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October 13, 2000

**VIA HAND DELIVERY**

James J. McNulty, Secretary  
PA Public Utility Commission  
P.O. Box 3265  
Harrisburg, PA 17105

RE: Pennsylvania Public Utility Commission v. Philadelphia Gas  
Works, Docket Nos. R-00005654

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works, enclosed for filing please find an original and nine copies of its Main Brief with regard to the above referenced matter. Also enclosed is a diskette containing the brief in Microsoft Word.

As evidenced on the attached Certificate of Service, all parties to the proceeding are being served with a copy of this document.

Very truly yours,



Daniel Clearfield

For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

DC/lww  
Enclosure

cc: Hon. Marlane Chestnut w/enc.  
Per Attached Certificate of Service w/enc.

DSH:24360.1

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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FOLDER

Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

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Docket No. R-00005654

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MAIN BRIEF OF PHILADELPHIA GAS WORKS

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**DOCKETED**

OCT 16 2000

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## I. INTRODUCTION AND SUMMARY OF ARGUMENT

Just short of two months ago, the Commission authorized this expedited proceeding to address Philadelphia Gas Works' ("PGW" or "the Company") critical need for immediate, interim rate relief to maintain the financial health of the Company until a full-scale, permanent base rate case can be completed. While ordering this expedited process, the Commission cautioned that PGW continued to bear the burden of proving its need to have its rates increased on an interim basis. Furthermore, the Commission conditioned its approval on, among other things, PGW's continuing commitment to its "Transition to Excellence" plan for improvement of its operations and service as well as assurances that PGW is providing safe and adequate service.

PGW has done all this — and more. First, it has formally promised — through a binding resolution of its Governing Board<sup>1</sup> — to abide by the commitments requested by the Commission in the Order.<sup>2</sup> In particular, PGW has committed to continuing its "Transition to Excellence" program and has continued to make strides to improve all aspects of its service. PGW is now billing all of the customers who previously had not been billed; it is also on its way to correcting other identified concerns.<sup>3</sup>

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<sup>1</sup> PGW-IR Exh. 1.5.

<sup>2</sup> The resolution also acknowledges that the interim increase is subject to refund, that PGW will not ask for recoupment if the final, permanent award is higher than the interim increase, and that it is prepared to demonstrate that it is providing safe and adequate service throughout the interim rate period. *Id.*

<sup>3</sup> PGW-IR Exh. 1.1; Tr. 145-47, 195; OCA Cross Exh. 1. In addition to correcting its bill issuance problems, PGW is on its way to correcting limitations in budget billing deficiencies; and it has identified concerns regarding the dispatch of appliance service persons into the field (not a public utility service). *Id.*

Furthermore, PGW has made it clear to all of its employees that a new commitment to cost reductions and efficiency is in effect. For example, the Company included in its \$52 million interim rate increase an assumption that PGW will achieve \$14 million in productivity savings in the coming fiscal year.<sup>4</sup> Moreover, the City Administrator has installed a new management team who are determined to move beyond the problems of the past and to deliver on PGW's pledge of excellence.<sup>5</sup>

Indeed, the evidence introduced by PGW clearly demonstrates that the Company could have justified an increase of over \$70 million, and an even higher level if the base rate effects of recent increases in gas costs are taken into account. Even though this will be its first base rate increase in over 9 years, to be conservative, and to try to minimize the effects on customers, PGW has asked that it be awarded only \$52 million as an interim grant. Therefore, this is not a case where the PUC can split the difference and award PGW any less than what it has requested. The intense public scrutiny to which the Company is subject does not permit PGW to exaggerate its claimed revenues and expenses for the purposes of a rate request.

It is also important to note that witnesses for both the OCA and OTS have agreed that it is in the interests of PGW and its customers to assure that PGW avoids the disastrous consequences of a technical default or bond downgrading, and have, therefore, submitted testimony that an interim base rate increase of at least \$25 – \$27.5 million is justified. These recommendations are

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<sup>4</sup> Without this commitment, the interim increase would have to be that much higher.

<sup>5</sup> The new management team reluctantly requested this interim increase only when the team concluded it was absolutely necessary and only after it had been reviewed by a host of parties (including the Mayor of Philadelphia).

technically and legally deficient, fail to adequately appreciate the seriousness of PGW's circumstances and leave the Company far too exposed if it experiences unexpected cost increases or an earnings decrease caused by warmer than normal weather. Nonetheless, they do set the bottom end of the award that the Commission should consider in exercising its express intention to maintain PGW's financial condition through the next several months, which, because of the concentration of sales in these few months, is determinative of PGW's financial performance for the entire fiscal year, ending next August.

The opposing parties also suggest that the owner of PGW, the City of Philadelphia, should be forced to contribute additional loans or forfeit its "return" to fund PGW's revenue shortfall. However, this position is analogous to requiring utility investors to fund large portions of a utility's legitimate revenue requirement without ratepayer contribution. Such a proposal would be summarily dismissed as unreasonable, illegal and unconstitutional for any other public utility and is no more acceptable for PGW.

Indeed, PGW has presented voluminous data and evidence plainly establishing its need for the entire \$52 million interim rate increase, a need which clearly has become more acute since its original filing in August. The evidence, which is fully discussed below, is summarized as follows:

- ❖ PGW bills almost  $\frac{3}{4}$  of its revenues during the winter heating season (65% in just the four months from December through March). Accordingly, the Company must raise base rates no later than mid-November to address any deficiencies in earnings or cash-working capital projected for the entire 2000-2001 fiscal year (ending in August, 2001), as well as in the first pre-winter months of its next fiscal year.

- ❖ Even with PUC approval of an increase in the Company's GCR, without interim rate relief PGW is projected to end its fiscal year in technical default on one of its bond ordinance covenants, even on a fully weather normalized basis.<sup>6</sup>
- ❖ Without interim rate relief, PGW would be deficient by tens of millions of dollars in the month-to-month and year-end cash balances it must have to pay for gas purchases, make debt service payments and satisfy lender requirements.
- ❖ PGW's financial advisor testified that a PGW technical default on its bond coverages would bring an immediate downgrade to junk bond status. This would, in turn, make it impossible for the Company to access the bond market in the Spring of 2001 for \$75 million of additional long-term debt, the issuance of which is crucial to PGW's capital improvement program judged indispensable to maintain system safety and reliability and to meeting its cash-working capital needs.
- ❖ A failure to obtain rate relief sufficient to satisfy PGW's cash flow needs is also of such acute concern to the rating agencies and to PGW's lenders that Standard & Poor's has placed PGW on "CreditWatch with Negative Implications" and has indicated that a downgrade to junk bond status would be forthcoming in the absence of an adequate rate award.
- ❖ PGW's commercial paper program, which was initiated to provide a source of cash during low cash flow periods, has now become a permanent part of PGW's capital structure. PGW has utilized this program to its maximum limit primarily as a result of three warmer than normal winters, and is in danger of defaulting if it cannot replace the letter of credit that secures the program. This risk increases significantly if PGW's earnings and cash-working capital levels are not set at adequate levels.

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<sup>6</sup> PGW's projected fiscal year results also normalize to eliminate any revenue under-collections caused by PGW's now corrected billing problems.

- ❖ An inability to issue additional long term debt and/or a loss of its commercial paper line of credit will threaten PGW's continued ability to maintain its construction program, including its main replacement program, to continue to improve its billing system and service in general. It will also result in PGW being faced with several hundred million dollars of liability with no apparent way to satisfy these obligations.
- ❖ PGW's original interim rate request could have justifiably been at least \$20 million higher and would still have produced minimum levels of earnings and cash-working capital for the fiscal year. But, since its initial filing, PGW's financial projections have taken a significant turn for the worse as a result of gas costs continuing to escalate well beyond the levels assumed in PGW's pending \$97 million GCR filing. (Presently, wholesale gas costs have almost doubled since last year and have increased by 40% just in the last few months.) Gas costs have increased to such an extent that PGW's GCR would have to be increased by another \$75 million just to keep up with these levels. These additional gas costs — even if they are reflected in a higher GCR rate — increase PGW's bad debt expense and its cash-working capital needs. They, in turn, reduce the margin to cover contingencies included in PGW's \$52 million request to bare bones levels.
- ❖ In light of these concerns, the City Administration has requested City Council approval for additional support in the form of proposed \$45 million interest-free loans in order to provide a financial backstop for a cash-working capital deficiency. The City's proposal of support is as a backstop and must be specifically conditioned on the ability of PGW to pay the loans back, rather than as a replacement for interim rate relief. Indeed, under present projections, PGW may have to call on the City-loan backstop as soon as next month. PGW will certainly require the loan by January, even with full interim rate relief and an increase in the GCR.
- ❖ The public advocates, while acknowledging PGW's need for at least 50% of its interim rate request, have submitted recommendations which urge the PUC to replace rate relief with the City's financial backstops or simply ignore a major

portion of PGW's revenue requirement needs, including its cash-working capital needs both throughout and at the end of the fiscal year. These approaches are inconsistent with the legal requirements which apply to this case. Just as important, they would thrust PGW and its customers onto the high wire of the coming winter season without a net, because the only existing financial backstop available to PGW would already have been used to avoid the full interim rate increase. For example, if Philadelphia's winter is 12.5% warmer than normal (not even as warm as last winter), PGW's projected earnings would be reduced by \$25 million. These revenue reductions would result in a shortfall of over \$20 million of the earnings necessary to meet its coverage calculations under OCA's recommendation. To avoid this result, the OCA's recommendation would have to be increased to \$45 million. Alternatively, if the OTS' recommendation were adjusted to provide PGW with adequate year-end working capital, it would have to be increased to \$38.5 - \$43.5 million.

The City and the Company are committed to doing their part — now the Company needs the PUC to authorize assistance from PGW's ratepayers. PGW's requested interim rate increase is reasonable, and under the circumstances, very conservative. Furthermore, the Company's rate levels continue to be subject to further review and refund if, upon further investigation in the permanent base rate proceeding, the rates are found to be unreasonable. The interim increase is absolutely essential to assure PGW's continued ability to provide safe, adequate and reasonable service at reasonable rates through this coming winter and for the next 12 - 14 months.

Accordingly, the full requested \$52 million increase should be granted in full.

## **II. STATEMENT OF CASE**

This request for interim rate relief was initiated by PGW on August 8, 2000, through the filing of a Petition for Establishment of Interim Rate Procedures and for a Declaratory Order

(“Petition”).<sup>7</sup> On August 17, 2000, the Commission entered an Order granting the request for an expedited hearing schedule and established interim rate procedures (“August 17 Order”). The August 17 Order conditioned approval of the schedule on PGW’s: a) filing a full base rate case no later than January 1, 2001; b) committing that any interim rates granted by the Commission are subject to refund at the conclusion of a full base rate case if the Commission determines that a lower level of rates is just and reasonable; c) committing that it will not seek to recoup additional revenues from ratepayers if the Commission ultimately determines that a higher level of rates is just and reasonable; and d) committing to its “Transition to Excellence” plan for improvement and a demonstration throughout the interim rate period that it is providing safe and adequate service.<sup>8</sup>

With respect to PGW’s request for declaratory order, the Commission acknowledged its obligation — under 66 Pa.C.S. §2212(e) — to utilize the same “ratemaking methodology and requirements” as were applied by the PGC prior to the Commission’s assumption of jurisdiction. Finally, the Commission granted PGW’s request for a waiver of any provisions of the Public Utility Code or regulations to the extent necessary to perfect PGW’s interim rate filing.<sup>9</sup>

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<sup>7</sup> Docket No. P-00001831.

<sup>8</sup> August 17 Order at 8. At the hearing in this matter, PGW entered into the record a resolution of PFMC dated August 25, 2000 committing to all of these conditions. PGW-IR Exh. 1.5; Tr. 132-33.

<sup>9</sup> August 17 Order at 12 (ordering paragraph 5).

Pursuant to the Commission's direction, an evidentiary record has been developed before ALJ Marlane Chestnut. This Main Brief supports PGW's request for interim rate relief.<sup>43</sup>

### **III. STANDARD OF REVIEW FOR INTERIM RATE RELIEF**

#### **A. PGW's Request for Rate Relief Continues to be Governed by the 1972 Management Agreement, Which Has the Force of Law.**

The ratemaking methodology applicable to PGW prior to July 1, 2000, when the Commission assumed jurisdiction over PGW under the Gas Choice Act,<sup>44</sup> is the "cash flow" methodology contained in the Management Agreement between the City and the Philadelphia Facilities Management Corporation ("PFMC"), dated December 29, 1972 and adopted on that date as an ordinance of the City (hereinafter, "Management Agreement" or "Ordinance/Agreement").<sup>45</sup> That ratemaking methodology is adopted by Section 2212(e) of the Gas Choice Act. Section 2212(e) requires the Commission, when determining PGW's "revenue requirement and approving overall rates and charges," to "follow the same ratemaking methodology and requirements that were applicable to [PGW] prior to the assumption of jurisdiction" by the Commission over PGW until all "approved bonds have been retired, redeemed, advance refunded or otherwise defeased."<sup>46</sup>

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<sup>43</sup> A more detailed statement of the case is attached hereto as Appendix "A."

<sup>44</sup> The Natural Gas Choice and Competition Act ("Gas Choice Act") is Section 3 of the Act of June 22, 1999 (P.L. 122, No. 1999-21), 66 Pa. C.S. §§ 2201-12

<sup>45</sup> The Management Agreement is Exhibit B to PGW's Petition For Interim Rate Procedures and is contained in Appendix C, Tab 5, hereto. The City's rights are further recognized in Sections 2212(f) and 2212(s) of the Gas Choice Act.

<sup>46</sup> (Emphasis added.) All "approved bonds" have not been "retired, redeemed,  
(continued...)

The “cash flow” ratemaking methodology applicable to PGW in the Management Agreement was recognized and upheld by the Commonwealth Court in *Action Alliance v. Philadelphia Gas Comm’n*, 406 A.2d 1155, 1158 (Pa. Cmwlth. 1979). This method of ratemaking is established in Section VII, ¶1 of the Management Agreement, and mandates, in part, that the Philadelphia Gas Commission (“PGC”):

shall fix and regulate rates and charges for supplying gas to customers . . . which . . . will, in each fiscal year produce revenues, at a minimum:

- (a) Sufficient to pay all of the operation and maintenance costs and expenses 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 . . .
  - (i) to make base payments to the City in the aggregate annual principal amount of \$18,000,000 . . . ;
  - (iii) To provide cash, or equivalent, for working capital in such reasonable amounts as may be determined by Company to be necessary and as shall be approved by the Gas Commission.<sup>47</sup>

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<sup>46</sup>(...continued)

advance refunded or otherwise defeased” as of this date and will not be “retired, redeemed, advance refunded or otherwise defeased” prior to the date of the Commission’s order in this case.

<sup>47</sup> The list of costs and expenses required to be covered in PGW’s rates, pursuant to Section VII, ¶ 1 of the Management Agreement, includes depreciation, retirement costs, all sinking fund charges payable for principal and interest on PGW bonds, capital additions, working capital and an annual \$18 million base payment to the City.

The Management Agreement also commits the “Commission” to setting rates so that all bond ordinance covenants are honored.<sup>48</sup> Thus, the cash flow method requires rates to be set so that they compensate the Company for all of the items listed in Section VII of the Management Agreement, which includes revenues sufficient to satisfy the Company’s bond covenants.<sup>49</sup>

Section 2212(d) of the Gas Choice Act complements Section 2212(e) by providing that, until such time as a new tariff is filed by PGW and approved by the Commission in connection with PGW’s restructuring,<sup>50</sup> PGW continues and “shall continue to provide natural gas supply and natural gas distribution services to its customers under the prior tariff and the policies or programs existing . . .” on July 1, 2000. Section 1.2 of PGW’s “prior tariff” provides that the tariff “may be revised, amended, supplemented or otherwise changed from time to time in accordance with applicable law”<sup>51</sup> and the [Management] Agreement, with the approval of the PGC. Such tariff changes would include supplements seeking an increase in base rates. Of

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<sup>48</sup> Management Agreement, Section VII, ¶ 1 (c).

<sup>49</sup> *In the Matter of a Proposed Rate Increase for the Philadelphia Gas Works*, filed June 19, 1981, Supplemental Opinion and Order dated November 18, 1981 at 4-5, 10 (attached hereto as Appendix “C,” Tab 2).

<sup>50</sup> Section 2212(g) of the Gas Choice Act requires that, in connection with such restructuring, PGW file its “initial tariff” for approval by the PUC, not its prior tariff. Its “prior tariff” (which has been submitted to the PUC pursuant to Section 2212(d), was simply accepted by the PUC on or around July 1, 2000.

<sup>51</sup> The “applicable law” includes the Gas Choice Act, the Philadelphia Home Rule Charter and the Ordinance/Agreement. These provisions have been held to have statutory effect. *School District of Philadelphia v. Zoning Board of Adjustment*, 417 Pa. 277, 207 A.2d 864 (1965); *Action Alliance v. Philadelphia Gas Comm’n*, 45 Pa. Cmwlth. 234, 241, 406 A.2d 1155, 1158 (1979).

course, the Gas Choice Act has replaced the PGC with this Commission as the body with the authority to approve rate changes.<sup>52</sup>

The PGC has consistently followed the “cash flow” ruling issued in *Action Alliance*. For example, in its Opinion and Order with respect to PGW’s fiscal year 1981-82, the PGC held:

Since the Court, in *Action Alliance*, *supra*, has found the Ordinance/Agreement to have the effect of an Act of Assembly, and that the cash flow method, which includes, *inter alia*, the annual fixed payment to the City, prevails, we now conclude that the Commission is governed and bound by the terms of the said Ordinance/Agreement and that the cash flow method, comprised of all items contained in Section VII of said Ordinance/Agreement, is just and reasonable for rate-making purposes in this case. Accordingly, we reject all arguments to the contrary.<sup>53</sup>

In its Opinion and Order regarding PGW’s rates for the fiscal year 1982-83, the PGC similarly recognized the need to establish rates that would cover all the costs and expenses listed in Section VII of the Management Agreement, as follows:<sup>54</sup>

We recognize that we are governed by the requirements of the Management Agreement that the rates we establish must be sufficient to produce revenues to cover all of the items contained in Section VII thereof reasonably projected and, indeed, the revenue level herein established is reasonably designed to do so.

Further, we reiterate our acceptance of the principle of “normalization” and find that this does not violate the Management

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<sup>52</sup> 66 Pa. C.S. § 2212(d).

<sup>53</sup> *In the Matter of a Proposed Rate Increase for the Philadelphia Gas Works*, filed June 19, 1981, Supplemental Opinion and Order dated November 18, 1991, at 7 (emphasis added). (Attached as Appendix “C,” Tab 2.)

<sup>54</sup> *In the Matter of a Proposed Rate Increase for the Philadelphia Gas Works*, filed May 4, 1982, Adjudication and Order dated September 3, 1982 at 9. (Attached hereto as Appendix “C,” Tab 3).

Agreement. Thus, the level of costs must be estimated for the fiscal year 1982-83, since no one can know now exactly what the actual costs of PGW's operation will be at the end of the year.

Finally, in the PGC's most recent decision addressing PGW's request for a base rate increase for fiscal year 1991-92, the PGC similarly described its obligation to set rates in accordance with the cash flow method.<sup>55</sup> Accordingly, the regulator, whether it be the PGC or the Commission, has an obligation to increase PGW's rates under the "cash flow method" when PGW's rates are shown to be "just and reasonable." *Action Alliance* at 1158.

