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April 3, 2002

James J. McNulty, Secretary  
Pennsylvania Public Utility Commission  
Commonwealth Keystone Building, 2<sup>nd</sup> Floor, 7 North  
400 North Street  
Harrisburg, PA 17120

Filed by Federal Express

Re: Philadelphia Gas Works (Extraordinary Rate Petition)  
Docket No. R-00017034F0002

ORIGINAL

Dear Secretary McNulty:

I represent the Consumers Education and Protective Association (CEPA), the Association of Community Organizations for Reform Now (ACORN), the Tenants' Action Group (TAG) and Action Alliance of Senior Citizens of Greater Philadelphia, (collectively CEPA et al.) in the above-captioned matter.

Enclosed please find for filing an original and nine copies of the Memorandum of CEPA et al.

The Memorandum is being distributed this date to each Commissioner's Office, the Office of Special Assistants and the Law Bureau electronically and in paper format pursuant to Administrative Law Judge Fordham's March 29 Order # 3 in this case.

As evidenced by the attached Certificate of Service, all parties to the proceeding are being served with copies of this Memorandum.

Very truly yours,

*Philip A. Bertocci*

PHILIP A. BERTOCCI  
Attorney for CEPA et al.

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PUBLIC UTILITY COMMISSION  
SECRETARY'S BUREAU

cc: All Commissioners

Administrative Law Judge Cynthia W. Fordham  
Kirk House, Esquire, Office of Special Assistants  
Karen Moury, Esquire, Law Bureau

Enclosures

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

vs.

PHILADELPHIA GAS WORKS

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Docket No. R-00017034F0002

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MEMORANDUM OF CEPA ET AL. IN OPPOSITION TO  
PGW'S EXTRAORDINARY RATE PETITION

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PA PUBLIC UTILITY COMMISSION  
SECRETARY'S BUREAU

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DATED: April 3, 2002

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Lower Frederick Township v. Pa. P.U.C., 409 A.2d 505 (Pa. Cmwlt. 1980)

Public Advocate v. Philadelphia Gas Commission, 637 A.2d 676  
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### Statutes:

66 Pa. C.S. § 315(a)

66 Pa. C.S. § 1301

66 Pa. C.S. § 1308(e)

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66 Pa. C.S. § 2212(c)

66 Pa. C.S. § 2212(e)

**City of Philadelphia Ordinances:**

Management Agreement, passim

General Inventory and Receivables Gas Works Revenue Note Ordinance of 1983

## Statement of Questions Involved

1. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility seeking a base rate increase solely to obtain working capital, as opposed to the cost of working capital?

Proposed Answer: No.

2. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility seeking a base rate increase to correct a perceived inadequacy in the rate increase provided in a prior recent base rate case?

Proposed Answer: No.

3. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility which brought any emergency which might exist upon itself through failure to take timely steps to provide for an owner infusion of cash working capital?

Proposed Answer: No.

4. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility which has failed to meet the burden of showing that the requested relief is immediately necessary in order to maintain normal customer service, normal maintenance and to avoid substantial reductions in employment?

Proposed Answer: No.

5. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility which has failed to meet the burden of showing that the requested relief is immediately necessary in order to maintain normal customer service, normal maintenance and to avoid substantial reductions in employment?

Proposed Answer: No.

6. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility which has failed to meet the burden of showing that the requested relief is immediately necessary in order to maintain normal customer service, normal maintenance and to avoid substantial reductions in employment?

Proposed Answer: No.

7. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available for a utility which has failed to meet the burden of showing that the amount of requested relief would produce no more than the rate of return on the utility's common equity established in the utility's prior rate case or no more than debt service coverage ratios provided by such prior rate case?

Proposed Answer: No.

8. Has the utility met its burden of showing just cause for a Commission declaration waiving or declaring inapplicable the legislative intent reflected in Section 1308(e) that the grant of extraordinary rate relief be subject to a quantifiable limitation?

Proposed Answer: No.

9. Is extraordinary relief under the Section 1308(e) of the Public Utility Code available when the utility requesting such relief has not met its burden of showing that the amount of relief requested would result in "just and reasonable" base rates?

Proposed Answer: No.

## **CEPA et al.'s Memorandum in Opposition to PGW's Extraordinary Rate Petition**

### **I. Introduction.**

The grand strategy of PGW's Petition for Extraordinary Rate Relief is immediately recognizable to anyone who is familiar with PGW's efforts since July, 2000 to increase base rates in order to require ratepayers to provide not only the costs of working capital, but the working capital itself. Such an objective is contrary to the principles and law governing ratemaking for regulated public utilities. In pursuing this goal, PGW and its owner the City of Philadelphia have attempted to give the appearance of fulfilling ownership responsibilities in the refurbishment of PGW, while in fact, minimizing the dollar contribution of the City in PGW's financial recovery.

In this case, as in prior cases, the City's position has been that it would be willing on a one time basis only to grant back a portion of the annual \$18 million City payment, to the extent such a grant back is shown to be necessary after the end of PGW's fiscal year to assure that PGW achieves its 1.5 debt service coverage ratios on the 1975 and 1998 bonds. PGW E.R.P. St. 5, at 4. The City can be expected to make every effort to avoid having to perform even on this negligible conditional offer. At the same time, the City continues a campaign of disinformation, in which it describes waiver or grant back of this payment as an inappropriate City "subsidy" to PGW; however, in fact, it has historically been the ratepayer funded \$18 million which has been an annual subsidy provided to the City by PGW, without reference to PGW's actual performance, or even

whether PGW had generated sufficient earnings to make that payment. PGW E.R.P. St: 5, at 3.

On February 25, 2002, PGW filed its Petition for Extraordinary Rate Relief (hereinafter "Petition") pursuant to Section 1308(e). In the Petition, it alleged that the threat of a downgrade of PGW's bond ratings contained in Standard & Poor's February 12, 2002 Notice necessitated immediate grant by the Commission of \$44 million extraordinary base rate increase effective in mid-April, 2002. Such a ratings downgrade, it was alleged, would immediately precipitate an abrupt reduction in service that PGW could provide to customers and system maintenance, and a substantial reduction in employment.

As set forth below, the Commission should reject this Petition. At bottom, the Petition incorrectly assumes that ratepayers may legally be required to bear virtually all the substantial financial burdens necessary for the restoration of PGW's liquidity, and that the City may be required to provide little more than a token contribution.

## **II. Statement of the Case.**

The Consumers Education and Protective Association (CEPA), the Association of Community Organizations for Reform Now (ACORN), the Tenants' Action Group

(TAG), and the Action Alliance of Senior Citizens of Greater Philadelphia ( hereinafter collectively “CEPA et al.”) incorporate by reference Administrative Law Judge Cynthia Williams Fordham’s ample Statement of the Case read into the record in this case at the March 26, 2002 evidentiary hearing.

For those who do not have ready access to the hearing transcript, CEPA et al. has participated in this proceeding as an Active Participant. On March 6, 2002, CEPA et al. filed a Formal Complaint docketed at R-000017034 against PGW’s pending base rate increase filing, and specifically protesting the granting of extraordinary rate relief. On March 19, 2002, CEPA et al. filed the Answer of CEPA et al. to Philadelphia Gas Works’ Petition for Extraordinary Relief, docketed at R-00017034F0002.

### **III. Argument.**

#### **A. Legal Standards.**

In Pa.P.U.C.v. Metropolitan Edison Company, Docket No. P-800070235 (August 28, 1980) (hereinafter “Metropolitan Edison”), the Commission recognized that in a Section 1308(e) proceeding, the utility had the “heavy burden” to make a “specified showing” by substantial evidence that all four requirements for extraordinary relief had been met. Metropolitan Edison, at 5,6. *Extraordinary relief can not be granted on the basis of “speculation or conjecture.”* Metropolitan Edison, at 6.

In addition, under the Public Utility Code, the utility has the additional burden of showing by substantial evidence that any base rate, whether extraordinary or not, is “just and reasonable.” 66 Pa.C.S. 315(a). Lower Frederick Township v. Pa. P.U.C., 409A. 2d 505, 507 (Pa.Cmwlth. 1980); Brockway Glass v. Pa. P.U.C., 437 A.2d 1067 (Pa. Cmwlth. 1981). In this case, as in any rate case, PGW must establish that “[t]he elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.” Burleson v. Pa. P.U.C., – Pa. –, 461 A.2d 1234, 1236 (1983).

Finally, as the Commission itself has recognized, application of the “just and reasonable” standard in ratemaking under Section 1301 of the Public Utility Code and the U.S. Constitution requires a balancing of the interests of both customers and the utility. Pa. P.U.C. v. PGW, Docket No.R-00006042, October 4, 2001 Order, at 25.

**B. PGW’s Proposed \$44 Million Extraordinary Rate Increase Is Not Just and Reasonable because It Imposes Virtually All the Costs of PGW’s Liquidity Restoration on Ratepayers, without Providing that the City as PGW’s Owner Bear an Equal Share of this Substantial Burden.**

In putting forward its request for extraordinary relief, PGW and its owner the City have refused to accept more than a minimal share of the burdens of PGW’s liquidity restoration. Overall PGW residential rates are currently 15% above pre-November 22, 2000 levels on an annualized basis, and have been as much as 50% higher for significant lengths of time during this period. In contrast, the City has continued to receive the \$18

million City Payment, while providing a cash advance pursuant to the Management Agreement, has taken no extraordinary measures to address PGW's financial problems. Because in the final analysis, the Commission is constitutionally bound to balance the interests of ratepayers and the utility, it must deny PGW's Petition as unjust and unreasonable. This section examines various financial measures under consideration to address PGW's financial difficulties, and assesses the relative burden which these measures impose on ratepayers and upon PGW and its owner the City.

In this case, as in prior cases, the City's position has been that it would be willing on a one time basis only to grant back to PGW a portion of the annual \$18 million City payment, to the extent that such a grant back is necessary after the end of PGW's FY2002 on August 31, 2002 to assure that PGW achieves its 1.5 debt service coverage ratios on the 1975 and 1998 bonds. PGW E.R.P. St. 5, at 4. Despite a liquidity problem which it has itself recognized for over two years, the City has astonishingly insisted on receiving its annual \$18 million payment. As OCA witness Mr. LeLash tellingly notes: "No other utility in this country would continue to pay dividends to its owners were it facing the liquidity problems which PGW faces." OCA St. ERP-1, at 11.

Even in this supposedly "extraordinary" situation, the City's determination to deflect any inroads on the \$18 million City payment is so uncompromising that it has not even committed this year to waive the \$200,000 in interest which it extracts as payment

for its allowing PGW to defer the payments (due in four equal installments March 31, April 30, May 31, and June 30) until June 30. PGW E.R.P. St. 2, Exhibit JRB-1, p. 1.

In its previous decisions, the PUC has opined that it does not have the authority to order PGW to waive or grant back the \$18 million – but has sent a clear signal to PGW and the City that in the exercise of its discretionary ratemaking powers, the Commission is not indifferent to whether the \$18 million City payment is committed to addressing the utility's financial difficulties. Thus, in its October 4, 2001 Order, the Commission stated:

...we urge the City of Philadelphia, as owner of PGW, to continue to take measures to insure the financial health of PGW. It is the expectation of this Commission that the City of Philadelphia, as owner of PGW, continue to assist PGW in its cash flow requirement so that a financial crisis does not take place. One way of insuring PGW's overall financial health is to grant back or waive, in part or in total, the City payment when necessary. We hope that the City of Philadelphia will be as diligent in its concern for the financial health of PGW as the Commission is in granting the rate relief described herein.

Pa. P.U.C. v. PGW, Docket No. R-00006042 ,October 4, 2001 Order, at 34.

In adjudicating PGW's 2000 Interim Base Rate Increase Case (Pa. P.U.C. v. PGW, Docket No. R-00005654) and PGW's 2001 Base Rate Increase Case, the Commission has recognized that in determining a "just and reasonable" rate, the Commission must balance the interests of the utility with those of its customers. In reaching those decisions, the Commission of necessity took into account the level of assistance that the City was

providing to PGW.<sup>1</sup>

This assistance included the \$45 million City Advance, a line of credit provided by the City interest free, commencing January 2001, and currently repayable on January 25, 2003. While the City claims that the value of this loan is between \$2 and \$3 million per year, the City admits that the cost to the City has been less, due to the fact that PGW has been required to repay this line of credit before it repays its TXCP, so as to maximize the time that the funds are in a City account drawing interest for the City. Without denying the benefits to PGW from this Advance, it is important to recognize that provision of substantial credit by the City to PGW was contemplated in the Management Agreement, and to that extent, is not out of the ordinary. Management Agreement, §IV(3).<sup>2</sup> Moreover, the long term effect of such loans, for the most part, is not to relieve substantial burdens on ratepayers, but rather to postpone imposition of those burdens to a future time.

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<sup>1</sup> The Commission alludes to the \$45 million advance in its October 4, 2001 Order (Pa.P.U.C. v. PGW, R-00006042), at 34, when it says: "It is the expectation of this Commission that the City of Philadelphia, as owner of PGW, continue to assist PGW in its cash flow requirements so that a financial crisis does not take place." (Emphasis added).

<sup>2</sup> PGW may claim that the value to PGW of the City Advance is greater than the amount of interest foregone by City, due to the fact that use of the City Advance may eliminate the need to use PGW's TXCP facility at a higher interest rate than what the City pays for Advance. This added benefit comes only when PGW has a choice between use of its TXCP funds and the City Advance. Up until now, City Advance funds have been drawn when TXCP was unavailable, and repaid before TXCP. Moreover, the value of any particular action for the purposes of evaluating the relative burden on the City should be the cost of the action to the City, not the value of the benefit experienced by PGW.

Even before the decision to file the instant Petition for Extraordinary Rate Relief, PGW had decided to request deferment of the repayment date for the \$45 million City Advance from January 2003 to August 31, 2003. However, PGW and the City have not yet filed the necessary proposed Ordinance with Philadelphia City Council.<sup>3</sup>

The City may also be expected to claim that it would have fulfilled any additional obligation to share in PGW's refurbishment by obtaining for PGW's benefit a Forward Purchase Agreement which would generate \$20 million in project revenues this year. The Forward Purchase Agreement is a financial transaction in which the City sells for an "up front" price the right to interest for a period of years on a portion of the Sinking Fund Reserve which is maintained in connection with the almost \$1 billion in outstanding long term PGW gas revenue bonds. In the mid-1990's, the City entered into a similar Forward Purchase Agreement on behalf of PGW using the Company's gas revenue bonds. The interest generated by the Sinking Fund Reserve has thus for some time now been recognized as a resource available to PGW.

The City may be anticipated to claim that in any balancing process involving PGW base rates, the City's provision of the interest on a portion of the Sinking Fund Reserve associated with PGW's bonds should be given great weight as an indicia of the City's

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<sup>3</sup> PGW E.R.P. St. 1, at 10 and Thomas E. Knudsen Testimony at the March 26, 2002 Evidentiary Hearings.

acceptance of its ownership responsibilities.<sup>4</sup> It is true that technically, the interest on the Sinking Fund Reserve belongs to the City, and that the City is within its rights to transfer that interest to the City's General Fund. Appelmans v. City of Philadelphia, 826 F.2d 214 (3<sup>rd</sup> Cir. 1987). However, the fact is that under PGW's bond covenants, ratepayers, and ratepayers alone have historically paid the debt service (principal and interest) on PGW's long term borrowing. While the City may have the right to the Sinking Fund Reserve interest, PGW and its owner should not be overly praised for recognizing that the interest has been paid for with ratepayer funds. Like the \$18 million City Payment, but less visibly, the Sinking Fund Reserve interest is but another cash benefit which the City has extracted from PGW ratepayers without any relation to the performance of the utility.

Finally, from a ratepayer perspective, resort to a Forward Purchase Agreement is not an optimal use of the Sinking Fund Reserve interest. The optimal use for PGW customers would be to transfer that interest on an annual basis to PGW to be booked as "Other Income" on the Income Statement. This treatment would both assist PGW cash flow needs on an annual basis, and at the same time would dampen upward pressure on base rates by providing non-rate project revenues for debt service coverage ratio purposes. This treatment would have the added benefit to PGW ratepayers of avoiding

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<sup>4</sup> PGW E.R.P. St.1, at 5. The effect of the Forward Purchase Agreement was not reflected at all in the schedules supporting PGW's initial filing. However, it is reflected on the Revised 3-26-02 Philadelphia Gas Works Fiscal Year 2001-02 Projected Income Statement as part of "Other Income" constituting PGW Bogdonavage Rebuttal Exhibit 1. There, the effect of utilization of the Forward Purchase Agreement is to reduce to \$7.5 million the amount of the hypothetical grant back of the City payment.

the transaction costs which are always present when the City's financial consultants and white collar legal patrons participate in the formulation and execution of these arrangements.

The use of Sinking Fund Reserve interest through a Forward Purchase Agreement functions, like most of the stratagems utilized by PGW, to ward off the necessity of truly sharing in the burdens of PGW's refurbishment by granting back the \$18 million City Payment. For the period in which the Forward Purchase Agreement is in effect, PGW's ratepayers will be deprived of the potential contribution of project revenues stemming from Sinking Fund Reserve interest. This financial transaction is thus a technique to transfer to future ratepayers through higher rates the present day costs of PGW working capital refurbishment.

In this situation, one might expect that the City as owner of PGW would at least commit to including the City itself, as recipient of the "Rate MS" among the rate classes which would be called on to pay the increased rates to which the City and PGW claim an "extraordinary" need. However, that is not the case. Supplement No. 17 to Tariff-Gas PA P.U.C. No. 1.<sup>5</sup> Rather, the City insists that under the Gas Choice Act, the

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<sup>5</sup> If the MS Rate participated in the proposed \$44 million increase on a same percentage basis as the other firm rate classes, PGW would realize approximately three quarters of a million incremental dollars on an annualized basis.

Commission may not alter the MS Rate without prior City Council approval. PGW and the City have not sought, and apparently have no plans to seek City Council approval for application of any extraordinary relief that might be granted to the MS Rate class. PGW and the City have raised this issue in their consolidated appeal to the Commonwealth Court of the PUC Order in PGW's 2001 Base Rate Increase Case.<sup>6</sup> However, there is no reason why the City as owner can not consent to pay its share of whatever extraordinary relief might be obtained from the PUC, while reserving its rights on the underlying issue.

In these circumstances, there can be no grant of rate relief in any form unless there is provision for equal sharing of the burdens of PGW's liquidity restoration between the City and PGW's ratepayers. In these extraordinary circumstances, what the City is prepared to offer going forward in additional resources should be matched against what would be required from ratepayers. Mr. LeLash, the OCA's witness, has set forth a proposal for such equal sharing, which could well serve as the cornerstone of a financial solution. OCA St. 1-ERP, at 10-14, 31-36.

**C. Section 1308(e) Is Not Available to PGW under the Circumstances of this Case.**

**1. Section 1308(e) Is Not Available to Provide Cash Working Capital, as Opposed to the Cost of Cash Working Capital or Funds for Operations.**

PGW has filed this Extraordinary Relief Petition to provide cash working capital,

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<sup>6</sup> City of Philadelphia et al. v. PUC, Commonwealth Court, Nos. 19, 20 C.D. 2002 (Consolidated).

not to obtain revenues from rates to fund operating expenses. While not willing to specifically designate revenues derived from the Extraordinary Relief Petition for pay down of its outstanding short term debt, the rate increase request's declared purpose is to address PGW's liquidity problem, as defined by the so-called S&P fixed-charge formula. As Mr. Knudsen testified: "While the \$33.6 million of [2001] rate relief proved salutary and addressed, in the main, PGW's needs regarding ongoing operating requirements, S&P recognized that the level was insufficient to address PGW's total lack of liquidity." PGW E.R.P. St.1, at 3. On paper, PGW projects that the requested extraordinary relief would permit it to pay down its short term Commercial Paper Program (hereinafter "TXCP") from \$97 million to \$77 million in FY2002,<sup>7</sup> to pay back the \$45 million City Advance in August, 2003,<sup>8</sup> and further reduce its outstanding TXCP in August, 2003 to \$57 million.<sup>9</sup>

It is a general ratemaking principle that ratepayers may be required to pay the cost of reasonable working capital for a regulated utility, but not be required to pay for that capital itself.<sup>10</sup> The Management Agreement, consistent with this principle, provides that PGW ratepayers shall provide through rates a "reasonable amount of working capital."

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<sup>7</sup> PGW E.R.P. St.2, Exhibit JRB-1, p.1.

<sup>8</sup> PGW E.R.P. St.2, Exhibit JRB-1, revised p.2.

<sup>9</sup> PGW E.R.P. St. 4, Exhibit BCB-3, column G (2002-03).

<sup>10</sup> OCA Statement 1-ERP, at 5,10,11; OCA Statement , at 12-19 (Docket No. R-00006042).

Management Agreement, at §VII(1)(b)(iii). For many years, ratepayers have provided PGW with a Tax Exempt Commercial Paper Program, on which they have paid the debt service.<sup>11</sup> In the 2001 Base Rate Case, the Commission recognized this principle when it stated: “The [Management] Agreement clearly states that only a reasonable amount of working capital is to be included in rates. The Management Agreement does not assume that customer rates will cover all PGW’s capital and cash needs as if no other sources of capital or revenues are available to PGW.” Pa.P.U.C. v. PGW, Docket No. R-00006042, Opinion and Order, December 6, 2001, at 29. This principle applies to any Commission approved rates, both base rates provided under Sections 1301 and 1308(d) of the Public Utility Code, and to extraordinary rate relief provided under Section 1308(e).

Mr. LeLash’s analysis of Section 1308(e) in light of general principles of utility regulation confirms the proposition that this provision does not support rate relief for the purposes of a ratepayer infusion of working capital itself:

As I understand it, Section 1308(e) addresses extraordinary needs for revenues to meet operating expenses. It does not contemplate a utility seeking a capital contribution from its ratepayers. Accordingly, it is my belief that the Section 1308(e) provisions are not applicable to PGW’s rate relief request.

Utility regulation has consistently recognized that ratepayers are responsible for a utility’s operating expense, including a return on the utility’s capital. However, there is no precedent, to my knowledge, where

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<sup>11</sup> General Inventory and Receivables Gas Works Revenue Note Ordinance of 1983 (September 30, 1983), Bill No. 1761, Ordinances of the City of Philadelphia (January 1, 1983 to December 31, 1983), pp. 1346-1368.

ratepayers have been held responsible to serve as the initial source of funds to meet a utility's capital needs. Therefore, by definition, the Section 1308(e) provisions do not contemplate, nor provide, a standard for PGW's pending request.

OCA Statement No. 1-ERP, at 27.

**2. Section 1308(e) Relief Is Not Available as a Means of Correcting a Perceived Inadequacy in a Prior Base Rate Proceeding.**

Section 1308(e) relief is not available to PGW for this liquidity restoration purpose for another reason. PGW fully litigated its 2001 Base Rate Case on the basis of the uncompromising legal assertion that ratepayers should provide PGW with sufficient working capital so that it would have \$35 to \$40 million in fiscal year end cash. In ruling on the base rate increase request, the Commission, first in its October 4, 2001 Order, declined to set rates primarily on the basis of year end cash balances, and then, in its December 6, 2001 Order, squarely rejected PGW's demands for \$35-\$40 million in year end cash. In its most recent Order, it reminded PGW that its "just and reasonable" determination resulted in year end cash of \$10.2 million, and explicitly declared that PGW ratepayers could not be held responsible for meeting all PGW's cash needs.

Pa.P.U.C. v. PGW, R-00006042, December 6, 2001 Order, at 27-31. PGW ignored these clear signals from the Commission, continuing to allow the rating agencies to believe that the Company had reasonable prospects of securing additional rate relief for cash purposes via future extraordinary and base rate filings. OCA Cross-Examination Exhibit No. 2.

Now, PGW seeks through this proceeding the ratepayer infusion of cash working

capital (as opposed to the cost of that working capital) which the PUC previously denied the Company. In so doing, PGW has placed itself outside of the ambit for Section 1308(e) extraordinary rate relief.

It is well settled Commission precedent that Section 1308(e) is not available for a utility to pursue a rate award denied in a recent prior proceeding. This was a subtext in two proceedings involving utility requests for extraordinary rate relief – Pa.P.U.C. v. Pennsylvania Electric Company, Docket No. R-7804599, September 21, 1978 Order (hereinafter “Pennsylvania Electric”) and Pa.P.U.C. v. Metropolitan Edison Company, Docket No. P-80070235, August 28, 1980 Order. In both cases, the Commission squarely declared that Section 1308(e) could not be utilized as a vehicle to relitigate issues decided in recent rate cases:

We find no legislative intent that a utility may, under the guise of petitioning for extraordinary rate relief, secure increased revenues in order to maintain or improve its return on common equity, absent clear and convincing proof that such extraordinary rate relief is immediately necessary under the criteria set forth in Section 308(f) [now Section 1308(e)] of the Public Utility Code. We wish to make clear that an inability to earn the rate of return on common equity determined to be appropriate by the Commission in the previous rate proceeding or dissatisfaction with such *rate of return cannot support a request for extraordinary rate relief under Section 308(f) [Section 1308(e)].*

Metropolitan Edison, at 22, quoting from Pennsylvania Electric. Just as these utilities were barred from relitigating a rate of return issues just recently decided, so here, PGW is barred from relitigating the cash flow issues decided by the Commission’s October 4,

2001 and December 6, 2001 Orders in PGW's 2001 Base Rate Case.

**3. Section 1308(e) Relief Is Not Available to Address an "Emergency" Created by the Utility Itself.**

It stands to reason that PGW may not utilize Section 1308(e) on the grounds of "emergent" circumstances necessitating extraordinary relief when those circumstances are PGW's own creation. To grant extraordinary relief in such circumstances would encourage utilities to behave in the imprudent, even reckless manner that is present in this case. As Mr. LeLash testified, PGW's liquidity problems have their origins in the historic failure of the City to manage PGW, to subject its operations to the level of public scrutiny which occurs only in the context of base rate cases, while at the same time insisting on draining \$18 million annually in cash from a deteriorating utility without regard for the future.

From the outset of passage of jurisdiction over PGW to the PUC, there was a significant question whether the PUC would accept PGW's view that the so-called Cash Flow Method required the Commission to provide PGW through rates not merely the cost of reasonable working capital, but the working capital itself. Thus, the City and PGW ignored the message of the Interim Base Rate Case, which was that the Commission had reservations about PGW's claims for the Cash Flow Method ("In addition to the lack of any legal requirement to apply PGW's cash flow method in this proceeding, the

Commission also agrees with OCA's position that it is fundamentally unreasonable to expect ratepayers to provide PGW's cash working capital as well as meet revenue requirements in this proceeding...").<sup>12</sup> This message should have taken on added weight in light of Standard & Poor's placing of PGW on Credit Watch (with Negative Implications) in July, 2000. PGW E.R.P. St.1, at 2. This message was reiterated, in more specific terms in the Commission's October 4, 2001 and December 6, 2001 Orders in PGW's 2001 Base Rate Case.

A prudent owner, paying attention to these regulatory messages, would have begun preparing last fall for a resolution of PGW's liquidity problems. Such preparation would certainly have involved initiating the necessary City ordinances, educating the rating agencies through communication of a more objective assessment of PGW's situation, negotiating with the providers of credit holding the necessary discussions with the Pennsylvania Intergovernmental Cooperation Authority (PICA) and working with Commission staff to prepare an acceptable plan for PGW's liquidity restoration. Further, they might also have involved more long range steps such as assuring that economic development programs subsidized directly or indirectly by the City are linked where practicable to a commitment to use natural gas as the fuel of preference.

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<sup>12</sup> Pa.P.U.C. v. PGW, Docket No. R-00005654, November 22, 2000 Order, at 9.

Such a plan would necessarily have included provision for a substantial equity infusion to PGW by the City. However, as Mr. LeLash observes, the City has declined to engage on these issues. No matter what the City's financial circumstances, the response has always been: "we do not have the money." Given the overall size of the City's budget and resources, a more candid response would be that the City does not have the will. OCA St. No. 1-ERP, at 34.

To this day, the City has done the absolute minimum necessary to assure that PGW met debt service coverage and paid debt service, always in such a way that ratepayers would continue to be on the hook ultimately for all such costs. As was foreseeable, such tactics did not ward off and have not mitigated any threat of bond rating downgrade which currently exists. If an emergency exists today, it is an emergency created by the City and PGW management under City control.

Extraordinary relief should not be available to a utility which itself has created whatever emergency may exist.

**D. PGW Has Not Satisfied Any of the Four Statutory Requirements for Section 1308(e) Relief.**

If PGW and its owner the City are not barred from Section 1308(e) extraordinary rate relief for the purposes of remedying a working capital deficiency of their own

making, then the Commission must decide whether they have met the “stringent” and “heavy burden” of proving by convincing evidence that that section’s four requirements have been satisfied.<sup>13</sup>

### **1. Section 1308(e) Relief Is Not Immediately Required.**

The Standard & Poor’s Notice does not require an “immediate, permanent” base rate increase as claimed by PGW. PGW E.R.P. St. 1, at 14. Although PGW offers the testimony of Mr. Knudsen, Mr. Bogdonavage and Ms. Bisgaier to “interpret” the Notice in this sense, that testimony is inherently unreliable, due to these witnesses institutional duties and loyalties. Absent authoritative testimony by an authorized representative of Standard and Poor’s, the Commission must limit itself to the four corners of the Notice itself. To do otherwise is to violate the requirement that the utility must make a “specified showing” which rises above mere “speculation or conjecture.” Metropolitan Edison, at 6. In this case, the Company’s testimony on the intricacies of Standard & Poor’s rating practices has not met this admittedly “heavy burden.” Metropolitan Edison, at 6.

When the Notice is read without the interpretative gloss provided by PGW, it

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<sup>13</sup> This portion of the Memorandum is written pursuant to the Administrative Law Judge’s directives that “The parties shall address each of the four prongs in section 1308(e), the legal standard for granting extraordinary rate relief, as a separate issue.” Prehearing Order (March 6, 2002, at 6; Order # 3 (March 29, 2002), at 2.

provides a significantly less prescriptive message. The Notice identifies a liquidity problem in the current fiscal year, and states that “[without] immediate cash flow improvement, ratings will be lowered.” It acknowledges that PGW has filed “an emergency rate request,” and announces its intention to postpone its decision on whether to downgrade one or more of PGW’s bond ratings for the relatively short period for Commission decision.<sup>14</sup> However, it does not state that the problem can be resolved only and solely by an emergency permanent base rate increase. It does not state that a permanent base rate increase of \$44 million is necessary. It does not even state that if a downgrade is coming, it will be announced in mid-April, 2002. It does not say that any of PGW’s bonds will be downgraded below investment grade status. Rather, it only acknowledges that it will await the resolution of the method that PGW has chosen on its own to address its liquidity problem.

Moreover, the Notice’s statement that PGW’s “poor liquidity” is “due, in part, to the PUC final rate order of a \$33.6 million rate increase in December 2001, about \$31.0 million less than requested” does not support PGW’s one-track mind inference that the only acceptable response to this situation is an “immediate” emergency rate increase. As OCA witness LeLash testifies, “[r]egulated utilities should not obtain revenue relief, particularly extraordinary revenue relief, based on speculation concerning what actions a

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<sup>14</sup> The Notice quotes the S&P credit analyst Aneesh Prabhu that “if the PUC approves an emergency rate request, Standard & Poor’s will review the adequacy of the increase and determine if ratings will be affirmed or lowered.” PGW E.R.P. St. 4, Revised Exhibit BCB-1.

rating agency may or may not take.” OCA Statement No. 1-ERP, at 6.

Indeed, the Notice’s inclusion of the words “in part” support an alternative inference that just as a variety of factors have contributed to this year’s liquidity problems, so a variety of methods would be appropriate to address the problem. In fact, as Standard & Poor’s itself recognizes, an emergency rate increase effective in mid-April, 2002 would not be sufficient in any event to resolve this year’s liquidity problem, due to the fact that the incremental revenues that PGW would derive from rates between mid-April and fiscal year end are only \$2.5 million. PGW E.R.P. St. 4, Exhibit BCB-3. Moreover, the Notice itself, in its discussion of PGW’s temporary borrowings from its capital fund, notes that additional “project revenues” as opposed to “rate relief” would potentially lessen PGW’s dependence upon this practice.<sup>15</sup>

In a similar vein, the Notice’s identification of the “risks” reflected in the ratings includes not just “weak fixed-charge coverage” but several factors which unbiased, independent analysts would recognize to be within the control of the Company and its owner the City, including supposed “limited ability of the City of Philadelphia to provide assistance due to city’s tight financial situation,” PGW’s “problems with high account receivables” and “[i]nability to convert from interim management to permanent

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<sup>15</sup> See also OCA Statement No. 1-ERP, at 6. Such “project revenues” would include grant back of the \$18 million City Payment and transfer of interest from the Sinking Fund Reserve.

management by December 2001, as directed by PUC's interim rate order." The identification of these factors in conjunction with the rest of the Notice suggests that a downgrade would not "immediately" occur if PGW and the Commission were to arrive at a credible plan to address PGW's liquidity problems. Such a plan, as suggested by OCA witness LeLash would include an appropriate time-limited surcharge ear-marked to paydown short term debt, but would also include other necessary components, including, but not limited to, waivers or grant backs of the City Payment, extension of the City Advance, and a Forward Purchase Agreement.<sup>16</sup>

The Commission, as a matter of policy, should not give significant weight to the interpretations of the Notice offered by Mr. Knudsen and Ms. Bisgaier. Their testimony takes advantage of the fact that Standard & Poor's analysts themselves are not available to undergo cross examination on the bases for the positions taken by Standard & Poor's on the basis of their analyses. Due to the positions these City/Company witnesses occupy, the Commission should not uncritically accept their expansive interpretation of the Standard & Poor's Notice.<sup>17</sup>

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<sup>16</sup> CEPA et al. believe that such a plan should also include enforceable City commitment to link natural gas use to City economic development subsidies whenever practicable.

<sup>17</sup> In this respect, Knudsen testifies : "Essentially, this is the deadline that S&P has imposed. It is looking to see immediate, permanent improvement in PGW's liquidity or it will downgrade now." PGW E.R.P. St.1, at 14; see also the testimony, at 13. Similarly, Bisgaier testifies: "Absent the grant of emergency rate relief so that this fixed cost coverage rate can be achieved on a permanent ongoing basis, Standard & Poors will take negative credit action within the next two months." PGW E.R.P. St.4, at 5.

In the conscientious performance of their duties as PGW Senior Management, or as the City's Financial Advisor, they may have communicated to S&P a one-sided view of the range of remedies open to PGW and its owner the City at this time. Neither witness is in a position to determine whether the City shall make available a capital infusion for PGW, and in fact, one measure of their success from the City's point of view will be avoiding this necessity. It is notable that the Notice fully credits the self-serving representations of the City that it has no capacity to provide PGW with any level of equity infusion; it also uncritically credits PGW's claims that the PUC's prior rate relief has been "inadequate" without recognition of the contribution that the Commission authorized to assist PGW by allowing retention of \$10.7 million in FY2001 GCR overcollections.

Finally, although PGW's debt service ratio is determined without considering the \$18 million payment as an expense, the fixed charge standard would require rates to provide for the \$18 million City payment. Given that the City's strategy is to avoid ever having to give up the \$18 million City payment, Knudsen and Bisgaier are not now in a position to adopt a critical stance toward the S&P analysts whom they have been cultivating for months and years.<sup>18</sup> Inevitably, once the S&P Notice was issued, they

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<sup>18</sup> PGW E.R.P. St. 4, at 4 and passim; PGW E.R.P. St. 1, at 4.

have been placed in the position of making the best of it – and trying to assure that the Notice does not become a lever forcing their ultimate employer or client, the City, to make a meaningful equity contribution to PGW’s refurbishment.

In addition, the attitudes taken by Moody’s and Fitch, two other bond rating agencies, suggest that PGW is not in their view, on the edge of a downgrade. These bond rating agencies do not see the immediate risks that Knudsen and Bisgaier interpret the Standard & Poor’s Notice to signal. As LeLash points out, the Fitch analyst states that PGW is “bouncing along at the triple-B level, and we’ll continue to watch it... We expect things are not going to run smoothly for them but we still continue to feel that they’re going to be able to pay their debts.” Moody’s also does not anticipate an immediate downgrade: “If the utility does not get that base rate increase and is required to pay back the city loan, the stress on the utility’s liquidity will be significant...It’s very possible that at that point the rating could be in trouble.” OCA Statement ERP-1, at 19.

In sum, the Notice raising the issue of a credit downgrade does not support the conclusion advanced by PGW that only “immediate” permanent base rate relief would be sufficient to prevent a downgrade. As OCA witness LeLash testified: “This is not to say that PGW does not have a liquidity problem, but rather it is unclear that the sole remedy is an immediate \$44 million revenue increase [from rates].” OCA Statement 1-ERP, at 19. To the contrary, immediate commitment to a plan requiring actions to occur over the

remainder of FY2002, FY2003 and FY2004 would satisfy the Notice's implication that PGW's liquidity problem be addressed in a comprehensive manner.

**2. Section 1308(e) Relief Is Not Immediately Necessary for the Financial Stability Enabling Maintenance of Normal Utility Functions.**

Section 1308(e) requires a showing that rate relief is "necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to customers...." As Metropolitan Edison teaches, this provision does not guard against all types of financial instability, but only those which impair the utility's ability to perform certain identified operational functions. Extraordinary relief is thus not statutorily available to address all types of financial crisis, even when these crises may be very severe and a utility's financial situation "precarious." In Metropolitan Edison, the Commission denied extraordinary relief even though the utility's securities had been downgraded to below investment grade status, the utility was foreclosed from access to the bond market, and the utility had paid no dividends on its common stock for several months and had "no visible prospect of paying any." Metropolitan Edison, at 8,9, 18.

As the Metropolitan Edison ALJ held, the "statute itself specifically cites the nature of the financial stability giving right to extraordinary rate relief." Metropolitan Edison, at 13. Continued maintenance of those functions is consistent with the purpose of Section 1308(e) which is operational in focus -- "to assure adequate and continuous

service to utility customers and to prevent interruptions thereof due to the financial instability of the utility.” Metropolitan Edison, at 5.

PGW claims that any downgrade of any of its bonds would precipitate a series of events in which the Company’s financial infrastructure would collapse like a house of cards. The downgrade would first bar the possibility of a Forward Purchase Agreement involving interest income from the Sinking Fund Reserve which is anticipated to provide PGW with \$20 million in project revenues. Next, PGW’s TXCP program would not be renewed, or at least \$50 million of that \$80 million facility, as the banks collaborating with J.P Morgan Guaranty Trust withdrew at the end of August, 2002. PGW would then be faced with deprivation of this part of its short term credit, and the need to enter into a workout agreement with the departing banks to pay the \$50 million balance owed over a period of two years. cite.

However, according to PGW’s testimony as filed, PGW would appear to be able to maintain normal operations through November, 2002. For the next eight months, from April through November, with only a grant back of the City \$18 million payment and through normal belt tightening and sale of some gas inventory, PGW would be able to satisfy its debt service coverage requirement and maintain positive cash flows.<sup>19</sup> In

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<sup>19</sup> On PGW’s debt service coverage, see OCA Statement ERP-1, Schedule 1at Current Estimate (2). With the \$18 million grant back, the debt service coverage ratio requirements would be met even if PGW

Metropolitan Edison, one of the reasons cited for the denial of extraordinary relief was that no substantial impairment of operations was likely to occur for nine months from the date of the petition. Metropolitan Edison, at 9, 21. As is discussed in more detail below, no substantial impairment of normal PGW operations would be necessary for a similar period of time, until November, approximately nine months from the date of the Petition.<sup>20</sup>

The only evidence presented by PGW to the contrary is its Revised 3-25-02 Estimate 2001-2002 contained in PGW Bogdonavage Rebuttal Exhibit 1. The Commission should not rely on this estimate because of its speculative nature, elevating without justification the estimates of margin loss due to warm weather to \$32 million, predicting without any support a GCR over collection of \$16.8 million, and making other adjustments based on summary statements regarding pension expense and bad debt. The Company does not advance similar speculations concerning its abilities to increase its income through inventory sales and to cut expenses in other categories. This one-sided

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experiences a \$30 million, rather than \$25 million margin loss due to warm weather in FY2002. OCA ERP-1, at 26.

On PGW's cash flows, see PGW E.R.P. St.2, Exhibit JRB-1, at 1. Cash flow in this period would be easily positive but for the need to pay down the TXCP program from \$97 million to \$77 million. Factoring in this necessity, with grant back of the \$18 million, year end cash would be (\$2.8 million). This shortfall could be managed by such inventory sales or other common cash management techniques. Assuming grant back of the \$18 million, cash flow in the early months of FY2003, through November, would be positive. PGW E.R.P. St. 2, Exhibit JRB-1, at revised 2.

<sup>20</sup> As OCA's witness LeLash testified on this point: "There is no evidence per se which would indicate that, during the pendency of its base rate case, it would suffer impairment to its ability to provide on-going safe and reliable gas service to its customers." OCA Statement No. 1-ERP, at 8.

eleventh hour schedule is precisely the type of speculation which may not support extraordinary relief.

**3. Section 1308(e) Relief Is Not Immediately Necessary to Support Normal Utility Functions.**

The Company has not met its burden of showing that extraordinary rate relief is immediately necessary to “enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment...” PGW’s liquidity problem would not prevent PGW from providing normal service between now and November, 2002. As Mr. Knudsen recognizes, the \$33.6 million base rate increase granted in PGW’s 2001 base rate case “proved salutary and addressed in the main, PGW’s needs regarding ongoing operating requirements....” PGW E.R.P. St.1, at 3.

The Company provides a list of steps that it would be prepared to take in the event of a downgrade which barred implementation of a Forward Purchase Agreement, the renewal of its TXCP Program at the \$80 million level in September, 2002, and access to the bond markets in December 2002. Some steps, such as obtaining deferral of repayment of the \$45 million City Advance and depletion of natural gas inventories presently unit priced above current market rates, are steps which involve no diminishment

of normal services or maintenance programs. PGW St.1, at 10-11.<sup>21</sup> Others, like a “hold on unnecessary spending” and reductions in expenditures on personnel (overtime, temporary employees, etc.) would not initially involve reduction of normal customer services and maintenance services or “substantial” staff reductions, but rather represent the type of sound husbanding of resources which has long been sadly lacking at PGW. PGW St. 1, at 11-12.

Other steps itemized by PGW to cut back on normal service and maintenance are not “emergent” or “emergency” actions, as required by the Section 1308(e). Metropolitan Edison, at 13. PGW would not be immediately forced by a bond ratings downgrade to undertake such measures as suspension of normal customer and maintenance services and “substantial” reduction in employment. The downgrade in itself will not immediately compel such actions as abrogation of the PGW 18 miles per year cast iron main replacement program, cut back or elimination of appliance repair programs, abrogation with PUC authorization of the no lay-off clause in the Company’s collective bargaining agreement followed by layoffs of bargaining unit personnel, and attempts to obtain waiver of Chapter 56 limitations on terminations and payment

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<sup>21</sup> Such depletion is not necessarily incompatible with a least cost fuel procurement policy – in fact, in many circumstances, depletion of such storage gas permits the Company to take advantage of lower current prices in replenishing its storage for the next heating season.

agreement terms.<sup>22</sup> Sufficient liquidity exists without extraordinary rate relief to continue normal operations through the Fall, 2002. As in Metropolitan Edison, the incremental revenues from any extraordinary relief that might be granted, while they might be required in the future, are not necessary to fund the continuation of such activities in this period. Metropolitan Edison, at 16.

PGW claims that a downgrade of its bond ratings would immediately require an “an abrupt and profound downsizing of Company operations.” PGW E.R.P. St.1, at 11. The Company justifies this approach on the grounds that such immediate downsizing would permit it to buy maximum amount of time to accomplish what might be necessary to assemble the resources to operate the utility, or to sell the utility to a party with the resources to operate it. However, the testimony shows that assuming PGW’s credit rating is reduced to non-investment grade, this “abrupt and profound downsizing” would become actually necessary only in November or December, 2002.

