

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility	:	
Commission, et al.	:	Docket Numbers
	:	
v.	:	R-00005654
	:	R-00005654C0001-C0004
Philadelphia Gas Works	:	

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MAIN BRIEF OF THE
APARTMENT ASSOCIATION
OF GREATER PHILADELPHIA

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Dated: October 12, 2000

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I. HISTORY

A. Introduction and Background

On August 8, 2000, the Philadelphia Gas Works ("PGW") filed with the Commission a Petition for Establishment of Interim Rate Procedure and for a Declaratory Order ("Petition") pursuant to various sections of the Pennsylvania Public Utility Code and this Commission's regulations.

On August 14, 2000, the Office of Consumer Advocate ("OCA") filed an Answer to the Petition. Similarly, on that date the Consumer Education and Protective Association, the Association of Community Organizations for Reform Now, the Action Alliance of Senior Citizens Greater Philadelphia and the Tenants' Action Group ("CEPA" *et. al*) filed its Answer requesting that this Commission not grant PGW any rate relief until the fall of 2001. On August 15, 2000, the Answer of the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") was filed.

On August 24, 2000, the Apartment Association of Greater Philadelphia ("AAGP") filed its Petition to Intervene. By Prehearing Order #2, issued August 31, 2000, Administrative Law Judge Chestnut granted AAGP's Petition.

Hearings, both public input and evidentiary were held the week of September 25, 2000. By order dated October 3, 2000, Administrative Law Judge Chestnut certified the record in this proceeding to the Commission for decision. Pursuant to Prehearing Order #2, main briefs of the parties are due October 13, 2000. This Main Brief of the Apartment Association of Greater Philadelphia is filed in compliance with that Order.

B. Scope of the Proceeding

Pursuant to Section 2212 of the Natural Gas Choice and Competition Act, 66 Pa. C.S. §2212, the Commission

...in determining the city natural gas distribution operation's revenue requirement and approving overall rates and charges . . . shall follow the same ratemaking methodologies and requirements that were applicable to the city natural gas distribution operation prior to the assumption of jurisdiction by the commission.

66 Pa. C.S. §2212(e). In acknowledging this statutory requirement in its order establishing the procedural schedule and parameters of this proceeding, the Commission did not limit arguments as to the proper applications of those

methods and requirements.¹ One requirement has been made clear by this Commission:

. . . suffice it to say that 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.

Slip Op. 8. The purpose of this proceeding is to insure that PGW is able to meet its operational needs for this heating season and to maintain minimally adequate bond coverage until such time as the Commission can rule upon a traditional base rate proceeding. Accordingly, AAGP submits that this Commission should not seek in this proceeding to fashion a solution for long term systemic problems faced by PGW.

AAGP submits that the purpose of this proceeding is to permit sufficient revenues "through the winter heating season" and not to remedy any past difficulties or to provide recovery for future costs.

As stated by OCA Witness LeLash:

Despite the emphasis on the immediate cash crisis, the company has admitted that its \$52 million rate request seeks to address longer term objectives.

¹ Despite being required on an interim basis to adopt "methodologies and requirements" of the Philadelphia Gas Commission, nothing contained within the Natural Gas Choice and Competition Act has suspended or repealed the Commission's §1301 statutory duty to insure that PGW's rates are just and reasonable.

* * *

However, I do not believe that the focus of this proceeding should be over such a long period of time. Rather, the focus should be on the short-term, that is 9 to 12 months or, more specifically, until this Commission and the other parties have an opportunity to fully evaluate the Company and all rate related issues in the context of a full base rate case.

OCA Statement No. 1, page 24. AAGP submits that this statement is consistent with the Commission's goal of insuring that any interim rate increase reflects the minimum amount necessary to maintain a minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season.

II. SUMMARY OF ARGUMENT

The Commission is presented with a request for \$52 million in rate relief to reflect PGW's increased gas costs; to protect PGW's bond coverages; and to provide a \$35-40 million cushion to permit PGW to enter the next winter heating season.