The "cash flow" methodology has been held by our Supreme Court to produce rates that are constitutionally just and reasonable. *Public Advocate v. Philadelphia Gas Comm'n*, 544 Pa. 129, 139, 674 A.2d 1056, 1061 (1996), where the Court stated (emphasis supplied):

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 the rates set in accordance with the 1972 City ordinance . . . are constitutional.

This Commission has itself recognized the applicability of the cash flow method under the Management Agreement in its explicit reference in the August 17 Order to Section 2212(d) of the Gas Choice Act, which:

succinctly states that until such time as a new tariff is filed by PGW and approved by the Commission in connection with a restructuring, PGW "shall continue to provide natural gas supply and natural gas distribution services to its customers under the

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<sup>55</sup> *In the Matter of a Proposed Base Rate Increase by the Philadelphia Gas Works for Fiscal Year 1991-1992*, Memorandum Opinion and Order adopted December 19, 1991 at 4-5. (Attached hereto as Appendix "C," Tab 4).

prior tariff and the policies or programs existing . . .” on July 1, 2000.<sup>56</sup>

In that August 17 Order, the Commission further acknowledged that it “is cognizant of the relevant sections of the Gas Choice Act and their applicability to the Commission. We fully intend to comply with the statutory mandate at Section 2212(e) to utilize the same ‘ratemaking methodology and requirements’ as were applied by the Gas Commission prior to the PUC’s assumption of jurisdiction.”<sup>57</sup> Accordingly, PGW’s rates continue to be governed by the cash flow ratemaking methodology contained in the Management Agreement, which has the force of law, and the Commission is required to apply that methodology.

**B. The Commission Must Utilize the Same Cash Flow Ratemaking Methodology for Providing Interim Relief.**

The Commission’s August 17 Order authorizing this expedited proceeding established the time frame that should be considered in setting PGW’s interim rates:

PGW must present substantial evidence to support its assertion that an interim rate increase is necessary to maintain a minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season until the Commission can conduct and rule on a full base rate proceeding. In particular, PGW must present substantial evidence to support its assertion that an interim rate increase is necessary for PGW to comply with its covenants to the holders of any approved bonds.<sup>58</sup>

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<sup>56</sup> August 17 Order at 6. The Commission also recognized that Section 2212(d) permits PGW to request, and the Commission to approve, changes in PGW’s tariffs prior to PGW’s restructuring.

<sup>57</sup> *Id.* at 10 (emphasis added).

<sup>58</sup> August 17 Order at 7-8.

In accordance with the August 17 Order, PGW's interim rate request focused only on the level of additional revenues it needs to collect over the winter heating season in order to maintain minimally acceptable financial levels.<sup>59</sup> Because 65% of PGW's total revenues are billed in just four winter months (December - March),<sup>60</sup> PGW must increase its rates commencing at the beginning of the upcoming winter heating season (mid-November) if it is to meet its financial obligations not only during this coming winter, but also through the end of the fiscal year and into the next fiscal year as well (prior to the following winter). PGW's standard for requesting interim rate relief was straightforward: what are PGW's financial requirements that can be met only by increasing the Company's revenues for the 2000-2001 winter season? All of PGW's requests squarely comply with that requirement. Accordingly, PGW's financial analysis utilized a fully normalized, budgeted test year for its fiscal year ending August 31, 2001 and focused on *producing sufficient end-of-year revenues, earnings and cash balances, as well as monthly cash balances during the year.*<sup>61</sup> If rates are not increased sufficiently this winter, any subsequent revision will be "too little, too late" to satisfy these requirements.

Importantly, the August 17 Order focuses on the time period to be examined: the period affected by the rates to be charged during this upcoming "winter heating season."<sup>62</sup> Nothing in the August 17 Order changes the ratemaking methodology and requirements that are legally

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<sup>59</sup> PGW-IR St. 1 at 5-6.

<sup>60</sup> PGW-IR St. 1.1 at 14; Tr. 184. Mr. LeLash also acknowledged this. Tr. 283.

<sup>61</sup> PGW's normalized projections calculated revenues without including any lost revenues due to past billing deficiencies, i.e., as if the collections were going to occur in the future. Tr. 145.

<sup>62</sup> August 17 Order at 7.

required to apply to the establishment of PGW's revenue requirement. Indeed, the PUC implicitly recognized PGW's ratemaking methodology in acknowledging its responsibility under 66 Pa. C.S. § 2212(e).<sup>63</sup> As set forth above, the ratemaking methodology that must be utilized is the "cash flow" method traditionally employed by the PGC, mandated by the Management Agreement and adopted by the Gas Choice Act.

#### **IV. EVIDENTIARY SUPPORT FOR INTERIM RATE INCREASE**

##### **A. Financial Criteria For Interim Rate Relief.**

PGW used three benchmarks to determine an appropriate level of interim rate relief consistent with the "cash flow" method of ratemaking:

- 1) What level of revenues and earnings is needed to assure compliance with PGW's bond ordinance covenants for fiscal year 2000-2001;
- 2) What level of operating revenues or cash-working capital is needed in order for PGW to have sufficient revenues to meet its daily, monthly and year-end obligations for fiscal 2000-2001; and
- 3) What financial results are needed to maintain levels of financial health for PGW in order to maintain its minimally acceptable credit rating and its present lending sources.

These criteria generally are the same as those used by the PGC in establishing the revenue requirement for PGW prior to the transfer of regulatory authority to the Commission. A

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<sup>63</sup> August 17 Order at 10.

specific analysis of each benchmark and resulting support for \$52 million in interim rate relief follows.

1. **Bond Ordinance Covenants**

Satisfying PGW's bond ordinance covenants is the most basic financial requirement facing PGW. PGW relies substantially on its long-term and short-term debt to fund its construction program as well as to provide a source of operating funds for day-to-day operations. This coming spring, PGW must be able to issue an additional \$75 million in bonds. From these bond proceeds, PGW will fund crucial improvements to PGW's LNG plant and distribution system. Furthermore, PGW will "borrow" some of these proceeds prior to the time they are needed for the capital improvements to provide a much needed supplemental source of cash working capital at the beginning of the 2001-02 fiscal year.<sup>64</sup>

The PGW bond covenants are contained in two principal documents, commonly referred to as the 1975 Bond Ordinance<sup>65</sup> and the 1998 Bond Ordinance.<sup>66</sup> Because the debt service coverage covenants are the most difficult to meet, the parties have focused on PGW's projected ability to meet those covenants at the end of the 2000-2001 fiscal year. PGW financial advisor,

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<sup>64</sup> PGW-IR St. 1 at 10; PGW-IR Exh. 1.1 at ¶¶ 8-9; PGW-IR St. 2 at 6; PGW Cross Examination Exh. 4 (detail of 2000-2001 capital projects).

<sup>65</sup> The 1975 Bond Ordinance (Bill No. 1871) is contained, *inter alia*, in PGW-IR Exh. 1.4, Volume I, Tab 2, Exh. A.

<sup>66</sup> The 1998 Bond Ordinance (Bill No. 980232) is contained in PGW-IR Exh. 1.4, Tab 6 (behind the last yellow sheet).

Barbara Bisgaier, testified that the Gas Works has never in its history violated any of its bond covenants.<sup>67</sup>

In addition to PGW's obligation to actually make its debt service payments when scheduled, its legal obligation to the holders of the bonds under its covenants is to collect revenues which will allow it to meet the following requirements:

- (1) Pay the costs of operating and maintaining PGW (the "rate covenant");<sup>68</sup>
- (2) Pay the interest and principal, when due, of outstanding PGW revenue bonds;<sup>69</sup>
- (3) After operating expenses have been met, provide at least 1.5x coverage of the debt service on outstanding PGW revenue bonds (its "coverage" covenant);<sup>70</sup> and
- (4) Pay principal and interest on subordinated bonds, including interest on the commercial paper.<sup>71</sup>

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<sup>67</sup> Tr. 212-13.

<sup>68</sup> The rate covenant requires that PGW's revenues are sufficient to cover all of its Net Operating Expenses; Net Operating Expenses do not include depreciation or the mandated \$18 million City Payment. *See*, PGW-IR Exh. 1.4, Tab 2, Exh. A for the 1975 Ordinance; for the 1998 Board Ordinance Tab 6. In each case, Sec. 2.01 (definition of "Operating Expenses" and "Net Operating Expenses") and Sec. 4.03 (rate covenant).

<sup>69</sup> *Id.* at Sec. 4.03(c).

<sup>70</sup> *Id.* at Sec. 4.03(b)(iii).

<sup>71</sup> PGW-IR St. 2 at 12.

Ms. Bisgaier testified that a technical violation of these covenants would bring swift and catastrophic consequences, including the immediate downgrading of PGW's bonds to junk bond status.<sup>72</sup> That status, Ms. Bisgaier explained, will prevent PGW from accessing the public bond markets or obtaining bond insurance.<sup>73</sup> The immediate effect would be to bar PGW from making its planned bond issuance in the spring, not only threatening PGW's ability to make crucial capital improvements, but also eliminating its ability to "borrow" a portion of the issuance to supply the cash necessary to fund operations prior to the 2001-02 winter.<sup>74</sup>

Technical default on PGW's bonds would have another devastating effect: the collapse of PGW's commercial paper program — PGW's only other source of financing. PGW has completely utilized its commercial paper up to its \$100 million limit.<sup>75</sup> While the program initially was designed to smooth over periodic cash deficiencies, it has become a permanent part of PGW's capital structure. As Ms. Bisgaier testified,

[T]he ability of PGW to issue its commercial paper is an absolute necessity for the maintenance of the basic operation and financial integrity of PGW. It is almost impossible to imagine PGW as a going concern without access to its commercial paper program.<sup>76</sup>

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<sup>72</sup> When the Philadelphia Water Department technically defaulted on its bonds in 1991 it was immediately downgraded several levels to below investment-grade. Tr. 215.

<sup>73</sup> PGW-IR St. 2 at 5.

<sup>74</sup> *Id.* at 5-6; PGW-IR St. 1.1, Exh. 1.3, Sch. 1.

<sup>75</sup> PGW-IR St. 2 at 6.

<sup>76</sup> *Id.* at 7.

PGW's commercial paper is secured by a letter of credit issued by Morgan Guaranty Bank. Morgan has declined to extend the term of the letter of credit until PGW's financial condition becomes clearer, after the Commission responds to PGW's base rate request.<sup>77</sup> A technical default on PGW's bonds, however, would make it a "virtual certainty" that neither Morgan nor any other bank would issue PGW a new letter of credit.

Even if PGW were to return to investment grade status or otherwise find a way to issue long-term debt or secure a letter of credit to maintain its commercial paper line, the credit market would continue to exact a stiff premium for such borrowing, increasing the costs to PGW and its customers for years to come.<sup>78</sup> Ms. Bisgaier summarized the effects of a PGW bond covenant failure:

Q. WHAT WOULD BE THE OVERALL CONSEQUENCES TO PGW AND ITS CUSTOMERS IF PGW FOUND ITSELF IN TECHNICAL DEFAULT OF ITS COVENANTS?

A. . . . PGW's bonds would be down-graded to junk bond status. Access to the capital markets would be eliminated. Even upon an ultimate return to investment-grade status, interest rate premiums would be significant and would add to the cost to add to carry PGW's debt for years to come. Most immediately, there would, in my opinion, be a staggering cash crisis that would threaten the ongoing operation of PGW as a result of inability to retain the cash life line of the commercial paper program.<sup>79</sup>

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<sup>77</sup> *Id.* at 7-9; PGW-IR Exh. 1.3, Sch. 1.

<sup>78</sup> PGW-IR St. 2 at 9-10.

<sup>79</sup> *Id.* at 13-14.

The downgrading would not only adversely affect PGW, but would hurt the City and even potentially the investor confidence in state agency tax free bonds as well.<sup>80</sup>

Virtually all of the witnesses testifying in the proceeding agreed that providing PGW with the rate relief necessary to avoid a technical default on PGW's bonds was a critical necessity, in the best interest of the Company and its customers, and a legitimate goal of this interim rate proceeding.<sup>81</sup> In its earliest opinions regarding PGW, the PGC also recognized the importance of providing PGW with the opportunity to earn sufficient revenues to maintain its bond rating.<sup>82</sup> The Commission likewise reflected this concern by noting that, among other things, PGW must “present substantive evidence to support its assertion that an interim rate increase is necessary for PGW to comply with its covenants to the holders of any approved bonds.”<sup>83</sup> Clearly, in light of the negative consequences of missing this standard, the record in this proceeding supports only one result — that the entire interim rate increase is necessary for PGW to be completely assured

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<sup>80</sup> PGW-IR St. 2 at 15-16.

<sup>81</sup> Tr. 258-59 (OCA witness LeLash); OTS St. 3 at 7-8.

<sup>82</sup> “We must provide PGW with the opportunity to earn sufficient revenues so that it will have reasonable access to the capital markets. We adopt as an essential goal the retention of PGW's present bond rating.” *In the Matter of a Proposed Rate Increase for the Philadelphia Gas Works*, filed June 19, 1981, Opinion and Order dated November 9, 1981 at 18 (attached hereto as Appendix “C,” Tab 1). In its next adjudication, in 1982, the PGC reiterated that concern. *In the Matter of a Proposed Rate Increase for Philadelphia Gas Works*, filed May 4, 1982, Adjudication and Order dated September 3, 1982 at 37-41 (attached hereto as Appendix “C,” Tab 3). It should be noted that in the 1982 case, the PGC was attempting to prevent PGW from going below A- minus rating. *Id.* at 38.

<sup>83</sup> August 17 Order at 7-8 (emphasis supplied). The Commission further reflected this concern in its Secretarial Letter of September 7, 2000 seeking relevant bond documents. *See*, PGW-IR Exh. 1.4.

that PGW will meet its bond covenants and maintain its financial viability. Such a result can only be assured if an interim rate increase is granted which provides PGW with earnings to meet its coverages and a cushion to assure that these coverages are met.<sup>84</sup>

2. **Revenues Sufficient to Meet Current Operating Requirements (Cash Working Capital)**

In addition to the bare minimum debt service coverage requirements, PGW's revenue requirement includes the amount necessary to meet its ongoing obligations prior to the time it is able to collect revenues from customers to defray those obligations. This "cash working capital or "cash flow need" is, as indicated above, specifically authorized by the Management Agreement and has been part of the ratemaking methodology and requirements recognized and utilized by the PGC since at least 1972. The PUC's August 17 Order also specified that the interim rates were to include revenues "necessary to maintain a minimal, adequate level of financial health required to fund operations. . . ."<sup>85</sup>

Mr. Knudsen testified that PGW's operating cash requirements included having sufficient cash, on a monthly basis, to pay its obligations and make its debt service payments when they come due. A second critical cash need is PGW's obligation each year to pay off (or demonstrate its ability to pay off) its entire commercial paper line of credit for at least 5 business days. The

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<sup>84</sup> Tr. 321 (OTS witness Weakley agreeing that debt coverage cushion is appropriately for PGW in this instance).

<sup>85</sup> August 17 Order at 7 (emphasis added).

Company must have enough cash to be able to make that payment in early June. In this fiscal year, its payment obligation will be to “pay off” \$97 million on a one-time basis.<sup>86</sup>

A final critical cash working capital need comes at the end of PGW’s fiscal year. Mr. Knudsen testified that PGW needs \$35 to \$40 million of liquidity going into a new fiscal year in order to fund critical gas purchases in preparation for the upcoming winter and to pay its debt service obligations.<sup>87</sup> In the last several years, PGW has realized its liquidity by a combination of cash from operations and by “borrowing” from the proceeds of long-term debt issuances prior to the time that those dollars are scheduled to be utilized for construction projects. So long as PGW can certify that it can pay the dollars back when needed to fund the projects, those dollars can be used as a temporary source of cash flow liquidity.<sup>88</sup> (Any excess funds must be returned to the construction fund by each year end.) While at the beginning of the 2000-2001 fiscal year PGW’s liquidity resulted almost exclusively from its ability to borrow on existing capital fund balances, it will have only just over \$21 million of liquidity from this source available at the beginning of the 2001-2002 fiscal year (and only if it successfully issues the planned \$75 million in bonds). This will cause a shortfall of \$13.5 - \$18.5 million of its minimum gas purchase

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<sup>86</sup> PGW-IR St. 1.1 at 4, 15-16. After that, PGW will be able to immediately start to borrow from the commercial paper.

<sup>87</sup> PGW-IR St. 1 at 9; Exh. 1.1, ¶ 8-9; Tr. 135. Making gas purchases before the winter and injecting them into storage (or liquefying the gas using its LNG plant) is critical, not only to avoid high prices in the peak season, but because PGW’s ability to meet its customers’ peak requirements is dependent upon these supply sources. See PGW-GCR Exh. 1.1, Exh. A, Vol. 1. No witness seriously disputed PGW’s need for this level of liquidity. See, e.g., Tr. 242-43, 326.

<sup>88</sup> *Id.*; PGW-IR Exh. 1.1, ¶ 26.

requirements of \$35 to \$40 million.<sup>89</sup> This level of liquidity is absolutely essential if the Company is to be able to continue to provide safe, adequate and reliable gas service to its customers, but the only way in which PGW will be able to have this level of cash going into the critical “shoulder” months is by increasing its rates sufficiently prior to the start of this coming winter.

No party disputed either PGW’s legitimate need to have operating revenues or cash flow, or that PGW’s operating revenue requirements at the end of the 2000-2001 fiscal year and the beginning of the next fiscal year are legitimate requirements that have to be addressed during this coming winter heating season.<sup>90</sup> Only Mr. LeLash, on behalf of the OCA, disputed the appropriateness of considering these operating revenue requirements in the Company’s overall “interim” revenue requirement. As will be shown below, his concerns are completely unfounded and legally unsupportable.

### **3. Lender and Rating Agency Requirements**

PGW financial advisor Bisgaier testified that, in addition to the above, PGW’s interim revenue requirement had to be sufficient to demonstrate to the rating agencies and PGW’s lenders that its financial circumstances are secure enough to prevent the Company’s long term debt rating to be down-graded to junk bond status.<sup>91</sup> Ms. Bisgaier testified, without contradiction, that the Commission’s response to PGW’s interim rate request would be viewed as

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<sup>89</sup> *Id.*

<sup>90</sup> Tr. 242-43; 326.

<sup>91</sup> PGW-IR St. 2 at 14.

a signal by the rating agencies and PGW's lenders about the commitment of PGW's new regulatory agency to protect their financial investment:

In my opinion, the rating agency analysis and conclusion in this instance will not only focus upon the fact that the bond covenants had been met, but also upon whether the Public Utility Commission clearly demonstrates a willingness to meet its legal obligation to grant rates sufficient to permit PGW to meet its bond covenants. It is important to PGW and its customers that the correct signal be sent to PGW's creditors.<sup>92</sup>

Ms. Bisgaier's opinion is well-founded. In July, Standard and Poor's placed PGW on its "CreditWatch, with negative implications." Standard and Poor's blunt conclusion was "Rate relief is needed by this fall. . . . To preserve its ratings, PGW will need to obtain rate relief and implement the projected productivity savings ranging from 5-10% annually."<sup>93</sup> The Standard and Pooers analysis not only commented upon the need to maintain PGW's bond ordinance requirements, but also expressed concern about the level of cash available to meet obligations.<sup>94</sup> This was consistent with Ms. Bisgaier's testimony that the rating agencies were "extremely concerned" about PGW's ability to meet its cash working capital needs.<sup>95</sup>

OTS witness O'Donnell concluded that Standard and Poor's candid assessment requires the grant of interim rate relief request at sufficient levels to ameliorate the Company's negative financial condition:

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<sup>92</sup> PGW-IR St. 2 at 11.

