



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

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October 20, 2000

James J. McNulty, Secretary
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Re: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00005654

Dear Secretary McNulty:

Enclosed for filing please find an original and nine (9) copies of the Reply Brief of the Office of Trial Staff in the above-captioned proceeding.

Copies are being served on all active parties of record.

Sincerely,

Johnnie E. Simms
Senior Prosecutor
Office of Trial Staff

JES:pae

c: Parties of Record

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY :
COMMISSION :

v. :

PHILADELPHIA GAS WORKS :
(Interim Base Rate Proceeding) :

Docket No. R-00005654

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REPLY BRIEF
OF THE
OFFICE OF TRIAL STAFF

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Johnnie E. Simms
Senior Prosecutor

The Office of Trial Staff
Pennsylvania Public Utility Commission
P.O. Box 3265
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(717) 787-1976

Date: October 20, 2000

I. INTRODUCTION

On October 13, 2000, the Office of Trial Staff (“OTS”) filed its Main Brief in this proceeding setting forth the evidence and law in support of an interim base rate increase of \$27.5 million. Main Briefs were also filed by the PGW Gas Works (“PGW”), the Office of Consumer Advocate (“OCA”), Apartment Association of Greater Philadelphia, CEPA and the Philadelphia Industrial and Commercial Gas Users Group.

OTS’ Reply Brief is limited to those matters raised by the other participants in their Main Briefs and not specifically addressed by OTS in its Main Brief and to those matters previously addressed by OTS, but which require additional discussions as a result of the Main Brief of PGW. For ease of review, OTS will endeavor for the most part herein use the same headings as utilized by PGW in its Main Brief.

II. ARGUMENT

A. The Need For Interim Rate Relief

On page 25 of its Main Brief, PGW argues that “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.” In response, OTS submits that initially there was a connection between PGW’s interim rate request and the escalating gas costs. In that regard, the Company’s had requested in its GCR filing \$97 million, which was an under projection of the escalating gas costs. Accordingly, OTS witness Metro recommended that PGW update its commodity cost projections before the closed of the record in the GCR proceeding.¹ Additionally, OTS witness Metro recommended that PGW’s tariff be modified to permit PGW to follow the Pennsylvania Public Utility Commission (“Commission”) Regulations at Title 52, Chapter 53, Section 64, paragraph (b), which allows for interim filings for “known and measurable changes” in gas costs in excess of 2%.² Based upon its comments on page 33 of its Main Brief, PGW has adopted Mr. Metro’s recommendations, as the Company “intends to revised its proposed GCR factor, or to submit a supplemental filing to recognized and recover these additional costs in its GCR prior to the onset of cold weather.”

¹ See OTS Statement No. 1 at page 11, at Docket No. R-00005619 (GCR proceeding).

² Presently PGW can only file interim filings if the gas costs at the end of the computation year would result in either over or under billings in excess of 5%.

Accordingly, by the Company intending to address the additional costs in its GCR, alleviates, if not eliminates, any adverse effect that raising gas costs may contribute to its cash flow problems. Consequently, PGW's argument on page 25 of its Main Brief that the "extraordinary" escalation in gas costs "heightened" the need for the full request of \$52 million is without merit.

B. Recommendation of OTS

On pages 39 through 40 of its Main Brief, PGW suggests that OTS's recommended \$27.5 million interim rate increase should be increased to \$32.5 million recognizing \$5 million in unrealized productivity savings.³ Since, PGW is willing to engage in speculative assumptions of unrealized productivity savings, OTS submits that the speculation should continue with respect to other monies, such as the City's loan and the one time grant back by the City of \$18 million as proposed by the OCA. In that regard, it must be noted that OTS' recommended \$27.5 million increase provides sufficient revenues for the \$18 million City Payment, net earnings of \$16.1 million, positive cash flow for the year ended August 31, 2001 and adequate debt service. OTS St. No. 1 at 2.

Consequently, any loan or grant from the city of Philadelphia, makes OTS' recommended \$27.5 million increase even more attractive for the Bond Holders and reasonable for the Company and its customers, even with a consideration of \$5 million in unrealized productivity savings.

³ The unrealized productivity savings of \$5 million is associated with OCA witness Lelash's revision, calculated by Mr. Lelash, and not endorsed by any OTS witness.

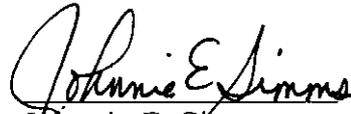
Finally, on page 47 of its Main Brief, PGW is criticizing OTS due to fact that its recommendation of \$27.5 million produces a positive \$2.5 million for the Company at the end of its fiscal year. OTS in response would note that this instant interim rate relief is only attempting to provide “a minimal, 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. Moreover, if the City waives its receipt of the \$18 million payment, the OTS recommendation of \$27.5 produces a positive \$20.5 million for PGW at the end of its fiscal year. PGW in its Main Brief is attempting to have the Commission treat this proceeding as a full base rate inquiry, not recognizing the undisputed fact that the Company will be filing a full base rate case very soon after the Commission rules on this instant Interim Rate Filing.

By viewing this proceeding in the manner intended by the Commission, OTS's recommended interim rate relief of \$27.5 million is very reasonable.

III. CONCLUSION

OTS recommendation of \$27.5 million for PGW provides an adequate level of financial rate relief to fund PGW's operations and meet debt service requirements through the winter heating season until the Commission can conduct and rule on a full base rate proceeding. Accordingly, OTS respectfully requests that the Commission adopt OTS' recommendation of \$27.5 million.

Respectfully submitted,


Johnnie E. Simms
Senior Prosecutor

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Date: October 20, 2000

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility
Commission

v.

Philadelphia Gas Works

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R-00005654

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CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Reply Brief** of the Office of Trial Staff, dated October 20, 2000, either personally, by first class mail, electronic mail, or by fax upon the persons listed below:

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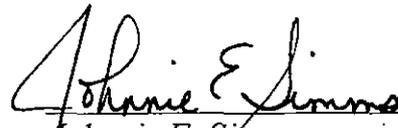
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Re: Pennsylvania Public Utility Commission v. Philadelphia Gas Works
Commission Docket No. R-00005654

Dear Secretary McNulty:

Please be advised that the Apartment Association of Greater Philadelphia will not be filing a Reply Brief in the above captioned matter. As indicated by the attached certificate of service, all parties of record have been served a copy of this letter.

If you have any questions, please feel free to contact me

Respectfully submitted,

Craig A. Doll
Craig A. Doll

cc: AAGP
All parties of record
Hon. Marlane Chestnut

ORIGINAL

Pennsylvania Public Utility
Commission

v.

Philadelphia Gas Works

Docket No.

R-00005654

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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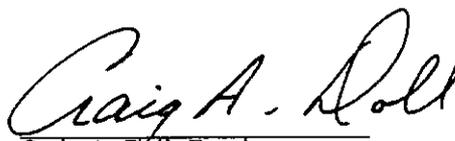
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Dated: October 20, 2000

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COMMONWEALTH OF PENNSYLVANIA



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Re: Pa. Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00005654

Dear Secretary McNulty:

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

Copies of this document have been served upon all parties as evidenced by the attached Certificate of Service.

Sincerely yours,

Stephen J. Keene
Assistant Consumer Advocate

DOCUMENT
FOLDER

Enclosure

cc: All parties of record
Hon. Marlane Chestnut, Administrative Law Judge

64

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY
COMMISSION

v.