To its discredit, the City has not yet begun to explore any avenue of liquidity restoration for PGW other than asking the PUC to place this burden virtually in toto on

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<sup>22</sup> PGW appears to have no immediate plans to request waiver of Chapter 56 provisions. PGW claims just now to be developing a “Comprehensive Collections Strategy” despite long recognized inadequacies of its billing, metering and collections function. OCA Statement No. 1-ERP, at 13. Chapter 56 has been long recognized as a framework for effective utility collections practices. In this respect, PGW’s request for a Chapter 56 waiver would represent a step away from maximization of cash flow, in favor of collection methods which have never been proven to be cost effective. See the BCS Investigation of Uncollectible Balances. Final Report to the Pennsylvania Public Utility Commission, February 1992 and the 1996 BCS Report of the Collection Issues Task Force.

ratepayers. This is an unacceptable solution and would produce an unjust and unreasonable level of base rates. CEPA *et al.* support in principle the type of sharing of the burdens of PGW's liquidity restoration proposed in Mr. LeLash's testimony on behalf of OCA. OCA Statement No. 1-ERP, at 31-42; see also 10-14.<sup>23</sup> There is still time for the City to responsibly explore other alternatives which are more in the public interest. That time could be maximized if PGW promptly and efficiently implements the less drastic measures discussed above. At the same time, the City must for the first time recognize and orient its actions around the recognition that PGW's liquidity restoration should not and can not be accomplished absent a plan based on a true sharing of the out of pocket costs going forward of PGW's short term debt reduction between ratepayers and the City as PGW's owner.

#### **4. The Quantifiable Cap on Section 1308(e) Relief Is Applicable and May Not Be Waived Absent Just Cause.**

Section 1308(e) limits the amount of extraordinary rate relief available under that provision of the Public Utility Code to "no more than the rate of return on the utility's common equity established by the commission in consideration of the utility's preceding rate filing." 66 Pa.C.S. §1308(e). In its Extraordinary Relief Petition, PGW recognizes that this provision represents a cap, but proposes that the cap be waived pursuant to

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<sup>23</sup> The plan to be assembled as part of this global solution should assure more systematic PGW involvement in City financed or subsidized economic development, reform of PGW governance, engagement of permanent management, and establishment of enforceable PGW performance standards which enhance management accountability.

Section 2212(c) of the Gas Choice Act, or be declared “inapplicable” to PGW as a non-investor owned utility. PGW offers as a justification for such an action that “[a]s a municipally owned utility, PGW does not have private investors and does not have common equity or a return on that equity, like an investor owned utility.” PGW further states that rates are not set “utilizing the rate of return method.” Petition, ¶ 26.

PGW then proposes that since the cap is waivable or non-applicable, the Commission should focus on application of the so-called S&P fixed charge formula.

PGW’s argument, whether as a request for waiver, or as an exercise in statutory interpretation, is not reasonable. The cap provision in Section 1308 clearly evidences a legislative intent to impose some limit on the amount of extraordinary relief available under the Code. The provision provides, in other words, that whatever the problem justifying extraordinary relief may be, Section 1308 is not to be read as an authorization to seek only through rates the sums necessary to resolve the problem. If an investor owned utility encountered an operational problem justifying extraordinary relief, that relief would be capped at the previous rate of return on equity. The investor owned utility, even if it was without fault, would be required to resort to other non-rate resources in order to address the shortfall between the actual revenue need, and the portion of that revenue available through extraordinary relief. Under the Gas Choice Act, public utility service rendered by PGW “shall be subject to regulation and control by the commission with the same force as if the service were rendered by a public utility.” 66 Pa.C.S.

§2212(b). As such, PGW must be presumed to be subject to comparable limitations on its ability to obtain extraordinary relief.

Moreover, despite PGW's protestations, the \$18 million City payment is most aptly characterized as a return on equity. That is how the Pennsylvania Supreme Court justified its recovery in a particular base rate case. Public Advocate v. Philadelphia Gas Commission, – Pa.–, 674 A.2d 1056, 1059-62 (1996) ( \$18 million City Payment in that case would represent “return on equity” of 9%, a “ rate of return [which] is reasonable and rationally related to the City’s asserted equity in PGW”). And the Commission itself has also implicitly endorsed that categorization in its discussion of the \$18 million City Payment in the 2001 Base Rate Case. Pa.P.U.C.v PGW, Docket No. R-00006042, October 4, 2001 Order at 33-34. To categorize the City Payment as a payment made in lieu of taxes has been held to render that payment unconstitutional. Public Advocate v. Philadelphia Gas Commission, 637 A.2nd 676 (Pa. Cmwlth. 1994). Finally, in this proceeding, the City’s Director of Finance, Janice Davis refers to the \$18 million as the City’s “return on its investment” in PGW. PGW E.R.P. St.5.1, at 3.

For this reason, also, the Commission should reject PGW’s attempt to distinguish itself from all other utilities which generate a return on equity.

CEPA et al. agree with OCA, that if PGW is found to be otherwise entitled to

any “extraordinary relief” pursuant to Section 1308(e), the Commission may effectuate the limiting legislative intent by providing no more than is necessary to satisfy PGW’s minimum debt service ratio requirements at year end 2002.<sup>24</sup>

CEPA et al. also recognize that the Gas Choice Act provides that the Commission “may” waive provisions of the Public Utility Code except for Section 2212. 66 Pa.C.S. §2212(c). Such waivers, may not however, abrogate the constitutionally based provisions of the Code which require that rates must be “just and reasonable.”<sup>25</sup> This requirement would impose, if a waiver is granted, a different but strict limitation on the relief which PGW is seeking. As the Commission recently observed, in the 2001 Base Rate Case, the final rate order in that case approved a revenue requirement which includes a “reasonable amount of cash working capital, results in rates that are just and reasonable in accordance with the statutory directives of the Public Utility Code.” The Commission further explained that “[t]he Management Agreement does not assume that customer rates will cover all PGW’s capital and cash needs as if no other sources of capital or revenues are available to PGW.” Pa. P.U.C. v. PGW, Docket No. R-00006042,

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<sup>24</sup> See Office of Consumer Advocate’s Answer to Philadelphia Gas Works’ Petition for Extraordinary Rate Relief, at 3,4.

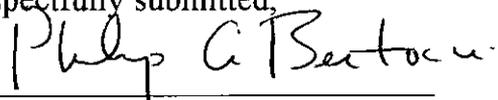
<sup>25</sup> See Pa.P.U.C. v. PGW, Docket No. R-00006042, October 4, 2001 Order, at 25 (“...the ‘just and reasonable’ standard in Section 1301 is coextensive with the federal constitutional standard for determining utility rates”). In PGW’s 2000 Interim Base Rate case, which was not based specifically either on Section 1308(d) providing general rate increases, or the Management Agreement, the Commission justified limited relief on the grounds that “[w]e balance the statutory requirement of meeting debt servicing requirements incurred by the Philadelphia Gas Works (PGW) with our goal affording just and reasonable rates to consumers in the context of that statutory requirement.” Pa.P.U.C. v. PGW, Docket No. R-00005654, November 21, 2000 Order, at 2.

December 6, 2002 Order at 28, 29.

**IV. Conclusion.**

After obtaining increases in base rates or equivalent over pre-November 22, 2000 levels amounting to in excess of \$30 million for 2001 and 2002, PGW now seeks extraordinary relief which would increase overall residential customer rates an additional 9% on an annualized basis. For all the foregoing reasons, CEPA et al. request that the Commission deny PGW's Petition for Extraordinary Rate Relief.

Respectfully submitted,

  
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EDWARD A. MCCOOL, ESQUIRE

Attorneys for CEPA et al.

April 3, 2002

## Appendix A

### CEPA et al.'s Proposed Findings of Fact and Conclusions of Law

#### Proposed Findings of Fact:

1. The sole purpose of PGW's request for extraordinary rate relief is to obtain from base rates substantial amounts of working capital, as opposed to the cost of working capital. PGW E.R.P. St.1, at 3.
2. In this Section 1308(e) proceeding, PGW seeks to obtain from ratepayers a level of working capital which was denied to the Company by the Commission in the recent base rate proceeding. Pa.P.U.C. v. PGW, R-00006042, December 6, 2001 Order, at 27-31.
3. In this Section 1308(e) proceeding, PGW seeks to obtain extraordinary rate relief in order to address a putative emergency which derives from the failure of PGW and its owner to recognize and provide for non-rate working capital. OCA Statement No. 1-ERP, at 32-35.
4. The Standard & Poor's Notice does not require an immediate, permanent base rate increase of \$44 million. PGW E.R.P. St.4, Revised Exhibit BCB-1; OCA Statement No. ERP-1, at 5,6.
5. The Standard & Poor's Notice does not require that PGW's liquidity problems be immediately resolved solely by an equity infusion by customers through base rates. PGW E.R.P. St.4, Revised Exhibit BCB-1; OCA Statement No. ERP-1, at 5,6.
6. The Standard & Poor's Notice does not state that a downgrade would result in any of PGW's bonds being reduced to below investment grade status. With the exception of the subordinate bonds, PGW's bonds could be downgraded one level without losing their *investment grade status*. PGW E.R.P. St. 4, at 3.
7. Even if PGW's bonds were downgraded to below investment grade status in mid-April, 2002, PGW would have sufficient funds to maintain normal service to customers, normal maintenance operations, and virtually normal employment levels through November, 2002, if the City were to grant back the \$18 million City Payment. OCA Statement No. 1-ERP, Schedule 2 at Current Estimate (2); OCA Statement No. 1-ERP, at 26; PGW E.R.P. St.2, Exhibit JRB-1, at 1; PGW E.R.P. St. 2, Exhibit JRB-1, at revised p. 2.
8. Even if PGW's bonds were downgraded to below investment grade status in mid-April, 2002, with the City grant back of the \$18 million City payment, there would be no

immediate need for an abrupt reduction of normal utility functions or for substantial reduction in employment. OCA Statement No. 1-ERP, Schedule 2 at Current Estimate (2); OCA Statement No. 1-ERP, at 26; PGW E.R.P. St.2, Exhibit JRB-1, at 1; PGW E.R.P. St. 2, Exhibit JRB-1, at revised p. 2.

9. PGW, the Courts and the Public Utility Commission concur that the \$18 million City payment is best characterized as a dividend or return on equity. Pa.P.U.C. v. PGW, Docket No. R-00006042, October 4, 2001 Order at 33-34; PGW E.R.P. St. 5.1, at 3.

### **Proposed Conclusions of Law:**

1. Section 1308(e) relief is not available for a utility seeking to obtain from base rates substantial amounts of working capital, as opposed to the cost of working capital. Pa.P.U.C. v. PGW, Docket No. R-00006042, Opinion and Order, December 6, 2001, at 29; OCA Statement No. 1-ERP, at 27.

2. Section 1308(e) relief is not available as a means of correcting a utility's perceived inadequacy in a prior base rate award. Pa.P.U.C v Metropolitan Edison Company, Docket No. P-80070235 (August 28, 1980 Order).

3. Section 1308(e) relief is not available as a means for a utility to address an "emergency" created by the utility itself. 66 Pa.C.S. §1308(e).

4. Section 1308(e) relief is not available to a utility which has not met a "heavy burden" of showing by substantial evidence that its situation satisfies each of the four requirements of that section concerning the necessity to prevent a financial crisis which would immediately require an abrupt reduction of customer service and system maintenance service below normal levels and substantial reduction in employment. 66 Pa.C.S. §1308(e); Pa.P.U.C v Metropolitan Edison Company, Docket No. P-80070235 (August 28, 1980 Order).

5. A public utility which pays its municipal owner an annual dividend or return on equity in the form of a fixed annual payment is subject to the quantitative limitations on emergency relief available under Section 1308(e). 66 Pa.C.S. §1308(e).

6. PGW has not shown good cause for a waiver of the quantitative limitations on extraordinary relief contained in Section 1308(e). 66 Pa.C.S. 2212(c).

7. Any extraordinary rate relief granted under Section 1308(e) must be "just and reasonable." 66 Pa.C.S. §1301; Pa.P.U.C. v. PGW, Docket No. R-00005654, November 21, 2000 Order, at 2.

8. In this case, PGW has not met its burden of showing by substantial evidence that the requested extraordinary rate increased is “just and reasonable” in that, inter alia, PGW and its Owner the City of Philadelphia have not provided for an equal sharing of the burdens of PGW liquidity restoration. Pa.P.U.C. v. PGW, Docket No. R-00006042, October 4, 2001 Order, at 25; Pa.P.U.C. v. PGW, Docket No. R-000056554, November 21, 2000 Order, a 2.

R-00017034F0002

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing Memorandum upon the participants listed below in accordance with the requirements of 52 Pa.Code §1.54 (relating to service by a participant).

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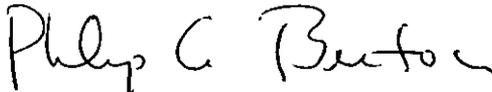
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PHILIP A. BERTOCCI

Date: April 3, 2002

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April 3, 2002

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Re: Pennsylvania Public Utility Commission v.  
Philadelphia Gas Works  
Docket No. R-00017034F0002,  
Petition for Extraordinary Rate Relief

Dear Secretary McNulty:

Enclosed for filing please find an original and (9) nine copies of the Memorandum of Law of the Office of Consumer Advocate in the above-referenced proceeding.

A copy of document has been served upon all parties of record as evidenced on the attached Certificate of Service.

Sincerely yours,

Tanya J. McCloskey  
Senior Assistant Consumer Advocate

Enclosure

cc: Honorable Cynthia W. Fordham, Administrative Law Judge, Via e-mail and overnight mail  
Chairman Glen R. Thomas  
Vice Chairman Robert K. Bloom  
Commissioner Aaron Wilson, Jr.  
Commissioner Terrance Fitzpatrick  
Commissioner Kim Pizzingrilli  
All parties of record

64

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

v.

PHILADELPHIA GAS WORKS

:  
:  
:  
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DOCKET NO. R-00017034F0002

In the Matter of Philadelphia Gas Works'  
Petition for Extraordinary Rate Relief

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OFFICE OF CONSUMER ADVOCATE'S  
MEMORANDUM OF LAW

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DOCUMENT  
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PA.P.U.C.  
SECRETARY'S BUREAU

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Dated: April 3, 2002

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## I. INTRODUCTION

On February 25, 2002, Philadelphia Gas Works (PGW) filed a general base rate case seeking a \$60 million increase in its base rates. Simultaneously, PGW filed a Petition for Extraordinary Rate Relief pursuant to Section 1308(e) asking that \$44 million of its request be approved on an immediate and permanent basis. In its Petition, and in its testimony in support of the Petition, PGW avers that Standard and Poor's (S&P) will downgrade its bond ratings if PGW does not receive \$44 million in extraordinary rate relief.

The alleged basis of S&P's concern is with PGW's continuing liquidity problems. These problems have arisen over many years. Throughout the 1990s, PGW's financial condition deteriorated as it experienced warmer than normal winter weather and extended its commercial paper borrowing to the maximum limit. PGW did not seek rate relief in this time frame, but it continued to make its \$18 million annual payment to the City. Since 1996, the City has taken \$108 million out of PGW through the payment of the City fee even as PGW's financial condition worsened. Now, based on a sudden S&P announcement citing liquidity problems, PGW seeks \$44 million in immediate, extraordinary rate relief. Yet, the City continues to take its \$18 million payment, and has offered to grant back only a portion of this fee this year if needed to meet PGW's bond indenture coverages. As OCA witness LeLash testified, no other utility would continue to pay a dividend under these circumstances. OCA St. 1-ERP at 11.

The OCA does not dispute that there are valid concerns about PGW's financial condition. These are concerns that the Commission and all parties have been addressing through a series of proceedings that have been on-going ever since the Commission assumed

jurisdiction over PGW in July 2000. Since July 2000, the Commission has awarded PGW \$33.6 million in permanent, non-gas cost base rate relief. Additionally, the Commission has permitted PGW to include a \$7 million bad debt expense in its GCR on a one-time basis, and to retain \$10.8 million in GCR overrecovery that would otherwise have been returned to ratepayers. OCA St. 1-ERP at 6. The Commission has allowed PGW to update its GCR on a quarterly basis which enabled PGW to bill and recover its higher gas costs in 2001 on an expeditious basis, a strength cited by S&P and the other rating agencies.

The Commission, as well as the parties, have shown a willingness to restoring PGW's financial health over an appropriate period of time, matched to appropriate improvements in service quality. All the while, the City has continued to withdraw its \$18 million per year, without granting back any amount to assist PGW in addressing its liquidity problems. Since 1996, the City has withdrawn \$108 million in cash while its City equity in the operation has dwindled, now standing below 20%. As PGW witness Knudsen acknowledged, in general, a highly leveraged company has a higher financial risk. Tr. 71.

The on-going financial problems of PGW have not happened overnight, and they cannot be remedied overnight solely at the expense of ratepayers. Although it is the position of the OCA that the Company has not met the heavy burden necessary for the grant of extraordinary rate relief, the OCA has set forth a comprehensive proposal to address PGW's long-standing liquidity problems. If the City is willing to stop taking \$18 million per year out of PGW for a limited time period so as to assist in restoring PGW's financial health, the OCA recommends that ratepayers put \$18 million per year in to PGW through a three-year ratepayer capital surcharge. The proposed ratepayer surcharge would then be effectively

“matched” by PGW’s owner, the City of Philadelphia, through a grant back of its \$18 million City fee. PGW could substantially reduce its short term commercial paper and pay off its outstanding City loan with this \$36 million in additional annual revenue. The OCA also recommends that the City agree to a restructuring of the repayment of its \$45 million loan. These actions would restore PGW’s liquidity and financial health. The OCA submits that the Commission could take this action immediately through the imposition of a surcharge while PGW’s pending base rate proceeding is fully litigated on a normal schedule.

The OCA submits that this proposal provides a just and reasonable mechanism to address PGW’s continuing liquidity problem and places PGW on the road to financial health. This proposal is also consistent with the principles set forth by this Commission in its prior PGW rate Order. In that Order, the Commission stated:

[W]e urge the City of Philadelphia, as owner of PGW, to continue to take measures to insure the financial health of PGW. It is the expectation of this Commission that the City of Philadelphia, as owner of PGW, continue to assist PGW in its cash flow requirements so that a financial crisis does not take place. One way of insuring PGW’s overall financial health is to grant back or waive, in part or in total, the City payment when necessary. We hope that the City of Philadelphia will be as diligent in its concern for the financial health of PGW as the Commission is in granting the rate relief described herein.

Pa. PUC v. PGW, Docket No. R-00006042, *slip op.* at 34 (Order entered Oct. 4, 2001).

The OCA’s proposal establishes an equitable sharing of the burden between ratepayers and the owner, the City. Through this mechanism, additional progress can be made to permanently restoring PGW’s financial health.

## II. LEGAL STANDARDS

### A. Introduction

The Commission's authority to consider a request for extraordinary rate relief is set forth in Section 1308(e) of the Public Utility Code. Section 1308(e) provides:

*Upon petition to the commission at the time of filing of a rate request or at any time during the pendency of proceedings on such rate request, any public utility may seek extraordinary rate relief of such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on common equity established by the commission in consideration of the utility's preceding rate filing, . . .*

66 Pa.C.S. §1308(e).

The Commission has had only limited occasion to consider cases under Section 1308(e), or its predecessor sections of the Public Utility Code. When it has, the Commission has found that Section 1308(e) provides a stringent standard that must be specifically met by the utility to justify an award of rate relief. Pa. PUC v. Metropolitan Edison Co., Docket No. P-80070235 and R-80051196, *slip op.* at 5 (Order entered August 28, 1980)(Met-Ed)(attached in Appendix A). As set forth in more detail below, the Commission has found that the utility has a heavy burden to establish every element of the statutory standard with a specific showing.

In the few cases where the Commission has considered extraordinary rate relief, the Commission has rarely granted such relief. When it has, the Commission has only done so in circumstances where the utility has met every element of the strict statutory standard. The Commission's decisions clearly recognize that such relief is extraordinary and should be

awarded cautiously to protect ratepayers since a full record cannot be developed given the expedited time frame for consideration of the request.

The OCA submits that PGW must be held to these strict standards and must satisfy every element of Section 1308(e) if the Commission is to consider an award of extraordinary rate relief. Moreover, the OCA submits that the Commission must apply all of the provisions of Section 1308(e) to PGW, including the provisions that limit the amount of rate relief that can be awarded through an extraordinary rate relief petition.

B. Burden of Proof

It is axiomatic that the burden of proof to establish the justness and reasonableness of every element of a Company's rate increase request is upon the Company. As set forth in Section 315(a) of the Public Utility Code:

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

66 Pa.C.S. § 315(a).

This principle has been interpreted by the Commonwealth Court as follows:

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

Lower Frederick Twp. v. Pa. PUC, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980) (emphasis added). See also, Brockway Glass v. Pa. PUC, 63 Pa. Commw. 238, 437 A.2d 1067 (1981). The Pennsylvania Supreme Court also has clearly stated that the party with the

burden of proof has a formidable task before its position can be adopted by the Commission. Even where a party has established a prima facie case, the litigant still must establish that "the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary." Burleson v. Pa. PUC, 501 Pa. 433, 461 A.2d 1234 (1983) (emphasis added).

For extraordinary rate relief pursuant to Section 1308(e), the Commission has held that the utility bears a heavy burden. Pa. PUC v. Metropolitan Edison Co., Docket No. P-80070235 and R-80051196, *slip op.* at 6 (Order entered August 28, 1980)(Met-Ed) and Pa. PUC v. Pennsylvania Electric Co., 52 Pa. PUC 487, 488 (Sept. 5, 1978)(Penelec). In Penelec and Met-Ed, the Commission held that Section 1308(e):

*... entitles petitioner to extraordinary rate relief only if it can show that such rate relief is immediately necessary for the maintenance of petitioner's financial stability (i) in order to continue providing normal services, (ii) avoid reductions in its normal maintenance programs, and (iii) avoid substantially reducing employment. Proof of such immediate necessity for such rate relief required for the maintenance of the utility's financial stability must be clear and fully supportable of a finding by the commission that the financial stability of the utility is actually in jeopardy.*

Penelec, 52 Pa. PUC at 488, Met-Ed, *slip op.* at 6 (emphasis added). As the Commission found in Met-Ed, the mere risk of loss of revenue during the interim period does not relieve the utility of this heavy burden. Id. Additionally, the Commission has found that extraordinary relief cannot be granted based on speculation or conjecture. Id.

The OCA submits that a utility seeking extraordinary rate relief has a formidable task to show that it is suffering from financial constraints sufficiently severe that if not immediately remedied, would impair the provision of safe and adequate service. See, Met-

Ed at 6-7. The OCA submits that PGW must be held to this heavy burden.

C. The Commission's Prior Applications Of Section 1308(e)

As noted above, the Commission has applied Section 1308(e), and its predecessor Section 308(f), in only a few cases. In one of the first cases considered under Section 1308(e), the Commission considered Met-Ed's request for extraordinary rate relief in the years following the accident at TMI-2. The Commission first noted that the newly enacted Section 1308(e), unlike its predecessor, required a specific showing by a utility to obtain relief. Met-Ed at 5. The Commission noted that this showing was to be more specific and inflexible than previously required under Section 308(f). Id.

The Commission's analysis of Section 1308(e) in Met-Ed is instructive. The Commission first set forth the purpose of Section 1308(e) as follows:

In our opinion, the purpose of Section 1308(e) is to assure adequate and continuous service to utility customers and to prevent interruptions thereof due to the financial instability of the utility.

Met-Ed at 5. The Commission then analyzed Met-Ed's request in light of its financial condition, the immediacy of the situation, the effect of Met-Ed's financial condition on the provision of service, and the intended purpose of the extraordinary rate relief.

The Commission denied Met-Ed's request for extraordinary rate relief even though Met-Ed had paid no dividend on its common stock for over a year and had no prospect of paying any dividend; had a pre-tax interest coverage ratio below its debenture indenture for the issuance of additional funded debt; had an after-tax preferred stock coverage ratio below its requirement under the charter for the issuance of additional preferred stock; had a negative return on common equity; had its securities downgraded below investment grade; had

reduced operation and maintenance expenditures below normal levels; and had only \$22 million remaining on its revolving credit agreement, which was expected to be reduced. Met-Ed at 8-9. Although finding Met-Ed's financial condition to be "precarious" and poor, the Commission found Met-Ed's condition to be stable in the statutory sense, and to remain stable for 6-8 months more. The Commission concluded that "Met-Ed does not need the immediate infusion of cash to maintain its financial stability; it faces no immediate emergency." Met-Ed at 18.<sup>1</sup>

The Commission, in Met-Ed, was cognizant of the concerns of the intervening banks with Met-Ed's financial condition. The Commission, however, noted the fact that the Commission had provided relief to Met-Ed in a recent Order that was to aid Met-Ed in rehabilitating its financial condition. The Commission quoted with approval from its prior Order as follows:

As to the apprehension of the intervening banks, the Commission said in Pa. P.U.C. v. Metropolitan Edison Company and Pennsylvania Electric Company, at I-79040308, mimeo p. 4, on May 23, 1980: "Respondent must convince its bank creditors that it has the will and ability to rehabilitate itself." The Commission by its May 23 Order provided the means for Met Ed to rehabilitate itself. We shall expect the same concern by other involved parties.

Met-Ed at 21. In its May 23 Order, the Commission indicated that although it will provide a means of financial rehabilitation for Met-Ed, it would "write no blank checks on its ratepayers." Pa. P.U.C. v. Metropolitan Edison Co. and Pennsylvania Electric Co., at I-79040308, *slip op.* at 4, Met-Ed, at 16.

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<sup>1</sup> The Commission also concluded that the major thrust of Met-Ed's petition was to make funds available for the clean-up of TMI, either directly or indirectly, a purpose that the Commission found not valid under Section 1308(e).

The Commission has considered requests for extraordinary rate relief on other occasions as well. In those cases, the Commission stresses the need for the request to adhere to the statutory requirements, particularly the requirement of an immediate need. See, e.g., Pa. PUC v. Pennsylvania Electric Co., 52 Pa. PUC 487, 488 (Sept. 5, 1978)(Penelec)(Petition rejected because petitioner presented no evidence demonstrating that immediate or imminent reductions in normal operations are anticipated nor that it would be required to reduce its normal maintenance programs nor substantially reduce employment without the requested rate relief); Pa. PUC v. Claysville Natural Gas Co., Docket No. R-860423 (Order entered Nov. 13, 1986) (No immediate service problem to support approval of the petition; no immediate need for rate relief to avoid employment reductions; no immediate cash problems.)(attached in Appendix A)

In one of the only cases that the OCA has found where the Commission granted extraordinary rate relief, such grant of relief was made upon a substantial showing of actual work force reductions and actual reduced ability to respond to emergency calls.<sup>2</sup> Pa. PUC v. Pocono Water Co. and Pocono Sewer Co., Docket No. R-80011059 and R-80011060 (Order entered March 3, 1980)(attached in Appendix A). The Commission, in Pocono, specifically found:

The evidence of record has established that PWC and PSC, because of insufficient funds, have been forced to (1) reduce their work force from six maintenance and service employees to two, (2) reduce maintenance and improvements to the water and sewer systems, and (3) terminate 24-hour repair service causing severe difficulty in servicing emergency calls and

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<sup>2</sup> The OCA has found one other case where an extraordinary rate increase was implemented through a settlement of the parties. Pa. PUC v. Jackson Sewer Co., Docket No. R-00005997 (Order entered May 24, 2001)

repairing numerous leaks in the lines. These conditions warrant a grant of Respondents' requests for extraordinary rate relief.

Pocono at 3.

As these cases demonstrate, extraordinary rate relief is only granted in extraordinary circumstances when the continued provision of safe and adequate service has been placed in actual jeopardy.

D. Limitation Provisions Of Section 1308(e)

Section 1308(e) also contains provisions that limit the amount of extraordinary rate relief that the Commission can award. Specifically, Section 1308(e) provides:

. . . which will provide no more than the rate of return on the utility's common equity established by the commission in consideration of the utility's preceding rate filing . . .

66 Pa.C.S. §1308(e).

PGW requested in its Petition that this provision be waived arguing that it is inconsistent with the ratemaking methodology set forth in Section 2212. The OCA submits, however, that these limitation provisions should not simply be waived. The limitation provisions are an important protection for ratepayers that must be adhered to given the expedited review process that accompanies a Section 1308(e) request. Moreover, the limitation provisions evidence the clear intent of the General Assembly that Section 1308(e) not be utilized as a means of providing rate relief far in excess of the status quo. Given the limited time for review, it cannot be the intent of Section 1308(e) to immediately resolve a utility's long-standing financial problems. Rather, Section 1308(e) is intended to address the immediate need to continue to provide service until a company's full request can be properly

evaluated in the context of the pending full base rate case.

The OCA submits that rather than waive the limitation provisions of Section 1308(e), the Commission should determine the appropriate limitation consistent with the provisions of Section 2212. As the rules of statutory construction provide, whenever a statute is amended, *the original statute and the amendment shall be read together and viewed as one statute passed at one time.* 1 Pa.C.S. §1953. Additionally, whenever a general provision conflicts with a specific provision, the two are to be construed so that effect may be given to both, if possible. 1 Pa.C.S. §1933.

The OCA submits that the Commission must reconcile the limitation provisions in Section 1308(e) with the ratemaking methodology provisions of Section 2212. As the OCA set forth in its Answer, if the Commission determines to award any rate relief at all to PGW, the Commission should limit the award of rate relief to that amount necessary to meet PGW's bond indenture coverage requirement. That is, if extraordinary relief is justified, the Commission must only award PGW relief sufficient to meet the 1.5x coverage requirement contained in PGW's bond indenture, calculated in accordance with the formula set forth in PGW's bond indenture. In this way, the Commission can ensure that, as required by Section 1308(e), ratepayers are adequately protected until the conclusion of the full base rate case, if any extraordinary rate relief is justified.

III. PGW HAS NOT MET THE REQUIREMENTS FOR EXTRAORDINARY RATE RELIEF

A. PGW's Request Is Based On Speculation Of Standard & Poor's Future Actions Rather Than An Analysis Of What Is Just And Reasonable And Required Under Section 1301 And Section 2212.

1. Introduction

It is without doubt that PGW's request for extraordinary rate relief of \$44 million has been made in an attempt to satisfy the analysts at Standard and Poor's (S&P). Notably, Moody's, another rating agency that provides a rating of PGW's bonds, has affirmed PGW's current ratings as recently as February 2002. OCA Cross-Exam Exh. 1. Additionally, a Fitch analyst noted in a recent article that he believed that PGW would be able to pay its debts. PGW Cross-Exam Exh. 1 at 2; OCA St. 1-ERP at 18-19. There was no reference from Fitch as to a possible downgrade. As PGW's own case demonstrates, without the threat of a downgrade by S&P, and with its planned Forward Purchase Agreement, PGW's financial situation would be stable, and PGW would be able to provide service, meet its obligations, and continue with its service improvements and capital projects. PGW E.R.P. St. 2, Exh. JRB-1; OCA St. 1-ERP at 8. With a City grant back of the \$18 million fee, PGW would have a coverage of 1.87x on its bonds, more than its technical requirements. OCA St. 1-ERP, Sch.1.

Now, based on a sudden and unexpected announcement by S&P highlighting PGW's long-standing liquidity problems, PGW argues that this financial stability is in peril. The Commission, however, does not and can not set rates simply to satisfy S&P. Nor should the Commission set rates based on speculation about what actions a rating agency may take. The

Commission must set rates based on what is just and reasonable, and in conformity with Section 2212 of the Public Utility Code. As the Wyoming Public Service Commission recently noted when considering a request for emergency rate relief to forestall a threatened downgrade in a utility's credit rating:

We further do not believe that it would be wise to use general rating agency parameters as a basis for ratemaking in derogation of Wyoming law. We do not believe that rates set merely to avoid changes in a credit rating would be set justly or reasonably as those terms are used in our statutes.

In re PacifiCorp, No. 200000-EP-01-167, 2001 WL 1672469 at \*8 (Wyo. PSC, Oct. 3, 2001).

Here also, the Commission must be guided by what is just and reasonable and in conformity with Sections 1301 and 2212, not on analysts' statements or speculation regarding analysts' future actions. As the OCA sets forth below, establishment of a comprehensive plan, which shares the burden of permanently restoring PGW's financial health, and evidences the commitment of the Commission, the City and all parties to the steps necessary to remedy PGW's financial situation, would be a just and reasonable result. Granting of extraordinary rate relief, that is significantly overstated and based solely on an analyst's formula, however, cannot meet the necessary standards of Section 1308(e).

2. The S&P Announcement Does Not Provide A Basis For Extraordinary Rate Relief.

In support of its request for \$44 million in extraordinary rate relief, PGW relies upon an announcement by S&P and a formula provided by S&P to PGW for the first time in February, 2002. PGW argues that without the \$44 million in rate relief that the formula produces, S&P will downgrade PGW. It is important to note that PGW's case is based upon

this announcement and PGW's conversations with these ratings analysts. No analyst from S&P testified in this extraordinary rate relief proceeding. Additionally, the announcement does not specify any level of rate relief that is needed, nor does it specify any source of revenue, *i.e.* project revenues or rate relief, that is needed.

The operative language in the S&P announcement is as follows: "If the PUC approves an emergency rate request, Standard and Poor's will review the adequacy of the increase and determine if ratings will be affirmed or lowered." PGW St. 4, Exh BCB 1 (Updated); OCA St. 1-ERP at 6. Based on this statement, and S&P's statement that "Without immediate cash flow improvement, ratings will be lowered," PGW seeks \$44 million in extraordinary rate relief. PGW does not seek assistance from its owner, the City of Philadelphia, but instead seeks to remedy this entire problem through an increase in rates to ratepayers. In fact, PGW seeks to continue to pay to the City its \$18 million fee, as it has done in every year as PGW's cash and liquidity situation continued to worsen. OCA St. 1-ERP at 35.

PGW witnesses testified that the action by S&P was sudden and unexpected. PGW witness Knudsen testified that the Company had been meeting with S&P both before and after the Commission's Order awarding PGW \$33.6 million in rate relief was finalized in December of 2001. Tr. 186-187. Up until February of 2002, it had been PGW's expectation that the plans that it had in place to address its liquidity problems, including the base rate case to be decided by November of 2002, would satisfy S&P. Tr. 187. S&P, however, contacted the Company on February 4, 2002, and issued its announcement on February 12, 2002 citing concerns over PGW's liquidity position.

Although the S&P announcement, as well as the S&P formula, identify PGW's ongoing cash flow and liquidity problems as a primary concern, PGW's liquidity problem is not new. PGW's cash flow deteriorated through the 1990s as a result of warmer than normal winter weather and the failure to seek any base rate relief since 1992. OCA St. 1-ERP at 10. PGW's net earnings in this time period have not exceeded \$17 million and have been negative in some years. Tr. 173. OCA witness LeLash testified:

There is no doubt that PGW's lack of liquidity stems from its actions and those of its owner, the City of Philadelphia. Inadequate rate filings during the 1990's forced the Company to utilize both short and long-term borrowings to the degree that it is currently precluded from obtaining further debt capital from the financial markets. Adding to the current capital deficiency was the fact that the City continued to withdraw its annual \$18 million dividend from its Company despite its readily apparent deterioration in the Company's capital position.

OCA St. 1-ERP at 10.

In its first two occasions to consider just and reasonable rates for PGW, the Commission considered these liquidity problems, as well as the level of service being provided by PGW to its customers and the City's responsibility as owner of PGW. As the Commission stated as recently as October of 2001 when it awarded PGW \$33.6 million in rate relief:

Thus, we must determine the reasonable level of revenues and expenses, including a reasonable amount of cash requirements and balance the interests of customers and PGW in this base rate proceeding to fulfill our statutory mandates. . . . The Commission must, and intends to, exercise its discretion to determine a just and reasonable level of rates for PGW while balancing the interests of the Company's customers as we do in all other rate cases before us.

PGW Oct. 4, 2001 Order, at 26.

The OCA submits that the Commission's findings regarding just and reasonable rates for PGW must be the foundation for rate relief. Critically, the ratings agencies do not balance the interests of the stakeholders as the Commission is required to do in setting just and reasonable rates. When those interests are balanced, it is clear that PGW's ratepayers must not bear the entire burden of resolving PGW's long-standing liquidity problems simply to satisfy S&P. PGW must receive revenue relief only if it meets the statutory standards and only if the Commission finds such relief to be just and reasonable.

3. The S&P Formula Cannot Form The Basis Of Just And Reasonable Rates Under Section 1308(e) Or Section 2212.

After two litigated proceedings where PGW argued strenuously for the use of the ratemaking methodology previously used by the Philadelphia Gas Commission, PGW now asks the Commission to award rate relief based on a previously unknown S&P formula because S&P threatens the Company with a downgrade of its bonds if it does not meet the coverages which S&P has set under this formula. PGW's calculations produce a need for a \$44 million increase in rates from its ratepayers to meet a fixed cost coverage ratio of 1.2x to 1.3x based on an S&P formula that an S&P analyst now says is required.

The Company's reliance upon the S&P formula as a means of determining just and reasonable rates is seriously flawed. The S&P formula bears no relationship to the actual financial requirements that PGW is faced with, the ratemaking methodology that PGW has strenuously argued for in the past, or the nature or extent of improved liquidity which could be obtained if the City provided assistance in the form of project revenues.

Of note, the fixed cost coverage formula of S&P differs significantly from the

requirements of PGW's own bond indentures. Under the S&P formula, the \$18 million obligation to the City as well as the \$20 million reduction in commercial paper for 2002 are part of the coverage equation while they are not included in PGW's bond coverage formula.<sup>3</sup>

OCA St. 1-ERP at 21. OCA witness LeLash explained the problem with this approach:

Needless to say, these additional payments of \$38 million lower the coverage ratio calculated by the S&P formula by a considerable amount. To be clear, *this additional coverage is not legally required by the 1998 bond ordinance*; rather it is used by S&P for its own purposes. The Company then utilizes this formula to show that a \$44 million base revenue increase is necessary to achieve the fixed coverage ratio, required by S&P, for the "test year budget" numbers.

OCA St. 1-ERP at 25.

The effect of including these additional payments in the coverage formula is immediately apparent. Under PGW's bond indenture, the Company will have a 1.28x coverage on its 1998 senior debt service, and with an \$18 million grant back of the City payment, which the City has indicated it will make this year if needed to meet the coverage on the bonds, coverage would be 1.87x, well above the 1.5x required for the bonds.<sup>4</sup> OCA St. 1-ERP at 26. Under the S&P formula, which includes the City payment and the paydown of the commercial paper, the fixed cost coverage is 0.77x and .91x if the \$20 million repayment of the commercial paper is not counted. PGW ERP St. 2, Exh. JRB-2(corrected).

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<sup>3</sup> S&P also includes another \$20 million reduction in the commercial paper for 2003. The terms of the commercial paper for 2003 have not yet been negotiated and there is no present requirement for an additional \$20 million paydown. Tr. 59-60.

<sup>4</sup> The City has only committed to grant back to PGW the amount necessary to meet its 1.5x bond coverage if it is unable to meet this coverage at the end of the Fiscal Year. Under current estimates, this would not require that the entire \$18 million be granted back to PGW.

As PGW Bisgaier confirmed, since at least 1998, PGW would not have met the 1.2x to 1.3x coverage ration under the S&P formula that the S&P analysts now seek. Tr. 58.

Notably, if PGW received the \$44 million extraordinary rate relief that it seeks, its coverages under PGW's own bond indenture would be 3.02x on the 1975 bonds and 3.43x on the 1998 senior debt service, about twice the required amount under the bond indenture requirements. PGW Rebuttal Exh. JRB-1. As can be seen, the S&P formula, only recently revealed to PGW, cannot be relied upon to form the basis of extraordinary rate relief. The formula produces results inconsistent with Section 2212, and attempts to immediately remedy a long-standing problem that PGW, ratepayers, and the Commission have been seeking to resolve through a series of measured steps.

4. The Commission And The Company Can Only Speculate As To S&P's Actions Even If Rate Relief Is Granted.

Although resting its case on certain limited statements in an S&P announcement, and the S&P formula, PGW acknowledges that it has been provided no guarantees that even if it receives all of the \$44 million in rate relief, that such award will ensure that a downgrade will not occur. Tr. 67. Nor does the announcement specify how it will consider any extraordinary rate relief, or any of the other risks or strengths that it identifies in its announcement. All are left to speculate as to how S&P will evaluate any action by the Commission, speculation that cannot and should not form the basis of extraordinary rate relief.

The process for evaluating PGW was explained in an e-mail from the S&P analyst to PGW as follows:

S&P first rates the business position. The business position includes aspects such as markets, operations, regulation, competitive position and management, among others. Subsequently, the financial process is risk weighted to reflect the business position in the analysis, i.e. a stronger business position can support relatively weaker financial numbers to maintain a specific rating. Also, while bond coverage and fixed charge coverages are some major indicators used in the financial analysis, S&P also looks at other indicators like month-end cash in hand, liquidity position (unencumbered cash to operating expenses), among others.

OCA Cross-Exam Exh. 2.

S&P's announcement reflects this multitude of factors that is considered in the rating process. For example, the S&P announcement lists a number of strengths and risks of PGW. Among the risks identified by S&P are the poor liquidity position of PGW, the weak fixed-charge coverage, high accounts receivable, a warm winter, inability to convert from interim management to permanent management, and the limited ability of the City of Philadelphia to provide assistance due to its tight financial situation. PGW St. 4, Exh. BCB-1 (updated).

Among the strengths that S&P finds "offset" these risks are a favorable closing to the labor contract, operational improvements, including correction of the faulty billing system and customer call center improvements, its sound bond indenture coverage of 1.5x, the PUC's timely approval of gas cost rate increases, and its successful solicitation of LIHEAP and Crisis grants. Id.<sup>5</sup>

Although listing strengths and risks, as PGW witnesses testified, the process that S&P utilizes to determine whether a bond downgrade will occur is not a transparent process. As PGW witness Bisgaier testified, the ultimate decision will be made by a committee at

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<sup>5</sup> The Moody's report lists similar strengths and risks. OCA Cross Exam Exh. 1. PGW Bisgaier also testified that the ratings agencies have used similar criteria when looking at PGW. Tr. 63-64.

S&P, whose members are not known to PGW, based on the evaluation of all of these strengths and risks. Tr. 66-67. As noted, PGW witness Bisgaier also acknowledged that the ratings agency has not provided any guarantees to PGW that even if it receives relief, a downgrade will not occur. Tr. 67.

The OCA submits that such a non-public process should not be the basis for rate relief. The Commission should award rate relief only after consideration of all relevant factors, a determination of whether the statutory standards have been met, and a balancing of the interests of all the parties. An announcement or formula of one rating agency cannot suffice.

Moreover, in relying on only S&P's announcement, PGW also asks the Commission to ignore the views of other rating agencies. Indeed, S&P's announcement, which has *precipitated this request, expresses a view that is not shared by the other ratings agencies.* As noted, Moody's has affirmed PGW's rating as late as February of 2002. In its report, Moody's identified similar strengths and risks for PGW. While noting a number of concerns regarding PGW, Moody's affirmed its rating. Thus, Moody's stated:

Moody's believes the credit outlook remains negative. Despite some recent financial and operational improvements, failure to appoint permanent management leaves open the potential for another change in direction and slows the utility's efforts to implement changes to improve operational performance and financial liquidity as it operates in a competitive and changing industry.

OCA Cross-Exam Exh. at 1.

Additionally, as OCA witness LeLash testified:

The Fitch analyst is quoted in The Bond Buyer as stated, "It's bouncing along at the triple-B level, and we'll continue to watch it. . . We expect things are

not going to run smoothly for them but we still continue to feel that they're going to be able to pay their debts."

OCA St. 1-ERP at 18-19.

The Commission must consider all of the relevant factors and balance the interests of all stakeholders when setting just and reasonable rates. As OCA witness LeLash summarized:

Regulated utilities should not obtain revenue relief, particularly extraordinary revenue relief, based on speculation concerning what actions a rating agency may or may not take.

OCA St. 1-ERP at 6.

The OCA submits that the Commission's actions to date have balanced the interests and have shown strong support for working with PGW to resolve its long-standing problems. The Commission should not allow speculation about an announcement from S&P be the basis of extraordinary rate relief.

5. The Commission's Actions Have Been Supportive Of PGW And Sought A Just And Reasonable Resolution To These Long-Standing Problems.

Since assuming jurisdiction over PGW, the Commission and all of the parties have taken many steps to assist PGW in stabilizing its financial condition and in improving its service. Since July 2000, the Commission has awarded PGW \$33.6 million in permanent, non-gas cost base rate relief. Additionally, the Commission has permitted PGW to include a \$7 million bad debt expense in its GCR on a one-time basis, and to retain \$10.8 million in GCR overrecovery that would otherwise have been returned to ratepayers. OCA St. 1-ERP at 6. Additionally, the Commission has allowed PGW to update its GCR on a quarterly basis

which enabled PGW to bill and recover its higher gas costs in 2001 on an expeditious basis. The Commission, as well as the parties, have shown a willingness to help restore PGW's financial health over an appropriate period of time, matched to appropriate improvements in service quality.

