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March 23, 2020

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

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

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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cc: The Honorable Steve K. Haas, ALJ **(via electronic mail only)**
The Honorable Benjamin J. Myers, ALJ **(via electronic mail only)**
Office of Special Assistants **(e-mail:** ra-OSA@pa.gov)
Certificate of Service
*285403

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 Reply 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 23rd day of March 2020.

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Dated: March 23, 2020
*285406

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY EXCEPTIONS OF THE OFFICE OF CONSUMER ADVOCATE

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Dated: March 23, 2020

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I. INTRODUCTION

Administrative Law Judges Steven K. Haas and Benjamin Myers issued a Recommended Decision setting forth their conclusions in the Valley Energy Company (Valley or Company) base rate case on February 28, 2020. The Office of Consumer Advocate filed Exceptions addressing various aspects of the ALJs' R.D. on March 13, 2020. Valley, the Bureau of Investigation and Enforcement (I&E), and the Office of Small Business Advocate (OSBA) also filed Exceptions on that date. In these Exceptions, the OCA addresses Valley's and OSBA's Exceptions.

For the reasons set forth below and in the OCA's Exceptions, the Office of Consumer Advocate respectfully requests that the Commission deny Citizens' Exceptions and grant the OCA's Exceptions and Reply Exceptions.

II. REPLY EXCEPTIONS

OCA Reply to Valley Exception No. 1: The ALJs Correctly Denied The Company's Across-The-Board Three Percent Inflation Factor (R.D. at 23-24; OCA M.B. at 21-25; OCA R.B. at 11-16)

In its Exceptions, the Company claims that its across-the-board 3% inflation factor should be approved. Valley Exc. at 2-8. In the R.D., the ALJs correctly understood that the Company's claim for a 3% across-the-board inflation adjustment lacked evidentiary support and concluded:

> We agree with the 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 the 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.

R.D. at 23.

The Company included in its FPFTY Operations & Maintenance (O&M) expenses a 3% inflation adjustment to recognize a general level of rising costs. OCA St. 2 at 8.[1] In its Exceptions, the Company argues that its 3.0% across-the-board inflation factor is supported in the record. Valley Exc. at 10-12. The OCA submits that this is an incorrect characterization of the support presented by the Company. The Company identified in response to a discovery request that the 3.0% was determined based on judgment rather than a quantitative method and referenced the use of the Producer Price Index (PPI) data sourced from the Bureau of Labor Statistics (BLS) that suggest an historical PPI inflation rate higher than the 3.0 percent. OCA St. 2 at 8; OCA M.B. at 21. The ALJs R.D. agreed with the OCA's argument that this was not appropriate stating:

> 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 we noted, we do recommend the Company's FPFTY projections that the Company has sufficiency [sic] 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.

R.D. at 24.

In further support of its argument, the Company cites to the example raised in Rejoinder Testimony that such expenses as healthcare and employee salaries would increase by more than 3%. Valley Exc. at 5, citing Tr. 78-79. The OCA submits, however, that the individual expenses do not support an across-the-board inflation adjustment. The Company has not limited its proposed inflation adjustment to expenses that it reasonably anticipates will increase. The Company inflation adjustment simply assumes that all expenses will increase by a 3.0% inflation factor without providing evidentiary support for those proposed increases. As OCA witness

[1] As the R.D. notes, the Company did amend its proposal for the FPFTY to annualize 9 months of actual data and then apply the 3% inflation factor across-the-board to the annualization. Valley 1-R at 8-9; see, OCA St. 1-SR (Revised) at 7.

Morgan explained, "[I]n this proceeding the Company is attempting to use an inflation escalation as the sole determinant of virtually all of the FPFTY expenses." OCA St. 2-SR at 5. Mr. Morgan concluded:

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

OCA St. 2-SR at 5-6.

