BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

EXCEPTIONS
OF VALLEY ENERGY, INC.

Pamela C. Polacek (PA I.D. No. 78276)
Adeolu A. Bakare (PA I.D. No. 208541)
Matthew L. Garber (PA I.D. No. 322855)
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone: (717) 232-8000
Fax: (717) 260-1744
ppolacek@mcneeslaw.com
abakare@mcneeslaw.com
mgarber@mcneeslaw.com

Counsel to Valley Energy, Inc.

Dated: March 13, 2020

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. EXCEPTIONS 2

A. Exception No. 1: The R.D. erred in rejecting the Company's 3% Fully Projected Future Test Year inflation adjustment as speculative. (R.D. at 24). 2

B. Exception No. 2: The R.D. erred in denying the Company's proposal to increase its FPFTY O&M expense based on an annualization of 9-month FTY expense data. (R.D. at 25). 8

C. Exception No. 3: The R.D. erred in reducing the Company's claim for Industrial/Commercial Meters and Regulators Operations Expense by $9,429. (R.D. at 30). 10

D. Exception No. 4: The R.D. erred in declining to apply a 3% labor-related adjustment to the FPFTY for Customer Records and Collection Expense. (R.D. at 35). 11

E. Exception No. 5: The R.D. erred in declining to apply a 3% labor-related adjustment to the FPFTY for Administrative and General Salaries. (R.D. at 38). 12

F. Exception No. 6: The R.D. erred in approving I&E's Uncollectible Expense adjustment of $24,201 based on the 3-year average write-off ratio (62%) versus the Company's reliance on the HTY write-off ratio (84%). (R.D. at 46). 12

G. Exception No. 7: The R.D. erred in declining to consider multiple methods to establish the ROE where data shows DCF results to be unreliable based on a market-to-book analysis. (R.D. at 56). 13

H. Exception No. 8: The R.D. erred in failing to apply the Company's 100 basis point adjustment for size risk to the ROE. (R.D. at 72). 17

III. CONCLUSION 20

I. INTRODUCTION

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

The Office of Consumer Advocate ("OCA") filed a Formal Complaint against Valley's rate increase on July 30, 2019. The Office of Small Business Advocate ("OSBA") and the Bureau of Investigation and Enforcement ("I&E"), thereafter, submitted Notices of Appearance in this proceeding. Pursuant to 52 Pa. Code § 5.61(d), Valley elected not to file an Answer to OCA's Complaint.

On December 16, 2019, and December 17, 2019, Administrative Law Judges ("ALJs") Steven K. Haas and Benjamin Myers held an evidentiary hearing for the Citizens' Electric Company of Lewisburg, PA ("Citizens'"), Wellsboro Electric Company ("Wellsboro"), and Valley ("collectively, Companies") proceedings. During this hearing, the parties entered their prepared Testimony and Exhibits into the record. Company witnesses Howard S. Gorman, Dylan W. D'Ascendis, Edward E. Rogers, and Jamie Levering presented Oral Rejoinder Testimony. I&E and OCA witnesses were also sworn in and submitted to cross-examination.

On January 8, 2020, and January 22, 2020, OCA, OSBA, I&E, and Valley submitted a Main Brief and Reply Brief, respectively. On February 28, 2020, ALJs Haas and Myers issued a Recommended Decision ("R.D.") in this proceeding.

For the reasons set forth below, Valley hereby files these Exceptions to the ALJs' R.D.

---

[1] In its Rebuttal Testimony, Valley subsequently revised its proposed revenue increase to approximately $745,000. Valley Main Brief at 1.

II. EXCEPTIONS

A. <u>Exception No. 1</u>: The R.D. erred in rejecting the Company's 3% Fully Projected Future Test Year inflation adjustment as speculative. (R.D. at 24).

The R.D. fails to appropriately recognize the substantial evidence in support of the Company's 3% inflation factor, which meets the known and measurable standard as historically applied by the Commission. As described below, the Company provided evidence, including consistent historical expense increases, supporting its projection that total Operations and Maintenance ("O&M") expenses will increase by at least the 3% rate of inflation in the Fully Projected Future Test Year ("FPFTY"). As the Company has only proposed a conservative O&M inflation adjustment supported by historical experience, the Company submits that approval of the proposed 3% inflation adjustment is reasonable and consistent with the Commission's authority to approve FPFTY expenses. Alternatively, the Company submits that particularly strong evidence supporting a 3% FPFTY increase in salaries and benefits supports approval of the 3% inflation adjustment for the accounts where labor is the primary expense.

