COMMONWEALTH OF PENNSYLVANIA

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March 13, 2020

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

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

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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Enclosures:
cc: The Honorable Steve K. Haas, ALJ
The Honorable Benjamin J. Myers, ALJ
Office of Special Assistants (e-mail: ra-OSA@pa.gov)
Certificate of Service

*285128

CERTIFICATE OF SERVICE

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

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

Dated this 13th day of March 2020.

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Dated: March 13, 2020
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

EXCEPTIONS
OF THE
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Dated: March 13, 2020

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I. INTRODUCTION

On February 28, 2020, Administrative Law Judges (ALJs) Steven K. Haas and Benjamin J. Myers issued a Recommended Decision (RD), setting forth their recommendations in Valley Energy Company's (Valley) base rate case. As part of their comprehensive RD, the ALJs recommended that Valley's end of year rate base proposal be accepted and consequently, the ALJs recommended approval of the Company's depreciation expense claims based on the end of year numbers. The ALJs also accepted the Company's proposed FPFTY revenues. In addition, the ALJs accepted Valley's claims for Meters and Regulators expense (Account 878) and Meter Reading Expense (Account 902). The ALJs adopted the Company's nine month annualized costs for Customer Installations (Account 879). Additionally, the ALJs did not address the OCA's adjustment to Uncollectible Accounts expense (Account 904). The ALJs also adopted the OCA's adjustment to the Company's Office Supplies/Expenses (Account 921) but further adjusted the OCA's recommendation to include increased expenses incurred in the first nine months of 2019. The ALJs normalized Valley's rate case expense over three years. The ALJs recommended a 9.93 return on equity and a 25 basis point management efficiency adder to the return on equity.

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

II. EXCEPTIONS

OCA Exception No. 1: The ALJs Erred By Recommending That Valley Energy's End of Year Rate Base Proposal Be Accepted. (R.D. at 7-15; OCA M.B. at 11-16; OCA R.B. at 4-8)

In their Recommended Decision, the ALJs rejected the OCA's average rate base proposal. R.D. at 10-11. The ALJs also denied the associated accumulated depreciation, depreciation expense adjustment, and the impact on Construction Work In Progress (CWIP). R.D. at 11-15. The ALJs principally relied upon the UGI Order and the Commonwealth Court's decision regarding the UGI Order. R.D. at 10-11; see, Pa. PUC v. UGI Utilities, Inc. –Electric Division, Docket No. R-2017-2640058 (Order entered Oct. 25, 2018); Tanya J. McCloskey, Acting Consumer Advocate v. Pa. PUC, Case No. 1529 C.D. 2018 (McCloskey). The ALJ's Recommended Decision states:

> 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 order on this issue on January 15, 2020. *See, McCloskey v. Pa. Pub. Util. Comm'n*, 1549 C.D. 2018 (Pa. Cmlwth. Jan. 15, 2020). Accordingly, the parties to this proceeding, and subsequent rate proceedings are bound by the Commission's holding in the *UGI Order*.

R.D. at 10-11. The OCA respectfully requests that the Commission consider the record and arguments here, on their own merits, which clearly show that the Company's earnings will be overstated if the end-of year method is used.

The ALJs' R.D. misstates the Commonwealth Court's conclusion in McCloskey regarding the UGI Order when they state that "subsequent rate proceedings are bound by the Commission's holding in the *UGI Order*." R.D. at 11. The Commonwealth Court did not conclude that all utilities are bound by its determination or that an average rate base could never be used. The Court instead concluded that this was a matter within the Commission's discretion and that the determination of the Commission was not clearly erroneous. The Court ultimately concluded that it would not disturb the Commission's decision based on the record before it. McCloskey at 24-29. As a matter of discretion, the OCA would urge the Commission to consider this record and the arguments here which clearly shows that the Company's earnings will be overstated if the end of test year method is used.

The OCA's evidence demonstrates the effect of the Company's proposal. OCA M.B. at 11-16. The ALJs' decision appears to erroneously conclude that the OCA's proposal would not allow the Company to use the FPFTY. OCA witness Morgan's proposal in this case would continue to allow the Company to use the FPFTY. The OCA submits that the ALJs have misunderstood the purpose of using the average rate base rate for the FPFTY. OCA witness Morgan explained the difference between using the end of test year plant in a FTY versus with the FPFTY:

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

OCA St. 2-SR at 2. The average method properly reflects the fact that plant is added throughout the year and not all at once on the first day of new rates.