<sup>93</sup> PGW-IR St. 2, App. A at 3.

<sup>94</sup> *Id.*

<sup>95</sup> Tr. 216.

Q. IS MS. BISGAIER CORRECT THAT PGW WILL LIKELY EXPERIENCE A DOWNGRADE IN ITS CREDIT RATING IF RELIEF IS NOT GRANTED IN THE GCR AND INTERIM BASE RATE PROCEEDING?

A. Unfortunately, yes. On July 20, 2000, Standard and Poors's sent PGW a letter which informed the Company that they "have placed the rating of 'BBB' on CreditWatch . . . ."<sup>96</sup>

Mr. O'Donnell opined that the interim rate relief granted by the Commission should be sufficient to "address the imminent financial crisis so that a technical default will not occur and the soundness of [PGW's] credit rating will be preserved."<sup>97</sup> Ms. Bisgaier testified that she and the Company are meeting regularly with the rating agencies and PGW's lenders and that they are all concerned about the same earnings and cash flow projections being provided to the Commission in this proceeding.<sup>98</sup>

**B. The Need For Interim Rate Relief.**

Applying these benchmarks, it is absolutely clear that PGW is in urgent need of interim rate relief. Indeed the Company's financial projections demonstrated that the requested \$52 million interim rate relief, if anything, is extremely conservative. While the Company's original \$52 million request had been fully justified when originally filed, by the close of the record the need for the full request had been heightened due to the effects upon the Company of the extraordinary gas cost escalations that are now projected.

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<sup>96</sup> OTS St. 3 at 7.

<sup>97</sup> *Id.* at 8.

<sup>98</sup> Tr. 215-17.

**1. The Basis for PGW's Calculations**

PGW utilized a fully normalized "test year" that represented its projected operating and capital budget for fiscal year 2000-2001. This is consistent with the methodology and approach that it utilized before the PGC prior to the transfer of ratemaking authority to the PUC.<sup>99</sup> Using that operating and capital budget PGW calculated that, without interim rate relief or an increase to its GCR prior to the beginning of the winter heating season, the Company would be in technical default of all of its bond ordinance covenants, and would experience such huge cash operating revenue deficiencies that it would simply not be able to continue to provide gas service to customers. The following summarizes PGW's original projected results if the Company is not able to obtain both base rate relief and GCR increases:

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<sup>99</sup> PGW-IR St. 1, at 17-18.

**TABLE 1  
PGW FINANCIAL PROJECTIONS  
AS OF AUGUST, 2000**

**NO BASE RATE RELIEF  
NO GCR**

	<b>Projected</b>	<b>Minimum Needed</b>
Earnings	(\$111,450)	N/A
Coverage on 1975 Bonds	.04 <sup>100</sup>	1.5x
Coverage on 1998 Bonds	(1.95)	1.5x
Year End Cash Balance (Assuming \$21.5 million available from new long term debt issuance)	(\$113.5 M) <sup>101</sup>	\$13.5 M - \$18.5 M

Even if one assumes that PGW would be able to increase its GCR to reflect, at least partially, the rapidly increasing gas costs, its financial status would still be far from adequate:

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<sup>100</sup> PGW-IR St. 1, App. B, p. 3.

<sup>101</sup> PGW Exh. 1.1, Sch. 1 (\$113.5) + \$21.5 = (\$92) compared to the necessary level at year end of \$35 - \$40 million. This calculation is purely hypothetical as PGW would not be able to issue long term debt in this situation.

**TABLE 2  
PGW FINANCIAL PROJECTIONS  
AS OF AUGUST, 2000**

**GCR INCREASE @ \$97 MILLION  
NO BASE RATE INCREASE**

	Projected	Minimum Needed
Earnings	(\$17,402)	N/A
Coverage on 1975 Bonds	1.67	1.5x
Coverage on 1998 Bonds	1.26	1.5x
Year-End Cash Balance (assuming \$21.5 million available from new long term debt issuance)	(\$25.1 M) <sup>102</sup>	\$13.5 M - \$18.5 M

PGW's \$52 million interim rate request was designed to repair these obvious and serious deficiencies, assuming that its GCR would be permitted to be increased as per its GCR filing. Even at this point, PGW's request was extremely conservative — and could have been at least \$20 million greater — for a number of reasons:

- Increased Bad Debt Expense. PGW had calculated a \$52 million base rate increase as its needed revenue requirement in its initial filing before the PGC on June 19, 2000. At that point, it was projecting that its required GCR increase would be just \$42 million. This was based on the best available information available at that time concerning the likely level of gas costs in the 2000-2001

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<sup>102</sup> PGW St. 1, App. B at 4. (\$25,056) + \$21.5 (from borrowing on long-term debt service produces -\$3.5 million available operating revenues at year end compared to necessary level of \$35 - \$40 million.

fiscal year.<sup>103</sup> However, just a few weeks after that filing, revised gas cost estimates were provided to PGW which made clear that its gas costs would be more than 100% greater — and it revised its GCR from \$47 million to \$97 million,<sup>104</sup> the level at which it made its initial GCR filing with the Commission. While PGW recovers its actual gas costs (no more, no less) through its GCR, these increased gas costs have two significant financial impacts which are not covered by its GCR rate. First, an increased GCR factor increases the level of uncollectible and bad debt expense that the Company incurs. All of its bad debt expenses are included in its base rates and are not recovered in its GCR.<sup>105</sup> Accordingly, when the GCR increases there is a corresponding increase in projected bad debt expense which, in turn, justifies a higher revenue requirement. In this instance, PGW's initial \$52 million base rate request not only did not include the effect upon its bad debt expense of its revised, \$97 million GCR costs (i.e., from \$47 million to \$97 million) it also reflected an aggressive and lower uncollectible factor of 8.4%.<sup>106</sup> Use of these factors was based on the assumption that PGW was going to increase its efforts to collect unpaid bills and reduce the percentage of uncollectibles it would experience. Mr. Knudsen testified that the Company experience is that in times of rapidly increasing rates, its percentage of

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<sup>103</sup> See, PGW-GCR St. 1, at 2-3; Exh. 1.1.

<sup>104</sup> *Id.*

<sup>105</sup> PGW-IR St. 1.1 at 9.

<sup>106</sup> See, Tr. 193-94.

uncollectibles becomes greater, and a higher factor % should be justified under such circumstances.<sup>107</sup> Using this higher uncollectible factor and recognizing PGW's increased GCR filing, the Company's revenue requirement claim could have been increased by more than \$10 million.<sup>108</sup> Notwithstanding this irrefutable evidence that its revenue requirement was more than \$52 million, the Company chose to hold the line at \$52 million in the interest of mitigating the effects on ratepayers.

- Productivity Savings of \$14 million. In addition, the Company's \$52 million revenue requirement assumed that it would be able to shave a full \$14 million from its operating expenses through a combination of productivity savings, revisions to its collective bargaining agreement and other revisions by management. As Mr. Knudsen indicated during the hearings, while the Company continues to be fully committed to achieving these productivity savings, the Company's likelihood of success, especially in this fiscal year, remains uncertain and a real challenge.<sup>109</sup> If these productivity savings had not been included the budget or if they do not materialize, the Company's revenue requirement would have been \$14 million higher.

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<sup>107</sup> See, PGW-Ir St. 1.1 at 11.

<sup>108</sup> PGW-IR St. 1.1 at 9-10, Exh. 1.1 at ¶ 15.

<sup>109</sup> Tr. 194-95.

- Effects of Warmer Than Normal Weather. While all of PGW's revenue requirement calculations were based on a normalized test year, the reality is that PGW has not enjoyed a "normal" winter for many years. Indeed, in each of the last three years, PGW has experienced much warmer than normal weather — last year it was 15% warmer than normal.<sup>110</sup> A 13% - 15% warmer than normal winter means that PGW does not sell as much Gas as is projected for a "normal" year and loses the margin built into the Gas rates that it uses to produce earnings. This, in turn, affects debt service coverage. For example, PGW lost \$25 million in margin — and earnings — in each of the last three years because of the warmer than normal winter it experienced.<sup>111</sup>

Considering all of these factors, PGW's \$52 million interim base rate filing was clearly conservative at the time it was filed, and represented a minimum amount of interim rate relief in a concerted attempt to minimize the overall effects on customers. Keeping these factors in mind, PGW's original calculation of its coverages and year-end cash produced by its requested \$52 million interim request produced bond coverages on the 1975 and 1998 bond ordinances and permitted the Gas Works to meet its bond ordinance obligations as well as a cushion for contingencies. The relief also produced sufficient cash-working capital at year-end to just

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<sup>110</sup> Tr. 256.

<sup>111</sup> See, PGW St. 1.0 at 12.

produce the \$35 million - \$40 million of liquidity it needs to fund operations.<sup>112</sup> But even these projections were optimistic.

PGW's initial financial projections before the Commission assumed that its GCR would be increased by \$97 million to account for gas costs as they were then projected. But, soon after that filing, it became clear that gas costs were headed still higher. As the Commission is well aware, wholesale gas costs have almost doubled since last year and have moved up rapidly in just the last few months. For example, while PGW's original DRI average forecasted price (on which its requested \$97 million increase was based) for August, 2001 was \$3.13/dec., the next DRI forecast had increased its projection to \$3.54/dec for that same period. By September 19, the forward contract price on the NYMEX for August, 2001 had increased to **\$4.46**, or an increase of 42.5%.<sup>113</sup>

These enormous increases prompted OTS witness Metro to testify that, if anything, PGW's proposed \$97 GCR was too low by some \$62 million,<sup>114</sup> and that the Company should be permitted to recover these additional costs as soon as possible. The difference between PGW's original, \$97 million GCR filing and Mr. Metro's calculation was simply the timing of the projections, with Mr. Metro's calculation utilizing more recent data. PGW verified Mr. Metro's

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<sup>112</sup> PGW's originally calculated projected earnings at the requested \$52 million increase were \$27.1 million and its bond coverage projections were 2.73 and 2.76 for the 1975 and 1998 bond ordinances respectively. PGW-IR St. 1, App. B., at 3. Its original projected year-end cash was \$12.1 million, still short of its required \$13.5 million - \$18.5 million *Id.*, at 2.

<sup>113</sup> OCA GCR St. 1, Sch. 1 at 3.

<sup>114</sup> OTS St. 2 at 9.

calculations in the testimony of PGW witness White where, using further updated gas cost projections, he testified that PGW's present projections were understated by \$79 million and that, when more current projections were included, PGW's GCR factor would need to be increased by approximately \$75 million.<sup>115</sup> PGW intends to revise its proposed GCR factor, or to submit a supplemental filing to recognize and recover these additional costs in its GCR prior to the onset of cold weather. However, there is one thing that is beyond dispute: these significant hikes in gas costs increase PGW's base rate revenue requirement to account for additional bad debt expense<sup>116</sup> associated with these higher rates. For example, reflecting the additional gas costs in its GCR would produce an additional \$6-\$7 million in bad debt expense for the Company over and above the amount it associated with its August \$97 million filing.<sup>117</sup>

Further, increased gas costs have an enormous affect on the Company's operating revenue needs. Even if these additional obligations are reflected in its GCR, there is a considerable lag between the time the GCR makes the Company whole for its actual gas costs (calculated to be by the end of the fiscal year) and the time that PGW actually has to purchase gas to meet customer needs. Accordingly, these additional projected costs further heighten the

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<sup>115</sup> PGW-GCR St. 1.1 at 5.

<sup>116</sup> Indeed, as Mr. Knudsen testified, it is not unreasonable to expect record levels of uncollectibles due to the convergence of a needed base rate case with a substantial (30%) increase in the GCR. All of the bad debt expense must be captured in PGW's base rates or it will not be captured at all. Increased bad debt expense has a direct effect on its realized earnings and, therefore, on its ability to make debt service coverages.

<sup>117</sup> *Compare*, PGW Cross Exh. 1 at 1 (showing total bad debt expense assuming \$70 additional gas costs at \$61.7 million), *with*, PGW St. 1, App. B at 1 (bad debt expense of \$57 million).

need for the full, interim rate increase requested by the Company. The result: any cushion or margin of error contained in PGW's original, \$52 million interim base rate increase has been eliminated.

Mr. Knudsen's rebuttal testimony calculated PGW's benchmark financial indicators when these additional projected gas costs are factored in:

**TABLE 3  
PGW FINANCIAL PROJECTIONS  
AS OF SEPTEMBER, 2000**

**GCR INCREASE @ \$97 MILLION  
PLUS ADDITIONAL \$70 MILLION GAS COST INCREASE AND  
\$52 MILLION INTERIM BASE RATE INCREASE**

	<b>Projected</b>	<b>Minimum Needed</b>
Earnings	\$22.3 Million	N/A
1975 Coverages	2.64x	1.5x
1998 Coverages	2.60x <sup>118</sup>	1.5x
Required Year End Cash Balance	\$3.0M <sup>119</sup>	\$13.5 M - \$18.5 M

Several things are significant about PGW's currently projected financial results, even assuming that the full \$52 million is granted. First, coverages produced using the Company's fully normalized projected fiscal year results provide very little margin of error. Indeed, when calculated using the Company's traditional, pre-1998 method, the coverage levels are in the exact

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<sup>118</sup> PGW-IR Exh. 1.3, Sch. 3 at 3.

<sup>119</sup> *Id.* at 2. Mr. Knudsen's calculation used \$70 GCR increase, slightly lower than the level calculated by Mr. White — \$75 million.

range of PGW's historic, pre-1998 experience.<sup>120</sup> A colder than normal winter (which could remove as much as \$25 million of earnings from the calculation),<sup>121</sup> a failure to realize all or a portion of the \$14 million in projected expense savings or higher than projected bad debt expense due to the extraordinary gas cost increases, would result in PGW coming very close to failing to meet its covenant requirements. Second, its year-end operating cash was reduced down to just \$3 million or \$10 million to \$15 million short of the level needed for PGW to purchase necessary gas stocks and make short-term debt payments prior to the 2001-2002 winter. Thus, even if the Company's request is granted in full as justified, PGW's cash needs will have to be supplemented by a City loan.

Finally, review of the monthly cash statement (PGW-IR St. 1.1 Sch. 3 at 2) shows that PGW will have substantial negative cash balances in January (negative \$12.6 million). Moreover, it must be able to "take down" the entire outstanding balance of its commercial paper for at least 5 days in June. Under its own calculations, and assuming a full \$52 million rate increase, PGW will still be short some \$25 million of the necessary cash to meet this requirement in June. Again, PGW will have to rely on the support that the City Administration has proposed even after full interim rate relief is granted.

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<sup>120</sup> Mr. Knudsen explained that in 1998 the method calculating indenture coverage changed and that, using the historic method, the Company's interim rate filing using its August gas cost projections was just 1.74x. PGW-IR St. 1 at 17-18. Under PGW's revised gas cost projections, PGW's coverages using the traditional coverage calculation methodology would be ever lower — approximately 1.7x, well within the range set by the PGC in 1991 as appropriate target levels. *Id.*

<sup>121</sup> PGW-IR St. 1 at 12.

## 2. City Support For PGW

The City of Philadelphia Administration has requested City Council approval of a substantial financial backstop as a supplement to — but not as a replacement for — full interim rate relief. The above analysis demonstrates that, even if PGW receives the full \$52 million requested interim rate increase, it is nonetheless going to be in need of additional assistance in order to meet its monthly cash flow needs, its obligations to its commercial paper lenders and to provide up to a \$5 million backstop to assure that the Company does not technically default on its bonds during the 1999-2000 fiscal year.<sup>122</sup> The City Administration has agreed to seek these loans to PGW for several reasons. First, it recognized the dire circumstances in which PGW finds itself and has determined that it is appropriate to make a contribution to assist PGW through these difficult times.<sup>123</sup> Moreover, both PGW and the City Administration are extremely concerned about the overall effect of these increases on customers. By agreeing to provide loans the City remains committed to considering other steps that any other owner of a utility might consider in times of difficulty. However, there are a variety of legal and policy reasons why the City support must be viewed as a supplement and not as a replacement for interim rate relief — just as any other utility would be treated. The most obvious is that, in light of PGW's present and projected financial circumstances, PGW absolutely needs both the full rate relief and the City support in order to have adequate assurances that it will be able to meet its financial

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<sup>122</sup> PGW-IR St. 1.1 at 5.

<sup>123</sup> PGW-IR St. 1.1 at 4.

obligations, to continue its customer service obligations throughout the year, and to have sufficient margin of error for contingencies.

**V. THE RECOMMENDATIONS OF THE PARTICIPATING PARTIES ARE INADEQUATE TO MAINTAIN PGW AT MINIMALLY ACCEPTABLE FINANCIAL LEVELS**

**A. Introduction.**

The three parties making recommendations on the record with respect to PGW's interim rate increase have all recognized that a base rate increase is necessary in order to maintain PGW's financial benchmarks. By the same token, their recommendations all fail to grasp the seriousness of PGW's financial situation and the reasons why an interim rate increase of \$52 million is the minimum amount necessary in addition to (rather than in lieu of) of any assistance from the City. The recommendations of the OCA, OTS and PICGUG follows:

**TABLE 4**

**RECOMMENDATIONS OF THE PARTIES  
INTERIM RATE INCREASE**

	<b>Amount</b>	<b>Comments</b>
OCA	\$25 M	Assumes \$20 M loan from City or \$20 M loan and \$18 M grant back.
OTS	\$27.5M	Recommendations would increase to \$32.5 M if assumed productivity savings were reduced to \$9 M (as per OCA witness LeLash).
PICGUG	\$15.6 M	No specific explanation given.

- **Recommendation of OCA**

The OCA submitted the testimony of Richard LeLash who testified initially that PGW could justify no more than \$7.5 million of interim rate increase, focusing exclusively on PGW's bond covenant requirements and refusing to apply the "cash flow" ratemaking methodology. Nonetheless, after reviewing the rebuttal testimony of PGW witness Knudsen, Mr. LeLash revised his testimony substantially and indicated an interim rate increase of "up to" \$25 million could be justified. His revision focused on the fact that his initial recommendation had not fully taken account of all of the uncollectible/bad debt expense that PGW likely will incur as a result of the \$97 million increase in its GCR and a recognition that the \$52 million increase was calculated assuming that the Company would realize \$14 million in productivity savings, savings which he testified were unlikely to be fully realized in the fiscal year 2000-2001. Accordingly, he revised PGW's projections to add \$12.5 million for bad debt expense and \$5 million for likely unrealized productivity savings to the Company's fiscal year expenses (leaving in \$9 million). Holding all other things equal, Mr. LeLash's revised recommendation continued to maintain PGW's 1998 Bond Ordinance coverages at just 1.5x — barely meeting the exact legal requirement under the bond covenants and allowing no room to account for unanticipated events. *His recommendation provided for positive cash balances only by including within his calculation the City proposed \$20 million loan.*<sup>124</sup> Notwithstanding this revised recommendation, Mr. LeLash apparently continued to contend that a significant portion of the Company's request could be avoided by "forcing" the City to give up its legally authorized \$18 million payment, by

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<sup>124</sup> OCA St. 1, Sch. 2 at 2.

declaring that PGW should have pursued other means of securing additional revenues or PGW's service allegedly is inadequate.<sup>125</sup>

- **Recommendations of PICGUG**

PICGUG witness Baudino recommended a \$15.6 million interim rate increase. His recommendation was not based upon any particular analysis but appeared to be driven by the notion that there were other means of PGW securing the necessary revenues to meet its financial benchmarks and, even if it did suffer a financial failure – such as a technical default on its bonds — the consequences wouldn't be as dire as PGW contended.<sup>126</sup>

- **Recommendation of OTS**

The OTS recommended a \$27.5 million interim rate increase using the Company's calculations — which included its projected goal of \$14 million of productivity savings.<sup>127</sup> During cross-examination, Mr. Weakley agreed that if his recommendation were adjusted to assume that some \$5 million of the anticipated productivity savings would not be realized — in the same way that Mr. LeLash had adjusted his calculation — his recommended interim rate increase would have to increase, presumably by a comparable amount.<sup>128</sup> If the productivity

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<sup>125</sup> *Id.* at 35-36; Tr. 234, 236-37, 241.