1. The "known and measurable" standard does not preclude inflation adjustments.

The R.D. misapplies the known and measurable standard in its rejection of the Company's inflation adjustment. The R.D. asserts that inflation adjustments "are not actually known and measurable because they do not reflect the true cost of expenses [because] the adjustments are blanket adjustments which do not directly relate to the actual costs expected to be incurred." R.D. at 23. This holding is inconsistent with Commission precedent. Even prior to the Pennsylvania Legislature's authorization of the FPFTY through Act 11 of 2012 ("Act 11"), the "known and measurable" standard was not universally applied to deny inflation adjustments – in fact, it had traditionally been applied in quite the opposite manner. In 1996, the Commonwealth Court of Pennsylvania stated: "PUC decisional law reflects its consistent acceptance of the application of

an inflation factor to expenses which are not otherwise adjusted, and has not indicated that there are any inherent flaws in this adjustment procedure." *Nat'l Fuel Gas Distrib. Corp. v. Pa. Pub. Util. Comm'n*, 677 A.2d 861, 865 (Pa. Cmwlth. 1996). Consequently, there is nothing inherently inconsistent between the "known and measurable" standard and an inflation adjustment. The R.D.'s attempt to distinguish the Company's proposed inflation adjustment as a "blanket adjustment" does not invalidate the Company's method because the Company did not apply a blanket adjustment to all FPFTY costs. The Company applied an inflation adjustment solely to O&M expenses, which, as discussed below, is consistent with the Company's historical experience.

By way of contrast, the two cases cited by OCA that involve application by the Commission of the "known and measurable" standard to deny inflation adjustments involved far broader and more speculative adjustments. As stated in the Company's Main Brief, the Commission previously denied an inflation adjustment proposed by PECO Energy Company ("PECO") where PECO proposed to recover a true blanket 2% attrition adjustment to expenses, revenue, and rate base. *See* Valley Main Brief at 39 *citing Pa. PUC v. Philadelphia Electric Company*, Docket No. R-822291 (Order Entered Nov. 22, 1983). In contrast, the Company's adjustment applies only to expenses, and not to revenue or rate base. Valley Main Brief at 30. Similarly, OCA's reliance on the Commission's decision in a 2007 Philadelphia Gas Works ("PGW") case as a rejection of an inflation factor misconstrues the Commission's decision in that case. *See* R.D. at 24. There, PGW proposed a 2% annual attrition adjustment to expenses as part of a broader proposal to set rates based on a five-year forecast. *See* Valley Main Brief at 39; *see also Pa. PUC v. Philadelphia Gas Works*, Docket No. R-00061931 et al. (Order Entered Sept. 28,

2007) ("PGW Order") at 14.[2] As clearly stated in the PGW Order, the Commission rejected the proposal based not on the inflation factor component, but rather the speculative nature of five-year projections. *See* PGW Order, at 17. Here, Valley used the inflation adjustment solely for one year, the FPFTY. Therefore, the R.D. erred in concluding that OCA's cited cases support rejection of Valley's proposal. *See* R.D. at 23. While the Commission has rejected certain inflation adjustments in the past, it has not categorically denied inflation adjustments as contrary to the known and measurable standard. In fact, the Commission has accepted inflation adjustments as consistent with the known and measurable standard. Valley Main Brief at 38.

2. *The Company's claim is supported by the record and meets the "known and measurable" standard as historically applied by the Commission.*

The R.D. fails to recognize the substantial evidence in support of the Company's 3% inflation factor. The Company's inflation factor is supported with Company-specific historical experience, 2020 budget increases, and other information, and meets the known and measurable standard as historically applied by the Commission.

First and foremost, the historical O&M expense increases demonstrate a consistent and verifiable trend of increased expenses. In fact, as seen in Schedule C1-1, actual historic O&M expenses show a greater than 3% increase *every year* from 2016 to 2018 (the last year full expense data is available). Valley Main Brief at 37; *see also* Valley Statement No. 1, Exhibit__(HSG-1), Schedule C1-1 (R) at 2. In other words, the Company's actual annual O&M expenses have consistently increased over 3%. It is clear that, historically, 3% is a reasonable and conservative projection of the Company's FPFTY increase in O&M costs. This approach parallels OCA witness

[2] The Company's Main Brief incorrectly referenced a November 28, 2007, entry date for the PGW Order instead of the correct September 28, 2007, entry date.

Sherwood's statement that historical expense trends should be considered along with known and measurable increases when setting rates. Valley Main Brief at 40.