The ALJs also state that they see "no record evidence to show that the proposed rate base or rates are unjust or unreasonable." R.D. at 11. The ALJs also erroneously conclude that if the Company earns interest for the whole FPFTY on an asset that is not put in service until the end of year, the Company will not be overearning on the investment in contravention of Section 1301 of the Public Utility Code. R.D. at 11. As pointed out in the OCA's Main and Reply Briefs and explained by OCA witness Morgan, the year-end method would be the equivalent of an individual making a deposit into an interest-bearing savings account on Day 365, but requiring the bank to pay interest beginning on Day 1. The bank would likely deny such a request because the interest is paid from the time of deposit, not one year in advance. See, OCA St. 1 at 4-5. Indeed, the individual would earn more interest than what he/she is entitled to.

In reaching their conclusion that the Company's will not be over-earning, the ALJs adopted the Company's argument that the OCA's proposal would deny the Company rate recovery. R.D. at 11. The annual average method will not cut Valley's earnings. Rather, the annual average method calculates the rate base by properly reflecting investments as they are made throughout the FPFTY and reflecting the return requirements as projects are placed in service throughout the FPFTY. It is, in fact, the Company that has not supported its end of test year method. The Company's only argument is that the annual average method would "blunt the purpose of using FPFTY." Valley 1-R at 8. Indeed, the purpose of the FPFTY is to mitigate regulatory lag, not eliminate it, which is exactly what the average rate base method does.

It is the Company's burden, and not the OCA's burden, to demonstrate that the rates charged to customers are just and reasonable. The record in this case shows that the Company has not met its burden. Allowing the Company to over-earn on plant will result in rates that are unjust and unreasonable in direct contravention of Section 1301 of the Public Utility Code. Section 1301 of the Public Utility Code requires that "[e]very rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or order of the commission." 66 Pa. C.S. § 1301. By law, a utility is only provided with a "rate that allows it to recover those expenses that are reasonably necessary to provide service to its customers as well as a reasonable return on its investment." City of Lancaster (Sewer Fund) v. Pa. PUC, 793 A.2d 978, 982 (Pa. Commw. 2002). The utility bears the burden of "proving the reasonableness of its rates" and proving the "reasonableness of those expenses which form the basis for its rates." Carnegie Nat'l Gas Co. v. Pa. PUC, 433 A.2d 939, 942 (Pa. Commw. 1981); see also, Keystone Water Co. White Deer Dist. v. Pa. PUC, 477 Pa. 495, 609-610 (1978)(addressing the inclusion of a specific plant in rate base). Allowing the Company to recover more than its necessary costs cannot be found to be just and reasonable.

The OCA submits that the reasons offered by the Company in support of utilizing an end of year rate base in the FPFTY do not justify requiring ratepayers to overpay the revenue requirement. For the reasons set forth in the OCA's Main Brief and Reply Brief and based upon the record presented in this case, the OCA requests that the Commission adopt the OCA's recommendation and approve the use of an average rate base. If the Commission adopts the OCA's proposed use of the average rate base, the accumulated depreciation, depreciation expense, and CWIP should be adjusted accordingly.

OCA Exception No. 2: The ALJs Erred By Addressing The OCA's Claim Regarding Plant Retirements As A Part Of The End Of Year Rate Proposal. (R.D. at 10-11; OCA M.B. at 16-17; OCA R.B. at 8-9)

In their Recommended Decision, the ALJs appear to have denied the OCA's claim regarding Valley's plant retirements and corresponding effect on accumulated depreciation. R.D. at 10-11. The ALJs included the issue as a part of their summary of the OCA's position regarding average rate base and do not otherwise address the issue in their Recommended Decision. R.D. at 10. The OCA submits that the ALJs misunderstood the OCA's claim regarding the Company's plant retirements. The issue is not related to the OCA's claim regarding average rate base. The

OCA adjusted year-end FPFTY amounts for inclusion in rate base to reflect the use of the average rate base, but OCA witness Morgan did this to conform the adjustment to the calculation of the average rate base. The issue is not impacted by whether the average rate base or end-of-test year rate base is used, but instead, it is about the plant that is permitted to be included in rate base.