Many factors have contributed to PGW's current situation and many factors must be resolved for PGW to successfully complete its transition to a financially healthy utility. As OCA witness LeLash explained:

Accordingly, PGW's impaired financial condition is not solely a function of cash flow, nor does its financial improvement rely solely on the immediate attainment of additional revenues. S&P, along with the other rating agencies, would be more favorably inclined toward PGW if permanent management had been approved, the \$45 million City debt had been restructured with a realistic deferred payback period, the accounts receivable balance had been managed effectively, and capital expenditures and cash flow had been managed better in the past. It is not the Commission which has control over these determinants of financial improvement, and it is unreasonable that it be given an immediate ultimatum to require PGW's ratepayers to be the only ones to shoulder the burden.

OCA St.1-ERP at 20.

The Commission's statement to the investment community when considering the Met-Ed request seems particularly apt here, even 20 years later:

As to the apprehension of the intervening banks, the Commission said in Pa. P.U.C. v. Metropolitan Edison Company and Pennsylvania Electric Company, at I-79040308, mimeo p.4, on May 23, 1980: "Respondent must convince its bank creditors that it has the will and ability to rehabilitate itself." The Commission by its May 23 Order provided the means for Met Ed to rehabilitate itself. We shall expect the same concern by other involved parties.

Met-Ed at 21.

As detailed below, the OCA submits that the Commission should continue on its course of providing a measured resolution to PGW's problems consistent with improvements in service quality and meeting other necessary regulatory standards. The Commission should urge other concerned stakeholders, including the City, to support PGW as it is restored to financial health over a reasonable period of time.

6. Conclusion

The possibility of a bond downgrade, conveyed in an S&P announcement cannot form the basis for extraordinary rate relief. The Commission must set rates based on what is just and reasonable in accordance with Pennsylvania law. In this case, it is clear that PGW's request, based on a previously unknown S&P formula, cannot meet this test.

B. By The Company's Own Admission, Its Request Concerns Liquidity Requirements And Not Operating Expense Requirements As Contemplated By Section 1308(e).

The Company acknowledges that S&P's primary concern, as evidenced by its announcement, is with PGW's on-going liquidity problems. In this case, PGW has not asserted that it has an inability to pay its operating expenses, and indeed, had been projecting that with its planned Forward Purchase Agreement, it would meet its operating expenses through the end of its Fiscal Year in August 2002. OCA St. 1-ERP at 8. What the Company seeks here is a capital infusion to alleviate its long-standing problem with liquidity.

OCA witness LeLash testified that what the Company seeks, and what S&P seeks, is a resolution to PGW's on-going liquidity, or working capital requirements. As Mr. LeLash stated:

While S&P states that PGW needs approval of an adequate rate increase to

forestall a downgrading, in reality PGW's problem is inadequate capital. If PGW had additional equity capital and no City loan and no outstanding commercial paper, we would not have S&P threatening a downgrading. As stated, the extraordinary revenue request is not intended to cover operating expenses, but rather is an artifice to justify funds above and beyond those necessary to meet its bond coverages so that the Company's deficient retained earnings can be augmented, not by its owner, but by its captive ratepayers.

OCA St. 1-ERP at 16-17.

PGW does not dispute that it seeks a capital contribution from ratepayers through this extraordinary rate relief petition, nor does it dispute that if it had not extended its commercial paper to the maximum amount, S&P would not be threatening the action that it now is. Tr. 65. But these long-standing liquidity problems do not meet the statutory requirement for extraordinary rate relief. Mr. LeLash explained:

As I understand it, Section 1308(e) addresses extraordinary needs for revenues to meet operating expenses. It does not contemplate a utility seeking a capital contribution from ratepayers. Accordingly, it is my belief that the Section 1308(e) provisions are not applicable to PGW's rate relief request.

Utility regulation has consistently recognized that ratepayers are responsible for a utility's operating expense, including a return on the utility's capital. However, there is no precedent, to my knowledge, where ratepayers have been held responsible to serve as the initial source of funds to meet a utility's capital needs. Therefore, by definition, the Section 1308(e) provisions do not contemplate, not provide, a standard for PGW's pending request.

OCA St. 1-ERP at 27.

The Commission, in Met-Ed reached a similar conclusion. The Commission, in denying Met-Ed's request for relief, stated:

The purpose of Section 1308(e) is not to thrust the cost of nonfunctioning TMI capital assets onto ratepayers, but to permit the recovery of extraordinary costs incident to serving the public. Here, to the contrary, emergency relief is sought from ratepayers largely for the costs attendant to capital assets not

in the public service.

Met-Ed at 23. Here too, PGW's own estimates show that with the Forward Purchase Agreement it was meeting its public service obligations and would continue to do so throughout the pendency of its base rate case. PGW E.R.P. St. 2, Exh. JRB-1. It is only the need to address its capital needs, made into an emergency by S&P, that has brought PGW to the Commission's door. Such a request does not meet the strict statutory standards.

- C. There Is Insufficient Evidence In The Record To Establish That Extraordinary Rate Relief Is Immediately Necessary For PGW To Maintain The Financial Stability Necessary In Order To Enable The Utility To Continue To Provide Normal Services To Its Customers, Avoid Reductions To Its Normal Maintenance Programs And Avoid Substantially Reducing Its Employment.

As a prerequisite to receiving extraordinary rate relief under Section 1308(e) of the Public Utility Code, a utility must demonstrate that such relief is "immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on the utility's common equity established by the commission in consideration of the utility's preceding rate filing." 66 Pa.C.S. §1308(e).

With respect to these elements that must be satisfied under Section 1308(e), the utility has a heavy burden of proof. Met-Ed at 6. The OCA submits that the Company has not presented sufficient, credible evidence to demonstrate that it has met these elements. Rather, PGW sets forth a chain of events that might happen if it is downgraded and if it does not

adequately respond to the crisis. OCA witness LeLash explained, there would be two preconditions before the Company met the Section 1308(e) criteria – bond downgrade and a failure by the Company to respond. OCA St. 1-ERP at 16.

The Company relies heavily on its assumption that if its bonds are downgraded, it would be unable to renew its commercial paper and it would be unable to issue additional debt. Initially, the OCA submits that it is simply uncertain what action S&P will take, or whether there are actions that can be taken by the Commission, the parties, and the City other than extraordinary rate relief, that would forestall such a result. The Company acknowledged that it had not even discussed with S&P the comprehensive proposal presented by the OCA as a means of permanently restoring its financial health. Tr. 69, 123. Thus, S&P's reaction to alternative solutions is unknown.

At this time, the Company has not taken any significant steps yet that have impacted the quality of service or substantially reduced employment levels. Additionally, PGW has not even sought a deferral of the repayment of its \$45 million loan from the City at this time. OCA St. 1-ERP at 16. Although now listing steps that it would take to cut non-essential service and employment if it is downgraded by S&P to conserve approximately \$100 million in cash, the Company has only identified one step that it has taken thus far to conserve cash. The step that the Company has taken thus far, is to implement a cost reduction program that is expected to conserve approximately \$1 million per month for a few months. Tr. 143, 168.<sup>6</sup>

It is not surprising that the Company has not yet had to take any actions. With the

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<sup>6</sup> PGW witness Knudsen also explained that there are some exceptions to these cost cutting measures at the discretion of Mr. Knudsen and Mr. White. In particular, the privilege has been retained to hire when needed to replace departing staff. Tr. 144.

recently authorized base rate increase of \$33.6 million, and an additional \$10.8 million supplement from the GCR overrecovery, PGW has not been projecting that it will be unable to meet its operating expenses. OCA St. 1-ERP at 16. Rather, its projections of cutbacks come only after a threatened S&P downgrade and only if PGW is unable to complete a forward purchase agreement, renew its short term paper, or issue further debt.

The OCA submits that at this time, there is no way of knowing whether PGW will be downgraded and exactly what would happen in the event of a downgrade by S&P. This is especially true when two of the three rating agencies have reaffirmed PGW's credit rating.

While a downgrade to below investment grade would not be viewed positively by the lending community, it is simply uncertain what the effect would be on PGW's ability to renew its commercial paper. The City was able to exert influence on local banks last year to obtain renewal of the commercial paper program. PGW E.R.P. St. 4 at 6. As PGW witness Bisgaier testified, a downgrade of the PGW bonds would eventually negatively impact the City's bonds. Tr. 67-68. Given the implications for the City, it is still not clear what steps the City would pursue to assist PGW and forestall such a downgrade.

It should also be noted that PGW recently completed a full base rate case that resulted in an increase in annual revenues of \$33.6 million. During this proceeding, the Commission set rates at a level that was sufficient for the Company to cover its operating and maintenance expenses and meet the required coverage ratios on its bonds. The current pending base rate case may allow for further adjustments to PGW's rates prior to the next winter heating season so as to assure that PGW will have an appropriate revenue requirement on an ongoing basis.

Finally, as described more fully in Section IV below, the OCA has proposed an

alternative to Extraordinary Rate Relief in this proceeding which would obviate the need for PGW to take any steps with respect to cuts in service or employment. The OCA's proposal will provide PGW with sufficient liquidity to get through the current fiscal year and provide a rehabilitation plan that would pay down nearly all of the Company's short term debt while building up capital for the Company. The OCA submits that adoption of this plan would put PGW on the road to financial recovery. While S&P will have to decide what will satisfy it, it is the Commission that must decide what is just and reasonable.

D. If The Commission Determines That PGW Is Entitled To Relief, PGW's Request For \$44 Million Is Overstated And Violative Of The Limitations For Extraordinary Rate Relief Set Forth In Section 1308(e).

As set forth above in Section III.A.3, the formula used by S&P differs significantly from the legal requirements of PGW's bond indentures. Although identifying these bond coverage requirements as a strength of PGW, S&P then inexplicably requires much more. OCA St. 1-ERP at 21; PGW E.R.P. St. 4 at 4, PGW Exh. BCB-1 (Updated). In this case, the S&P formula requires PGW to include \$38 million in fixed cost payments, the \$18 million City fee and the \$20 million commercial paper paydown, that are not otherwise required in an analysis of whether PGW can meet its own bond coverage indentures. OCA St. 1-ERP at 21, PGW E.R.P. St. 4 at 4-5. Additionally, S&P requires that its coverage test be met without taking into account any funds which S&P deems to be "non-recurring." OCA St. 1-ERP at 22. Under these S&P requirements, PGW's financial situation appears particularly strained.

When PGW's coverage is assessed in accordance with its bond indenture formula, a different picture emerges. The current estimate for Fiscal Year 2002 shows a 1.28x

coverage on the 1998 senior debt service. OCA St. 1-ERP at 25-26. With a grant back by the City of the \$18 million City payment, the coverage on the 1998 senior debt is 1.87x, well above the required 1.50x. Id. OCA witness LeLash testified:

Thus, if the City actually were to grant back the City payment, there would be no actual coverage problem for FY2002 under PGW's bond indenture. If one assumes that the Company's Margin Loss due to warmer than normal weather will actually equal \$30 million, then the indenture coverage falls to 1.12x and with an \$18 million grant back it would be 1.70x or still above the required 1.50x under the bond indenture.

OCA St. 1-ERP at 26.

PGW, however, seeks \$44 million from its ratepayers to satisfy the S&P formula. PGW's request for a \$44 million rate increase is intended to put PGW at the high end of the coverage range of 1.2x to 1.3x under the S&P formula. PGW E.R.P. St. 2 at 3. OCA witness LeLash performed a calculation to determine the amount of revenues, whether project revenues or rate relief, that would be necessary to meet the minimum coverage level under the S&P formula. Mr. LeLash explained:

On Schedule 2, calculations are shown which measure the level of project revenues necessary to achieve 1.2x coverage using the Company's calculations under the S&P formula. As shown, project revenues of \$35.4 million would meet this minimum S&P coverage level all other things being equal. It is again important to note that this \$35.4 million is far more than under PGW's bond indenture and is being driven by S&P's inclusion of capital requirements and the City payment in its formula.

OCA St-1-ERP at 26-27.

By any measure, PGW's request is overstated. If any extraordinary rate relief is found to be appropriate under Section 1308(e), the Commission should ensure that such relief is not overstated and complies with the limitation requirements of Section 1308(e).

Specifically, if the Commission awards any extraordinary rate relief, it should award no more than necessary to meet the coverage formula in PGW's bond indenture.

IV. A LONG TERM SOLUTION COULD BE PUT IN PLACE THAT IS JUST AND REASONABLE AND RESTORES PGW's LIQUIDITY.

A. Introduction

As discussed above, the Company's request is driven by a need for additional working capital and not by increased operating expenses. As such, the OCA submits that extraordinary rate relief under Section 1308(e) of the Public Utility Code is inapplicable in this case. The OCA does recognize, however, that PGW continues to face an ongoing liquidity problem due to the fact that its commercial paper program has been fully extended for the past several years and, in effect, has become a permanent part of the Company's capital structure. PGW E.R.P. St. 1 at 6. The \$100 million commercial paper program is what PGW traditionally relied upon to finance seasonal needs for fuel purchases and seasonal increases in accounts receivable. Id. However, in the past 2-3 years, the commercial paper has been fully extended and therefore not available to the Company for smoothing out its seasonal cash flow. Id. This has left PGW in a position of very poor liquidity since it does not have access to its commercial paper to handle the seasonal nature of its revenues and expenses or to backstop the Company in the event that it experiences margin losses due to a warmer than normal winter, such as it experienced this year.

Without its commercial paper available, PGW must finance its cash working capital needs out of existing operating expense revenues and by borrowing from its capital fund. This has created the ongoing liquidity problems faced by the Company today. In recognition

of this problem, the OCA has proposed in this proceeding a plan to rehabilitate the Company's financial situation and restore PGW's liquidity. The OCA's plan does not saddle ratepayers with the entire burden of restoring PGW's long-term financial health through the imposition of a rate increase that is unjust and unreasonable. Instead, the OCA's proposal calls for a commitment from various PGW stakeholders – including ratepayers, the City of Philadelphia and PGW – to restore the Company's liquidity and ensure that the Company returns to financial stability.

B. The OCA's Recommendation - Commitments From Various Stakeholders

1. Necessary Commitments From The City Of Philadelphia

Through the Direct Testimony of OCA witness LeLash, the OCA has laid out a framework for addressing PGW's ongoing capital insufficiency and liquidity problems through a variety of actions by PGW's stakeholders, including PGW's owner, the City of Philadelphia. OCA St. 1-ERP at 31. In its December 6, 2001 Opinion and Order (Docket No. R-00006042), the Commission stated that PGW's "Management Agreement does not assure that customer rates will cover all PGW's capital and cash needs as if no other source of capital or revenues are available to PGW." December 6 Order at 29. In fact, in its previous Order of October 4, 2001, the Commission "urged the City of Philadelphia, as owner of PGW, to continue to take measures to insure the financial health of PGW. It is the expectation of this Commission that the City of Philadelphia, as owner of PGW, will continue to assist PGW in its cash flow requirements so that a financial crises does not take place." October 4 Order at 34. Through the instant Petition, the Company claims that a financial crisis will occur if S&P downgrades its bonds to below investment grade. Thus,

the onus is squarely upon the City of Philadelphia to step up to the plate and assist in preventing a crisis. Surely the Commission would not expect a utility's stockholders to still be taking a full dividend in such circumstances.

As a first step in addressing the Company's ongoing liquidity problems, OCA witness LeLash testified that the City must make several commitments as part of any prospective financial recovery. First, the City should agree to restructure the terms of the \$45 million City loan to be paid back in equal installments over the next three fiscal years. OCA St. 1-ERP at 36. During this period, the City should be paid interest on the outstanding balance of the loan. Id. The loan is currently interest free. Second, OCA witness LeLash testified that the City should grant back the \$18 million City payment as project revenues for at least the next three years. Id. In other words, the City should stop taking a dividend from this cash strapped utility. This would provide the Company with an additional \$54 million of capital at the end of the three years. Finally, the City should designate permanent management for PGW and disclose the major findings and conclusions concerning the feasibility and desirability of the City's sale of PGW. Id. The OCA submits that these actions by the City are, at a minimum, the sort of measures contemplated by the Commission in its October 4 Order that are necessary to ensure the financial stability of the Company and avert a financial crisis.

The OCA submits that the City, as owner of the troubled utility, must acknowledge its ownership obligations. OCA St. 1-ERP at 32. If PGW were to fail, the City itself would be harmed through loss of value in its enterprise. Id. Furthermore, PGW witness Bisgaier testified that a downgrade of PGW bonds could eventually have an impact on the City's bond

ratings and its access to the credit markets. Tr. 67-68.

The City claims that it has little or no ability to provide financial assistance to PGW. PGW E.R.P. St.5 at 3. PGW witness Davis, Finance Director for the City of Philadelphia, testified that the City is facing a deficit of \$296 million over the life of its five-year plan for fiscal years 2003-2007. Id. However, during the last base rate proceeding, the City also claimed that it could not provide assistance to PGW, even though at that time it was projecting a *\$180 million surplus* in its five-year plan. Id. As OCA witness LeLash noted, "in good or bad times the City has taken the position that 'PGW, as a municipal utility, is intended to be self sufficient' (Davis Testimony, Docket No. R-00006042, page 3)." OCA St. 1-ERP at 33.

The OCA submits that the City cannot simply ignore its obligation to PGW. A downgrade of PGW's bonds would have a negative impact on both PGW's finances as well as the City's. While the City may be projecting a large deficit in its current 5-year plan, these projections are very fluid and can change significantly from year-to-year depending upon the state of the economy. One needs only to look at the past year when the City's projections for the five year forecast period went from a \$180 million surplus for the period to a \$296 million deficit for the five year period to understand how quickly these projections can change. PGW E.R.P. St. 5 at 3. PGW witness Davis confirmed, though, that the City ended the last fiscal year with a \$230 million surplus. Tr. 155.

The OCA submits that the City, as owner of this troubled utility, must acknowledge its obligations by making some sort of commitment to restoring the financial stability of the Company. If PGW is downgraded, the effect will be felt not only by ratepayers, but also by

the City itself. Therefore, the City should commit to grant back as project revenues the \$18 million for at least three years and to restructure the repayment schedule of the \$45 million City loan.

2. Contribution From Ratepayers - Capital Surcharge

It has become increasingly clear that other interested parties, in addition to the City, may have to be called upon to address PGW's financial problems. During the recently concluded interim rates proceeding and base rate proceeding, the OCA took the position that rates should be set at the minimum level necessary to provide for the Company's operating and maintenance expenses and meet the necessary bond coverages. At the time that rate setting authority was transferred from the Philadelphia Gas Commission to this Commission, the Company's service was at unacceptable levels, wholesale gas prices were at unprecedented high levels and ratepayers were facing staggering rate increases due to rising gas costs. OCA St. 1-ERP at 29. With ratepayers facing unprecedented high natural gas prices and the inadequate levels of service provided by the Company, the OCA did not believe that it was an appropriate time to address the Company's capital deficiency. OCA St. 1-ERP at 38-39. Since then, however, natural gas prices have fallen considerably. Furthermore, in the last base rate proceeding, OCA witness LeLash did recognize that some augmentation of the Company's retained earnings would be necessary in the future to address the Company's liquidity problems. Id. at 39. The Company's current Gas Cost Rate ("GCR") is \$2.0203 per Mcf compared with the GCR of \$6.6959 that was in effect at the time the last base rate case was being litigated. Id. The Company has also made strides in improving the quality of its service since then. With far lower GCR rates and improved

customer service, it may now be a more appropriate time for the Commission to address PGW's capital deficiency. As OCA witness LeLash testified, "... the future is now, and PGW can no longer work around its liquidity problems or its highly leveraged capital structure." Id. Thus, it may be necessary for ratepayers to augment rates with a contribution of capital to the Company, *if* the City is willing to make similar commitments to PGW.

OCA witness LeLash testified that the Commission should address PGW's request for what it is – a capital requirement under the cash flow method – not a request for extraordinary rate relief under Section 1308(e). OCA St. 1-ERP at 28. Since the basis for PGW's claim in this proceeding is a capital insufficiency, then any such recovery cannot be considered traditional revenues for operating expenses, but should be viewed instead as a capital contribution and should be recorded on the Company's books as such. Id. OCA witness LeLash testified that one way to address PGW's capital insufficiency would be through the imposition of a time-limited capital surcharge *if* the City makes appropriate commitments.

OCA witness LeLash's specific proposal calls for a capital infusion from ratepayers through the implementation of a time-limited surcharge of \$18 million per year for three years which is matched by a grant back from the City. OCA St. 1-ERP at 39-40. This surcharge would go directly toward paying down the City loan and commercial paper. Id. at 40. This surcharge should only be considered by the Commission if it determines that incremental capital is required by the Company, and only if the City makes the necessary commitments set forth above. Id. at 29-30. The OCA submits that with the proper commitment from the City, and a determination by the Commission that it would be

reasonable for ratepayers to provide a portion of such capital to address this problem, then a time-limited capital surcharge may be appropriate. Id. at 30.

However, it should be made clear that such a surcharge is not based solely upon the potential requirements of one bond rating agency. OCA St. 1-ERP at 30. Instead, it represents a balance reflecting both just and reasonable rates and PGW's long-term capital needs. It would be, in effect, part of a multi-year rehabilitation plan for the Company which will restore its liquidity and improve its financial conditions, with commitments made by the City of Philadelphia, ratepayers and the Company. Id. It is only through this type of sharing of responsibility for PGW's rehabilitation that a fair and equitable solution to the problem can be crafted.

3. Commitments From PGW - Improve Collection Efforts And Cash Conservation Measures.

OCA witness LeLash laid out several steps that PGW itself should take in order to conserve cash during this period of restricted cash flow. OCA St. 1-ERP at 36. The Company needs to take a look at all aspects of its on-going operations and determine which activities, if any, can realistically be deferred without harming reliability or customer service. Id. Once that is determined, the Company should establish written objectives and plans concerning identified activities and it should quantify their impact on operational and financial results. Id. More importantly, the Company should be required to finish developing and then implement a comprehensive collection program. Id. A more comprehensive collection program will enable the Company to substantially increase its collection percentage and increase its cash flow. Id.

Mr. LeLash also recommended that the Company be required to establish specific and aggressive initiatives concerning several cash flow-related areas, including the following:

- Gas storage management which will minimize the Company's overall investment in gas inventory.
- utilization of asset management agreements if they can be structured economically and allow the deferral of gas acquisition.
- increased customer sign up for external low income assistance (LIHEAP and Crisis Grants) in order to maximize revenues while reducing customer bills.
- deferral, if feasible, of special projects and a phase in of the restructuring contemplated by the Act.

OCA St. 1-ERP at 36-37.

The above-mentioned cash conservation measures, along with an increased emphasis on the Company's collection program, will provide necessary cash flow to help PGW get through its current liquidity problem. These actions by PGW, along with the contributions from the City and ratepayers will dramatically improve PGW's cash flow and restore the Company's long-term financial health by the end of the three-year rehabilitation plan.

#### 4. Conclusion

The commitments from PGW and the City recommended above, along with the infusion of additional capital by ratepayers through a capital surcharge, would be sufficient to restore PGW's liquidity and long-term financial health. With the commitment from the City and the capital surcharge from ratepayers, short-term debt could be reduced by nearly \$110 million by the end of the three-year rehabilitation plan. OCA St. 1-ERP at 40. This would allow PGW to pay down its commercial paper program to about \$15 million, while at the same time increasing retained earnings. *Id.* at 41. With this sort of improvement, the Company would have the necessary working capital and short term debt available to it to

meet the cash requirements associated with volatility in wholesale gas prices and the seasonal nature of its revenues and expenses. Id. at 40. This solution is not a one-time infusion of cash to meet coverages in a specific year, it is a means to the permanent restoration of financial health. It is hard to imagine that the rating agencies would not look favorably upon a rehabilitation plan approved by this Commission that contained these sorts of commitments from ratepayers, the City and the Company.

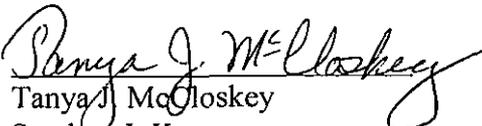
If PGW's bond ratings are affirmed, then the Company will be able to go forward with the planned forward purchase agreement which is expected to yield about \$20 million of incremental project revenues in this fiscal year. OCA St. 1-ERP at 41. The forward purchase agreement, along with the impact of the City leaving its dividend in the Company, ratepayers paying a matching capital surcharge, and the proactive efforts by the Company on collections and cash conservation, should provide PGW with sufficient working capital for the remainder of this fiscal year. Id. As the full effects of the capital infusions take effect in subsequent years, the Company's liquidity will be fully restored and the Company's financial position stabilized.

V. CONCLUSION

For the reasons set forth above, the OCA submits that the Petition of Philadelphia Gas Works For Extraordinary Rate Relief should be denied. The Public Utility Commission, not an S&P analyst, must determine just and reasonable rates for this Company in accordance with Pennsylvania law.

The Commission should, however, implement the alternative set forth by the OCA in this Memorandum. The OCA proposal fairly allocates the burden of resolving PGW's financial problems through a sharing between ratepayers and PGW's owner, the City of Philadelphia.

Respectfully submitted,



Tanya J. McCloskey  
Stephen J. Keene  
Senior Assistant Consumer Advocates

Counsel for:  
Irwin A. Popowsky  
Consumer Advocate

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Dated: April 3, 2002  
68443

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## Appendix A

Pennsylvania Public Utility Commission

v.

Metropolitan Edison Company

Docket No. P-800070235

Order dated August 28, 1980

Pennsylvania Public Utility Commission

v.

Claysville Natural Gas Company

Docket No. R-860423

Order dated November 13, 1986

Pennsylvania Public Utility Commission

v.

Poconos Water Company and Poconos Sewer Company

Docket No. R-80011059 and R-80011060

Order dated March 3, 1980

**EXTRA COPY**

Public Meeting held August 28, 1980

Commissioners Present:

Susan M. Shanahan, Chairman  
Michael Johnson  
James H. Cawley  
Linda C. Taliaferro

Pennsylvania Public Utility Commission  
v.  
Metropolitan Edison Company

P-80070235

**ORDER**

**BY THE COMMISSION:**

We adopt as our action the Recommended Decision of Administrative Law Judge Matuschak dated August 20, 1980; THEREFORE,

**IT IS ORDERED:**

1. That the Petition of Metropolitan Edison Company for Extraordinary Rate Relief in the amount of \$35 million, pursuant to the provisions of Section 1308(e) of the Public Utility Code, is hereby denied without prejudice.

2. That the exceptions, as filed by the Office of the Consumer Advocate, Metropolitan Edison Company, the Commission Trial Staff, Citibank and Chemical Bank, Victaulic Company of America, P.H. Glatfelter Co., St. Regis Paper Company, and National Gypsum Company, are hereby denied.

**BY THE COMMISSION,**

William P. Thierfelder  
Secretary

(SEAL)

ORDER ADOPTED: August 28, 1980

ORDER ENTERED: August 28, 1980

PLICATE RECORD.  
ORIGINAL CERTIFIED  
TO COMMONWEALTH COURT.

Before the  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY :  
COMMISSION, et al. :  
v. : Docket No. R-80051196  
METROPOLITAN EDISON COMPANY : Docket No. P-80070235

RECOMMENDED DECISION

(Subject to Commission Approval)

BEFORE: Joseph P. Matuschak  
Administrative Law Judge

APPEARANCES: Ryan, Russell & McConaghy, Esquires  
Samuel B. Russell, Esquire  
W. Edwin Ogden, Esquire  
Alan Michael Seltzer, Esquire  
For: Metropolitan Edison Company

Steven A. McClaren, Esquire  
Bohdan R. Pankiw, Esquire  
Edward Munce, Esquire  
For: Pennsylvania Public Utility Commission

Walter W. Cohen, Esquire  
David M. Barasch, Esquire  
Craig A. Burgraff, Esquire  
For: Office of the Consumer Advocate

McNees, Wallace & Nurick, Esquires  
Maurice A. Frater, Esquire  
For: P. H. Glatfelter Co.  
St. Regis Paper Company  
National Gypsum Company

Duane, Morris & Heckscher, Esquires  
Roland Morris, Esquire  
Robert E. Kelly, Jr., Esquire  
For: Victaulic Company of America

EXHIBIT RECORD.  
CERTIFIED  
COMMONWEALTH COURT.

Wolf, Block, Schoor and Solis-Cohen, Esquires  
Gerald Cornish, Esquire

For: Citibank, N.A., Agent, and  
Chemical Bank, Co-Agent

**BRIEFS:**

Briefs were filed by Metropolitan Edison Company, Commission Trial Staff, Office of the Consumer Advocate, and Victsulic Company of America. Joint briefs were filed by  
(1) Citibank and Chemical Bank, and  
(2) P.H. Glatfelter Co., St. Regis Paper Company, and National Gypsum Company.

Pennsylvania Public Utility Commission:

R-80051196  
P-80070235

Office of the Consumer Advocate  
David C. Thomsen  
Victaulic Company of America  
P. H. Glatfelter Co.  
St. Regis Paper Company  
Robert Jude Jenison

R-80051196C001  
R-80051196C002  
R-80051196C003  
R-80051196C004  
R-80051196C005  
R-80051196C006

v.

Metropolitan Edison Company

## HISTORY OF THE PROCEEDING

On July 29, 1980, Metropolitan Edison Company (Met Ed) filed its Tariff Electric Pa. P.U.C. No. 44 with the Commission for a proposed increase in its retail base rates of \$76.5 million per year, or an increase in overall charges to retail customers of 17.27. In conjunction with this filing, Met Ed filed a Petition for Extrordinary Rate Relief under Section 1308(e) of the Public Utility Code, 66 Pa. C.S., Section 1308(e), requesting that \$35 million,<sup>1/</sup> or approximately 46% of the total request, be allowed to go into effect not later than September 1, 1980.

A number of complaints<sup>2/</sup> to both the rate proceeding and the petition for extraordinary rate relief have been consolidated with the proceeding on the petition. In addition, we granted the petition of Citibank, N.A., Agent, and Chemical Bank, Co-Agent, to intervene in the proceeding.

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<sup>1/</sup> While no doubt coincidental, this is almost exactly the amount of deferred energy costs estimated to be collected by Met Ed by year-end 1980. The intervening banks suggest that such deferred energy cost receipts should be applied to reduce Met Ed's short-term debt, and not, as projected, to be used for other purposes.

<sup>2/</sup> Complaints were filed by: The Office of the Consumer Advocate, David C. Thomsen, Vertaulic Company of America, P.R. Glatfelter Co., St. Regis Paper Company, and Robert Jude Jenison.

Hearings were held before us in Harrisburg on August 4, 5, 11 and 12, 1980.

At the hearing held on August 4, the Office of the Consumer Advocate (Consumer Advocate) submitted a motion to dismiss Met Ed's petition for extraordinary rate relief on the ground that the petition failed to comply with the provisions of the Commission's Statement of Policy entered on November 6, 1978 at M-78100089, which directed that certain specified information, in the form therein set forth, is to be submitted with a petition for extraordinary rate relief, purportedly as a regulation under 52 Pa. Code, Section 53.1, et seq.

Upon inquiry, we ascertained that while a copy of said Statement of Policy was, in fact, served on Met Ed on November 7, 1978, the Statement of Policy was never published in the Pennsylvania Bulletin, as required by the provisions of 1 Pa. Code, Section 31.13 for rulemaking purposes.

Commission Trial Staff (Commission Staff) recommended that the Consumer Advocate's motion to dismiss be denied.

We held that while we would not give rulemaking effect to the Statement of Policy, neither would we disregard the Commission's expressed need for such information. We directed Met Ed to promptly supply the information of the kind and in the form required. We further held that no useful purpose would be served in requiring a reformed petition: no party would be prejudiced if the information was promptly submitted, and the information would be available for the Commission's purposes. Accordingly, we denied the Consumer Advocate's motion to dismiss Met Ed's petition for extraordinary rate relief.

INTRODUCTION

Although the Commission has not yet suspended the rate filing of Mat Ed, we and all parties have proceeded here on the assumption that such suspension is forthcoming.

It must be understood that nothing contained herein shall be considered as a predisposition of any matters involved in the rate filing, or as approving or not approving any of the matters therein contained, or as to the ultimate outcome of the rate proceeding.

## DISCUSSION

### Legal Authority

The Commission's authority to grant extraordinary rate relief is governed by Section 1308(e) of the Public Utility Code, 66 Pa. C.S., Section 1308(e), which provides:

Extraordinary Rate Relief. -- Upon petition to the Commission at the time of filing a rate request or at any time during the pendency of proceedings on such rate requests, any public utility may seek extraordinary rate relief on such portion to the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on the utility's common equity established by the Commission in consideration of the utility's preceding rate filing, except that no utility shall file, either with a request for a general rate increase or at any time during the pendency of such a request, more than one petition under the subsection pertaining to rates for a particular type of service, nor any supplement or amendment thereto, except when permitted to do so by order of the commission. Any public utility requesting extraordinary rate relief shall file with the petition sufficient additional testimony and exhibits which will permit the Commission to make appropriate findings on the petition. The public utility shall give notice of the petition in the same manner as its filing upon which this petition is based. The commission shall within 30 days from the date of the filing of a petition for extraordinary rate relief, and after hearing for the purpose of cross-examination of the testimony and exhibits of the public utility, and the presentation of such other evidentiary testimony as the commission may by rule prescribe, by order

setting forth its reasons therefor, grant or deny, in whole or in part, the extraordinary rate relief requested. Absent such order, the petition shall be deemed to have been denied. Rates established pursuant to extraordinary rate relief shall not be deemed to be temporary rates within the meaning of that term as it is used in Section 1310. [Emphasis supplied]

In our opinion, the purpose of Section 1308(e) is to assure adequate and continuous service to utility customers and to prevent interruptions thereof due to the financial instability of the utility.

It must be noted, however, that unlike prior legislation, Section 1308(e) requires a specified showing by a utility to obtain interim relief. The showing is more specific and inflexible than previously required. We must treat the instant petition in the light of the letter and the spirit of statutory directives.

Burden of Proof

Met Ed, in seeking the exercise of the Commission's discretion to grant its request for extraordinary rate relief, prior to the Commission's determination of the revenue requirement, bears a heavy burden.

As stated in the Commission's Order entered on September 21, 1978 in Pa. P.U.C. v. Pennsylvania Electric Company, 26 PUR (4th) 337, Section 1308(e)

. . . entitles Petitioner to extraordinary rate relief only if it can show such rate relief is immediately necessary for the maintenance of Petitioner's financial stability (i) in order to continue providing normal services, (ii) avoid reductions in its normal maintenance programs, and (iii) avoid substantially reducing employment. Proof of the immediate necessity for such rate relief required for the maintenance of the utility's financial stability must be clear and fully supportable of a finding by the Commission that the financial stability of the utility is actually in jeopardy.  
[Emphasis supplied]

The fact that the rate increase sought by the petition cannot be made retroactive, and failure to grant interim increases may result in unrecoverable loss of revenue during the interim of the period, does not relieve Met Ed from this burden. Nor can the Commission grant interim relief on speculation or conjecture.

In its brief, at page 5, Met Ed admits that:

It is clear that a utility seeking extraordinary rate relief has the formidable task of showing circumstances which would justify the conclusion

that it is suffering from financial constraints sufficiently severe that, if not remedied, would result in the impairment of safe and reliable electric service to consumers. This view has been confirmed by order of the Public Utility Commission on September 5, 1978 in Pa. P.U.C. v. Pennsylvania Electric Company at R-78040599.

For the reasons hereinafter set forth, it is our opinion that Met Ed has not sustained the statutory burden placed upon it for entitlement to extraordinary rate relief.

From our review of all the evidence, it is our view that the major thrust of this petition is to make available funds, directly or indirectly, for clean up of TMI. This is not a valid purpose for extraordinary rate relief under the stringent requirements of the statute.

Met Ed's Presentation

Met Ed's request for \$35 million in extraordinary rate relief is based upon the future test year for the 12 months ended March 31, 1981, excluding the investment and associated costs of TMI-1 and TMI-2, and is claimed to yield no more than 13.38% return on common equity allowed by the Commission in Met Ed's last rate case.

In support of its petition, Met Ed avers that:

- (a) Met Ed has been unable to issue any first mortgage bonds, debentures or preferred stock since January of 1979.
- (b) For the 12 months ended June 30, 1980, Met Ed had a pre-tax interest coverage ratio of only 1.45 times, which is below the 2.0 times requirement in its debenture indenture for the issuance of additional funded debt.
- (c) For the 12 months ended June 30, 1980, Met Ed had a after-tax preferred stock coverage ratio below the 1.04 times, which is below the 1.5 times required under Met Ed's charter for the issuance of additional preferred stock.
- (d) Met Ed has paid no dividends on its common stock since February, 1979, and has no visible prospect of paying any.
- (e) The return on Met Ed's average common equity investment for the 6 months ended June 30, 1980, was a negative 0.6 percent.
- (f) Met Ed's return on common equity for 1980 without rate relief is projected to be a negative 2.3 percent.

- (g) Met Ed's securities have been downgraded below investment grade.
- (h) Met Ed's present transmission and distribution expenditures are the lowest they have been in more than 10 years.
- (i) Met Ed's present operation and maintenance expenditures are significantly below normal levels.
- (j) The number of Met Ed's transmission and distribution and operating and maintenance employees are significantly below normal levels.
- (k) Met Ed's short term debt under the revolving credit agreement (RCA) is \$83 million and is subject to a present limitation of \$105 million.
- (l) Absent (a) prompt rate relief, or (b) the substantial cut-backs in expenditures needed to conserve the substantial equivalent of the cash which would be generated by the requested rate relief, Met Ed will need cash in excess of that available under the RCA in April of 1981.
- (m) The \$105 million limitation on short-term debt for Met Ed under RCA is neither guaranteed nor insured and should be expected to be reduced still further in the near future.

Met Ed offered testimony generally in support of such contentions.

Position of the Parties

Met Ed

Met Ed submits that it has forcefully demonstrated that the requested \$35 million of extraordinary rate relief meets each and every one of the criteria contained in Section 1308(e) of the Code, and that such rate relief should be allowed on or before September 1, 1980.

Commission Staff

Commission Staff requests the Commission to deny Met Ed's petition because:

- a) Met Ed is financially solvent, stable, and in a condition consistent with the Commission's May 23 Order.
- b) Potential Staff adjustments to Met Ed's claim would require substantial refunds.
- c) Met Ed's proposal for uniform increase per KWH fails to correct inequities in the existing rate structure and fails to encourage energy conservation in any specific way.

Consumer Advocate

The Consumer Advocate takes the position that Met Ed's petition does not comport with the requirements of Section 1308(e) or sound regulatory principles and should, therefore, be denied. If the Commission grants part or all of Met Ed's requested relief, it urges that the revenues be recovered on an equal KWH basis as suggested by Met Ed.

St. Regis Paper Company  
P. H. Glatfelter Company  
National Gypsum Company

These industrial concerns state that the Commission should give consideration to Met Ed's request for extraordinary rate relief, but they take no position with respect to the level of rate relief to be granted.

They urge, however, that any extraordinary rate relief granted by the Commission should be recovered on the basis of the non-fuel portion of the present rates, or in the alternative, on the basis of the present base rates, rather than on the KWH basis as suggested by Met Ed.

Victaulic Company of America

This company urges that the extraordinary rate relief request by Met Ed be denied.

Citibank, N.A., Agent and  
Chemical Bank, Co-Agent

These intervening banks state that Met Ed has shown a continuing deterioration in its earnings, the rapid amortization of its deferred energy account, and the effect of its projected financial picture on its short-term debt balance under the Revolving Credit Agreement (RCA), which, absent any relief from the Commission, will exceed the \$105 million debt limit currently in effect by April, 1981.

Furthermore, they aver that although Met Ed's projections show a short-term debt balance of \$90.5 million as of December, 1980,

absent extraordinary rate relief, there is no assurance that such amount will be permitted by the banks. In any event, with or without interim rate relief, they stated there would be a step-down of Met Ed's short-term debt limitation under the RCA, but that such limitation may be lower without interim relief.

Reductions in Service,  
Maintenance and Employment

The specific statutory requirement for extraordinary rate relief is that it:

. . . can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment. . .  
[Emphasis supplied]

Met Ed has failed to meet this statutory requirement. The statute itself specifically cites the nature of the financial stability giving right to extraordinary rate relief.

In our opinion, the statutory reference to "extraordinary" rate relief connotes an emergent form of rate relief. While Met Ed, in its brief, finds fault with the use by other parties of the word "extraordinary" and "emergency" interchangeably, we note that Met Ed, itself, in its Exhibit B-1, refers to its petition for extraordinary rate relief as an "Emergency Petition." It further states that its petition for extraordinary rate relief seeks a "level of emergency rate relief." The Commission, too, has in the past referred to extraordinary rate relief as "emergency rate relief." (R-73040599)

Is there such an emergency? None has been shown by Met Ed under present circumstances, nor has it been shown that any emergency condition is likely within the next few months. While it appears from

the record that Met Ed is suffering both from a revenue deficiency and an earnings erosion, these have not created a situation which the statute seeks to prevent.

Mr. Newton, General Public Utilities (GPU) Vice President of System Operations, testified on page 17 of his prepared Statement F, as follows:

- Q. Mr. Newton, do you have an opinion regarding the levels of employees in the T&D area at 5/31/80?
- A. Yes. In my opinion, the level of employees at year ending 5/31/80 are reasonable and appropriate in the light of all of the existing circumstances. However, this level is not sufficient to maintain the existing quality of service to our customers if such level remains constant over a period of several years. The number of T&D employees will definitely have to be increased with time or the quality of service will inevitably be degraded.  
[Emphasis supplied]

He further testified on cross-examination as follows:

- Q. Mr. Newton, counsel asked you if the company did not receive extraordinary rate relief, what deductions would take place in employees, and I believe you said, you would expect attrition in transmission and distribution employees of approximately 40 over the next twelve months, is that correct?
- A. That's correct.
- Q. If you receive extraordinary rate relief, in this respect, how would the company operate differently?
- A. Its impossible to predict precisely all of the demands that are going to be presented for the utilization of that amount of increased revenue.

We in the T and D area will certainly make as aggressive a plea for maintaining at least the present level --- so we will not have that attrition. But its a matter of decision by the board exactly how the increased revenues will be distributed among the company demands.

Q. I take it from your answer that its entirely possible that if the company gets extraordinary rate relief, that you will still have the expected attrition of 40 employees without employees to replace them.

A. That's possible. I like to think that it won't happen that way, but its possible.

\* \* \*

Q. Isn't it your testimony that the company has not had a normal complement of transmission and distribution employees since 1973?

A. That is correct.

[Emphasis supplied]

His testimony as to construction employees was in the same vein.

Met Ed's witnesses could not be certain that any of the requested \$35 million interim rate relief would be expended for continuation of normal services, maintenance and employment, or that given such interim relief, specific reductions would be avoided.

Mr. Graham, CPU Treasurer, admitted that there were no corporate plans to apply early revenues, and that specific assurance could not be given that such interim revenues would not be used to fund TMI clean-up, to reduce short-term debt, or for other purposes.

Mr. Dieckamp, GPU President and Acting President of Met Ed, described the "areas of cost reduction." He could give no definite plan of cost reduction, but asserted that operation and maintenance expenses and construction budgets are at the minimum acceptable levels, and absent early rate relief, the budgeted amounts would exceed the revolving credit agreement (RCA) limit. The stated areas of cost reduction, however, were designed to meet the state tax payment due in April, 1981, a point in time well beyond the short-term period contemplated by Section 1308(e). This testimony indicates that while additional funds may be required in the future, they are not immediately necessary to avoid reductions outlined by Mr. Dieckamp. A careful reading of Mr. Dieckamp's testimony shows that Met Ed's major concern in this petition is its effect on TMI cleanup.

In its May 23, 1980 Order in Pa. P.U.C. v. Metropolitan Edison Company and Pennsylvania Electric Company, mimeo, p. 4, the Commission stated:

. . . The Commission will provide Met Ed the means of financial rehabilitation. However, we will write no blank checks on its ratepayers.

Met Ed's witnesses either were unable or reluctant to identify the specific needs for, or the intended use of, the requested \$35 million interim rate increase, as it related to the avoidance of reduction in service, maintenance or employment.

While Met Ed alleges that its present distribution and transmission expenses, and its number of distribution and transmission employees are below "normal," Met Ed agrees that even as late as March 31, 1980 its service was adequate, despite the fact that such "below normal" conditions had existed over the last several years. At least, this would indicate that no immediate emergency condition exists in this respect.