In support of its position, the Company relies upon the Commonwealth Court's decision in Nat'l Fuel Gas Distrib. Corp. v. Pa. PUC, 677 A.2d 861, 865 (Pa. Commw. 1996)(NFGD). Citizens' Exc. at 3. In the NFGD case, the Commonwealth Court remanded an issue related to an inflation adjustment for expenses because the Commission's underlying decision lacked foundation. In response to the claim for an inflation adjustment for expenses, the Commission simply stated "we agree that the Company's Exception regarding this issue is unsubstantiated." NFGD at 865. The Court stated "this is the extent of the PUC's analysis." Id. The Court's decision does not support the Company's claim for an inflation adjustment, but rather states that the Commission ultimately failed to provide support for its decision to deny the inflation adjustment. The Court remanded the issue for further findings. On remand, the Commission reversed its decision and stated "[u]pon review of this issue, we find that NFG did bring its claim within the parameters of PAWC I and PAWC II." Pa. PUC v. Nat'l Fuel Gas Distrib. Corp., Docket No. R-942991, Tentative Order at 7 (March 2, 1998), citing Pa. PUC v. Pennsylvania-American Water

Co., *et al.*, Docket No. R-880916, Order (Oct. 21, 1988)(PAWC I); Pa. PUC v. Pennsylvania-American Water Co., *et al.*,71 Pa. PUC 210 (1989)(PAWC II).[2]

In the case below, the Company relied upon PAWC I. As OCA witness Morgan testified PAWC I is not applicable to the instant case:

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

OCA St. 2-SR at 3 (footnote omitted). The OCA submits that in this case, the ALJs have correctly concluded that the Company has failed to substantiate its claims for an across-the-board inflation factor and has failed to substantiate the inflation factor that it has used. R.D. at 23-24.

The Commission has also found that across-the-board inflation factors, or attrition adjustments, should not be used to establish rates because they are speculative in nature. See, Pa.

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[2] Based upon Comments made by the OCA, the Commission subsequently amended the amount of the inflation adjustment expense recoupment in its Final Order. Pa. PUC v. Nat'l Fuel Gas Distrib. Corp., Docket No. R-942991, Order (April 29, 1998).

PUC v. Philadelphia Gas Works, 2007 Pa. PUC LEXIS 45 (Sept. 28, 2007)(PGW); Pa. PUC v. Philadelphia Electric Co., 1990 Pa PUC LEXIS 155 (May 16, 1990)(rejection of attrition adjustment to Limerick 2); Pa. PUC v. Philadelphia Electric. Co., 58 Pa. PUC 7, 11-12 (1983)(PECO 1983).

In its Exceptions, the Company argues that the PGW and PECO 1983 cases are not applicable to the Company's proposal. Valley Exc. at 3-4. Contrary to the Company's arguments in Exceptions, there is a strong similarity between the instant case and the PGW case. The Company attempts to distinguish PGW because PGW proposed to use a 2% inflation factor adjustment over a five year budget period instead of only across the FPFTY. Valley Exc. at 3-4. The OCA submits, however, the length of the adjustment is inapposite. It is the speculative and unsupported nature of an across-the-board inflation adjustment that is relevant. PGW at *26-*28.

The Company argues that the PECO 1983 case is inapplicable because PECO proposed an overall increase of 2% to expense, revenue, and rate base. Valley Citizens' Exc. at 3. The fact that PECO applied the inflation factor as an attrition adjustment to expenses, revenues, and rate base does not change the Commission's conclusion that the "proposed attrition adjustment must be rejected as speculative in nature." PECO 1983 at 12. The concern here is the same. The proposed across-the-board inflation factor is speculative and not a known and measurable change.

The Company also argues that the OCA's position undercuts the purpose of the FPFTY authorized by Act 11. Valley Exc. at 6-7. The Company claims that the known and measurable standard does not preclude well-founded projections. Valley Exc. at 6. The OCA submits, however, that the Company's across-the-board inflation adjustment is not a well-founded projection. The purpose of Act 11 was not simply to increase rates but to provide an opportunity

to mitigate regulatory lag for known and supported changes in the FPFTY. The ALJs agreed and concluded:

> 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).

R.D. at 23.

