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 Stmt. No. 2 at 33-34. Mr. D'Ascendis rebuttal testimony presents the results of the analysis supporting the risk-free rate of 2.64%.[17] Valley Main Brief at 60-61.

> 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%.

Valley Main Brief at 61.

We note the stand alone CAPM ROE and DCF ROE were within 20 basis points, thus making Mr. D'Ascendis' DCF analysis appears reasonable.

4. <u>Size Adjustment</u>

Valley 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 D'Ascendis. Valley argues that Mr. D'Ascendis demonstrated that a 437-basis point

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[17] 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 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.1.

adjustment could be justified for the company, but he recommends a more modest 100 basis point adjustment. Joint Stmt. 2 at 45.

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 Stmt. 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.

OCA Reply Brief at 32-33.

Dr. Habr further commented on the proposed size adjustment as follows:

> Yes. Utility customers should not be required to pay higher costs associated with inefficient utility operations. If a utility company chooses to operate at such a small scale that its cost of common equity is truly increased, there

is no reason for the utility's captive customers to pay any increased costs resulting from the utility's inefficient size.

OCA Main Brief at 63.

Valley disputes OCA's position as follows:

> 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.

Valley Main Brief at 90-91.

I&E explains its opposition to Valley's claims in its Main Brief as follows:

> I&E witness Henkel rebutted Valley witness D'Ascendis's claims by citing the variance year-to-year of returns for large- and small-capitalization stocks listed on the NYSE, AMEX, and NASDAQ.[18] I&E

[18] I&E Stmt. No. 2-SR at 22-23 (citing Ibbotson *Stocks, Bonds, Bills & Inflation: 2015 Yearbook*, pp. 100, 109, 112 ("While the largest stocks actually declined in 2001, the smallest stocks rose more than 30%. A more extreme case occurred in the depression-recovery year of 1933, when the difference between the first and 10th decile returns was far more substantial. The divergence in the performance of small- and large- cap stocks is evident. In 30 of the 89 years since 1926, the difference between the total returns of the largest stocks (decile 1) and the smallest stocks (decile 10) has been greater than 25 percentage points…. In four of the last 10 years, large-capitalization stocks (deciles 1-2 of NYSE/AMEX/NASDAQ) have outperformed small-capitalization stocks (deciles 9-10). This has led some market observers to speculate that there is no size premium. But statistical evidence suggests that periods of underperformance should be expected…. Because investors cannot predict when

witness Henkel also opines Valley witness D'Ascendis's size adjustment is unnecessary because none of the technical literature he cites supporting investment adjustments related to the size of a company is specific to the utility industry; therefore, such an adjustment is not appropriate.[19] In *UGI Utilities, Inc. – Electric Division*, the Commission rejected use of technical literature not specific to the regulated utility industry to support a size adjustment.[20]

Specific to the utility industry, I&E witness Henkel cites an article stating a size adjustment for risk is not applicable to utility companies.[21] In the article "Utility Stocks and the Size Effect: An Empirical Analysis," Dr. Annie Wong concludes:

> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that there is no need to adjust for the firm size in utility rate regulation.[22]

I&E Main Brief at 46-47.

Valley responds to I&E's arguments on page 97 of its Main Brief:

> 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 Stmt. 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.

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small-cap returns will be higher than large-cap returns, it has been argued that they do not expect higher rates of return for small stocks."))

[19] I&E Stmt. No. 2 at 42.

[20] *Pa. Pub. Util. Comm'n* v. *UGI Utilities, Inc. – Electric Division*, Docket No. R-2017-2640058 (Order Entered October 25, 2018), p. 100. Relatedly, when asked whether he had performed a specific analysis why it would be appropriate for the Company to receive a size adjustment when UGI Electric did not, Valley witness D'Ascendis did not point to any particular analysis he had performed comparing the two companies, but generally stated UGI Electric was a larger company than Valley and referred back to his testimony analysis on the subject. Tr. at 59-60, 63-65.

[21] I&E Stmt. No. 2 at 42-43.

[22] Wong, Annie, "Utility Stocks and the Size Effect: An Empirical Analysis" *Journal of the Midwest Finance Association* (1993), pp. 95-101.

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.

Valley Main Brief at 88-89.

I&E responds to Valley's argument on page 47 of its Main Brief:

As explained by I&E witness Henkel, Dr. Zepp's article does not contain credible enough evidence to refute Dr. Wong's findings. First, it simply speculates on other possible reasons for her results and references the results of two other studies. The first study, completed by California Public Utilities Commission Staff in 1991, is not included in the article, and, therefore, Dr. Zepp's opinions cannot be properly evaluated. Dr. Zepp also draws his conclusions about an entire industry based on the second study, which examines the effects of size on only four water utility companies.[23] Additionally, Dr. Zepp admitted the limited relevance of the two studies, stating "*to the extent that water utilities are representative of all utilities*, there is support for smaller utilities being more risky than larger ones".[24]

I&E Main Brief at 47.