AAGP submits that the increased natural gas costs should be recovered through PGW's GCR proceeding and should have no bearing upon the level of any temporary interim rate relief, if any, granted in this proceeding.

This Commission should grant only such rate relief necessary after considering all other sources of interim financing and funding available to PGW. While a technical default of bond coverages may occur without rate relief, Wall Street, using its own coverage calculations has seen PGW bond coverages below 1.5 times in the past. No doubt exists that PGW is a financially troubled company, but the dire consequences outline be PGW are mere speculation. Should this Commission determine that some rate relief is appropriate on an interim basis, AAGP submits that this amount should not exceed \$25 million.

III. ARGUMENT

A. Operational Needs

The filings before this Commission are premised upon several factors: PGW's projected cash flow difficulties and the unforeseen ever rising cost of natural gas. Within this general category, and as set forth by PGW Witness Knudsen, PGW requests immediate rate relief to cover expenses for the current fiscal year which include the payment for the projected increase in natural gas costs, maintain bond coverage, and to "have sufficient liquidity at the end of the 2000-2001 fiscal year" to meet projected costs for the 2001-2002 fiscal year.²

1. Revenues and Expenses

Due to the abbreviated nature of this interim proceeding, a detailed review of the revenues and expenses of PGW could not be undertaken. However, in light of PGW's commitment: (1) to refund any rates granted in this proceeding that are subsequently found to be excessive; (2) to address rate structure issues in the context of the permanent base rate proceeding to be filed no later than January, 2000; and (3) to preserving all rights of the parties hereto to seek disallowance of any expenses deemed not to be appropriately collected from ratepayers, AAGP does not take issue with any of the revenues and expenses as set forth in the PGW filing with this Commission.

² PGW-1R, St. 1.0, page p. 9. Mr. Knudsen suggests that a \$35-40 million cash liquidity cushion be available for subsequent fiscal years. See also Tr. 137.

2. Projected Gas Costs

The largest factor which could lead to PGW's inability to meet upcoming expenses is the huge increase in natural gas costs and warmer than normal weather for the past three years (Tr. 139). While in no way suggesting that this cost is minimal nor that from a cash flow basis the GCR proceeding and this proceeding are not related, AAGP submits that recovery of this cost is appropriate through PGW's GCR proceeding and not through base rates. AAGP submits that an increase in natural gas costs cannot be utilized as a reason for increasing base rates when the incremental cost of natural gas is contained in a GCR.

3. The City of Philadelphia "Entitlement"

PGW has maintained throughout this proceeding that without both a base rate and GCR increase, PGW is projected to fall below required bond coverage amounts, thus triggering a technical default of the bond covenants. Not to be forgotten in any discussion of PGW is the unique position held by the City of Philadelphia ("City") relative to PGW. It is undisputed that the owner of PGW is the City. PGW-1R St. 1.1, page 4. As owner, the City has, through an ordinance required PGW to make an annual payment of \$18 million to it. Petition, Exhibit B, Section VII, Paragraph 1(b)(i). Although not characterized as such, this payment is, in essence, a dividend payment by PGW to its owner. It is a fundamental principal in investor owned companies that a reduction or elimination of dividend payments generally occurs, or are frequently required to occur, in order to prevent bond defaults and in other instances of company distress.

While it may be argued that section 2212(f) of the Code precludes the Commission from requiring the City to forego its annual payment, there exists no similar prohibition from considering the foregoing of this payment in

considering the rates to be charged customers. This is no different than that encountered by the Commission in countless situations with respect to investor owned utilities - the Commission's legal authority to require a dividend reduction is also questionable as the Commission's general statutory charge is to insure just and reasonable rates and not approve individual budgets or expenditures.³ However, nothing would prohibit this Commission from considering every available source of funding that could be utilized to alleviate the cash poor position of the Company in addition to increased revenues from ratepayers. This is particularly appropriate in conjunction with an interim or emergency rate request. While apparently the cash poor position of PGW is not novel, the City has heretofore been able to receive this \$18 million payment on a consistent basis from PGW. During this "crisis situation" all available cash should be viewed as a source of at least temporary funding.⁴

Section 2212 (e) requires that the Commission:

shall permit the city natural gas distribution operation to impose, charge or collect rates or charges as necessary to permit the city natural gas distribution operation to transfer or pay to the city that is the owner of the city natural gas distribution operation, on an annual basis, such amount as may be specified from time to time in the applicable ordinances of the city or agreements of the city approved by ordinances.