In the alternative, the Company requests that the 3% inflation factor be applied to its Industrial/Commercial Meters and Regulators (Account 878); Customer Records and Collection (Account 903); and Administrative & General Salaries (Account 920). Valley Exc. at 7-8. The OCA submits that the Company's proposed alternative should also be denied. For the reasons set forth above, the Company has failed to substantiate its claim for a 3% inflation factor for any of the proposed expenses and has failed to meet its burden of proof to demonstrate that the inflation factor is appropriate for any of the claimed expenses.[3]

The OCA respectfully requests that the Commission deny Citizens' Exception No. 1 and adopt the ALJs' determination to deny an across-the-board 3 percent inflation factor.

OCA Reply to Valley Exception No. 2: <u>The ALJs' R.D. Correctly Excluded The Company's Proposal To Use A Nine-Month Annualization Of FPFTY Plus 3% Inflation Factor For Its O&M Expenses.</u> (R.D. at 25).

In its Exceptions, Valley argues that the ALJ inappropriately denied its proposal to use a 9-month annualization of its FPFTY plus 3% inflation factor. Valley Exc. at 8-9. The Company challenged the OCA and I&E's individual adjustments to Valley's expense claims and argued that

[33] As the OCA discusses in its Main and Reply Briefs, the OCA also opposes the calculation of the proposed 3.0% inflation factor. If an inflation factor is applied, a better measure for ratemaking purposes would be the forecasted Gross Domestic Product Price Index (GDP-PI) of 2.1% for calendar year 2020). <u>See</u>, OCA M.B. at 24; OCA R.B. at 15-16.

the OCA and I&E "penalize" the Company for managing its budget. See, Valley's Exc. at 9; R.D. at 25. The Company has an obligation under the law to demonstrate that each and every element of its claim is supported under the law. The ALJs correctly rejected the Company's claims and correctly stated the law. The ALJs' R.D. stated:

> 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 "In any proceeding upon the motion of the commission, involving 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. § 315(a). As a result, individual expense claim [sic] will be analyzed below, to determine the justness and reasonableness of each claim."

R.D. at 25.[4]

The OCA respectfully requests that the Commission deny Valley's Exception No. 3 and adopt the ALJs' determination.

OCA Reply to Valley Exception No. 3: The ALJ Correctly Reduced The Company's Claim For Industrial/Commercial Meters and Regulators Operations Expense (Account 876). (R.D. at 29-30; OCA M.B. at 25-26; OCA R.B. at 16-17.)

In the R.D., the ALJs concluded that Company's claim for Account 876 lacked justification and that OCA's recommendation should be adopted. R.D. at 30. The ALJs noted OCA's position accounts for the Company's concern that approximately 30% of the annual expenses for Account 876 are incurred in the 4th quarter. R.D. at 30.

In Exceptions, the Company disagrees with the ALJs' determination that the OCA's position accounts for the fact that 30% of the annual expenses occur in the 4th quarter of each year.

[4] The OCA did not address the Company's Operations and Maintenance Expenses separately in its briefs below. As the OCA discussed at pages 12 of its Exceptions regarding the Customer Installations expense, however, the OCA does not believe that a 9-month annualization is appropriate for any expense. See, OCA Exc. at 12, OCA St. 1-SR (Revised) at 8-10.

Valley Exceptions at 10. The Company also returns to its original claim for the Account contending the ALJs erred in decreasing it. Valley Exception at 10.

As detailed more fully in OCA's Main Brief, OCA witness Sherwood noted the Company's justifications for Account 876 increase fall short. OCA witness Sherwood testified:

> Yes, but I still do not agree with the Company's projections. It is evident that in the past two years, the fourth quarter expenses are equivalent to approximately 30 percent of the annual expenses. However, I do not agree that the Company will exceed or meet the FTY projections. The Company projected that the FTY expenses will be $71,587; however, if you annualize Account 876 by increasing the nine month expense by 30 percent, it only increases from $48,034 to $62,444, which is approximately $9,100 less than the Company's projection. Furthermore, witness Gorman accepts a lower claim of $7,508 as part of his adjustment to the FPFTY O&M claim. . . I am proposing to accept the Company's FTY annualized claim for Account 876. As a result, this decreases my adjustment from $15,730 to $9,429.