PHILADELPHIA GAS WORKS
(Interim Base Rate Proceeding)

Docket No. R-00005654

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OFFICE OF CONSUMER ADVOCATE'S
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Senior Assistant Consumer Advocate
James A. Mullins
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Assistant Consumer Advocates

Counsel for:
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Dated: October 20, 2000

TABLE OF CONTENTS

I. INTRODUCTION 1

II. REPLY ARGUMENT 4

 A. The Commission Should Seek To Provide The Minimal Amount Of Financial Assistance Necessary For This Interim Period And Address The Company's Longer Term Financial Problems In The Context Of Full Base Rate Review. 4

 B. The Company's Argument Regarding The Ratemaking Methodology That Applies In This Interim Proceeding Divests The Commission Of All Discretion. 11

 C. The Quality Of PGW's Service Is A Relevant Consideration Under The Public Utility Code As Well As The Management Agreement. 16

III. CONCLUSION 20

TABLE OF CITATIONS

CASES

Action Alliance v. Philadelphia Gas Comm'n, 406 A.2d 1155 (Pa. Cmwlth. 1979) . . . 15

American Aniline Products, Inc. v. Lock Haven, 288 Pa. 420, 135 A. 726 (1927) 15

D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Commission, 466 F.2d 394, (D.C. Cir. 1972), cert. denied, 409 U.S. 1086 17, 18

Duquesne Light v. Barasch, 488 U.S. 299 (1989) 15

Public Advocate v. Philadelphia Gas Commission, 674 A.2d 1056 (Pa. 1996) 15, 17

Smythe v. Ames, 169 U.S. 466 (1898) 18

ADMINISTRATIVE DECISIONS

Pa. PUC v. Pa. Gas and Water Co., 68 Pa. PUC 191 (1988) 17

STATUTES

66 Pa.C.S. §526 16, 18

66 Pa.C.S. §1301 14

66 Pa.C.S. §1308(e) 5

66 Pa.C.S. §1501 19

66 Pa.C.S. §2212 11, 19

66 Pa.C.S. §2212(b) 14

I. INTRODUCTION

On October 13, 2000, the parties to this proceeding filed Main Briefs in support of their positions. In its Main Brief, the Office of Consumer Advocate (OCA) set forth its position that in this interim rate proceeding, the Commission should award Philadelphia Gas Works (PGW or the Company) no more than a \$25 million increase in its base rates, subject to certain conditions. In its Brief and Testimony, the OCA demonstrated that under a variety of reasonable assumptions, this level of interim relief will allow the Company to meet its debt service obligations and fund its operations through the winter heating season. The OCA demonstrated that if the Company wished to be in a better cash position, or encountered unexpected contingencies, it could still call on its owner, the City of Philadelphia, to provide assistance through a grant back of the \$18 million City payment and an additional loan of \$25 million. The OCA's position strikes a reasonable balance for this interim rate proceeding, and properly calls on all stakeholders to contribute to managing this financial crisis until a full base rate case is conducted and completed.

The Company, in its Brief, argues that the OCA's recommendation is insufficient, and does not meet the legal standard as set forth by the Natural Gas Choice and Competition Act. Under the Company's interpretation of the Act, the Commission is left with no discretion and must simply approve all of PGW's request. The Company also argues that the Commission must completely ignore the circumstances that have brought this case before the Commission, and ignore the need for the City to contribute to resolving this financial crisis. PGW argues that the Company's ratepayers must provide for every

unexpected contingency that can be hypothesized by the Company. The OCA submits that the Company's position cannot be sustained.

This is a unique proceeding not specifically provided for in the Natural Gas Choice and Competition Act, not specifically provided for in the Public Utility Code, and not specifically provided for in the Company's Tariff. The procedures for this proceeding were established by the Commission to address this unique, one-time extraordinary occurrence -- a financial emergency that was brought to the Commission's attention just as the transfer of jurisdiction over PGW from the Philadelphia Gas Commission to the Pennsylvania Public Utility Commission was being accomplished. But, this is an "emergency" that was long in the making. It is an "emergency" forced on the Commission after three successive warmer than normal winters which impacted the Company's revenues and after lengthy and costly problems with the Company's billing system which resulted in customers going months without being billed. And it comes at a time of unprecedented increases in the cost of natural gas.

The Company, in its Main Brief, suggests that ratepayers have somehow benefitted from these delays and failures since they did not have to pay higher rates sooner. PGW M.B. at 57. To suggest, however, that ratepayers have benefitted from the Company running up its debt, reaching the limits of its short term borrowing, reducing its expenditures on its mains replacement, and being in such a financial crisis is questionable at best. Ratepayers would have been better served by timely action that would have enabled them to adjust their budgets to the increasing costs and would have enabled them to have the benefit of budget billing to help manage their bills. Instead, customers are faced with a significant

increase in base rates – perhaps only the initial, interim increase – at the same time that they face skyrocketing gas costs, with a billing system that is still not capable of providing budget billing in accordance with PGW’s Tariff or the Commission’s regulations.

Given these extraordinary circumstances, the OCA submits that the Commission must reach a balance where all stakeholders contribute to addressing the immediate and most urgent needs of the Company. Of critical importance, the OCA submits that the increase to be borne by ratepayers must be mitigated in this interim proceeding, particularly as they are confronted with unprecedented increases in the Gas Cost Rate (GCR) due to increases in the cost of gas supplies. As the public input testimony demonstrated, such significant increases in both gas costs and base rates may simply make PGW’s rates unaffordable to many ratepayers.

The OCA’s proposal seeks to achieve this balance. The OCA submits that the interim rate relief granted in this proceeding does not have to result in the year-end cash balances that the Company requests be provided through rates. Instead, the interim rate relief should only be enough to maintain a minimal level of financial health required to fund operations and meet debt service requirements through the winter heating season. The OCA’s \$25 million base rate increase, subject to certain conditions, meets this standard. If PGW has additional cash requirements, or faces unexpected problems, it should seek assistance from its owner, the City of Philadelphia, through either an additional temporary advance or a return of the \$18 million City payment to PGW for use as project revenues.

For the reasons set forth in the OCA’s Main Brief, and the reasons set forth below, the OCA submits that its recommendation should be adopted for this interim period.

II. REPLY ARGUMENT

A. The Commission Should Seek To Provide The Minimal Amount Of Financial Assistance Necessary For This Interim Period And Address The Company's Longer Term Financial Problems In The Context Of Full Base Rate Review.

Throughout its Main Brief, the Company focuses both its analysis and its request on a longer term resolution of its problems than what is justified in this interim, emergency proceeding. PGW M.B. at 15-25. The Company's arguments predict dire consequences if the Commission does not provide it revenue, in this interim proceeding, to resolve its current financial crisis and end its fiscal year with a significant cash balance.¹ The OCA submits, however, that the Company's focus is misplaced. This is **not** the permanent base rate case and it is **not** the proper forum to accomplish long term financial fixes. The OCA submits that PGW's problems did not occur overnight and they will take time, and additional steps, to resolve. The focus of this proceeding must be on managing PGW's current financial situation, with the assistance and cooperation of all stakeholders. The Commission correctly captured the task at hand when it stated the interim rate increase should only be what is necessary to maintain a minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating

¹ The Company predicts an immediate downgrade of its bonds to junk status if it is not granted all of its interim rate increase request. As demonstrated on cross-examination, however, the Company's prediction is based on a worst case scenario that assumes no increase in the GCR and no increase in interim rates. Tr. 211-212. All parties have supported an increase in the GCR which should assist the Company in addressing cash flow problems associated with gas price increases. The OCA has also recommended that procedures for updating the GCR be put in place. More importantly, however, as PICGUG witness Baudino testified, bond rating agencies look at both present and expected future circumstances of a company in determining ratings. PICGUG St. 1 at 10. Mr. Baudino testified that while looking for a level of rate relief, the relief could come now or later in the form of permanent base rates. *Id.*, Tr. 308-311.

season until the full base rate case can be conducted and concluded. August 17 Order at 7.

In addition, recognizing the importance of this subsequent full base rate review, the Commission directed PGW to file its case by January 1, 2001.

The OCA submits that the Commission was correct in seeking to keep the interim rate increase to the minimum necessary, particularly since the Commission's Management Audit has not been completed and the Commission, on this record, has not had sufficient time to review and consider all of PGW's expenditures or financial plans for remedying its financial problems. At this point in time, without full review, there is simply no justification to provide the Company with anything other than the minimal amount of rate increase necessary to meet its obligations through the winter heating season.