³ In traditional rate proceedings, the Commission does not preclude expenditures from being made, establish budgets, or dictate other internal actions by a particular utility. Just as an owner of an investor owned utility would do, the City of Philadelphia through the Philadelphia Gas Commission retains full authority to control budgets and expenditures of PGW.

⁴ To their credit, PGW and the Administration of the City of Philadelphia have been engaged in numerous discussions in an effort to utilize the \$18 million annual payment and other City funds as a backstop for contingencies.

The Commission's statutory charge is clear. This Commission shall permit rates that are sufficient to permit PGW to make its annual \$18 million payment to the City of Philadelphia, not guarantee that payment.

Since this annual payment is not a new expense for the Company, one can appropriately presume that existing rates already reflect this continuing obligation and should not be considered in the context of a single line item expense or in the context of this interim rate proceeding. AAGP submits that this Commission should not base its grant of emergency temporary rate relief upon the necessity to make the annual \$18 million payment to the City of Philadelphia.

B. Bond Coverages.

Assuming that this Commission permits PGW to recover its legitimate natural gas costs within the context of its GCR, there remains two items requested by PGW to consider - sufficient funds to preserve bond coverages and funds to have sufficient liquidity at the end of the fiscal year to meet projected costs for the 2001-2002 fiscal year.

What is clear from the record in this proceeding is that non-payment of the \$18 million dividend to the City of Philadelphia, while helping the cash flow position of the company, would not cause a technical default of the rate covenant that is contained within PGW's Bond Ordinance. As stated by PGW Witness Bisgaier:

To avoid a technical default of its "rate covenants," it [PGW] needs to have collected sufficient revenue in that year to cover all of its operating expenses including all of its debt service obligations, but not

including its payment obligation to the City. In addition, PGW must satisfy its covenants associated with its "debt service" and "coverage". A monetary default would occur if PGW failed to pay timely principal and/or interest on its revenue bonds. A technical default would occur if PGW paid principal and interest timely, but did not produce sufficient revenues from rates to cover all of its operating expenses (which does not include its City payments) and provide the mandated 1.5x debt service coverage from revenues available after the payment of operating and maintenance expenses.

Emphasis added. PGW-1R St. 2., page 12, lines 1-10.⁵ Thus, it is immaterial for bond coverage purposes whether or not the City of Philadelphia's \$18 million payment is made.⁶

Due to the interim nature of this expedited proceeding, certain basic premises were necessary to accept. Although AAGP has accepted the proposition that PGW currently is facing a cash flow problem which has the potential to decrease bond coverages, no satisfactory explanation could be developed to explain the exact causes of PGW's problems. For example, prior to the issuance of PGW's \$176 million bond issuance in June 1999, Stone & Webster Management Consultants, Inc. prepared an Independent Consultant's Report. PGW-IR - Exhibit 1.4 Volume III, tab 5. As part of that report, Stone & Webster set forth certain

⁵ No party to this proceeding has remotely suggested that a monetary default be permitted to occur. To its credit, PGW appears to have received assurances from the City of Philadelphia that such a monetary default would not occur. See generally, PGW-1R, St. 1.1, pages 4-5. AAGP acknowledges that Philadelphia City Council must formally approve such actions, but fully anticipates a reasonable response from Philadelphia's City Council.

⁶ The payment or non-payment of the \$18 million annual payment to the City of Philadelphia does affect the cash position of PGW, but is not included in coverage calculations.