<sup>126</sup> PICGUG St. 1 at 7-10.

<sup>127</sup> OTS St. 1 at 2.

<sup>128</sup> Tr. 325.

savings assumptions were revised along the lines of Mr. LeLash's revision, OTS's recommendation would increase from \$27.5 million to \$32.5 million.<sup>129</sup>

All of these alternative recommendations were based chiefly upon a faulty legal view of the standard to be employed by the Commission in considering this interim rate request, or failed to adequately consider the full extent of PGW's financial requirements, and especially its month-to-month and year-end cash working capital needs. Moreover, the assertion that the rate request should be denied either because of alleged alternative sources of cash or because of PGW service problems is both legally invalid and factually unsupported. Most importantly, the arguments made particularly by OCA witness LeLash, that the interim rate increase is not needed because the Company should be forced to rely on City loans or the grant back of its mandated \$18 million payment to the City, is not only legally impermissible, but dangerous and risky when one considers the very real likelihood that such support will be needed as a backstop and additional assistance — not as a replacement for a rate increase.

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<sup>129</sup> The OTS' recommendation was also understated because it includes an unrealistically low level of bad debt expense — \$52 million. OTS St. 1 at 7. Mr. Weakley recommended this level by using a "historic" 7.3% bad debt expense figure derived from an average of PGW's experience in 1994-98. OTS Exh. 1, Sch. 5 at 2. The PGW revised factor (8-9%) used a more realistic average from the last 3 years to account for the fact that, due to the dramatic rise in gas costs, the Company is likely to see much higher levels of uncollectibles than it experienced during the mid-90's, when gas rates were relatively stable. PGW-IR St. 1.1 at 11, Sch. 2 (showing rapid growth in bad debt percentage in late '70's - early '80's). If PGW's more realistic level of bad debt expense were to be used, OTS' recommendation would have to be \$10 million higher.

**B. The Interim Rate Increase May Not Be Denied Because of the City's Willingness to Provide Loans Or By Assuming A One-Time Grant Back of the City Payment.**

As indicated above, the City Administration has proposed that the City provide PGW up to \$45 million in loans in order to assist PGW in meeting its cash needs throughout the fiscal year. The loans are authorized pursuant to the Management Agreement and require that the City be paid back in two years. In addition, the City has indicated that it will provide a "debt service coverage" backstop by making available for fiscal year 1999-2000, a potential grant back of up to \$5 million of the payment from PGW to the City, required by the Management Agreement.<sup>130</sup> The observation of OCA witness LeLash that no interim rate relief was needed was based on his view that the City, for whatever reason, could make the necessary financial advances in lieu of rate relief, and his subsequent claim that a mere \$25 million interim increase would be sufficient to meet PGW's cash requirements is similarly based almost entirely upon the contention that further needs for cash or contingencies can be provided not by ratepayers through higher rates, but by a forced loan or grant back from the City.<sup>131</sup> However, the City's willingness to provide additional backstops may not be used as a replacement for interim rate relief and the City cannot — either directly or indirectly — be forced to give up the required \$18 million payment for a number of reasons:

- Section 2212(e) of the Code requires that PGW's revenue requirement be established using the ratemaking methodology and requirements used by the PGC

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<sup>130</sup> PGW-IR St. 1.1 at 5.

<sup>131</sup> *See, e.g.*, Tr. 235.

to set PGW's rates. As indicated above, that ratemaking standard is set forth in the Management Agreement, and requires that rates be set to cover all expenses, debt service, a reasonable amount for cash working capital and the \$18 million payment to the City.<sup>132</sup> In addition, the Public Utility Code separately mandates that, in setting rates for PGW, the Commission must make an allowance to permit the transfer or payment to the City of the annual payment required by the Management Agreement.<sup>133</sup> Therefore, the Commission does not have the legal authority to deny PGW's rate increase on the ground that the City should be required to supply loans or to "give up" the required City Payment. The fact that this investigation is to establish interim rates, as opposed to a process of establishing permanent rates, does not authorize an alteration of these legal requirements in the Code. Refusing to increase rates to cover PGW revenue requirements is not only unreasonable — no other utility would be forced to give up its investor capital in this way — but it is illegal and unconstitutional; it would constitute the confiscation of the property of the owner of the Gas Works — the City of Philadelphia.<sup>134</sup> It is well-established that a regulatory commission may

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<sup>132</sup> See, Section III, A of this Brief, supra.

<sup>133</sup> 66 Pa. C.S. § 2212(f).

<sup>134</sup> Previous appellate cases have made clear that principles of confiscation apply to PGW and its owner as with any utility.

not refuse to permit the recovery in rates of otherwise prudent expenses or other obligations.<sup>135</sup>

- The City cannot and will not provide the support as a replacement for rate relief. One term under which PGW may obtain loans from the City (with approval of City Council) is that the loan must be repayable within 24 months meaning that PGW must show that it has sufficient revenues to make the repayments.<sup>136</sup> The City would be acting irresponsibly if it allowed its backstop funds to be used to replace or eliminate the required rate increase because without the appropriate relief the loans cannot be paid back. Under such conditions, PGW would be left with absolutely no available alternative if unanticipated events threatened PGW's ability to meet its legal obligations. As Mr. Knudsen stated, "if the City's line of credit is issued simply to meet projected obligations, PGW will literally have no protection if it needs to respond to contingencies such as warmer or colder than normal weather."<sup>137</sup> Indeed, PGW is going to need the loans as soon as November regardless of the Commission's decision in this case.<sup>138</sup> Using up PGW's only

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<sup>135</sup> *Public Advocate v. Philadelphia Gas Comm'n*, 544 Pa. 129, 139, 674 A.2d 1056, 1061 (1996). The cases specifically provide that confiscation occurs when a rate award so fails to provide a return on investor capital that it constitutes confiscation. *See, Duquesne Light Co. v. Barash*, 488 U.S. 299 (1989). In this instance, any refusal to allow recovery of an otherwise proven revenue requirement would in effect unfairly confiscate the property of PGW's owner.

<sup>136</sup> PGW-IR St. 1.1 at 5-6.

<sup>137</sup> *Id.* at 6.

<sup>138</sup> *Id.* at 4-5.

available lifeline would be like burning one's roof for heat. Perhaps an effective one-time, short-term solution but with dire consequences if the next day brings snow and sub-zero temperatures.

- Both Mr. Knudsen and Ms. Bisgaier testified that relying on the City backstop as a replacement for, rather than as a supplement to, an interim rate increase will be extremely detrimental to PGW's standing with the investment community. "[T]he investment community will be left with the view that PGW will not be able to survive on its own. Such a conclusion (which would be very difficult to refute) almost certainly would result in PGW losing its short-term line of credit as well as the downgrading of its long-term debt. This would be a disaster."<sup>139</sup> Ms. Bisgaier provided greater detail on this point:

A loan from the City to PGW would certainly help PGW's cash flow situation but a loan (as opposed to an outright, unconditional grant) would not be "project revenues" under the terms of the rate covenant and, therefore, could not be counted towards meeting the rate covenant requirements . . . . [I]n my opinion, PGW's ability to satisfy technically its bond covenants . . . as a result of one time payments from the City necessitated by the unwillingness or inability for some reason of the Public Utility Commission to grant rate relief would result in virtually the same set of outcomes [as a technical default]. Specifically, PGW would be viewed very negatively by the rating agencies. One of the greatest concerns in rating utility bonds is the potential responsiveness of a regulatory body to provide rate relief to enable bond covenants to be satisfied. The failure of the Public Utility Commission to grant such request through

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<sup>139</sup> PGW-IR St. 1.1 at 6; PGW-IR St. 2 at 17.

relief would be a substantial negative in their assessment of PGW's creditworthiness.<sup>140</sup>

Thus, it is both unsupportable and inadvisable to rely on the offers of support from the City as a means of avoiding PGW's well documented need for additional interim rate relief.

**C. The Recommendations of the Opposing Parties Fail to Adequately Take Account of PGW Monthly and End-of-Year Cash Needs.**

The second principal basis on which several of the opposing witnesses — i.e., Mr. LeLash, PICGUG witness Baudino and OTS witness Weakley — have recommended less than PGW's proposed \$52 million increase is not taking adequate account of — or by completely ignoring — the Company's operating revenue/cash working capital needs both during the fiscal year as well as at the end of that year, going into the next. Mr. LeLash's testimony indicates that he believes that it would be "unreasonable" to set rates that include a cash working capital allowance. While Mr. LeLash is wrong about this point — there is nothing inherently unreasonable about recovering cash working capital allowances from ratepayers<sup>141</sup> — the unrebutted testimony in the record establishes that PGW has historically included its cash working capital needs in its revenue requirement.<sup>142</sup> As the August 17 Order clearly acknowledged, the "ratemaking methodologies and requirements" previously employed by the PGC — PGW's previous ratemaking regulatory body — applies to this case as well as future cases establishing PGW's rates. Accordingly, as a matter of law, PGW's cash working capital

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<sup>140</sup> PGW-IR St. 2 at 15-17.

<sup>141</sup> *See*, PGW-IR St. 1.1 at 18.

<sup>142</sup> *See*, PGW-IR St. 1 at 17; Exh. 1.1, ¶ 1, 8-9.

needs must be included in the determination of the appropriate level of interim rates for the Company.<sup>143</sup>

Accordingly, Mr. LeLash was clearly incorrect both legally and factually in his view that coverage is the only concern and not PGW's cash flow. The PGC has ruled on this issue and it is therefore a part of the established ratemaking methodology that the Commission must follow.

Wholly apart from this legal justification, the fact is that PGW will have an enormous cash working capital need that cannot be made up from any other source without depleting all available protections if PGW's financial condition turns out to be worse than projected.

Nevertheless, neither Mr. LeLash nor any other witness seriously disputed PGW witness Knudsen's testimony that PGW had a requirement of \$35 million to \$40 million in cash at the end of the fiscal year and that this level of cash could only be produced by increasing rates over this coming winter.<sup>144</sup> Yet, Mr. LeLash's projected end of the year cash balance would be a negative \$9 million and is transformed into a positive \$11.2 million balance only by inclusion of

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<sup>143</sup> Importantly, the PGC was faced with a similar argument back in 1981-82, when the public advocate then contended that the PGC should be concerned only with debt coverage and not with cash flow. The PGC rejected that argument. The PGC pointed out that "Public Counsel . . . argue . . . the Gas Commission should look primarily to debt service coverage . . . . PGW argues that the cash flow method is the proper basis of setting rates under the Management Agreement. . . . The PGC, as we have seen above, ruled in that case:

that the cash flow method . . . prevails, [and] that the Commission is governed and bound by the terms of the said Ordinance/Agreement and that the cash flow method, comprised of all items contained in Section VII of said Ordinance/Agreement, is just and reasonable for ratemaking purposes in this case.

<sup>144</sup> See, Tr. 242-43 (OCA) and Tr. 326 (OTS).

the \$20 million temporary advance from the City.<sup>145</sup> Obviously, he has used the \$20 million temporary advance as a replacement for a similar amount of a rate increase needed to provide PGW with adequate cash working capital. To produce an adequate recommendation Mr. LeLash's recommendation would have to increase by more than \$20 million to \$45 million. Similarly, OTS witness Weakley's recommendation produces just \$2.5 million at the end of the fiscal year. Again to reach the required level, his recommendation needs to increase by \$11 - \$16 million, just to achieve PGW's bare minimum cash requirements, producing an interim rate award of \$39.5 - \$43.5 million.<sup>146</sup>

**D. The Opposing Parties' Recommendations Fail to Leave An Adequate Financial Cushion or Margin of Error.**

In addition to all the above deficiencies, both Mr. LeLash and Mr. Baudino fail to recognize sufficiently the dire consequences that would befall PGW and its ratepayers if it technically defaulted on its bonds or found itself without sufficient cash working capital to make necessary payments to maintain operations.<sup>147</sup> Mr. LeLash's recommendations are designed to

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<sup>145</sup> See OCA Sch. 2.1 at 2.

<sup>146</sup> These adjusted results are slightly different because of different assumptions used by Mr. LeLash and Mr. Weakley.

<sup>147</sup> Mr. Baudino's claim that PGW needed just \$15.6 million in additional base rate relief was not based on any calculation of any coverages or cash flow and appeared to be based on his misunderstanding of the consequences of PGW's failure to meet its coverages. On cross-examination, he indicated that his opinion had been based on a Standard and Poors analysis included in Ms. Bisgaier's testimony (PGW-IR St. 2, Appendix A) in which the analyst first recognized that PGW was meeting its debt coverage covenant of 1.5x as calculated pursuant to PGW's bond covenants, and then calculated coverages on an alternative calculation, which included payment of PGW's \$18 million payment to the City,  
(continued...)

permit PGW only to realize coverages that just satisfy its bond ordinance covenants for its crucial 1998 Ordinance bonds, and, as discussed, he has refused to acknowledge PGW's significant working cash needs, suggesting that such needs will be made up "by the owner." In addition to its other problems, this approach is enormously dangerous because it leaves no "margin for error" or "cushion" to take account of unforeseen contingencies such as the more predictable effects of abnormal weather, or unrealized budget assumptions.

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<sup>147</sup>(...continued)

and calculated coverages after removing that \$18 million from the funds available calculation. *Id.*, Appendix A, page 3 of 3. The resulting coverages were lower than the 1.5x causing Mr. Baudino to conclude that there is no particular need to increase rates for PGW to avoid a technical default. However, every other piece of evidence in the proceeding proved that a technical default would be a total disaster for PGW costing it and its customers millions of dollars of additional expenses and threatening the very ability of PGW to continue to provide safe, reliable and adequate gas service. *See, e.g.*, PGW-IR St. 2. Mr. Baudino's recommendation is obviously inadequate. In addition, Mr. Baudino clearly does not have anywhere near the hands-on experience of Ms. Bisgaier in dealing with rating agencies, and none of his experience has been with municipally-owned utilities. Tr. 311-12. Indeed, he was not aware of the example of the Philadelphia Water Department's technical failure to meet its bond covenant in 1991, which caused an immediate downgrade of two levels to below investment grade. *Compare* Tr. 215 (Bisgaier) with Tr. 306 (Baudino).

PGW showed during cross-examination that, under either LeLash's original \$7.5 million recommendations or his subsequent revision to \$25 million,<sup>148</sup> when properly calculated,<sup>149</sup> the failure of PGW to realize any of its productivity savings would result in it failing to meet its debt service coverage requirements by over \$20 million.<sup>150</sup> Moreover, the cash effects of such a scenario would be even more horrendous: Under Mr. LeLash's revised recommendation, PGW would have an approximate negative cash balance of \$32 million at the end of fiscal year 2000-2001 if its productivity savings did not materialize.<sup>151</sup> Accordingly, under Mr. LeLash's recommendation, PGW would have to utilize all of its backstops available from the City just to obtain the necessary cash at the end of the year to be able to purchase gas and pay its debt service in the first few months of the next fiscal year 2001-2002.

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<sup>148</sup> These figures are also applicable to Mr. LeLash's \$25 million increase because he specified that the additional revenues he was allowing were specifically due to his view that he had understated bad debt expense and overstated the amount of productivity savings that the Company likely would realize by \$5 million. Accordingly, there would be no change to PGW's actual projected earnings. Tr. 262-63. he testified that the consequences of his recommendation on the Company's cash position can be determined by adding the additional revenue recommendation to the Company's end of year cash position. Tr. 241-42.

<sup>149</sup> The PGW cross-examination exhibit also updated the assumed level of bad debt expense to \$61.7 million to fully account for the effects of higher gas costs. See PGW Cross-Examination Exh. 1 at 1. Mr. LeLash only included \$52 million in his analysis, implicitly using an unrealistically low factor. See, n. 98, *supra*. See Tr. 230; OTS Exh. 1, Sch. 1.

<sup>150</sup> See, PGW Cross-Examination Exh. 1 at 5.

<sup>151</sup> Calculated by adding \$17.5 million (the additional revenue from Mr. LeLash's revised recommendation) to the negative cash balance calculated on PGW Cross-Examination Exh. 1 at 3.

But, those calculations assume **normal weather**. If — as occurred in the last three winters — PGW experiences just a 12.5% warmer than normal weather on top of unrealized productivity savings, the results would be disastrous. Under Mr. LeLash’s recommendations, PGW would suffer a \$32.2 million shortfall for coverages — producing only a 0.4 coverage for its 1998 bonds.<sup>152</sup> Moreover, PGW would experience a negative cash flow at the end of the fiscal year of \$50.5 million.<sup>153</sup> These cataclysmic results occur simply by reversing two assumptions in PGW’s normalized test year calculations, both of which are perfectly capable of occurring. If they did, PGW and its customers would be left in a position where it would be in default of its bond ordinance covenants and without sufficient cash to buy gas for the next winter to meet its obligations to customers or even continue with necessary main replacement or maintenance.

Mr. LeLash frankly admitted that, if he was in the role of manager of PGW, he would never want to go into a winter with the kind of paper-thin margin of error his recommendation would produce.<sup>154</sup> Yet, when confronted with these calculations, Mr. LeLash could only point to other vague, unsubstantiated and completely undefined “savings” that could be produced to offset these disasters, all of which were shown to be either too costly, too speculative or both.<sup>155</sup> Mr. LeLash’s only other fallback was to point, once again, to PGW’s last line of defense — the

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<sup>152</sup> PGW Cross-Examination Exh. 2, pg. 5.

<sup>153</sup> *Id.* (adjusted to account for Mr. LeLash’s revised recommendation).

<sup>154</sup> Tr. 259.

<sup>155</sup> *Compare*, Tr. 248-254, 258 with, PGW-IR St. 1.1 at 21-23.

give up of the \$18 million payment.<sup>156</sup> But even if those dollars were available, the City backstops would not be enough to avoid disaster if these scenarios came to pass! The OCA's recommendation is simply too risky for the Company and its customers.<sup>157</sup>

**E. OCA has Failed to Show that Adequacy of Service is a Basis for Denying Interim Rate Relief to PGW.**

OCA witnessed LeLash testified that PGW's service has been inadequate and that such inadequacy is a basis for denying any interim rate relief.<sup>158</sup> He claimed that PGW is not currently operating at a level that is comparable to other utilities in performance, cost or level of service.<sup>159</sup> Mr. LeLash also contended that a case could be made that PFMC had not met its contractual obligations under the Management Agreement for several years so that it may not be proper to base an interim rate increase solely on the terms of the Management Agreement.<sup>160</sup> Neither his factual nor his legal contentions have any merit.