The OCA would also caution against overstating the precedential value of this proceeding. As set forth in the Introduction, this is a unique proceeding that was convened on an expedited basis to meet an immediate need for this winter. There is certainly no provision for this type of proceeding in PGW's Tariff, and this is a unique proceeding under the Public Utility Code.² The OCA submits, though, that the purpose of this proceeding was not to resolve all problems of PGW, or to provide PGW with long term cash liquidity. The OCA does not dispute that these will be important considerations in the full base rate case that is yet to be filed. But here, the OCA submits that the Commission must strike a

² As set forth in the OCA's Main Brief, this proceeding is more akin to extraordinary rate relief under Section 1308(e). The principles set forth by the Commission in considering extraordinary rate relief are instructive in this instance. Importantly, while the Commission should provide some of the means for the Company to rehabilitate itself, other involved parties must contribute. In addition, the Commission should not rely upon speculation or conjecture and the Commission should not write a blank check. OCA M.B. at 8-13.

reasonable balance to manage this financial crisis—albeit one of long making by PGW. The OCA submits that given these circumstances, it is only reasonable that all stakeholders participate in managing and addressing this financial crisis.

The OCA's analysis and recommendation fulfills these requirements. Importantly, the OCA's recommendation refrains from placing the entire burden of correcting all of the problems caused by PGW's past failures solely on PGW's customers. The OCA's proposal of a \$25 million interim rate increase, coupled with assistance from the owner of PGW, the City of Philadelphia, in the form of a \$20 million temporary advance, will allow PGW to meet its bond coverages, fund its operations, provide safe and adequate service, and end the year with a positive cash balance. This recommendation even assumes that the \$18 million payment to the City will be retained by the City. PGW's situation would improve substantially if the City granted the \$18 million back to the Company as project revenues. If the City returns the \$18 million as project revenues, PGW would have a fiscal year-end cash balance of \$29.4 million and bond coverages of 2.36x on the 1975 bonds and 2.11x on the 1998 bonds. OCA Sch. 3.1 at 2,3. Moreover, the OCA's recommendation does not consider the potential for an additional loan by the City to PGW of approximately \$25 million.³

The Company argues that the OCA's recommendation relies too heavily upon the City and leaves PGW with little or no margin for unexpected occurrences or abnormal

³ The City is considering a loan of \$45 million to PGW which would include the \$20 million temporary advance assumed by the OCA and an additional \$25 million. In response to PGW's Motion to Update the Record, the OCA has requested that the Company include the status of this loan in its updated information to the Commission.

weather. PGW M.B. at 49-51. In support of its contention, the Company relies upon calculations it performed using assumptions regarding a range of scenarios such as warmer than normal weather on top of unrealized productivity savings to assert that the results of the OCA's recommendation would produce negative cash flow. PGW. M.B. at 49-50. But, as OCA witness LeLash testified, the assumptions used by the Company in support of its claim are not realistic and may be internally inconsistent. Tr. 286. Moreover, under the Company's various worst-case scenarios, even the Company's requested increase would be insufficient.

It cannot be the responsibility of the Commission, or the standard for this proceeding, to provide for every single, potential negative occurrence. Certainly, it should not be the responsibility of ratepayers to provide for every possible scenario that could occur. To assess such responsibility would be to base this interim relief on conjecture and speculation. Ratemaking, and the Commission's consideration here, must be based on a reasonable set of assumptions to arrive at a balanced result. The Company must continue to explore and implement areas of cost savings, and work with its owner, the City of Philadelphia, to address unexpected contingencies, if any, during the pendency of its full base rate case.⁴ The OCA's recommendation strikes this balance by providing for the bond

⁴ As OCA witness LeLash testified, the Company needs to continue exploring options to identify additional working capital sources from such things as storage management agreements, potential overfunding of pension liabilities, and cash flexibility associated with the Company's sinking funds. In addition, Mr. LeLash recommended that the Company prioritize its operating expenditures, particularly in months of low cash flow while the base rate case is pending. OCA St. 1 at 29. The Company argues that these efforts will take too much time or may not come to pass. PGW M.B. at 50, 59. The OCA submits, however, that these are efforts the Company could have and should have been pursuing for
(continued...)

coverages required by the ordinances and providing a positive cash balance at the end of the Fiscal Year. The OCA's recommended increase, with a temporary advance from the City of \$20 million, provides a coverage of 2.01x on the 1975 bonds and 1.50x on the 1998 bonds. OCA Sch. 2.1 at 3. In addition, the Company ends the fiscal year with \$11.2 million in cash. OCA Sch. 2.1 at 2. These coverages and year-end cash even assume that the \$18 million payment is made to the City and not granted back as project revenue. The City could still return the \$18 million City payment as project revenue for this fiscal year, and an additional \$25 million loan is still pending. As set forth above, if the City returns the \$18 million as project revenues, the Company ends the year with a cash balance of \$29.4 million and bond coverages of 2.36x on 1975 bonds and 2.11x on 1998 bonds. OCA Sch. 3.1 at 2,3.

As can be seen, based on the Company's own case, the OCA's recommendation fully meets the bond coverage requirements and satisfies the rate covenants.⁵ The OCA submits that ratepayers simply cannot be expected to cover every contingency, whether reasonable or not, in the context of this interim proceeding. The City, as owner of this Company, must assist in resolving this financial crisis and provide the

⁴(...continued)

many months if not years before seeking rate relief from the Commission. Moreover, as noted in the OCA's testimony and Brief, the Company has not had the type of cash "cushion" that it now seeks for these contingencies for many years, and in fact, had negative earnings in FY1998 and FY1999. OCA St. 1 at 21.

⁵ It is important to note that as the Company acknowledges in its Brief, the rate covenant, for purposes of the bonds, only requires revenues sufficient to cover net operating expenses and does not include depreciation or the \$18 million City payment. PGW M.B. at 17, fn. 68 [sic].

necessary backstop for unexpected contingencies, if any, as the full base rate case is conducted.

At page 50 of its Brief, the Company argues that even OCA witness LeLash would want to cover these unexpected contingencies if he was manager of PGW. PGW M.B. at 50. The Company makes the statement that OCA witness LeLash “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.” PGW M.B. at 50. The Company’s recounting of this discourse between Mr. LeLash and the Company’s attorney is incomplete. What Mr. LeLash actually said is as follows:

It would always be prudent for the company to have some measure of cushion against the minimum requirements that they need. But I cannot set aside something that you premised in your question, and that is in these conditions the amount of that cushion has to reflect the significant burden that is going to be placed on ratepayers with the GCR increases that are attendant to these rate settings. And so, yes, there needs to be a cushion but under the current circumstances it has to be the minimum cushion possible.

Tr. 259.

The OCA submits that its recommendation reaches this balance of providing the minimum cushion possible and mitigating the burden on ratepayers, particularly as they face the extraordinary increase in the GCR. It is important to note that the OCA has reflected the \$97 million in GCR increase in all of its analyses. With the minimum \$97 million immediate increase to the GCR and the \$25 million interim increase in base rates, the OCA submits that ratepayers have reasonably contributed to managing this financial crisis for this

winter heating season.⁶ Other stakeholders must also now contribute to managing this situation until the full base rate case is conducted.

The Company also argues that providing it any increase less than its request would be confiscatory. PGW M.B. at 42. Contrary to the Company's argument at page 42 of its Brief, the OCA's recommendation is far from confiscatory. PGW M.B. at 42. The OCA's recommendation starts from the Company's own base case and includes the revenue requirement and the expenditures that the Company has included in its request. The primary difference between the OCA's recommendation and the Company's position is in the level of cash "cushion" that should be provided to the Company through this interim proceeding. The OCA submits that an award of interim revenues which would provide the Company with a significant cash "cushion" at the end of the fiscal year is unreasonable and inconsistent with the Commission's August 17 Order. If the Company wishes additional cash before the end of the full base rate review, the Company should seek support from its owner, the City of Philadelphia.⁷

⁶ In its Main Brief in the GCR proceeding at Docket No. R-00005619, the Company has now requested a GCR increase of \$120 million.