From the statutory criteria, we would consider "normal" to refer to the "ordinary" "typical" or "usual" complement of expenditures or employees, or as averaging over a number of years, rather than a "preferred" or "desired" level, or a level existing several years before. Productivity gains, too, should be given some consideration.

Met Ed's  
Financial Condition

As we view it, the weakness of Met Ed's presentation is that though it established a valid record showing that it is in a precarious financial condition, it failed to meet the statutory test that such financial condition requires the immediate extraordinary rate relief to continue to provide normal services to its customers, avoid reductions in its normal maintenance programs, or avoid reducing its employment.

There is no question that the financial condition of Met Ed is poor. It presently has no access to permanent financing; and must depend on short-term debt for its outside funds.

Mr. Graham, Treasurer of GPU, recognized that for the next two years, and until TMI-1 returns to service and to rate base, Met Ed will not have access to the bond or equity markets, and that Met Ed will have to continue to rely heavily on short-term credit.

But though poor, Met Ed's financial condition is stable in the statutory sense, and is projected to remain stable, by its own cash projections, until about April, 1981, when a state tax payment becomes due. In short, Met Ed does not need the immediate infusion of cash to maintain its financial stability; it faces no immediate emergency.

The Commission, in its May 23 Order, determined that Met Ed should remain financially viable; increased Met Ed's energy

cost recovery to a fully current level; and provided for an 18-month recovery of all deferred energy costs. The Commission's May 23 Order stabilized Met Ed's financial condition. Although there has been a continuing deterioration of the earning, there has been no material change in Met Ed's financial condition since the May 23 Order.

The following Met Ed's estimates of its short-term debt balance in the event no extraordinary rate relief is granted, are indicative of its financial stability for that period.

1980

	<u>July</u>	<u>August</u>	<u>September</u>	<u>October</u>	<u>November</u>	<u>December</u>
Short-term debt balance	\$86.9m	\$86.6m	\$88.1m	\$87.7m	\$91.1m	\$90.5m

Met Ed's current financial problems consist of a lack of adequate earnings rather than cash flow.

Met Ed, in its presentation, has calculated that a 13.38% rate of return on the utility's common equity established by the Commission in the last rate case, based on a year-end rate base for a future test year ended March 31, 1981, would yield \$35.3 million. Commission Staff, however, in a preliminary review of Met Ed's submissions, has arrived at potential adjustments of some \$47 million, which could reduce Met Ed's revenue requirement well below the \$35 million interim rate relief requested. Since no emergency has been shown by Met Ed, any interim relief should await further development of the facts within the next few months.

It must be conceded by all that Met Ed still faces enormous financial problems. It is apparent that this financial difficulty arises not only from the accident at TMI-2 and the inactive status of TMI-1, but also the resulting effect of endeavoring to render adequate service to its customers, while at the same time spending millions to restore and clean up TMI-1 and TMI-2.

In its Order entered on June 19, 1979 in Pa. P.U.C. v. Metropolitan Edison Company and Pennsylvania Electric Company, at I-79040308, mimeo p. 13, the Commission said:

The Commission is of the view that none of the cost of responding to the accident, including repair, disposal of wastes and decontamination are recoverable from rate-payers. These costs are and should be insurable.

As it now turns out, millions of dollars will have to be expended by Met Ed, over and above the \$300 million insurance recovery, in order to restore and clean up TMI.

Because of such impact upon Met Ed's finances, we cannot divorce this petition from TMI, even though certain data calculations in support thereof, exclude the investment and associated costs of TMI.

The result is that Met Ed customers may be required indirectly to pay for a substantial portion of such clean up costs

through increased rates. In order to support the financing for such purposes. This petition is the first step in that direction. Before embarking on that course, the Commission may first want to make a reassessment of the TMI restoration and clean-up upon the ratepayers, be it direct or indirect.

Mr. Graham stated that if TMI-2 would be considered a total loss by the insurance carrier, as he was pressing, the balance of the insurance proceeds would be immediately paid, affording Met Ed another substantial possible source of funds to meet its expenses during the next few months.

As to the apprehension of the intervening banks, the Commission said in Pa. P.U.C. v. Metropolitan Edison Company and Pennsylvania Electric Company, at I-79040308, mimeo p. 4, on May 23, 1980: "Respondent must convince its bank creditors that it has the will and the ability to rehabilitate itself." The Commission by its May 23 Order, provided the means for Met Ed to rehabilitate itself. We shall expect the same concern by other involved parties.

Met Ed will not be in a serious cash flow problem until April 15, 1981. In the interim, all parties and the Commission will have the opportunity to reassess their positions in the light of events as they occur. As permitted by Section 1308(e), the Commission will keep open its door for another petition for extraordinary rate relief, if need be, at a more appropriate time, and for a more valid

purpose, in a more deliberate and more informed climate. The Commission has the ability to meet any critical situation as it may occur, be it at the conclusion of the rate hearing, or prior thereto. Here, Met Ed's petition is premature in its stated apprehension for the future.

Statutory provisions must be followed in the granting of extraordinary rate relief. In Pa. P.U.C. v. Pennsylvania Electric Company, at R-78040599, on September 21, 1978, the Commission said:

The 1976 amendments to the Public Utility Code reduced to seven months, after the effective date of filed rates, the maximum period which could elapse before proposed rates could become effective. These 1976 amendments evidenced a legislative intent that rate cases be expeditiously resolved and that multi-stage rate filings be limited. We find no legislative intent that a utility may, under the guise of petitioning for extraordinary rate relief, secure increased revenues in order to maintain or improve its return on common equity, absent clear and convincing proof that such extraordinary rate relief is immediately necessary under the criteria set forth in Section 308(f) [now Section 1308(e)] of the Public Utility Code. We wish to make clear that an inability to earn the rate of return on common equity determined to be appropriate by the Commission in the previous rate proceeding or dissatisfaction with such rate of return cannot support a request for extraordinary rate relief under Section 308(f) [Section 1308(e)]

Here, as there, the utility failed to meet its burden of showing that emergency rate relief is immediately necessary for the maintenance of its financial stability under the statutory criteria. The difference is a matter of degree.

The purpose served by Section 1308(e) is not to thrust the cost of nonfunctioning TMI capital assets onto the ratepayers, but to permit the recovery of extraordinary costs incident to serving the public. Here, to the contrary, emergency relief is sought from the ratepayers largely for the costs attendant to capital assets not in the public service.

Expedited Rate Case Proceeding

Because the investigation and consideration of a rate application can become such a complex and time-consuming procedure, the Legislature has given the Commission the authority to suspend the collection of the proposed rate increase during which time the Commission is investigating and deliberating on the application, a provision obviously designed to protect the public interest from the collection of rate increases which the Commission may later determine to be unwarranted.

Commission Staff recommends that Met Ed's petition for extraordinary rate relief be denied, but that the Commission expedite the general rate case proceeding for conclusion prior to year-end 1980.

We are not persuaded that such recommendation should be adopted, both because of possible due process infirmity and pragmatic weakness.

Due process means different things at different times and under different circumstances. In an expedited procedure, as herein, involving interim rate increases with refund provisions under extraordinary situations, only minimal opportunity for testing may be required. On the other hand, in a permanent rate proceeding, due process would require the opportunity for a more thorough testing of the propriety of the utility's request for a rate increase.

The permanent rate proceedings for Met Ed and Pennsylvania Electric Company (Penelec), sister company, are scheduled to be consolidated, so far as possible, in rate hearing procedure. We are concerned not only that due process considerations may not be adequately met by Staff's recommendation, but even more importantly, from a practical viewpoint, that the suggested expedited procedure may prove to be counterproductive. We question that sufficient opportunity would be given to all parties to test the propriety of the rate request, including investigation, preparation of prepared testimony, discovery, cross-examination of witnesses, briefs, recommended decision, exceptions and Commission action. Short-cutting in procedure could result in short-cutting either Met Ed or its customers.

Proposed Allocation of  
Extraordinary Rate Increase

In view of our treatment of Met Ed's petition for extraordinary rate relief, we do not reach the issue of the appropriate method of spreading such proposed interim rate increase among Met Ed's classes of customers. Some comment in this connection, however, may be appropriate.

We reject Commission Staff's contention that some alleged inequity, either in Met Ed's existing or proposed interim rates, supports the denial of extraordinary rate relief.

If the Commission were to otherwise determine that all or part of the extraordinary rate relief should be granted, the fact that precise and ultimately equitable allocation of the increase cannot at this time be finally determined, should not be a cause for the rejection of the request. If extraordinary rate relief must await a full investigation and determination of ultimate allocations, Section 1308(e), which requires a speedy disposition, would be meaningless.

Further, if the Commission should grant the extraordinary rate relief request, in whole or in part, we recommend the allocation of such rate increase on the basis suggested by Met Ed as appropriate.

Once revenue requirements have been determined, it remains how, and from whom, the additional revenue is to be obtained. It is at this point that many countervailing considerations come into play. The Commission, acting in a legislative manner, may then balance factors such as cost of service, ability to pay, tax consequences and ability to pass on the increase, in order to achieve a fair and reasonable allocation of the increase among the consumer classes, the careful balancing of public policies and private needs. The Commission may balance both cost and non-cost factors in making choice among public policy alternatives. While the Commission may not be in position to finalize an equitable allocation of a proposed increase in rates, certain obvious considerations may be sufficient to support short-term interim rates.

The Commission has repeatedly rejected the "zero-energy" approach of allocating rate increases, as advocated by some of the industrials. Nor can it be said that in the present time frame, with changing energy considerations, reliance can be given to the use of existing base rates, as urged by such industrials as an alternative. While we agree with Commission Staff that extraordinary rate relief, based solely on an energy component, may not precisely reflect all aspects of cost, we are of the opinion that until a full review of rate allocation can be completed, a temporary reliance in the interim on a uniform KWH is the most appropriate approach.

FINDINGS OF FACT

1. Met Ed has been unable to issue any first mortgage bonds, debentures or preferred stock since January of 1979.

2. Met Ed avers that for the 12 months ended June 30, 1980, Met Ed had a pre-tax interest coverage of only 1.45 times, which is below the 2.0 times requirement in its debenture indenture for the issuance of additional funded debt, but such data has not been verified.

3. Met Ed avers that for the 12 months ended June 30, 1980, Met Ed had a after-tax preferred stock coverage ratio below the 1.04 times, which is below the 1.5 times required under Met Ed's charter for the issuance of additional preferred stock, but such data has not been verified.

4. Met Ed has paid no dividends on its common stock since February, 1979, and has no visible prospect of paying any.

5. Met Ed claims a return on its common equity investment for the 6 months ended June 30, 1980, was a negative 0.6 percent, but such data has not been verified.

6. Met Ed claims a return on common equity for 1980 without rate relief projected to be 2.3 percent.

7. Met Ed's securities have been downgraded below investment grade.

8. Met Ed's present transmission and distribution expenditures are sufficient to render adequate service to its customers, and to maintain a normal maintenance program.

9. Met Ed's present operation and maintenance expenditures are sufficient to render adequate service to its customers, and to maintain a normal maintenance program.

10. Met Ed has sufficient financial ability to avoid any substantial reduction in the number of its employees.

11. Met Ed has sufficient cash flow, and will continue to maintain sufficient cash flow until about April 15, 1981.

12. Met Ed's financial condition is stable.

13. Met Ed has no plans for the utilization of the proposed interim revenues, and has no plans for specific reductions if no extraordinary rate relief is granted.

14. Met Ed has sufficient financial stability to enable it to continue to render normal services, avoid reduction in its maintenance program, and avoid any substantial reduction in its employment.

15. Met Ed has sufficient short-term credit available at least until year-end 1980.

16. Met Ed has no immediate need for extraordinary rate relief under the provisions of Section 1308(e) of the Public Utility Code.

17. Since no extraordinary rate relief is granted, it is unnecessary to address the appropriate method of allocation of any interim rate increase.

18. Met Ed faces no immediate emergency financial situation.

19. Met Ed has given no assurance that the interim rate increase revenues would be applied to the continuation of normal services, the avoidance of reduction in its normal maintenance program, or the avoidance of reduction in its employment.

20. Met Ed may face cash flow problems on or about April 15, 1981.

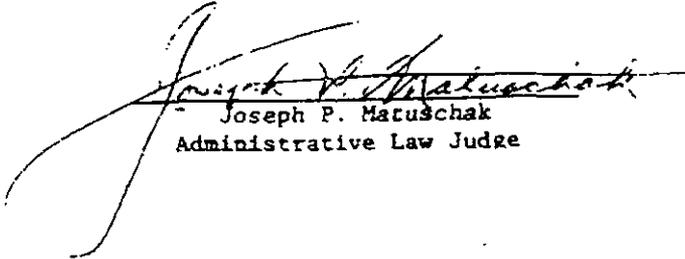
CONCLUSIONS OF LAW

1. The Commission has jurisdiction of the parties and of the subject matter.
2. The parties are properly before the Commission.
3. Met Ed has not sustained its burden to entitle it to the \$35 million extraordinary rate relief, under the provisions of Section 1308(e) of the Public Utility Code, 66 Pa. C.S., Section 1308(e).
4. Met Ed's petition for extraordinary rate relief should be denied, without prejudice.

RECOMMENDED ORDER

(Subject to Commission Approval)

IT IS HEREBY ORDERED that the petition of Metropolitan Edison Company for extraordinary rate relief in the amount of \$35 million, pursuant to the provisions of Section 1308(e) of the Public Utility Code, be, and is hereby denied, without prejudice.

  
Joseph P. Matuschak  
Administrative Law Judge

August 20, 1980

PENNSYLVANIA  
PUBLIC UTILITY COMMISSION  
Harrisburg, PA 17120

Public Meeting held November 13, 1986

Commissioners Present:

Linda C. Taliaferro, Chairman  
Frank Fischl  
Bill Shana

Pennsylvania Public Utility Commission

v.

R-860423

Claysville Natural Gas Company

O R D E R

BY THE COMMISSION:

We adopt as our action the Recommended Decision of Administrative Law Judge Robert A. Christianson dated November 5, 1986, and that Exceptions be denied; THEREFORE,

IT IS ORDERED:

That the October 21, 1986 petition for extraordinary rate relief filed by Claysville Natural Gas Company is denied, without prejudice.

BY THE COMMISSION,



Jerry Rich  
Secretary

(SEAL)

ORDER ADOPTED: November 13, 1986

ORDER ENTERED: November 13, 1986

COMMONWEALTH OF PENNSYLVANIA  
PENNSYLVANIA PUBLIC UTILITY COMMISSION  
P. O. BOX 3265, HARRISBURG, PA 17120

November 5, 1986

IN REPLY PLEASE  
REFER TO OUR FILE

R-860423

DOCUMENT  
FOLDER

To All Parties

Pennsylvania Public Utility Commission  
v.  
Claysville Natural Gas Company

TO WHOM IT MAY CONCERN

Enclosed is a copy of the Recommended Decision prepared by  
Administrative Law Judge Robert A. Christianson.

An original and nine (9) copies of signed exceptions to the decision,  
if any, MUST BE FILED WITH THE SECRETARY OF THE COMMISSION IN ROOM 8-18, NORTH  
OFFICE BUILDING, NORTH STREET AND COMMONWEALTH AVENUE, HARRISBURG, PA OR  
MAILED TO P.O. BOX 3265, HARRISBURG, PA 17120 and a copy served on each party  
of record on or before November 7, 1986. The signed exceptions will be deemed  
filed on the date actually received by the Secretary of the Commission.

Replies to exceptions, if any, must be served on the Secretary of the  
Commission, in the manner described above, on or before November 12, 1986  
by 11:00 a.m.

Exceptions and reply exceptions shall obey 52 Pa. Code 5.533 and  
5.535, particularly the 40 page limit for exceptions and the 25 page limit  
for replies to exceptions. Exceptions should be clearly labeled as "EXCEPTIONS  
OF (name of party) - (protestant, complainant, staff, etc.)".

Any reference to specific sections of the Administrative Law Judge's  
Recommended Decision shall include the page number(s) of the cited section of  
the Decision.

All timely filed exceptions and replies thereto will be attached to  
the decision for consideration at Public Hearing. Late filed exceptions and  
late filed replies will not be attached. This decision will be listed on the  
Agenda for Public Meeting November 13, 1986.

cc: ALJ Christianson/Office of ALJ/Law Bureau/OTS/Mr. Branson/OSA/Chairman/  
Commissioners/Correspondence/our file

Very truly yours,

*Allison K. Turner*

Allison K. Turner  
Chief Administrative Law Judge

19

Enclosures

Certified Mail

Receipt Requested

Refer to: See attached list.

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

Claysville Natural Gas Company

R-860429

RECOMMENDED DECISION

Before

Robert A. Christianson  
Administrative Law Judge

DOCUMENT  
FOLDER

DOCKETED

NOV 2 1986

Introduction

This decision concerns a petition for extraordinary rate relief, dated October 21, 1986, filed by Claysville Natural Gas Company (Claysville) pursuant to provisions at 66 Pa. C.S. §1308(e). Claysville distributes natural gas to the public in a six and one half square mile area west of the City of Washington, Washington County. The Claysville service territory is primarily rural in nature but includes the Borough of Claysville. Claysville has approximately 1,048 residential and 86 commercial customers. Much of Claysville's distribution system is old, dating from before 1917, and much of it is above ground. The level of unaccounted for gas is high. See Claysville St. 2, p. 5. Claysville is tied to a full requirements contract with

Columbia Gas Transmission Company, purchasing gas at approximately \$4.04 per Mcf. Claysville is delinquent on payments under this contract. It is also seeking to terminate the contract and arrange for transportation of gas.

This petition was filed with the docket number associated with a pending general rate increase proceeding, R-860423, and no other docket number has been assigned to the petition. The petition was filed shortly before the first hearing in the underlying rate proceeding and was assigned to the Office of Administrative Law Judge. The record for the petition is the entire record made so far in the rate proceeding, including Claysville's entire direct case and evidence offered by the Office of Trial Staff (OTS) concerning this petition. Hearings have been held on October 24 and October 31, 1986. Claysville and OTS are the only parties participating in this proceeding.

On May 29, 1986, Claysville filed for a \$153,752 (approximately 16%) rate increase. The effective date had been July 31, 1986 but was extended to August 22, 1986, with the suspension to expire March 22, 1987. On August 21, 1986, the Commission adopted an order offering Claysville the option of a \$38,853 rate increase but this option was rejected and the matter was assigned to the Office of Administrative Law Judge.

Claysville has filed testimony indicating a revised claim for revenue relief of \$115,126. Claysville St. 1, p. 12. Claysville seeks the same amount, \$115,126, in extraordinary rate

relief. OTS filed a response to the extraordinary rate relief petition. In this response, which is dated October 31, 1986, OTS outlines its opposition to the petition and asks that the petition be denied entirely.

The Public Utility Code, at 66 Pa. C.S. §1308(e), provides for a 30-day Commission response time to extraordinary rate relief petitions. Because of this time limit, a hearing for the purpose of cross-examination relating to the petition was held on Friday, October 31, 1986. Counsel were given the opportunity to argue their cases at the end of that hearing. Beyond that, Claysville was allowed to file a memorandum on Monday, November 3, 1986 and OTS was allowed to file a reply on November 4, 1986.

#### Discussion and Findings

The Public Utility Code indicates that extraordinary rate relief must be based on a finding that such relief is immediately necessary to maintain financial stability in order to (1) continue to provide normal service or (2) avoid reductions in normal maintenance programs or (3) avoid substantially reducing employment. 66 Pa. C.S. §1308(e). Extraordinary rate relief must also provide no more than the rate of return on the utility's common equity established in the utility's preceding rate filing. In this instance, that return was set at 15.4% in Pa. P.U.C. v. Claysville, 57 Pa. P.U.C. 541 (1983). The statutory language has

been applied to various situations. See, for instance, Pa. P.U.C. v. Metropolitan Edison Company, P-80070235, Commission order adopted August 28, 1980 and Pa. P.U.C. v. Pennsylvania Electric Company, 52 Pa. P.U.C. 497, 26 PPR 4th 337 (1978). In Metropolitan Edison, the Commission adopted the Recommended Decision of Administrative Law Judge Joseph P. Matuschak dated August 20, 1980, showing docket numbers R-80051196 and P-80070235.

In Metropolitan Edison, extraordinary rate relief was denied, without prejudice, even though the utility had stated that it had no visible prospect of paying dividends, showed a negative return on equity and had operation and maintenance expenditures significantly below normal levels. Recommended Decision, pp. 8-9. Judge Matuschak emphasized the statutory standards and noted that the Commission had stated that it would write no blank checks on the utility's ratepayers. See, especially, Recommended Decision, p. 16.

In the instant extraordinary rate relief petition, Claysville touches on maintenance and service at paragraph 7. It deals with debt problems and employment at paragraphs 8 and 9. It asserts, at paragraph 10, that \$115,126 in rate relief would produce an equity return below 15.4%. In the response, OTS asserts that the requested relief would produce an equity return of 26%, that rate relief is not immediately necessary, that the hiring of an employee (not employment reductions) is contemplated,

that Claysville is providing safe service, that OTS has arrived at potential adjustments to the rate relief claim of some \$70,000 (including disallowance of a \$30,220 cash flow deficiency claim) and that Claysville showed a net income of \$9,660 on public utility operations for the year ended March 31, 1986. The OTS rate of return calculation is shown as OTS Ex. No. CLK-1A. The cash flow deficiency claim is shown at Claysville St. 1, p. 10 and Ex. 5 attached thereto. Concerning income, see Claysville Ex. 12, Schedule D.

In the petition, Claysville asserts that its system is old and has a high level of unaccounted for gas. It also asserts that its ability to provide normal service requires a catch-up pipeline replacement program to control (and, presumably, reduce) the level of unaccounted for gas. Claysville indicates that money for this program must come from customers because it is unable to raise debt or equity capital. It states that its employees are underpaid. However, none of its arguments fit the statutory standards at 66 Pa. C.S. §1308(a).

Claysville has a problem with unaccounted for gas levels but its president states that the system is safe. Tr. 150, 152, 159-60. The problem with leaks is gas losses (and the associated impact on rates) rather than safety. Tr. 152-3. Service appears to be normal. I find no immediate service problem to support approval of this petition.

Claysville has plant replacement problems. Testimony indicates that main replacements had reduced unaccounted for gas levels but that, more recently, a reduced main replacement program had allowed unaccounted for gas levels to go up again. Claysville St. 2, pp. 4-5. I find, however, no immediate need for rate relief to avoid reductions in normal maintenance. Safety-related repairs are being made. A high rate of main replacement might be useful but I would not characterize a main replacement program as normal maintenance.

Claysville does not even project employment reductions. In fact, an additional employee, for system repairs and rehabilitation, is projected. Claysville Ex. 3 (attached to Claysville St. 2). I find no immediate need for rate relief in order to avoid employment reductions.

Of the \$115,126 sought in rate relief, only \$84,906 is the claimed revenue deficiency. Claysville St. 1, p. 7. The other \$30,220 is to meet a schedule of payments on the \$230,000 arrearage owed Claysville's gas supplier and, at the same time, support a \$70,000 annual capital improvement program. Claysville Ex. 5. Of the \$84,906, \$74,572 represents return. Claysville St. 1, p. 7. Expenses claimed by Claysville include \$30,000 a year in the basic management fee to an affiliated interest. Tr. 119, OTS Cross-Examination Exhibit 1. Claysville has cash flow and capital replacement problems but I find no immediate

cash problem to support any 66 Pa. C.S. §1308(e) extraordinary rate relief. Rate relief under §1308(d) might be appropriate after a full general rate increase case. Such relief should not be granted under §1308(e) now, in response to this petition.

As in the Metropolitan Edison case, the utility in the instant proceeding has a financial problem which does not fit well within the prescribed §1308(e) standards. Claysville's problem is its gas supply contract with Columbia Gas Transmission Company.

Claysville has a full requirements gas supply contract, under which it pays approximately \$4.04 per Mcf. Claysville St. 2, p. 3. It hopes to be able to terminate this contract and save something like \$1.30 per Mcf by purchasing and transporting gas. Tr. 93-4. Claysville, however, owes the supplier approximately \$230,000. Tr. 132. Rather than pay the gas supplier, Claysville paid off a bank loan and replaced some of its plant. Claysville St. 2, pp. 6-7, Tr. 135. Whatever the reasons for the arrearage owed the gas supplier, Claysville feels that it can reduce its gas costs if it can demonstrate to its gas supplier that it can pay off the arrearage in a reasonable manner. Tr. 166-8. As Claysville views the situation, rate relief now can enable Claysville to convince the supplier that the arrearage will be paid. This will, in turn, provide a good basis for termination of the supply contract and the consequent lower price

for gas. For Claysville, immediate rate relief is the key to a reduction in its gas supply price by close to \$1.30 per Mcf. However, this goal does not fall within the requirements of §1308(e).

In the memorandum filed November 3, 1986, Claysville emphasizes the "financial stability" element of 66 Pa. C.S. §1308(e). It goes on to argue that high line losses mean that its service is not normal. It presents the financial consequences of these line losses. It observes, correctly, that extraordinary rate relief may be granted in the absence of dangerous service conditions. It points out the financial benefits associated with a change of gas suppliers and presents the argument that rate relief is the key to convincing its present supplier, and alternative suppliers, that Claysville will pay its debts and should be allowed to change its gas supply arrangements. Claysville presents a "public interest" standard and suggests that bankruptcy looms if extraordinary rate relief is denied. Claysville also provides a Commission order, at Pa. P.U.C. v. Poconos Water Company and Poconos Sewer Company, R-80011059 and R-80011060, February 29, 1980, granting extraordinary rate relief.

The Poconos order provides some basis for the argument that past due bills can support extraordinary rate relief.

Poconos, p. 4. However, the §1308(e) elements were demonstrated and found before the level of relief was calculated. Poconos,

p. 3. Claysville, on the other hand, wants extraordinary rate relief to make capital improvements and to, perhaps, convince suppliers that it will pay its debts. Neither the need for capital improvements nor the supply contract problem represents an immediate crisis within the scope of §1308(e). Service is about as normal as it has been over several years, normal maintenance is continuing and no employment reductions are contemplated. Claysville appears to be unable or unwilling to raise needed capital and pay its debts. The resulting situation might produce a gas supply crisis. However, Claysville's customers should not be required to provide extraordinary rate relief in the hope that such relief will soon produce lower gas procurement costs and will eventually produce lower line losses. See the well-reasoned OTS November 4, 1986 memorandum, especially pages 3 and 6.

Claysville is just now entering its winter heating season. Claysville Ex. 6, 6th page. Relatively high sales, and cash flow, should continue until the pending Claysville general rate increase proceeding is concluded and appropriate revenue relief is granted. Meanwhile, normal operations can be expected to continue, absent some crisis relating to the supply contract. If such a crisis occurs, and if it can be brought within the §1308(e) standards, extraordinary rate relief might be sought, if the Commission so orders. Meanwhile, such relief should be denied for failure to meet the §1308(e) standards.

Conclusion

1. The Commission has jurisdiction over the parties and the subject matter.
2. Claysville has not sustained its burden, under 66 Pa. C.S. §1308(e), to show that extraordinary rate relief should be granted.
3. Claysville's petition for extraordinary rate relief should be denied, without prejudice.

THEREFORE, THE FOLLOWING ORDER IS RECOMMENDED:

That the October 21, 1986 petition for extraordinary rate relief filed by Claysville Natural Gas Company is denied, without prejudice.

Date: November 5, 1986

*Robert A. Christianson*  
Robert A. Christianson  
Administrative Law Judge

PENNSYLVANIA  
PUBLIC UTILITY COMMISSION  
Harrisburg, PA 17120

Public Meeting held February 29, 1980

Commissioners Present:

Susan M. Shanaman, Chairman  
Michael Johnson  
James H. Cawley  
Linda C. Taliaferro

Pennsylvania Public Utility Commission, et al.

v.

Poconos Water Company and Poconos Sewer Company

R-80011059  
R-80011060

O R D E R

BY THE COMMISSION:

On January 28, 1980, Pocono Water Company (PWC) and Pocono Sewer Company (PSC) each filed Supplement No. 8 to their Tariffs No. 1, proposing increases in water and sewer rates calculated to produce \$188,472 and \$536,112 respectively, in additional water and sewer revenues, (based on test year data ended September 30, 1979), said increase to become effective April 1, 1980.

Pursuant to the Petitions filed on February 1, 1980, PWC (at R-80011059) seeks approval of extraordinary rate relief to produce \$47,188 of the \$188,472 annual revenues requested in its Supplement No. 8, and PSC (at R-80011060) seeks approval of extraordinary rate relief to produce \$225,764 of the \$536,112 annual revenues requested in its Supplement No. 8.

The Association of Property Owners of the Hideouts, Inc. (POA) filed a complaint at R-800110590001, opposing the water general rate increase and a complaint at R-800110600001, opposing the sewer general rate increase. In addition, on February 13, 1980, POA also filed "Complainants' Reply to Petitions For Extraordinary Rate Relief of Poconos Water Company and Poconos Sewer Company."

A hearing was held in Harrisburg on February 13, 1980, in accordance with §1308(e) of the Public Utility Code. 66 Pa.C.S. §1308(e). Briefs were requested and filed. A recommended decision of Administrative Law Judge Banzoff, dated February 25, 1980 approved extraordinary rate relief in the amount requested by Respondent. Oral argument was held before us on February 29, 1980.

MAR 5 1980

### Extraordinary Rate Relief

Our authority to grant extraordinary rate relief is governed by Section 1308(e) of the Public Utility Code. 66 Pa.C.S. §1308(e) which provides:

"(e) Extraordinary Rate Relief - Upon petition to the Commission at the time of filing a rate request or at any time during the pendency of proceedings on such rate requests, any public utility may seek extraordinary rate relief on such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on the utility's common equity established by the commission in consideration of the utility's preceding rate filing, except that no utility shall file, either with a request for a general rate increase or at any time during the pendency of such a request, more than one petition under this subsection pertaining to rates for a particular type of service, nor any supplement or amendment thereto, except when permitted to do so by order of the commission. Any public utility requesting extraordinary rate relief shall file with the petition sufficient additional testimony and exhibits which will permit the commission to make appropriate findings on the petition. The public utility shall give notice of the petition in the same manner as its filing upon which this petition is based. The commission shall within 30 days from the date of the filing of a petition for extraordinary rate relief, and after hearing for the purpose of cross-examination of the testimony and exhibits of the public utility, and the presentation of such other evidentiary testimony as the commission by rule prescribe by order setting forth its reasons therefore, grant or deny, in whole or in part, the extraordinary rate relief requested. Absent such order, the petition shall be deemed to have been denied. Rates established pursuant to extraordinary rate relief shall not be deemed to be temporary rates within the meaning of that term as it is used in Section 31C."

The requirements of the Public Utility Code are quite clear. In order for this Commission to grant in whole or in part, any petition for extraordinary rate relief, Respondent must show that rate relief is immediately necessary:

1. to enable the utility to continue providing normal service to its customers;
2. to avoid reductions in its normal maintenance programs,  
and
3. to avoid substantially reducing its employment.

The evidence of record has established that PWC and PSC, because of insufficient funds, have been forced to (1) reduce their work force from six maintenance and service employees to two, (2) reduce maintenance and improvements to the water and sewer systems, and (3) terminate 24-hour repair service causing severe difficulty in servicing emergency calls and repairing numerous leaks in the lines. These conditions warrant a grant of Respondents' requests for extraordinary rate relief.

Having determined that extraordinary rate relief is necessary, we must determine the appropriate level of such rate relief.

Pocono Sewer Company claims, and the Administrative Law Judge accepts, the amount of \$225,769 to be reasonable. We find this amount to be in excess of that amount necessary to meet the requirements of Section 1308(e).

#### Debt Service Requirement

In the development of the Debt Service Requirement for PSC, Respondent and the Administrative Law Judge included a "Note Payable re: Additional Investment to Meet Day-to-Day Requirements, \$75,854 at 16%" and a "Note Payable re: Additional Investment Related to Purchase of Systems, \$75,103 at 12%". At this time, we question these notes. In light of the controversy surrounding the characterization of these notes as debt, and the inadequacy of sufficient record evidence for us to determine accurately their proper characterization, we shall eliminate these items from our determination of the debt service requirement. Accordingly, we find the Debt Service Requirement of Pocono Sewer Company, for the purpose of this Petition only, to be \$174,238.

For the same reasons we shall eliminate from the Debt Service Requirement of PWC the notes designated by the Administrative Law Judge as "Note Payable re: Additional Investment to Meet Day-to-Day Requirements, \$25,146 at 16%" and "Note-Payable re: Additional Investment Related to Purchase, \$24,897 at 12%." We find the Debt Service Requirement of Pocono Water Company, for the purpose of this Petition only, to be \$57,762.

### Revenue Requirement

Respondent Pocono Sewer Company claims and the Administrative Law Judge accepts, Operating Revenues of \$247,751 and Expenses of \$227,194, resulting in "Funds Available for the Payment of Debt Service" in the amount of \$20,557. We agree with the claims made for revenues and those expenses listed in the Petition as the beginning point. Staff has proposed downward expense adjustments to adjust the claimed annualized payroll to a normal level of operation (\$20,568), and to adjust the purchased power expense claimed to the Test Year level of expense (\$4,488). Staff Brief App. B. Sch. 2, p. 1. It has been the practice of this Commission to adjust expenses which may vary from year to year in order to reflect the amount to be recovered from ratepayers in "normal" circumstances. See Pa. P.U.C. v. Philadelphia Suburban Water Company, R-79040824 (February 1, 1980). This normalized expense is then allowed for ratemaking purposes. We see no need to deviate from that practice in the present case. Respondent has further claimed a 15% increase in its purchased power costs. We find nothing within the present record to enable us to ascertain the correctness of this figure, and will eliminate this amount for the purpose of determining expenses for this case. We note that Respondent has not claimed the amount of \$9,620 representing past due bills payable to the Pennsylvania Power and Light Company (P.P.&L.). Without the services provided by P.P.&L., Respondent's operations would cease immediately. We find the payment of this bill so essential to the services provided by Respondent that we shall include this amount in expenses allowed.

In view of the foregoing, we find expenses in the amount of \$211,740 to be reasonable for our purposes here. Subtracting from Current Operating Revenues of \$247,751, the amount of expenses found reasonable (\$211,740), we find the "Funds Available for the Payment of Debt Service" to be \$36,011. Applying these available funds to our previously found Debt Service Requirement (\$174,238), we find a shortfall of \$138,227. In order to compensate Respondent for the anticipated uncollectible expense and increased P.U.C. Assessment, we find Respondent Pocono Sewer Company's Operating Revenues must be increased in the amount of approximately \$146,000.

Respondent Pocono Water Company claims and the Administrative Law Judge accepts, Operating Revenues of \$243,204 and Expenses of \$211,077. As was the case with Pocono Sewer Company, we shall accept these figures as the beginning point. Adjustments identical to those proposed and accepted by us with regard to PSC (differing only in amounts), will also be made in the case of PWC. Accordingly, we find expenses in the amount of \$192,934 to be reasonable. Performing the same calculations as those made with regard to Pocono Sewer Company and recognizing an increase in the uncollectible expense and P.U.C. Assessment, we find a shortfall in income available for debt service to be \$7,492, and the necessary increase in Operating Revenues to be approximately \$7,800; THEREFORE,

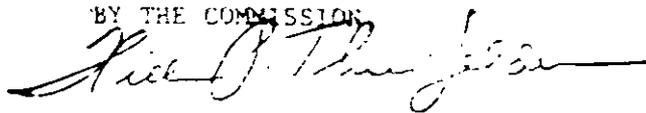
IT IS ORDERED:

1. That the Petition of Poconos Water Company for Extraordinary Rate Relief is granted to the extent of the amounts set forth in this Order, to become effective for service rendered on and after March 1, 1980.

2. That the Petition of Poconos Sewer Company for Extraordinary Rate Relief is granted to the extent of the amounts set forth in this Order, to become effective for service rendered on and after March 1, 1980.

3. That the above amounts allowed will be on an interlocutory basis, and subject to refund, pending completion and order of the Commission on the general rate increases heretofore requested by the Companies.

BY THE COMMISSION



William P. Thierfelder  
Secretary

(SEAL)

ORDER ADOPTED: February 29, 1980

ORDER ENTERED: March 3, 1980

CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission  
v.  
Philadelphia Gas Works  
Docket No. R-00017034F0002

I hereby certify that I have this day served a true copy of the foregoing document, Memorandum of Law of the Office of Consumer Advocate, 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 3<sup>rd</sup> day of April, 2002.

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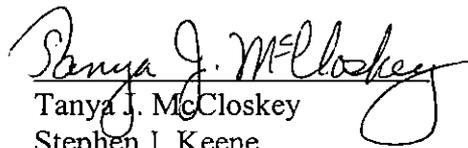
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Re: Pennsylvania Public Utility Commission v. Philadelphia  
Gas Works , Docket No. R-00017034F0002

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works enclosed for filing please find an original and nine copies of its Memorandum in Support of Petition for Extraordinary Rate Relief with regard to the above referenced matter.

All parties of record have been served as evidenced by the attached Certificate of Service.

Very truly yours,

Daniel Clearfield

For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

DC/lww  
Enclosure

- cc: Chairman Glen Thomas, w/enc.
- Vice Chairman Robert K. Bloom, w/enc.
- Hon. Aaron Wilson Jr., Commissioner, w/enc.
- Hon. Terrence J. Fitzpatrick, Commissioner, w/enc.
- Hon. Kim Pizzingrilli, Commissioner, w/enc.
- Hon. Cynthia W. Fordham w/enc.
- Karen Moury, Esq., Law Bureau, w/enc.
- Kirk House, Esq., Office of Special Assistants, w/enc.
- All Parties of Record w/enc.

DSH:31667.1/PHI211-156924

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## CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing document upon the participants listed below in accordance with the requirements of § 1.54 (relating to service by a participant).

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Dated: April 3, 2002

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

v.

PHILADELPHIA GAS WORKS

:  
:  
:  
:  
:  
:

Docket No. R-00017034-0002

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MEMORANDUM OF PHILADELPHIA GAS WORKS'  
IN SUPPORT OF PETITION FOR EXTRAORDINARY RATE RELIEF

---

**DOCKETED**

APR 05 2002

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## I. STATEMENT OF THE CASE

On February 12, 2002, Standard and Poor's ("S&P"), one of the chief credit rating agencies that evaluates municipal bonds, including those of the Philadelphia Gas Works ("PGW" or "the Company"), issued a notice which informed the financial markets generally that the bond ratings for all of PGW's senior and subordinate revenue bonds would be lowered if it did not obtain immediate cash flow improvement.<sup>1</sup> This announcement prompted PGW to prepare and file a request for extraordinary rate relief in conjunction with a base rate request filing that had been in process at the time. On February 25, 2002, PGW filed Supplement No. 17 to Tariff Gas Pa. PUC No. 1, set to become effective on April 26, 2002. At the same time, pursuant to Sections 1308(e) and 2212 of the Public Utility Code, 66 Pa. C.S. §§ 1308(e), 2212, PGW filed a Petition for Extraordinary Rate Relief ("Petition"). In the Petition, the Company requested that \$44 million of its \$60 million base rate request be approved as extraordinary rate relief in order to prevent the S&P downgrade, and the resulting disastrous consequences that such a downgrade would bring. In order to assure that the PUC had adequate time to consider its request, PGW also asked the Commission to address the Petition according to a 45 day schedule, rather than the usual statutory 30 day schedule, and to make a ruling on the Petition at the Commission's April 11, 2002 meeting. In addition, PGW requested that the Commission consider the Petition and appropriately revise the Section 1308(e) standard for relief in accordance with PGW's status as a municipally-owned and operated utility.

In support of PGW's Petition, it filed the testimony of five individuals: Thomas E. Knudsen, Interim President and Chief Executive Officer (PGW ERP St. 1); Joseph R.

---

<sup>1</sup> PGW Exh. BCB-1 (Updated). A downgrade will result in PGW's credit rating going from investment grade to junk bond status. S&P made clear that it needed a decision within 4 – 6 weeks of February 12, 2002.

Bogdonavage, Senior Vice President, Finance (PGW ERP St. 2); Gary Krellenstein, Senior Analyst and Vice President, JP Morgan Guaranty (PGW ERP St. 3); Barbara C. Bisgaier, Managing Director, Public Financial Management, Inc. (PGW ERP St. 4); and Janice Davis, Director of Finance, City of Philadelphia (PGW ERP St. 5). In addition, PGW submitted the testimony of Craig R. White, Interim COO, on the issue of rate increase allocation, but, due to a stipulation among the parties, that testimony was withdrawn.

The active parties who filed complaints with the Commission or intervened include the Office of Consumer Advocate ("OCA"), the Office of Trial Staff ("OTS"), the Office of Small Business Advocate ("OSBA"), the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") a coalition of consumer groups (hereinafter referred to as "CEPA"). In addition, PECO Energy Company and Trigen-Philadelphia Energy Corporation and Grays Ferry Cogeneration Partnership filed interventions but did not actively participate.

On March 4, 2002, the Commission issued a Secretarial Letter indicating that it would consider PGW's request at its Public Meeting scheduled for April 11, 2002. A prehearing conference was held on March 7, 2002 with ALJ Cynthia Williams Fordham ("ALJ") presiding. An informal discovery session was held at PGW's headquarters on March 13th and responsive testimony was filed on March 21, 2002, on behalf of the Office of Consumer Advocate (Richard Lelash, OCA St. ERP-1) and the Office of Trial Staff (OTS St. 1 (Weakley) and OTS St. 2 (Deardorff)). An evidentiary hearing was held on March 26th in Philadelphia.

At the hearing, the parties submitted a stipulation regarding the manner in which any authorized extraordinary rate relief would be allocated among the firm customer classes. (Attachment "D" to this Memorandum). The parties also agreed that certain portions of PGW's base rate testimony filing would be included in the record in this proceeding (PGW BRP Sts. 1 &

3, and Volume II of PGW Supporting Financial Information). This Memorandum is filed in support of PGW's request for extraordinary rate relief.

## II. INTRODUCTION AND SUMMARY

PGW and this Commission have reached a crossroads and face a decision which will determine PGW's ability to provide safe and adequate service to customers for years to come. Indeed, PGW's progress over the past two years, its ability to maintain its present levels of service, maintenance and employment, and even its ability to continue as a going concern hang in the balance. Without immediate improvement in the Company's liquidity, PGW's bonds will be downgraded to non-investment grade (i.e., "junk") and the downgrade will plunge the Company into a financial crisis of enormous proportions which will have far reaching implications for both PGW and its customers.

In order to avoid this scenario, the Commission must satisfy Standard & Poor's and grant rate relief in this proceedings which provides PGW with adequate liquidity to justify maintenance of its bond rating. The record reflects that a \$44 million rate increase is required to assure that S&P will be satisfied under the rating agency's stated criteria. The dire nature of the scenario in which PGW finds itself is not in dispute. Indeed, OTS and OCA both acknowledge that PGW requires tens of millions of dollars of extraordinary rate relief in order to meet S&P's fixed cost coverage ratio. The only dispute pertains to the magnitude of the relief required in order to avoid a junk bond downgrade as well as the source of the relief.<sup>2</sup> Unfortunately, these remaining issues, if decided incorrectly, could result in S&P taking the action that all parties have agreed should be prevented.

---

<sup>2</sup> OTS and OCA claim that a rate increase of between \$25 million (OTS) and \$35.4 million (OCA) would be adequate to avoid a downgrade, although OCA argues that one half of the relief should be in the form of a contribution from the City of Philadelphia. However, both OCA and OTS improperly apply the S&P coverage calculation, fail to provide any margin for error, and, as to OCA, require illegal and inappropriate contributions from the City. *See Section IV infra.*

For the past two years, PGW, the City of Philadelphia, the Commission and the parties have all been working strenuously to improve all phases of PGW's operations as well as its financial stability. This effort has produced real progress that has been recognized by all.<sup>3</sup> The Company's billing system has been repaired; where once it could take an hour or more to obtain access to a service representative at the Company's Call Center it now generally takes less than one minute;<sup>4</sup> the Company's collective bargaining agreement has been reformed to include the flexibility needed to maintain customer service levels; and the Company has continued to keep its natural gas costs well within industry averages. In fact, PGW's March 1, 2002 GCR decrease will more than offset any increase which might result from this proceeding.<sup>5</sup>

Despite these positive service and efficiency improvements, PGW's finances have not kept pace. Now, because PGW's very poor liquidity position has gotten much worse, it threatens not only to stop all of PGW's forward progress but also to drag the Company dramatically backwards. Due to its liquidity crisis, in the last few years, PGW has been forced to turn to a variety of one-time transactions to meet its ongoing cash needs, ranging from assistance and loans from the City, to the use of its construction fund for intra-fiscal year cash working capital infusions, to the Commission-approved retention of a GCR overcollection reserve.<sup>6</sup>

---

<sup>3</sup> See, e.g., OCA St. 1 (Lelash) at 29.