Valley further argues as follows:

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:

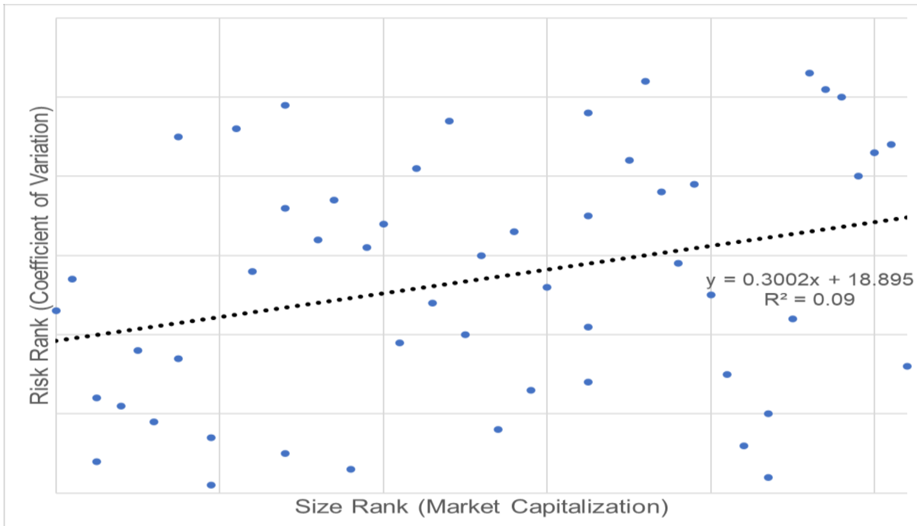
---

23 I&E Stmt. No. 2-SR at 21.

24 Valley Stmt. No. 2-R at 33-34 (emphasis added, citing Zepp, Thomas M. "Utility Stocks and the Size Effect --- Revisited", *The Quarterly Review of Economics and Finance*, 43 (2003) at 578-582).

Main Brief Table 8

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



Joint Stmt. 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.

Valley Main Brief at 89-90.

We are persuaded that there is a general inverse relationship between size and risk generally; however, we are asked to consider whether utilities may be immune to this risk. I&E presents a singular study that suggests size may not be a factor in determining rates for utility stocks. Mr. D'Ascendis points out that the Wong Study only describes risk captured in beta and cites a study by Thomas Zepp that criticizes the Wong Study, as well as indicating size may be a risk factor for water utilities. Mr. Henkel refutes these claims by noting that Zepp's research is limited to only a few water companies and is unable to be properly evaluated. Similarly, the study Mr. D'Ascendis performed, which shows weak correlation, does not seem to be significant enough to prove that size is a risk for utilities. Thus, we are unable to conclude whether size is or is not a risk for utilities although, generally, we agree that size does seem to be a risk factor for companies. Ultimately, we believe it is reasonable to conclude that smaller companies face size risk and Valley is a smaller company.

Valley addresses this issue on page 86 of its Main Brief:

> 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 Stmt. 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.

Valley Main Brief at 86.

We agree with Valley and believe it is reasonable to conclude that a smaller company would be impacted to a greater degree by significant events that affect sales, revenues, and earnings. Valley is significantly smaller than the Proxy Group companies, and it is reasonable to conclude that it would face proportionally greater financial and business risk than much larger utilities. While we decline to quantify a specific amount, based on the record evidence, we recommend that the Company's ROE be based upon the higher end of the DCF range. This ensures that we utilize a market-based result while acknowledging the risk of a smaller utility.

We recommend use of a one standard deviation range of 7.24% to 9.68% based on I&E's constant growth DCF recommendation. We note that the top of I&E's range falls between the ranges for both Valley and OCA. Accordingly, we shall utilize a 9.68% rate to represent our DCF results. The charts below summarize the results of the DCF range.

I&E			
STD	1.22	Range	
DCF Results		Upper	Lower
I&E Average	8.46	9.68	7.24
Mean. (1)	8.47	9.69	7.25
Median (2)	8.77	9.99	7.55
Avg. (1+2)	8.62	**9.84**	**7.40**

Valley			
STD	1.70	Range	
DCF Results		Upper	Lower
Mean (1)	9.15	**10.85**	**7.45**
Median (2)	8.90	10.60	7.20
Avg. (1+2)	9.02	10.72	7.32

OCA			
STD	1.96	Range	
DCF Results		Upper	Lower
Mean (1)	8.70	**10.66**	**6.74**
Median (2)	8.51	10.47	6.55
Avg. (1+2)	8.61	10.57	6.65

5. Management Effectiveness Adjustment

Under the Public Utility Code, the Commission is required to consider management performance and effectiveness when setting rates: Section 523 states:

> 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.

66 Pa. C.S. § 523(a).

In past decisions, the Commission has included upward adjustments to the cost of common equity to reflect solid management effectiveness. See, *e.g. 2012 PPL Order at* 98-99; *Pa. Pub. Util. Comm'n. v. Aqua PA., Inc.*, Docket No. R-00072711, 2008 Pa. PUC LEXIS 50 (Order dated July 17, 2008); *Pa. Pub. Util. Comm'n v. West Penn Power Co.*, Docket Nos. R-00942986, 1994 Pa. PUC LEXIS 144 (Order dated 12/29/1994). In order to be rewarded with a rate of return premium, the utility must provide specific evidence to support the adjustment. *Pa. Pub. Util. Comm'n v. Columbia Water Co.,* 2013 Pa. PUC Lexis 763, *82.

Valley requests in this proceeding that it be given a 25-basis point addition to the cost of common equity due to its management effectiveness. Both I&E and OCA oppose the award of any allowance for management effectiveness.

Valley summarized various initiatives and accomplishments in its main brief as follows:

> 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).

Valley Main Brief at 82-83.

OCA and I&E challenge Valley's request that it be given an upward performance adjustment for management effectiveness, generally on the basis that the company should not be rewarded for merely doing what it is required to do under the Public Utility Code.

OCA witness Habr testified:

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

OCA Stmt. 3 at 31.

I&E witness Henkel testified:

> Ultimately, for any company, true management effectiveness is earning a higher return through its efficient use of resources and cost cutting measures. The greater net income resulting from growth, cost savings, and true efficiency in management and operations is available to be passed on to shareholders. . . . Valley should not be granted additional basis points for

> doing what they are required to do in order to provide adequate, efficient, safe and reasonable service.

I&E Stmt. 2 at 44-45.