OCA St. 1-SR (Revised) at 7.

Contrary to the Company's contention, and correctly recognized in the R.D., the OCA's adjustment to Account 876 did in fact account for the Company's position that approximately 30 percent of the annual expenses are incurred in the fourth quarter. OCA St. 1-SR at 9-10; OCA M.B. at 25-26; R.D. at 30.

As detailed more fully in the OCA's Main Brief, Ms. Sherwood demonstrated that the projected FTY expense will be $71,587; however, if you annualize Account 876 by increasing the nine-month expense by 30 percent, it only increases from $48,034 to $62,444, which is approximately $9,100 less than the Company's projection. Furthermore, witness Gorman accepts a lower claim of $7,508 as part of his adjustment to the FPFTY O&M claim. Based off the FTY annualized claim for Account 876, the OCA submits an adjustment of $9,429 is appropriate.[5] OCA

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

St. 1-SR (Revised). As the ALJs stated "[w]e believe annualizing the FTY costs is the appropriate method here for determining the Company's FPFTY claim, in light of the lack of justification for the Company's proposed claim. We recommend that the Commission approve OCA's adjustment . . . by $9,429." R.D. at 30.

The Company also contends that the ALJs' erred in not including a 3% inflation factor to its FPFTY adjustment. Valley Exception at 11. For the reasons set forth in OCA Reply to Valley's Exception No. 1 above, the OCA respectfully requests that the Commission deny the Company's Exception No. 3 and adopt the ALJs' determination regarding the 3% across-the-board inflation factor.

OCA Reply to Valley Exception No. 4: The ALJ Correctly Denied The Companies 3% FPFTY Adjustment For Account 903. (R.D. at 11; OCA M.B. at 30-31; OCA R.B. at 18.)

In the R.D., the ALJs concluded 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." R.D. at 35. The Company accepts this determination by stating "The R.D. recommended a reduction of the Company's claim for Customer Records and Collection Expense from $513,237 to $466,164." Valley Exceptions at 11. The Company makes no attempt to dispute this portion of the ALJs' recommendation, instead, the Company continues to propose a "3% adjustment to the expense approved for this account." Valley Exceptions at 11.

The Company contends that the ALJs erred in not including a 3% "adjustment," or inflation factor, to its FPFTY adjustment. Valley Exception at 11. For the reasons set forth in OCA Reply to Valley's Exception No. 1 above, the OCA respectfully requests that the Commission deny the

Company's Exception No. 4 and adopt the ALJs' determination regarding the 3% across-the-board inflation factor.

OCA Reply to Valley Exception No. 5: The ALJ Correctly Denied the Companies 3% FPFTY Adjustment For Account 920. (R.D. at 37-38; OCA M.B. at 33; OCA R.B. at 19.)

In the R.D., the ALJs concluded that OCA's recommendation be adopted due to Valley's failure to justify increases. R.D. at 38. The Company states "The R.D. recommended a reduction of the Company's claim for Administrative and General Salaries Expense from $536,697 to $466,427." Valley Exceptions at 12. The Company makes no attempt to dispute this portion of the ALJs' recommendation, instead, the Company continues to propose a "3% adjustment to the expense approved for this account." Valley Exceptions at 12.

The Company contends that the ALJs' erred in not including a 3% "adjustment," or inflation factor, to the FPFTY adjustment. Valley Exceptions at 12. For the reasons set forth in OCA Reply to Valley's Exception No. 1 above, the OCA respectfully requests that the Commission deny the Company's Exception No. 5 and adopt the ALJs' determination regarding the 3% across-the-board inflation factor.

OCA Reply to Valley Exception No. 7: The ALJ Correctly Rejected the Company's Deviation From The Preferred Methods In Determining The Cost of Common Equity. (R.D. at 52-79; OCA M.B. at 46; OCA R.B. at 27.)

The ALJs adopted OCA's and I&E's recommendation that the DCF and CAPM models are the appropriate methods to determine the cost of common equity for the Company. R.D. at 56. The ALJs stated "[w]e agree with I&E and OCA 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." R.D. at 56. In its Exception No. 7, the Company states "[b]y 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." Valley Exceptions at 13.