"Financial Considerations"⁷ representing those factors taken into consideration in its findings and conclusions relative to the bond issuance in question. Stone & Webster considered, *inter alia*, the effect of a 14.7% decrease in degree days during fiscal 1999 (AAGP Cross-Examination Exhibit 1, page 32), a recent downgrading of PGW bonds, (Tr. 201-203)⁸, a gas supply financial hedging program that was before the Philadelphia Gas Commission for review, and PGW's budget, revenue and expenses including the \$18 million payment to the City of Philadelphia.

Based upon the information furnished, Stone and Webster concluded that bond coverages would be in the range of 1.95 (year 2000) to 3.01 in 2003 for the bonds issued pursuant to the 1975 Ordinance; 2.02 to 3.07 for the Senior Bonds issued pursuant to the 1998 Ordinance and 14.94 to 31.02 for the Subordinate Bonds issued pursuant to the 1998 Ordinance. Stone & Webster Report, Table 15A. Thus, considering the warmer than usual weather experienced in fiscal 1999, and a proposed \$20 million rate increase in 2002⁹, PGW was projected to have sufficient funding to meet or exceed minimum bond coverage amounts. While not questioning the new management team currently in place at PGW or the calculations made by that management team, it is imperative that within the context of this case and the full base rate proceeding anticipated in January, 2000, the Commission not place the burden of rescuing PGW totally on the backs of the ratepayers of PGW.

⁷ The portion of the Stone & Webster Report labeled Financial Considerations was reproduced for ease of reference and entered into the record as AAGP Cross-Examination Exhibit 1.

⁸ As acknowledged by Ms. B, PGW's bonds were downgraded due to the instability of the prior management at PGW. (Tr. 202)

⁹ AAGP. Cross-Examination Exhibit 1, page 33.

Assuming that PGW is permitted to recover its gas costs through the GCR mechanism, it becomes necessary to determine what level of interim rates is necessary to “maintain a minimal adequate level of financial health required to meet debt coverage. PGW Witness Ms. Bisgaier has maintained that the entire \$52 million rate request is essential. Ms. Bisgainer opines that PGW would be in technical default of its “rate” covenant and fail to meet the bond coverage tests as set forth in the various revenue bonds. (PGW-IR, St. 2, pages 12-13). Ms. Bisgaier proceeds to outline the consequences:

As noted above, 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 carry PGW’s debt for years to come.

PGW-IR, St. 2 page 13.

Despite the certainty of the testimony relative to the loss of bond rating to junk bond status, such testimony is speculative. As stated by PICGUG Witness Baudino:

I interpret Ms. Bisgaine’s testimony in this regard to mean that a downgrade will happen if the Commission does not grant the Company’s request for interim rate relief. I assert that neither Ms. Bisgaier nor myself can predict what absolutely will happen to the Company’s bond rating if interim rate relief is not granted. My reading of the Standard and Poor’s evaluation of PGW is that the agency believes that the Company needs some rate relief. However, whether that relief comes now in the form of an interim increase or later in the form of a permanent rate increase is not specifically stated. My past experience in reviewing bond rating reports is that the agencies look at both the present and expected future circumstances of a company in determining their bond ratings. It has been my

experience that a company can fall short of the quantitative requirements for a particular rating and still not be downgraded if the agencies believe that the subject company will obtain relief in the future.

PICGUG Statement No. 1, pages 10-11. In fact, as noted by Standard & Poor's report appended to Ms. Bisgaier's testimony:

Minimal coverage has been a historic problem. PGW implemented non-recurring actions in fiscal 1995, 1998, and 1999 to meet its rate covenants. Steps were not needed in fiscal 2000, because the calculation of the rate covenant was liberalized under the provisions of the 1998 indenture. Another warmer-than-budgeted winter in 2000 led to reduced gas sales, and revenue was 15% lower than budget. Debt service coverage in fiscal 1999 of all revenue bonds was 1.11 times (x), with estimated fiscal 2000 results generating 1.31x DSC. However, when coverage of all fixed payments – including lease payments – is calculated, fiscal 1999 DSC was a minimal 1.01x, and fiscal 2000 DSC is 1.20x.