**1. Mr. LeLash's Contentions Claiming That Adequacy of Service Should Be Used As A Criteria For Judging PGW's Interim Rate Request Is Not Legally Supportable**

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<sup>156</sup> Tr. 234.

<sup>157</sup> To the same effect is the OTS recommendation which, while allowing for some cushion in its coverage calculations, would produce just \$2 million in end of year cash. *See*, OTS Exh. 1, Sch. 2. This is far less than PGW needs to operate with any reasonable margin of safety. to repair this deficiency OTS's recommendation needs to be increased to \$38.5 million to \$43.5 million.

<sup>158</sup> OCA St. No. 1 at 12, 54.

<sup>159</sup> OCA St. No. 1 at 48-49.

<sup>160</sup> OCA St. No. 1 at 18-19.

Notwithstanding the financial support for PGW's \$52 million interim rate increase request, Mr. LeLash suggested that the PUC would have the legal authority to deny PGW's request, on the ground that PGW's service is "inadequate." Mr. LeLash's contention was based on a contention that Section 526 of the Public Utility Code permits the Commission to completely deny a rate increase for service reasons.

Section 526 of the Public Utility Code enables the Commission to consider service quality issues in setting utility rates.<sup>161</sup> However, such service quality evaluations within the ratemaking context are not a component of PGW's traditional ratemaking methodology and, accordingly, cannot be utilized here.

Furthermore, the Commission's exercise of Section 526 authority, consistent with application of constitutional requirements, is limited to adjusting the utility's rate of return on equity. The Commission is not empowered to preclude recovery of legitimate operating costs or working capital.<sup>162</sup> Here, because of its status as a municipally-owned utility, PGW does not pay its investors (the City) a return, nor does it recover any such return from its ratepayers. Accordingly, any exercise of Section 526 by the Commission would preclude recovery of legitimate operating expenses and necessary working capital and would go beyond constitutional

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<sup>161</sup> Section 526 enables the Commission to reject a utility rate increase request, in whole or in part, based on a finding that the utility's service is inadequate.

<sup>162</sup> *See National Utilities, Inc. v. Pennsylvania Public Utility Commission*, 709 A.2d 972, 979 (Pa. Cmwlth. 1998) (holding that exercising Section 526 to deny or decrease a rate increase is only consistent with constitutional requirements when "the result is a rate of return [on equity] less than it would otherwise be entitled to receive," but also finding that Section 526 could not be utilized to deny sufficient funds required for necessary operating expenses or to repay loans).

limitations precluding confiscation of PGW's property – thus representing an improper exercise of statutory authority. Accordingly, any such relief requested by the OCA or any other party should be rejected on its face.

While PGW does not pay its investors a return on equity nor recover such return from ratepayers, it is likely that parties, including the OCA, will characterize the City Payment as being in the nature of equity return,<sup>163</sup> and, as a result, subject to adjustment (or elimination) under Section 526. However, such an analysis overlooks the fact that the General Assembly has legislated, and, in effect, guaranteed the recovery of the City Payment in PGW's rates.<sup>164</sup> Accordingly, even if the City Payment could be viewed as a return on equity, the General Assembly has expressly determined that the recovery of that City Payment cannot be adjusted by the Commission, in whole or in part, including as a result of exercise of 66 Pa. C.S. §§ 523, 526.

## 2. The Record Does Not Support a Finding of Inadequate Service

In addition to the legal insufficiency of Mr. LeLash's claims, they were also virtually devoid of any evidentiary basis. When tested on cross-examination, Mr. LeLash's factual claims of inadequacy of service principally focused on a series of anecdotal references to independent

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<sup>163</sup> For example, in the *Public Advocate* case, 674 A.2d at 1056, the Supreme Court considered the City Payment as being in the nature of equity returns – a payment to the owner of PGW which “would represent a little less than a nine percent rate of return on equity.” 674 A.2d at 1062.

<sup>164</sup> 66 Pa. C.S. 2212(f). The only exception provided by Section 2212(f) is if the City Payment exceeds 110% of the amount that was authorized as of June 30, 2000 — an exception which is not relevant here.

consultant draft studies PGW itself had commissioned.<sup>165</sup> He did not know whether any parts of the studies had specifically concluded that PGW was providing service that fell below any legally recognizable standard — or whether the studies referenced any PUC statutory or regulatory standards whatsoever.<sup>166</sup>

Moreover, the additional “evidence” Mr. LeLash provided during cross-examination boiled down to claims that other utilities appeared to be doing better in certain areas. For example, his allegation that PGW was not compliant with a provision in the Management Agreement that requires it to take all reasonable steps to meet the maximum requirements of gas users in the City<sup>167</sup> turned out to be one instance where PGW did not fulfill a wholesale transaction.<sup>168</sup> He candidly admitted that he had no evidence that PGW had failed to deliver gas to retail customers adequately.<sup>169</sup>

With respect to gas procurement policies, Mr. LeLash first claimed that while PGW generally does a good job in procurement, there have been lapses. But the one “lapse” he referred to was an instance when PGW “blew out” its LNG inventory in November or December, before the cold season started, which is not usually done in the gas business,<sup>170</sup> because PGW

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<sup>165</sup> Tr. 264-73.

<sup>166</sup> *Id.*, at 275. The reports are not in the record.

<sup>167</sup> Tr. 264-65.

<sup>168</sup> Tr. 265.

<sup>169</sup> Tr. 264-65.

<sup>170</sup> Tr. 266.

needed the cash.<sup>171</sup> Indeed, he elsewhere admitted that PGW's procurement policies had saved ratepayers \$27.0 million in gas costs this year.<sup>172</sup>

Finally, his claim as to safety failures was better characterized as a potential concern. While he first stated that PGW's safety record is significantly worse than other gas distribution companies in Pennsylvania, what he was actually referring to is the fact that PGW had not been able to keep up with its main replacement program despite the fact that PGW acknowledged that it should be replacing 1% of its mains annually.<sup>173</sup> Mr. LeLash admitted he had no evidence that PGW's actual safety record is worse than that of any other local distribution companies.<sup>174</sup> Presumably his concern was his claim that PGW had in the past not met its own goal for main replacements could cause future problems. But PGW is fully committed to adhering to its main replacement goals — assuming it has the financial support to do so.

With respect to the contention that the Management Agreement would preclude a rate increase, Mr. LeLash was unable to point to any section of the Management Agreement that makes rates dependent on adequacy of service.<sup>175</sup> Indeed, there is no such provision. In fact, the Management Agreement, as seen above, provides for a cash flow basis of ratemaking and does not make a rate increase contingent upon adequacy of service.

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<sup>171</sup> Tr. 284.

<sup>172</sup> OCA St. 1 (GCR) at 25-26.

<sup>173</sup> Tr. 267.

<sup>174</sup> Tr. 266-67.

<sup>175</sup> Tr. 268-70.

Indeed, Mr. LeLash ultimately admitted that he was not contending that the Commission could deny PGW's entire interim rate relief request because of inadequate service at the call center, BCCS and other services that do not go directly to the procuring and furnishing of gas.<sup>176</sup> He conceded that while it was his opinion that PGW's service is inadequate in several respects, he was not, in fact, offering an opinion as to whether PGW's service falls below the threshold level which the PUC believes is sufficient to warrant altering its revenue requirement.<sup>177</sup>

Under the circumstances, where there is no basis in the Management Agreement for denying interim rate relief based on adequacy of service; where no evidence has been introduced that the basic functions of procuring and providing gas in a safe manner have not been carried out by PGW; and where the consequences of Mr. LeLash's recommendation would in fact interfere with PGW's ability to improve its services – his recommendation should be thoroughly disregarded by the Commission.

**F. Other Arguments by OCA and PICGUG Against a Rate Increase Are Unsupportable and Unreasonable.**

Both OCA witness LeLash and PICGUG witness Baudino stretched to find reasons to deny the necessary interim rate increase in this case. They make similar arguments, which are, in most instances, unsupportable and unreasonable.

**1. Failure to Seek a Rate Increase Previously**

Both witnesses claim that PGW waited too long to seek a rate increase when its position was deteriorating for several years previously. While PGW witness Knudsen conceded that had

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<sup>176</sup> Tr. 276-77.

<sup>177</sup> Tr. 277.

he been in management previously, PGW would have sought relief sooner, the fact that prior management did not do so is clearly not a basis to deny PGW the relief it presently needs and seeks. Both Messrs. LeLash and Baudino admitted that if PGW had sought and obtained rate relief at an earlier time, the effect would be that PGW's ratepayers would have been paying more for their gas for a longer period of time. In fact, Mr. LeLash admitted that PGW management was now taking the "responsible" action it should have taken three years ago by seeking a rate increase.<sup>178</sup> Accordingly, while it may have been more prudent for PGW to seek a rate increase several years ago, the effect is an interest-free loan to PGW's ratepayers who did not have to pay higher rates during the past several years. More importantly, it is no reason to deny PGW the increase it currently requires.

## 2. Main Replacement Program

By the same token, both witnesses deal with PGW's main replacement program. OCA witness LeLash chastised PGW for not keeping up with its main replacement program, which he considers a matter of safety, but then suggested that an interim rate increase could be denied — eliminating PGW's future ability to pay for that program. Similarly, Mr. LeLash's contentions regarding PGW's need to improve its BCCS and other service operations would admittedly be constrained by failing to give PGW the necessary rate relief.<sup>179</sup> Clearly, his contention that the PUC should consider refusing a rate increase because of past inadequate service is antithetical to PGW's need to expend funds on main replacement and other capital improvements which PGW

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<sup>178</sup> Tr. 293.

<sup>179</sup> Tr. 278-79.

is endeavoring to do. Mr. LeLash claimed that PGW's base case and his recommendation approving PGW's budget would furnish PGW the capital necessary to make the main replacements as well as the other improvements necessary.<sup>180</sup> However, it is clear that if PGW does not have the funds to meet its more pressing obligations of day-to-day business activity, such as purchasing gas, whether or not these funds are budgeted for capital improvements, they will have to be used for those critical needs. The best way to assure capital and service improvements is to assure that they are adequately funded.

PICGUG witness Baudino, on the other hand, claimed that PGW could save money by not implementing some part of its entire \$62.3 million capital program,<sup>181</sup> over 90% of which relates to refurbishing the LNG system, the main replacement program and meter repairs – all of which he considers to be important issues, and, if related to safety or reliability, not subject to deferral.<sup>182</sup> They clearly are. Mr. Baudino also admitted he had no basis to challenge any of these expenditures as unreasonable or unnecessary.<sup>183</sup> Moreover, in listing the financial concerns of PGW that the Commission should address when determining the amount of rate relief, Mr. Baudino ironically included PGW's current inability to invest in ongoing system expansion.<sup>184</sup> Again, it would be self-defeating for PGW to cut back on needed improvements where the result would implicate safety and reliability considerations.

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<sup>180</sup> Tr. 278.

<sup>181</sup> PICGUG St. No. 1 at 8.

<sup>182</sup> PGW Cross Examination Exh. No. 4; Tr. 303-04.

<sup>183</sup> Tr. 301.

<sup>184</sup> PICGUG St. No. 1 at 7; Tr. at 299-300.

### 3. Other Sources of Funds

OCA also contends that PGW could obtain additional funds by various schemes, such as appropriating an allegedly overfunded pension fund, refinancing its bond sinking funds or entering into gas storage management contracts.<sup>185</sup> While these ideas were tossed out by Mr. LeLash with no concrete plan or substantiation, PGW witness Knudsen showed why none of them is viable, at least as short term solutions in the present circumstances.<sup>186</sup> Several of the ideas would require PGW to mortgage its future and give up future revenues — at a high cost now — the same type of activity that PGW followed in the past that led to its present financial predicament. Indeed, it is essentially the same type of action PGW was required to undertake when it “blew out” its LNG prematurely for cash — an event that Mr. LeLash singled out for criticism. Moreover, any effort to appropriate overfunded pension liabilities would require City Council approval, which would not only take time, but could generate opposition. In short, none of Mr. LeLash’s quick fixes can remedy PGW’s present critical needs and they should be disregarded.

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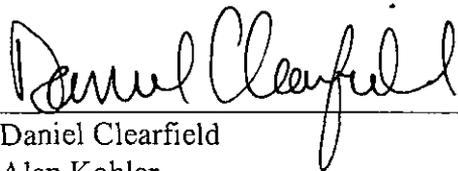
<sup>185</sup> OCA St. No. 1 at 16-17.

<sup>186</sup> PGW-IR St. 1.1 at 21-22.

**VI. CONCLUSION**

PGW's direct and rebuttal testimony provided substantial evidence of the need for a \$52 million interim rate increase. While the City Administration has requested approval from City Council of substantial assistance in order to assure that PGW remains a viable going concern and is able to continue to pay its bills, the evidence is overwhelming that an interim rate increase awarded by this Commission is necessary in addition to, as opposed to in lieu of, this assistance. PGW's interim rate request should be granted in full, subject to further review and refund in the Company's mandated permanent base rate case. The proposed interim rate increase should be implemented in accordance with the proposed across-the-board rate increase proposal set forth in PGW-IR St. 3.

Respectfully submitted,



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Dated: October 13, 2000

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## APPENDIX "A"

### **I. STATEMENT OF THE CASE**

This request for interim rate relief was initiated by Philadelphia Gas Works ("PGW") on August 8, 2000, through the filing of a Petition for Establishment of Interim Rate Procedures and for a Declaratory Order at ("Petition").<sup>1</sup> The Petition requested the Commission to establish an expedited hearing schedule to establish interim rates for PGW effective no later than November 15, 2000; to direct the conduct of such a procedure in a manner designed to enable the Commission to consider and determine such an interim rate increase that would permit PGW to maintain a minimal, adequate level of financial health through the winter heating season until the Commission can conduct and rule on a full base rate proceeding; to declare that the only issue within the scope of the proceeding is the level of interim rates necessary to maintain PGW's ability to fund operations until the completion of a full base rate case; declare that the Commission would utilize the rate-making methodology and requirements utilized by the Philadelphia Gas Commission ("PGC") in reviewing similar requests, as mandated by 66 Pa. C.S. § 2212(e); and waive any provisions of the Public Utility Code or regulations that are inconsistent with the request. The Petition was accompanied by an Affidavit and Verification of Thomas Knudsen, PGW's Interim Chief Financial Officer and numerous supporting exhibits.

The Commission issued a Secretarial Letter dated August 9, 2000 directing responses by August 15, 2000 so that the Petition could possibly be considered by the Commission on August 17, 2000. After considering replies to the Petition, the Commission, on August 17, 2000, entered

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<sup>1</sup> Docket No. P-000018381.

an Order granting the request for an expedited hearing schedule and establishing interim rate procedures (“Order”). The Commission preliminarily noted that it had only assumed jurisdiction over PGW on July 1, 2000 and that prior to that time, PGW’s rates, terms and conditions of service were regulated by the PGC. The Commission also noted that, under 66 Pa.C.S. §2212(d), until a new tariff is filed by PGW and approved by the Commission, PGW continues to provide natural gas supply and distribution services to its customers under the prior tariff and the policies or programs existing on July 1, 2000.<sup>2</sup> The Commission finally noted that 66 Pa C.S. §2212(d) nonetheless permits PGW to request the Commission to approve modifications to its prior tariff “at any time prior to the effective date of the final order approving the restructuring plan and new tariff.”<sup>3</sup>

The Commission then granted PGW’s request for an expedited procedure to determine whether interim rates should be granted.<sup>4</sup> In so doing, it conditioned its approval of the schedule on PGW’s: filing a full base rate case no later than January 1, 2001; committing that any interim rates granted by the Commission are subject to refund at the conclusion of a full base rate case if *the Commission determines that a lower level of rates is just and reasonable*; committing that it will not seek to recoup additional revenues from ratepayers if the Commission ultimately determines that a higher level of rates is just and reasonable; and committing to its “Transition to

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<sup>2</sup> Order at 6.

<sup>3</sup> *Id.*, citing 66 Pa.C.S. §2212(d).

<sup>4</sup> Order at 7.

Excellence” plan for improvement and a demonstration throughout the interim rate period that it is providing safe and adequate service.<sup>5</sup>

With respect to PGW’s request for declaratory order, the Commission acknowledged its obligation under 66 Pa.C.S. §2212(e) — to utilize the same “ratemaking methodology and requirements” as were applied by the PGC prior to the Commission’s assumption of jurisdiction — but stated it would not preclude the other parties from presenting arguments as to the proper application of the prior “ratemaking methodology and requirements” to PGW’s request for interim rates.<sup>6</sup> The Commission also stated it would not limit the scope of the hearing process nor foreclose other parties from raising relevant issues during the expedited review process,<sup>7</sup> and denied PGW’s request to limit the scope of hearing without prejudice.<sup>8</sup> Finally, the Commission granted PGW’s request for a waiver of any provisions of the Public Utility Code or regulations to the extent necessary to perfect PGW’s interim rate filing.<sup>9</sup>

The Commission assigned the matter to ALJ Marlane R. Chestnut to conduct a hearing, with the briefs to be filed directly with the Commission and an adjudication to be issued by the Commission without a recommended decision. PGW served its Direct Testimony on August 25, 2000, consisting of three statements: PGW-IR St. 1.0 — the Direct Testimony of Mr. Knudsen;

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<sup>5</sup> Order at 8. At the hearing in this matter, PGW entered into the record a resolution of PFMC dated August 25, 2000 committing to all of these conditions. PGW-IR Exhibit 1.5; Tr. at 132-33.

<sup>6</sup> Order at 10, 11-12 (ordering paragraph 4).

<sup>7</sup> Order at 10.

<sup>8</sup> Order at 11 (ordering paragraph 3).

<sup>9</sup> Order at 12 (ordering paragraph 5).

PGW-IR St. 2 – the Direct Testimony of Barbara Bisgaier, a managing director of Public Financial Management, Inc., a financial advisor to the City of Philadelphia and PGW; and PGW-IR St. 3 – the Direct Testimony of Craig White, Senior Vice President of Marketing and Supply Services of PGW.

ALJ Chestnut issued three prehearing orders. The first was dated August 9, 2000, in which she scheduled a prehearing conference on August 25, 2000 and ordered the filing of prehearing memoranda. The prehearing conference was held on August 25, 2000 at which time certain additional procedures were implemented as to discovery, and a schedule for the filing of testimony, hearings and filing of briefs was announced. The ALJ issued Prehearing Order #2 on August 31, 2000, embodying those determinations, and Prehearing Order #3 on September 20, 2000 to address certain procedural matters.

The active parties in the hearing, in addition to PGW, were OTS, OCA, OSBA, the Philadelphia Industrial and Commercial Gas Users Group (“PICGUG”), the Consumers Education and Protective Association, Association of Community Organizations for Reform Now, Action Alliance of Senior Citizens of Greater Philadelphia and Tenants Action Group (“CEPA”, et. al.) and the Apartment Association of Greater Philadelphia (“AAGP”).

While all these parties participated in the hearings, only OCA, OTS, OSBA and PICGUG served Direct Testimony in the case on September 18, 2000.<sup>10</sup> PGW served Rebuttal Testimony by Mr. Knudsen on September 25, 2000.