As explained more fully in OCA's Main Brief, in January 2004 in its Opinion and Order in Pa. PUC v. Pennsylvania American Water Company, the Commission wrote:

> Historically, we have primarily relied on the DCF methodology in arriving at our determination of the proper cost of common equity. We have, in many recent decisions, determined the cost of common equity primarily based upon the DCF method and informed judgment. *See Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company*, 71 Pa. PUC 593, 623-632 (1989); *Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company*, 67 Pa. PUC 529, 559-570 (1988); *Pennsylvania Public Utility Commission v. Roaring Creek Water Company*, 150 PUR4th 449, 483-488 (1994); *Pennsylvania Public Utility Commission v. York Water Company*, 75 Pa. PUC 134, 153-167 (1991); *Pennsylvania Public Utility Commission v. Equitable Company*, 73 Pa. PUC 345-346 (1990). We determine that the DCF method is the preferred method of analysis to determine a market based common equity cost rate.

Pa. PUC v. Pennsylvania American Water Company, 99 Pa. PUC 38, 42 (2004) (PAWC 2004), aff'd on other grounds, Popowsky v. Pa. PUC, 868 A.2d 606 (Pa. Commw. Ct. 2004); accord Pa. PUC v. Aqua Pa, Inc., 99 Pa. PUC 204, 233 (2004).

Further, in its recent UGI-Electric decision, the Commission affirmed its primary reliance on the DCF method, stating that it has "found no reason to deviate from the use of this method in the instant case." Pa PUC v. UGI Utilities, Inc. – Electric Division, Docket No. R-2017-2640058, et al, slip op. at 106 (Order entered October 25, 2018) (UGI-E). This Commission has stated that determining a fair rate of return is an exercise of informed judgment, based upon the facts of each case. Pa. PUC v. Pennsylvania Power Co., 55 Pa. PUC 552, 579 (1982). "The interests of the Company and its investors are to be considered along with those of the customer, all to the end of

assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved." Pa. PUC v. Pennsylvania Power Co., 55 Pa. PUC at 579.

In coming to this informed judgment, the Commission has stated on numerous occasions its preference to rely upon the DCF methodology over other methods such as the Risk Premium (RP) and Capital Asset Pricing Model (CAPM) in determining the rate of return. In PPL's 2012 and 2004 base rate case, the Commission reaffirmed its reliance upon the DCF method. Pa. PUC v. PPL Electric Utilities Corp., Docket No. R-2012-2290597 (Order entered December 28, 2012) (PPL 2012); Pa. PUC v. PPL Electric Utilities Corp., 237 P.U.R. 4th 419, 2004 Pa. PUC LEXIS 40 (December 2, 2004) (PPL 2004). The Commission additionally noted, however, that while it is not required, other methodologies can be used to check DCF results. PPL 2012 at 80.

The Company recommends a deviation from sound and consistent Commission precedent. The Company contends that relying on the DCF solely in this case would "understate the appropriate rate of return for the Company." Valley Exceptions at 14. However, this statement disregards the use of the CAPM as check on the DCF results. As the ALJs state "the Commission has traditionally utilized the DCF method, with use of the CAPM method as a check." R.D. at 60. In the PAWC 2004 case, the ALJ quoted the following description of the DCF model from a leading treatise on public utility rate making:

> The DCF method is derived from valuation theory, and rests on the premise that the market price of a stock is the present value of the future benefits of holding a stock. Those benefits are the future cash flows provided by holding the stock. They are, quite simply, the dividends paid and the proceeds from the ultimate sale of the stock. Since dollars to be received in the future are not worth as much as dollars received today, the cash flows must be discounted back to the present at the investor's required rate of return. The most basic form of this model assumes that dividends grow at a constant rate each year (g), and that the stock is held "forever". Since the stock is not sold, the only relevant contribution to its value is the dividends to be received. The basic theoretic difficulties are the assumption of

> a constant or fixed retention or payout rate and the assumption that dividends will grow at a constant "g" rate in perpetuity.
>
> The first point to remember in evaluating the growth rate is that it is not what a witness thinks the growth rate should be that matters. What matters is what investors expect the growth rate to be. The rate of return analyst is really trying to (or should be trying to) replicate the thinking of investors in developing their expectations regarding the growth in dividends. In all, the DCF method takes into account several factors important in the determination of the fair rate of return: (1) preferences of investors; (2) equity financing; (3) risk, and (4) inflation.