OCA witness Morgan modified the Company's proposed retirements and contributions of plant in service in the FTY and the FPFTY. OCA M.B. at 16-17; OCA R.B.at 8-9; OCA St. 2 at 4, Sch. LKM-1.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 for the FTY or the FPFTY. The exclusion of retirements causes the year end balances to be overstated. Therefore, I have determined that it is necessary to adjust plant retirements and contributions in 2019 and 2020.

OCA St. 2 at 4, Sch. LKM-1.

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

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

OCA St. 2 at 5, Sch. LKM-1 (footnote omitted).

In Rebuttal Testimony, Company witness Gorman did not specifically address Mr. Morgan's recommendations with respect to plant retirements. See, Valley St. 1-R at 11-12 (Gorman discussion of response to OCA witness Morgan's plant in service, Materials and

Supplies, Customer Deposits, removal of CWIP, use of average rate base in the FPFTY, and EDIT recommendations). In its Main Brief and Reply Brief, Valley did not deny the exclusion of retirements, but only stated that the adjustments did not have a material impact on the Company's rate base claim. Valley M.B. at 16; Valley R.B. at 3. Without any further justification or argument, Valley concludes that the Company's calculations of its Plant in Service and Accumulated Depreciation should be adopted without modification.

The ALJs' decision does not address the issue raised by the OCA. The Company has not addressed Mr. Morgan's concerns that the exclusion of retirements causes the year end balances to be overstated. Whether the Company considers the impact to be minimal or significant, the Company cannot justify including overstated balances in rates. The OCA submits that the Company has failed to meet its burden of proof to demonstrate that its proposed calculation of Plant in Service and Accumulated Depreciation are accurate. The OCA requests that the Commission adopt the OCA's recommendation.

OCA Exception No. 3: The ALJ Erred By Adopting The Company's Proposed FPFTY Revenues. (R.D. at 17-19; OCA M.B. at 19-20; OCA R.B. at 9-11)

In the R.D., the ALJs adopted Valley's proposed FPFTY revenues. R.D. at 17-19. The ALJs determined that "we agree with the use by Valley's witness of the regression analysis as an appropriate method to forecast future sales." R.D. at 19. The OCA submits that the ALJs' recommendation is contrary to the evidence presented. The Commission should not adopt the ALJs' recommendation as to the Company's proposed FPFTY revenues.

OCA witness Mierzwa proposed to adjust Valley's FPFTY revenues to reflect the most recent available usage of Valley's customers. Mr. Mierzwa utilized the 12-month period ending August 2019 and proposed an adjustment to increase projected revenues by $164,857. OCA St. 4 at 31, Sch. JMD-6. In Surrebuttal Testimony, OCA witness Mierzwa updated his adjustment to reflect the most recent data available and included the more localized weather information provided in response to OCA-VI-2 rather than the State College, Pa. data he had originally used. OCA St. 4-SR at 16. Mr. Mierzwa updated his FPFTY revenues projection of $141,561 in his Surrebuttal Testimony. OCA St. 4-SR at 16, Sch. JDM-6S.

The ALJs adopt the Company's regression analysis as an "appropriate method to forecast future sales," but the problem is that, as Mr. Mierzwa testified, the Company's methodology does not align with Valley's actual annual revenues. See, R.D. at 19; OCA St. 4-SR at 15. OCA witness Mierzwa's projected revenue adjustment more accurately reflects anticipated revenues. See, OCA St. 4-SR at 15.

The ALJs state that the OCA did not provide sufficient justification to deny the approach and cite to Mr. Gorman's testimony that the OCA did not claim that there were any flaws in the Company's analysis. R.D. at 19, citing Tr. 84. The OCA submits that this is simply incorrect. The issue with Company witness Gorman's analysis is that a comparison of the Company's most recent annual revenues demonstrate that Mr. Gorman's projections will significantly understate the FPFTY revenues. OCA St. 4-SR at 15. As OCA witness Mierzwa testified, last winter was significantly colder than normal, a result that should be accounted for when projecting future revenues, and Mr. Mierzwa's methodology incorporates this analysis. OCA St. 4 at 31; OCA St. 4 at Sch. JDM-6. Mr. Gorman's analysis does not address this issue. As Mr. Mierzwa testified:

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

OCA St. 4-SR at 15. OCA witness Mierzwa reviewed Valley's most recent annual revenues and found them a reasonable estimate of FPFTY revenues. Mr. Mierzwa utilized the most recent data along with the localized weather data provided the Company. OCA witness Mierzwa's updated FPFTY revenues projection is $141,561. OCA St. 4-SR at 16, Sch. JDM-6S.