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<sup>10</sup> OCA (Richard LeLash), OSBA (Brian Kalcic), PICGUC (Richard A. Baudino) each presented the testimony of one witness. OTS presented three witnesses: Charles T. Weakley, III (OTS St. No. 1), Paul J. Metro (OTS St. No. 2) and Andrew R. O’Donnell (OTS St. No. 3), each with exhibits.

Prior to the hearings, PGW objected to certain discovery from CEPA seeking copies of draft reports from consultants regarding PGW's progress in its Transition to Excellence program. CEPA filed a motion to compel PGW to respond to that discovery. At the same time, PGW moved to strike testimony of OCA witness LeLash relative to the adequacy of PGW's service and problems with PGW's BCCS system as being outside the scope of this limited proceeding.

On September 26, 2000, ALJ Chestnut issued two orders, one denying CEPA's Motion to Compel, and the other denying PGW's Motion to Strike. The ALJ's rationale was that, in keeping with her understanding of the Order she would not foreclose OCA from raising the adequacy issue, because the Commission is free to consider any issue it feels is appropriate and for which there is adequate evidence in the record.<sup>11</sup> At the same time, she denied CEPA's Motion to Compel, not because it went beyond the scope of the hearing, but because it would not be fair to subject PGW to cross-examination on draft documents on such short notice with no opportunity to respond.<sup>12</sup>

Hearings were held in Philadelphia on September 27 and 28, 2000 at which the record was made. All the direct and rebuttal testimony was introduced<sup>13</sup> and several of the witnesses

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<sup>11</sup> Order Denying PGW's Motion to Strike at 2.

<sup>12</sup> Order Denying CEPA et al's Motion to Compel at 2-3.

<sup>13</sup> In addition to its previous exhibits, PGW also introduced its response to the Commission's Secretarial Letter dated September 7, 2000 with a copy of the relevant bond documents as PGW-IR Exhibit 1.4 (in 3 volumes), as well as the resolution of PFMC agreeing to the conditions in the Order as PGW-IR Exhibit 1.5.

were cross-examined.<sup>14</sup> Public input hearings were held on September 26 and 29, 2000 and were also transcribed.

Simultaneous with the filing of its briefs PGW has requested that the records in the interim rate proceeding (R-00005654) and the GCR proceeding (R-00005619) be consolidated for briefing purposes.

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<sup>14</sup> The ALJ has prepared and submitted to the Commission a list of statements of testimony and exhibits that were introduced into the record.

**PROPOSED  
FINDINGS OF FACT AND CONCLUSIONS OF LAW**

**FINDINGS OF FACT**

1. The public utility seeking this interim rate increase is Philadelphia Gas Works ("PGW"), with its principal place of business at 800 W. Montgomery Avenue, Philadelphia, PA 19122.
2. PGW is a group of real and personal assets owned by the City of Philadelphia ("City") and used for the acquisition, storage, processing and distribution of natural gas within the City. PGW is a "city natural gas distribution operation" as defined in Section 102 of the Public Utility Code, 66 Pa.C.S. § 102.
3. The Philadelphia Facilities Management Corporation ("PFMC") is a non-profit corporation organized by the City of Philadelphia ("City") for the specific purpose of operating PGW. The Board of PFMC is appointed by the Mayor of Philadelphia pursuant to an Agreement between the City and PFMC for the Management and Operation of the Philadelphia Gas Works dated December 29, 1972 ("Management Agreement").<sup>1</sup> The Management Agreement was incorporated into and approved by an ordinance of the Philadelphia City Council on December 29, 1972 (No. 455 of 1972). Pursuant to the Management Agreement, PFMC is responsible for all operations of PGW (Section I, ¶1).

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<sup>1</sup> A copy of the Management Agreement, as amended through and including December 31, 1995, is attached to PGW's Main Brief as Appendix "C," Tab 5.

4. Prior to the passage of the "Gas Choice Act,"<sup>2</sup> PGW — as a municipally-owned natural gas operation providing service only within the corporate limits of the City — and its rates, terms and conditions of service, were exempt from the jurisdiction, regulation and control of the Commission. Instead, pursuant to Sections VI, ¶9 and VII, ¶1 of the Management Agreement, PGW has been regulated by the PGC, a local agency of the City provided for by the Philadelphia Home rule Charter §§ 3-100, 3-909 and 5-902, 351 Pa. Code §§ 3.3-100, 3.3-909 and 5.5-902.

5. On August 8, 2000, PGW filed a Petition for Establishment of Interim Rate Procedures and Declaratory Order at Docket No. P-000018381, seeking an expedited schedule for an interim rate increase ("Petition").

6. In accordance with the Commission's Order of August 17, 2000 ("Order") granting the Petition, PGW filed an interim base rate case on August 25, 2000, seeking a \$52 million increase in rates, subject to refund upon the completion of a full base rate case which it undertook to file by January 1, 2001 in accordance with the Order.

7. The Order was subject to various conditions,<sup>3</sup> all of which have been accepted by PGW.<sup>4</sup>

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<sup>2</sup> The Natural Gas Choice and Competition Act ("Gas Choice Act") is Section 3 of the Act of June 22, 1999 (P.L. 122, No. 1999-21), 66 Pa.C.S. §§ 2201-2212 (hereinafter "the Gas Choice Act").

<sup>3</sup> Order at 11 (Ordering paragraph 2).

<sup>4</sup> PGW-IR Exh. 1.5.

8. PGW has demonstrated that without interim rate relief in the amount of \$52 million it will default on its bond covenants.<sup>5</sup>

9. PGW utilized a fully normalized “test year” that represented its projected operating and capital budget for fiscal year 2000-2001. This is consistent with the methodology and approach that it utilized before the PGC prior to the transfer of ratemaking authority to the PUC.<sup>6</sup>

10. PGW relies substantially on its long term and short term debt to fund its construction program as well as to provide a source of operating funds for day-to-day operations.<sup>7</sup>

11. PGW must satisfy its PGW’s bond ordinances covenants to remain financially viable.<sup>8</sup>

12. This coming spring, PGW anticipates issuing an additional \$75 million in bonds from which, in addition to funding crucial improvements to PGW’s LNG plant and distribution system, PGW will “borrow” some of the proceeds prior to the time they are needed for the capital improvements, to provide a supplemental source of cash working capital at the beginning of the 2001-02 fiscal year.<sup>9</sup>

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<sup>5</sup> PGW-IR Exh. 1.3, Sch. 3, p.3; PGW St. 1, PGW St. 2.

<sup>6</sup> PGW-IR St. 1 at 17-18.

<sup>7</sup> PGW-IR St. 2.

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

<sup>9</sup> PGW-IR St. 1 at 10; PGW-IR Exh. 1.1 at ¶¶ 8-9; PGW-IR St. 2 at 6; PGW Cross Exh. 4 (detail of 2000-2001 capital projects).

13. PGW's bond covenants are contained in two principal documents, commonly referred to as the 1975 Bond Ordinance<sup>10</sup> and the 1998 Bond Ordinance.<sup>11</sup>

14. The Gas Works has never in its history violated any of its bond covenants.<sup>12</sup>

15. In addition to PGW's obligation to actually make its debt service payments when scheduled, its legal obligation to its lenders under its covenants is to collect revenues which will allow it to meet the following requirements:

- (1) Pay the costs of operating and maintaining PGW (the "rate covenant");<sup>13</sup>
- (2) Pay the interest and principal, when due, of outstanding PGW revenue bonds;<sup>14</sup>
- (3) After operating expenses have been met, provide at least 1.5x coverage of the debt service on outstanding PGW revenue bonds (its "coverage covenant");<sup>15</sup> and

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<sup>10</sup> The 1975 Bond Ordinance (Bill No. 1871) was included in PGW-IR Exh. 1.4, Volume I, Tab 2, Exh. A.

<sup>11</sup> The 1998 Bond Ordinance (Bill No. 980232) was included in PGW-IR Exh. 1.4, Tab 6 (behind the last yellow sheet).

<sup>12</sup> Tr. 212-13.

<sup>13</sup> The rate covenant requires that PGW's revenues are sufficient to cover all of its net operating expenses; net operating expenses do not include depreciation or the mandated \$18 million City Payment. *See*, PGW-IR Exh. 1.4, Tab 2, Exh. A for the 1975 Bond Ordinance; for the 1998 Board Ordinance, see Tab 6. In each case, see Sec. 2.01 (definition of "Operating Expenses" and "Net Operating Expenses") and sec. 4.03 (rate covenant).

<sup>14</sup> *Id.* at Sec. 4.03(c).

<sup>15</sup> *Id.* at Sec. 4.03(b)(iii).

- (4) Pay principal and interest on subordinated bonds, including interest on the commercial paper.<sup>16</sup>

16. A technical violation of these covenants would bring swift and catastrophic consequences to PGW in that a failure to meet its bond covenants would result in the rating agencies immediately downgrading PGW to junk bond status.<sup>17</sup>

17. A downgrade to junk bond status would prevent PGW from accessing the public bond markets or obtaining bond insurance.<sup>18</sup> The immediate effect would be to bar PGW from making its planned bond issuance in the spring, not only threatening PGW's ability to make crucial capital improvements but also eliminating its ability to "borrow" a portion of the issuance to supply the cash necessary to fund operations prior to the 2001-02 winter.<sup>19</sup>

18. Technical default on PGW's bonds would also cause the collapse of PGW's commercial paper program, PGW's only other source of financing.<sup>20</sup>

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<sup>16</sup> PGW-IR St. 2 at 13-14.

<sup>17</sup> *Id.*

<sup>18</sup> PGW-IR St. 2 at 5-6; 14-17.

<sup>19</sup> *Id.*; PGW-IR St. 1.1, Exh. 1.3, Sch. 1.

<sup>20</sup> PGW-IR St. 2 at 6-10.

19. PGW has completely utilized its commercial paper up to its \$100 million limit.<sup>21</sup>

20. While the commercial paper program initially was designed to smooth over periodic cash deficiencies, it has become a permanent part of PGW's capital structure.<sup>22</sup>

21. PGW's commercial paper is secured by a letter of credit issued by Morgan Guaranty. Morgan has declined to extend the term of the letter of credit until PGW's financial condition becomes clearer, after the Commission responds to PGW's base rate request.<sup>23</sup>

22. A technical default on PGW's bonds would make it a "virtual certainty" that neither Morgan nor any other bank would issue PGW a new letter of credit.<sup>24</sup>

23. In its earliest opinions regarding PGW, the PGC recognized the importance of providing PGW with the opportunity to earn sufficient revenues to maintain its bond rating.<sup>25</sup>

24. This Commission, in the Order, likewise reflected concern with bond coverage by noting that, among other things, PGW must "present substantive evidence to support its assertion that an interim rate increase is necessary for PGW to comply with its covenants to the holders of any approved bonds."<sup>26</sup>

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<sup>21</sup> PGW-IR St. 2 at 6.

<sup>22</sup> PGW-IR St. 2 at 7-9.

<sup>23</sup> PGW-IR St. 2 at 7-9.

<sup>24</sup> PGW-IR St. 2 at 9-10.

<sup>25</sup> See 1981 and 1982 PGC adjudications (Appendix "C" to PGW's Main Brief, Tabs 1-3).

<sup>26</sup> Order at 7-8 (emphasis supplied). The Commission further reflected this concern in its Secretarial Letter of September 7, 2000 seeking relevant bond documents. PGW-IR Exh. 1.4.

25. Virtually all of the witnesses testifying in the proceeding agreed that providing PGW with the rate relief necessary to avoid a technical default on PGW's bonds is a critical necessity, in the best interest of the Company and its customers, and a legitimate goal of this interim rate proceeding.<sup>27</sup>

26. PGW's revenue requirement also includes the amount necessary to meet its ongoing obligations prior to the time it is able to collect revenues from customers to defray those obligations.

27. PGW's "cash working capital or "cash flow need" is specifically authorized by the Management Agreement,<sup>28</sup> has been part of the ratemaking methodology and requirements recognized and utilized by the PGC since at least 1972, and is part of PGW's revenue requirement before this Commission.

28. PGW's operating cash requirements include having sufficient cash on a monthly basis to pay its obligations and make its debt service payments when they come due.<sup>29</sup>

29. PGW is obligated "pay off" its entire commercial paper line of credit for at least 24 hours each year. The Company must have enough cash to be able to make that payment by the end of May.<sup>30</sup>

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<sup>27</sup> Tr. at 258-59; OTS St. 3 at 9.

<sup>28</sup> Section VII, ¶1(b)(ii) and (iii) (App. C, Tab 5 to this Brief).

<sup>29</sup> PGW-IR St. 1 at 9; Exh. 1.1, ¶ 8-9.

<sup>30</sup> PGW-IR St. 1.1 at 4, 15-16.

30. PGW has established that it needs \$35 to \$40 million of liquidity at the end of its fiscal year and going into a new fiscal year in order to be able to make critical gas purchases in preparation for the upcoming winter and to pay its debt service obligations.<sup>31</sup>

31. In the last several years, PGW has realized its liquidity by a combination of cash from operations and by “borrowing” from the proceeds of long term debt issuances prior to the time that those dollars are scheduled to be utilized for construction projects.<sup>32</sup>

32. While at the beginning of the 2000-2001 fiscal year PGW’s liquidity need resulted almost exclusively from its ability to borrow on prior long term debt issuances, it will have only just over \$21 million of liquidity available at the beginning of the 2001-2002 fiscal year from this source (assuming it successfully issues the planned \$75 million in bonds), making it short by \$13.5 - \$18.5 million of its minimum requirements of \$35 to \$40 million.<sup>33</sup>

33. In July, Standard and Poor’s placed PGW on its “CreditWatch, with negative implications.” Standard and Poor’s conclusion was “Rate relief is needed by this fall. . . . To preserve its ratings, PGW will need to obtain rate relief and implement the projected productivity savings ranging from 5-10% annually.”<sup>34</sup>

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<sup>31</sup> PGW-IR St. 1 at 9; Tr. 135.

<sup>32</sup> PGW-IR Exh. 1.1, ¶26.

<sup>33</sup> PGW-IR St. 1 at 9; Exh. 1.1, ¶ 26.

<sup>34</sup> PGW-IR St. 2, App. A at 3.

34. The Standard & Poor's analysis not only commented upon the need to maintain PGW's bond ordinance covenants, but also expressed concern about the level of cash available to meet obligations.<sup>35</sup>

35. Ms. Bisgaier, PGW's financial consultant, and the Company are meeting regularly with the rating agencies and PGW's lenders and that they are all concerned about the same earnings and cash flow projections submitted in the record in this proceeding.<sup>36</sup>

36. An inability to issue additional long term debt and/or a loss of PGW's commercial paper line of credit will threaten PGW's continued ability to maintain its construction program and improve service.

37. Without interim rate relief or an increase to its GCR prior to the beginning winter heating season, PGW will be in technical default of all of its bond ordinances, and will experience such large cash operating revenue deficiencies that it would simply not be able to continue to provide gas service to customers.<sup>37</sup>

38. PGW bills 65% of its revenues during the winter heating season (November - March).<sup>38</sup>

39. Accordingly, PGW must raise base rates immediately to address the deficiencies in earnings, coverage and cash working capital that will exist at the end of this fiscal year.

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<sup>35</sup> *Id.*; Tr. 216.

<sup>36</sup> Tr. 215-17.

<sup>37</sup> *Id.*; PGW-IR St. 1, App. B at 3.

<sup>38</sup> PGW-IR St. 1.1 at 14; Tr. at 184.

40. The following scenario would occur if the Company were not able to obtain both base rate relief and GCR increases:<sup>39</sup>

**TABLE 1  
PGW FINANCIAL PROJECTIONS  
AUGUST, 2000  
NO BASE RATE RELIEF  
NO GCR**

	<b>Projected</b>	<b>Minimum Needed</b>
Earnings	(\$111,450)	N/A
Coverage on 1975 Bonds	.04	1.5x
Coverage on 1998 Bonds	(1.95)	1.5x
Year End Cash Balance (Assuming \$21.5 million available from new long term debt issuance)	(\$92 M)	\$13.5 M - \$18.5 M

41. Even with a GCR increase of \$97 million, PGW's financial status would still be far from adequate and PGW would end its fiscal year in technical default of its 1998 bonds. The following would occur:<sup>40</sup>

<sup>39</sup> PGW Exh. 1.1, Sch. 1  $(\$113.5) + \$21.5 = (\$92)$ .

<sup>40</sup> PGW-IR Exh. 1.1, Sch. 1.

**TABLE 2  
PGW FINANCIAL PROJECTIONS  
AUGUST, 2000**

**GCR INCREASE @ \$97 MILLION  
NO BASE RATE INCREASE**

	<b>Projected</b>	<b>Minimum Needed</b>
Earnings	(\$17,402)	N/A
Coverage on 1975 Bonds	1.67	1.5x
Coverage on 1998 Bonds	1.26	1.5x
Year-End Cash Balance (assuming \$21.5 million available from new long term debt issuance)	(\$25,056 M) <sup>41</sup>	\$13.5 M - \$18.5 M

42. The granting of a \$52 million interim rate request to repair these serious deficiencies is extremely conservative for a number of reasons discussed below.

43. PGW calculated a \$52 million base rate increase as its needed revenue requirement in its initial filing before the PGC on June 19, 2000 at which time, it was projecting that its required GCR increase would be just \$47 million. Since then PGW has revised its GCR

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<sup>41</sup> PGW St. 1, App. B, p. 4 (\$25,056) + \$21.5 (from borrowing on long term debt service produces -\$3.5 million available operating revenues at year end compared to necessary level of \$35 - \$40 million.

from \$47 million to \$97 million,<sup>42</sup> the level at which it made its initial GCR filing with the PUC, and is now projecting yet an additional \$79 million.<sup>43</sup>

44. While PGW recovers its actual Gas costs through its GCR, these increased Gas costs have two significant financial impacts which are not covered by its GCR rate. First, an increased GCR factor increases the level of uncollectible and bad debt expense that the Company incurs, but all of its bad debt expenses are included in its base rates and are not recovered in its GCR.<sup>44</sup>

45. In this instance, PGW's initial \$52 million base rate request not only did not include the effect upon its bad debt expense of its revised, \$97 million GCR costs (i.e., from \$47 million to \$97 million), it also reflected a lower uncollectible factor of 8.4%<sup>45</sup> on the assumption that PGW was going to increase its efforts to collect unpaid bills and reduce the percentage of uncollectibles it would experience.

46. PGW's experience is that in times of rapidly increasing rates, its uncollectible experience becomes greater, and that a factor of at least 9% could be justified under such circumstances.<sup>46</sup>

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<sup>42</sup> See PGW-GCR St. 1.

<sup>43</sup> PGW-GCR St. 1.1; OTS witness Metro agreed this was in the "ballpark." Tr. at 317.

<sup>44</sup> PGW-IR St. 1.1 at 9.

<sup>45</sup> See, Tr. 193-96.

<sup>46</sup> See, PGW-IR St. 1.1 at 11.

47. Using this higher uncollectible factor and recognizing PGW's higher GCR filing, the Company's revenue requirement could have been increased by another \$10 million.<sup>47</sup>

48. Productivity Savings. In addition, the Company's \$52 million revenue requirement assumed that it would be able to save \$14 million from its operating expenses through a combination of productivity savings, revisions to its collective bargaining agreement and other revisions by management.

49. If these productivity savings had not been included the budget or, if they do not materialize, the Company's revenue requirement would have been \$14 million higher.