Second, the Company's 2020 budget indicates the proposed 3% expense adjustment represents a conservative estimate of the FPFTY costs. On Rejoinder, Valley CEO Edward Rogers described the Company's incorporation of inflation adjustments into its budgeting process, stating, "...it would be extremely improper not to include inflationary costs of inflation." Tr. 201. Mr. Rogers testified that "[o]n an overall basis, we expect expenses to increase by over 3% from 2019 to 2020, with significantly higher increases in some areas (e.g. health insurance costs) being offset by management's efforts to manage costs." Valley Main Brief at 37 *citing* Valley Statement No. 4-R at 5.

Third, the Company testified to labor and healthcare expense increases justifying the 3% inflation adjustment for FPFTY expenses. As noted above, Mr. Rogers testified that the Company anticipated increases to health insurance costs and employee salaries. Tr. 201. In fact, Mr. Gorman testified that the Premium Summary provided by Highmark points to increases of as much as 9.79% for health care. *See* Tr. 78-79. Mr. Rogers explained on Rejoinder that labor and overhead historically comprise 65% of Valley's total O&M expenses, meaning annual wage and benefit increases make up the majority of the Company's O&M expense. Valley Main Brief at 38 *citing* Tr. 201.

Most of the evidence above, which had been summarized in the Company's Main Brief, was not addressed by the R.D. Instead, the R.D. rejected the Company's inflation adjustment as a "blanket" adjustment unrelated to the actual costs to be incurred. R.D. at 24. However, as described above, the Company supported the proposed adjustment by presenting evidence of actual costs to be incurred. The Company has demonstrated that labor costs will rise by approximately

3%, and certain vendor and overhead costs such as health insurance will escalate by much greater amounts. The Company has established, by a preponderance of the evidence, that its O&M expenses will increase by 3% from 2019 to 2020. This evidence is sufficient to warrant acceptance of the Company's proposed adjustment.

3. The R.D.'s decision, if adopted, would frustrate the purpose of Act 11 and the FPFTY.

The Company's approach to projecting 2020 costs aligns with the purpose of the FPFTY. The General Assembly enacted Act 11 to establish the FPFTY as a ratemaking tool to "reduce regulatory lag due to the use of rate case inputs that are outdated by the time new base rates become effective and, further, to provide more ratemaking flexibility for the timely recovery of prudently incurred infrastructure costs." *Implementation of Act 11 of 2012*, 2012 Pa. PUC LEXIS 1223 (2012) at *4-5. While the R.D. correctly states that Act 11 did not abolish the "known and measurable" standard, it also does not preclude reliance on well-founded projections. To the contrary, Section 315 of the Public Utility Code explains that there will be "estimates" included with the Future Test Year ("FTY") and the FPFTY. 66 Pa. C.S. § 315 ("[T]he utility shall provide, as specified by the commission in its final order, appropriate data evidencing the accuracy of the *estimates* contained in the future test year or a fully projected future test year" (emphasis added)). The R.D., by denying the Company's well-supported 3% increase for FPFTY O&M expenses, would erode the benefits of Act 11 and the FPFTY as an authorized ratemaking tool for the Company.

Contravening the clear purpose of Act 11, the R.D. relies on 2019 data for FPFTY expense allowances, despite substantial evidence that 2020 costs will increase at or above the 3% rate proposed by the Company. Where historical O&M expenses affirm the Company experiences annual expense increases in excess of 3%, denying a modest 3% expense adjustment for the

FPFTY directly conflicts with the forward-looking policy basis underlying Act 11 and the introduction of the FPFTY.

4. *At minimum, the 3% inflation adjustment should be applied to expense categories consisting primarily of labor and benefits expense, as the record demonstrates the Company's employee labor and benefits expense will increase by 3%.*

Although the Company maintains that the proposed 3% inflation adjustment should be granted in full, the R.D.'s rejection of the proposed inflation adjustment is particularly unjust as applied to the various expense accounts consisting primarily of labor and overhead expenses. As discussed above, the record shows that the Company will incur increased expenses from the FTY (2019) to the FPFTY (2020) for employee salary and benefits. These expense increases are not conditional – for every hour worked, the Company will experience higher employee labor and overhead costs.