The OCA submits that the Commission should reject the ALJs' recommendation as to Valley's revenues because Valley's proposed revenues understate the FPFTY revenues.

OCA Exception No. 4: <u>The ALJs' Recommended Decision Erred By Adopting Valley's Claims For Meters and House Regulators Expense (Account 878) and Meter Reading Expense (Account 902).</u> (R.D. at 31-32; OCA M.B. at 26-27, 29-30; OCA R.B. at 17)

In the R.D., the ALJs addressed together the OCA's proposed adjustments regarding Valley's claims for Meters and House Regulators (Account 878) expense and Meter Reading (Account 902) expense. R.D. at 31-32. The ALJs recommended the rejection of the OCA's proposals to reduce the meters and house regulators expense claim by $33,736 to $138,827 and reduce the meter reading expense claim by $12,847 to $86,821. The Company argues that expenses for Account 878 equal $172,563 and expenses for Account 902 equal $99,668. Valley M.B.; OCA St. 1 at 9. The Company's proposed expense for Account 878 is $28,488, or 20 percent, higher than the expense in the HTY. OCA St. 1 at 6. Valley's proposed expense for Account 902 is $14,821, or 17 percent, higher than the expense in the HTY. OCA St. 1 at 9. The ALJs recommended the adoption of Valley's claim for Meters and House Regulators and Meter Reading expense claims. R.D. at 32. The ALJs accepted Valley's argument that FTY projections for Account 902 (Meter Reading) would track with proposed increases to Account 878 (Meters and House Regulators). R.D. at 32. The OCA submits that the ALJs' findings are in error and the Commission should not adopt the ALJs' recommendation as to the Company's Meters and House Regulators and Meter Reading expense claims.

The Company argues that the increase in Account 878's forecasted expenses is due to a shift in expenses from Account 902 to Account 878. R.D. at 32. As explained in the OCA's Main

Brief and Reply Brief, OCA witness Sherwood disagrees with the Company's underlying forecast. OCA M.B. at 26-27; OCA R.B. at 17. In Surrebuttal Testimony, Ms. Sherwood explained that Account 902's forecast does not accurately reflect the supposed shift in expenses. OCA St. 1-SR (Revised) at 10-11.

Specifically, regarding Account 902's increase in expenses, the Company cites to increases in overhead expenses of payroll taxes and estimated increases in benefits costs such as healthcare and retirement; however, the Company through the first half of 2019 has not experienced this level of forecasted expenses. OCA M.B. at 29; OCA R.B. at 17. The Company has failed to justify the significant proposed increase particularly as the costs in the first half of 2019 have not experienced such a level of increase. OCA M.B. at 30; OCA R.B. at 17.

In order to address year to year fluctuations in expenses, the OCA submits that a three-year average of the Account 878 expenses for 2016 through 2018 is reasonable. OCA M.B. at 27. The OCA accepts the Company's increase to the labor and overhead costs by three percent, to reflect the approved salary increases for FTY, but recommends an adjustment to Account 902 of $12,847 because the Company's proposed expense claim is unsupported. OCA St. 1 at 10; OCA M.B. at 30; OCA R.B. at 17.

In fact, the Company did not even respond directly to the OCA witness Sherwood's recommendations regarding Account 902 but only made general comments about all line items of O&M expenses. Valley St. 1-R at 9. Company witness Gorman criticizes OCA witness Sherwood's adjustments to O&M expense in general but not specifically with respect to Account 902. Valley St. 1-R at 9. OCA witness Sherwood responded to this issue by stating:

> I recommended adjustments to accounts that appeared to have aberrations based upon historical trends and year-to-year comparisons. If the Company reasonably justified the expense increases, then I accepted the Company's proposed claim…Mr. Gorman is incorrect about my methodology for proposing adjustments.