We agree with Valley and recommend that its request for a 25-basis point upward adjustment for management effectiveness be granted. Section 523(a) merely requires that the Commission consider a utility's efficiency, effectiveness and adequacy of service in determining just and reasonable rates. This section does not state that any particularly remarkable or extraordinary level of efficiency, effectiveness or customer service is required for the Commission to award an adjustment for management effectiveness, and we do not so interpret this section here. We believe that the undisputed record evidence noted above demonstrates that, in fact, Valley is operated in a very efficient and effective manner and provides very good customer service. There simply is no record evidence that suggests or proves otherwise. We also note here that, other than OCA, I&E and OSBA, only three other parties filed complaints to Valley's rate increase request, all of which challenged the amount of the requested increase. No party raised service quality issues. Accordingly, there is no record evidence in this proceeding demonstrating that the company is operated in an inefficient or ineffective manner, or that it does not provide very good service to its customers. For these reasons, we recommend that Valley's request that it be given a 25-basis point upward adjustment for management effectiveness be approved.

E. Summary of Valley's Return on Common Equity

Valley presented four methods for determining the cost of equity: Discounted Cash Flow (DCF), Risk Premium (RP), Capital Asset Pricing Model (CAPM), and Comparable Earnings (CE).

I&E recommended using the Discounted Cash Flow (DCF) method as the primary method to determine the cost of common equity. I&E Stmt. No. 2 at 16; I&E Stmt. No. 2-SR at 6. Further, I&E recommended using the results of the Capital Asset Pricing Model (CAPM) as a comparison to the DCF results. *Id.* In the recent case of *Pa. Pub. Util. Commn. v. City of*

DuBois-Bureau of Water, Docket No. R-2016-2554150 (Opinion and Order entered March 28, 2017), the Commission reaffirmed its support for I&E's methodology of basing its recommended cost of common equity on a DCF method analysis with a CAPM analysis solely as a check. The Commission stated, "although there are various models used to estimate the cost of equity, the DCF method applied to a barometer group of similar utilities, has historically been the primary determinant utilized by the Commission." *City of Dubois Water Bureau* at 88.

Accordingly, we did not utilize the Comparable Earnings Method or the Risk Premium Method. We utilized the DCF Method with the CAPM as a check.

For the DCF calculation, we will use the top of Valley's DCF range of 9.68% reflecting its status as a company significantly smaller than the companies in the proxy group.

Additionally, we grant Valley the additional .25% management effectiveness adjustment for a ROE of 9.93%.

F. <u>Conclusion</u>

The parties do not dispute a capital structure consisting of 47.45% debt and 52.55% equity; nor do they disagree to a cost of debt of 4.54%. Although agreement could not be reached regarding the cost of equity, we have examined the testimony and determined a 9.93% cost rate of common equity is appropriate. Based on the evidence presented, the appropriate overall rate of return that will result in just and reasonable rates is 7.37%.

Description	**Capitalization Ratio**	**Embedded Cost**	**Return-%**
Long-Term Debt	47.45%	4.54%	2.15%
Common Equity	52.55%	9.93%	5.22%
Total	100.00%		7.37%

VII. TAXES

No party raised an issue in this proceeding regarding taxes. OCA did, however, indicate that an issue related to the treatment of Excess Deferred Income Taxes (EDIT), which had arisen between OCA and Valley, had been resolved. OCA Main Brief at 8. There are, therefore, no recommendations to be made regarding this topic.

VIII. RATE STRUCTURE

A. Allocated Class Cost of Service Study (ACCOSS)

Valley did not have a requirement to file an ACCOSS under the regulations as the regulations only require that an ACCOSS be filed if the rate request is in excess of $1 million. 52 Pa. Code § 53.53.

B. Revenue Allocation

Valley's Position

Valley proposed an across-the-board increase to all tariff rate schedules as outlined in Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule B5 (R). The across the board increase reflects the unbundling of certain GCR-related costs. Valley noted that no party opposes its proposed revenue allocation. *See,* OCA Stmt. No. 4 at 23; I&E Stmt. No. 3 at 12; OSBA Stmt. No. 1 at 4.

OCA's Position

OCA noted that Valley proposed to increase the tariff rates for each class by the same percentage (as rounded) but excluded from the proposed rate increase Valley's three Firm Fixed and Firm Volumetric customers whose rates are set by contract. OCA Stmt. 4 at 22; *see also*, OCA Stmt. 4 at 22, Table 7. OCA found Valley's proposed across-the-board increase for tariff customers as well as Valley's proposal for contract customers to be reasonable and, therefore, does not recommend any adjustments. OCA Stmt. 4 at 23.

<u>OSBA's Position</u>

OSBA found that Valley's proposed revenue allocation reflected an across-the-board increase for all rate classes, excluding contract customers. OSBA witness Kalcic testified:

> The Company argues, in part, that: 1) the composition of firm sales (ccf) has been relatively stable over time across rate classes; 2) a uniform rate increase is the simplest to implement and one that is most acceptable to ratepayers; and 3) a class cost-of-service study ("COSS") (which would be used to guide the development of an alternative class revenue allocation) would be expensive and time consuming to produce.

OSBA Stmt. No. 1 at 3.

Absent class cost-of-service information, Mr. Kalcic determined that there is no cost basis to assign non-uniform increases to individual classes and concluded that Valley's proposal to assign uniform increases to rate classes was appropriate. *Id.* at 4.

<u>I&E's Position</u>

I&E noted that Valley was requesting an across-the-board increase for the residential, commercial, interruptible, small industrial and transportation customers (excluding Firm-Contract) between 21.52% and 21.85%, with most classes receiving an increase of approximately 21.6% (excluding the cost of gas). I&E Statement No. 3 at 11. I&E accepted Valley's approach.