As an alternative to applying the proposed 3% inflation adjustment to total O&M expense, the 3% inflation adjustment should be applied to the following expense accounts, which are comprised of a majority of labor and overhead expenses:

- Industrial/Commercial Meters and Regulators Operations (Account 876). The R.D. recommended an allowance of $64,046 based on annualization of the 9-month, September 30, 2019 data. However, this did not include a labor-related expense adjustment for the FPFTY. Because this account is primarily labor and overhead associated with meter maintenance, a 3% adjustment should be added to the final amount approved by the R.D. *See* OCA Statement No. 1 at 5.
- Customer Records and Collection Expense (Account 903). The R.D. recommended an allowance of $466,164 based on annualization of the 9-month, September 30, 2019, data. However, this did not include a labor-related expense adjustment for the FPFTY. Because

this account is primarily labor and overhead, a 3% adjustment should be added to the final amount approved by the R.D. *See* OCA Statement No. 1 at 9-10.

- Admin and General Salaries (Account 920). The R.D. recommended an allowance of $466,164 based on an adjusting the Company's proposed increase in overhead expense from the Historic Test Year ("HTY") to the FTY from 30% down to 3%. However, this did not include a similar labor-related expense adjustment for the FPFTY. Because this account is primarily labor and overhead, a 3% adjustment should be added to the amount approved by the R.D. *See* OCA Statement No. 1 at 14-15.

As indicated above, to ignore these known and measurable increases for employee salary and benefits is inconsistent with the weight of the evidence and inconsistent with the forward-looking purpose of the FPFTY under Act 11. Even in denying the well-supported proposal to increase total O&M expense by 3% for the FPFTY, the R.D. maintains that FPFTY cost increases that are demonstrated and explained should be accepted. Accordingly, at minimum, the Commission should apply the 3% expense adjustment to the FPFTY for the above-referenced accounts with predominant labor and overhead components.

B. <u>Exception No. 2:</u> The R.D. erred in denying the Company's proposal to increase its FPFTY O&M expense based on an annualization of 9-month FTY expense data. (R.D. at 25).

The Company proposed to project its FPFTY expenses by compiling all individual expense accounts based on annualized 9-month FTY actuals and applying a 3% inflation adjustment to derive total 2020 expenses. R.D. at 25. The R.D. rejected this approach, stating that the public utility must evaluate each individual cost claim under 66 Pa. C.S. §§ 1308(d), 315(a). However, this assumes that the Company's approach does not adequately address individual accounts. In fact, Section 315(a) requires only that the public utility meets its burden of proof to show that the

rate involved is just and reasonable. It does not prescribe the methods used to demonstrate the justness and reasonableness of a proposed rate, or how individual expenses may be justified.

Here, the Company's approach to projecting its costs is based on the most recent available data for each individual account. Valley Main Brief at 32-34. Valley's actual FTY expenses as of September 30, 2019, closely track its projected FTY expenses and demonstrate that the Company has very effectively managed to its budget. *Id.* This approach is consistent with the operations of a small public utility with limited staff. *See* Valley Main Brief at 35. As described by Witness Rogers, the Company's smaller size requires flexibility for labor assignments because "the Company shifts resources and priorities during the year as operational needs arise." *Id. citing* Valley Statement No. 4-R at 4.

In contrast, I&E and OCA's approach to reviewing Company expenses penalizes the Company for effectively managing its budget. Valley Main Brief at 35. This selective approach focused on accounts where expenses ran below budget in the FTY without recognizing the commensurate increases in other accounts, despite the fact that movement between accounts is required for a small Company like Valley to operate effectively. *Id.*

The R.D. erred by rejecting the Company's approach. R.D. at 25. Contrary to the R.D.'s conclusion, the Company's use of the most recent available data to develop its FPFTY projection is consistent with Section 315(a) because it reflects the actual FTY data for each expense account. For the reasons set forth above, the Commission should grant this Exception and approve the Company's proposed FTY expense based on the annualized 9-month FTY expense plus the 3% inflation adjustment.[3]

[3] In the event that the Commission denies this Exception, Exception Nos. 3-6 address individual expense accounts.

C. **<u>Exception No. 3</u>: The R.D. erred in reducing the Company's claim for Industrial/Commercial Meters and Regulators Operations Expense by $9,429. (R.D. at 30).**

The R.D. reduced the Company's $73,475 claim for Industrial/Commercial Meters and Regulators Operations Expense (Account No. 876) by $9,429 based on annualized 9-month FTY data. R.D. at 30. Review of the R.D.'s analysis indicates the adjustment incorporates a mathematical error. Additionally, as discussed above, this expense account consists primarily of labor and overhead expense and should be adjusted by 3% consistent with the Company's historical and budgeted wage and benefits increases.