> My methodology did not vary by years, rather if the adjustment was not focused on labor and overhead expenses, I recommended that a three-year average be used to determine the expense for FTY. If the adjustments were for labor and overhead expenses, then I recommended that a three percent increase be applied to HTY labor and overhead expenses. My methodology for proposing the adjustments varied, it was done to provide a fair adjustment for the Company.

OCA St. 1-SR (Revised at 8-9)

The OCA submits that the Company has failed to justify the proposed increase in expense. The OCA submits that the Commission should reject the ALJs' recommendation as to the Company's Account 878 and Account 902 claims and adopt the OCA's proposed adjustment.

OCA Exception No. 5: <u>The ALJs' Recommended Decision Erred By Adopting The Company's Nine Month Annualized Costs For Customer Installations (Account 879) And Disregarding The Historical Expenses Incurred For The Account.</u> (R.D. at 32-33; OCA M.B. at 27-28; OCA R.B. at 18)

In their Recommended Decision, the ALJs adopted the Company's recommendation regarding Account 879 for Customer Installations. R.D. at 32. The OCA submits that the Commission should not adopt the ALJs recommendations as to the Company's Account 879 regarding Customer Installations. The Company projects that the total cost of customer installations will be $132,269, which is $17,933, or 16 percent, higher than the expense in the HTY. OCA St. 1 at 7. The Company claims that the increase from 2018 to 2019 of $13,352 is due to a 3 percent increase in wages, effective January 1, 2019, but the 2019 increase in overhead costs is actually 25 percent higher than 2018 overhead costs. OCA St. 1 at 7.

In the proceeding, the Company provided no explanation for the proposed increase. In Rebuttal Testimony, the Company did not respond directly to the OCA's recommendations regarding Account 879 but instead made general comments about all line item expenses. Valley St. 1-R at 9. In order to address the year to year fluctuations, OCA witness Sherwood uses a three-year average to calculate the total expense to be $117,396. Company witness Gorman disagrees with OCA witness Sherwood's use of a three-year average.

The ALJs used the Company's annualization of the 9-month actual data, or $136,265, to support the Company's claim of $132,269 without addressing the factual issues raised by OCA witness Sherwood regarding the Company's inflated claim. R.D. at 32. The OCA submits that the ALJs' assessment appears to be solely based upon the Company's actual 9-month data, but the claim ignores the Company's historical spending and OCA Sherwood's unanswered questions regarding the Company's claim. Acceptance of the Company's claim based solely upon the actual data provided for the future test year ignores the historical changes to expenses. OCA witness Sherwood responded to this issue as follows:

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

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

OCA witness Sherwood, using the average expense for Account 879, calculates the three-year average total expense to be $117,396. OCA St. 1 at 8. This methodology properly accounts for variations and aberrations in year-to-year expenses to develop a normal level of on-going expense. Ms. Sherwood's adjustment is reasonable and should be adopted. App. A, Table II. The OCA submits that the Commission should reject the ALJs' recommendation as to the Company's customer installations expense claim and adopt the OCA's proposal to adjust this claim.

OCA Exception No. 6: The ALJs Correctly Adopted The OCA's Adjustment To The Company's Office Supplies and Expenses (Account 921), But Erred By Increasing The Adjustment Due To One-Time Increases Experienced In The First Nine Months Of 2019. (R.D. at 39-40; OCA M.B. at 34-35; OCA R.B. at 20-21).

The ALJs' R.D. accepted the OCA's adjustment to the Company's Office Supplies and Expenses (Account 921), but erred in their modification of the OCA's adjustment. The OCA recommended an adjustment to the Company's by $19,510, from the Company's claim of $74,701 to $55,191. The ALJs proposed to increase the OCA's adjustment from $55,191 to $59,934 because they argue that "it reflects the travel and training expenses that Valley has experienced through the first 9 months of 2019." R.D. at 40.