<u>Disposition</u>

We find Valley's revenue allocation to be reasonable; therefore, we recommend that it be adopted as stated herein. All of the parties agreed that uniform increases to each rate class was fair and appropriate. We agree that in this instance a uniform rate increase is the simplest to implement and one that is most acceptable to ratepayers. Absent class cost-of-service information, there is no cost basis to assign non-uniform increases to individual classes.

C. Rate Design

Valley's Position

Valley noted that its rate design reflected the across-the-board revenue allocation. *See* Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule B5 (R). Although it did not conduct a Cost of Service Study, Valley did provide a customer charge analysis to support the proposed increases. *See,* Valley Stmt. No. 1, Exhibit__(HSG-1), Schedule C1-8 (R). No party opposes Valley's proposed rate design. *See,* OCA Stmt. No. 4 at 28; I&E Stmt. No. 3 at 12; OSBA Stmt. No. 1 at 4.

OCA's Position

OCA noted that Valley has one residential customer rate class, Schedule R, which consists of a $10.50 per month customer charge and $2.5628/Mcf usage charge. Valley proposes to increase the customer charge from $10.50 per month to $12.79 per month, or by 21.8% and proposes to increase the volumetric distribution charge by approximately 21.5% to $3.1142/Mcf. OCA Stmt. 4 at 23. Valley presented an analysis of the direct residential customer costs. *See*, Valley Stmt. No. 1, Exhibit__(HSG-1), Sch. C1-8(R). OCA witness Mierzwa testified that a proposed increase to the residential customer charge equal to the system average increase authorized by the Commission would be reasonable and cost-justified. OCA Stmt. 4 at 28. OCA argued that rather than adopt the Company's 21.8% increase to the customer charge, it should be increased by a percentage that reflects the Commission's final rate determination and the volumetric distribution charge should be adjusted accordingly. OCA Stmt. 4 at 23, 28.

OSBA's Position

OSBA determined that there is no cost basis to assign non-uniform increases to individual rate elements and concluded that Valley's proposal to assign uniform increases to individual distribution rate elements was appropriate. OSBA Stmt. No. 1 at 5.

I&E's Position

I&E had no tariff structure recommendations.

Disposition

We find Valley's rate design to be reasonable; therefore, we recommend that it be adopted as stated herein. While Valley did not conduct a cost of service study, it did provide a customer charge analysis to support the proposed increases. The other parties generally support these proposed increases. We acknowledge OCA's proposal to increase the residential customer charge equal to the system average increase authorized by the Commission. We also recognize OCA's argument to instead increase the customer charge by a percentage that reflects the Commission's final rate determination and the volumetric distribution charge, rather than the 21.8% increase Valley has proposed. OCA Stmt. 4 at 23, 28. However, we find Valley's proposal to be reasonable and not only supported by a customer charge analysis but by all of the parties generally. Valley's rate design reflects the across-the-board revenue allocation the parties also support and which we have also recommended.

D. Scale Back

Valley's Position

Valley noted that I&E and OSBA's proposed proportional scale back was consistent with the its proposed revenue allocation and therefore should be approved in the event the Commission awards less than Valley's requested revenue increase. *See* I&E Stmt. No. 3 at 12; OSBA Stmt. No. 1 at 4.

<u>OCA's Position</u>

OCA argued that if a rate increase less than Valley's requested revenue requirement is approved, Valley's proposed across-the-board allocation should be applied to the approved increase. OCA recommended that the customer charge should also only be increased by the system average increase authorized by the Commission.

<u>OSBA's Position</u>

OSBA noted that Valley has proposed an across-the-board increase of 21.6% to all rate classes, excluding contract customers. OSBA Stmt. No. 1 at 4. In the event the Commission awards Valley an increase less than the full request, OSBA recommends that the class increases shown in column 3, lines 1-11 of Schedule BK-1(V), be reduced proportionally.

<u>I&E's Position</u>

I&E recommends that, if the Commission grants less than the full increase, the approximately 21.62% increase in rates described above be reduced so that the percentage increase is the same for all rate classes that experienced an increase. I&E Stmt. No. 3 at 12-13. I&E argues that since the Company requested that all rates described be increased approximately 21.62%, it is reasonable that these rates also be scaled back so that the percentage increase in these rates is the same regardless of the increase allowed by the Commission.

<u>Disposition</u>

We find Valley's proportional scale back, which is consistent with its proposed revenue allocation, to be reasonable; therefore, we recommend that it be adopted as stated herein. The parties all generally agree that, should Valley receive less that the full increase which it has requested, the percentage increase should be the same for all rate classes. We agree that it is reasonable that these rates also be scaled back so that the percentage increase in these rates is the same regardless of the increase ultimately allowed by the Commission.

IX. MISCELLANEOUS ISSUES

A. Reporting Requirements

I&E witness Cline recommended in his direct testimony that Valley be required to provide, no later than April 20, 2020, an update to its plant in service projections by updating Valley Ex._(HSG-1), Sch. C3(R) showing actual capital expenditures, plant additions and retirements by month for the twelve months ending December 31, 2019, as well as an additional update no later than April 1, 2021, showing actuals through December 31, 2020. I&E Stmt. 3-SR at 4-7. No other party addressed this issue. I&E notes in its Main Brief that this reporting requirement has been accepted by the Commission in numerous other rate proceedings and requests that it be required in this proceeding as well. I&E Main Brief at 54.

In response, Valley argues that it is already required under the Public Utility Code and Commission regulations to make numerous filings with the Commission each year, including annual reports that include detailed plant, expense, and sales data. Valley notes that Commission regulations also require quarterly updates while a filing is pending. It argues that year end balances are already provided by other means. Valley Main Brief at 93. Valley further argues that the Commission has not yet adopted regulations that comprehensively address requirements for utilities that utilize the FPFTY. It argues that Valley should not be required to comply with additional filing requirements that have not been adopted by the Commission and are not applicable to all NGDCs. Valley Main Brief at 93.