In determining the appropriate expense allowance for Account No. 876, the R.D. adopts OCA's proposal to use annualized 9-month expense for the FTY. R.D. at 30. Notably, the record shows the Company incurs approximately 30% of the annual Account No. 876 expenses in the 4th quarter of each year. *Id.* OCA also concurs that "it is evident that in the past two years, the fourth quarter expenses are equivalent to approximately 30 percent of the *annual* expense." OCA Statement No. 1-SR, at 8. The R.D. acknowledges this trend, but claims its adjustment based on annualized 9-month data accounts for the higher 4th quarter expenses. *See id.*

However, the R.D.'s final recommendation relies on a mathematical error. The R.D. claims that "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." R.D. at 30. This analysis increases the 9-month expense by 30% *of the 9-month expense* (.30 x $48,034 = $14,410) instead of 30% of the total annual expense. *See id.* To accurately reflect the accepted premise that 30% of the annual expense is incurred in the 4th quarter, the 9-month FTY data ($48,034) should represent 70% of the full year's expenses, such that the annualized FTY expense would be $68,620 ($48,034 / .70). Accordingly, the claim that

OCA's adjustment accounts for the fact that Valley incurs 30% of its annual Account No. 876 expense in the 4th quarter is incorrect.

Additionally, the R.D. did not include a FPFTY adjustment. As explained above, Valley has budgeted for increases to employee wages and benefits, and health care costs are increasing by more than 9%. *See* Valley Main Brief at 37-38; *see also* Tr. 78-79. Because this account consists primarily of labor and overhead expense, it is reasonable to apply the Company's proposed 3% adjustment to the expense approved for this account. *See* I&E Exhibit No. 1, Schedule 4.

In light of the mathematical error and the increasing labor expense for the FPFTY, the Company respectfully requests that the Commission grant this Exception and approve the Company's original claim of $73,475, as the R.D.'s recommendation would understate the appropriate FPFTY expense.

D. Exception No. 4: The R.D. erred in declining to apply a 3% labor-related adjustment to the FPFTY for Customer Records and Collection Expense. (R.D. at 35).

The Company's Account No. 903, Customer Records and Collection Expense, includes employee salaries, wages, and overhead (employee benefits) expenses. *See* OCA Statement No. 1 at 10. The R.D. recommended a reduction of the Company's claim for Customer Records and Collection Expense from $513,237 to $466,164. R.D. at 35. This allowance was based on annualization of the 9-month, September 30, 2019, data. However, the R.D. did not include a FPFTY adjustment. As explained above, Valley has budgeted for increases to employee wages and benefits, and health care expenses are increasing by more than 9%. *See* Valley Main Brief at 37-38; *see also* Tr. 78-79. Because this account consists primarily of labor and overhead expense, it is reasonable to apply the Company's proposed 3% adjustment to the expense approved for this account.

E. Exception No. 5: The R.D. erred in declining to apply a 3% labor-related adjustment to the FPFTY for Administrative and General Salaries. (R.D. at 38).

The Company's Account No. 920, Administrative and General Salaries Expense includes employee salaries, wages, and overhead (employee benefits) expenses. *See* OCA Statement No. 1 at 14-15. The R.D. recommended a reduction of the Company's claim for Administrative and General Salaries Expense from $536,697 to $466,427. R.D. at 38. This allowance was based on annualization of the 9-month, September 30, 2019, data. However, the R.D. did not include a FPFTY adjustment. As explained above, Valley has budgeted for increases to employee wages and benefits and health care expenses are increasing by more than 9%. *See* Valley Main Brief, 37-38; *see also* Tr. 78-79. Because this account consists primarily of labor and overhead expense, it is reasonable to apply the Company's proposed 3% adjustment to the expense approved for this account.

F. Exception No. 6: The R.D. erred in approving I&E's Uncollectible Expense adjustment of $24,201 based on the 3-year average write-off ratio (62%) versus the Company's reliance on the HTY write-off ratio (84%). (R.D. at 46).

The R.D. approved an adjustment of $24,201 to the Company's $55,430 claim for Uncollectible Expense based on average of the annual write-off ratios for the period 2016 - 2018 (62%). The R.D. concluded that the Company overstated its claim by relying on the actual HTY write-off ratio (84%). R.D. at 46. As stated in the Company's Main Brief, in 2014, 2015 and 2018, the Company experienced higher write-off ratios than the 62% ratio recommended by the R.D. *See* Valley Main Brief at 49. As the 2016 and 2017 uncollectible ratios appear to be unusually low in comparison to the years prior *and* the years after, it is reasonable and prudent for the Company to rely on the most recent year as more reflective of normal operating conditions. *See id.*

Accordingly, the Company requests that the Commission grant this Exception and apply the 82% write-off ratio to the final base rate increase.