The OCA submits that the proposed increase to the Office Supplies and Expenses claim is inappropriate. As OCA witness Sherwood stated, there is no indication in the record that the Company's proposed training and travel expenses will continue beyond 2020. OCA St. 1-SR (Revised) at 11; OCA M.B. at 34-35; OCA R.B. at 20. The Company's adjustment essentially places greater emphasis on the Company's most recent one-time expenditures, regardless of whether those expenditures will continue in the future. OCA witness Sherwood testified:

> Witness Gorman states that the entire year's expenses should be evaluated; however, I would argue that multiple years should be evaluated when considering the budget for the FPFTY. While expenses may be running close to the Company's overall FPFTY claim, it does not necessarily mean that the level of expenses incurred in FTY will be incurred in FPFTY due to one-time expenses and/or unexpected projected. Furthermore, there is potential for expenses in the FTY to be higher or lower in that year in comparison to other years. Therefore historical

> expense trends should be considered along with known and measurable increases when setting rates.

OCA St. 1-SR at 9.

The OCA submits that the ALJs' Recommended Decision erred by increasing the OCA's proposed adjustment to Office Supplies and Expenses (Account 921) due to one-time increases experienced in the last 9 months. The Commission should reject the ALJs' proposed increase to the OCA's adjustment, and the Commission should adopt the OCA's recommendation.

OCA Exception No. 7: The ALJs Erred In Recommending That Valley Rate Case Expense Be Normalized Over Three Years. (R.D. at 26-29; OCA M.B. at 35-37; OCA R.B. at 21)

In the R.D., the ALJs' recommended that Valley's rate case expense be normalized over three years as proposed by the Company. R.D. 426-29. The OCA submits that a three-year normalization period is inconsistent with both Commission precedent and the Company's filing frequency. As detailed in the OCA's Main Brief, in past rulings, the Commission utilized the actual filing history to establish the normalization period for rate case expense. OCA M.B. at 35-37.

The Company states that the 3-year normalization period is appropriate, as that is the time period since its last rate case filing. OCA St. 1-SR (Revised) at 13; OCA M.B. at 36. Additionally, the Company cites increased revenues shortly after 2010 allowing them to delay filing a rate case for nine years, and they now predict that those revenues will not continue. Id.

OCA witness Sherwood recommends a more appropriate 60-month normalization period. Ms. Sherwood explained why a 60-month normalization period is more appropriate as follows:

> There is Commission precedent to utilize the average period between rate cases to determine the normalization of the rate case expense, as I have done to calculate the normalization period in this case. This method does not penalize or discourage the Company from filing a rate case as needed, rather it is a way to match the

> expense recovery over the average period of time of when cases are filed. Therefore, I maintain my recommendation to utilize a 60 month normalization period. Additionally, as with the Company's concern regarding under-recovery, there is concern for over-recovery of rate case expense if the Company does not file within the time period.

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

It is generally accepted that the purpose of a rate case normalization period is to spread costs over the actual frequency that the Company files rate cases. OCA M.B. at 37. Moreover, the Commission has consistently held that rate case expenses are normal operating expenses, and normalization should, therefore, be based on the historical frequency of the utility's rate filings. Popowsky v. Pa. PUC, 674 A.2d 1149, 1154 (Pa. Commw. 1996); Pa. PUC v. Columbia Water Co., 2009 Pa. PUC LEXIS 1423 (2009); Lancaster Sewer, 2005 Pa. PUC LEXIS *84; Pa. PUC v. National Fuel Gas Distribution Corp., 84 Pa. PUC 134, 175 (1995); Pa. PUC v. Roaring Creek Water Co., 73 Pa. PUC 373, 400 (1990); Pa. PUC v. West Penn Power Co., 119 PUR4th 110, 149 (Pa. PUC 1990). In recent cases the Commission reiterated that the normalization period is determined, "by examining the utility's actual historical rate filings, not upon the utility's intentions." Pa. PUC v. City of Lancaster – Bureau of Water, 2011 Pa. PUC LEXIS 1685, *56-57 (Lancaster 2011); Pa. PUC v. Metropolitan Edison Co., 2007 Pa. PUC LEXIS 5 (2007); Lancaster Sewer, 2005 Pa. PUC LEXIS *84; Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 (Order entered May 18, 2017, at 65) (City of Dubois).

By changing the normalization period, OCA witness Sherwood is recommending an adjustment of $36,133, this adjustment is reflected in OCA schedule SLS-15. OCA St. 1 at 18; App. A, Table II. Valley has historically filed a rate case every 60 months on average. R.D. at 29. Valley has not supported its claim that a shortened normalization period is appropriate. The OCA therefore recommends that the ALJ's recommendation to adopt the Company's proposed three year normalization period be rejected and the OCA's 60-month normalization period be utilized.