⁷ The Company continues to argue throughout its Brief that relying on the City for help would eliminate its backstop in case of unforeseen circumstances. PGW M.B. at 43-44. The Company even argues that relying upon the City at this time would be like burning one's roof for heat even if the winter is not over. PGW M.B. at 49-50. The OCA submits, however, that given the extraordinary increase in the GCR coupled with this significant increase in base rates, it will be the ratepayers who will be placed in the position of "burning their roofs for heat" since many of these ratepayers simply have no "backstop" to rely upon. The level of increase requested by the Company will make gas service unaffordable to many residents of Philadelphia. As the City Finance Director acknowledged in the hearings before the Philadelphia Gas Commission, an additional 24,000 families would fall behind in their payments if the requested increase was granted. OCA St. 1 at 28. The City Finance Director
(continued...)

For the reasons set forth above, the OCA submits that its recommendation strikes a reasonable balance. In this interim proceeding, before full base rate review, the OCA has sought to mitigate the burden on ratepayers, yet provide the Company the amount necessary to maintain financial health through the winter heating season. The OCA submits that to do more in this interim proceeding would result in rates for this period that are unjust and unreasonable.

B. The Company's Argument Regarding The Ratemaking Methodology That Applies In This Interim Proceeding Divests The Commission Of All Discretion.

In its Main Brief, the Company argues that in this interim proceeding and in a full base rate case, Section 2212 of the Natural Gas Choice and Competition Act, and PGW's Management Agreement with the Philadelphia Facilities Management Corporation (PFMC) control all aspects of PGW's request, leaving the Commission with little or no discretion. PGW M.B. at 8-15. For example, on page 10 of its Main Brief, the Company asserts that the "Management Agreement commits the 'Commission' to setting rates" to meet all of PGW's identified needs. PGW M.B. at 10. Taken to its logical conclusion, PGW argues that the Commission has absolutely no discretion in considering its rate request, and must simply award it all of the dollars that PGW thinks it is going to spend.⁸ PGW's

⁷(...continued)

also recognized that the cost to the City of providing social services to these families could approach, if not exceed, the amount of the City payment by PGW. *Id.* Given these circumstances, it is in the interest of all stakeholders to contribute to resolving these problems in an attempt to maintain the affordability of gas service in Philadelphia during th winter heating season.

⁸ Another logical extension of PGW's argument is that PGW and PFMC could
(continued...)

argument would waive the Public Utility Code in its entirety as it relates to PGW, and have the Commission rely solely upon PGW's representation of its financial needs and the Management Agreement. Such an interpretation of the Act provides little or no protection to the ratepayers of Philadelphia and could not be what was intended by the General Assembly in bringing the rates and operations of PGW under the Commission's jurisdiction.

The OCA submits that PGW's argument simply proves too much. PGW argues throughout its Brief that the Commission is absolutely bound by and committed by the provisions of the Management Agreement between PGW and PFMC – as PGW interprets those provisions – and must allow recovery of all expenses and obligations claimed by PGW. In essence, PGW asserts that the Commission can reach no different conclusion as to what *the terms of the Management Agreement mean than what PGW has already concluded.*

Initially, the OCA would note that the Management Agreement contains commitments between PFMC and PGW and was negotiated by these parties. The Management Agreement binds these parties in the operation of the Gas Works.⁹ The

⁸(...continued)

agree on changes to the Management Agreement that would then bind the Public Utility Commission. Again, PGW's argument appears to leave the PUC with no discretion or authority to actually regulate PGW.

⁹ The Company relies heavily in its Brief on certain selected provisions of the Management Agreement. The OCA would note, however, that the Management Agreement must be read as a whole and the obligations and performance of each entity should be considered. As OCA witness LeLash testified, PFMC's primary obligation was to apply the highest standards of management practice and diligence to the operations of the Gas Works and to provide management personnel for the operation of the Gas Works. OCA St. 1 at 18. It is certainly clear that PFMC did not provide management personnel given that PGW went without a chief executive for several years. *Id.* PGW's performance also raises concerns as to whether all obligations under the Management Agreement were met.

Commission has not participated in the establishment of this Agreement, and has not yet had the opportunity to fully review and determine the proper interpretation of this Agreement under the Public Utility Code.

In fact, PGW's interpretation of the Management Agreement may not be consistent with provisions of the Public Utility Code or Commission precedent regarding the rates of a municipal utility. By way of example, the Company argues throughout this proceeding that the Management Agreement requires ratepayers to provide all working capital for the Company. See, e.g. PGW M.B. at 45-46. But, as OCA witness LeLash testified, under traditional ratemaking, ratepayers are only responsible for providing revenues to cover the *cost* of capital, not to advance the capital itself. OCA St. 1 at 14. This places the responsibility on the owner to provide capital or to facilitate the acquisition of additional debt. Id. Here, however, the Company urges an interpretation of the Management Agreement that would require ratepayers to provide this capital, plus all other expenses and costs which PGW identifies.

OCA witness LeLash succinctly summarized the flaw in the Company's logic as follows:

The Company's definition or application of this method has ratepayers provide PGW's capital as well as meeting its revenue requirements. From a regulatory perspective, this interpretation of the Act and the cash flow method is fundamentally unreasonable. If it is followed, it would have the effect of absolving the City from any of its ownership responsibilities. In effect, the City would always be able to say that any PGW deficiencies were the result of insufficient revenues for cost and capital. Failure to rectify Billing, Collections and Customer Service System (BCCS) problems, lack of adequate mains replacement, unreasonable levels of

customer service could always be explained away by inadequate rate allowances. In effect, the cash flow method of setting rates as espoused by the Company would allow service to follow rates.

OCA St. 1 at 27.

The OCA submits that for the General Assembly to bring PGW under the Commission's jurisdiction and then to divest the Commission of any discretion or ability to review this Company and its rates as the Company suggests would be an absurd result. The goal of the Natural Gas Choice and Competition Act was not to bring PGW under the Commission's jurisdiction so that the Commission would simply add up all of the dollars that PGW chooses to spend and pass them on to the ratepayers.

The OCA submits that the purpose of the Act can be seen in Section 2212(b) where it provides:

...public utility service being furnished or rendered by a city natural gas distribution operation within its municipal limits shall be subject to regulation and control by the commission with the same force as if the service were rendered by a public utility.

66 Pa.C.S. §2212(b)(emphasis added). The task, then for the Commission must be on harmonizing and reconciling the Public Utility Code with the ratemaking methodologies in place for PGW, not in disregarding fundamental principles of the Public Utility Code.

The OCA submits that a fundamental principle of the Public Utility Code that must guide the Commission, no matter what the ratemaking methodology, is that rates must be just and reasonable.¹⁰ 66 Pa.C.S. §1301. The cases cited by PGW in support of its

¹⁰ Even the Management Agreement which PGW relies upon states:
(continued...)

argument that the Commission must follow PGW's interpretation of the cash flow method also recognize that the standard of just and reasonable rates must be adhered to even by PGW. See, Action Alliance v. Philadelphia Gas Comm'n, 406 A.2d 1155, 1158 (Pa. Cmwlth. 1979) and Public Advocate v. Philadelphia Gas Commission, 674 A.2d 1056, 1061 (Pa. 1996)(Public Advocate). For example, the Pennsylvania Supreme Court in Public Advocate held as follows:

We hold today that the United States Supreme Court guidelines for determining the constitutionality of a rate are also applicable to examining rate disputes involving municipal utilities.

674 A.2d at 1062. Those standards are that rates must be just and reasonable. Id. at 1061. See also, American Aniline Products, Inc. v. Lock Haven, 288 Pa. 420, 424, 135 A. 726, 727 (1927).¹¹ Without such a standard, PGW would be subject to no control.