G. Exception No. 7: The R.D. erred in declining to consider multiple methods to establish the ROE where data shows DCF results to be unreliable based on a market-to-book analysis. (R.D. at 56).

The R.D. recommended a 9.93% Return on Equity ("ROE") for the Company. R.D. at 79. To arrive at its recommendation, the R.D. averaged the mean and median proxy group ROE from the Company' s Discounted Cash Flow ("DCF") analysis and set the base ROE at one standard deviation above that average (9.68%). *Id.* The R.D. additionally approved a 0.25% performance adjustment to arrive at the final recommended 9.93% ROE. *Id.*

By developing a recommended ROE based solely on the Company's DCF analysis, the R.D. erred in declining to consider multiple methods to determine the appropriate ROE for the Company. The record in this case presents credible evidence demonstrating that primary reliance on the DCF method in the current market environment will understate the appropriate ROE. The Commission should consider this evidence and incorporate the multiple models presented by Company witness Mr. Dylan D'Ascendis in determining the appropriate ROE for the Company.

The R.D. reviews prior Commission decisions and concludes that the Commission has historically relied on the DCF as the preferred method for determining an appropriate ROE, with the Capital Asset Pricing Model ("CAPM") method serving as a check. R.D. at 56. However, although the ALJ quoted select material from the Commission's decision in *Pa. Pub. Util. Comm'n v. UGI Utilities, Inc. – Electric Division* ("UGI Order"), the R.D. omits language from the UGI Order demonstrating that the Commission will consider other methods where appropriate. As noted in the Company's Main Brief, the Commission clarified this point as follows:

> Initially, we note that UGI has presented a valid argument that sole reliance on one methodology without checking the validity of the results of that methodology with other cost of equity analyses does not always lend itself to responsible ratemaking.

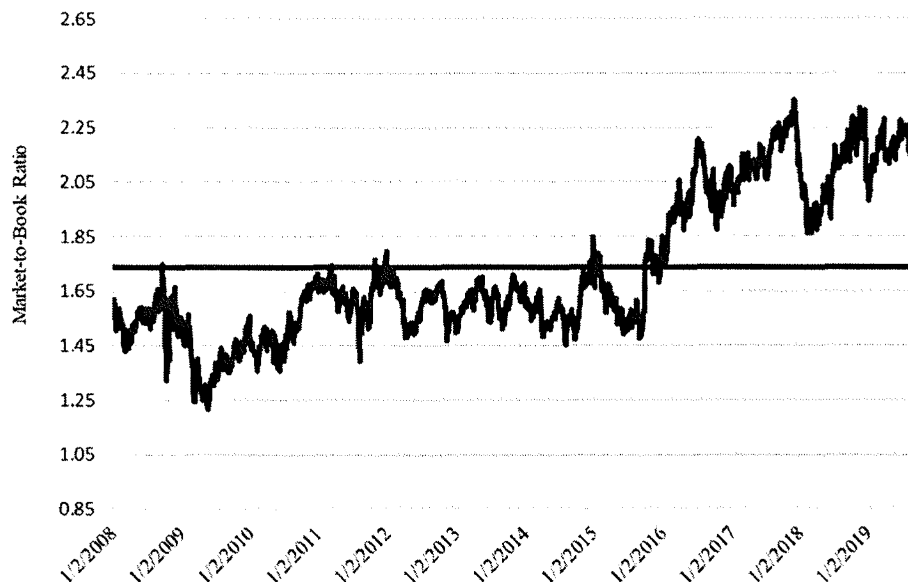
> As such, where evidence based on other cost of equity methods indicates that the DCF-only results may understate the utility's current cost of equity capital, we will consider those other methods, to some degree, in evaluating the appropriate range of reasonableness for our equity return determination.

Valley Main Brief at 66 *citing* UGI Order at 104-105. The Company submits that the Commission's comments in the UGI Order clarify that the DCF is the preferred method, but other methods will be considered where reliance on the DCF would lead to unreasonable results.