PGW-IR St. 2, Appendix A page 3 of 3. Despite this report of debt service coverage, there has been no downgrading of PGW's bonds tied to a lack of coverage. Even if such a downgrade is experienced, there is no guarantee that the downgrade would consist of more than one step, and is speculative.¹⁰ (Tr. 218).

Should such a downgrading occur, PGW would not be precluded from accessing the bond market. In February of 1999, PGW's Senior Revenue Bonds were downgraded one step by Standard & Poor's from Baa-1 to Baa-2 due to the instability of PGW's management. (Tr. 210-202). Despite this downgrade, PGW was able to access the financial markets with their \$176 million June 1,

¹⁰ PGW's bonds carry a nominal rating of BBB by Standard and Poor's and a Baa-2 rating by Moody's. It would be necessary for each bond rating service to downgrade PGW's bonds two grades or steps for the bonds to lose their investment grade status.

1999 bond issuance. In order to improve the rating of the issuance, and to reduce the interest rate and expense to PGW, PGW obtained bond insurance. (Tr. 214). As admitted by PGW Witness Bisgaier she was aware of a bond insurance company that, as a business practice, insures distressed companies. While not providing an AAA rating, such insurance would raise non-investment grade bonds to an A rating and an improvement in interest rates and expenses to PGW. (Tr. 217-218).

C. What Is Sufficient Revenues To Maintain Bond Coverages?

Assuming that this Commission is of the opinion that some rate relief is required to enhance PGW's financial outlook, the question remains as to the level of that rate relief.

OCA Witness LeLash presented credible testimony recommending *an interim maximum amount of temporary rate relief of \$25 million*. In arriving at this figure, Mr. LeLash modified slightly the projections prepared by PGW. As explained by Mr. LeLash:

Based on both Mr. Knudsen's rebuttal testimony and in some part the cross-examination from yesterday, as well as information that was obtained during the City Council meeting yesterday, I would like to make two modifications to my recommendation in this proceeding.

The first, I believe at this time that the Commission can consider an increase to the bad debt allowance of up to 12-and-a-half million dollars. This would take into account some of the uncertainty that was discussed in Mr. Knudsen's testimony and during his cross-examination. It also parenthetically places

my uncollectible or bad debt allowance quite close to the OTS Staff Weakley's recommendation.

And second, I would suggest that the Commission also might wish to look for an adjustment on the revenue requirement up to four to five million dollars for the uncertainties associated with the cost savings that the company has built into its base revenue requirement plan and which for a variety of factors, some of which I discussed in my direct testimony, might make it difficult to achieve the full level of the savings that they have factored into the base case. Accordingly, I believe that a revenue allowance by the commission in the neighborhood -- somewhere up to \$25 million would be reasonable at this time, given the uncertainties and financial condition and also the uncertainties on several of the major expense factors such as uncollectibles.

Tr. 229-230.

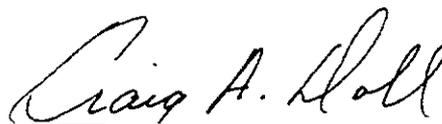
Mr. LeLash also sponsored two exhibits which indicate that adopting his recommendation would result in bond coverages for the 1975 Ordinance Bonds at 2.36x; for 1998 Ordinance Bonds at 2.11x and coverage for the 1998 Ordinance Subordinate Bonds of 16.44x. Not only does Mr. LeLash's proposal provide sufficient coverage to prevent a technical default on PGW's bonds, but provides a cushion as well.

AAGP submits that all this Commission need do is to provide the minimal amount of temporary rate relief necessary. AAGP respectfully submits that the amount presented by OCA Witness LeLash -- up to \$25 million -- is more than sufficient.

IV. CONCLUSION

The Apartment Association of Greater Philadelphia respectfully requests that this Commission determine that the maximum interim rate relief to be granted to the Philadelphia Gas Works should be \$25 million, and that the granting of that amount is more than sufficient for PGW to meet the criteria set forth in the Commission's Order establishing this proceeding.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I, Craig A. Doll, Esquire, do hereby certify that I have this day served a true and correct copy of the foregoing document upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

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