As such, PGW's argument that the Commission's only job is a mechanical application of the rate provision of the Management Agreement cannot withstand scrutiny. The Commission must have the authority and the discretion to consider the Company's claim and to apply the fundamental principles of the Public Utility Code to any claim under the Management Agreement. In particular, the Commission must always determine that rates

¹⁰(...continued)

"WHEREAS, the City desires to provide quality gas service to its citizens at reasonable rates. . ." Management Agreement, p. 1.

¹¹ The Company also argues at pages 42-43 that the Commission may not refuse to permit recovery in rates of otherwise prudent expenses or other obligations and cites Duquesne Light v. Barasch, 488 U.S. 299 (1989). The OCA submits that this is *not* the holding of Duquesne. Duquesne actually holds that recovery of all prudent expenses is not constitutionally required.

are just and reasonable. In this case, the Commission must consider whether interim base rates at the level requested by the Company would be just and reasonable. The OCA submits that for this interim proceeding, before full base rate review, any interim rate that exceeds the 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 would not be just and reasonable.

C. The Quality Of PGW's Service Is A Relevant Consideration Under The Public Utility Code As Well As The Management Agreement.

At pages 51 to 56 of its Main Brief, PGW argues that service quality evaluations are not a component of PGW's "traditional ratemaking methodology" and thus cannot be considered by the Commission in this or any other proceeding. PGW M.B. at 52. PGW also argues that if the Commission determines to exercise its discretion under Section 526, it would preclude recovery of legitimate operating costs and working capital and would go beyond constitutional limitations. PGW M.B. at 52-53. The OCA submits, however, that PGW's arguments must fail.

For support of its position, PGW again relies upon the Management Agreement between PGW and the Philadelphia Facilities Management Corporation (PFMC). PGW, however, would have the Commission read Section VII of the Management Agreement regarding gas rates, in isolation from every other provision of the Management Agreement and the Public Utility Code. PGW's argument is like saying that since the pricing provisions in a contract are separate from the quantity provisions, one must pay under the

contract even if one received no goods or services. Such a result is simply absurd. The Management Agreement must be read as a whole.

When the Management Agreement is reviewed in its entirety, it is found that it clearly specifies that the one of the key purposes of the Management Agreement is to provide quality gas service. PGW M.B., Appendix C, Tab 5 at 1. In the initial clauses of the Management Agreement where the purpose of the Agreement is set forth, it provides:

WHEREAS, the City desires to provide quality gas services to its citizens at reasonable rates;

Management Agreement, p.1. Moreover, as set forth above, the Courts have held that PGW's rates must be just and reasonable. Public Advocate v. Philadelphia Gas Commission, 674 A.2d 1056, 1062 (Pa. 1996). The OCA submits that the Courts and this Commission have long held that service is an essential consideration in determining just and reasonable rates. See, D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Commission, 466 F.2d 394, 422 (D.C. Cir. 1972), cert. denied, 409 U.S. 1086 (D.C. Transit). See also, Pa. PUC v. Pa. Gas and Water Co., 68 Pa. PUC 191, 197 (1988).

The U.S. Court of Appeals for the District of Columbia Circuit in D.C. Transit perhaps stated this consideration best when reviewing a decision of the Washington Metropolitan Transit Commission. In that case, the Transit Commission had made a fare increase contingent upon steps calculated to rectify serious deficiencies in the service that the Company furnished the public. The Court summarized the Company's argument and concluded as follows:

Transit's argument has one central theme: its revenues cannot be permitted to fall below the level of fair return, and surely

not below the breakeven point, no matter what the circumstances, and even if its management is uneconomical and inefficient and its service inadequate. If Transit is correct, the Commission is powerless to sanction corrective measures by deferring further consideration of a fare increase. *If Transit is correct, it may disregard its public responsibilities at will . . . and yet insist that the public respond to its demands for higher rates. We cannot accept that position. We do not believe that the Constitution left the Commission impotent to deal with the situation confronting it in a sensible manner.*

D.C. Transit, 466 F.2d at 422 (emphasis added). As far back as Smythe v. Ames, 169 U.S. 466 (1898), the United States Supreme Court has recognized that service is an essential consideration in just and reasonable rates. The Court held:

[W]hat the public is entitled to demand is that no more be extracted from it for use of a public highway than the services rendered by it are reasonably worthy.

Id. at 547.

The Company also argues that to make any disallowance under Section 526 of the Code would preclude recovery of legitimate operating costs and working capital. This argument also misses the point. As the D.C. Circuit Court held in D.C. Transit:

It has long been recognized that the caliber of a utility's service need not remain a neutral factor in determinations as to its allowable return. . . Much the same rationale undergirds the universal rule that expenditures incompatible with economical and efficient management are to be disallowed.

D.C. Transit, 466 F.2d at 419-420.

The OCA submits that the Commission should reject PGW's argument that service considerations are irrelevant to a consideration of PGW's rates. The constitutional standard of just and reasonable rates, which also governs the setting of PGW's rates, as well

as the Public Utility Code, requires that service be safe, adequate, reasonable and efficient. 66 Pa.C.S. §1501. The OCA submits that there is nothing in Section 2212 or in the Management Agreement that would justify a different standard for PGW.

As set forth in the OCA's Main Brief, the record in this case, including the Public Input testimony, has demonstrated that PGW's service must be improved. OCA M.B. at 40-52. As such, the OCA submits that any award of interim rate relief must be subject to certain conditions in addition to the conditions specified in the Commission's August 17 Order. Specifically, based upon the public input testimony and the record, the OCA recommends that the following additional conditions be required:

- PGW should be required to achieve a 1% replacement rate in its mains replacement program as provided in the Company's base case capital budget;
- PGW should commit to correcting the problems with its billing system (BCCS), particularly the immediate need to rectify the budget billing system, and provide periodic reports to BCS on the progress it is making to correct these problems;
- PGW should proceed with its LNG Liquefaction Replacement Program to ensure PGW's system supply and reliability are maintained; and
- PGW must show improvements in its customer service functions and report on its progress to the Commission.

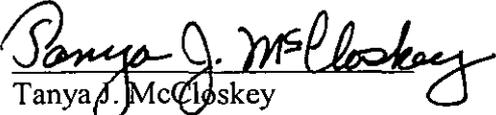
III. CONCLUSION

For the reasons set forth above, and for the reasons set forth in the OCA's Main Brief and Direct Testimony, the OCA submits that the Commission should allow PGW an interim base rate increase of no more than \$25 million, subject to the following conditions:

- PGW must file a full base rate case with the Commission on or before January 1, 2001;
- any interim rates ultimately granted 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;
- PGW will not seek to recoup additional revenues from ratepayers if the Commission ultimately determines that a higher level of rates is just and reasonable;
- PGW commit to its "Transition to Excellence" plan for improvement and make a demonstration throughout the interim rate period that it is providing safe and adequate service.
- PGW should be required to achieve a 1% replacement rate in its mains replacement program as provided for in the Company's base case capital budget;
- PGW should commit to correcting the problems with its BCCS, particularly the need to rectify the budget billing problems, and provide periodic reports to BCS on the progress it is making correcting the BCCS problems;
- PGW should proceed with its LNG Liquefaction Replacement Program to ensure that PGW's system supply and reliability are maintained; and
- PGW must show improvement in its customer service functions and report on its progress to the Commission.

The OCA's recommendation satisfies the standards for interim rate relief set forth in the Commission's August 17, 2000 Order and should be adopted.

Respectfully submitted,


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Re: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00005654

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I hereby certify that I have this day served a true copy of the foregoing document, the Office of Consumer Advocate's Reply Brief, 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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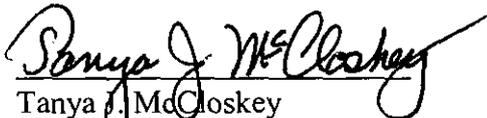
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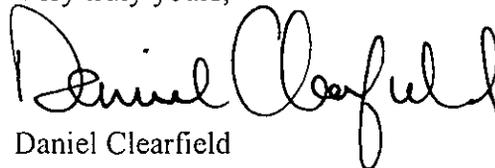
RE: Pennsylvania Public Utility Commission v. Philadelphia Gas Works; Docket No. R-00005654

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works, enclosed for filing please find an original and nine (9) copies of its Reply Brief with regard to the above referenced matter. As indicated by the attached certificate of service, all parties of record have been served with a copy of this filing.