The record in this proceeding presents evidence that relying on DCF results will understate the appropriate rate of return for the Company. Mr. D'Ascendis analyzed the market-to-book ratios of the combined I&E and OCA gas utility proxy groups and observed that the market-to-book value for the combined proxy group has significantly exceeded the 1.75 ten-year average, with particularly high market-to-book ratios since 2018. Valley Main Brief at 67. The below table presents the results of Mr. D'Ascendis' analysis:

Main Brief Table 4

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



Valley Main Brief at 67. As explained by Mr. D'Ascendis, the DCF model assumes a market-to-book ratio of 1.0, which means that the model will overstate or understate the required ROE if the actual market-to-book value of the proxy group deviates from 1.0. *See id.* This is due to incongruent methods by which investors and regulators assess value; investors evaluate returns based on market value, while regulators authorize returns based on book value. *Id.* This effect is mitigated when the market-to-book ratio is at or close to 1.0. *Id.* Thus, in the current environment where the market-to-book ratio more than doubles 1.0, and even significantly exceeds the ten-year average of 1.75, the DCF model will understate the appropriate return for the Company.

In addition to presenting this analysis, Mr. D'Ascendis also provided extensive supporting evidence corroborating his findings. Mr. D'Ascendis reviewed financial literature concluding that "application of the standard DCF model to utility stocks understates the investor's expected return when the market to-book (M/B) ratio of a given stock exceeds unity." Valley Main Brief at 68. He further demonstrated the unreasonable results of the I&E and OCA ROE recommendations by applying the I&E and OCA cost rates to book value instead of market value, which reduced the I&E and OCA growth rates from 5.75% and 5.65% at market value, to just 0.98% and 0.99% at book value. *Id.* Finally, to further illustrate the impropriety of using a DCF model where the market-to-book ratio exceeds unity (1.0), Mr. D'Ascendis applied the I&E and OCA DCF models to the book value capital structure of the respective proxy group. *Id.* This adjustment corrects the apples-to-oranges result of the R.D., which relies on a DCF model with a market value capital structure to develop an ROE that will ultimately be applied to book value. Correcting this imbalance by running the I&E and OCA DCF models with a book value capital structure increases the respective ROEs by over 100 basis points (8.10% to 9.19% for the I&E DCF ROE and 8.38% to 9.45% for the OCA DCF ROE). *Id.*

While the R.D. partially addresses the shortcomings of the I&E and OCA ROE recommendations by establishing the recommended ROE at the high end of a standard deviation range based on the average of Valley's mean and median constant growth DCF results, the R.D. justified this recommendation as reflecting a size adjustment, rather than reflecting an adjustment due to understated DCF results. R.D. at 74-75. As detailed above, Mr. D'Ascendis established the inaccuracy of the DCF model in the current market environment where the market-to-book ratio far exceeds unity (1.0). While the R.D. does apply the CAPM model as a check on the DCF, it declines to consider the full multiple model analysis proposed by the Company, despite the Commission's indication in the UGI Order that consideration of other models is appropriate in circumstances where the results of such models show the DCF results may be understated. R.D. at 56; *but cf.* Valley Main Brief at 66. The result of this omission is that the R.D. applies a size adjustment to a base ROE of 8.62, where the appropriate result would be to apply the size adjustment to the base ROE of 9.35, as justified by the multiple model approach proposed by Mr. D'Ascendis. *See* R.D. at 75; *but see* R.D. at 54.

Consistent with the above analysis of the market-to-book ratio, each of the alternative analyses developed by Mr. D'Ascendis show an ROE higher than the DCF method. R.D. at 54. These results reinforce the necessity to view DCF results with skepticism when running the model in an environment where market values far exceeds book value. Although the Commission has used the standard deviation range around the DCF results in determining the quarterly Distribution System Improvement Charge ("DSIC") ROEs, it is more precise to examine and consider multiple models. In this environment, the Commission should carefully consider the alternative models proposed by Mr. D'Ascendis, as detailed in the Company's Main Brief. Valley Main Brief at 57-63.

To ensure the Company has an opportunity to earn a reasonable rate of return, the Company requests that the Commission grant this Exception and develop an unadjusted ROE recommendation based on the multiple models proposed by Mr. D'Ascendis.

H. <u>Exception No. 8</u>: The R.D. erred in failing to apply the Company's 100 basis point adjustment for size risk to the ROE. (R.D. at 72).

As explained previously, the R.D. developed a recommended ROE for the Company using the high end of a standard deviation range based on the average of Valley's mean and median constant growth DCF results. R.D. at 75. The R.D. set the ROE at the high end of the standard deviation range in recognition of the evidence affirming that Valley faces size risk. *Id.* While the Company appreciates the R.D.'s acknowledgement of size risk, the Company submits that the methodology developed by the R.D. results in an ROE that is commensurate with the ROEs established for much larger Natural Gas Distribution Companies ("NGDCs"), and thus not truly reflective of the Company's size risk. To accurately account for the Company's size risk, the Commission should approve the Company's proposed size adjustment, subject to the maximum proposed ROE of 10.60%.