PAWC 2004, Docket No. R-00038304, R.D. at 65 (Nov. 26, 2003) quoting J. Bonbright, A. Danielsen & D. Kamerschen, Principles of Public Utility Rates 318 - 319 (2d ed. 1988).

Lastly, the Company suggests that 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 . . ." Valley Exceptions at 16. This is wholly inaccurate considering the ALJs clearly accept the DCF and CAPM methods. The use of the high-end standard deviation that the Company wrongly references, is actually the ALJs' attempt to acknowledge "the risk of a smaller utility", not because they found the DCF results inadequate as the Company suggests. R.D. at 74. ("More recently, the Commission affirmed reliance primarily on the DCF and rejected giving equal weight to the other methodologies." R.D. at 55.) 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%.

OCA Reply to Valley Exception No. 8: The ALJ Correctly Denied the Company's 100 Basis Point Size Adjustment — Any Size Adjustment Is Improper. (R.D. at 68-75; OCA M.B. at 61-63; OCA R.B. at 32.)

In its Exception No. 8, the Company states that the ALJs' decision to reject the Company's size adjustments was improper. Valley Exceptions at 17. The Company disagrees with the ALJs' decision to deny the 100 basis point adder and instead, utilize the top range of the Company's DCF results. R.D. at 74-75.

Regarding the 100-basis point size adjustment made by Mr. D'Ascendis, both OCA and I&E witnesses explained why the Company should not be awarded a size premium. Dr. Habr testified:

> **Q: TURNING TO MR. D'ASCENDIS' TESTIMONY, DO YOU AGREE WITH HIS 100 BASIS POINT SIZE ADJUSTMENT ADDITION TO HIS RECOMMENDED RETURN ON COMMON EQUITY FOR CITIZENS' ELECTRIC, WELLSBORO ELECTRIC, AND VALLEY ENERGY?**
>
> A: No, I do not. 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).

Dr. Habr further commented on the proposed size adjustment with an additional basis for rejecting such an adjustment:

> 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 St. 3 at 29-30.

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 principles, 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.[6]

The ALJs found I&E's DCF range of 7.24-9.68% to be reasonable. The average of I&E's results equal 8.46%. R.D. at 75. Additionally, OCA's DCF results, which the ALJs also found to be reasonable, equaled 8.34% and I&E's equaled 8.46%. OCA M.B. at 45. It is the position of the OCA that a recommendation based on a DCF result of 9.68% is unreasonable given the DCF range

[6] As set forth in OCA Exception No. 8, the Company's CAPM is unreasonable and should not be used for any purpose in this proceeding.

presented by the parties in this proceeding and is particularly unreasonable to reflect a size adjustment for the Company.

OCA Reply to OSBA Exception No. 1: The ALJs' R.D. Correctly Approved Valley's Modifications To Its Main Extension Policy. (R.D. at 87-90; OCA M.B. at 70-74; OCA R.B. at 36-40)

In its filing, Valley proposed to add a third option to its existing service and main extension policy in order to provide customers with additional opportunities to obtain natural gas service from Valley and to address an inequity in the Company's existing policy. Valley St. 4-R at 12. Customers with different unit installation costs are treated differently under the existing policy, and the third option will provide an additional option for determining the amount of net capital investment the Company will contribute towards a facility extension project. See, OCA St. 4-R at 6; Valley St. 4 at 14-15; Valley St. 4-R at 12-13. The ALJs correctly recommended approval of the Company's proposed modification to the Company's facilities extension policy (Extension Policy). R.D. at 90. The ALJs stated:

> 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.

R.D. at 90.