50. All of PGW's revenue requirement calculations were based on a normalized test year, but the reality is that PGW has not enjoyed a "normal" winter for many years.

51. In each of the last three years, PGW has experienced much warmer than normal weather — last year it was 15% warmer than normal. A 13% - 15% warmer than normal winter means that PGW does not sell as much Gas as is projected for a "normal" year and loses the margin built into the Gas rates that it uses to produce earnings, which in turn affects debt service coverage.

52. PGW calculated that it lost \$25 million in earnings last year because of the warmer than normal winter it experienced.<sup>48</sup>

53. PGW's financial picture has deteriorated still further because of the continued rapid escalation of gas costs.

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<sup>47</sup> PGW-IR St. 1.1 at 9-10; Exh. 1.1 at ¶15.

<sup>48</sup> PGW-IR St. 1. at 12.

54. Wholesale gas costs have more than doubled since last year and have moved up still further in just the last few months. For example, while PGW's original DRI average forecasted price (on which its requested \$97 million increase was based) for August, 2001 was \$3.13/dec., the next DRI forecast had increased its projection to \$3.54/dec for that same period. By September 19, the forward contract price on the NYMEX had increased to \$4.46, or an increase of 42.5%.<sup>49</sup>

55. Increased Gas costs have an enormous effect on the Company's operating revenue needs. Even if these additional obligations are reflected in its GCR, there is a considerable lag between the time the GCR makes the Company whole for its actual Gas costs (calculated to be by the end of the fiscal year) and the time that PGW actually has to purchase Gas to meet customer needs.

56. Any cushion or margin of error contained in PGW's original, \$52 million interim base rate increase has been eliminated.

57. The Commission finds the following benchmark financial indicators when the above additional projected gas costs are factored in together with the interim relief of \$52 million we hereby grant:

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<sup>49</sup> OCA GCR St. 1, Sch. 1, pg. 3.

**TABLE 3  
PGW FINANCIAL PROJECTIONS  
SEPTEMBER, 2000**

**GCR INCREASE @ \$97 MILLION  
PLUS ADDITIONAL \$70 MILLION GAS COST INCREASE AND  
\$52 MILLION INTERIM BASE RATE INCREASE**

	Projected	Minimum Needed
Earnings	\$22.3 Million <sup>50</sup>	N/A
1975 Coverages	2.64x	1.5x
1998 Coverages	2.60x <sup>51</sup>	1.5x
Required Year End Cash Balance	\$3.0M <sup>52</sup>	\$13.5 M - \$18.5 M

58. PGW's projected financial results, even with the full interim relief of \$52 million produce coverages which provide very little margin of error. A colder than normal winter (which could remove \$25 to \$30 million of earnings from the calculation), a failure to realize all or a portion of the \$14 million in projected expense savings or higher than projected bad debt expense due to the extraordinary price hikes being experienced, would result in PGW coming very close to failing to meet its covenant requirements.

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<sup>50</sup> PGW-IR Exh. 1.3, Sch. 3 p. 3.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 2.

59. PGW's year-end operating cash results are reduced down to just \$3 million or \$10 million to \$15 million short of the level needed for PGW to purchase necessary Gas stocks and make short term debt payments in the 2001-2002 fiscal year. Thus PGW's cash needs will have to be supplemented by a City loan.

60. Under PGW's own calculation, PGW will still be short some \$25 million of the necessary cash to make the commercial paper showing in May. PGW will have to rely on the support that the City Administration has proposed.<sup>53</sup>

61. The City of Philadelphia Administration has agreed to request approval of a substantial financial backstop as a supplement to — but not as a replacement for — full interim rate relief.<sup>54</sup>

62. The City Administration has agreed to seek additional loans to PGW for several reasons. First, it recognized the dire circumstances in which PGW finds itself and has determined that it is appropriate to make a contribution to assist PGW through these difficult times.<sup>55</sup> Moreover, both PGW and the City Administration are extremely concerned about the overall effect of these increases on customers.

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<sup>53</sup> PGW-IR St. 1.1 at 4-5.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

63. PGW needs both the rate relief granted herein and the City support in order to have adequate assurances that it will be able to meet its financial obligations and its customer service obligations throughout the year.<sup>56</sup>

64. The City cannot and will not provide the support as a replacement for rate relief.<sup>57</sup>

65. The terms under which PGW may obtain loans from the City (with approval of City Council) is that the loan must be repayable within 24 months meaning that PGW must show that it has sufficient revenues to make the repayments.<sup>58</sup>

66. Relying on the City backstop as a replacement for rather than as a supplement to an interim rate increase would be extremely detrimental to PGW's standing with the investment community. The investment community will be left with the view that PGW will not be able to survive on its own.<sup>59</sup>

67. PGW will have an enormous cash working capital need that cannot be made up from any other source without depleting all available protections if PGW's financial condition turns out to be worse than projected.<sup>60</sup>

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<sup>56</sup> *Id.*

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

<sup>58</sup> *Id.*

<sup>59</sup> PGW-IR St. 2 at 17.

<sup>60</sup> PGW-IR St. 1.1 at 17.

68. The recommendations of other parties fail adequately to account for PGW's end of year cash needs.<sup>61</sup>

69. The recommendations of the opposing parties do not provide sufficient earnings of debt service coverage cushion to assure that PGW will avoid a technical default in 2000-01.<sup>62</sup>

70. OCA's factual claims of inadequacy of service principally focused on a series of anecdotal references to independent consultant draft studies PGW itself had commissioned and were otherwise unsupported.<sup>63</sup>

71. There is no basis to find that PGW could save money by not implementing some part of its entire \$62.3 million capital program,<sup>64</sup> over 90% of which relates to refurbishing the LNG system, the main replacement program and meter repairs — all of which are related to safety or reliability, not subject to deferral.<sup>65</sup>

72. OCA's contention that PGW could obtain additional funds by various schemes, such as appropriating an allegedly overfunded pension fund, refinancing its bond sinking funds or entering into gas storage management contracts have no merit as short term solutions in the present circumstances.<sup>66</sup>

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<sup>61</sup> PGW-IR St. 1.1 at 14-20; PGW Cross Examination Exhs. 1, 2; PGW Main Brief, Section V, C.

<sup>62</sup> *Id.*; PGW Main Brief, Section V, D.

<sup>63</sup> Tr. at 264-73.

<sup>64</sup> PICGUG St. No. 1 at 8.

<sup>65</sup> PGW Cross Exh. No. 4; Tr. at 303-04.

<sup>66</sup> PGW-IR St. 1.1 at 21-22.

73. PGW has made a proposed interim rate increase that should be implemented in the proposed across-the-board rate proposal set forth in PGW-IR St. 3.

## CONCLUSIONS OF LAW

1. This Commission has jurisdiction over this matter.

2. The ratemaking methodology applicable to PGW prior to July 1, 2000, when the PUC assumed jurisdiction over PGW under the Gas Choice Act, is the “cash flow” methodology contained in the Management Agreement (PGW Main Brief, Appendix "C," Tab 5).

3. That ratemaking methodology is continued in effect by Section 2212(e) of the Gas Choice Act, which requires this Commission, when determining PGW’s “revenue requirement and approving overall rates and charges,” to “follow the same ratemaking methodology and requirements that were applicable to [PGW] prior to the assumption of jurisdiction” by this Commission over PGW until all “approved bonds have been retired, redeemed, advance refunded or otherwise defeased.”

4. All "approved bonds" have not been "retired, redeemed, advance refunded or otherwise defeased" as of this date.

5. The “cash flow” ratemaking methodology applicable to PGW in the Management Agreement was recognized and upheld by the Commonwealth Court in *Action Alliance v. Philadelphia Gas Comm'n*, 45 Pa. Cmwlth. 234, 241, 406 A.2d 1155, 1158 (1979).

6. The cash flow method of ratemaking is established in Section VII, ¶1 of the Management Agreement, and mandates that the Philadelphia Gas Commission (“PGC”):

shall fix and regulate rates and charges for supplying gas to customers . . . which . . . will, in each fiscal year produce revenues, at a minimum:

- (a) Sufficient to pay all of the operation and maintenance costs and expenses 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 . . .

- (i) to make base payments to the City in the aggregate annual principal amount of \$18,000,000 . . . ;
- (iii) To provide cash, or equivalent, for working capital in such reasonable amounts as may be determined by Company to be necessary and as shall be approved by the Gas Commission.

7. The list of costs and expenses required to be covered in PGW's rates, pursuant to Section VII, ¶ 1 of the Management Agreement, includes depreciation, retirement costs, all sinking fund charges payable for principal and interest on PGW bonds, capital additions, working capital and an annual \$18 million base payment to the City.

8. The Management Agreement also commits the "Commission"<sup>67</sup> to setting rates to provide sufficient revenues so that all bond ordinance covenants are honored.<sup>68</sup> Thus, the cash flow method requires rates to be set so that they compensate the Company for all of the items listed in Section VII of the Management Agreement, which includes revenues sufficient to satisfy the Company's bond covenants and the City's annual \$18 million base payment.<sup>69</sup>

9. Section 2212(d) of the Gas Choice Act complements Section 2212(e) by providing that until such time as a new tariff is filed by PGW and approved by the PUC in connection with PGW's restructuring, PGW continues and "shall continue to provide natural gas

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<sup>67</sup> 66 Pa.C.S. §§ 2212(d) and (e) make these provisions applicable to this Commission.

<sup>68</sup> Management Agreement, Section VII, ¶ 1 (a)(v).

<sup>69</sup> *In the Matter of a Proposed Rate Increase for the Philadelphia Gas Works*, filed June 19, 1981, Supplemental Opinion and Order dated November 18, 1981 at 4-5, 10, 18-19. (Attached to PGW's Main Brief as Appendix "C," Tab 2).

supply and natural gas distribution services to its customers under the prior tariff and the policies or programs existing . . .” on July 1, 2000.

10. Section 1.2 of PGW’s “prior tariff” provides that it “may be revised, amended, supplemented or otherwise changed from time to time in accordance with applicable law”<sup>70</sup> and the [Management] Agreement, with the approval of the Philadelphia Gas Commission.” This would include tariff changes seeking an increase in PGW’s base rates.

11. The PGC has consistently followed the “cash flow” ruling issued in *Action Alliance*.

12. Section VII of the Management Agreement has been construed to have the effect of a statute, requiring the regulator, whether it be the PGC or the PUC, to increase PGW’s rates under the “cash flow method” when PGW’s rates are “just and reasonable.” *Action Alliance* at 1158.

13. The “cash flow” methodology has been held by our Supreme Court to produce rates that are constitutionally just and reasonable. *Public Advocate v. Philadelphia Gas Comm’n*, 544 Pa. 129, 139, 674 A.2d 1056, 1061 (1996), where the Court stated (emphasis supplied):

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

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<sup>70</sup> The “applicable law” includes the Gas Choice Act, the Philadelphia Home Rule Charter and the Ordinance/Agreement. These provisions have been held to have statutory effect. *School District of Philadelphia v. Zoning Board of Adjustment*, 417 Pa. 277, 207 A.2d 864 (1965); *Action Alliance v. Philadelphia Gas Comm’n*, 45 Pa. Cmwlth. 234, 241, 406 A.2d 1155, 1158 (1979). The reference to “Philadelphia Gas Commission” now applies to this Commission.

that the rates set in accordance with the 1972 City ordinance . . . are constitutional.

14. This Commission has itself recognized the applicability of the cash flow method under the Management Agreement in its explicit reference in the Order to Section 2212(d) of the Gas Choice Act, which:

succinctly states that until such time as a new tariff is filed by PGW and approved by the Commission in connection with a restructuring, PGW “shall continue to provide natural gas supply and natural gas distribution services to its customers under the prior tariff and the policies or programs existing . . .” on July 1, 2000.<sup>71</sup>

15. The Commission’s Order authorizing this expedited proceeding set forth the time frame that should be considered in setting PGW’s interim rates:

PGW must present substantial evidence to support its assertion that an interim rate increase is necessary to maintain a minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season until the Commission can conduct and rule on a full base rate proceeding. In particular, PGW must present substantial evidence to support its assertion that an interim rate increase is necessary for PGW to comply with its covenants to the holders of any approved bonds.<sup>72</sup>

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<sup>71</sup> Order at 6. This Commission also recognized that Section 2212(d) permits PGW to request, and this Commission to approve, changes in PGW’s tariffs prior to PGW’s restructuring.

<sup>72</sup> Order at 7-8 (emphasis added).

16. In accordance with the Order, PGW's interim rate request properly focused only on the level of additional revenues it needs to collect over the winter heating season in order to maintain minimally acceptable financial levels.<sup>73</sup>

17. Pursuant to 66 Pa.C.S. § 2212(e), which requires that PGW's revenue requirement be established using the ratemaking methodology and requirements used by the PGC to set PGW's rates, the ratemaking standard set forth in the Management Agreement requires that rates be set to cover all expenses, debt service, a reasonable amount for cash working capital and the \$18 million payment to the City.

18. In addition, 66 Pa.C.S. § 2212(f) separately mandates that, in setting rates for PGW, the Commission must make an allowance to permit the transfer or payment to the City of the annual payment required by the Management Agreement. Accordingly, the General Assembly has legislated, and in effect guaranteed, the recovery of the City Payment in PGW's rates.<sup>74</sup>

19. The City cannot — either directly or indirectly — be forced to give up the required \$18 million payment.

20. Accordingly, the City's willingness to provide additional backstops may not be used as a replacement for PGW's entitlement of interim rate relief.

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<sup>73</sup> PGW-IR St. 1 at 5-6.

<sup>74</sup> The only exception provided by Section 2212(f) is if the City Payment exceeds 110% of the amount that was authorized as of June 30, 2000 — an exception which is not relevant here.

21. 66 Pa.C.S. § 526, which enables the Commission to consider service quality issues in setting utility rates, is not a component of PGW's traditional ratemaking methodology and, accordingly, cannot be utilized here.

22. The Commission's exercise of Section 526 authority, consistent with application of constitutional requirements, is limited to adjusting the utility's rate of return on equity. The Commission is not empowered to preclude recovery of legitimate operating costs or working capital.<sup>75</sup> Because of its status as a municipally-owned utility, PGW does not pay its investors (the City) a return, nor does it recover any such return from its ratepayers. Accordingly, any exercise of Section 526 by the Commission would be inappropriate.

23. Even if the City Payment could be viewed as a return on equity, the General Assembly has expressly determined that the recovery of that City Payment cannot be adjusted by the Commission, in whole or in part, including as a result of exercise of 66 Pa. C.S. §§ 523, 526.

24. There is nothing in the Management Agreement that makes rates dependent on adequacy of service.<sup>76</sup> In fact, the Management Agreement, as seen above, provides for a cash flow basis of ratemaking and does not make a rate increase contingent upon adequacy of service. Accordingly, in applying 66 Pa.C.S. § 2212(e), adequacy of service is not an issue.

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<sup>75</sup> See *National Utilities, Inc. v. Pennsylvania Public Utility Commission*, 709 A.2d 972, 979 (Pa. Cmwlth. 1998) (holding that exercising Section 526 to deny or decrease a rate increase is consistent with constitutional requirements when "the result is a rate of return [on equity] less than it would otherwise be entitled to receive," but also finding that Section 526 could not be utilized to deny sufficient funds required for necessary operating expenses or to repay loans).

<sup>76</sup> Tr. at 268-70.

25. In any event, there was no evidence in the record that PGW failed to meet the standard of adequate service under 66 Pa.C.S. §§ 523, 526.

26. The fact that PGW waited longer than necessary to seek a rate increase when its position was deteriorating for several years previously is not a basis to deny PGW the relief it presently needs and seeks. If PGW had sought and obtained rate relief at an earlier time, the effect would be that PGW's ratepayers would have been paying more for their gas for a longer period of time.

27. PGW is entitled to interim rate relief in the amount of \$52 million, subject to the conditions set forth in the Order at 11 (ordering paragraph 2).

PROPOSED ORDERING PARAGRAPHS

**IT IS ORDERED:**

1. That Philadelphia Gas Works' proposal for an interim base rate increase filed August 7, 2000 and docketed at R-00005654 is hereby granted, consistent with this Order.
2. That Philadelphia Gas Works is hereby authorized to file tariff supplement designed to increase its base rates in accordance with the method set forth in PGW-IR St. 3 to produce additional annual revenues of \$52.0 million.
3. PGW shall file a compliance filing implementing this Order, to be effective upon one (1) day's notice. The tariffs shall indicate that the rates are interim and subject to refund.
4. All complaints submitted in opposition to PGW's proposed interim rate increase are hereby denied, consistent with this opinion and order.

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

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Docket No. R-0000565

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MAIN BRIEF OF PHILADELPHIA GAS WORKS

**APPENDIX C**

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Dated: October 13, 2000

# APPENDIX C

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BEFORE THE PHILADELPHIA GAS COMMISSION

In the Matter of:

A Proposed Rate Increase	:	
	:	
for	:	Filing date: June 19, 1981
	:	
The Philadelphia Gas Works	:	

OPINION AND ORDER

The Philadelphia Gas Commission has before it for Adjudication, the request of Philadelphia Gas Works filed on June 19, 1981 for a rate increase, originally in the amount of \$89,000,000, to become effective October 1, 1981.

I. BACKGROUND OF THE CASE

One would have to be made of stone not to have been moved by the emotional and often eloquent statements made at the hearings in this matter by the many individuals and associations who presented their views to the Commission. The immediate concern of most of the speakers was the proposed rate increase. Others focused on the need to encourage energy conservation. Still others used the proceeding as a forum to vent their anger and express their feeling of helplessness against the conditions which surrounded them.

We are impressed with the sincerity of the rate-payers who appeared at the hearings. We feel sympathy for

them, but unfortunately, our feelings do not determine the matter. It is our duty to apply the law and authorize such just and reasonable rates as will be the minimum necessary to insure adequate, safe and reliable gas service.

In exercising our duty, we are confronted with the inexorable fact that gas bills are reflecting the enormous increase in the cost of natural gas in recent years, following partial deregulation in 1978. Neither this Commission, nor the Mayor, nor City Council has any control over the price of natural gas. Gas consumers should be expressing their concern to those in Washington who do have the power to control the price of natural gas.

Being aware of and understanding the concern of gas consumers, we determined at the outset to establish a process that would gain public confidence not only in its fairness, but also in its determination that the PGW request would be vigorously scrutinized and subjected to rigorous independent cross examination. To that end, we engaged public counsel and an experienced consultant to advocate the public interest in the hearing on the proposed rate increase. To insure that all consumer views would be fully represented, we authorized counsel for certain consumer groups to engage expert witnesses of their own choosing. In

so doing the Gas Commission established a process which insured that all sides would be represented.<sup>1</sup>

## II. HISTORY OF THE CASE

On June 19, 1981, the Philadelphia Gas Works (PGW) requested an increase in rates designed to produce \$89,000,000 of additional revenue in fiscal year 1981-82, an increase of 18.1% over existing rates. PGW requested that the increase should become effective as of October 1, 1981.