Please contact me if you have any questions with respect to the enclosed.

Very truly yours,



Daniel Clearfield

For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

DC/jlg
Enclosure

cc: All Parties of Record w/enc.
Hon. Marlane Chestnut w/enc.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

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Docket No. R-00005654

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TABLE OF CONTENTS

| | <u>PAGE</u> |
|--|--------------------|
| I. INTRODUCTION | 1 |
| II. CLAIMS THAT PGW DOESN'T NEED THE FULL REQUESTED INTERIM RATE INCREASE TO AVOID A TECHNICAL DEFAULT AND BOND DOWNGRADE ARE MISPLACED | 4 |
| III. CLAIMS THAT PGW'S REVENUE REQUIREMENT SHOULD BE REDUCED BY LOANS AND/OR THE WAIVER OF PGW'S CITY PAYMENT ARE LEGALLY AND FACTUALLY DEFICIENT | 12 |
| IV. THE RECOMMENDATIONS OF THE PARTIES ARE INADEQUATE TO MAINTAIN THE FINANCIAL STABILITY OF PGW UNTIL A PERMANENT BASE RATE DECISION CAN BE MADE | 17 |
| A. Introduction | 17 |
| B. The Recommendations of the Parties Do Not Provide Sufficient Assurances That PGW Will Be Able to Meet Its Bond Ordinance Covenants and Inappropriately Rely On Hoped-For Assistance From the City. | 17 |
| C. Establishing PGW Interim Rates To Cover Its Cash-Working Capital Needs is Required By Law, Is Necessary To Maintain PGW's Financial Condition And Is Fully Supported By The Record | 21 |
| D. The OCA and OTS Recommendations Use An Inappropriately Low Level of Bad Debt Expense | 26 |
| E. The Parties Have Failed to Take Account of The Fact That PGW's Hoped-For Productivity Savings Are Unlikely to Be Fully Realized in The Next 12 Months | 32 |
| F. PGW's Base Case Weather Normalization Adjustment Is Reasonable and OCA's and OTS's Objections Should Be Rejected | 34 |
| G. Summary of Deficiencies in OCA Recommendations | 36 |
| H. Summary of Deficiencies in OTS Recommendations | 37 |
| I. Summary of Deficiency of Position of PICGUG | 38 |

V. THERE IS NO BASIS - LEGALLY OR FACTUALLY - TO DENY OR
REDUCE PGW'S INTERIM RELIEF BECAUSE OF ALLEGED INADEQUATE
SERVICE 39

VI. THE CONTENTION THAT PGW WAITED TOO LONG TO BRING THIS CASE
AND THAT ITS INTERIM RATE INCREASES SHOULD BE DENIED TO
AVOID "RATE SHOCK" SHOULD BE REJECTED 44

VII. OCA'S LIST OF "CONDITIONS" ON THE GRANT OF INTERIM RATE
RELIEF HAVE ALREADY BEEN AGREED TO BY PGW OR ARE ITEMS THAT
PGW IS FULLY COMMITTED TO, ASSUMING IT RECEIVES ADEQUATE
RATE RELIEF 47

VIII. CONCLUSION 50

I. INTRODUCTION

Philadelphia Gas Works ("PGW" or the "Company") hereby submits this response to the Main Briefs of the Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), CEPA, *et al.* ("CEPA"),¹ the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") and the Apartment Association of Greater Philadelphia ("AAGP"). Several preliminary points are in order.

First, PGW's need for interim rate relief has continued to become more pressing. Wholesale gas costs continue to be higher than in prior years, and PGW's available resources to meet all of its other needs as well as to purchase gas at these high rates continue to dwindle. While the City Administration has requested City Council approval of up to a \$45 million line of credit (a request that, as of this writing, still has not been approved), PGW's need for this backstop from the City has accelerated. The Company's original projections were that a City loan would have to be used by January, 2001; by the time that rebuttal testimony was filed that projection had been advanced to November.

All the parties acknowledge that PGW's wholesale gas costs for this year will be significantly higher than its initially requested \$97 million GCR increase. PGW's calculation, as placed in the record, shows that an additional increase of \$75 million over and above its request in August is needed to fully recover these costs. PGW's position in the GCR proceeding, however, is to request only a portion of these additional costs — an additional \$23 million — for

¹ The other parties joining CEPA in its Brief are Action Alliance of Senior Citizens of Greater Philadelphia, ACORN and the Tenants Action Group.

immediate inclusion in its GCR. Why? To hold off implementing the full increase in the possible — but, unlikely — event that gas costs suddenly reverse their recent upward spiral, and, if so, to avoid burdening ratepayers. But whether these higher gas costs are reflected in PGW's GCR factor now or two months from now, PGW is still going to feel the financial effects. Even if these additional costs are fully recovered in PGW's GCR, additional gas costs increase PGW's cash working capital needs and cause higher bad debt expense (recovered in its base rates) which reduces PGW's net increase and its ability to meet its bond covenants.

These multiple problems have not gone unnoticed by the investment community. The rating agencies continue to send the clear signal that, absent adequate rate relief from the Commission, the Company is in serious danger of being downgraded. Just last week, Moody's Investment Service announced that it had placed PGW's revenue bonds on its "Ratings Watchlist" for possible downgrade with the clear implication was that PGW will be downgraded if the rate relief granted is not sufficient.² As PGW's investment advisor, Barbara Bisgaier, indicated, a downgrade at this point likely would lead to junk bond status, making it impossible for PGW to access the capital markets at reasonable rates and ending PGW's long-standing \$100 million commercial paper program — a critical financial resource. The result would be upwards of \$200 million in liabilities, or needed financing that PGW would have no ability to cover or secure. An interim rate increase at this point is, more than ever, an urgent necessity.

Second, several of the parties — principally CEPA and secondarily the OCA — have asserted that the PUC should recognize the loans that the City Administration has sought

² PGW Exh. 4. Attachment "A" hereto.

approval to offer PGW, as well as PGW's required \$18 million City payment, as a replacement for (rather than as a supplement to) the rate relief for which they acknowledge, PGW has demonstrated a need. As explained below, this demand is not only inadvisable, but illegal. But, from a broader policy basis, it is important to recognize that any reduction of PGW's revenue requirement, on the notion that the City will (or should) supply the funds, really amounts to an attempt to usurp the clear prerogative of the citizens of Philadelphia, through their elected and appointed officials, to determine how the City's limited funds should be allocated.

A decision here that assumes that the City will "bail out" PGW simply means that the City would be forced to take funds from other legitimate projects — such as improving the City schools or reducing urban blight — to keep the gas flowing, assuming such funds were even available. Clearly, PGW has proven its need for the full \$52 million increase and that determination must be made without offsetting or discounting the claim by possible City loans or "grants." The Commission should recognize that this result is not only legally required, but is also appropriate public policy, deferring to the City on how and where its additional funds should be allocated is for the PUC.

Third, while all parties but CEPA have recommended that the Commission allow some interim increase, none has recommended that the full \$52 million be adopted. Their inadequate recommendations stem principally from unreasonably low allowances for cash-working capital at the end of the year, unrealistic projections of bad debt expense and *pro forma* sales levels and an unwillingness to recognize the need to set rates to be reasonably sure that PGW will be able to satisfy its crucially important bond ordinance covenants.

At the same time, however, several of the parties —and in particular, the OCA — have insisted that the Commission condition even these limited awards on PGW’s commitment to deliver on a long list of customer service improvements, including repairing PGW’s budget billing system, maintaining a 1% replacement of its cast iron mains, making improvements to the Company’s call center, etc. What should be obvious is that “one cannot make chicken soup out of chicken feathers.” That is, PGW is already fully committed to pursuing these capital and service improvements. Denying PGW the revenues it needs in the coming months will simply serve to make it very difficult for the Company to continue to do what it has committed to do. It is simply common sense that, to the extent that PGW does not receive sufficient revenues to fund fully its operations and capital improvement projects, those efforts will have to be cut back. The best way for the Commission and the parties to ensure PGW the wherewithal to follow-through with these commitments is to grant the interim rate relief requested by PGW.