We agree with Valley on this issue and will not require the updated filings sought by I&E at this time. We are unwilling to single out Valley for unique filing or reporting requirements associated with its plant in service projections that are not applicable that are not uniformly applicable to all NGDCs. The Commission may include such requirements at such time as it adopts comprehensive FPFTY regulations that will apply to all similarly situated NGDCs. We will not do so in this proceeding involving a single NGDC.

We are unpersuaded by I&E's argument that the reporting requirement it seeks here was approved by the Commission in numerous prior proceedings. As noted by I&E in its Main Brief, all of the proceedings cited by I&E in support of its request were settled and the Commission was asked to approve Joint Petitions for Settlement in each case. Accordingly, in those proceedings, the utility voluntarily agreed to the requested reporting requirements. That is not the case here.

For these reasons, we recommend that I&E's request that Valley be required to provide, no later than April 20, 2020, an update to its plant in service projections by updating Valley Ex._(HSG-1), Sch. C3(R) showing actual capital expenditures, plant additions and retirements by month for the twelve months ending December 31, 2019, as well as an additional update no later than April 1, 2021, showing actuals through December 31, 2020, be denied.

B. Proposed Tariff Changes

1. Proposal to Clarify Existing Defined Terms Consistent with Company Practice.

Valley proposes to modify certain terms in its tariff to clarify company practices, eliminate duplicative language, alphabetize the definitions section, and conform the definitions to reflect proposed changes to other tariff sections. Valley Stmt. 4 at 12-13; Valley Main Brief at 95. No party opposed or challenged these proposed tariff modifications. We believe the unopposed proposed changes are in reasonable and in the public interest in that they further simplify and clarify for Valley's customers certain tariff provisions and definitions. Accordingly, we recommend that they be approved by the Commission.

2. Proposal to Clarify Valley's Natural Gas Shortage and Emergency Conditions Policy.

Valley is proposing changes to its Natural Gas Shortage and Emergency Conditions Policy to add additional detail about the company's curtailment procedures. Valley Stmt. 4 at 13; Valley Main Brief at 95. No party opposed or challenged these proposed tariff modifications. We believe the unopposed proposed changes are reasonable and in the public interest in that they further explain and clarity for Valley's customers the company's emergency conditions policy and curtailment practices and procedures. Accordingly, we recommend that the proposed modifications be approved by the Commission.

3. Proposal to Update the Automatic Meter Reading Equipment Language to reflect current technologies.

Valley proposes to modify its automatic meter reading equipment language for certain rate schedules to clarify the costs associated with automatic meter reading equipment to include ethernet connections and/or wireless communications devices and wireless communication subscription plans. Valley Stmt. 4 at 15. No party opposed or challenged these proposed tariff modifications. We believe the unopposed proposed changes are reasonable and in the public interest in that they further explain and clarity for Valley's customers the various costs associated with the company's automatic meter reading equipment. Accordingly, we recommend that the proposed modifications be approved by the Commission.

4. Proposal to Modify Valley's Facilities Extension Policy.

Valley proposes in this proceeding to modify its Facilities Extension Policy to clarify its right to adjust cost estimates, implement a third method for calculating Valley'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. The only challenge or opposition to these proposals is OSBA's opposition to Valley's proposal to implement a third method for calculating Valley's portion of service line extension costs. OSBA

Stmt. 1 at 9. I&E took no position on any of Valley's proposals and OCA agrees with and supports Valley's position on the line extension costs issue. OCA Main Brief at 70-74.

As explained by Valley in its Main Brief:

> 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.*

Valley Main Brief at 96.

In opposing Valley's proposal, OSBA argues:

> The rationale behind the Company's proposal to modify its existing policy is based on Valley's claim that the current method of determining the allowable investment is inequitable. In the Company's view, the current service extension policy does not treat customers with different (unit) installation costs equitably. However, as long as the Company's unit installation costs vary across new installations, it is inevitable that some customers will receive a greater (or lesser) dollar investment allowance under a service extension policy that provides for a fixed allowance of 200 feet. Indeed, Mr. Kalcic testified that one should expect new customers to qualify for different allowable investment levels, whether due to differences in customer EBAR revenue credits or unit installation cost differences.
>
> Since Valley's proposal would permit the Company to install service extension facilities in excess of 200 feet (without requiring a CIAC) in certain circumstances, the Company's proposal would effectively raise

> its existing proxy EBAR credit above the cost of 200 feet of service and/or main extension. However, Valley has provided no evidence to suggest that raising its allowable investment level is cost justified, or that doing so would ensure that its completed service extension projects remain economic. In short, the Company's proposal to reduce the required level of CIACs going forward undermines the purpose of a CIAC, which is to offset that part of the cost of an extension that is not otherwise supported by an applicant's expected revenue stream.
>
> The OSBA opposes the Company's proposed modifications to its Main Line Extension Policy because the proposal would shift a portion of the cost of main extensions from individual customer applicants of any class to general ratepayers, compared to Valley's existing extension policy. Adoption of the proposed modification would not lower the Company's cost of extending service to applicants, it merely would excuse the customer applicant from paying a portion of that cost and transfer the responsibility for that cost to existing (general) ratepayers thereby creating a subsidy.

OSBA Main Brief at 9-10.

In response, Valley argues:

> 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."

Valley Main Brief at 97.

In supporting Valley's proposal, OCA witness Mierzwa noted the following example as illustration of how the company's current policy may provide unreasonable results:

> Customer A, with a lower than average (unit cost) of installation, may require a total of 250 feet of mains/service line investment as a cost of, say, $6,500, or $26 per foot. Customer B, with a greater than average (unit cost) of installation, may require a total of 200 feet of main/service line investment at a cost of, say, $6,800, or $34 per foot. Under the Company's existing service extension policy, Customer B would not be required to pay

> a CIAC since the service extension does not exceed 200 feet. On the other hand, Customer A would be required to provide a CIAC equal to the cost to install facilities beyond 200 feet. Valley deems this outcome inequitable since Customer A is required to pay a CIAC even though Customer A's total cost of installation ($6,500) is less than the total cost to extend service to Customer B.