<sup>4</sup> Tr. 137.

<sup>5</sup> The recent GCR decrease would more than offset the extraordinary rate increase, leaving residential customers with slightly lower rates even after consideration of the full, \$44 million request (\$95.81/month prior to March 1 for 100 Mcf/year Residential Customer versus \$93.12/month after March 1, assuming full extraordinary rate relief). All other classes will also see net reductions.

<sup>6</sup> PGW ERP St. 5 (Davis) at 2; PGW ERP St. 4 (Bisgaier) at 8-9; Tr. 86.

The Company was attempting to continue the process of repairing its financial position by, among other things, filing for a base rate increase (for which it notified the parties and the Commission in late December 2001) when, in February of this year, Standard and Poor's announced that it had run out of patience. After putting PGW on Credit Watch (With Negative Implications) in July 2000, it announced on February 12 that the Company was in a liquidity crisis and without immediate and significant improvement in its permanent, ongoing financial position, S&P would downgrade the Company's bonds to junk status.<sup>7</sup> S&P expressed the degree of danger facing PGW, and its customers, when it stated that: "If the PUC approves an emergency rate request, Standard and Poor's will review the adequacy of the increase and determine if ratings will be affirmed or lowered."<sup>8</sup> The basis for S&P's conclusions are not conjecture but are specifically included in the record and require PGW to meet a liquidity formula under which its cash flow (essentially, net revenues) exceeds all of its fixed costs (not just its bond debt service) by a minimum ratio ranging from 1.2 to 1.3. This requirement is a lofty standard for PGW since it presently does not even meet a 1 to 1 coverage ratio. Indeed, in subsequent press statements, S&P has made clear that, right now, "given its current financial profile, [PGW doesn't] look investment grade."<sup>9</sup> As the testimony of its witnesses clearly and

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<sup>7</sup> PGW Exh. BCB-1 (S&P's February 12, 2002 "Credit Watch Update" (Attachment "A" to this Memorandum)). At least one of PGW's bonds are already at the lowest investment grade level – BBB minus. PGW witnesses testified that S&P would put all of PGW's bonds at the same, non-investment, grade if it is downgraded. PGW ERP St. 4 (Bisgaier) at 3.

<sup>8</sup> *Id.*

<sup>9</sup> PGW ERP St. 4 (Bisgaier) at 5.

consistently indicates, absent immediate and permanent cash flow improvement, PGW will be downgraded to junk bond status.<sup>10</sup>

Such a downgrade would immediately put into motion a series of negative events that would quickly lead to reduced customers service and maintenance levels, employee layoffs and a long-lasting financial crisis. Specifically:

- Because the downgrade would result in the cancellation of all or most of the Company's current short term line of credit, and keep it from selling any new bonds, in order to find the funds to keep operating safely the Company would have to:
  - 1) drastically cut back or eliminate all customer service initiatives;
  - 2) drastically cut back or eliminate all non-essential maintenance programs; and
  - 3) lay-off approximately 500 employees.
- The results would negatively effect all aspects of the Company including the Call Center, new customer hookups, improvements to the billing system, senior and low income discounted appliance repair, the continuation of district offices and continued efforts at preparation of the Company's restructuring filing, to list just a few.
- Customers would immediately feel the far-reaching effects of PGW's diminished ability to serve its customers as a result of PGW's sole remaining focus of distributing gas safely through the pipes.

There is one way, and only one way, to prevent the downgrade, and that is to provide PGW with additional revenues sufficient to allow PGW to operate as a viable enterprise and to satisfy the S&P fixed charge coverage standard (1.2 - 1.3x). A \$44 million increase is needed to meet the upper end of the range (1.28x) and to assure that PGW's investment grade rating is

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<sup>10</sup> PGW ERP St. 4 (Bisgaier) at 5 and 9; PGW ERP St. 3 (Krellenstein) at 2.

maintained.<sup>11</sup> Based upon this evidence, there should be no question that PGW has met the stringent requirements of Section 1308(e) and that extraordinary rate relief is justified.<sup>12</sup>

The fact that PGW is seeking an extraordinary rate increase does not mean that the Company and its owner, the City of Philadelphia, are not doing everything possible under the circumstances to assist in the crisis. In fact, the opposite is true. PGW has instituted a reevaluation of all of its expenditures to determine which can be deferred or revised.<sup>13</sup> It has rushed into place a collections enhancement plan that it had been formulating and preparing for several months. The City has granted back to PGW the use of the interest income on the Bond Sinking Fund to effectuate a \$20 million Forward Purchase, it has allowed PGW the use of \$45 million of loan proceeds at no interest cost to customers and has agreed to grant back that portion of its \$18 million City fee that is necessary in order to backstop PGW and to assure that it will be able to satisfy the debt service coverage covenants in its bonds (presently projected at \$7.5 million).<sup>14</sup> The City is actively investigating the feasibility of selling the Company to a private entity<sup>15</sup> and is very close to completing its nationwide search for a permanent CEO.<sup>16</sup>

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<sup>11</sup> S&P has provided no guarantee that it will maintain PGW's bond rating if only the low end of the range of the formula results is reached.

<sup>12</sup> The relief requested by PGW is just and reasonable as the PUC has applied this standard to PGW in setting just and reasonable rates for the Company in the last base rate case. Additionally, PGW has shown that the amount sought is immediately necessary to prevent drastic reductions in service, maintenance and employment. Therefore, the result adequately considers the interests of the Company and its ratepayers in avoiding this crisis.

<sup>13</sup> PGW ERP St. 1 (Knudsen) at 9-13; Tr. 129-142.

<sup>14</sup> PGW ERP St. 5 (Davis) at 2-3; Tr. 82.

<sup>15</sup> Tr. 156-158.

<sup>16</sup> Tr. 175. Unfortunately, the City is unable to do more without threatening its own financial plans. See ERP St. 5 (Davis).

While all of these steps are significant and are necessary for financial recovery or to improve efficiency, only the \$44 million in extraordinary rate relief will avoid the pending downgrade and related disastrous effects on PGW and its customers. PGW has no other sources of borrowing; it cannot obtain revenues in sufficient time (or on a sufficiently permanent basis) from any other source. Additional temporary fixes from the City will not prevent a downgrade. Whatever steps might have been taken in the past which could have avoided this situation, the Commission must deal with the Company and its problems as they exist today.

At the end of the day, PGW faces an extraordinary situation of financial distress which justifies extraordinary relief at this time. PGW acknowledges that the awarding of an extraordinary rate increase is unusual; but S&P's demand for immediate action requires the kind of unusual intervention requested here. While the Company wishes there were some alternative, there simply is no other choice and the Commission must act now to protect the interests of PGW and its customers.

**III. PGW HAS SATISFIED THE STANDARD FOR OBTAINING EXTRAORDINARY RATE RELIEF UNDER SECTION 1308(e) OF THE PUBLIC UTILITY CODE.**

**A. Introduction.**

The testimony and evidence in this proceeding, presented by PGW as well as the OCA and OTS,<sup>17</sup> clearly show that PGW has satisfied that standard in Section 1308(e) for extraordinary rate relief: 1) it faces an immediate need; 2) to maintain financial stability, which, if it is unsuccessful in doing so, will result in the utility; 3) not being able to provide normal services to its customers; 4) not being able to continue normal maintenance programs; and 5)

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<sup>17</sup> PGW Sts. 1-4; PGW Knudsen Rebuttal Exh. 1; OTS St. 1 at 3; Tr. 212-13 (Lelash).

having to reduce employees.<sup>18</sup> If these standards are met, then the utility is entitled to extraordinary rate relief consistent with the earnings standards established in the utility's prior rate proceeding without being forced to seek other alternative funding sources.<sup>19</sup> Such a result is *per se* just and reasonable.

The fact that PGW is in a state of financial instability due to a severe liquidity crisis was undisputed by the parties. This liquidity crisis has prompted Standard and Poor's to announce that if PGW's liquidity problem is not corrected immediately (i.e., within 45-60 days) it will downgrade the Company's bonds, which has created the immediate need for extraordinary rate relief. Any downgrade will plunge PGW into "junk" status. Should that downgrade occur, PGW has shown, and the OTS and OCA have concurred, that it will not be able to continue to provide normal service to its customers, will be forced to suspend and reduce normal maintenance and construction immediately, and will be compelled to take immediate steps to reduce both its union and non-union workforce in order to enable the Company to continue the 'bare bones' delivery of gas.<sup>20</sup> As confirmed by OTS witness Charles Weakley, III:

In [a]ccordance with 66 Pa. C.S.A. § 1308(e), PGW has demonstrated the immediate need for extraordinary rate relief in order to maintain financial stability. Absent immediate rate relief,

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<sup>18</sup> The relevant portion of Section 1308(e) provides: ". . . any public utility may seek extraordinary rate relief of such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment . . ." 66 Pa. C.S. § 1308(e).

<sup>19</sup> *In re Keystone Tariff Agency, Inc., et al.*, 1990 Pa. PUC LEXIS 45, \*3.

<sup>20</sup> PGW ERP St. 1 (Knudsen) at 9-13; PGW Knudsen Rebuttal Exh. 1; OTS St. 1 at 3; Tr. 213.

PGW will have to cut maintenance programs, services to customers and employee levels . . . .<sup>21</sup>

The evidence in the record shows that the only feasible way to avoid the downgrade is to provide PGW with sufficient additional rate relief so that PGW's projected fixed charge coverages, calculated using the methodology and inputs identified by S&P itself in worksheets provided to the Company,<sup>22</sup> will be adequate to maintain PGW's investment grade rating. Only by setting the rate increase to meet this target, will the PUC be able to "maintain the financial health" of the Company, the avowed goal of the Commission in awarding PGW's last base rate increase and the goal that the PUC should continue to strive to attain.

**B. PGW's Extraordinary Rate Request Is Consistent With Prior PUC Determinations While Recognizing Its Unique Status As A Municipal Utility.**

While PGW's request for extraordinary rates is consistent with prior decisions of this Commission, it also recognizes the Company's special status as a municipal utility and its almost complete dependence on external financing. In past decisions, the Commission has recognized the significance of a utility maintaining an investment grade bond rating and access to the long-term capital markets. In the context of investor-owned utilities, the Commission has stated as a matter of principle that a utility is entitled to a fair rate of return, which it measured as the level of return that provides the utility with access to the capital markets in "all except the most unusual market conditions."<sup>23</sup> Moreover, as declared by former Commissioner Helen O'Bannon,

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<sup>21</sup> OTS St. 1 at 3.

<sup>22</sup> See PGW Exh. BCB-3.

<sup>23</sup> *Pa. PUC v. Blue Mountain Consolidated Water Co.*, 1982 Pa. PUC LEXIS 160, \*3.

"[i]t is never the Commission's intention, . . . to act in a way that would adversely affect the bond rating of any company and subsequently the cost [of] acquiring capital."<sup>24</sup>

In addition, when both granting and denying extraordinary rates, the Commission has specifically emphasized the existence, or lack thereof, of a cash flow problem as a legitimate basis for doing so. In granting extraordinary rate relief to Pocono Water Company and Pocono Sewer Company, the Commission upheld a finding that such rates were necessary to ensure that debt service payments were made and to maintain the utilities' liquidity and its source of cash for both daily operating expenses and capital improvements.<sup>25</sup> Likewise, in denying the requests of Metropolitan Edison Company and the Claysville Natural Gas Company, the Commission noted that in neither case did the companies have a cash flow problem.<sup>26</sup>

Like Pocono Water and Pocono Sewer, and unlike Met Ed and Claysville, PGW faces a severe liquidity problem and an immediate need for extraordinary rates if it is to maintain its bond rating, its access to short-term and long-term debt and, consequently, its sources of funds for both capital and operating expenses. Therefore, PGW is experiencing the type of financial

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<sup>24</sup> *Pa. PUC v. Philadelphia Electric Co.*, 1976 Pa. PUC LEXIS 129, \*5.

<sup>25</sup> *Pa. PUC v. Pocono Water Co. and Pocono Sewer Co.*, R-80011059 and R-80011060, Recommended Decision (February 25, 1980) at 10-13; *Pocono Water Co. and Pocono Sewer Co. v. Pa. PUC*, R-80011059 and R-80011060, Order (March 3, 1980). Contrary to the testimony of OCA witness Richard Lelash, in which he asserted that Section 1308(e) was inapplicable to capital needs (OCA St. 1 at 27) and that the Commission had never granted extraordinary rates in order to provide capital (Tr. 230), the Commission in this case expressly awarded extraordinary rates for both capital and operating expenses.

<sup>26</sup> *Pa. PUC v. Metropolitan Edison Co.*, R-80051196 and P-80070235, Recommended Decision (August 20, 1980) at 18-19 ("In short, Met Ed does not need the immediate infusion of cash to maintain its financial stability . . . Met Ed's current financial problems consist of a lack of adequate earnings rather than cash flow"); *Pa. PUC v. Claysville Natural Gas Co.*, R-860423, Recommended Decision (November 13, 1986) at 6-7 (" . . . I find no immediate cash problem to support any 66 Pa. C.S. § 1308(e) extraordinary rate relief"). Both Recommended Decisions were adopted by the Commission.

instability required by Section 1308(e) and its Petition for Extraordinary Rate Relief is consistent with Commission precedent.<sup>27</sup>

However, PGW's need for extraordinary rates is unique in several respects as well. PGW is a municipal utility and has no investors. While it is owned by the City of Philadelphia, the City is not an investor of risk capital in the Company and has never made capital infusions to PGW.<sup>28</sup> PGW is regulated using the Cash Flow Method, which assumes that "the revenues [from] operation would be sufficient to cover the cost of operation and to essentially fund over time the capital needs of the company."<sup>29</sup> Moreover, as detailed below, PGW presently is entirely dependent upon external sources to obtain the funds it needs to finance essential construction and service improvements. As a result, it is crucially dependent on an investment grade bond rating both to access the capital markets as well as to maintain its commercial paper program, its only source of short term capital.<sup>30</sup> Thus, maintaining an investment grade bond rating is directly tied to maintaining PGW's financial stability – both short and long term.<sup>31</sup>

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<sup>27</sup> Another significant distinction exists between the facts in this case and those present in *Met Ed*. In *Met Ed*, the Commission noted that the company had experienced "no material change" in its financial condition since its last base rate case. *Metropolitan Edison Co.*, R.D. at 19. Here, S&P's February 12, 2002 notice and its threatened downgrade of PGW "without immediate cash flow improvement" constitutes a very material and dramatic change in PGW's condition since the Commission's December 6, 2001 Order in PGW's last base rate case.

<sup>28</sup> Tr. 178. The "City Equity" or fund balance on the Company's balance sheet is simply the accumulation of net earnings over 165 years, and is not ordinarily available to the City. Tr. 178-79, 225.

<sup>29</sup> Tr. 178-79; 189. In its 165 year history, there has been no material contribution directly from the City to fund assets of PGW. *Id.*

<sup>30</sup> PGW ERP St. 1 (Knudsen) at 6.

<sup>31</sup> Maintaining PGW's investment grade rating is consistent with the Commission's application of the just and reasonable test to PGW, as a Cash Flow Method company, as the PUC applied it in the Company's last base rate case. PUC Opinion and Order on

**C. PGW's Liquidity Crisis, Which Has Prompted S&P To Threaten An Immediate Downgrade To Junk Status, Is The Type Of Financial Instability Sought To Be Remedied By § 1308(e).**

1. PGW's Liquidity Crisis.

As emphasized by S&P in its February 12, 2002, Credit Watch Update, due to a variety of factors, PGW has a very poor level of liquidity – one which is "not appropriate for the current [bond] rating level."<sup>32</sup> Liquidity is the cash that all businesses need in excess of that required to pay their operating expenses, debt service, shareholder payments or, in the case of PGW, statutory fees to its owner.<sup>33</sup> Traditionally, PGW has obtained its liquidity from a number of sources: construction funds made available from the issuance of long term debt, which may be utilized by the Company in advance of expending them for construction when PGW is reasonably certain it will actually undertake the construction project in that fiscal year;<sup>34</sup> commercial paper, backed by a \$100 million Letter of Credit;<sup>35</sup> earnings booked to "fund balance" or "City Equity" which are available to PGW to fund construction;<sup>36</sup> grants from the City, such as its grant of the interest earned on the Bond Sinking Fund required by the Bond

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Reconsideration, Docket No. R-00006042 (December 6, 2001) at 30 (quoting October 4 Opinion and Order at 43-44). As \$44 million is the amount required to avoid a downgrade and maintain an investment grade rating, the Commission's authorization of an extraordinary rate increase in that amount would be just and reasonable.

<sup>32</sup> PGW Exh. BCB-1.

<sup>33</sup> As the PUC has recognized, the \$18 million City payment is required by both Section 2212(f) of the Code and an ordinance of Philadelphia City Council. *Pa. PUC v. Philadelphia Gas Works*, R-00006042, Order (October 4, 2001) at 33. The City Council's ordinance has the force and effect of a state statute. *Public Advocate v. Philadelphia Gas Comm'n*, 674 A.2d 1056, 1061 (Pa. 1996).

<sup>34</sup> PGW ERP St. 1 (Knudsen) at 8.

<sup>35</sup> *Id.* at 6.

<sup>36</sup> PGW has not, however, had positive earnings for several years.

Ordinances and held by the City;<sup>37</sup> and, to the extent that these other sources are not sufficient, cash working capital produced from rates charged to ratepayers. As indicated above, PGW, as a municipal utility, historically has been regulated by the Cash Flow Method.<sup>38</sup> The PUC found in PGW's prior rate proceeding that the Cash Flow Method provides that customers will be charged rates that will cover all of its operating expenses, debt service, and a "reasonable amount of cash working capital as determined by the Commission."<sup>39</sup>

In the last several years, the combination of insufficient rates, warmer than normal winters, extra costs incurred to repair its billing system after replacement of its legacy system, as well as the economic demographics of PGW's customer base have stretched PGW's liquidity to the breaking point,<sup>40</sup> such that, recently, it has not had sufficient ongoing revenues to cover all of its fixed costs, let alone provide for a margin in excess of those fixed obligations. The Company thus was forced to rely on a variety of one-time transactions and band aid approaches for supplying the necessary revenues and cash it needed to operate.<sup>41</sup> These fixes included: the Company's conversion of its commercial paper program from a source of contingency cash to a part of its permanent debt structure so that it is now 100% utilized (rather than being available to meet seasonal and other contingencies);<sup>42</sup> the pervasive use of the bond proceeds in its

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<sup>37</sup> PGW ERP St. 5 (Davis) at 2.

<sup>38</sup> Tr. 189-90; *Action Alliance of Senior Citizens v. Philadelphia Gas Comm'n*, 406 A.2d 1155, 1156 (Pa. Cmwlth. 1979) (Cash Flow Method defined as "tailoring [rates] to [PGW's] anticipated need for cash").

<sup>39</sup> *Pa. PUC v. Philadelphia Gas Works*, R-00006042, Order (October 4, 2001) at 11-16.

<sup>40</sup> PGW ERP St. (Knudsen) at 2-3; Tr. 119.

<sup>41</sup> PGW Exh. BCB-1; Tr. 48.

<sup>42</sup> PGW ERP St. 1 (Knudsen) at 6-7.

construction fund as a source of intra-fiscal year working capital (without the assurance that the funds will actually be expended in the fiscal year on the contemplated construction projects, as had been the case in the recent past),<sup>43</sup> and the acquisition of project revenues through the sale of future earnings on the Bond Sinking Fund via a Forward Purchase Agreement.<sup>44</sup> Most recently, after all other sources of funds and one-time transactions had been exhausted, additional assistance was needed. Accordingly, the City of Philadelphia provided the Company with a \$45 million, interest-free loan/line of credit, which originally was due to be paid back in January 2003.<sup>45</sup> In addition, as warm weather has decimated PGW's earnings in recent years,<sup>46</sup> the City has had to pledge to "grant back" the portion of the City payment, legally required by City Ordinance and Section 2212(f) of the Code, as necessary to backstop the Company's ability to meet its bond covenant debt service requirements.<sup>47</sup>

PGW's liquidity crisis has come to a head with S&P's February 12, 2002 Credit Watch Update. S&P initially placed PGW on Credit Watch (With Negative Implication) in July 2000 in recognition of the above-discussed factors, but did not change PGW's bond rating for nearly 20 months, an extremely unusual action.<sup>48</sup> As PGW financial advisor Barbara Bisgaier testified, the agency deferred definitive action while the Company pursued a variety of steps to improve

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<sup>43</sup> *Id.* at 8; Tr. 130.

<sup>44</sup> PGW ERP St. 1 (Knudsen) at 4-5; PGW ERP St. 5 (Davis) at 2.

<sup>45</sup> PGW ERP St. 5 (Davis) at 2.

<sup>46</sup> Tr. 79, 87; PGW Bogdonavage Rebuttal Exh. 2.

<sup>47</sup> PGW ERP St. 5 (Davis) at 4.

<sup>48</sup> PGW ERP St. 4 (Bisgaier) at 4.

its financial position.<sup>49</sup> But when the final results of the Company's last rate case were known, and, more decisively, when the projected effect on its earnings of the FY 2002 winter were communicated to S&P (PGW is now projecting that it will lose over \$32 million in operating margin due to warm weather in this fiscal year)<sup>50</sup> the agency was not willing to wait any longer.<sup>51</sup> PGW was informed that it needed to obtain extraordinary rate relief providing additional, permanent revenues. The factors listed in S&P's Notice for the downgrade were PGW's lack of liquidity and reliance on restricted funds, weak fixed charge coverage, potential inability to meet legal debt requirements, the limited ability of the City of Philadelphia to assist the Company, PGW's continuing problems with reducing levels of account receivables and a warmer than normal winter which will strain any remaining mechanisms supporting fulfillment of bond coverage ratios in the next two years.<sup>52</sup> Given PGW's mandatory obligations over the next 18 months, S&P has determined that PGW will not be able to maintain the level of liquidity which is required for an investment grade bond rating. S&P warned, "[W]ithout immediate cash flow improvement, ratings [on PGW bonds] will be lowered."<sup>53</sup>

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<sup>49</sup> PGW ERP St. 4 (Bisgaier) at 3-4.

<sup>50</sup> Tr. 79; PGW Bogdonavage Rebuttal Exh. 2.

<sup>51</sup> PGW ERP St. 1 (Knudsen) at 4.

<sup>52</sup> PGW ERP St. 1 (Knudsen) at 3; Exh. BCB-1.

<sup>53</sup> PGW Exh. BCB-1.

## 2. S&P's Fixed Cost Coverage Requirements.

In a nearly unprecedented move, S&P has provided PGW and the Commission with the coverage formula, standards and inputs it is using to evaluate the Company.<sup>54</sup> This information is contained in PGW Exhibit BCB-3 and was explained by PGW witness Barbara Bisgaier:

[T]hey [S&P] (along with Moody's) have expressed concern that PGW's coverage, after payment of operating expenses, of its fixed obligations has been and will continue to be less than 1, absent reliance on non-recurring revenues. They make a fairly simple calculation of this "fixed cost coverage ratio." They subtract operating expenses and depreciation from revenues to obtain the amount available to pay fixed costs. They define these fixed costs as debt service on the 1975 ordinance bonds and the 1998 ordinance bonds, the capital lease payments, interest on the commercial paper and the \$18 [million] payment to the City of Philadelphia. To this they have added an additional \$20 million annual reduction in the commercial paper program.<sup>55</sup>

Ms. Bisgaier clearly stated that the purpose of S&P's formula was: "to insure that the entity that [S&P is] rating has sufficient liquidity to withstand a variety of exigencies."<sup>56</sup> Ms. Bisgaier testified further that, using the fixed cost coverage analysis, S&P had indicated that the standard for an investment grade rating for PGW was a fixed cost coverage of at least 1.2 to 1.3 times.<sup>57</sup>

S&P's analysis provides quantitative evidence of the Company's present liquidity crisis. The analysis shows a fixed cost coverage ratio for PGW for FY 2002 of .88 well below the 1.2x to 1.3x range needed to maintain an investment grade rating.<sup>58</sup> Indeed these data show that, for

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<sup>54</sup> Previously, S&P only alluded to these standards in discussing PGW's rating. Tr. 57.

<sup>55</sup> PGW ERP St. 4 (Bisgaier) at 4-5; *see* PGW Exh. BCB-3 (Attachment "B" to this Memorandum).

<sup>56</sup> PGW ERP St. 4 (Bisgaier) at 5.

<sup>57</sup> *Id.*

<sup>58</sup> PGW Exh. BCB-3; PGW ERP St. 4 (Bisgaier) at 5. The FY 2003 S&P calculation, even with a \$30 million emergency rate increase, still shows a .97 coverage. *Id.*

both FY 2002 and FY 2003, PGW will not even be able to cover its fixed obligations, one time, to say nothing of having cash or liquidity in excess of those fixed obligations to handle cash flow leads and lags or contingencies such as continued warmer weather.

PGW's witness Joseph R. Bogdonavage confirmed this analysis, showing that an application of the S&P formula to its actual experience as of March 2002 and projected operations for the remainder of the year, produced a coverage ratio of just .77.<sup>59</sup> Looking at the actual FY 2002 numbers, revised to account for a grant back of approximately \$7.5 million of the City fee which will be necessary in order for PGW to meet its bond covenant requirements, as well as the receipt of \$20 million from the City-provided Forward Purchase, PGW's fixed charge coverage is still just .83.<sup>60</sup>

Viewing these coverage ratios, PGW witness Bisgaier summarized the Company's perilous position: "Absent the grant of emergency rate relief so that this fixed cost coverage ratio [1.2-1.3] can be achieved on a permanent ongoing basis, Standard & Poors will take negative credit action within the next two months."<sup>61</sup>

3. If PGW is Downgraded, It Will Be Plunged Into A Financial Crisis Which Will Result In Service Degradations, Maintenance Cutbacks And Layoffs.

If PGW is not afforded sufficient extraordinary rate relief, S&P will downgrade its bonds to non-investment grade level. At least one of PGW's long term bonds and its commercial paper are already at the lowest "investment" grade of BBB minus; therefore a downgrade will clearly

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<sup>59</sup> PGW Exh. JRB-2 (corrected); PGW Bogdonavage Rebuttal Exh. 1 (both of which are included as Attachment "C" to this Memorandum).

<sup>60</sup> PGW Bogdonavage Rebuttal Exh. 1. This calculation assumed that PGW would bill approximately \$8 million in FY 2002 as a result of the award of \$44 million in extraordinary rate relief. Tr. 80.

<sup>61</sup> PGW ERP St. 4 (Bisgaier) at 5.

put these credits at non-investment level.<sup>62</sup> Moreover, Ms. Bisgaier testified that since the financial criteria that S&P will utilize to evaluate PGW is known, it is a certainty that if, after PUC action, the Company is not able to show that its fixed charge coverages are in 1.2-1.3x area, all of its bonds will be downgraded to junk status.<sup>63</sup> Indeed, one of the S&P analysts that is assigned to monitoring PGW has publicly stated that "given [its] current financial profile, [PGW does not] look investment grade."<sup>64</sup>

If the Company is downgraded by S&P, it will enter a downward financial spiral and an operational crisis that will cripple its ability to perform even the most basic customer service and routine maintenance functions. PGW witnesses Knudsen, Bisgaier and Krellenstein documented the additional financial chaos that would result from a downgrading by S&P. These additional financial consequences of an S&P downgrade were recognized by the OTS and went unchallenged by the OCA.<sup>65</sup>

First, PGW has already lost a source of desperately needed working capital in the form of a new Forward Purchase Agreement for the Sinking Fund Reserve earnings.<sup>66</sup> The Company had been working on such a transaction and anticipated that it would yield \$20 million of cash during the spring of 2002, cash that the City had agreed to allow PGW to retain.<sup>67</sup> As a result of

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<sup>62</sup> PGW ERP St. 4 (Bisgaier) at 3

<sup>63</sup> *Id.* at 5 and 9. Ms. Bisgaier's opinion is based upon over 10 years of interacting with S&P on PGW and other clients as well as specific conversations with the relevant analysts at S&P. Tr. 45-48.

<sup>64</sup> PGW ERP St. 4 (Bisgaier) at 5, (quoting, *The Bond Buyer*, February 21, 2002).

<sup>65</sup> OTS St. 1 (Weakley) at 3; Tr. 212-213.

<sup>66</sup> PGW ERP St. 1 (Knudsen) at 4-5.

<sup>67</sup> *Id.*; PGW ERP St. 5 (Davis) at 2.

the S&P Credit Watch Update, the transaction is now on hold until a determination is made that PGW will retain its investment grade rating.<sup>68</sup>

In addition to the potential loss of the \$20 million Forward Purchase Agreement, PGW would likely immediately be downgraded by the other two rating agencies, Moody's and Fitch, as they would understand the impacts of the S&P downgrade.<sup>69</sup> In any event, however, the S&P downgrade would result in the loss of a majority if not all of the banks participating in the Letter of Credit backing up PGW's commercial paper, its sole source of short-term debt, when the Letter of Credit comes up for renewal in August of this year.<sup>70</sup> As stated by Ms. Bisgaier and Mr. Krellenstein, of JP Morgan Chase Bank, in 2001, PGW faced great difficulty in securing the renewal of the Letter of Credit behind its commercial paper program. While the Company was able to renew the Letter of Credit, it was required to reduce the available balance of outstanding commercial paper by \$20 million by the end of FY 2002 and the annual fee more than doubled.<sup>71</sup>

In the event of the S&P downgrade, Ms. Bisgaier and Mr. Krellenstein testified that, in their professional opinions, the majority of banks, with the possible exception of Morgan Guaranty Trust, will withdraw from the Letter of Credit when it expires in August 2002.<sup>72</sup> As a result, the Letter of Credit will be reduced from \$100 million to no more than \$30 million, and

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<sup>68</sup> PGW ERP St. 1 (Knudsen) at 4-5; PGW ERP St. 4 (Bisgaier) at 9.

<sup>69</sup> PGW ERP St. 4 (Bisgaier) at 6.

<sup>70</sup> PGW ERP St. 3 (Krellenstein) at 3-4; PGW ERP St. 4 (Bisgaier) at 7.

<sup>71</sup> PGW ERP St. 4 (Bisgaier) at 6. Of the amount received by PGW in the last base rate case, \$20 million in intended cash flow went back to the banks and not to the Company to pay bills. PGW must be allowed to keep its access to the maximum amount of short term debt under any circumstances.

<sup>72</sup> *Id.* at 6-7; PGW ERP St. 3 (Krellenstein) at 3-4.

potentially less.<sup>73</sup> Consequently, PGW will be forced to pay down at least \$70 million of commercial paper as it matures – without any ability to do so.<sup>74</sup> PGW will then have to draw on the Letter of Credit for the amount not renewed and the liability will be transformed into an immediately payable demand note held by the banks. PGW will then have to try to enter into a loan workout agreement to pay off the demand note, with interest being due and owing to the banks at a taxable rate.<sup>75</sup> If the other rating agencies had not immediately followed S&P and downgraded PGW's bonds to junk status, they would certainly do so at this point.

Moreover, regardless of the nature of the Letter of Credit repayment workout, the evidence shows that the downgrade to junk status will make it impossible for PGW to sell bonds or access the capital markets.<sup>76</sup> PGW issues bonds to fund 100% of its construction program.<sup>77</sup> As PGW witness Knudsen testified, those capital needs include \$35-\$40 million of construction that is required annually at a minimum in order to maintain the safety and reliability of PGW's system.<sup>78</sup> Significantly, the Company also utilizes the proceeds of its bond issuances as a source of interim liquidity that enables it to meet its debt service and gas supply obligations.<sup>79</sup> PGW

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<sup>73</sup> The first \$20 million reduction has already been mandated. PGW ERP St. 4 (Bisgaier) at 6-7. Given the current "liquidity crisis" in the market, generally, as described by Mr. Krellenstein, Morgan is facing a greater demand for its commercial paper facilities and could simply choose to leave PGW for a more attractive applicant, and even it would have to seriously consider canceling the arrangement. Tr. 118.

<sup>74</sup> PGW ERP St. 4 (Bisgaier) at 7.

<sup>75</sup> *Id.* at 8.

<sup>76</sup> PGW ERP St. 1 (Knudsen) at 8; PGW ERP St. 4 (Bisgaier) at 8-9; Tr. 116-117.

<sup>77</sup> PGW ERP St. 1 (Knudsen) at 8; PGW Exh. TEK-1.

<sup>78</sup> Tr. 131; PGW Knudsen Rebuttal Exh. 1.

<sup>79</sup> PGW ERP St. 1 (Knudsen) at 8.

had intended to sell its next series of bonds in December 2002. If PGW does not receive an extraordinary rate increase sufficient to avert a downgrade by S&P, it will not be able to issue new bonds,<sup>80</sup> and therefore will have no means of funding even the most critical of its capital requirements. Moreover, without the ability to borrow from the new issuance in January 2003, PGW will totally miss the first of two debt service payments next fiscal year.

The result of an S&P downgrade therefore would be the loss of the Forward Purchase, the almost immediate loss of all short-term borrowing capability, the creation of a \$50-70 million immediate repayment obligation, and the inability to access the bond market, its only source of funds for keeping the gas system operating safely and reliably.

**D. If A Bond Rating Downgrade Is Not Averted, PGW And Its Customers Will Suffer Customer Service Degradations, Maintenance Cutbacks And Layoffs.**

In light of the above, PGW's response to a bond downgrade will be swift and painful. If the Company's bonds are downgraded, Mr. Knudsen testified that the Company would immediately implement a crisis plan designed to try to keep the Company providing bare bones gas service to customers for as long as possible.<sup>81</sup> As indicated above, PGW's analysis shows that it must spend \$35-40 million in distribution system construction (such as cast iron main replacement, leak repair, etc.) that could not be put off without threatening the safety and

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<sup>80</sup> *Id.*; PGW ERP St. 4 (Bisgaier) at 8-9; PGW ERP St. 3 (Krellenstein) at 3.

<sup>81</sup> Significantly, Section 1308(e) only requires a showing that "normal" service and maintenance would be reduced, and does not require that PGW no longer be able to provide "safe" or "safe and reliable" service (OCA St. 1 at 6 and 8). OCA witness Lelash asserts in his direct testimony that "even with a bond downgrading, the Company appears to acknowledge that it could take proactive measures in order to respond to the ensuing crisis and continue to operate." OCA St. 1 at 7. The Commission should recognize two flaws in the OCA's analysis: (1) not being able to continue to operate is not the standard that PGW must meet in order to qualify for extraordinary rates – reductions in "normal" service and maintenance is the standard; and (2) the "proactive measures" that the OCA emphasizes PGW would take are the very reductions in services, maintenance and employment that are a predicate for relief under Section 1308(e).

reliability of the system.<sup>82</sup> In addition to the payroll costs of distribution maintenance employees, the billing and collection staff would have to be continued. When these absolutely necessary expenditures are combined with the need to continue to pay debt service on its long term debt, as well as to replace the cash anticipated from the Forward Purchase and to repay its short term commercial paper obligations, Mr. Knudsen estimated that PGW would be facing approximately \$100 million in obligations and cash needs in the first 6 - 12 months following the downgrade, with at least half of that amount required in subsequent years as well.<sup>83</sup> In order to find the dollars to fund these obligations, PGW would have to take steps to terminate virtually all discretionary or nonessential activities and customer services including: eliminating discounted appliance repair to low income customers; reducing call center access to the bare minimum necessary to handle emergency calls; closing the Company's five district offices; seeking waivers of Chapter 56 obligations to enter into payment agreements with non-paying customers and to waive prohibitions against terminations for non-payment; suspending customer complaint response and investigation activities; suspending low income outreach programs; suspending new customer service line installations; suspending BCCS (billing system) enhancement activities; suspending AMR battery replacement activities; and suspending all efforts to prepare and file the Company's restructuring filing.<sup>84</sup> In addition, the Company would be forced to suspend all non-safety related construction, including the portion of the cast-iron main

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<sup>82</sup> Tr. 131; PGW ERP St. 1 (Knudsen) at 9-13. PGW Knudsen Rebuttal Exh. 1 (Answer to OCA Set II-3).

<sup>83</sup> *Id.*; Tr. 129-32.

<sup>84</sup> PGW Knudsen Rebuttal Exh. 1.

replacement maintenance program that is not essential to proactively preventing leaks or system failures.<sup>85</sup>

The largest bulk of the savings that would result from suspending the above activities and programs would stem from the payroll and related expense reductions that PGW would realize by laying off all non-essential personnel. Mr. Knudsen estimated that to try to free up the dollars needed to meet debt service and other financial obligations to fund needed construction and keep the system operating, it would be necessary to lay off approximately 500 employees – both management and union.<sup>86</sup> PGW's present union collective bargaining agreement has a "no lay-off" clause that protects all but about 75 union workers.<sup>87</sup> However, that contract may be altered or amended if the Company obtains an order from a regulatory body with jurisdiction over PGW. PGW presently is preparing an application for approval to waive this portion of the collective bargaining agreement in the event that PGW does not receive adequate extraordinary rate relief and S&P downgrades it to junk status.<sup>88</sup> These lay-offs were projected to save approximately \$25 million on net.<sup>89</sup> With another \$5 -10 million savings possible from cut-backs in non-labor costs,<sup>90</sup> PGW would not even be able to satisfy the first year cash deficiency of \$100 million, to say nothing of subsequent years.

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<sup>85</sup> *Id.*; PGW ERP St. 1 (Knudsen) at 10-11.

<sup>86</sup> Tr. 131.

<sup>87</sup> Tr. 133.

<sup>88</sup> Tr. 133 and 166-67.

<sup>89</sup> A targeted layoff in the range of 500 persons would produce savings of \$24-30 million less approximately \$5-6 million in unemployment costs (PGW self-insures) and required outsourcing. The targeted layoff range includes both union and non-union personnel. PGW Knudsen Rebuttal Exh. 1, Answer to OCA Interr. Set II-3(e).

<sup>90</sup> *Id.*

Just as concerning, however, taking the steps listed above would drastically reduce services below their present, normal levels, result in cut backs on existing maintenance programs and significantly reduce employment. Mr. Knudsen explained PGW's mission under these circumstances: "In short, we would focus only on assuring that gas flows through the mains and services and that we bill and collect – that is all!"<sup>91</sup> Any employees who are not directly related to this stripped-down mission of PGW would be laid-off – and still the Company would not be able to finance its cash deficiency for very long.

Granting PGW an extraordinary rate increase based on the above showing is clearly warranted and is consistent with the Commission's prior decisions on extraordinary rate requests. Similar to PGW, Pocono Water Co. and Pocono Sewer Co. were found by the Commission to have satisfied the elements of Section 1308(e) because they reduced their workforce, discontinued needed maintenance and improvements to their water and sewer systems, and eliminated important services such as their 24 hour repair service.<sup>92</sup> The record here sets forth the exact same types of reductions in employees, construction and system improvements, and important services.<sup>93</sup>

In contrast, and unlike PGW, the utilities in *Met Ed.* and *Claysville Natural Gas* failed to demonstrate any linkage between their financial instability and reductions in service, maintenance and employment. In *Met Ed.*, the Commission observed that Met Ed's president

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<sup>91</sup> PGW ERP St. 1 (Knudsen) at 11.

<sup>92</sup> *Pa. PUC v. Pocono Water Co. and Pocono Sewer Co.*, R-80011059 and R-80011060, Order (March 3, 1980) at 3; *Id.*, Recommended Decision (February 25, 1980) at 8-13.

<sup>93</sup> PGW ERP St. 1 (Knudsen) at 9-13; PGW Knudsen Rebuttal Exh. 1. While these service and employment reductions are planned if a downgrade occurs, such anticipated action is covered by Section 1308(e) which uses such anticipatory terms as "continuing" to provide normal service and "avoiding" reductions in maintenance or employment. *See* 66 Pa. C.S. § 1308(e).

"could give no definite plan" of the reductions in the statutory categories that would occur if the extraordinary rate relief was not granted.<sup>94</sup> Mr. Knudsen's testimony for PGW was exactly to the contrary, providing a detailed plan for such reductions. Additionally, Met Ed witnesses testified that its level of employees was sufficient to provide quality service, but that a problem could have arisen if the level persisted "over a period of several years."<sup>95</sup> The company merely planned to lose 40 employees over a period of 12 months due to attrition.<sup>96</sup>

The Commission found a similar lack of impact on service, maintenance and employment in *Claysville Natural Gas* where it adopted a finding that "service is about as normal as it has been over several years, normal maintenance is continuing and no employment reductions are contemplated."<sup>97</sup> Indeed, Claysville was planning to hire additional employees, not reduce employees.<sup>98</sup> In contrast, PGW has already reduced normal operations in anticipation of the potential emergency, suspending new hires and putting service improvement projects on hold, pending the outcome of this case.<sup>99</sup>

Moreover, PGW has shown that the consequences of a downgrade will be long lasting and extremely difficult to reverse. As PGW witness Krellenstein testified, if the Commission fails to award PGW sufficient extraordinary rates and a downgrade occurs, an upgrade will not

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<sup>94</sup> *Pa. PUC v. Metropolitan Edison Co.*, R-80051196 and P-80070235, Recommended Decision (August 20, 1980) at 16.

<sup>95</sup> *Id.* at 14.

<sup>96</sup> *Id.*

<sup>97</sup> *Pa. PUC v. Claysville Natural Gas Co.*, R-860423, Recommended Decision (November 5, 1986) at 9. The Decision was adopted by Order of the Commission dated November 13, 1986.

<sup>98</sup> *Id.* at 6.

<sup>99</sup> PGW ERP St. 1 (Knudsen) at 9-13; PGW Knudsen Rebuttal Exh. 1; Tr. 127-140.

be automatic or even follow quickly upon the later granting of additional rates.<sup>100</sup> For example, in one instance after being downgraded, a municipal utility was locked out of the bond market for a period of seven years.<sup>101</sup> Further, when PGW does return to investment grade, it will still face substantially higher financing costs for many years, which will negatively impact customer service and ultimately be passed on to consumers.<sup>102</sup> PGW must be awarded sufficient extraordinary rates if these very serious and damaging consequences to both the Company and its customers are to be avoided.

**E. PGW's Need For Extraordinary Rates Is Immediate and Concrete.**

Based on their numerous conversations with S&P, as well as their extensive experience<sup>103</sup> in working with the rating agencies, PGW witness Knudsen and experts Bisgaier and Krellenstein all confirmed that PGW must be afforded extraordinary rate relief of \$44 million within the time lines of this proceeding if it is to avoid an S&P downgrade and its impacts, and the PUC will not be able to repair the damage by granting a rate increase in the base rate proceeding.<sup>104</sup> No party offered any evidence or argument in the record that questioned S&P's threat to downgrade or the immediacy of PGW's need for additional, permanent revenues.

While OCA witness Lelash mildly implied in his direct testimony that the S&P downgrade threat, and therefore PGW's need for extraordinary rates, was speculative, his

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<sup>100</sup> PGW ERP St. 3 (Krellenstein) at 3-4.

<sup>101</sup> Tr. 117.

<sup>102</sup> PGW ERP St. 3 (Krellenstein) at 4.

<sup>103</sup> PGW ERP St. 3 (Krellenstein) at 1; PGW ERP St. 4 (Bisgaier) at 1-2; Tr. 46-47 and 115.

<sup>104</sup> PGW ERP St. 1 (Knudsen) at 4; PGW ERP St. 4 (Bisgaier) at 5; PGW ERP St. 3 (Krellenstein) at 3.

insinuation could not be more incorrect.<sup>105</sup> First, the text of the S&P Credit Watch Update relied on by Mr. Lelash for this assertion states: "If the PUC approves an emergency rate request, Standard and Poor's will review the adequacy of the increase and determine if ratings will be affirmed or lowered."<sup>106</sup> Contrary to showing that PGW's need for extraordinary rates is speculative, this quote from S&P demonstrates that PGW's need is concrete and absolute if a downgrade is to be avoided. The only source of speculation in the S&P notice is whether PGW is downgraded even if extraordinary rates are granted; i.e., if the Commission cuts PGW's request too close and grants it insufficient extraordinary rates.<sup>107</sup>

In addition to showing the immediacy of the threatened S&P downgrade, and thus the need for extraordinary rates, PGW has also conclusively demonstrated the immediacy of the negative impacts on service, maintenance and employment that would occur upon being downgraded. Indeed, PGW witness Knudsen testified that PGW was already taking action to reduce expenses related to service, maintenance and construction, and extensively detailed the immediate steps that PGW would implement to husband cash by reducing customer service, ceasing non-essential construction and maintenance, and terminating substantial numbers of employees if a downgrade actually occurs.<sup>108</sup>

Importantly, the fact that, if downgraded, PGW would immediately act to reduce drastically normal service levels; stop all but safety and reliability related maintenance and

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<sup>105</sup> OCA St. 1 (Lelash) at 6.