OCA Exception No. 8: The ALJs Erred By Recommending A 9.93% Return On Equity For Valley. (R.D. at 49-79; OCA M.B. at 38-66; OCA R.B. at 23-32)

In the R.D., the ALJs recommended that the OCA's proposed Return on Common Equity of 8.34% be rejected. R.D. at 78-79. Instead, the ALJs recommended that Valley be awarded an ROE of 9.93%[1]. Id. The ALJs based their recommendation roughly on size and performance adjustments. R.D. 78-79. The OCA submits that the recommendation to award Valley an ROE of 9.93% is both inconsistent with the evidence and inconsistent with the low-cost capital environment, therefore should not be adopted.

A. Introduction

In determining their recommended return on equity, the ALJs held that following Commission precedent and contrary to the Company's position, the DCF should be the primary method used to determine the ROE. R.D. at 55. Furthermore, the ALJs held the CAPM method is appropriate to check the reasonableness of the DCF results. R.D. at 55. Company witness D'Ascendis initially recommended an ROE of 11.35%, which was later adjusted to 10.60%. Valley St. 2-R at 2; OCA M.B. at 39. OCA witness Dr. Habr recommends an ROE of 8.34% and I&E witness Spadaccio recommends an ROE of 8.46%. See, OCA M.B. at 45. As explained in more detail in OCA's Main Brief, Dr. Habr's analysis of the cost of common equity for similar risk utility operations persuasively supports a cost of equity of 8.34%.

[1] The 9.93% ROE includes the 25 basis point "Management Effectiveness" adder that will be discussed further in OCA Exception No. 10.

B. <u>The ALJs Erred In Utilizing The Upper Range DCF Results To Accommodate The Company's Desired Size Adjustment</u>

While the Company used four methods to determine the cost of equity, the ALJs affirmed that the "Commission has traditionally utilized the DCF method, with the CAPM method as a check." R.D. at 59-60. The ALJs determined that with each parties DCF results being similar and reasonable, to adopt I&E's. R.D. at 65. Furthermore, regarding Valley's DCF results, the ALJs stated we "note the standalone CAPM ROE and DCF ROE were within 20 basis points, thus making Mr. D'Ascendis' DCF analysis appears reasonable." R.D. at 68.

The Company proposed a 100-basis point size adjustment to account for its perceived additional risks due to operating as a smaller utility. OCA St 3 at 29-30; OCA M.B. at 62-63. In its Main Brief, the Company suggests that it would be appropriate for them to receive up to a 437basis point adjustment in compensation for the size of the Company. R.D. at 68.

The Company argues that investors demand greater returns to account for the size risk associated with the Company. R.D. at 68. However, as detailed further in OCA's Main Brief, Dr. Habr appropriately disposes of the Company's argument and further testifies that a size adder to ROE would be unduly burdensome for ratepayers. <u>See</u>, OCA M.B. at 62-63. More specifically, Dr. Habr found that, after review of all the Company testimony on the subject, the economic literature presented by the Company in an attempt to bolster its position, actually, more accurately supports a downward adjustment. Dr. Habr explained:

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

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

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

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

When the OLS betas and size premiums for all ten deciles are taken into account, it is clear that regulated utility companies have more in common with the first decile.

What this table shows is that positive size premiums are associated with OLS betas that are greater than one. All of the utility holding companies in the proxy groups in this proceeding have betas that were calculated using ordinary least squares and have values less than one. This suggests that if any adjustment is made for size, it should be negative rather than positive.

OCA St 3 at 29-30 (footnote omitted); OCA M.B. 62-63.

Dr. Habr further commented on the proposed size adjustment:

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 St. 3 at 29-30; OCA M.B. 62.

I&E opposes the unnecessary size adjustment as well. I&E witness Henkel testified that the Company's size adjustment is unnecessary because none of the technical literature the Company cites to in support is specific to the utility industry. I&E M.B. at 46-47. Furthermore, I&E cites an article stating a size adjustment for risk is not applicable to utility companies. I&E M.B. at 46-47.