OCA Stmt. 4-R at 7-8; OCA Main Brief at 73.

OCA witness Mierzwa further explains that since OSBA's recommendation would result in the same fixed investment for each new customer within a customer class, it does not address cost differences that may exist in extending facilities to new customers. OCA Stmt. 4-R at 10. Both Valley and OCA argue that Valley's proposal would appropriately recognize these potential cost differences. Valley Main Brief at 98; OCA Stmt. 4-R at 10.

Additionally, as summarized by OCA:

> Recognizing the benefit that low-cost natural gas can provide to residential ratepayers, other utilities have sought – and had approved— modifications to main extension policies that will facilitate the expansion of service. <u>See</u>, <u>Pa. PUC v. Peoples Natural Gas Company, LLC</u>, Docket No. R-2018-3006818, Order at 35 (October 3, 2019); <u>Pa. PUC v. Columbia Gas of Pa.</u>, Docket No. R-2015-2468056, Order at 14, 22 (June 19, 2015); <u>see also</u>, <u>Pa. PUC v. Columbia Gas of Pa.</u>, 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.

OCA Main Brief at 74.

We agree with Valley and OCA and recommend that Valley's proposal to implement a third method for calculating Valley's portion of service line extension costs be approved. We agree that, as argued by both Valley and OCA, Valley's proposal will address inequities in line extension costs present in the company's current main extension policy and, as such, will facilitate the expansion of natural gas facilities and service into unserved and underserved areas in Pennsylvania.

5. Disconnection/Reconnection Fees.

Valley proposes in this proceeding to increase its current disconnection and reconnection fees by $10.00. Valley's proposal would increase the fees for disconnections/reconnections occurring during working hours from $25.00 to $35.00 and increase fees for disconnections/reconnections occurring during non-working hours from $30.00 to $40.00. Valley Stmt. 4 at 16; Valley Main Brief at 98. In supporting its proposed increase, Valley argues in its Main Brief, "[t]en 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 increase to Valley's reconnection and disconnection fees should be approved." Valley Main Brief at 99. It further argues that, ". . . fees were increased to account for 13 years of inflation." Valley Reply Brief at 42.

In opposing Valley's proposal, OCA argues that Valley provided no cost-based justification for the increase. OCA argues:

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

OCA Main Brief at 70.

We agree with OCA and recommend that Valley's proposal to increase its disconnection and reconnection fees be denied. As correctly noted by OCA, the Public Utility Code requires that such fees, while permitted, must be based upon the utility's costs in providing the service. Here, Valley merely argues that the increases are sought to account for thirteen years of inflation. We agree with OCA that such justification is not sufficiently cost-based, and that Valley has not supported its request with evidence demonstrating the costs associated with providing the services and the need for increases. Utilities must prove that each and every element of their rate requests is just and reasonable. *Burleson v. Pa. Pub. Util. Comm'n.*, 461 A.2d 1234, 1236 (Pa. 1983). Valley has failed to do so here. Accordingly, we recommend that Valley's request to increase its current disconnection and reconnection fees by $10.00 be denied.

C. Unbundled Procurement Costs to be Recovered in Valley's GCR

Pursuant to the Commission's Order of June 23, 2011 at Docket No. L-2008-2069114, Valley proposes in this proceeding to unbundle procurement costs from delivery rates. Valley notes that it was provided a waiver of this requirement until its next base rate case by Commission order entered December 5, 2012 at Docket No. P-2012-2321937. Valley Main Brief at 99. Valley's request in this proceeding is merely intended to come into compliance with these two Commission orders. Valley notes that no party opposed its proposed unbundling adjustment.

As Valley's unopposed proposal will bring it into compliance with the Commission's orders at Docket Nos. L-2008-2069114 and P-2012-2321937, we recommend that the Company's proposal to unbundle procurement costs from delivery rates be approved.

X. ORDER

THEREFORE,

IT IS RECOMMENDED:

1. That Valley Energy, Inc. shall not place into effect the rates contained in Supplement No. 49 to Tariffs Gas - Pa. P.U.C. No. 2, which have been found to be unjust and unreasonable and, therefore, unlawful.

2. That Valley Energy, Inc. shall be permitted to file tariffs, tariff supplements or tariff revisions containing proposed rates, rules and regulations to increase annual revenues in the total amount of not more than $497,080.00.

3. That Valley Energy, Inc's. tariffs, tariff Supplements or tariff revisions may be filed on less than statutory notice, and pursuant to the provisions of 52 Pa. Code §§ 53.31 and 53.101, may be filed to be effective on at least one day's notice after entry of the Commission's Final order, for service rendered on and after the date of entry of the Commission's Final Order in this matter.

4. That Valley Energy, Inc. shall comply with all directives, conclusions and recommendations in this Recommended Decision that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

5. That Valley Energy, Inc. shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class in the manner set forth in the Recommended Decision.

6. 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.

7. That the complaint filed by the Office of Consumer Advocate in this proceeding at Docket Number C-2019-3011850 be dismissed and marked closed.

8. That the complaint filed by Athens Borough in this proceeding at Docket Number C-2019-3012397 be dismissed and marked closed.

9. That the complaint filed by South Waverly Borough in this proceeding at Docket Number C-2019-3012396 be dismissed and marked closed.

10. That the complaint filed by Larry E. Cole in this proceeding at Docket Number C-2019-3012219 be dismissed and marked closed.