II. CLAIMS THAT PGW DOESN’T NEED THE FULL REQUESTED INTERIM RATE INCREASE TO AVOID A TECHNICAL DEFAULT AND BOND DOWNGRADE ARE MISPLACED

In addition to many other arguments, several of the parties have suggested that one of the fundamental premises of PGW’s case — that it is in the interest of all concerned to avoid a downgrade to junk bond status caused by PGW’s technical default on its bonds — is not a serious concern because such a potential is merely “speculative.”³ Even the OCA, whose witness’ recommendations were designed to produce minimally adequate coverages, has

³ OCA M.B. at 36-38; *see*, PICGUG M.B. at 7-8.

suggested that the Company's concerns about the potential downgrade are "uncertain."⁴ These contentions are starkly contradicted by the record, including evidence that materialized just this week. Moody's Investor Service showed the investment community's serious concern about PGW's ability to avoid a technical default by placing PGW's revenue bonds on its "Ratings Watchlist for possible downgrade."⁵ The concern about technical default was stated specifically in the Moody's opinion:

Moody's Investors Service has placed Philadelphia Gas Works (PGW) revenue bonds on its Ratings Watchlist for possible downgrade as the utility faces a cash crunch beginning in November that could get worse should the November 9, 2000 rate decision before the state Public Utility Commission (PUC) be held up. Further, the utility's liquidity could also worsen should warm winter weather occur over the next several months. Moody's rates PGW's \$869.5 million senior lien obligations Baa2 and subordinate bonds, Baa3 both with a negative outlook. PGW's next interest payment date is January 1, 2001. If these issues are not resolved in PGW's favor, PGW could find itself in technical default then and have to use its debt reserve to meet the required payment. Moody's will continue to monitor this situation.⁶

Moody's action highlights PGW's precarious financial situation in and the absolute need for the PUC to award it the full \$52 million rate increase requested.

Going beyond Moody's warning, there is ample legal and factual support for PGW's position that the PUC must take the necessary steps to permit PGW to avoid a technical default

⁴ OCA M.B. at 37-38.

⁵ PGW Exh. 4, Attach. "A" hereto. PGW's motion requesting the PUC take official notice of the Moody's announcement or enter the document into the record as a late filed exhibit was granted by ALJ Chestnut in her Posthearing Order #2.

⁶ *Id.* (emphasis added).

on its bonds both because it is legally required to do so and because it has been shown that a failure to meet these obligations will result in a downgrade to junk bond status as well as other negative consequences. As indicated, several of the opposing parties, however, have argued that the Commission should not be too concerned about setting PGW's interim rates to assure that the Company will not technically default on its bonds because PGW's predicted response from the investment community is "speculative" or "uncertain."⁷

First, all of these parties have apparently overlooked the fact that, whether or not one concludes that a PGW technical default would cause a downgrade, the PUC is under a legal obligation to set rates for PGW that assures that it will satisfy its bond covenants. This legal requirement is set forth in at least two parts of the same subsection of the Gas Choice Act. Section 2212(e) obligates the PUC to set PGW's rates in accordance with the previously utilized ratemaking methodology, which, in turn, is set forth in PGW's Management Agreement.⁸ The Management Agreement specifically requires that PGW be permitted to set its rates to satisfy its bond covenants.⁹

But, in addition, another portion of that same subsection specifically focuses on this obligation:

Notwithstanding any provision in this title to the contrary, the commission shall permit the city natural gas distribution operation [i.e., PGW] to impose, charge or collect rates or charges as necessary to permit the city . . . that issued bonds on behalf of a

⁷ OCA M.B. at 36-38; PICGUG M.B. at 7-8; AAGP M.B. at 10-15.

⁸ PGW M.B. at 8-11; App. C, Tab 5.

⁹ *Id.*, Management Agreement, Section VII, ¶ 1(a)(v), (c).

city natural gas distribution operation [i.e., PGW] to comply with its covenants to the holders of any approved bonds.¹⁰

Thus, regardless of the consequences of a technical default, the PUC is legally obligated, to set rates that are, at the very least, “necessary” to allow PGW to comply with its bond covenants. Clearly, setting rates as the OCA’s recommendation would do, so that if all budgeted assumptions work out perfectly the Company will just comply with those requirements, would not allow the PUC to be sure it will comply with this legal directive. Just as obviously, ignoring PGW’s bond covenants altogether, on the ground that PGW’s service allegedly is inadequate, as CEPA has argued, or claiming that the PUC need not be concerned with a technical default, as PICGUG argues, is not only inconsistent with the evidence, but is contrary to law.

Second, the evidence in the record clearly shows that a technical default on PGW’s bonds — or even a conclusion by the rating agencies that rate support is so inadequate that a technical default is likely — will clearly result in a downgrade to junk bond status with serious negative consequences to PGW and its ratepayers that should be avoided.

Indeed OTS witness O’Donnell agreed that the downgrade would occur if PGW technically defaulted or did not receive adequate rate relief:

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 & Poor’s sent PGW a letter which informed the Company that they “have placed the rating of ‘BBB’ on CreditWatch with negative implications due

¹⁰ 66 Pa. C.S. § 2212(e).

to PGW's very weak cash flows arising from a convergence of budgeting that did not reflect the trend toward warmer winters; historic ongoing problems with high revenue receivables; and the faulty implementation of a new billing system." Moreover, in its July 2000 "Infrastructure Finance" report, Standard & Poor's opined: "To preserve its rates, PGW will need to obtain rate relief and implement the projected productivity savings ranging between 5% to 10% annually."¹¹

OCA witness LeLash, agreeing with OTS during the hearing, frankly admitted that it would not be in anyone's interest for there to be a technical default. He also did not dispute PGW's concern that such a default would immediately result in a downgrade.¹² Surprisingly, OCA now takes the position that it is uncertain whether a default would automatically trigger a downgrade of PGW's bonds to junk bond status.¹³ OCA relies on PICGUG witness Baudino, rather than its own witness, for this position.¹⁴ However, PGW has already shown why Mr. Baudino's position is unreliable and is based on a misreading of a Standard & Poor's analysis of PGW's bonds.¹⁵ Indeed, PICGUG still misses the point when it argues that Standard & Poor's allowed PGW to maintain a BBB rating even though it was cognizant of PGW's weak historic coverage.¹⁶ Whether or not coverage was weak, the Standard & Poor's analysis clearly showed there was, in fact, adequate coverage when calculated under the legally required method set forth

¹¹ OTS St. 3 at 7.

¹² Tr. 258-59.

¹³ OCA M.B. at 37.

¹⁴ PICGUG St. 1 at 10.

¹⁵ See PGW M.B. at 47-48, n. 147.

¹⁶ PICGUG M.B. at 8.

in PGW's covenants. Moreover, that coverage has always been there. Heretofore, PGW has never defaulted on its bonds, even technically.¹⁷

The other parties' views must be contrasted with the hands-on experience and expertise of PGW's financial advisor, Ms. Bisgaier. Her opinion should be given much more credibility and weight, especially in light of her dealings with the rating agencies¹⁸ and her first-hand experience with the Philadelphia Water Department when, in 1991, it had a technical default and was immediately downgraded two levels to a level below investment-grade.¹⁹

The parties also have failed to understand that bond covenant coverage requirements have special importance for municipal utilities, which have few other financial benchmarks by which to assure bond holders that the utility's ability to repay its debts is secure. Ms. Bisgaier, the only municipal bond investment expert testifying in the proceeding, explained the special status of debt service covenants for PGW as follows:

Failure of PGW to generate revenues to pay all of its expenses or to meet the 1.5x debt service coverage test, even if debt service payments are timely made, will result in a technical default under those bond resolutions. In my opinion, and in the present circumstances, this technical default (and the implications of such an eventuality) will immediately result in the down-grading to below investment-grade of PGW's long-term credit rating by each of the three municipal credit rating agencies. It has long been understood that PGW has maintained its investment grade rating substantially as a result of its unusually high debt service coverage requirement (most municipal utilities have required coverage between 1.1x and 1.25x annual debt service). Absent

¹⁷ Tr. 212-13.