Nonetheless, the ALJs were persuaded by the Company that "there is a general inverse relationship between size and risk . . ." R.D. at 73. The ALJs further stated "we are unable to conclude whether size is or is not a risk for utilities although, generally, size does seem to be a risk factor for companies. Ultimately, we must conclude that smaller companies face size risk and Valley is a smaller company." R.D. at 73-74. The OCA disagrees with the ALJs' reasoning here, essentially claiming that because size is a risk factor for companies in general, it is equally a risk factor to utilities. Such a proposition conflicts with solid ratemaking principals, especially considering the fact that utilities are natural monopolies and are to be treated as such.

While the ALJs agree to the principle presented by the Company, they hesitated to assign a specific number to the size adjustment, instead suggesting, "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 small utility." R.D. 74. Further the ALJs state:

> 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.

R.D. at 75.

The ALJs' adoption of the higher end of the DCF range violates the OCA's CAPM limits. As explained more fully in OCA's Main Brief, Dr. Habr states:

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

OCA St. 3 at 28; OCA M.B. at 57.

Additionally, the ALJs adopted the Company's CAPM analysis which OCA witness Dr. Habr found to be unreasonable. As described in more detail in OCA's Main Brief, Dr. Habr refuted Mr. D'Ascendis' CAPM analysis because Mr. D'Ascendis relied on an average 3.36% 30-year treasury yield based on a period covering the second quarter of 2019 through 2029. OCA St. 3 at 34; OCA M.B. at 59. Dr. Habr explains that the purpose of a test-year in utility regulation is to match the costs incurred that year with the services provided during that year. OCA St. 3 at 34; OCA M.B. at 59. Test-year costs are not based on costs that may exist during some period in the future. Id. To rectify this problem, Dr. Habr substituted the 2.66% 30-year treasury yield that was used in Dr. Habr's CAPM/Risk Premium analysis. The columns in Table – 8 from OCA St. 3 at 34 (OCA M.B. at 59) representing the Electric Company proxy group demonstrate the impact of this change in the 30-year treasury rate.

It is the position of the OCA that a recommendation based on a DCF result of 9.68% is unreasonable given the DCF range presented by the parties in this proceeding. Accordingly, the OCA submits that the recommendation of the ALJs to base the Company's ROE upon the higher end of the DCF range should not be adopted.

OCA Exception No. 9: The ALJs Erred By Recommending A Management Effectiveness Adjustment Adder Of 25 Basis Points To Valley Return On Equity. (R.D. at 75-78; OCA M.B. at 63-62; OCA R.B. at 31.)

In the R.D., the ALJs recommend adoption of Valley proposed 25 basis point management effectiveness adder. R.D. at 77-78. In rejecting the OCA's proposal, the ALJs recommended that Valley be awarded the full 25 basis point adder. Id. The OCA submits that the Management Effectiveness adder is unsupported and should not be granted.

As detailed more fully in OCA's Main Brief, the Commission should reasonably expect regulated utilities to provide safe, adequate, efficient and reasonable service in accordance with the utilities' public service obligation. OCA M.B. at 63. Accordingly, proposals such as Valley's "Management Effectiveness Adjustment" should be carefully scrutinized and only awarded in truly exceptional circumstances. The OCA submits that the record in this matter does not support the ALJs' recommended 25 basis point adder.

The ALJs' recommended 9.68% base ROE award is well above what the record here supports. Adding another 25 basis points on top of that already overinflated ROE is neither reasonable nor fair to the ratepayers, and is certainly not required to attract capital. OCA witness Dr. Habr explained that a management bonus is not a factor for reasonable investment decision making, as follows:

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

OCA St. 3 at 31; OCA M.B. at 63.

Additionally, I&E witness Henkel argued against granting Valley's 25-basis-point adder as follows:

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

I&E St. 2 at 44; OCA M.B. at 63.

The OCA submits that the record in this matter does not support the award of an additional financial adder based on management performance. Accordingly, the Commission should reject the ALJs' acceptance of Valley request for an additional 25 basis point ROE adder.

III. CONCLUSION

For the reasons set forth above in these Exceptions, and the OCA's Main and Reply Briefs, the OCA requests that the Commission grant these Exceptions and adopt the modifications and recommendations herein and in the OCA's Main and Reply Briefs.

Respectfully Submitted,

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