Date: February 28, 2020

/s/
Steven K. Haas
Administrative Law Judge

/s/
Benjamin J. Myers
Administrative Law Judge

APPENDICES

Office of Administrative Law Judge Recommended Decision

TABLE I

Valley Energy Company (PA)

INCOME SUMMARY

R-2019-3008209

		Pro Forma Present Rates (Revised) [1]	OALJ Adjustments [2]	OALJ Pro Forma Present Rates	OALJ Revenue Increase	Total Allowable Revenues
		(1)	(2)	(3) = (1) + (2)	(4)	(5) = (3) + (4)
1.	Operating Revenue	5,059,370	0	5,059,370	497,080	5,556,450
2.	Expenses:					
3.	O & M Expense	3,247,647	(164,072)	3,083,575	3,082	3,086,657
4.	Depreciation	971,413	0	971,413	0	971,413
5.	Taxes, Other	34,296	0	34,296	0	34,296
6.	Income Taxes:					
7.	State	(16,477)	16,365	(112)	49,350	49,238
8.	Federal	25,473	30,957	56,430	93,376	149,806
9.	Total Expenses	4,262,352	(116,750)	4,145,602	145,808	4,291,410
10.	Net Inc. Available for Return	797,018	116,750	913,768	351,272	1,265,040
11.	Rate Base	17,179,542	(20,509)	17,159,033	0	17,159,033
12.	Rate of Return	4.64%		5.33%		7.3724%

(1) Company Main Brief

(2) From Table II Adjustments

Revenue Change (%):	9.82%
% of requested Increase	66.72%

Office of Administrative Law Judge Recommended Decision

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
		(1)	(2)	[(3)=(1)x(2)]	(4)	[(5)=(3)x(4)]
1.	Total Cost of Debt			2.15423000%		2.15423000%
2.	Long-term Debt	47.45%	4.54%	2.15423000%		2.15%
3.	Short-term Debt	0.00%	0.00%	0.00000000%		0.00%
4.	Preferred Stock	0.00%	0.00%	0.00000000%	0.711079	0.00%
5.	Common Equity	52.55%	9.93%	5.21821500%	0.711079	7.34%
6.		100.00%		7.37244500%		9.4942%
7.	Pre-Tax Interest Coverage	4.41				
8.	After-Tax Interest Coverage	3.42				
9.	Tax Rate Complement (1-(21%+(9.99% X (1-21%))	71.10790%				

Office of Administrative Law Judge Recommended Decision

TABLE I(B)

Valley Energy Company (PA)

REVENUE FACTOR

R-2019-3008209

1.	100%	1.00000000	1.00000000
	Less:		
2.	Uncollectible Accounts Factor (*)	0.00620000	0.00000000
3.	PUC, OCA, OSBA Assessment Factors (*)	0.00000000	0.00000000
4.	(Line 1-(Line 2 + Line 3)	0.99380000	1.00000000
5.	Gross Receipts Tax	0.00000000	0.00000000
6.	Other Tax Factors	0.00000000	0.00000000
7.	(Line 5 + Line 6)	0.00000000	0.00000000
8.	Effective GRT/CST (Line 7 x Line 4)	0.00000000	0.00000000
9.	Factor after GRT and CST (Line 4 - Line 8)	0.99380000	1.00000000
10.	State Income Tax Rate (*)	0.09990000	0.09990000
11.	Effective State Income Tax Rate	0.09928062	0.09990000
12.	Factor After Local and State Taxes	0.89451938	0.90010000
13.	Federal Income Tax Rate (*)	0.21000000	0.21000000
14.	Effective Federal Income Tax Rate	0.18784907	0.18902100
15.	Revenue Factor (100% - Effective Tax Rates)	0.70667031	0.71107900
	recipricol/gross up	1.41508704	1.40631350

Office of Administrative Law Judge Recommended Decision
TABLE II
Valley Energy Company (PA)
SUMMARY OF ADJUSTMENTS
R-2019-3008209

	Adjustments (1)	Rate Base (2)	Revenues (3)	Expenses (4)	Depreciation (5)	Taxes-Other (6)	State Income Tax (7)	Federal Income Tax (8)
1.	RATE BASE:							
2.	CWC:							
3.	Int. & Div. (Table IV)	0						
4.	Taxes (Table V)	0						
5.	O & M (Table VI)	(20,509)						
6.	EDIT Adj.	0						
7.		0						
8.	Other	0						
9.	REVENUES:		0			0	0	0
			0			0	0	0
10.	EXPENSES:							
11.	Eliminate 3% Inflation Factor for 2020 (1)			(89,435)			8,935	16,905
12.	Rate Case Expense			0			0	0
13.	I/C Meters and Regulators Oper. Expense (Acct 876)			0			0	0
14.	Meters & House Regulators Operating Exp (Acct 878)/Meter Reading Exp. (Acct 902)			0			0	0
15.	Customer Installations (Acct 879)			0			0	0
16.	Mains Operating Expense (Acct 887)			(1,219)			122	230
17.	Customer Records & Collection Exp. (Acct 903)			0			0	0
18.	Misc. Customer Expense (Acct 905)			(8,515)			851	1,609
19.	Administrative& General Salaries (Acct 920)			0			0	0
20.	Office Supplies & Exp. (Acct 921)			0			0	0
21.	Regulatory Commission Expense (Acct 928)			(36,813)			3,678	6,958
22.	Miscellaneous General Expense (Acct 930)			(3,889)			389	735
23.	Uncollectible Accounts Expense			(24,201)			2,418	4,574
				0			0	0
				0			0	0
24.	TAXES:							
25.	Interest Synchronization (Table III)						(28)	(54)
26.	TOTALS	(20,509)	0	(164,072)	0	0	16,365	30,957

(1) Based on Valley Energy's Statement No. 1-R, Rebuttal Testimony of Howard S. Gorman page 5. Account 928 was adjusted to reflect its removal at the annualized amount. Otherwise, this amount reflects all other individual accounts annualizted amounts prior to the 3% inflation increase.