<sup>106</sup> *Id.* (emphasis added).

<sup>107</sup> Mr. Krellenstein testified, based upon his extensive knowledge and experience, that if the PUC grants all or substantially all of PGW's request, the chances of S&P nonetheless downgrading the Company are "extremely unlikely." Tr. 121-22.

<sup>108</sup> PGW ERP St. 1 (Knudsen) at 9-13; PGW Knudsen Rebuttal Exh. 1; Tr. 127-140.

construction, and layoff employees was not challenged on the record by any party. Significantly, the OTS witness admitted the immediacy of such reductions, and the OCA witness acknowledged that he did not dispute the fact that PGW would promptly take the actions described by PGW witness Knudsen.<sup>109</sup>

The immediate need and immediate negative effects on PGW's service, maintenance and employment levels which would occur absent extraordinary rates stands in sharp contrast to the lack of immediacy demonstrated in instances where the Commission has denied extraordinary rates. In *Pa. PUC v. Metropolitan Edison Co.*, the Commission emphasized the fact that Met Ed's financial condition was projected to remain stable for eight to nine months when it would face a state tax payment.<sup>110</sup> The Commission stated, "Met Ed does not need the immediate infusion of cash to maintain its financial stability; it faces no immediate emergency."<sup>111</sup> The Commission also noted that Met Ed would only be reducing 40 employees through attrition over a 12 month period.<sup>112</sup>

Likewise, in *Pa. PUC v. Claysville Natural Gas Co.*, the Commission found that Claysville had failed to show an "immediate service problem to support approval" of its petition, "no immediate need for rate relief to avoid reductions in normal maintenance," and "no immediate cash problem to support any . . . extraordinary rate relief."<sup>113</sup> As evidenced by the

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<sup>109</sup> OTS St. 1 (Weakley) at 3; Tr. 212-13 (Lelash).

<sup>110</sup> *Metropolitan Edison Co.*, R-80051196 and P-80070235, R.D. (August 20, 1980) at 18.

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 14.

<sup>113</sup> *Claysville Natural Gas Co.*, R-860423, R.D. (November 5, 1986) at 5-7. Significantly, *Claysville* demonstrates the costly price of miscalculating a utility's need for extraordinary rates or the immediacy of that need. Approximately one month after the

testimony of PGW witness Knudsen, PGW's circumstances are starkly different from the facts in the cited cases, and the immediacy of its need for the requested \$44 million in extraordinary rates has been conclusively shown.<sup>114</sup>

**F. PGW's Need For Extraordinary Rates Was Not Challenged On The Record.**

Significantly, both the OTS and OCA acknowledged the fact that PGW has satisfied the requirement in Section 1308(e) to show that immediate extraordinary rates are needed to continue to provide normal service and avoid reductions in normal maintenance and employment. OTS witness Weakly expressly confirmed PGW's showing in his direct testimony, and further stated that, in his opinion,

PGW has demonstrated the immediate need for extraordinary rate relief in order to maintain financial stability. Absent immediate rate relief, PGW will have to cut maintenance programs, services to customers and employee levels . . . .<sup>115</sup>

Mr. Weakley also confirmed that PGW had no other option for avoiding a downgrade by S&P and the related Section 1308(e) events other than to receive an extraordinary rate increase.<sup>116</sup> OCA witness Lelash also agreed that, assuming an S&P downgrade and the related negative financial consequences – which assumptions he stated he did not contest – PGW's customer service, maintenance and employment reductions "would be required."<sup>117</sup> The OCA further concurred with PGW that much if not all of the progress and improvement in PGW's

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Commission's rejection of extraordinary rate relief to Claysville Natural Gas, the company filed for bankruptcy. R-860423 (February 17, 1987).

<sup>114</sup> See, PGW ERP St. 1; Knudsen Rebuttal Exh. 1.

<sup>115</sup> OTS St. 1 (Weakley) at 3.

<sup>116</sup> *Id.*; Tr. 194.

<sup>117</sup> Tr. 212-13.

customer service functions that the Company, the Commission and the parties have worked so hard to achieve over the past two years would be lost in the event of a downgrade and the subsequent steps that would be necessary to address the same.<sup>118</sup>

**G. PGW Has Justified The Requested Level Of Emergency Rate Relief.**

1. The Level of Extraordinary Rate Relief Should be Sufficient to Maintain PGW's Financial Health By Avoiding a Bond Downgrade to Junk Status.

Once a utility has demonstrated that it meets the 1308(e) "need" standard, it must then establish the level of emergency rate relief that is authorized by the statutory section. The statute states that the extraordinary rate relief shall "provide no more than the rate of return on the utility's common equity established by the [C]ommission in consideration of the utility's preceding rate filing."<sup>119</sup> As the OTS expressly recognized, this rate of return on equity standard obviously is not applicable to a municipal utility such as PGW, which is regulated on the basis of the Cash Flow Method.<sup>120</sup> The Gas Choice Act gives the PUC the explicit authority to waive or amend any provision of the Code in order to translate a Public Utility Code provision to make it applicable to a municipal utility that is regulated differently than investor-owned utilities.<sup>121</sup> The most appropriate way in which to "translate" this investor-owned utility standard into a standard that would sensibly apply to PGW is to examine the Commission's intent in establishing the revenue requirement for PGW in its last base rate proceeding. The Commission's Order of December 6, 2001, succinctly stated the purpose and goal of its base rate decision:

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<sup>118</sup> OCA St. 1 (Lelash) at 29.

<sup>119</sup> 66 Pa.C.S. § 1308(e).

<sup>120</sup> OTS St. 1 (Weakley) at 2; PGW ERP St. 1 (Knudsen) at 14.

<sup>121</sup> 66 Pa. C. S. § 2212(c).

In our October 4 Order, we specifically found that a \$39 million increase in base rate revenues (later corrected to \$33.5 million in our October 12 Order) will provide PGW with adequate revenues "to ensure that PGW is able to maintain an adequate of level of financial health require[d] to fund operations and meet debt service requirements."<sup>122</sup>

Maintaining the Company's financial health so that it can continue to fund operations is essential if the Company is to "maintain its existing external financing and to continue to raise new capital."<sup>123</sup> As discussed in detail above, a bond rating downgrade to junk bond status would completely eliminate PGW's ability to "maintain its existing external financing and continue to raise capital," and, in turn, eliminate its ability to fund operations and meet debt service requirements. Accordingly, the level of extraordinary rate relief necessary to satisfy the modified standard that should be applicable to PGW is the amount needed to maintain PGW's bond rating at investment grade.<sup>124</sup>

2. PGW Needs \$44 Million In Additional Annual Revenues To Satisfy S&P's Coverage Test and Avoid a Downgrade to "Junk Bond" Status.

PGW Witness Bogdonavage provided an analysis of the Company's existing and projected financial position for the purposes of determining the degree to which it satisfied the S&P's coverage test.<sup>125</sup> Based on the detailed analysis provided by Ms. Bisgaier, Mr. Bogdonavage calculated PGW's current coverages using the S&P fixed charge coverage ratio method for the actual 2001-2002 period. He also calculated the coverages that the

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<sup>122</sup> PUC Opinion and Order on Reconsideration, Docket No. R-00006042 (December 6, 2001) at 30 (quoting October 4 Opinion and Order at 43-44).

<sup>123</sup> PGW ERP St. 1 (Knudsen) at 14.

<sup>124</sup> Alternatively, if one were to consider end-of-year, cash balances, with a \$44 million rate hike, PGW's FY 2002 end-of-year balance would be just \$7 million positive even including the effects of the one-time forward purchase and City fee grant back. Tr. 84.

<sup>125</sup> See Section III.C.2 of this Memorandum, *supra*.

Company would experience on a fully forecasted test year basis, the same basis on which PGW is supporting its base rate request, and assuming that PGW received the requested, \$44 million extraordinary rate request.<sup>126</sup> The results of these calculations are shown on Exhibit JRB-2 (corrected).

Mr. Bogdonavage's revenue requirement calculation was designed to produce coverages within the 1.2x-1.3x range demanded by S&P to maintain an investment grade rating, but are intentionally designed to approach the top of the range in order to build in a margin of error.<sup>127</sup> That calculation shows that a \$44 million rate increase would produce just 1.28x coverage,<sup>128</sup> with this figure falling below 1 if repayment of the \$45 million City loan in August is considered.<sup>129</sup> Importantly, Mr. Bogdonavage calculated the coverage produced by a \$44 million rate increase utilizing the exact S&P fixed charge coverage ratio calculation and inputs that Ms. Bisgaier testified, without contradiction, were utilized by the rating agency to evaluate PGW's financial performance.<sup>130</sup> Accordingly, this schedule should be used to determine PGW's extraordinary rate award and fully justifies the Company's \$44 million claim.

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<sup>126</sup> PGW ERP St. 2 (Bogdonavage) at 2-3. The use of the fully forecasted test year is intended to reflect Company operations on a normalized, going forward basis. *Id.*

<sup>127</sup> The need for such a margin was plainly evidenced by S&P's declaration that, "if the PUC approves an emergency rate request," it will still evaluate PGW to determine if ratings should be lowered. PGW Exh. BCB-1. Thus, it is clear that an increase which cuts the coverage ratio too close is too risky and should be rejected, as it will not ensure the avoidance of a downgrade.

<sup>128</sup> PGW Exh. JRB-2 (corrected).

<sup>129</sup> PGW ERP St. 2 (Bogdonavage) at 3.

<sup>130</sup> That calculation includes payment of the \$18 million City fee as well as an assumed \$20 million pay down of the Company's outstanding commercial paper levels in both FY 2002 and FY 2003. PGW Exh. BCB-3. While some of the parties, either directly or indirectly, have taken issue with this calculation methodology, these disagreements must be rejected. Calculating an S&P compliant coverage level without including these items,

3. The Requested Extraordinary Rate Relief is Consistent with the Just and Reasonable Rates Standard.

The proposed modified standard combined with the other requirements of Section 1308(e) will also ensure that the extraordinary rates requested by PGW and awarded by the Commission are just and reasonable. First, Section 1308(e) states that the Commission will set extraordinary rates consistent with a standard that was found to produce just and reasonable rates in the utility's immediately prior base rate case. Second, by requiring a showing by the utility that extraordinary rates are immediately necessary to avoid consumer harm via service, maintenance and employment reductions, Section 1308(e) implicitly balances the interests of consumers and the utility and concludes that a rate increase is in the best interests of all parties.

As detailed herein, PGW has satisfied Section 1308(e) and shown that an S&P downgrade will decimate its financial health and harm customers via the resultant degradations in service, maintenance and employment. Therefore, the Company's requested extraordinary rate relief is just and reasonable as it is necessary to avoid those consequences. Moreover, as referenced above, in applying the just and reasonable standard in a Cash Flow Method context in PGW's last base rate case, the Commission focused on maintaining the Company's fiscal health so that it could fund operations and continue to access external financing and raise new capital.<sup>131</sup> This just and reasonable goal can only be achieved by averting a downgrade, and a downgrade can only be averted by granting PGW's Petition and its requested \$44 million extraordinary rate increase.

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or the other items set out in the S&P worksheet, would create serious concern that the resulting rate increase would be deemed insufficient to maintain PGW's investment grade.

<sup>131</sup> PUC Opinion and Order on Reconsideration, Docket No. R-00006042 (December 6, 2001) at 30 (quoting October 4 Opinion and Order at 43-44).

**H. PGW And The City Have Taken Significant Steps To Contribute To Solving The Crisis Justifying Extraordinary Rate Relief.**

While there is no specific statutory requirement to do so, it may be argued that all involved parties should participate in the recovery of a utility that is faced with a situation justifying extraordinary rate relief. Both PGW and its owner, the City of Philadelphia, have taken significant steps to mitigate PGW's liquidity crisis, but those steps must be viewed as additions to and not as replacements of the rate relief necessary to avoid a bond downgrade.

PGW has taken immediate steps to put on hold any spending that is not absolutely necessary, holding up new hires and projects until the crisis is ended, saving some \$1 million over the next few months.<sup>132</sup> While this is not a step that can be continued for more than a few months without having a real negative effect upon service, this effort has the effect of husbanding PGW's scarce cash resources to the greatest extent possible preparatory to a more draconian response following a downgrading. In addition, the Company has rushed into place an aggressive collection effort which had been in the works for several months.<sup>133</sup> This effort could produce an additional \$20 million of cash receipts over time which has already been reflected in PGW's pro forma FY 2002 and 2003 test year and rate year cash flow forecasts.<sup>134</sup>

In addition, PGW has also taken the following steps to conserve cash and to enhance the chances that any extraordinary rate increase awarded will be deemed sufficient by S&P to maintain its investment grade status:

- PGW is utilizing its gas storage inventories in a manner that is saving its scarce cash (deferring necessary gas purchases until next fiscal year);<sup>135</sup>

<sup>132</sup> Tr. 138, 143-44, 167-68 and 188-89.

<sup>133</sup> Tr. 133-34.

<sup>134</sup> Tr. 133 and 187.

<sup>135</sup> Tr. 139.

- PGW is enhancing customer applications for LIHEAP grants by the use of public relations and advertising;<sup>136</sup> and
- PGW is studying the feasibility of deferring special projects or certain restructuring related activities where a consensus exists that a delay would be prudent.<sup>137</sup>

In addition, the City has made an enormous contribution to the Company. Even though PGW's method of ratemaking, the Cash Flow Method, assumes that revenues to provide needed capital for operations will be produced over time from rates charged to ratepayers, the City has continued its traditional role of providing PGW with support where possible.<sup>138</sup> The City's commitments, as reflected in the record, include the following:

- The City has agreed to defer the payment date for the \$45 million interest free line of credit from January 2003 to August 2003. Such a deferral means an additional loss of interest on the City loan as well as a cost to the City of having to borrow the funds in order to keep the \$45 million outstanding.<sup>139</sup>
- As part of its overall financial assistance, the City is continuing its plan to permit PGW to utilize the interest on the City's Sinking Fund Reserve account to execute a financial transaction where PGW will be paid the discounted present value of

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<sup>136</sup> Tr. 139.

<sup>137</sup> Tr. 140.

<sup>138</sup> Tr. 178; PGW ERP St. 5 (Davis) at 2-4.

<sup>139</sup> Tr. 159; PGW ERP St. 5 (Davis) at 2. City Finance Director, Janice Davis, testified that the City will incur interest charges of about 4.5% - 5% in order to maintain the City loan outstanding. That equates to an additional contribution to PGW of some \$1.5 million (5% x \$45 million ÷ 12 x 8 = \$1.5 million). Tr. 161

ten years of interest on that account, to which the City is technically entitled. This transaction, called a Forward Purchase, will realize \$20 million for PGW.<sup>140</sup>

- The City has agreed to "backstop" PGW in FY 2002 by granting back the portion of the mandated City fee that is necessary to assure that PGW will meet the debt service coverage requirements in its bond covenants. PGW witness Bogdonavage testified that his present projections show that PGW's earnings from ongoing operations will fall short of meeting the coverage requirements in its bond covenants by approximately \$35.5 million.<sup>141</sup> He noted that the grant of the Company's request for extraordinary rates would allow PGW to bill only about \$8 million in additional revenue by the end of the present fiscal year (August 31, 2002).<sup>142</sup> Even with revenues available from the City's granting of the Forward Purchase, therefore, the City will need to grant back approximately \$7.5 million of its \$18 million payment to permit PGW to meet its bond covenants (\$35.5 million less \$20 million Forward Purchase less \$8 million in FY 2002 from rate increase).<sup>143</sup> Without these grants, PGW would have been forced to request that the PUC take additional emergency actions, such as "compressing" any extraordinary rate award, to seek to recover more revenues more quickly.

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<sup>140</sup> PGW ERP St. 1 (Knudsen) at 4-5; PGW ERP St. 5 (Davis) at 2.

<sup>141</sup> Tr. 80 and 82. The \$35.5 million figure is reached by adding the \$20 million needed from the Forwarded Purchase, the \$8 million that PGW would collect in extraordinary rates by fiscal year end, and the \$7.5 million needed from the City fee.

<sup>142</sup> Tr. 80.

<sup>143</sup> Tr. 80 and 82.

In addition, the City is moving forward to put permanent management in place and to study the feasibility of selling the Company.<sup>144</sup> There should be no question, therefore, that all entities are participating in the rehabilitation of PGW to the full extent of their capacity.

But, it is also absolutely clear that none of these efforts together or individually would be sufficient to avoid a downgrade if the Company is not awarded a significant level of permanent extraordinary rate relief.<sup>145</sup>

#### **IV. POSITIONS OF THE PARTIES ON LEVEL OF EXTRAORDINARY RATE INCREASE**

##### **A. Introduction**

When the record is examined closely, very little disagreement exists concerning the level of rate increase needed to maintain PGW's financial health by avoiding a downgrade. OCA witness Lelash frankly admitted that PGW needs at least \$35.4 million in "project revenue" in order to satisfy the minimum requirement of maintaining PGW's financial health.<sup>146</sup> Mr. Lelash's recommendation that only an \$18 million rate increase should be authorized emanates from his insistence that the full revenue requirement should not come from rate increases but instead, one-half of it – fully \$54 million over three years – must come from City grant backs of its legally required fee from PGW.<sup>147</sup> The Office of Trial Staff's recommendation of a \$25 million increase,<sup>148</sup> when corrected for two adjustments necessary to conform the calculation to the S&P methodology and inputs, shows that a minimum of a \$40 million rate increase is necessary to

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<sup>144</sup> Tr. 156-58, 175.

<sup>145</sup> Tr. 72-73.

<sup>146</sup> Tr. 211-12.

<sup>147</sup> OCA St. 1 (Lelash) at 36.

<sup>148</sup> OTS St. 1 (Weakley) at 3; OTS Exh. 2, Sch. 2.

produce minimally adequate coverages. Accordingly, the floor for PUC consideration is \$35.4 million. The two recommendations, and their component parts, can be displayed as follows:

OCA Recommendation		OTS Recommendation	
PGW Claim	\$44 Million	PGW Claim	\$44 Million
Reduce to Produce 1.2x Coverage	\$8.6 Million	Reduce to Produce 1.25x coverage	\$4.0 Million
Reduce to Account for \$18 Million City Grant	\$17.4 Million	Reduce to "Add Back" Leases	\$5.9 Million
		Reduce to Reflect \$11 Million Payoff of Outstanding Commercial Paper	\$9 Million
<b>Total</b>	<b>\$18 Million</b>		<b>\$25 Million</b>

Indeed, and for the reasons stated below, the PUC should reject the arguments and adjustments proposed by these parties and grant the full, \$44 million request. It is the only amount that is fully compliant with the S&P methodology and will provide a coverage -1.28x - which is safely within the S&P required range. In addition, granting the full request will send an extremely important signal that this Commission intends to support the Company in light of its recent service and efficiency improvements. Such support will have an enormously positive effect on the Company's ability to get back on the road to full recovery.<sup>149</sup>

<sup>149</sup> If a level of a rate increase other than \$44 million is contemplated the Commission should consider permitting PGW to defer certain of its pro forma expense inputs in order to maintain the coverages at the 1.28x level. For example, PGW's fully forecasted pro forma expense claim (used as the basis of its S&P coverage calculation) contains \$10 million in additional expenses for compliance with PUC safety regulations, security costs and environmental remediation. PGW Exh. JRB-2 (corrected). For point of reference, these expenses are identified in PGW's underlying financial information and testimony. See PGW BRP St. 1 at 6. PGW has not begun to incur these charges. If an adjustment to PGW's claim is made it should be accompanied by a directive that the Company may defer recording these costs on its books until they are approved for recovery, either in the Company's base rate proceeding or its restructuring proceeding. This would permit anticipated FY 2003 expenses to be reduced and the resulting rate award will still produce coverages well within the S&P required zone.

**B. OCA's Recommendation That PGW Receive Only \$35.4 Million In Project Revenue in the Form of an \$ 18 Million Per Year, Three Year "Capital Contribution Surcharge" and an \$18 Million Per Year Grant Back of the City Fee is Not Legally or Practically Acceptable and Unacceptably Risky.**

As noted, OCA witness Lelash took no substantial issue with PGW's calculation of the level of additional revenues needed to satisfy the S&P coverage test. Instead, he made two "adjustments" which, unfortunately, made his recommendation legally and practically unacceptable. First, using the identical coverage calculation method as PGW witness Bogdonavage, Mr. Lelash calculated that \$35.4 million in additional revenues are necessary to meet the very bottom of the S&P coverage test – 1.2x,<sup>150</sup> leaving no room for error whatsoever. Second, Mr. Lelash insisted that this acknowledged revenue requirement be met, not by a rate increase, but by a combination of \$18 million per year "capital surcharge"<sup>151</sup> for three years and a corresponding grant back of the City fee over the same period.<sup>152</sup> Neither of these adjustments is appropriate.

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<sup>150</sup> OCA St. 1 (Lelash) at 26.

<sup>151</sup> PGW assumes that OCA's recommendation of such a surcharge is simply a device to avoid the granting of "extraordinary rates." Like extraordinary rates, the OCA surcharge would be implemented immediately (OCA St. 1 at 40) and, as Mr. Lelash testified, it would not be reconcilable. Tr. 221. PGW does not object to the surcharge nature of the OCA's recommendation, but rather to its wholly inadequate level of \$18 million and unlawfully forced grant back of \$54 million in City payments. PGW would accept a \$44 million/per year capital surcharge that could be reevaluated by the Commission at some future point (but not one that automatically sunsets as apparently proposed by Mr. Lelash).

<sup>152</sup> OCA St. 1 (Lelash) at 37. He also recommended that the City should "restructure the \$45 million City loan with payback over the next three fiscal years." *Id.* at 36. Mr. Lelash did not provide any calculation of the added cost to the City or PGW of such a restructuring. At any rate, City Finance Director Davis indicated that such a restructuring, when combined with yearly City grant backs of the City fee was beyond the City's capability at the present time. PGW ERP St. 5.1 (Davis).

1. Meeting PGW's Extraordinary Rate Requirement by a PUC-Ordered Mandatory Grant Back of the City Fee is Not Only Illegal, It is Infeasible For the City and Insufficient to Satisfy S&P's Requirements.

As he and the OCA did in the prior case,<sup>153</sup> Mr. Lelash continues, even in the face of the present crisis, to insist that the City of Philadelphia be forced to give up the only payment it receives in return for its ownership of PGW.<sup>154</sup> Essentially, the OCA's position is based upon a misunderstanding of the way in which municipal utilities are operated and financed, inappropriately imposing an "investor owned" model upon an enterprise where there are no investors, or where, at most, the investors (the citizens of Philadelphia) and the ratepayers are one in the same. This is why the Management Agreement, which sets forth the mandated Cash Flow Method of setting rates,<sup>155</sup> instructs that the dollars to operate the Company should come from rates charged to ratepayers. Indeed, the City has not made a direct contribution to the Company's capital requirements in its 165 year history.<sup>156</sup> But even if the PUC wanted to consider this complete reversal of the PGW regulatory format, it has made clear that this demand is outside its authority to order. As the Commission itself found in PGW's last base rate proceeding:

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<sup>153</sup> See, *Pa. PUC v. Philadelphia Gas Works*, R-00006042, October 4, 2001 at 30.

<sup>154</sup> That payment is the sole compensation it receives from PGW and is in lieu of all municipal tax payments, license fees, fees for the use of City streets and the like. Tr. 222-23. Importantly, the PUC's own Management Audit found the City to be entirely reasonable and appropriate and barely compensation for the foregone City property taxes that PGW would otherwise remit if it were not municipally owned. *Id.* Mr. Lelash's insistence that the City fee is really a "dividend payment" is belied by the fact that the City fee does not increase if profits increase and, when PGW earns in excess of the City fee, the City may not directly appropriate the additional earnings. Tr. 223-25.

<sup>155</sup> *Pa. PUC v. Philadelphia Gas Works*, R-00006042, October 4, 2001 at 13-15

<sup>156</sup> Tr. 178-79.

Section 2212(f) does not grant the authority to the Commission to order the City to waive or grant back the \$18 million payment. We believe that such condition, as advocated by several Parties, clearly is not within the Commission's authority under the Act.<sup>157</sup>

But there are equally important practical reasons why this recommendation must be rejected.

- An \$18 million rate increase is not adequate.

Mr. Lelash's recommendation essentially is an \$18 million rate increase buttressed by a "one time fix" of a three year grant back of the \$18 million City fee that PGW is legally obligated to pay and which the City is legally entitled to collect. Mr. Bogdonavage showed that an \$18 million extraordinary rate increase was completely inadequate - producing just 1.08x S&P coverages on a fully forecasted test year basis.<sup>158</sup> Since the Commission itself made clear that it has no legal authority to order the City to "grantback" its legally required payment, Mr. Lelash's recommendations must be viewed simply as an entirely deficient \$18 million increase recommendation.

- Acceptance of Mr. Lelash's Recommendation Will Cause PGW to Be Downgraded to Junk Status.

Both Ms. Bisgaier, PGW's financial advisor, and Mr. Krellenstein, a municipal bond analyst with JP Morgan, testified that acceptance of Mr. Lelash's recommendation would not prevent S&P from downgrading the Company. Unlike Mr. Lelash, both witnesses regularly

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<sup>157</sup> See, *PaPUC v. Philadelphia Gas Works*, R-00006042, October 4, 2001 at 34. The Commission went on to state its expectation that the City would continue to assist PGW in its cash flow requirements by voluntarily granting back, as necessary, its fee as a backstop. As indicated, for this fiscal year, the City has agreed to do just that, to the tune of almost \$8 million. Tr. 77, 84.

<sup>158</sup> PGW Bogdonavage Rebuttal Exhibit No. 1. To reach acceptable coverages (1.25x) instead of the bare minimum 1.2x recommended by Mr. Lelash, the rate increase would have to be \$22 million greater, or \$40 million. Tr. 85.

discuss PGW's bond rating with S&P and other rating agencies and have an intimate knowledge of S&P's current thinking and views. For example, Ms. Bisgaier testified as follows:

S&P has made it very clear that after years of [PGW] doing one-time fixes to sustain its bond covenant ratios [S&P is] looking for a permanent solution, not just interim fixes. They rate the bonds for the long term. PGW has bonds outstanding that are going to remain outstanding for 29 more years. They want to make sure that a proper rate structure is in place to sustain those bonds over the 29 year period. So an interim fix is not acceptable to them as a means to solving this problem.<sup>159</sup>

To the same effect was Mr. Krellenstein's testimony:

I have talked to both of the analysts that are on the [PGW] report that was submitted earlier last week and I have spent several hours with [one of them] down in Atlanta on Tuesday . . . [this] particular proposal that was presented [by OCA] is not the type of solution they are looking for in general. . . . As a general rule, when there is a problem of this nature they are looking for a solution that will come not from non-operating revenues or one shot deals but from ongoing business operations. That would mean they would be looking for something that would probably be taken by the Public Utility Commission as a rate increase. In the normal course of business they would collect it not something they could just count on for a short period of time.<sup>160</sup>

In contrast to the testimony of PGW's financial witnesses, OCA witness Lelash frankly admitted that he had not had any conversations with S&P, much less conversations about whether one-time fixes would satisfy the rating agency's requirements.<sup>161</sup> The Commission cannot rely upon an OCA consultant's "guess" that a grant back from the City will be sufficient

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<sup>159</sup> Tr. 48.

<sup>160</sup> Tr. 112-13; *see also* Tr. 120. Mr. Krellenstein testified that he had not discussed Mr. Lelash's proposal with S&P specifically, but did not need to because he had been told numerous times by S&P that, in general, they were not going to accept one-time or temporary fixes to solve PGW's problems. Tr. 123-24.

<sup>161</sup> Tr. 227. In addition, Mr. Lelash has no employment experience with bond rating agencies. *Id.*

to prevent the disaster of a downgrade. The required conclusion is clear: if PGW is to avoid a downgrade then it must receive a sufficient rate increase from the Commission that is permanent and ongoing, and does not rely on temporary infusions of capital from the City or other sources. A grant back of the City fee, whether it is for one year or three, is just the kind of one-time fix that S&P no longer will tolerate as a stop gap measure to fix PGW's chronic liquidity problems.

- The City cannot afford to provide a grant back of the City fee for three years.

Even if it were legal (which it isn't), and even if there was any question about S&P's willingness to accept one time grant backs as a sufficient solution for PGW's liquidity crisis – which there is not – the record shows that the City could not provide such grant backs in any event. City Finance Director Janice Davis testified without contradiction that the City is not in a position to grant back the City fee for more than a one year period. As she stated:

[T]he City is capable of granting back the \$18 million [City fee] on a one time basis only. In addition, if the full \$18 million is needed this year in order to meet PGW's bond coverage requirements, the City will have difficulty making the grant back and may have to go to City Council for an appropriation. Given the City's financial constraints there is simply no way for it to forego \$54 million in City payments from PGW (\$18 million for three years) . . . The one-time grant back of the \$18 million would result in a \$14 million deficit at the end of the City's current five year plan for 2003-2007. That level of deficit can be accommodated if absolutely necessary by making adjustments to the plan. However, the City simply cannot make up a \$54 million hole . . . by tinkering with expenditures and programs here and there.

Additionally, the OCA's proposal would create a significant variation in the City's Five Year Financial Plan FY 2003—FY 2007 which is submitted to and approved by the state pursuant to the Pennsylvania Intergovernmental Cooperation Act ("PICA"). The City's PICA Plan expressly states that it is relying on the continued transfer by PGW of the \$18 million payment as well as the repayment of the \$45 million loan in FY 2003. . . . The OCA's suggestion would result in a \$54 million hole in the PICA Plan. Without these revenues, the City will be forced to consider major cuts in City services, lay-offs or a hiring freeze, increases in taxes and fees or a combination of those steps. All of these steps would

have to be presented and approved by PICA; the City can't simply decide to forgo or defer these revenues, even if such a plan was approved by City Council.<sup>162</sup>

Ms. Davis went on to explain the additional financial burdens that are facing the City which did not exist during prior periods, such as additional pressure to support the School District and a substantial deficit over five years as opposed to the surplus that existed just a year ago.<sup>163</sup> Forcing the City to grant back the City fee in these circumstances, therefore, would inevitably result in the City having to choose what other programs to cut or lay-offs to make.<sup>164</sup> It is hard to understand how it is rational policy to force taxpayers of Philadelphia to bear the heavy burden of maintaining PGW's financial health by being forced to forego other needed programs or policies. Nor does it make sense to have state agencies dictating how the City will allocate scarce municipal resources. The bottom line is that even if it was legally permissible or acceptable to S&P, the City of Philadelphia is simply not in a position to grant back \$45 million of payments, as recommended by Mr. Lelash, and it would be bad policy to do so.

- The OCA Proposal Creates Additional Risks For PGW.

Finally, OCA's demand that the PUC deem the Company to be meeting the S&P coverage requirements by assuming that the City will grant back its full, \$18 million fee for three years creates significant and unreasonable risks for the Company. As PGW witness Bogdanovage pointed out, the potential for a City fee grant back in any one year is the only real "backstop" it has to prevent its technical default on its bonds by violating its debt service coverage

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<sup>162</sup> PGW ERP St. 5.1 (Davis) at 2-3.

<sup>163</sup> PGW ERP St. 5 ( Davis) at 3.

<sup>164</sup> *Id.* at 4.

covenants when, like this year, it has been ravaged by the effects of weather.<sup>165</sup> This year, PGW estimates that its weather-related losses will exceed \$32 million, or almost the entire amount of the base rate increase granted by the PUC in 2001.<sup>166</sup> Without the ability of the City to provide limited support by granting back the City fee, the Company would have no way to meet its bond obligations and it would be plunged into another financial crisis. However, under Mr. Lelash's recommendation, PGW would not have the City fee available to respond to extreme contingencies because it would already be accounted for simply to meet the liquidity standards that S&P expects an investment grade company will maintain on a normal, ongoing and permanent basis.<sup>167</sup> On the other hand, forcing PGW to have to rely so directly on the City's financial status creates new risk for the Company. PGW's ability to continue to provide existing levels of service should not be so directly linked to the financial health of the City. For all these reasons, OCA's demand that the City be forced to grant back for three-years its \$18 million/year fee should be rejected.

2. The OCA Recommendation is Unacceptable Because it Produces Coverages Which Fall At The Very Bottom Of The Acceptable S&P Range.

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Part of the difference between PGW's requested \$44 million increase and the recommendations of both the OCA and OTS can be attributed to the fact that both have used as a "target" a lower level of coverage than is produced by PGW's pro forma calculation. As shown on Exhibit JRB-2 (corrected), PGW calculated that a \$44 million rate increase would produce coverages of 1.28 times, using the Company's fully forecasted test year as representative of FY

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<sup>165</sup> Tr. 85-86.

<sup>166</sup> Tr. 79.

<sup>167</sup> Tr. 86, 102, 218.

2003 conditions. The only "adjustment" made by OCA witness Lelash to Mr. Bogdonavage's calculation was to reduce the revenue requirement so that the coverage produced was just 1.2x rather than the 1.28 times computed as necessary by PGW.<sup>168</sup> Considering the unanimous agreement that a bond downgrade for PGW would be disastrous for the Company and its rate payers, the recommendations of OCA and OTS to set PGW's revenue requirement at just the bare minimum level to satisfy the S&P coverage test – a coverage test that was not challenged by any of the parties on the record – appears inadvisable at best. Such a calculation would eliminate any margin for error and create the risk that, if PGW experienced substantially increased costs or reduced revenues, S&P might find the extraordinary rate increase to be deficient.<sup>169</sup> This is an especially concerning problem since PGW's expert analysts have testified that S&P, and the other rating agencies, are presently providing very little leeway to companies' in the kind of financial crisis in which PGW finds itself. As Mr. Krellenstein testified:

The past year has been particularly bad for rating agencies and investors also. The rating agencies in just the past week have been taken to task by Congress for their lax review of entities such as Enron and Global Crossing. In the last year, they have seen a tremendous number of credits being adversely impacted by the downturn in the economy. They clearly have gone to a much more conservative bent in the last several months as has the investment community also. . . . While no rating is absolute in terms of what will occur I would tend to say that they would give less credence to any patchwork efforts put on by the Philadelphia Gas Works and that they really want a solution, one that they can understand is encompassing and long-term in nature, and they will be less tolerant of something that they might have accepted just a year or

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<sup>168</sup> OCA St. 1 (Lelash) at 25. The OTS witness, while first recommending a coverage target of 1.25 times, then revised his target when he discovered that an adjustment he had made erroneously resulted in his recommended rate increase producing coverages of just 1.22 times. Tr. 198, 208-09.

<sup>169</sup> See PGW Exh. BCB-1 (S&P states that insufficient extraordinary rates could still result in lowered ratings).

two ago in a better economic environment where there was not such keen scrutiny of their actions.<sup>170</sup>

It would be extremely risky to set the rate increase in this case so that it produced coverage levels that just barely met the S&P coverage test. Unfortunately, that is exactly what the OCA has recommended (and what OTS's revised recommendation amounts to). In addition, Mr. Lelash's barebones recommendation ignores the fact that PGW's 2003 coverages are put below 1 temporarily when the City loan repayment is factored in, use of funds not even accounted for on Mr. Bogdonovage's schedule. While PGW believes that S&P will accept such a degradation for a short time, a rate increase that sets the coverages at just 1.2x would plunge the results well below 1 after the City loan repayment, creating dangerous risk that PGW will be downgraded even with some extraordinary rate increase award. It simply doesn't make sense to cut the margin of error so thinly when the effect on customers is minimal, but the costs of a resulting miscalculation are so enormous. Mr. Lelash's adjustment to reduce PGW's rate increase to just 1.2x should be rejected.

**C. The OTS Recommendation, When Properly Adjusted, Completely Supports PGW's \$44 Million Request.**

The OTS's recommendation of a \$25 million rate increase contained three adjustments to the PGW position, all of which have been shown to be inappropriate. First, OTS witness Deardorff adjusted the Company's revenue requirement calculation (shown on Exhibit JRB-2 (corrected)) to meet a 1.25x coverage level, instead of 1.28x.<sup>171</sup> Second, Mr. Deardorff claimed that Mr. Bogdonavage had inappropriately failed to "add back" capital leases in the amount of \$5.9 million in his coverage calculation. He therefore removed \$5.9 million from the revenue

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<sup>170</sup> Tr. 114.

<sup>171</sup> OTS St. 2 (Deardorff) at 5-6.

requirement needed to meet a 1.25x coverage test.<sup>172</sup> Third, he claimed that Mr. Bogdonavage had overstated the amount that should be included to take account of the Company's commercial paper paydown obligations. Referencing Mr. Bogdonavage's cash working capital analysis presented in the permanent base rate proceeding, Mr. Deardorff recommended that the coverage calculation should use the level of the commercial paper paydown reflected at the end of the fully forecasted test year, assuming a \$60 million base rate increase.<sup>173</sup> That amount is \$11 million, rather than the \$20 million used by Mr. Bogdonavage.<sup>174</sup> All of these adjustments were shown to be erroneous.

First, as Mr. Bogdonavage testified in rebuttal, his revised calculation of the revenue requirement needed to meet a 1.28 coverage – \$44 million – did in fact add back capital leases just as the S&P calculation requires.<sup>175</sup> It appeared that Mr. Deardorff had been unaware of this revision when he made his recommendation. Unfortunately, after Mr. Bogdonavage explained that the PGW calculation had in fact properly added back capital leases, Mr. Deardorff simply revised his "target" coverage levels rather than acknowledging that his \$25 million calculation had understated PGW's revenue requirement by at least \$5.9 million.<sup>176</sup> Reversing his filed testimony, he simply declared that it would be acceptable to set PGW's revenue requirement to meet a 1.22x coverage level instead of the midpoint of the S&P range, as he had originally testified. This is obviously inappropriate. Indeed, as discussed above, in the context of Mr.

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<sup>172</sup> *Id.* at 7.

<sup>173</sup> *Id.*

<sup>174</sup> *See*, Volume II Permanent Base Rate case supporting schedules, Exh. A-2.

<sup>175</sup> Tr. 90-91. This is consistent with the S&P calculation. *See* PGW Exh. BCB-3.

<sup>176</sup> Tr. 198.

Lelash's recommendation, even Mr. Deardorff's original recommendation that PGW's revenue requirement be set to meet just a 1.25x coverage was unacceptably risky. It was certainly not reasonable, when faced with the fact that he had made an almost \$6 million adjustment based upon an out-of-date schedule, to simply "lower the bar" and recommend that PGW's extraordinary rate award be set with no margin of error.

Similarly, Mr. Deardorff made another adjustment error when he substituted an \$11 million paydown of PGW's tax exempt commercial paper in place of the \$20 million paydown shown on Mr. Bogdonavage's exhibit.<sup>177</sup> As Mr. Bogdonavage explained in rebuttal, Mr. Deardorff's substitution of the \$11 million payment shown in PGW's permanent base rate case is wrong for at least three reasons. First, he failed to understand that, in the base rate case, Mr. Bogdonavage was projecting that the FY 2003 commercial paper pay down would be \$11 million only if PGW's full \$60 million rate increase request was in effect for a full year (the higher level of rates will allow PGW to use less commercial paper during the year and thus have less outstanding at the end of the year.)<sup>178</sup> In this context, the \$11 million "pro forma" projection is completely irrelevant for the present S&P calculations and the determination of extraordinary rate relief.

Second, that \$11 million pro forma payment is "in addition to" not as a substitute for the \$20 million mandatory commercial paper paydown that must occur by the end of FY 2002.<sup>179</sup> When confronted with this error, Mr. Deardorff insisted that since S&P was "forward looking," it would be more appropriate to use the FY 2003 non-mandatory commercial paper paydown rather

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<sup>177</sup> JRB-2 (corrected); PGW Bogdonavage Rebuttal Exh. 1.

<sup>178</sup> Tr. 92, 97.

<sup>179</sup> Tr. 93.

than the mandatory paydown that was reflected in Mr. Bogdonavage's schedule.<sup>180</sup> But if one were to determine the coverage level necessary to reflect the FY 2003 commercial paper paydown using the FY 2002 fully forecasted test year, it would be necessary to add the mandatory paydown from \$100 million to \$80 million plus an additional discretionary paydown of \$11 million (assuming one concluded that the \$11 million pro forma adjustment was more appropriate to use). The total that would have to be used in such a calculation would be \$31 million not \$20 million.<sup>181</sup> Reflecting the FY 2003 pro forma pay down of commercial paper at the full \$31 million level would further reduce coverages and would require additional revenue above the amount even the company requested to produce coverages in the appropriate range.

Finally, and most importantly, the evidence in the record demonstrates irrefutably that S&P calculated PGW's coverages assuming a \$20 million commercial paper pay down in each of FY 2002 and FY 2003 (the mandatory pay down from \$100 million to \$80 million in FY 2002 as well as the additional \$20 million pay down expected by S&P in FY 2003).<sup>182</sup> As virtually all the witnesses acknowledged, it is crucially important that PGW's extraordinary revenue requirement be calculated in accordance with the formula and inputs actually utilized by S&P. In this case, the S&P worksheet provides hard evidence as to the inputs that must be utilized to calculate the coverages, and shows \$20 million commercial paper pay downs in both FY 2002 and FY 2003.<sup>183</sup> Accordingly, a \$20 million commercial paper paydown must be utilized here as

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<sup>180</sup> Tr. 199, 202

<sup>181</sup> Tr. 93.

<sup>182</sup> Shown on PGW Exh. BCB-3 in the portion of the table entitled "Debt Service Coverage Analysis," and reflected on the fourth line from the bottom as "Others-Commercial Paper Notes."

<sup>183</sup> The first paydown (from \$100 to \$80 million) is mandatory and occurs at the end of FY 2002 – it has not happened yet. PGW ERP St. 4 (Bisgaier) at 6; Tr. 59-60. S&P's

well. The reversal of this error, combined with the correction of Mr. Deardorff's \$5.9 million lease add back adjustment, results in an OTS revenue requirement recommendation of \$40 million (at 1.25x coverage). As indicated above, however, the Commission should not take the risk that a 1.25x coverage will in fact avoid a downgrade. Accordingly, PGW's recommendation should be accepted in full.

**V. THE COMMISSION SHOULD DIRECT THAT THE \$44 MILLION EXTRAORDINARY RATE INCREASE BE ALLOCATED CONSISTENT WITH THE PARTIES' ALLOCATION STIPULATION.**

The issue of how to implement the \$44 million extraordinary rate increase and allocate it among the customer classes has been agreed to by the parties. A Stipulation and Settlement Regarding Allocation of Extraordinary Rate Increase was entered into by PGW, OCA, OTS, OSBA, and PICGUG. CEPA indicated that it did not oppose the Stipulation.<sup>184</sup> The allocation endorsed by the Stipulation is fair and reasonable, and should be adopted by the Commission.

Pursuant to the Stipulation, any extraordinary rate increase that the Commission grants will be attributed exclusively to the volumetric charge imposed on the firm customer classes. No customer charges will be increased. The parties proposed that any extraordinary rate increase will be allocated only among the following customer classes and in the following percentages: residential (ResGS/PHAGS) 83.75%, commercial 13.53%, industrial 1.83%, and PHA/PHA 0.89%.<sup>185</sup> In terms of the \$44 million extraordinary rate increase requested by PGW, the parties agreed that the residential class would be allocated \$36.85 million and the commercial,

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inclusion of a \$20 million paydown of its outstanding commercial paper in FY 2003 is consistent with PGW's own plan and the recommendations of the Black and Veatch Engineering Report that was prepared as part of the 2001 bond issuance. Tr. 59, 98.

<sup>184</sup> The Stipulation is attached to this Memorandum as Attachment D.