In its Exception, OSBA argues that the ALJs' recommendation to approve Valley's Extension Policy should be denied. OSBA Exc. at 6-7. OSBA argues that the Company has not presented sufficient evidence in support of its proposal and met its burden of proof. OSBA claims that its analysis has been ignored by the ALJ. OSBA Exc. at 6. OSBA also argues that the proposal is "uneconomic" and a "potential adverse financial impact" on Valley's ratepayers. OSBA Exc. at 6.

OSBA's analysis has not been ignored by the ALJs' R.D. See discussion, R.D. at 88-89. OSBA argued below that the Company's proposal would cause potential financial harm to ratepayers because the proposal would effectively increase Valley's Estimated Base Annual Revenue (EBAR) credit above the cost of 200 feet of service and/or main extension. OSBA M.B. at 9, citing OSBA St. 1 at 9. The OCA submits that OSBA's concerns are unfounded, and the ALJs appropriately denied OSBA's claims.

In Rebuttal Testimony, Company witness Rogers directly responded to OSBA's concerns. Contrary to OSBA's argument, Valley's proposal would not, in fact, raise the maximum amount that the Company can spend on any individual customer. Valley St. 4-R at 12-13; see, OCA M.B. at 70-74; OCA R.B. at 37-38. In Rebuttal Testimony, Company witness Rogers explained the calculation and stated that "from a cost perspective, it does not 'raise' the maximum benefit for any individual customer." Valley St. 4-R at 5. As Company witness Rogers testified, "Valley's position is that there is no reason to deprive any individual customer of the level of investment the Company offers, on average, to any customer for a 200-foot extension." Valley St. 4-R at 12.

The OCA agrees and supports the Company's proposal. OCA witness Mierzwa explained that accepting the Company's proposal would facilitate extending natural gas service into the unserved and underserved areas because a "CIAC can act as a deterrent to customers pursuing natural gas service." OCA St. 4-R at 10.

In its Exceptions and in support of its arguments, OSBA also cites to Lloyd v. Pa. PUC, 904 A.2d 1010, 1020 (Pa. Commw. 2006). OSBA argues that the modified Extension Policy would violate cost causation principles and violate established ratemaking principles by allowing for an inequitable result. OSBA Exc. at 7. The OCA submits that OSBA's arguments are misplaced, and the ALJs' decision is well-grounded in the law. The proposal would not violate

Lloyd or create inequity in violation of ratemaking principles. Section 1304 of the Public Utility Code provides, in relevant part, that:

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

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

As explained by the Commonwealth Court of Pennsylvania:

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

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

OSBA also argues that the proposal is "more generous" than Peoples' proposed main extension proposal. OSBA Exc. at 7, referencing the approval of Peoples' main extension policy at Pa. PUC v. Peoples Natural Gas Company, LLC, Docket No. R-2018-3006818, Order at 35 (Oct. 3, 2019). The OCA submits that Company's proposal is consistent with the law and in line

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

with the main extension policies of other NGDCs in the Commonwealth. See, OCA M.B. at 74; OCA R.B. at 39-40; see e.g., Pa. PUC v. Columbia Gas of Pa., Docket No. R-2015-2468056, Order at 14, 22 (June 19, 2015); Pa. PUC v. Columbia Gas of Pa., Docket No. R-2015-2468056, Order at 21-22 (Dec. 3, 2105)(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.

Considering the record as a whole, the OCA submits that Valley has met its burden of proof in this case that the modification to its Extension Policy will provide a benefit to customers seeking to obtain access to low-cost natural gas in unserved and underserved areas within the Commonwealth. The OCA supports the Company's proposed main extension modifications and agrees that the proposed modification would provide a necessary fix to address a customer inequity problem in its current main extension policy. The OCA submits that the Commission should deny OSBA's Exception and adopt the ALJs' recommendation to approve the Company's proposed Extension Policy.

III. CONCLUSION

For the reasons set forth below and in the OCA's Exceptions, the Office of Consumer Advocate respectfully requests that the Commission deny Citizens' Exceptions and grant the OCA's Exceptions and Reply Exceptions.

Respectfully Submitted,

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