Office of Administrative Law Judge Recommended Decision

TABLE III

Valley Energy Company (PA)

INTEREST SYNCHRONIZATION

R-2019-3008209

		Amount $
1.	Company Rate Base Claim (UGI Electric Main Brief)	17,179,542
2.	ALJ Rate Base Adjustments (From Table II)	(20,509)
3.	ALJ Rate Base (Line 1 - Line 2)	17,159,033
4.	Weighted Cost of Debt (From Table IA)	2.154230%
5.	ALJ Interest Expense (Line 3 x Line 4)	369,645
6.	Company Claim (1)	369,360
7.	Total ALJ Adjustment (Line 6 - Line 5)	(285)
8.	Company Adjustment	0
9.	Net ALJ Interest Adjustment (Line 7 - Line 8)	(285)
10.	State Income Tax Rate	9.99%
11.	State Income Tax Adjustment (Line 9 x Line 10) (Flow to Table II)	(28)
12.	Net ALJ Adjustment for F.I.T. (Line 9 - Line 11)	(257)
13.	Federal Income Tax Rate	21.00%
14.	Federal Income Tax Adjustment (Line 12 x Line 13) (Flow to Table II)	(54)

(1) Company Main Brief

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	
	(1)	(2)	(3)	(4)	(5)
1.	Company Rate Base Claim	$17,179,542	$17,179,542	Company Rate Base Claim	$17,179,542
2.	ALJ Rate Base Adjustments	($20,509)	($20,509)	ALJ Rate Base Adjustments	($20,509)
		$17,159,033	$17,159,033		$17,159,033
3.	ALJ Rate Base	$17,159,033	$17,159,033	ALJ Rate Base	$17,159,033
4.	Weighted Cost of Debt	2.154230%	0.00%	Weighted Cost Pref. Stock	0.00%
5.	ALJ Annual Interest Exp.	$369,645	$0	ALJ Preferred Dividends	$0
6.	Average Revenue Lag Days (1)	0.0	0.0	Average Revenue Lag Days (1)	0.0
7.	Average Expense Lag Days (1)	45.00	0.0	Average Expense Lag Days (1)	0.0
8.	Net Lag Days	-45.0	0.0	Net Lag Days	0.0
9.	Working Capital Adjustment				
10.	ALJ Daily Interest Exp.	$1,013	$0	ALJ Daily Dividends	$0
11.	Net Lag Days	-45.0	0.0	Net Lag Days	0.0
12.	ALJ Working Capital	($45,585)	$0		$0
13.	Company Claim (1)	$0	$0	Company Claim (1)	$0
14.	ALJ Adjustment	($45,585)	$0		$0
15.	Total Interest & Dividend Adj.	($45,585)			

(1) Company Main Brief.

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

	Description (1)	Company Proforma Tax Expense Present Rates (2)	ALJ Adjustments (3)	ALJ Pro forma Tax Expense Present Rates (4)	ALJ Allowance (5)	ALJ Adjusted Taxes at Present Rates (6)	Daily Expense (7)	Net Lead/ Lag Days (8)	Accrued Tax Adjustment (9)	
1.	PUC Assessment	$24,296	$0	$24,296	$0	$24,296	$66.56	0.00	$0	
2.	Public Utility Realty	$10,000	$0	$10,000		$10,000	$27.40	0.00	$0	
3.	Capital Stock Tax	$0	$0	$0		$0	$0.00	0.00	$0	
4.		$0	$0	$0		$0	$0.00	0.00	$0	
5.		$0	$0	$0		$0	$0.00	0.00	$0	
6.		$0	$0	$0		$0	$0.00	0.00	$0	
7.	State Income Tax	($16,477)	$16,365	($112)	$74,434	$74,322	$203.62	0.00	$0	0.00
8.	Federal Income Tax	$25,473	$30,957	$56,430	$140,836	$197,266	$540.45	0.00	$0	0.00
		$43,292	$47,322	$90,614	$215,270	$305,884			$0	
9.							ALJ Allowance		0	
10.							Company Claim (1)		0	
11.							ALJ Adjustment		0	

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
	(1)	(2)	(3)	(4)	(5)	(6)
1.	O&M	$3,247,647	$0	$3,247,647	45.63	$148,173,894
2.	Less: Uncollectibles	($55,430)	$0	($55,430)	45.63	($2,528,994)
3.		$0	$0	$0	45.63	$0
4.		$0	$0	$0	45.63	$0
5.		$0	$0	$0	45.63	$0
6.		$0	$0	$0	45.63	$0
7.		$0	$0	$0	45.63	$0
8.	Total O&M Adj. (2)	$0	($164,072)	($164,072)	45.63	($7,485,785)
9.		$0	$0	$0	45.63	$0
10.		$0	$0	$0	45.63	$0
11.		$0	$0	$0	45.63	$0
12.		$0	$0	$0	45.63	$0
13.		$0	$0	$0	45.63	$0
14.		$0	$0	$0	45.63	$0
15.		$0	$0	$0	45.63	$0
16.		$3,192,217	($164,072)	$3,028,145	0.00	$138,159,115
17.	ALJ Average Revenue Lag (1)	0.0				
18.	Less: ALJ Avg. Expense Lag	45.6				
19.	Net Difference	-45.6	Days/ 1/8 Method			
20.	ALJ Pro forma					
22.	O & M Expense per Day	$8,296				
23.	ALJ CWC for O & M (2)	($378,518)				
24.	Less: Company Claim	($399,027)	C1-6 R			
25.	ALJ Adjustment	($20,509)				

(1) Company Main Brief
(2) Table II Adjustments