<sup>185</sup> Stipulation at ¶ 1. As to all classes, the extraordinary rate increase would only be applied to firm customers.

industrial, and PHA/PHA classes would receive the remaining \$7.15 million of the total increase.<sup>186</sup>

The parties further reserved the right to litigate all rate structure issues as part of PGW's base rate proceeding. Thus, to the extent that any party or the Commission is not completely satisfied with the stipulated allocation method, an avenue exists for making modifications on a going forward basis.<sup>187</sup> However, for the purposes of this extraordinary rate proceeding, all parties concur that the stipulated allocation method is in the public interest, and have requested that the Commission approve and adopt its terms.<sup>188</sup>

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<sup>186</sup> Stipulation at Attachment A.

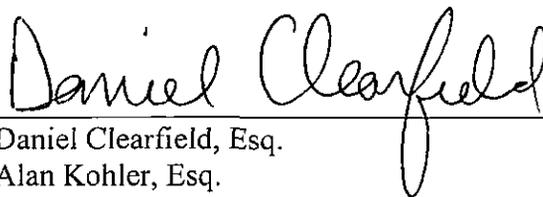
<sup>187</sup> Stipulation at ¶ 3.

<sup>188</sup> CEPA abstained from requesting Commission approval, but signed the Stipulation to indicate that it did not oppose its terms. Stipulation at ¶ 5.

**VI. CONCLUSION**

For all of the foregoing reasons, PGW respectfully requests that the Commission grant its request for a permanent, \$44 million extraordinary rate increase and adopt the parties' allocation stipulation.

Respectfully submitted,



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Date: April 3, 2002

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<b>STANDARD &amp; POOR'S</b>	<b>RATINGS DIRECT</b>
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**Research:**

Return to Regular Format

**Summary: Philadelphia, PA; Utility, Gas**

Publication date: 12-Feb-2002

Analyst: Anesh Prabhu, New York (1) 212-438-1285; Jodi E Hecht, New York (1) 212-433-2019

**Credit Profile**

**CREDITWATCH UPDATE**

	To	From
\$160.660 mil. Philadelphia gas wks rev bnds (1998 Gen Ordinance) ser A dtd 06/01/1998 due 07/01/1999-2014 2018 2026	AAA/BBB(SPUR)	BBB
\$103.550 mil. Philadelphia gas wks rev bnds (1998 Gen Ordinance) ser B dtd 06/01/1998 due 07/01/2014 2018 2028	AAA/BBB(SPUR)	BBB
\$20.010 mil. Philadelphia gas wks rev bnds (Sub1998 Gen Ordinance) ser C dtd 06/01/1998 due 07/01/1999-2014	AAA/BBB-(SPUR)	BBB-
\$61.960 mil. Philadelphia gas wks rev bnds 16th ser dtd 05/07/1999 due 07/01/2000-2009 2013-2015	AAA/BBB(SPUR)	BBB
\$112.245 mil. Philadelphia gas wks rev bnds 2nd ser dtd 05/07/1999 due 07/01/2000-2029	AAA/BBB(SPUR)	BBB
\$120.225 mil. Philadelphia gas works rev bnds (1998 Gen Ordinance) third ser dtd 06/01/2001 due 08/01/2003-2019 2021 2031	AAA/BBB(SPUR)	
\$355.825 mil. Philadelphia gas wks	BBB	BBB

**Rationale**

Standard & Poor's 'BBB' underlying rating (SPUR) and 'BBB' uninsured rating on Ordinance 1975 and 1998 senior bonds, and its 'BBB- SPUR' on the 1998 Ordinance subordinated bonds remain on CreditWatch with negative implications where they were placed July 20, 2000.

Philadelphia Gas Works' (PGW) PGW's poor liquidity position has worsened with December 2001 cash balances at \$3.8 million (2.5 days' cash) compared to ending cash of about \$8.4 million at fiscal year-end August 2000. PGW is filing an emergency rate relief in February 2002 with the Pennsylvania Public Utility Commission (PUC) to address liquidity issues. Without immediate cash flow improvement, ratings will be lowered. PGW's poor liquidity is due, in part, to the PUC final rate order of a \$33.6 million rate increase in December 2001, about \$31.0 million less than requested. This rate shortfall, combined with the warmer-than-budgeted weather this winter and higher receivables, contributes to poor liquidity, which is not appropriate for the current rating level. "If the PUC approves an emergency rate request, Standard & Poor's will review the adequacy of the increase and determine if ratings will be affirmed or lowered," said Standard & Poor's credit analyst Anesh Prabhu.

PGW, the largest municipally owned gas utility in the U.S., purchases, sells, and distributes gas to more than a half-million customers within the city of Philadelphia. At fiscal year-end August 2001, PGW had about \$900 million of debt outstanding.

The ratings reflect the following risks:

- The poor liquidity position required PGW to temporarily borrow from its capital fund account in January 2002 for servicing debt obligations, and requires PGW to rely on financial transactions that create nonrecurring revenues in this fiscal year. Without additional project revenues or rate relief, PGW may be unable to reimburse its capital fund. PGW will also seek a deferral on the \$45 million working capital city loan, due in January 2003.

- Weak fixed-charge coverage that, including lease payments and the annual payment to the city of Philadelphia, has ranged between 1.0 times (x)-1.1x during the past four years.
- Limited ability of the city of Philadelphia to provide assistance due to the city's tight financial situation.
- PGW's problems with high account receivables, which were exacerbated in 2001 due to escalating fuel prices recoverable through the gas cost recovery (GCR) mechanism. Receivables have been historically high due to a high proportion of low-income residents in the demographics of PGW's service territory.
- A warm winter, which likely will cause PGW to miss budgeted forecasts in fiscal 2002.
- Inability to convert from interim management to permanent management by December 2001, as directed by PUC's interim rate order in November 2000. The search for permanent management is at an advanced stage and is expected to conclude by April 2002.

Nonetheless, the following strengths offset the risks:

- A favorable closing to the labor contract negotiations in June 2001; the contract freezes labor costs for the next two years, reduces benefits, and reasserts management prerogatives regarding work rules.
- Operational improvements that included correcting the faulty billing system, improving call center performance, and auditing procedure improvements.
- Sound legal provisions that require 1.5x coverage on an accrual basis on the senior bonds.
- The PUC's timely approvals of required gas cost rate increases since regulatory oversight changed in July 2000.
- PGW has successfully solicited federal and state funds in the form of LIHEAP and Cnisis grants, which have aided the company's cash flow and earnings position.



PHILADELPHIA GAS WORKS  
FISCAL YEAR 2001-02  
PROJECTED INCOME STATEMENT

Revised 3-06-02

	<u>Current</u> <u>Estimate</u> <u>2001-02</u>	<u>Test Year</u> <u>Budget</u> <u>2001-02</u>
<b><u>Operating Revenues</u></b>		
Gas Revenues	\$872,188	\$638,733
Margin Loss Gas Sales	(25,000)	-
Proposed Base Rate Incr	-	44,000
Other Revenues	27,450	28,117
Total Operating Revenues	<u>\$674,638</u>	<u>\$710,850</u>
<b><u>Operating Expenses</u></b>		
Natural Gas Costs	\$373,016	\$334,566
Raw Material Exp	10	10
Total Nat. Gas & Raw Mat	<u>\$373,026</u>	<u>\$334,576</u>
Contribution Margins	\$301,612	\$376,274
Supply & Field Expenses	\$58,331	\$59,331
Customer Services	29,722	30,222
Bad Debt Expense	54,553	52,544
Marketing	4,000	5,596
Administrative & General	39,086	39,086
Health Insurance	31,490	30,490
Capitalized Benefits & A&G	(12,430)	(13,430)
Amortization	3,965	3,965
Pensions	3,091	3,091
Taxes	6,054	6,054
Added Costs PUC & Other	0	10,000
Labor/Cost Savings	(7,100)	(7,100)
Total Oper. & Maint	<u>\$210,762</u>	<u>\$219,849</u>
Depreciation	\$31,585	\$31,587
Total Oper. & Maint, Exp	<u>\$242,347</u>	<u>\$251,436</u>
Total Operating Expenses	<u>\$615,373</u>	<u>\$586,012</u>
Operating Income	\$59,255	\$124,838
Other Income	4,953	5,743
Income Before Interest	<u>\$64,208</u>	<u>\$130,581</u>
<b><u>Interest</u></b>		
Long-Term Debt	\$50,966	\$50,966
Other	6,148	6,498
AFUDC	(775)	(775)
Loss on Extinguished Debt	3,976	3,976
Total Interest	<u>\$60,315</u>	<u>\$60,665</u>
Net Income	\$3,913	\$69,916
City Payment	18,000	18,000
Net Loss From Operations	<u>\$(14,087)</u>	<u>\$51,916</u>

PHILADELPHIA GAS WORKS  
FISCAL YEAR 2001-02  
PROJECTED DEBT SERVICE COVERAGE

Corrected 3/15/02

	<u>Current</u> <u>Estimate</u> <u>2001-02</u>	<u>Test Year</u> <u>Budget</u> <u>2001-02</u>
<b><u>Debt Service Calculation</u></b>		
<b><u>Funds Provided</u></b>		
Operating Revenues	\$674,638	\$710,850
Other Income +/-	-	-
Restricted Funds	4,953	5,743
AFUDC	775	775
Total Funds Provided	<u>\$680,376</u>	<u>\$717,368</u>
<b><u>Funds Applied</u></b>		
Fuel Costs	\$373,026	\$334,576
Other Operating Exp	242,347	251,436
Less: Non-Cash Exp.	(36,165)	(26,165)
Total Funds Applied	<u>\$579,208</u>	<u>\$549,847</u>
Funds Available To Cover Debt Service	\$101,168	\$167,521
1975 Debt Service	<u>\$55,528</u>	<u>\$55,528</u>
Coverage Ratio	1.82	3.02
Funds Available To Cover Capital Leases	\$45,640	\$111,993
Capital Leases	<u>5,954</u>	<u>5,954</u>
Funds Available To Cover 1998 Sr. Debt Service	\$39,686	\$106,039
1998 Sr. Debt Service	<u>30,926</u>	<u>30,926</u>
Coverage Ratio	1.28	3.43
Funds Available To Cover 1998 Subordinate Debt Ser.	\$8,750	\$75,113
1998 Subordinate Debt Ser.	<u>1,966</u>	<u>1,966</u>
Coverage Ratio	4.41	37.82
<b><u>Revised Standard &amp; Poor's Fixed Charge Coverage Ratio</u></b>		
Net Available To Service Aggregate Debt Service	\$102,542	\$168,897
Aggregate Debt Service	\$94,394	\$94,394
Fixed Rate Coverage Ratio on Aggregate Debt Service	1.09	1.79
Fixed Rate Coverage Ratio Including \$18.0 M City Fee	0.91	1.50
Fixed Rate Coverage Ratio Including \$18.0 M City Fee & \$20.0 M TXCP Payment	0.77	1.23

**PHILADELPHIA GAS WORKS**  
**FISCAL YEAR 2001-02**  
**PROJECTED INCOME STATEMENT**

Revised 3-25-02			\$44.0 M	\$18.0 M
	<u>Revised 3-25-02</u>	<u>Current</u>	<u>Test Year</u>	<u>Test Year</u>
	<u>Estimate</u>	<u>Estimate</u>	<u>Budget</u>	<u>Budget</u>
	<u>2001-02</u>	<u>2001-02</u>	<u>2001-02</u>	<u>2001-02</u>
<b>Operating Revenues</b>				
Gas Revenues	\$672,188	\$672,188	\$638,733	\$638,733
Margin Loss Gas Sales	(48,800)	(25,000)	-	-
Proposed Base Rate Incr.	8,000	-	44,000	18,000
Other Revenues	27,550	27,450	28,117	27,817
<b>Total Operating Revenues</b>	<b>\$658,938</b>	<b>\$674,638</b>	<b>\$710,850</b>	<b>\$684,550</b>
<b>Operating Expenses</b>				
Natural Gas Costs	\$373,016	\$373,016	\$334,566	\$334,566
Raw Material Exp.	10	10	10	10
<b>Total Nat. Gas &amp; Raw Mat</b>	<b>\$373,026</b>	<b>\$373,026</b>	<b>\$334,576</b>	<b>\$334,576</b>
<b>Contribution Margins</b>	<b>\$285,912</b>	<b>\$301,612</b>	<b>\$376,274</b>	<b>\$349,974</b>
Supply & Field Expenses	\$58,331	\$58,331	\$59,331	\$59,331
Customer Services	29,722	29,722	30,222	30,222
Bad Debt Expense	56,553	54,553	52,544	51,794
Marketing	4,000	4,000	5,596	5,596
Administrative & General	39,086	39,086	39,086	39,086
Health Insurance	31,490	31,490	30,490	30,490
Capitalized Benefits & A&G	(12,430)	(12,430)	(13,430)	(13,430)
Amortization	3,965	3,965	3,965	3,965
Pensions	6,000	3,091	3,091	3,091
Taxes	6,054	6,054	6,054	6,054
Added Costs PUC & Other	0	0	10,000	10,000
Labor/Cost Savings	(7,100)	(7,100)	(7,100)	(7,100)
<b>Total Oper. &amp; Maint.</b>	<b>\$215,671</b>	<b>\$210,762</b>	<b>\$219,849</b>	<b>\$219,099</b>
Depreciation	\$31,585	\$31,585	\$31,587	\$31,587
<b>Total Oper. &amp; Maint. Exp.</b>	<b>\$247,256</b>	<b>\$242,347</b>	<b>\$251,436</b>	<b>\$250,686</b>
<b>Total Operating Expenses</b>	<b>\$620,282</b>	<b>\$615,373</b>	<b>\$586,012</b>	<b>\$585,262</b>
<b>Operating Income</b>	<b>\$38,656</b>	<b>\$59,265</b>	<b>\$124,838</b>	<b>\$99,288</b>
<b>Other Income</b>	<b>32,463</b>	<b>4,963</b>	<b>5,743</b>	<b>5,543</b>
<b>Income Before Interest</b>	<b>\$71,119</b>	<b>\$64,228</b>	<b>\$130,581</b>	<b>\$104,831</b>
<b>Interest</b>				
Long-Term Debt	\$50,966	\$50,966	\$50,966	\$50,966
Other	6,148	6,148	6,498	6,498
AFUDC	(775)	(775)	(775)	(775)
Loss on Extinguished Debt	3,976	3,976	3,976	3,976
<b>Total Interest</b>	<b>\$60,315</b>	<b>\$60,315</b>	<b>\$60,665</b>	<b>\$60,665</b>
<b>Net Income</b>	<b>\$10,804</b>	<b>\$3,913</b>	<b>\$69,916</b>	<b>\$44,166</b>
City Payment	18,000	18,000	18,000	18,000
<b>Net Loss From Operations</b>	<b>(\$7,196)</b>	<b>(\$14,087)</b>	<b>\$51,916</b>	<b>\$26,166</b>

**PHILADELPHIA GAS WORKS**  
**FISCAL YEAR 2001-02**  
**PROJECTED DEBT SERVICE COVERAGE**

Debt Service Calculation	<u>Revised 3-25-02</u>	<u>Current</u>	<u>\$44.0 M</u>	<u>\$18.0 M</u>
	<u>Estimate</u>	<u>Estimate</u>	<u>Test Year</u>	<u>Test Year</u>
	<u>2001-02</u>	<u>2001-02</u>	<u>Budget</u>	<u>Budget</u>
	<u>2001-02</u>	<u>2001-02</u>	<u>2001-02</u>	<u>2001-02</u>
<b>Funds Provided</b>				
Operating Revenues	\$658,938	\$674,638	\$710,850	\$684,550
Other Income +/-	-	-	-	-
Restricted Funds	32,463	4,963	5,743	5,543
AFUDC	775	775	775	775
<b>Total Funds Provided</b>	<b>\$692,176</b>	<b>\$680,376</b>	<b>\$717,368</b>	<b>\$690,868</b>
<b>Funds Applied</b>				
Fuel Costs	\$373,026	\$373,026	\$334,576	\$334,576
Other Operating Exp.	247,256	242,347	251,436	250,686
Less Non-Cash Exp.	(36,165)	(36,165)	(36,165)	(36,165)
<b>Total Funds Applied</b>	<b>\$584,117</b>	<b>\$579,208</b>	<b>\$549,847</b>	<b>\$549,097</b>
<b>Funds Available To Cover Debt Service</b>				
	\$108,059	\$101,168	\$167,521	\$141,771
<b>1975 Debt Service Coverage Ratio</b>	<b>\$55,528</b>	<b>\$55,528</b>	<b>\$55,528</b>	<b>\$55,528</b>
	1.95	1.82	3.02	2.55
<b>Funds Available To Cover Capital Leases</b>				
	\$52,531	\$45,640	\$111,993	\$86,243
<b>Funds Available To Cover</b>	<b>\$46,577</b>	<b>\$39,686</b>	<b>\$106,039</b>	<b>\$80,289</b>
<b>1998 Sr. Debt Service Coverage Ratio</b>	<b>30,926</b>	<b>30,926</b>	<b>30,926</b>	<b>30,926</b>
	1.51	1.28	3.43	2.60
<b>Funds Available To Cover 1998 Subordinate Debt Ser.</b>				
	\$15,651	\$8,760	\$75,113	\$49,363
<b>1998 Subordinate Debt Ser. Coverage Ratio</b>	<b>1,986</b>	<b>1,986</b>	<b>1,986</b>	<b>1,986</b>
	7.88	4.41	37.82	24.86
<b>Revised Standard &amp; Poor's Fixed Charge Coverage Ratio</b>				
<b>Net Available To Service Aggregate Debt Service</b>	<b>\$109,433</b>	<b>\$102,542</b>	<b>\$168,897</b>	<b>\$143,147</b>
<b>Aggregate Debt Service</b>	<b>\$94,394</b>	<b>\$94,394</b>	<b>\$94,394</b>	<b>\$94,394</b>
<b>Fixed Rate Coverage Ratio on Aggregate Debt Service</b>	<b>1.16</b>	<b>1.09</b>	<b>1.79</b>	<b>1.52</b>
<b>Fixed Rate Coverage Ratio Including \$18.0 M City Fee</b>	<b>0.97</b>	<b>0.91</b>	<b>1.50</b>	<b>1.27</b>
<b>Fixed Rate Coverage Ratio Including \$18.0 M City Fee &amp; \$20.0 M TXCP Payment</b>	<b>0.83</b>	<b>0.77</b>	<b>1.28</b>	<b>1.08</b>

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

v.

PHILADELPHIA GAS WORKS

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Docket No. R-00017034-0002

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**STIPULATION AND SETTLEMENT  
[REGARDING ALLOCATION OF EXTRAORDINARY RATE INCREASE]**

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This Stipulation and Settlement is entered into by and between Philadelphia Gas Works ("PGW"), the Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), and the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") (collectively "the Parties"). The Consumer Education and Protective Association et al. ("CEPA") does not join in the Stipulation and Settlement, but indicates by its signature below that it does not oppose the Stipulation.

WHEREAS, on February 25, 2002, PGW filed a Petition for Extraordinary Rate Relief, pursuant to Section 1308(e) of the Public Utility Code, and also filed for a general base rate increase. The Petition seeks \$44 million in extraordinary rates; and

WHEREAS, the Parties have held discussions concerning the allocation to each customer class of any extraordinary rates that the Commission may grant to PGW; and

WHEREAS, in order to amicably resolve the issue of how to allocate an extraordinary rate increase, if one is granted, without the need for litigation, the Parties have accepted and agreed to the terms set forth in this Stipulation solely in the context of PGW's extraordinary rate increase request.

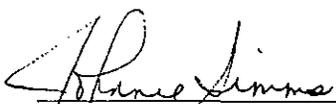
NOW THEREFORE, the Parties, intending to be legally bound, hereby stipulate as follows:

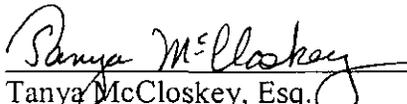
1. The Parties agree that any extraordinary rate increase that may be granted by the Commission should be attributed only to the volumetric charge and allocated among the customer classes as follows: residential (ResGS/PHAGS) 83.75%, commercial (firm customers) 13.53%, industrial (firm customers) 1.83%, and PHA/PHA 0.89%. An example of such an allocation at the full requested increase is shown on a schedule attached hereto as Attachment A.
2. The Parties agree not to enter testimony into the record regarding the allocation of the proposed extraordinary rate relief or to litigate the issue as part of the proceedings on PGW's Petition for Extraordinary Rate Relief.
3. The Parties reserve the right to litigate all rate structure, rate design and allocation issues as part of PGW's base rate case. The Parties further agree that any modification to the allocation of the rate increase that may be approved as part of the resolution of PGW's base rate case should be implemented on a going forward basis and should not result in a refund requirement on PGW or any customer class.
4. The Parties agree and it is expressly understood that this Stipulation constitutes a negotiated resolution solely of issues addressed herein and solely for the purposes of PGW's request for extraordinary rates, that this Stipulation shall not constitute or be cited as controlling precedent in any other proceeding (including the proceeding on PGW's request for a general base rate increase), and that it shall not be characterized as the position of any of the Parties nor constitute an admission of any fact or legal principle set forth herein in any such proceeding.
5. The Parties agree to the entry of this Stipulation into the record for the proceedings on PGW's Petition for Extraordinary Rate Relief and, as evidenced by their

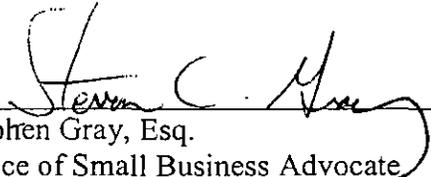
signatures hereto, request that the Commission approve and adopt its terms. CEPA indicates by its signature below that it does not oppose the Stipulation.

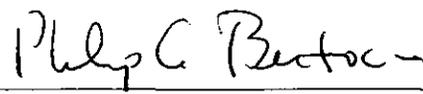
Respectfully submitted,

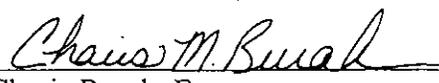
  
\_\_\_\_\_  
Daniel Clearfield, Esq.  
Mark S. Stewart, Esq.  
For: Philadelphia Gas Works

  
\_\_\_\_\_  
Johnnie Simms, Esq.  
Office of Trial Staff

  
\_\_\_\_\_  
Tanya McCloskey, Esq.  
Steve Keene, Esq.  
Office of Consumer Advocate

  
\_\_\_\_\_  
Stephen Gray, Esq.  
Office of Small Business Advocate  
STEVEN

  
\_\_\_\_\_  
Philip Bertocci, Esq.  
For: Consumer Education and Protective  
Association, et al.

  
\_\_\_\_\_  
Charis Burak, Esq.  
For: Philadelphia Industrial and  
Commercial Gas Users Group

Dated: March 26, 2002

**\$44 MILLION RATE INCREASE**  
(Residential Increase \$36.85 Million)

<u>Rate</u>	<u>Forecasted Average Monthly Billings 9/1/01 thru 8/31/02</u>	<u>Current Customer Charge</u>	<u>Current Customer Charge Revenue</u>
ResGS/PHAGS <sup>(1)</sup>	479,286	\$ 12	\$ 69,017,232
CommercialGS <sup>(1)</sup>	25,434	\$ 18	\$ 5,493,636
Industrial/GS <sup>(1)</sup>	1,084	\$ 50	\$ 650,250
PHA/PHA <sup>(1)</sup>	943	\$ 18	\$ 203,580
MUN/MS <sup>(1)</sup>	876	\$ 18	\$ 189,216
<b>Total</b>	<b>507,622</b>		<b>\$ 75,553,914</b>

**VOLUMETRIC RATE INCREASE**

<u>Rate</u>	<u>Forecasted Applicable Sales 9/1/01 thru 8/31/02 (mcf)</u>	<u>Current Volumetric Charge</u>	<u>Proposed Volumetric Charge</u>	<u>Current Volumetric Revenue</u>	<u>Proposed Volumetric Revenue</u>	<u>Revenue Increase</u>	<u>Total Current Revenue</u>	<u>Total Proposed Revenue</u>	<u>Percentage Increase in Revenue</u>
ResGS/PHAGS <sup>(1)</sup>	42,984,183	\$ 6.7770	\$ 7.6343	\$ 291,303,805	\$ 328,154,145	\$ 36,850,340	\$ 360,321,037	\$ 397,171,377	10.23%
CommercialGS <sup>(1)</sup>	10,785,098	\$ 7.1200	\$ 7.6719	\$ 76,789,898	\$ 82,742,193	\$ 5,952,296	\$ 82,283,534	\$ 88,235,829	7.23%
Industrial/GS <sup>(1)</sup>	1,468,077	\$ 7.1200	\$ 7.6671	\$ 10,452,708	\$ 11,255,893	\$ 803,185	\$ 11,102,958	\$ 11,906,143	7.23%
PHA/PHA <sup>(1)</sup>	735,256	\$ 7.1260	\$ 7.6615	\$ 5,239,434	\$ 5,633,164	\$ 393,730	\$ 5,443,014	\$ 5,836,744	7.23%
MUN/MS <sup>(1)</sup>	1,294,519	\$ 6.4130	\$ 6.4130	\$ 8,301,750	\$ 8,301,750	\$ -	\$ 8,490,966	\$ 8,490,966	0.00%
<b>Total Applicable Sales</b>	<b>57,267,133</b>			<b>\$ 392,087,596</b>	<b>\$ 436,087,146</b>	<b>\$ 43,999,550</b>	<b>\$ 467,641,510</b>	<b>\$ 511,641,060</b>	

<sup>(1)</sup> Firm Customer Class. No Interruptible customers are included.



COMMONWEALTH OF PENNSYLVANIA  
PENNSYLVANIA PUBLIC UTILITY COMMISSION  
P.O. BOX 3265, HARRISBURG, PA 17105-3265

IN REPLY PLEASE  
REFER TO OUR FILE

April 3, 2002

James J. McNulty, Secretary  
Pennsylvania Public Utility Commission  
P. O. Box 3265  
Harrisburg, PA 17105-3265

**ORIGINAL**

Re: Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works  
Docket No. R-00017034F0002

**DOCUMENT  
FOLDER**

Dear Secretary McNulty:

Enclosed for filing please find an original and nine (9) copies of the **Memorandum of the Office of Trial Staff (OTS)** in the above-captioned proceeding.

Copies are being served on all active parties of record.

Sincerely,

Johnnie E. Simms  
Senior Prosecutor  
Office of Trial Staff

JES:em

Enclosure

cc: Parties of Record

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BEFORE THE  
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Pennsylvania Public Utility Commission :  
v. : Docket No. R-00017034F0002  
Philadelphia Gas Works :

**CERTIFICATE OF SERVICE**

I hereby certify that I am serving the foregoing **Memorandum of the Office of Trial Staff**, dated April 3, 2002 either personally, by first class mail, electronic mail, or by fax upon the persons listed below:

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Hon. Cynthia W. Fordham  
Administrative Law Judge  
PA Public Utility Commission  
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Philadelphia, PA 19130



Johnnie E. Simms  
Senior Prosecutor  
Office of Trial Staff

Dated: April 3, 2002  
Docket No. R-00017034F0002

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission :  
v. :  
Philadelphia Gas Works :

Docket No.  
R-00017034F0002

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MEMORANDUM  
OF THE OFFICE OF TRIAL STAFF

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DOCUMENT  
FOLDER

Johnnie E. Simms  
Senior Prosecutor

Pennsylvania Public Utility Commission  
The Office of Trial Staff  
P.O. Box 3265  
Harrisburg, PA 17105-3265  
(717) 787-1976

Dated: April 3, 2002

DOCKETED  
APR 05 2002

## I. STATEMENT OF THE CASE

On February 25, 2002, Philadelphia Gas Works (“PGW”) filed Supplement No. 17 to Tariff Gas – Pa. P.U.C. No. 1 to become effective April 26, 2002.<sup>1</sup>

Concomitantly, PGW filed a Petition for Extraordinary Rate Relief (“Petition”), pursuant to Section 1308(e) and 2212(c) of the Public Utility Code, 66 Pa. C.S. §§1308(e) and 2212(c). In its Petition, PGW has requested that \$44 million of its \$60 million base rate request be approved as extraordinary rate relief in order to avoid an immediate downgrade of its bond rating from investment grade to junk bond status.

PGW is of the opinion that Standard & Poor’s (“S&P”), one of its three credit rating agencies, will downgrade its bond rating if PGW does not receive immediate improvement in its cash flow. PGW’s opinion is predicated on the fact that S&P issued a notice on or about February 12, 2002 warning that PGW’s ratings would be lowered without immediate improvement in its cash flow.<sup>2</sup> The credit rating is important because it determines how expensive it will be for PGW to raise capital.

In accordance with Section 1308(e) of the Code, the Commission is required to grant or deny, in whole or in part, the requested extraordinary rate relief within 30 days of the filing of the Petition requesting the same. In order to satisfy the timetable established by S&P, and allow the Commission to conduct

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<sup>1</sup> In the general base rate increase filing, PGW is seeking rate relief in the amount of \$60 million.

<sup>2</sup> PGW Exhibit BCB-1.

an orderly review of the Petition, PGW proposed that the Commission address the Petition within 45 days instead of the statutory 30 day schedule. The 45 day time period is scheduled to expire with a decision at the Commission's April 11, 2002 public meeting.<sup>3</sup>

Consequently, in recognition of the 45 day time period, a prehearing conference in this matter was held on March 7, 2002 before Administrative Law Judge Cynthia Williams Fordham. At the prehearing conference, a procedural schedule was established for the purpose of fulfilling the 45 day time period. Namely, that the other parties would submit testimony on March 21, 2002, with evidentiary hearings on March 26 and 27, 2002, and the filing of legal memoranda on April 3, 2002.<sup>4</sup> In accordance with the procedural schedule, other parties filing testimony and exhibits in this proceeding were the Office of Trial Staff ("OTS") and the Office of Consumer Advocate ("OCA"). As required by Section 1308(e) of the Code, the cross-examination of PGW, OTS and OCA witnesses took place on March 26, 2002 in Philadelphia before Administrative Law Judge Fordham.

This matter is now ripe for determination as to whether PGW has met the legal standards of Section 1308(e) of the Code, and if so, what level of extraordinary rate relief is required to satisfy the S&P coverage formula.

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<sup>3</sup> PGW believes that S&P will reevaluate PGW's position in the next six weeks and downgrade PGW's credit rating from investment grade to junk bond status without the extraordinary rate relief (See Petition ¶¶ 5,9).

<sup>4</sup> PGW filed its direct testimony and exhibits with the filing of the Petition.

## II. SUMMARY OF ARGUMENT

Section 1308(e) of the Public Utility Code requires that a utility requesting extraordinary rate relief must satisfy four criteria. After reviewing the statutory language and the surrounding facts associated with PGW's extraordinary rate relief filing, OTS is of the opinion that PGW satisfies three of the four criteria, with the fourth criteria, rate of return, not being applicable to PGW.

In reviewing the filing, OTS made two adjustments to the Company's calculation of the debt coverage ratio.<sup>5</sup> OTS corrected the errors made by the Company in (1) not adding back the capital leases and (2) including \$20 million for reducing its commercial paper program in the future test year. OTS calculated a debt coverage ratio of 1.25 times, which falls well within S&P's required range of 1.2 times to 1.3 times for PGW's debt coverage ratio. Based on the recommended 1.25 times debt service coverage for PGW, OTS was able to determine that the funds required to service aggregate debt coverage would be \$148,521,000.

Accordingly, based upon a debt service coverage of 1.25 times and funds available of \$148,521,000 to service aggregate debt, OTS is recommending extraordinary rate relief in the amount of \$25 million for PGW.

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<sup>5</sup> See PGW Exhibit JRB-2.

### III. THE LEGAL STANDARDS OF SECTION 1308(E) OF THE CODE HAVE BEEN SATISFIED BY PGW IN THIS PROCEEDING

#### A. Introduction

In its Petition, PGW requested that the Commission consider “this Petition under a standard which comports with PGW’s status as a municipality owned and operated utility.” While all other utilities under the Commission’s jurisdiction have their rates set in accordance with Chapter 13 of the Public Utility Code, the setting of rates for PGW must be in accordance with Sections 2212(e) and (f) of the Code. Notwithstanding that Sections 2212(e) and (f) of the Code govern the setting of rates for PGW, Section 1308(e) governs PGW’s request for extraordinary rate relief.

The legal standard for granting extraordinary rate relief is set forth in Section 1308(e) of the Code, which provides in pertinent part as follows:

**(e) Extraordinary rate relief.** ----Upon petition to the commission at the time of filing of a rate request or at any time during the pendency of proceedings on such rate request, any public utility may seek extraordinary rate relief of such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment and which will provide no more than the rate of return on the utility’s common equity established by the commission in consideration of the utility’s preceding rate filing.

66 Pa. C.S. § 1308(e).

Consequently, there must be an initial determination that PGW has satisfied the statutory requirements of Section 1308(e) of the Code, prior to any consideration

being given to the rate relief requested in PGW's petition.<sup>6</sup> In summary, Section 1308(e) of the Code requires that the utility must show that the rate relief requested is immediately necessary for the maintenance of financial stability in order to enable the utility to:

- a. Continue to provide normal services to its customers.
- b. Avoid reductions in its normal maintenance programs.
- c. Avoid substantially reducing its employment.
- d. Earn no more than the return on equity established by the Commission in the Company's preceding rate case.

**B. The Rate of Return On The Utility's Common Equity Requirement Does Not Apply To PGW**

One of the standards required in Section 1308(e) of the Code, is the extraordinary relief request "will provide no more than the rate of return on the utility's common equity established by the commission in consideration of the utility's preceding rate filing." It has been well established that the Commission will utilize PGW's prior ratemaking methodology in setting rates for PGW, which will allow the Company to "comply with its covenants to the holders of any approved bonds."<sup>7</sup> The prior ratemaking methodology that has been employed in setting PGW's rates is the cash flow method. The cash flow method has been the

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<sup>6</sup> By a Prehearing Order dated March 8, 2002, ALJ Fordham ordered the parties to address each of the four prongs in Section 1308(e), the legal standard for granting extraordinary rate relief, as a separate issue.

<sup>7</sup> Pennsylvania Public Utility Commission v. Philadelphia Gas Works, R-00005654, (Order entered February 22, 2001), at page 7, n. 1.

prevailing ratemaking methodology for PGW and has been endorsed by the Pennsylvania Commonwealth Court.<sup>8</sup>

Accordingly, based upon the Commission setting of PGW's rates on a cash flow method, the "rate of return" requirement of Section 1308(e) of the Code should not be utilized in determining the appropriate extraordinary rate relief for PGW.<sup>9</sup>

**C. PGW Has Satisfied The Remaining Three Requirements For Granting Extraordinary Rate Relief**

As referenced in Section 1308(e) of the Code, there are four requirements that must be satisfied by a utility in order to overcome the legal standard for the granting of extraordinary rate relief. As previously discussed, OTS is of the opinion that the "rate of return" requirement does not apply to PGW. However, the remaining three requirements must be satisfied by PGW before the granting of any extraordinary rate relief based on the "maintenance of financial stability". After examining the Filing, along with accompanied exhibits, OTS is of the opinion that PGW has demonstrated the immediate need for extraordinary rate relief in order to maintain financial stability.<sup>10</sup> It is OTS' opinion that in the absence of extraordinary rate relief, and a resulting downgrade by S&P, it appears that PGW would have to reduce maintenance programs, services to customers and employee levels.

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<sup>8</sup> Action Alliance of Senior Citizens of Greater Philadelphia v. Philadelphia Gas Commission, 406 A.2d 1158. (Pa. Cmwlth. 1979).

<sup>9</sup> OTS Statement No. 1 at page 2.

<sup>10</sup> OTS Statement No. 1 at page 3.

It is PGW's claim that it requires extraordinary rate relief in order to maintain S&P's investment grade credit rating for their outstanding debt.<sup>11</sup> As previously noted, the credit rating is important because it determines how expensive it will be for PGW to raise capital. OTS submits that credit ratings are important for all utilities, whether investor owned or non-investor owned. In PGW's case, its credit rating may have a more significant impact on its day-to-day operations, than would be the case with other Commission jurisdictional utilities, due to PGW's historical over-reliance on its commercial paper program to meet its financial obligations.

Consequently, OTS respectfully submits that PGW has satisfied the applicable legal standards as set forth in Section 1308(e) of the Code for the determination of its Petition for extraordinary rate relief. Accordingly, the only issue remaining for consideration by the Commission is whether PGW's request of \$44 million for extraordinary rate relief is justified.

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<sup>11</sup> OTS Statement No. 2, at page 1.

#### **IV. PGW's Extraordinary Rate Relief Request of \$44 Million Is Not Required To Satisfy S&P's Criteria For Debt Service Coverage**

##### **A. Introduction**

As earlier discussed, the filing of this Petition was initially due to S&P issuing a notice on or about February 12, 2002 warning that PGW's ratings would be lowered without immediate improvement in its cash flow.<sup>12</sup> By way of further background, PGW witness Knudsen testified that "S&P looked at the levels of funds flows available to PGW over the next 18 months and determined that there is an insufficient basis for assuming that the company can meet all of its operating and financially/legal mandated obligations and maintain the level of liquidity (cash) on hand, which is required for an investment grade company."<sup>13</sup> PGW acknowledges that S&P has not publicly identified a specific level of required extraordinary rate relief, rather, S&P established a standard formula which will be utilized in determining whether PGW's bond rating will be downgraded.<sup>14</sup>

The issue is whether PGW needs \$44 million dollars in extraordinary rate relief to satisfy the coverage formula with ongoing, permanent rate relief.

##### **B. \$25 Million In Extraordinary Rate Relief Is Needed By PGW In Order To Satisfy The Coverage Formula**

In support of its \$44 million extraordinary rate request, PGW witness Bogdonavage testified that the \$44 million revenue increase was necessary to

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<sup>12</sup> See PGW Exhibit BCB-1.

<sup>13</sup> PGW E.R.P. Statement No. 1 at page 3.

<sup>14</sup> PGW Petition at ¶19, at page 9.

produce debt service<sup>15</sup> coverage at a level consistent with S&P's criteria for investment grade.<sup>16</sup> OTS is in agreement with PGW that final determination of the appropriate revenue increase is linked to the Commission's determination of the appropriate debt service coverage for PGW.

In order to provide some assistance to the Commission, OTS witness Deardorff testified as to the meaning of debt service coverage as follows:<sup>17</sup>

Debt service coverage is a ratio of annual funds available to cover annual debt service divided by the annual debt service requirement (principal and interest). The Company's filing calculates debt service coverage using two different methods: 1) aggregate debt service coverage ratio and 2) debt service coverage ratios for each debt issue ranked according to subordination.<sup>18</sup>

In essence, the debt coverage ratio and ultimately the revenue required to satisfy S&P's criteria can be determined by mathematical calculation. The aggregate debt service coverage ratio is calculated by dividing the total cash available to service debt by the aggregate fixed charges.<sup>19</sup> After reviewing the S&P criteria and PGW's aggregate fixed charges, OTS witness Deardorff was able to mathematically calculate that the amount of funds required to provide PGW with adequate debt service coverage is \$148,521,000.

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<sup>15</sup> Debt service is the annual amount of principal and interest due on an outstanding loan.--OTS Statement No. 2 at page 3.

<sup>16</sup> PGW E.R.P. Statement No. 2, at page 2.

<sup>17</sup> OTS Statement No. 2 at page 3.

<sup>18</sup> This method is required in PGW's bond ordinances.

<sup>19</sup> S&P defined PGW's aggregate fixed charges to include the following: debt service on the 1975 ordinance bonds and the 1998 ordinance bonds, the capital lease payments, interest on the commercial paper, the \$18,000,000 payment to the City of Philadelphia, and a \$20 million annual reduction in the commercial paper program. OTS Statement No. 2 at page 4.

In order to calculate PGW's required amount of funds Mr. Deardorff had to make a determination as to the proper debt service coverage. The analysis commenced with recognition that debt service coverage of 1.20 times to 1.30 times is required by S&P to maintain PGW at investment grade.<sup>20</sup> Since the debt coverage required by S&P had a range, Mr. Deardorff decided to be conservative and selected the middle of that range as a reasonable target for this proceeding.<sup>21</sup>

OTS Exhibit Number 2, Schedule 2, provides the calculation of the revenue level necessary to produce a debt service coverage ratio of 1.25 times.<sup>22</sup> As Schedule 2 illustrates, a 1.25 times debt service coverage ratio results in \$148,521,000 as the funds needed to cover debt service. Continuing with OTS Exhibit Number 2, Schedule 2, under the column "Projected Income Statement", \$691,850,000 in Total Operating Revenues minus \$666,850,000 (638,733,000 + \$28,117,000) in test year budget revenues, equals \$25 million. Accordingly, the Commission should grant PGW \$25 million in additional revenues. OTS' recommended funds available of \$148,521,000 will provide for coverage of PGW's 1975 Ordinance Bonds and 1998 Senior Ordinance Bonds of 2.78 times and 3.01 times, respectively.<sup>23</sup> Both debt service coverages are in excess of the required 1.5 times.<sup>24</sup> Furthermore, the recommended funds available of

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<sup>20</sup> PGW E.R.P. Statement No. 4 at page 5.

<sup>21</sup> OTS Statement No. 2 at page 5.

<sup>22</sup> OTS Exhibit Number 2, Schedule 2 is similar to PGW Exhibit JRB-2, except OTS corrected two errors and the debt service coverage ratio is lowered to 1.25 times from 1.27 times.

<sup>23</sup> OTS Statement No. 2 at page 6.

<sup>24</sup> The Rate Covenant set forth in Article IV, Section 403 of its 1975 and 1998 Bond Ordinances requires PGW to maintain debt service coverage of 1.5 times for the 1975 Ordinance Revenue Bonds and 1998 Ordinance Senior Revenue Bonds and 1.0 times for 1998 Ordinance Subordinate Revenue Bonds.

\$148,521,000 provides a coverage ratio of 31.25 times for PGW's 1998

Subordinate Bonds, which is in excess of the required 1.0 times.<sup>25</sup>

The \$19 million difference between OTS' recommended \$25 million rate relief, and PGW's \$44 million rate relief request is a result of two errors contained in PGW Exhibit JRB-2. The first error is the failure of PGW to add-back capital leases (\$5,954,000) in the Company's debt service coverage calculation, which had the effect of reducing the debt service coverage ratio.<sup>26</sup> On rebuttal, PGW witness Bogdonavage testified that during the discovery sessions, PGW found a formula problem with PGW Exhibit JRB-2, and PGW corrected the exhibit based on S&P's calculation.<sup>27</sup> On surrebuttal, OTS witness Deardorff responded to the correction by testifying that PGW acknowledged that to adhere to the S&P fixed charge coverage ratio calculation, the capital leases of (\$5,954,000) had to be added back.<sup>28</sup> However, as Mr. Deardorff testified, while adding back the capital leases, PGW also changed its methodology to conform with the S&P methodology.<sup>29</sup> Notwithstanding the revised PGW Exhibit JRB-2, OTS will not be endorsing the change in methodology, since a revision would only change the debt coverage ratio by .03, which continues to leave the OTS' recommended coverage ratio in the S&P range of 1.2 times to 1.3 times.<sup>30</sup>

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<sup>25</sup>Id., at page 6.

<sup>26</sup>OTS Statement No. 2 at page 7.

<sup>27</sup>Tr. 75.

<sup>28</sup>Tr. 198.

<sup>29</sup>Tr. 198.

<sup>30</sup>Tr. 198.

The second error in PGW Exhibit JRB-2 is PGW's forecast of a \$20 million projected paydown of the commercial paper program for budget year 2001-2002. At line 18 of Exhibit A-2 in the base rate filing, PGW is projecting an \$11 million paydown for the budget test year 2001-02. To be consistent with the base rate filing the amount should be \$11 million.

The correct amount to use in the debt service calculation is \$11 million. The \$20 million paydown was a one time reduction to PGW's commercial paper program over the historic period. Recognizing the \$20 million claim as suggested by PGW would constitute retroactive ratemaking and should be properly excluded from the future test year. The best argument against PGW's \$20 million claim is its own witness, Mr. Knudsen, who testified that "it is my understanding that S&P looked at the level of funds and fund flows available to PGW over the next 18 months." The S&P 18 month forward-looking analysis through fiscal year 2003 is provided by PGW as Exhibit BCB-3

There currently exists no contract that mandates a paydown for the 2002-03 fiscal year. Given that S&P's debt service coverage is defined by default risk, only contractual obligations should be included in the calculation. Tr. 51. Since this is an extraordinary rate relief proceeding, its proper goal is to determine the minimum amount necessary to avoid an S&P downgrade. Tr. 199. While PGW's enthusiasm to paydown the commercial paper is admirable, this enthusiasm should not cloud the intent of this proceeding. Only by using PGW's original projection

of an \$11 million paydown in the debt service coverage calculation will the true intent of this proceeding be served.