On June 25, 1981 we deferred consideration of PGW's proposed 1982 Operating Budget and Forecast because that request involved many common questions of law and fact with those involved in the request for a rate increase. We directed, therefore, that consideration of the 1982 Operat-

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1. CEPA's Reply Brief at page 2 acknowledges this: "We would like to thank the Commission for having provided a meaningful opportunity for all sides to have been heard in the context of the adversarial process. Public Counsel has very ably and diligently represented the public interest. Consumer groups, who have been for years involved on a day to day basis in representing the interests of PGW's low and moderate income consumers, were able to present expert testimony on the myriad policy issues which faced PGW and its consumers. For the first time, the Commission has been presented with evidence in support of alternatives to PGW's positions on the issues. Thus, the Commission can weigh the evidence in its attempt to strike a proper balance among competing concerns and not merely have to accept or reject the judgment of PGW's management." In their Reply Brief Public Counsel state at page 1, "This rate case represents a watershed in the regulation of PGW. By requiring, for the first time, full scale adversary proceedings, the Commission has signaled that it is not going to operate as it has in the past."

ing Budget and Forecast, and the request for a rate increase for fiscal year 1982 should be consolidated for hearing and decision.

In accordance with Regulation No. 1,<sup>2</sup> a prehearing conference was held on July 13, 1981.

It was clear during this past winter that the existing Raw Material Adjustment Clause (RMA) had caused considerable confusion and concern among PGW's customers. The Commission therefore, directed at the outset that the RMA should be considered in the rate hearing and appropriate changes made.

At the Commission's direction, discovery had already commenced and was ongoing and vigorous at the time of the prehearing conference. After considering the matter with counsel, to afford them ample opportunity to complete discovery and to prepare and to be certain that all sides had ample opportunity to present all questions, it was determined that hearings would begin on August 19, 1981.

The hearings were opened on August 19, 1981, but recessed immediately because the number of people present exceeded the capacity of the Federal courtroom. The site of the hearings was then moved to the Chambers of City Council

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2. This Regulation governs the procedure for handling of this case and under its provisions public hearings could not begin prior to August 12, 1981.

and on the evening of August 20, 1981, public testimony was heard from many individuals and groups.<sup>3</sup>

In rate cases, direct testimony is prefiled in written affidavit form. On August 24, 1981 the cross-examination of the PGW direct case commenced. Testimony was taken through the balance of August and into September and October, closing the record on October 13, 1981. The record consists of some 2535 pages of testimony with 39 exhibits offered by PGW, 26 exhibits offered by Public Counsel and 65 exhibits offered by CEPA. The parties filed and served their Requests for Findings, Briefs and proposed Orders on Friday, October 23, 1981. Oral argument was heard for an entire day on October 26, 1981. Reply Briefs were filed on November 2, 1981.

### III. DISCUSSION

We are governed in the first instance by the Agreement between the City of Philadelphia and the Philadelphia Facilities Management Corporation (PFMC) for the management and operation of the Philadelphia Gas Works, dated December 29, 1972, as amended, pursuant to Ordinances of City Council.

SECTION II, paragraph 1, provides that "The Company shall take all reasonable steps to insure that the capacity

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3. On Friday morning, September 18, 1981 a second session was held and additional public testimony heard from many individuals and groups.

of the Gas Works to manufacture, provide and distribute gas is at all times sufficient for the estimated maximum requirements of gas users in the City of Philadelphia." (Emphasis ours).

SECTION VI, paragraph 9, gives the Gas Commission "the responsibility for the overseeing of the operation of the Gas Works by the Company."

SECTION VII, paragraph 1, directs the Gas Commission, inter alia, to "fix and regulate rates and charges for supplying gas to customers, . . . which . . . will, in each fiscal year produce revenues, at a minimum:

- (1) Sufficient to pay all of the operation and maintenance costs and expenses of conducting the Gas Works Enterprise and to pay the interest and amortization becoming due in each fiscal year on debt incurred for the Gas Works.
- (2) Sufficient also to make base payments to the City.
- (3) To provide appropriations for prepayment of debt and for capital additions which have been determined by the Gas Commission to be

reasonable and which have been approved by City Council; and

- (4) To provide cash, or equivalent for working capital in such reasonable amounts as may be determined by Company to be necessary and as shall be approved by the Gas Commission.

(Emphasis ours).

Thus, in the hearing a voluminous record was made regarding PGW's projections of revenues, operating expenses, working capital requirements and internally generated funds for capital improvements. During the hearing, PGW modified its original request to \$86.2 million dollars for a total revenue requirement of \$556.4 million dollars. After a thorough investigation of PGW's books and records, Public Counsel recommended that the rate increase should be limited to \$26 million dollars. The difference of some \$60 million dollars involves essentially discrete issues in all the categories of revenues, operating expenses, working capital requirements, and internally generated funds for capital improvements.

In large measure, the final result will be determined by what happens in the coming winter season. PGW looks to the very severe winter experience last year and

makes pessimistic projections based on it. Public Counsel contends that in rate making, expenses should be normalized. Accordingly, they take into account not only last year's experience, but also the previous three to five years in making their projections. Therein lies much of the difference, which can be seen when the issues are analyzed specifically.

A. Revenues.

PGW has projected total operating revenues for fiscal year 1981-82, of \$470.2 million dollars at current rates (PGW-30). Public Counsel, through their witness, Kenneth Hagstrom, argue that it understated revenues by \$2.7 million dollars. Resolution of this issue depends on two specific questions: (1) There are some 15,000 locations in which gas service is presently not being rendered because of shut offs. The disagreement is over how many of them will be returned to service; and (2) the statistical validity of the adjustment factor developed by PGW.

Considering the arguments pro and con, we conclude that it is reasonable to project an additional \$1 million dollars in the PGW total operating revenues for fiscal year 1981-82, to wit, \$471.2 million dollars at current rates.

B. Expenses.

PGW has projected operating expenses for fiscal year 1981-82 of \$444.8 million dollars (PGW-30). Public counsel presented testimony in opposition to several proposed expense levels. We will consider each seriatim.

1. Natural Gas Costs.

PGW has budgeted lost and unaccounted for gas at a 4.8% level. Public Counsel, through their witness, Kenneth Hagstrom, argue that a historical average of (4%) is reasonable.

We cannot accept a projection based only on the exceptional results of last winter. We are mindful of the experience over the last five years. We think it reasonable to average last year and the prior year which produces a 4.5% level. On this basis, we reduce this expense by \$600,000.

We find it not unreasonable to expect the management of PGW not to permit lost gas substantially in excess of the losses during the past two years, absent a showing that such excess loss is beyond reasonable control.

2. Other Raw Material Costs - Pre-season Tanker of Naphtha.

PGW has budgeted raw materials costs at \$19.6 million dollars. Public Counsel, through their witness, Kenneth Hagstrom, would reduce this by \$1.6 million dollars.

They argue that the purchase of such an additional shipload at \$1.07 per gallon would increase the average value of the naphtha in inventory. Naphtha normally is expensed only when sent out. Accordingly, Public Counsel calculate that such a purchase would unnecessarily increase the average value from .8725 cents per gallon to .93 cents per gallon.

This question impacts also in a much more substantial way in the consideration of working capital requirements. There, approximately \$10.3 million dollars is involved. Therefore, we will consider this entire question in the discussion under working capital.

### 3. Labor Expenses.

PGW has budgeted labor expenses of \$56.2 million dollars, based on a projection of 2972 employees. At June 30, 1981 there were 2692 employees, so that PGW is requesting an additional 180 employees for fiscal 1981-82. This involves an expense of \$2.4 million dollars for direct labor and \$1.2 million for indirect related labor charges.

Public Counsel oppose the amount budgeted, arguing there has been a nearly consistent number of customers over the last five years, and both management audits recommended decrease rather than increase in manpower levels.

We are not convinced that an increase in PGW's total complement, as projected by them is either necessary or reasonable. Therefore, we reduce budgeted direct labor expenses by \$1.2 million dollars.

4. Other Labor Expenses.

We will corresponding reduce by \$600,000 PGW's projected indirect labor expenses for pensions, insurance and payroll taxes, consistent with the foregoing conclusion regarding direct labor expenses.

5. Write-off of Uncollectible Accounts.

Public Counsel propose to make a \$5.1 million dollar reduction in PGW's claimed bad debt appropriation. PGW contends that this write-off is a cash flow item, and that it should be allowed to recover the amount of the write-off in its rates. Kenneth Hagstrom, an experienced independent accountant, testified unequivocally that the write-off of uncollectible accounts is a non-cash item and has no bearing whatsoever on the rates charged by PGW. He explained that an estimated expense, i.e., the appropriation for uncollectibles, is recorded in the current fiscal year and a reserve is established against receivables. This is an accounting entry which has no impact on cash flow but just reduces income and creates a reserve for potential write-off. When specific accounts are written off, the accounting entry reduces the accounts receivable and also reduces the reserve. Mr. Hagstrom testified that this changes neither the cash flow nor the amount of net receivables.

PGW's management disagrees with Mr. Hagstrom, but did not present in the hearings any independent accounting testimony to the contrary.

Accordingly, we accept as credible the testimony of Mr. Hagstrom and reduce this expense by \$5.1 million dollars.

C. Working Capital Requirements.

SECTION VII, paragraph 1(b)(iii) directs the Gas Commission in fixing rates to provide PGW with working capital "in such reasonable amounts as may be determined by PGW to be necessary and as shall be approved by the Gas Commission."

1. Con Gas.

Public Counsel argue that PGW should take the entire Con Gas supply which will be available next spring and substitute it for other pipe line gas which is more expensive. The projected fiscal year 1982 savings from this substitution is alleged to be \$1.7 million dollars. In this instance, we find it to be wiser, as PGW contends, to hold the Con Gas supply and use it to replace other pipe line gas in the Fall when the price of gas undoubtedly will be higher and the savings to ratepayers greater.

Accordingly, we make no adjustment for this item.

2. Naphtha Purchase.

We referred to this subject earlier in the consideration of operating expenses. Here, the question arises as a matter of working capital requirements.

PGW proposes to invest approximately \$10.29 million to purchase an additional ship load of naphtha to be added to inventory and charged to ratepayers as a working capital expense. PGW argues that this purchase is necessary to insure adequate supplies of gas during this heating season. Public Counsel oppose the purchase, arguing that it would be an imprudent investment and an unreasonable effort to insure supply without regard for the cost effect on customers. It is acknowledged that PGW has sufficient gas available from its various sources to satisfy the requirements of a normal season. At issue is whether PGW management should have available maximum quantities of gas to meet the demands of a design winter.

The term design winter does not refer to a normal winter condition, but rather, to an uncommonly cold winter condition.

We are impressed with the contention of Public Counsel that given the existing level of inventory, the unlikely occurrence of a design winter, the availability of alternate supplies, and the smaller size of the potential deficiency to be managed, to purchase this additional naphtha for inventory would be unjust and unreasonable.

We cannot agree for two reasons. First, the Agreement in SECTION II, paragraph 1 requires PGW to take all reasonable steps to insure that the capacity of the Gas Works to manufacture, provide and distribute gas is at all times sufficient for the estimated maximum requirements of gas users in the City of Philadelphia. Second, PGW's management argues most vigorously that this purchase is essential for public safety and convenience, against the possibility of a design winter.

We cannot lightly disregard serious contentions that public safety and convenience would be jeopardized. Accordingly, we make no adjustment here.

### 3. Accounts Receivable.

PGW has projected an increase in its Accounts Receivable of \$19 million dollars. In projecting that level of Accounts Receivable at June 30, 1982, the central issue is whether fiscal year 1982 delinquencies will more closely resemble fiscal year 1981, as PGW believes, or the three year average of fiscal year 1978-80 as contended by Mr. Hagstrom, who suggests that the correct figure is \$2.2 million dollars. The difference between the parties on this item, therefore, is \$16.8 million, the largest single issue in the rate case.

Public Counsel argue that the growth in Accounts Receivable experienced in fiscal year 1981 was "abnormal",

and that fiscal year 1982 will reflect a return to more "normal" past levels.

All parties agree that public perceptions regarding a "no shut-off" policy last winter, combined with the RMA, together caused a very large increase in Accounts Receivable, uncollectible accounts, delinquencies and ultimately write-offs.

We believe that fiscal year 1981 was indeed an unprecedented year. It was a most unusual event, one related to key factors that are unlikely to be repeated this year. These factors include the initial adoption by PGW of restrictions on winter shut-offs, viewed by the public as effectively a ban on shut-offs, combined with a sharp and sudden increase in rates because of the functioning of the RMA. It is clear at this point that the RMA experience will not be repeated, since the adoption of a levelized charge has been agreed to by all parties. This should permit customers to plan and budget their gas expenses more easily.

It is equally clear that the public perception of the situation has changed drastically, in light of the vigorous collection and shut-off activity engaged in over recent months. The Commission has mandated PGW to continue those vigorous efforts unabated.

Considering all these circumstances, we find it reasonable to anticipate in the coming year a more modest

increase in Accounts Receivable. Specifically, we reduce the PGW projection of \$19 million dollars by \$9.4 million dollars.

4. Accounts Payable.

Public Counsel propose a \$3.3 million dollar increase in Accounts Payable as at June 30, 1982, thereby reducing working capital requirements by the same amount. The rationale in making this adjustment is similar to the rationale applicable to the Accounts Receivable adjustment, i.e., for purposes of setting rates, it is important to "normalize" expenses so as to insulate the ratepayer from abnormal fluctuations (up or down) in operations. It is conceded by all parties that no one could possibly know exactly what the Accounts Payable account will look like on June 30, 1982, and this requires the exercise of judgment in selecting a figure.

While we believe there is some merit in the contention of Public Counsel, we find it more reasonable to limit this adjustment to \$1.3 million dollars and, accordingly, we make a reduction in that amount.

5. Increase in Cash at Year End.

PGW has proposed a \$7.5 million dollar ending cash balance at June 30, 1982. Mr. Hagstrom has recommended a downward adjustment to the company's projection by \$7 million dollars.

We are not satisfied that PGW has demonstrated any compelling business need requiring the ratepayers to provide \$7.5 million dollars for working capital to meet its cash flow requirements. We find \$4.5 million dollars to be reasonable and therefore make a reduction of \$3 million dollars in this item.

D. Allowance for Internal Generation of Fixed Capital.

PGW seeks to recover \$14 million dollars of its \$50.4 million dollar fiscal year capital expenditures from internally generated funds. PGW contends that this will produce important improvements in the Company's financial condition and is critical if PGW is to maintain its current "A" bond rating.

Mr. Hagstrom recommends that this should be limited to \$5.1 million dollars and that the difference of \$8.9 million dollars should be borrowed.

For the reasons advanced by PGW, we make only a relatively small deduction in this item, and we conclude that PGW should recover \$11 million dollars rather than the \$14 million dollars requested.

This \$11 million dollar sum will markedly improve debt coverage ratios which are a very important factor in determining bond ratings. These funds also will prevent further growth in PGW's relatively high debt ratio. The

consequences of a downgrading in PGW's bond rating are frightening. The cost to ratepayers could be enormous over the life of each new bond issue, and might very well prevent PGW from attracting new capital at any price.

This \$11 million dollars of internal capital also will help reduce the amount of revenue bond borrowing. Given the recent conditions of these markets, record high interest rates, and PGW's recent difficulties in obtaining capital, any method of reducing outside borrowing must be seriously considered. Long term borrowing undertaken now will saddle ratepayers with high interest costs for years to come and should be avoided if at all possible.

E. Coverage.

We must provide PGW with the opportunity to earn sufficient revenues so that it will have reasonable access to the capital markets. We adopt as an essential goal the retention of PGW's present bond rating.

A review of the testimony of the witnesses on this subject leads us to the conclusion that earnings producing interest coverages in the range of 1.75 to 2.00 times are reasonably likely to achieve this goal. Our conclusion is based on the testimony presented on the factors considered by bond rating agencies, and assumes a commitment by this Commission and by the management of PGW to do all that is required -- including "belt tightening" and even posterity.

measures where appropriate -- to achieve the desired level of earnings on a consistent basis in the future without putting an undue burden on ratepayers.

In sum, therefore, given the recommendation of Mr. Hagstrom that a rate increase of \$26 million dollars was reasonable, and adding the adjustments we have made herein which total \$26.1 million dollars, we hereby approve a rate increase of \$52.1 million dollars. It is our considered judgment that such an increase will provide interest coverage of not less than 1.75 times, and will serve to maintain the "A" bond rating.

F. Rate Design.

All parties agree that the rate increase shall be allocated on a volumetric basis, and PGW has requested that it shall be effective on November 15, 1981.

Other kinds of rate designs have been mentioned, but there has not yet been any serious study. Accordingly, we defer this matter for subsequent consideration.

G. Service Terminations.

Much has been said in this proceeding about last year's "ban" on service terminations, the so-called "no shut-off" policy. We recognize, of course, the need to avoid potential hazards to health and safety during the winter heating season. Yet, it has been argued that the no shut off policy resulted in the large scale increase in Accounts

Receivable and uncollectibles. We recognize also the financial burden imposed on all taxpayers by increases in the amount of uncollectibles and delinquent accounts.

We, therefore, now give express notice that for this heating season, PGW will be guided by the existing mandates under applicable state law. This Commission will not impose any ban other than as provided in existing state law, for termination of gas service. At the same time, we have directed PGW to exercise a very high standard of care when considering the institution of a service termination during the heating season, so as to avoid potential hazards to the health and safety of its customers.

H. Senior Citizens Discount.

PGW did not request and there never was any intention of terminating the discount for senior citizens in this case. What was discussed was the possibility of devising some administrative tool to identify persons technically eligible but not in need. PGW will file subsequently with the Commission its proposal in this regard.

Accordingly, and explicitly, no change is made in the senior citizens discount.

I. Raw Material Adjustment.

The Raw Material Adjustment Clause is abolished.

The RMA caused great confusion and concern among PGW's customers. The Commission determined at the outset to

make a change. We have directed establishment of a Gas Cost Rate (GCR) to replace the present Raw Material Adjustment charge. The purpose of the change is to provide a mechanism to recover the increases in cost of purchased gas and raw material on an annualized and levelized basis. This should be easier for PGW's customers to understand and make it easier for them to manage their payments.

We approve the procedure suggested by PGW and direct that it file forthwith for our consideration and approval Tariffs to establish the new GCR procedure.

#### IV. OTHER CONSIDERATIONS

It has been pointed out that collection of the increase herein authorized through rates charged for the balance of this fiscal year might result in excessive rates in the next fiscal year. Yet we do not intend to establish rates that must be revised every few months. Therefore, to protect the ratepayers from a hidden rate increase, and in an effort to establish regularity in rate proceedings with the opportunity to complete the process in time for effectiveness of new rates at the beginning or near the beginning of each fiscal year, we are directing PGW to file with this Commission by April 30, 1982 all the documentation necessary to substantiate the revenue requirements appropriate for fiscal year 1982-83. The documentation shall be in addition to the proposed operating budget for the fiscal year and

similar in format to the information provided and solicited during the course of this proceeding. This will enable us to consider the filing in sufficient time to establish just and reasonable rates for the start of the next fiscal year.

Therefore, upon a careful review of the entire record, briefs of counsel, and oral argument, IT IS ORDERED that:

1. Philadelphia Gas Works is hereby authorized to increase its rates to produce \$52.1 million dollars in additional revenue during fiscal 1981-82. This increase shall be allocated on a volumetric basis and shall be effective on November 15, 1981.

2. The rates authorized by this Order shall be effective for the period commencing November 15, 1981 and shall remain in effect thereafter until further Order of this Commission.

3. PGW forthwith shall file with this Commission for its review and approval a revised Tariff complying in all respects with this Order.

4. The Raw Material Adjustment charge is abolished. PGW shall establish and submit forthwith to this Commission a Gas Cost Rate (GCR) to replace the present Raw Material Adjustment charge.