The R.D. reasonably finds that an ROE based on the average mean and median DCF results on the record would produce an unreasonable result for the Company. However, the R.D. erred in attributing its use of the standard deviation method solely to the Company's size. As discussed in the Company's brief, the Commission applies the standard deviation method (setting an ROE within a standard deviation range of median or mean DCF results) in developing the ROE for purposes of calculating natural gas utility DSICs. Valley Main Brief at 77. As the DSIC is applicable primarily to large NGDCs, this suggests that the process of setting an ROE within a standard deviation of the mean or median DCF results does not reflect size risk. Accordingly, to ensure the authorized ROE reflects the Company's risk, the Commission should apply a size

adjustment to the result of the standard deviation method approved by the R.D. To the extent this result would exceed the Company's proposed ROE, the Company submits that the authorized ROE should be capped at the proposed 10.60%.

The Commission should also consider the conservative nature of the proposed 100 basis point size adjustment in comparison to the size adjustment supported by the Mr. D'Ascendis' analysis of the Company's size risk relative to the proxy group companies. As detailed in the Company's Main Brief, Mr. D'Ascendis conducted a market capitalization analysis showing Valley has a market capitalization of $19.24 million compared to an average company market capitalization of $4.6 billion for the companies in Mr. D'Ascendis' gas utility proxy group ("Gas Utility Proxy Group"). Valley Main Brief at 87. After determining the market capitalization of the Company and the Gas Utility Proxy Group companies, Mr. D'Ascendis relied on published data ranking publicly listed companies into size deciles grouped by ranges of minimum and maximum market capitalizations. *Id.* The $4.6 billion market capitalization of the Gas Utility Proxy Group companies ranks in the 4th decile while the Company's $19.24 million market capitalization ranks in the 10th decile. *Id.* The size decile rankings translate to a size premium spread of 4.37% between the Company and the Gas Utility Proxy Group companies. *Id.*

The calculated 4.37% or 437 basis point size premium spread between the Company and the Gas Utility Proxy Group companies corroborates the reasonableness of Mr. D'Ascendis' proposed 100 basis point size adjustment. Accordingly, the Commission should apply the 100-basis point size adjustment to any ROE that it would otherwise award to a larger NGDC. Since the ROE method applied in the DSIC Quarterly Reports indicates the standard deviation method is generally deployed to calculate an appropriate ROE for larger utilities, the R.D.'s use of that method does not obviate the necessity to apply a further adjustment to account for size risk.

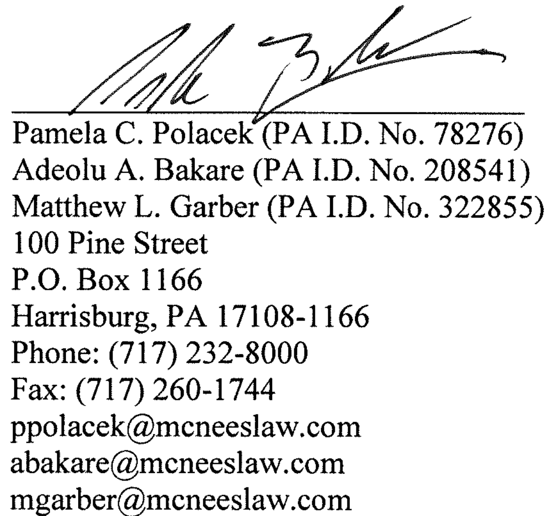
Therefore, while the Company concurs in the R.D.'s finding that Valley faces size risk, it respectfully requests that the Commission grant this Exception and apply the 100 basis point size adjustment to the ROE resulting from the R.D.'s standard deviation method, subject to a cap at the 10.60% maximum proposed ROE.

III. CONCLUSION

WHEREFORE, Valley Energy, Inc. respectfully requests that the Pennsylvania Public Utility Commission grant these Exceptions, approve the Company's recommendations therein, and otherwise adopt the Recommended Decision.

Respectfully submitted,

McNEES WALLACE & NURICK LLC



By ______________________

Pamela C. Polacek (PA I.D. No. 78276)
Adeolu A. Bakare (PA I.D. No. 208541)
Matthew L. Garber (PA I.D. No. 322855)
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
Phone: (717) 232-8000
Fax: (717) 260-1744
ppolacek@mcneeslaw.com
abakare@mcneeslaw.com
mgarber@mcneeslaw.com

Counsel to Valley Energy, Inc.

Dated: March 13, 2020