On rebuttal, PGW witness Bogdonavage compounded his error by testifying that the correct input to the debt service coverage calculation is \$31 million (the projected \$11 million plus the mandated \$20 million paydown of PGW's commercial paper). It appears that the Company witness is presenting three different scenarios for the paydown in the future test year: the \$11 million that appears in Exhibit A-3, the \$20 million that they provided to S&P for their spreadsheet and the \$30 million to \$31 million that Mr. Bogdonavage testified to on rebuttal testimony.<sup>31</sup> By way of further explanation, there should be no dispute that as part of the tax exempt commercial paper program ("TXCP"), PGW is required to paydown the loan balance by \$20 million by August 2002, which was substantially accomplished over a two-year period. During fiscal year 2001, PGW repaid \$19 million resulting in an ending balance of \$78 million, which is shown in PGW Exhibit JRB-1. The remaining \$1 million will be repaid during this fiscal year. These repayments are illustrated in PGW Volume II, Exhibit A-2. On cross-examination both PGW witness Bogdonavage and OTS witness Deardorff, acknowledged that no contract has been signed between PGW and its lending

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<sup>31</sup> Tr. 93. He testified that it is \$31 million but that Schedule A-3 only shows \$30 million. He never did explain what happened to the other \$1 million.

institutions requiring any paydown of PGW's commercial paper in the 2002-03 fiscal year.

In conclusion, if both errors are corrected on PGW Exhibit JRB-2, PGW's extraordinary rate relief request of \$44 million would result in aggregate debt service coverage ratio of 1.41 times, well in excess of the S&P required range of 1.20 times to 1.30 times. Accordingly, OTS recommends that Commission find that the appropriate aggregate debt service coverage ratio for PGW is 1.25 times, and the funds available for debt service is \$148,521,000.

**C. OTS' RECOMMENDED \$25 MILLION FOR EXTRAORDINARY RATE RELIEF HAS BEEN PROPERLY CALCULATED FOR CASH FLOW PURPOSES**

As previously discussed, OTS witness Deardorff determined that the funds available to service aggregate debt coverage of 1.25 need to be \$148,521,000. In order to calculate a \$25 million extraordinary rate relief, OTS witness Weakley added the total funds applied and subtracted restricted funds and AFUDC to calculate the total operating revenues of \$691,850,000 necessary to service aggregate debt coverage.<sup>32</sup> In order to determine the amount needed for extraordinary rate relief, Mr. Weakley compared test year budget revenues of \$666,850,000 (\$638,733,000 + \$28,117,000) to the calculated revenues and determined that PGW needs \$25 million (\$691,850,000 - \$666,850,000) in extraordinary rate relief.<sup>33</sup>

It appears from examining PGW Exhibit JRB-1, that in the absence of any extraordinary rate relief, PGW would end its fiscal year 2002 with a cash deficit of \$20.8 million. By comparison, Mr. Weakley prepared cash flow statements including OTS' recommended \$25 million extraordinary rate relief for the fiscal years ended August 31, 2002 and August 31, 2003, which show no cash deficiencies in either year.<sup>34</sup>

Mr. Weakley's analysis for fiscal year 2002, which shows no cash deficiency, is predicated upon the OTS position that for fiscal year 2002, the city fee should be granted back to PGW.<sup>35</sup> In this proceeding, the City of Philadelphia has proposed to grant back to PGW all or the necessary portion of its \$18 million fee on a one time basis to assure that PGW will not fall below its bond covenants and be in technical default on its bonds.<sup>36</sup> OTS is recommending that the City grant back the \$18 million even if PGW meets their bond covenant. If PGW's bond rating is downgraded, the City is exposed to the risk of losing its \$45 million city loan and any future annual fees of \$18 million.

The grant back of the \$18 million is particularly reasonable when one considers that the city must share responsibility for this potential S&P downgrade. While PGW witnesses failed to discuss this matter in their testimony, one of the reasons announced by S&P for the potential downgrade, is the "inability to convert

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<sup>32</sup> OTS Statement No. 1 at page 4.

<sup>33</sup> *Id.*, at page 4.

<sup>34</sup> See OTS Exhibit No. 1, Schedule 1 and Schedule 2.

<sup>35</sup> See OTS Exhibit No. 1, Schedule 3.

<sup>36</sup> PGW E.R.P. Statement No. 5 at page 4.

from interim management to permanent management by December 2001, as directed by PUC's interim rate order in November 2000. The search for permanent management is at an advanced stage and is expected to conclude by April 2002.<sup>37</sup> Accordingly, OTS is of the opinion that the grant back of the \$18 million is appropriate under the circumstances.

It should be noted that the cash flow impact in fiscal year 2002 of OTS' \$25 million extraordinary rate relief recommendation would be \$2.5 million.<sup>38</sup>

Finally, with respect to fiscal year ended August 31, 2003, Mr. Weakley is recommending that the \$45 million city loan payment be reduced to \$22.5 in fiscal year ended 2003. In the current base rate filing, PGW has requested \$22.5 million to repay the city loan.<sup>39</sup> Accordingly, the cash flow adjustment of \$22.5 million in fiscal year ended 2003 is merely being consistent with PGW's base rate case filing. By incorporating the beginning cash balance for August 31, 2003 and the \$22.5 million adjustment, the projected cash balance as of August 31, 2003 is \$15.8 million.

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<sup>37</sup> PGW Exhibit BCB-1.

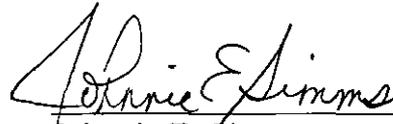
<sup>38</sup> See OTS Exhibit No. 1, Schedule 3

<sup>39</sup> PGW Volume II, Exhibit A-2 and OTS Exhibit No. 2, Schedule 3.

V. CONCLUSION

For the reasons set forth in this memorandum, the Office of Trial Staff is respectfully requesting the Pennsylvania Public Utility Commission allow the Philadelphia Gas Works' \$25 million in extraordinary rate relief.

Respectfully submitted,

  
\_\_\_\_\_  
Johnnie E. Simms  
Senior Prosecutor

The Office of Trial Staff  
P.O. Box 3265  
Harrisburg, PA 17105-3265  
(717) 787-1976

Dated: April 3, 2002

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COMMONWEALTH OF PENNSYLVANIA



ORIGINAL

OFFICE OF SMALL BUSINESS ADVOCATE  
Suite 1102, Commerce Building  
300 North Second Street  
Harrisburg, Pennsylvania 17101

(717) 783-2525  
(717) 783-2831 (FAX)

XXXXXXXXXXXXXXXXXXXX  
XXXXXXXXXXXXXXXXXXXX  
XXXXXXXXXXXXXXXXXXXX  
XXXXXXXXXXXXXXXXXXXX

Carol F. Pennington  
Acting Small Business Advocate

April 3, 2002

HAND DELIVERED

James J. McNulty, Secretary  
Pennsylvania Public Utility Commission  
Commonwealth Keystone Building  
P. O. Box 3265  
Harrisburg, PA 17105-3265

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Re: Philadelphia Gas Works  
Petition for Extraordinary Rate Relief  
Docket No. R-00017034F0002

Dear Secretary McNulty:

Enclosed for filing are the original and nine (9) copies of the Memoranda on behalf of the Office of Small Business Advocate in the above-docketed proceeding. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Steven C. Gray  
Assistant Small Business Advocate

Enclosures

- cc: Hon. Glen R. Thomas, Chairman
- Hon. Robert K. Bloom, Vice-Chairman
- Hon. Aaron Wilson, Jr., Commissioner
- Hon. Terrance J. Fitzpatrick, Commissioner
- Hon. Kim Pizzingrilli, Commissioner
- Karen Oill Moury, Deputy Executive Director
- Kirk House, Esquire, OSA
- (hand delivered and electronic)

49

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

v.

PHILADELPHIA GAS WORKS

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:  
:  
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:  
:

DOCKET NO. R-00017034F0002

CERTIFICATE OF SERVICE

I certify that I am serving the Memoranda on behalf of the Office of Small Business Advocate by first class mail upon the persons addressed below:

Hon. Cynthia W. Fordham  
Administrative Law Judge  
Pa. Public Utility Commission  
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(215) 560-3133 - Fax

Daniel Clearfield, Esquire  
Kevin J. Moody, Esquire  
Wolf, Block, Schorr & Solis-Cohen  
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Philadelphia Gas Works  
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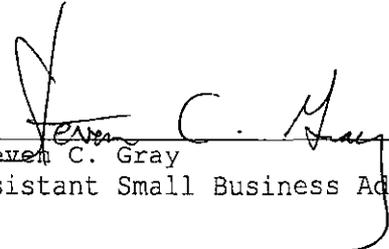
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Larry Speilvogel  
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Steven C. Gray  
Assistant Small Business Advocate

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Date: April 3, 2002

**ORIGINAL**

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY  
COMMISSION

v.

PHILADELPHIA GAS WORKS

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DOCKET NO. R-00017034F0002

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MEMORANDA  
ON BEHALF OF THE  
OFFICE OF SMALL BUSINESS ADVOCATE

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**DOCUMENT  
FOLDER**

**DOCKETED**

APR 05 2002

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RECORDED

Steven C. Gray  
Assistant Small Business Advocate

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(717) 783-2525

Dated: April 3, 2002

**Introduction**

Philadelphia Gas Works (“PGW” or “The Company”) filed a Petition for Extraordinary Rate Relief (“Petition”) on February 25, 2002, pursuant to 66 Pa. C. S. Sections 1308(e) and 2212. PGW’s Petition requests that the Pennsylvania Public Utility Commission (“Commission”) grant the Company \$44 million in extraordinary rate relief in order to avoid a threatened downgrade of PGW’s bond rating by Standard & Poor’s (“S&P”).

In addition, the Petition invoked 66 Pa. C. S. Section 2212(c), requesting that “the commission...suspend or waive the application to a city natural gas distribution operation of any provision of this title.” Specifically, PGW requested that the 30-day time frame of Section 1308(e) be modified to 45 days, thereby providing the Commission and all parties additional time to conclude this case. See Petition, para. 25. Furthermore, PGW requested that the Commission modify the fourth of the “four prongs” of Section 1308(e) which states that extraordinary rate relief may not result in “more than the rate of return on the utility’s common equity established by the commission in consideration of the utility’s preceding rate filing.” Instead, PGW proposed that the Commission choose a different standard, whereby “the Commission should focus on the amount of extraordinary rate relief required by S&P for PGW to maintain an investment grade rating for its bonds and commercial paper.” See Petition, para. 27.

The Office of Small Business Advocate (“OSBA”) filed an Answer to PGW’s Petition on March 6, 2002.

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**The Four Prongs of Section 1308(e)**

The statutory requirements for extraordinary rate relief, which includes the so-called “four prongs,” is set forth in Section 1308(e), which reads in part:

Upon petition to the commission at the time of filing of a rate request or at any time during the pendency of proceedings on such rate request, any public utility may seek extraordinary rate relief of such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on the utility’s common equity established by the commission in consideration of the utility’s preceding rate filing.

66 Pa. C. S. Section 1308(e).

The first three prongs of 1308(e), regarding continuing normal service, avoiding reductions in maintenance programs, and avoiding reductions in employment, are addressed by PGW in an incredible and highly speculative laundry list proposed by PGW witness Thomas Knudsen. See, e.g., Tr. pg. 128, ln. 5, et sqq. PGW asserts that these events will occur if S&P downgrades any of PGW's bonds below investment grade status. Thus, PGW's argument is premised upon two assertions. First, S&P will downgrade PGW's bonds if extraordinary rate relief is not granted, and second, the events catalogued by Mr. Knudsen will occur in the event of such a downgrade. Note also that PGW does not and cannot assert affirmatively either that granting the rate relief that it proposes will avert a downgrade by S&P, or that any actions other than the proposed rate increase could also avert such a downgrade. See, e.g., Tr. pg. 125, ln. 15-25. See also, Tr. pg. 68, ln. 23 to pg. 69, ln. 20.

The fourth prong of 1308(e) limits the award of extraordinary rate relief in light of “the rate of return on the utility’s common equity established by the commission in consideration of the utility’s preceding rate filing.” PGW argues that this fourth prong of Section 1308(e) simply does not apply to the Company, since a "rate of return on the utility's common equity" is a calculation that is not relevant to PGW. See Petition, para. 26. However, the Supreme Court of Pennsylvania apparently has no difficulty finding and calculating the City of Philadelphia's return on equity from PGW. "Therefore, since the \$201,951,000 net equity figure balance sheet figure represents the City's equity interest in PGW, the \$18,000,000 payment to the City would represent a little less than a nine percent rate of return on equity. Such a rate of return is reasonable and rationally related to the City's asserted equity in PGW." Public Advocate v. Philadelphia Gas Commission, 674 A.2d 1056, at 1062 (1996), a copy of which is attached. If the Supreme Court of Pennsylvania's view on the calculation of the return on equity to PGW's owner, the City of Philadelphia, prevails, then any infusion of equity capital provided by the ratepayers in excess of the \$18 million constitutes an increase in the return on equity. As PGW proposes to increase equity by the full amount of the rate increase, its proposed rate increase should be rejected in its entirety. For example, consider Exhibit JRB-2, wherein PGW predicts a test year net income (i.e., return to the shareholder) of \$69.916 million, or \$51.916 million **in excess** of the \$18 million payment to the City.

However, if Public Advocate does not control, PGW has requested that, under the provisions of Section 2212(c), the Commission modify this "fourth prong" so that the analysis is one of maintaining bond ratings, not comparing returns on common equity.

This leaves the Commission in uncharted legal territory, since PGW's requested remedy of a \$44 million infusion of equity, paid for every year until eternity by PGW's non-interruptible customers, was clearly not envisioned by the drafters of Section 1308(e).

For purposes of this case, the OSBA respectfully suggests a slightly reformulated version of the "fourth prong" as proposed by PGW. Specifically, taking the essence of what PGW proposes in Paragraph 27 of its Petition as a starting point, the fourth prong would be rewritten as follows: "The Commission should calculate the amount of extraordinary rate relief necessary in order to maintain PGW's investment grade rating for its bonds and commercial paper."

This formulation is superior to that of PGW's for two reasons. First, it eliminates the implication that the demands and dictates of S&P control how this Commission is required to act. Obviously, the Commission should be allowed to review the evidence of what S&P may or may not do in regards to PGW's credit rating, and reach its own conclusions as to what extraordinary rate relief is "required." Second, this formulation dovetails with the actual language of 1308(e), which requires that extraordinary rate relief must be "shown to be immediately necessary for the maintenance of financial stability." 66 Pa. C. S. 1308(e).

**"Immediately Necessary for the Maintenance of Financial Stability"**

Whether the Commission chooses to adopt the proposed "fourth prong" language of the OSBA, the word "necessary" remains in the language of 1308(e), and upon that word lies the failure of PGW's Petition.

Simply put, the use of the word “necessary” implies that all other options have been exhausted by a natural gas utility seeking extraordinary rate relief, leaving no other choice available. Or, as Webster’s Ninth New Collegiate Dictionary defines it, that the extraordinary rate relief is “logically unavoidable.” Thus, the key question to resolving PGW’s Petition essentially becomes: “How did PGW address the requirement that extraordinary rate relief in the exact amount of \$44 million per year is necessary and not optional?”

The answer, and actually PGW’s entire case for extraordinary rate relief, turns upon PGW Exhibit BCB-1 (Updated), the S& P February 12, 2002 summary of PGW’s credit profile (“Credit Profile”). PGW clearly acknowledges that the issuance of this Credit Profile is the catalyst for this entire case. “The urgency of this emergency [sic] rate relief request was precipitated on February 12, 2002, when Standard and Poors, a key credit rating agency for PGW’s bonds and commercial paper, released a press notice that updated its prior evaluation of PGW.” See Petition, para. 4. Specifically, the key phrase in the Credit Profile that PGW claims required the Company to file this Petition is S&P’s statement that “without immediate cash flow improvement [PGW’s] ratings will be lowered.” Id. However, the Credit Profile is silent as to the amount and type of “immediate cash flow improvement” required by S&P.

Significantly, no S&P witness was made available to provide any explanation or background with regards to the Credit Profile. Thus, PGW relies upon the two page Credit Profile as the basis for its permanent rate surcharge of \$44 million. This leaves all parties, including the Commission, with little explanation or insight into how to interpret S&P’s statement that “[w]ithout immediate cash flow improvement, ratings will be

lowered.” Ultimately, the Credit Profile is the only definitive statement of the analysis and intent of S&P in this case, and as the saying goes, “it says what it says.”

Naturally, without an S&P witness available for cross-examination, there is no unbiased way in which to explore the factors that are used by S&P to decide how to adjust the credit rating of a company like PGW, as well as considering how those factors might be weighted. In addition, no exploration of other options can be considered that also could potentially avoid S&P's threatened downgrade, such as an infusion of cash from the recalcitrant owner of PGW, a major reduction in PGW's embarrassing accounts receivable backlog, the \$20 million expected cash infusion from "Operation Cold Shower," or the sale of PGW to a solvent, investor-owned utility. See Tr. pg. 150, ln. 17-18. See also, Tr. pg. 187, ln. 19 to pg. 188, ln. 1.

The sparse additional evidence that attempts to provide insight into the S&P analytical process does not mitigate the lack of an S&P witness who could actually explain S&P's analytical process. For example, OCA Cross-Examination Exhibit number 2 reproduces an email message from S&P analyst Aneesh Prabhu to Thomas Knudsen, PGW witness and interim President and CEO of PGW. The second paragraph of that email message contains a general overview of the rating process that S&P engages in prior to issuing a credit profile. Unfortunately, a rough overview of the process is literally all that is provided, with no specifics whatsoever as to how S&P reached its conclusions in its PGW Credit Profile, nor any indication as to the actions that PGW or the Commission could take to in order to accomplish the “cash flow improvement” that S&P requires.

Furthermore, Ms. Bisgaier, the managing director of Public Financial Management, Inc., testified on cross-examination that S&P ultimately makes its final rating determination in a “secret” committee. (Tr. pg. 67, ln.1). Ms. Bisgaier noted that while the committee considers the recommendations of the analysts assigned to PGW, it ultimately makes the “final determination” itself. (Tr. pg. 66, ln. 21, to pg. 67, ln. 5).

Therefore, given that none of the witnesses presented by PGW are employees of S&P, no weight should be given to any statement by any PGW witness that he or she “knows” what S&P wants. In addition, the alleged existence of “secret committees” operating within S&P does nothing but further reduce the credibility of any PGW witness who claims to “know the intentions” of S&P. PGW witness Krellenstein perhaps best explained the situation when he described the role of rating agencies and analysts in the credit rating process. “We don’t actually recommend courses of action as much as we will evaluate what is presented to us. We are not there to be consultants. We are there to analyze what is brought to us.” (Tr. pg. 118, ln. 24 to pg. 119, ln. 3). This testimony is consistent with S&P’s statement in PGW’s Credit Profile that S&P “will review the adequacy of the increase and determine if ratings will be affirmed.” PGW Exhibit BCB-1 (Updated).

Thus, S&P has said all it is going to say on this matter when it issued its February 12<sup>th</sup> Credit Profile. Any other insight into S&P’s intent, analytical process, or cash flow requirements by any PGW witness is specious and speculative, and should be given no weight by the Commission.

### The Testimony of OCA Witness Lelash

In general, the OSBA finds the recommendations of OCA expert witness Richard W. Lelash as filed in this case to represent a reasonable compromise between ratepayers and shareholders. Furthermore, the arguments and analysis as set forth by Mr. Lelash in his Direct Testimony are cogent and responsive to the arguments raised by PGW in its Petition. Mr. Lelash's 17 points, beginning on page 5 of his Direct Testimony, provide an excellent summary of not only the issues confronting PGW, but possible solutions to PGW's current cash flow situation.

Mr. Lelash correctly recognizes that PGW's financial need is for an infusion of equity capital to provide liquidity to PGW. See, e.g., OCA Statement No. 1-ERP, at 36. Mr. Lelash also observes that the provisions of 1308(e) are not applicable to PGW's need for equity capital. Id. at 27. He also demonstrates how PGW's owner has not reinvested its \$18 million "dividend" in the manner of responsible investor owned utilities. Id. at 35. However, based on a sense of fairness, Mr. Lelash proposes that the necessary equity infusion be shared evenly between ratepayers and shareholders. Id. at 39-40. Mr. Lelash's proposal has the additional advantage that the equity surcharge be limited in duration, and not imposed in perpetuity. Id. at 40.

The OSBA recognizes the merit of the proposal that is set forth by Mr. Lelash beginning on the bottom of page 39 of his Testimony. However, the OSBA views that proposal, however equitable, in terms of a settlement offer to PGW and the parties, rather than the result of any "formal" analysis on the part of OCA to meet the requirements of Section 1308(e). As Mr. Lelash readily admits, his proposed 3-year, \$18 million per year

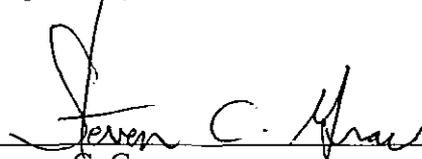
rate increase is predicated on meeting PGW capital requirements, and therefore is not easily justified under Section 1308(e) (Tr. pg. 228, ln. 15 to pg. 231, ln. 5).

In addition, there is one suggestion put forth by Mr. Lelash that the OSBA does not support. The OSBA respectfully disagrees with Mr. Lelash's testimony that the PGW restructuring plan should be constructed to "allow a phase-in of certain restructuring initiatives over time." OCA Statement No. 1-ERP, at 14. The restructuring plan of PGW should be filed on July 1, 2002, as required by 66 Pa. C. S. Section 2212(g), absent any phase-in or other modifications that could be made prior to that date.

**Conclusion**

For the reasons set forth above, the OSBA submits that PGW has failed to demonstrate any immediate financial need that would necessitate receiving extraordinary rate relief under 66 Pa. C. S. Section 1308(e). Therefore, the OSBA respectfully requests that the Commission deny PGW's Petition in its entirety.

Respectfully submitted,

  
\_\_\_\_\_  
Steven C. Gray  
Assistant Small Business Advocate

Date: April 3, 2002

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LEXSEE 674 a.2d 1056

**THE PUBLIC ADVOCATE, Appellee, v. PHILADELPHIA GAS COMMISSION  
and PHILADELPHIA GAS WORKS and PHILADELPHIA FACILITIES  
MANAGEMENT CORPORATION Appellants.**

No. 98 E.D. Appeal Docket 1994

SUPREME COURT OF PENNSYLVANIA

*544 Pa. 129; 674 A.2d 1056; 1996 Pa. LEXIS 814*

October 23, 1995, ARGUED

April 22, 1996, DECIDED

**PRIOR HISTORY:**

[\*\*1] Appeal from the order of the Commonwealth Court entered January 14, 1994 at No. 2545 C.D. 92 reversing in part and affirming in part the order of the Court of Common Pleas of Philadelphia County, Civil Division, entered October 16, 1992, at No. 2961, January Term, 1992. *161 Pa. Commw. 428, 637 A.2d 676 (1994)*. JUDGES BELOW: Hon. G. Craig Lord, (C.C.P.). Craig, Doyle, Colins, Palladino, (Cmwth.).

**CASE SUMMARY**

**PROCEDURAL POSTURE:** Appellants, the gas commission, the gas producing utility, and Philadelphia Facilities Management Corporation, challenged a judgment from the Commonwealth Court (Pennsylvania), in a utility rate action, where the court had ruled that an annual payment from appellant gas utility to the city constituted a tax which was imposed without the city properly exercising its taxing powers, and thus, was arbitrary and unconstitutional.

**OVERVIEW:** Appellant gas commission permitted appellant utility's rate increase for fiscal year 1991-92. Appellee public advocate represented residential customers in gas rate proceedings, and challenged the decision before the trial court. That court affirmed the gas commission's decision that the utility's \$ 18,000,000 payment to the City of Philadelphia did not violate the Pennsylvania Constitution or Pennsylvania law. The trial court held that the payment represented a reasonable return on the city's equity in the utility. Appellee contended the payment was an unconstitutional tax. The commonwealth court reversed, and held that the payment

was not proportionate to the ratepayers' use of the gas works, the annual payment constituted a tax which was imposed without the city properly exercising its taxing powers, and thus, was arbitrary and unconstitutional. The court reversed. The overall rate approved by the gas commission for the gas works' 1991-92 fiscal year was constitutional since it was just and reasonable and since the fixed annual payment was rationally related to the city's asserted equity in the gas works.

**OUTCOME:** The court reversed the judgment from the commonwealth court, which had reversed the trial court's ruling that the annual payment from appellant gas utility to the city was constitutional and a reasonable return on equity, because the city owned the utility, and the payment constituted a rational return on equity.

**COUNSEL:**

For Philadelphia, APPELLANT: Bruce W. Kauffman, Esquire, Steven L. Friedman, Esquire, P.G.W., Thomas E. Groshens, Esquire, Steven B. Goodman, Esquire. For City of Phila., APPELLANT: Richard Fader, Esquire, Joseph A. Dworetzky, City Solicitor.

For The Public Advocate, APPELLEE: Stephen P. Hershey, Esquire, Kimberly K. Hudson, Esquire. For Gas Commission, APPELLEE: Carl E. Singley, Esquire, Valoria L. Cheek, Esquire.

**JUDGES:**

BEFORE: NIX, C.J., FLAHERTY, ZAPPALA, CAPPY, CASTILLE AND MONTEMURO, JJ. Mr. Justice

Montemuro, who was sitting by designation, did not participate in the decision of this case. Messrs. Justice Zappala and Cappy concur in the result.

**OPINIONBY:**  
CASTILLE

**OPINION:**

[\*\*1057] [\*132] **OPINION**

**MR. JUSTICE CASTILLE**

DECIDED: April 22, 1996

The issue before this Court is whether the fixed annual \$ 18,000,000 payment by the Philadelphia Gas Works ("PGW") to the City of Philadelphia ("City"), as required by a [**\*\*1058**] 1972 City ordinance, is constitutional and can be included in the calculation of PGW's rate increase for fiscal year 1991-92. For the reasons expressed below, we believe this payment is constitutional, and therefore, we reverse the order of the Commonwealth Court which remanded this matter to the Philadelphia Gas Commission ("Gas Commission") to re-calculate PGW's [**\*133**] rate increase request for the 1991-92 fiscal year without the required [**\*\*\*2**] payment to the City.

PGW is a municipal utility wholly owned by the City. PGW is comprised of real and personal assets used to manufacture and deliver natural gas to citizens residing within the borders of the City.

Since PGW does not provide gas service beyond the City's borders, its rates are not regulated by the Pennsylvania Public Utility Commission ("PUC"). n1 Instead, PGW's rates are regulated and approved by the Gas Commission. The Gas Commission is an agency of the City established pursuant to Section 3-909 of the Philadelphia Home Rule Charter. n2

n1 Section 1301 of the Public Utility Code provides:

Every 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 orders of the commission. Only public utility service being furnished or rendered by a municipal corporation, or by its operating agencies of any municipal corporation, beyond its corporate limits, shall be subject to regulation and control by the

commission as to rates, with the same force, and in like manner, as if such service were rendered by a public utility.

66 Pa. C.S. § 1301. [**\*\*\*3**]

. n2 Section 3-909 of the Home Rule Charter provides:

The Gas Commission shall be constituted and appointed in accordance with the provisions of such contract as may from time to time be in effect between the City and the operator of the City gas works, or, in the absence of a contract, in such manner as may be provided by ordinance.

351 Pa. Code § 3-909.

In 1972, Philadelphia Facilities Management Corporation ("PFMC"), a non-profit corporation, entered into an agreement with the City to manage and operate PGW for the benefit of the City. Philadelphia City Council embodied this agreement in Ordinance No. 455 of 1972. Section VII of the ordinance gives the Gas Commission the authority to fix and regulate gas rates, and provides in pertinent part as follows:

#### Section VII

##### Gas Rates

1. The Gas Commission shall fix and regulate rates and charges for supplying gas to customers ..., without further [**\*134**] authorization of City Council, which ... will, in each fiscal year produce revenues, at a minimum:

(a) Sufficient to pay all of the operation and maintenance costs and expenses [**\*\*\*4**] of conducting the Gas Works enterprise and to pay the interest and amortization becoming due in such fiscal year on debt incurred for the Gas Works, including, but not limited to:

(i) Charges for depreciation as prescribed in Section IV 1.(b);

(ii) Charges for employees' retirement costs as prescribed in Section IV 1.(c);

(iii) A management fee to Company [PFMC] equal to the actual cost to Company of managing the Gas Works but not to exceed \$ 300,000 annually, effective as of January 1, 1979, and for all years thereafter. The Gas Works shall reimburse Company against vouchers on the first day of each calendar month for monies expended for the

operation of the Gas Works in the previous calendar month;

(iv) Expenses of the Gas Commission; and

(v) All sinking fund charges payable in respect of principal and interest on all obligations of the City issued for or with respect to the Gas Works and, with respect to Gas Works Revenue Bonds issued pursuant to the First Class City Revenue Bond Act, such additional amount as may be required to comply with any rate covenant and sinking fund reserve requirement approved by ordinance [\*\*\*5] of City Council in connection with [\*\*1059] the authorization or issuance of Gas Works Revenue Bonds.

(b) Sufficient also (together with the excess on a cumulative basis on internally generated funds available for the purposes set forth below in this subparagraph (b) of prior years beginning after June 30, 1974, to the extent that such excess shall not have been applied to such purposes and shall be available for payment of general expenses of such fiscal year and, subject and subordinate to the payment or provision for payment of all operation and maintenance costs and all sinking fund and sinking fund reserve requirements as set [\*135] forth in subparagraph (a) of this subsection 1., together with the excess funds provided by revenues of such fiscal year not required for such purposes):

(i) To make base payments to the City in the aggregate annual principal amount of \$ 18,000,000 payable in the amount of \$ 4,500,000 on each February 1, March 1, April 1 and May 1, provided the Gas Works may defer this payment to any time between said due date and June 30 of each year in which event it shall be assessed interest on the principal amount of prevailing rates, to be determined [\*\*\*6] by the Director of Finance and the Gas Works, for the said due date of the date of payment or such different amounts at such different time, not greater in annual aggregate principal amount, as City Council shall prescribe;

(ii) To provide appropriations, to the extent not otherwise provided for prepayment of debt and for capital additions which have been determined by the Gas Commission to be reasonable and which have been determined by the Gas Commission to be reasonable and which have been approved by City Council; and

(iii) To provide cash, or equivalent, for working capital in such reasonable amounts as may be determined by the Company to be necessary and as shall be approved by the Gas Commission. (emphasis added)

On July 16, 1991, PGW filed a proposed \$ 31,000,000 rate increase with the Gas Commission for the 1991-92 fiscal year. PGW subsequently amended this rate increase request to \$ 28,000,000. Following formal public hearings, the Gas Commission adopted an order on December 19, 1991 permitting PGW to increase its rates by a total of \$ 15,032,000 rather than the \$ 28,000,000 PGW had requested. n3

n3 The Gas Commission entered an order and memorandum opinion on March 19, 1992 explaining this order.

[\*\*\*7]

On January 21, 1992, the Public Advocate, which represents residential customers in gas rate proceedings, appealed the Gas Commission's decision to the Court of Common Pleas of [\*136] Philadelphia County. n4 On January 31, 1992, PGW and PFGC filed notices of intervention. The City also filed a notice of intervention on February 6, 1992. The Court of Common Pleas, in affirming the majority of the Gas Commission's decision, concluded that PGW's required annual \$ 18 million payment to the City did not violate the Pennsylvania Constitution or Pennsylvania law. In reaching this conclusion, the Court of Common Pleas noted that the \$ 18,000,000 represented a reasonable return on the City's equity in PGW as well as reasonable consideration for the economic benefits that ratepayers received from the City's ownership of PGW, such as: PGW's ability to issue debt through the City on which interest is exempt from taxation, which provided an estimated value of \$ 10,500,000 for the 1991-92 fiscal year; PGW's exemption from the state gross receipts tax on gas revenues, estimated benefit of \$ 23,500,000 for fiscal year 1991-92; and, the fact that PGW is not subject to federal or state income tax, which provided [\*\*\*8] an estimated benefit of \$ 22,100,000 for the 1991-92 fiscal year.

n4 Three community groups, Action Alliance of Senior Citizens, Consumer Education and Protective Association, and the Tenant Action Group joined in the Public Advocate's appeal from the Gas Commission's ruling.

On November 16, 1992, the Public Advocate appealed the Court of Common Pleas decision to the Commonwealth Court. The Public Advocate alleged that the annual \$ 18,000,000 payment to the City: (1) violated just [\*\*1060] and reasonable rate protections; (2) constituted an unlawful taking of customer's property for

public purposes; and, (3) was an illegal payment in lieu of taxes.

The Commonwealth Court (en banc, one judge concurring and dissenting) affirmed in part and reversed in part the decision of the Court of Common Pleas. The Commonwealth Court held that the annual \$ 18,000,000 payment to the City should not be used in the rate calculation because it bore no rational relationship to PGW's performance and use. The Commonwealth Court reasoned [\*\*\*9] that since the annual \$ 18,000,000 payment was not proportionate to the ratepayers' use of [\*137] PGW, the annual payment constituted a tax which was imposed without the City properly exercising its taxing powers, and thus, was arbitrary and unconstitutional. The Commonwealth Court also found that even though the City's balance sheet showed a net equity of \$ 201,951,000 in PGW, that amount did not justify the annual \$ 18,000,000 payment because the net equity figure cannot be said to have come directly from the City's own funding. The Commonwealth Court ultimately ordered that the matter be remanded to the Gas Commission to re-calculate PGW's rate increase request for the 1991-92 fiscal year without the required fixed annual \$ 18,000,000 payment to the City.

The City, PGW and PFMC (collectively "Appellants") filed a petition for allowance of appeal which this Court granted. n5 This Court granted allocatur in order to determine whether the fixed annual \$ 18,000,000 payment by PGW to the City, as required by the 1972 City ordinance, is constitutional and can be included in the calculation of PGW's rate increase for fiscal year 1991-92.

n5 After appellants filed their petition for allowance of appeal, the Public Advocate filed a motion with the Commonwealth Court to order that all payments made by PGW to the City since January 14, 1994 (the date of the Commonwealth Court's decision) pursuant to the 1972 ordinance be placed in escrow pending a final decision by this Court. The Public Advocate also sought an order requiring the Gas Commission to re-calculate all of PGW's rates for the period beginning from September 1, 1991 to the present without the annual \$ 18,000,000 payment. An en banc Commonwealth Court denied the Public Advocate's motion since such a request exceeded the narrow scope of its order compelling the Gas Commission to re-calculate PGW's 1991-92 rates and its previous order did not prohibit the making of future payments. See *Public Advocate v. Philadelphia Gas Commission*, 166 Pa. Commw. 41, 646 A.2d 19 (1994).

[\*\*\*10]

Where, as here, a complete record was developed before the local agency, n6 the court reviewing the matter on appeal must affirm the local agency unless it is determined that constitutional rights were violated, that an error of law was committed, that the procedure before the agency was contrary to statute or that necessary findings of fact were [\*138] unsupported by substantial evidence. *Insinger Machine Co. v. Philadelphia Tax Review Board*, 165 Pa. Commw. 344, 346 n.4, 645 A.2d 365, 366 n.4 (1994), appeal denied 540 Pa. 624, 657 A.2d 494, cert denied, 116 S. Ct. 303, 133 L. Ed. 2d 208 (1995); 2 Pa. C.S. § 754(b). n7

n6 It is undisputed that the Gas Commission is a local agency within the meaning of the Local Agency Law. 2 Pa. C.S. § 101.

n7 Section 754(b) provides:

In the event a full and complete record of the proceedings before the local agency was made, the court shall hear the appeal without a jury on the record certified by the agency. After hearing the court shall affirm the adjudication unless it shall find that the adjudication is in violation of the constitutional rights of the appellant, or is not in accordance with law, or that the provisions of Subchapter B of Chapter 5 (relating to practice and procedure of local agencies) have been violated in the proceedings before the agency, or that any findings of fact made by the agency and necessary to support its adjudication is not supported by substantial evidence. If the adjudication is not affirmed, the court may enter any order authorized by 42 Pa. C.S. § 706 (relating to disposition of appeals).

[\*\*\*11]

As previously discussed herein, the City owns PGW. By virtue of the First Class Home Rule Act, 53 P.S. § 13101, et seq., the City:

... Shall have and may exercise all powers and authority of local self government and shall have complete powers of legislation and administration in relation to its [\*\*\*1061] municipal functions ... and the city may enact ordinances, rules and regulations necessary and proper for carrying into execution the foregoing powers and all other powers vested in the city by the charter it adopts or by this and any other law.

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53 P.S. § 13131. An ordinance which is properly adopted by the Philadelphia City Council has the force and effect of an act of the Pennsylvania assembly. *School District of Philadelphia v. Zoning Board of Adjustment*, 417 Pa. 277, 207 A.2d 864, 871 (1965); *Action Alliance of Senior Citizens of Greater Philadelphia, Inc. v. Philadelphia Gas Commission*, 45 Pa. Commw. 234, 241, 406 A.2d 1155, 1158 (1979). As a legislative body, it is presumed that any laws enacted will be constitutional, even those laws effecting rates for gas service. See *Duquesne Light Company v. Barasch*, 488 U.S. 299, 316, 102 L. Ed. 2d 646, 109 S. Ct. 609 (1989) (United States Supreme Court has never doubted that legislative bodies are competent [\*139] bodies to set utility rates); *School District of Deer Lakes and Allegheny Valley v. Kane*, 463 Pa. 554, 345 A.2d 658, 662 (1975) (one of the most fundamental statutory interpretation presumptions is that the legislature has acted constitutionally).

There is no dispute that the 1972 ordinance in question was properly enacted by City Council. The 1972 City ordinance sets forth a formula for setting rates which will produce sufficient revenue to pay PGW's operating and maintenance expenses. See *Action Alliance*, supra (approved "cash flow" method established by the 1972 City ordinance as the method by which PGW could establish rates). Thus, it is presumed that rates set in accordance with the 1972 City ordinance, which includes the fixed annual payment in dispute, are constitutional.

PGW argues that it was error for the Commonwealth Court to strike down this annual payment as unconstitutional solely because it disagreed with the method employed to establish such a rate. As previously stated herein, PGW's rates are not subject to PUC regulation. *Action Alliance*, 45 Pa. Commw. at 241, 406 A.2d at 1158 (PGW "is [\*13] not subject to PUC regulation"). Thus, strict reliance cannot be placed upon public utility statutes and PUC case law concerning rates. Even though the PUC cannot regulate the rates charged by a municipal utility like PGW, it does not mean that municipal utilities are not subject to any control. As this Court stated in *American Aniline Products, Inc. v. Lock Haven*, 288 Pa. 420, 135 A. 726 (1927):

Courts have the power to determine questions relating to service and rates [of municipal utilities] where a complaint is based on 'reasonableness of the ordained rate or the justness of their application,' or discrimination amounting to confiscation.

288 Pa. at 424, 135 A. at 727.

When examining the 1991-92 rates for PGW, this Court is mindful that no applicable constitutional requirement is more exacting than the requirement of "just and reasonable" rates. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 607, 88 L. Ed. 333, 64 S. Ct. 281 (1944). The United States Supreme Court has held that not every aspect of ratemaking has constitutional dimensions despite the fact that it might effect property rights. *Id.* 320 U.S. at 610. Under the due process clause of the 5th and 14th [\*14] Amendments to the United States Constitution, a utility "is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services." *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475, 82 L. Ed. 1469, 58 S. Ct. 990 (1938).

When determining rates to charge to its users, utilities are not bound to use any single formula or combination of formulae. *Hope*, 320 U.S. at 610. Different rate making formulas are allowed since the designation of a single theory of ratemaking as a constitutional requirement would have the effect of depriving consumers and investors from benefitting from alternative rate methods. The Constitution leaves the states free to decide what ratemaking methodology best balances the interest of the utility and the public. *Duquesne*, 488 U.S. at 316.

[\*\*1062] When determining if the rate set by the utility is constitutional, the United States Supreme court has stated that:

It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at [\*15] an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

[\*141] *Hope*, 320 U.S. at 602. See also *Duquesne*, 488 U.S. at 314 (an otherwise reasonable rate if not subject to constitutional attack by questioning the theoretical consistency of the method that produced it since it is not the theory, but the impact of the rate order which counts). Any rate selected which falls within the broad zone of reasonableness cannot properly be attacked as unconstitutional for being confiscatory. *In re Permian*

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*Basin Area Rate Cases*, 390 U.S. 747, 770, 20 L. Ed. 2d 312, 88 S. Ct. 1344 (1968). This Court has followed the above guidelines set by the United States Supreme Court when examining utility rate disputes involving the PUC. See *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 509 Pa. [\*\*\*16] 324, 502 A.2d 130 (1985), appeal dismissed 476 U.S. 1137, 106 S. Ct. 2239, 90 L. Ed. 2d 687 (1986); *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 561, 493 A.2d 653 (1985). We hold today that the United States Supreme Court guidelines for determining the constitutionality of a rate are also applicable to examining rate disputes involving municipal utilities.

In holding that the fixed annual \$ 18,000,000 payment to the City as required by the 1972 City ordinance was unconstitutional, the Commonwealth Court appears to have focused on one element of the ratemaking formula rather than the overall impact of the Gas Commission's rate order. Past decisions of this Court and the United States Supreme Court have held that such a focus is improper. See *Hope*, supra; *Pennsylvania Electric*, supra.

A review of the overall impact of the Gas Commission's rate order for PGW's 1991-92 fiscal year mandates a different result. A review of the rate in question shows that the rate approved by the Gas Commission for PGW's 1991-92 fiscal year does not amount to a confiscatory rate. In fact, neither the Commonwealth Court nor the Public Advocate contends or has proven that the rate in question amounts [\*\*\*17] to either a confiscatory or an unjust and unreasonable rate. Moreover, the City owns PGW in its proprietary capacity. *Graham v. Philadelphia*, 334 Pa. 513, 518, 6 A.2d [\*142] 78, 80 (1939) As such, PGW stands on the same footing as a private corporation and is entitled to the same privileges as a private corporation. See *In re Petition of City of Philadelphia*, 340 Pa. 17, 16 A.2d 32 (1940) (a municipality which owns and operates sewers is treated like a private corporation). As the owner, PGW would be entitled to whatever proceeds were generated from the sale of PGW were the utility to be sold. Also, the net equity balance sheet figure represents not only the corporate owner's capital contributions to the corporation but also includes any earnings retained by the corporation less any losses sustained by the corporation less any capital distribution back to the corporate owners.

See 15 Pa. C.S. § 1551 (Distribution to Shareholders); See also Harold P. Starr, Pa. Bus. Corp. Prac. § 7.6 "Limitations on Distributions" (1991). Therefore, since the \$ 201,951,000 net equity figure balance sheet figure represents the City's equity interest in PGW, the \$ 18,000,000 payment to [\*\*\*18] the City would represent a little less than a nine percent rate of return on equity. Such a rate of return is reasonable and rationally related to the City's asserted equity in PGW. See *Graham*, 334 Pa. at 522, 6 A.2d at 78 (city entitled to reasonable rate of return on its Gas Works assets).

Thus, the overall rate approved by the Gas Commission for PGW's 1991-92 fiscal year [\*\*1063] was constitutional since it was just and reasonable and since the fixed annual \$ 18,000,000 payment is rationally related to the City's asserted equity in PGW. Therefore, the Commonwealth Court erred in remanding this case to the Gas Commission to re-calculate PGW's rate increase request for the 1991-92 fiscal year without the required fixed annual \$ 18,000,000 payment to the City.

Finally, this Court notes that even though the rates set by the 1972 City ordinance are constitutional, consumers are not left without a remedy if they are dissatisfied with rates charged by PGW. As stated above, PGW's rates are set in accordance with a 1972 ordinance enacted by City Council. City Council is comprised of representatives elected by the residents of the City. If City residents desire a change in PGW's rate making [\*\*\*19] method, they can either pressure City [\*143] Council to amend the 1972 ordinance or have their voices heard through the election process.

Accordingly, since the rates set by the Gas Commission's order for PGW's 1991-92 fiscal year are just and reasonable, it was proper for the Gas Commission to include the fixed annual \$ 18,000,000 payment by PGW to the City, as required by the 1972 City ordinance, in the calculation of that rate. Therefore, the order of the Commonwealth Court is reversed.

Mr. Justice Montemuro, who was sitting by designation, did not participate in the decision of this case.

Messrs. Justice Zappala and Cappy concur in the result.