¹⁸ Tr. 215-17.

¹⁹ Tr. 215.

achievement of the debt service coverage requirement, the rating agencies will have no alternative but to reduce PGW's rating to junk bond status. That status will prevent PGW from accessing the public credit markets.²⁰

In the face of this testimony, borne out by the Moody's credit warning, vague statements about other non-municipalities, such as those made by PICGUG witness Baudino²¹ — are obviously of no probative value.

The remaining speculative arguments of those opposing PGW's view are similarly specious. Ignoring testimony regarding recent warmer than normal winters, no rate increase since 1991-92 and PGW's past management instability, AAGP first contends that no satisfactory explanation can be developed to explain the exact causes of PGW's problems, and then joins the OCA and PICGUG position on this issue.²² AAGP relies on a portion of a Stone & Webster report prepared to support a PGW bond issuance in June 1999²³ simply to show that PGW's bonds were previously downgraded due to the instability of prior management,²⁴ and the leaps to the conclusion that, should a further downgrading occur, PGW would not be precluded from accessing the bond market.²⁵ This argument, however, ignores the fact (as Ms. Bisgaier clearly

²⁰ PGW-IR St. 2 at 5 (bold in original, underline added).

²¹ PICGUG St. 1 at 10-11; PICGUG M.B. at 7-8; OCA M.B. at 37-38. Mr. Baudino admitted that he had no experience with municipal utilities. Tr. 311-12.

²² AAGP M.B. at 10.

²³ *Id.* AAGP Cross-Exam. Exh. 1.

²⁴ AAGP M.B. at 11; Tr. 202.

²⁵ AAGP M.B. at 11-13.

explained on cross-examination) that the previous downgrade based on management instability was to a level that was still investment-grade; indeed, at that time, PGW was complying — and the Stone & Webster report clearly projected compliance — with the bond covenants.²⁶ Ms. Bisgaier testified that downgrade here will be to below investment-grade and, thus, will preclude PGW's reasonable access to the capital market.²⁷

OCA's and AAGP's obvious error arises from its unwarranted reliance on Mr. Baudino's testimony.²⁸ AAGP makes the same error as Mr. Baudino in quoting from the Standard & Poor's analysis that shows coverage below 1.5 x because AAGP — just like Mr. Baudino — fails to appreciate that the below 1.5x coverage shown in the report is not calculated according to the bond covenant ordinances, and that there was compliance with coverage calculated according to the ordinances.²⁹ On the other hand, an actual technical default — calculated pursuant to the covenants — would, according to Ms. Bisgaier, cause an immediate downgrade to junk bond status.³⁰ The ensuing catastrophic effects on PGW have been explained.³¹

²⁶ Tr. 213-14. AAGP also relies on the fact that Stone & Webster projected adequate coverages in 2000 even though the weather was warmer than usual in fiscal 1999 (AAGP M.B. at 11). What AAGP forgets is that the winter in fiscal 2000 also was also warmer — by 15% — than usual and the recent huge increases in the price of gas that PGW faces.

²⁷ *Id.*

²⁸ AAGP M.B. at 12-13.

²⁹ *See* PGW M.B. at 47-48, n.147.

³⁰ Tr. 213-15.

³¹ PGW-IR St. 2 at 5-7, 13-14; PGW M.B. at 17-21.

Accordingly, any contention that this Commission need not be concerned about a technical default is legally incorrect, reckless and should be rejected.

III. CLAIMS THAT PGW'S REVENUE REQUIREMENT SHOULD BE REDUCED BY LOANS AND/OR THE WAIVER OF PGW'S CITY PAYMENT ARE LEGALLY AND FACTUALLY DEFICIENT

As expected, several of the parties have focused on the City of Philadelphia's willingness to provide backstop loans to PGW as justification for recommending less than adequate interim rate relief. The OCA states candidly that its recommendation of \$25 million in interim rate relief should be sufficient, even though it produces coverage levels at minimally adequate levels, because, if additional cash is needed, the City's financial offers should be more than adequate.³² Indeed, CEPA has urged that the Commission disavow the entire requested interim rate increase, claiming that the City's support should fully replace the base rate increase.³³

In PGW's Main Brief we have already explained in detail why the requested interim rate increase cannot be satisfied by loans that the City Council has been asked to approve by the City administration. Neither can relief be avoided by forcing the City to "grant back" its \$18 million payment — which is required by PGW's Management Agreement and codified in the Public Utility Code.³⁴ While the loans are a welcome potential backstop for non-budgeted contingencies, they cannot be used to offset or discount the Company's need for interim rate relief.

³² OCA M.B. at 5, 28, 32. *Accord*, AAGP M.B. at 7-9; PICGUG M.B. at 6-7.

³³ CEPA M.B. at 15-22.

³⁴ PGW M.B. at 41-42; PGW Management Agreement (PGW M.B., App. C, tab 5) Section VII; 66 Pa. C.S. § 2212(f).

- Most importantly, from a very practical standpoint, the parties have failed to understand that any loans that will be made available by the City, with the approval of City Council, will be exhausted and will not be available to supply PGW's budgeted end-of-year cash needs. Mr. Knudsen testified, without contradiction, that the first \$25 million loan available from the City may be needed as early as November. The additional \$20 million will be needed to buttress PGW's ability to "take down" its \$100 million line of credit for 5 days in June.³⁵ Again, this means that the City support is going to be needed just to deal with already budgeted, pro forma deficiencies. To the extent that any additional dollars may be available, these funds are desperately needed to serve as a backstop to deal with unbudgeted contingencies that might threaten PGW's financial status even if the full \$52 million interim rate relief is granted. As PGW explained in detail in its Main Brief, a host of contingencies could put PGW in serious financial jeopardy even if its full \$52 million rate relief request is granted. This is especially true because PGW could have justified a rate request that was at least \$20 million higher than the amount it has claimed.³⁶
- Reducing or discounting rate relief to PGW on the theory that, even if it is insufficient, the City will come to the Company's rescue will have an immediate negative effect on the Company's bond rating and its ability to continue to access the capital markets. PGW witness Barbara Bisgaier testified that one-time fixes in the form of loans or grant backs from the City would send the signal to investment

³⁵ PGW M.B. at 35.

³⁶ PGW M.B. at 28-34.

analysts that PGW is not a “going concern,” calling into question its ability to weather the financial storms both now and in the future.³⁷

- Just as important, the Management Agreement specifically states that PGW is entitled to revenues that cover all of its expenses, debt service, a reasonable amount of cash, working capital and the required \$18 million payment to the City. Accordingly, as a matter of law, loans provided by City/owner cannot be a replacement for the PUC’s obligation to set rates to cover all of these items.³⁸
- The loans themselves are being made with the express provision that they will be able to be paid back in twenty-four (24) months. Mr. Knudsen testified without contradiction that substantial interim rate relief was necessary in order to be assured that PGW would be in a position to pay back these loans.³⁹
- The Commission itself has acknowledged its obligation to follow the ratemaking methodology and requirements that were utilized to set rates for PGW before jurisdiction was conferred on the PUC.⁴⁰ This is a requirement that the PUC’s own Office of Trial Staff has candidly and forthrightly acknowledged.⁴¹ That

³⁷ PGW-IR St. 2 at 10. CEPA attempted to impeach Ms. Bisgaier’s credibility on this issue by pointing out that she has advised the City as well as PGW on various bond issues. CEPA unfortunately failed to note that she had nothing to do with Philadelphia’s budgets and that her role for the City was limited strictly to assisting it in issuing long-term and short-term debt. PGW-IR St. 2 at 1-2.

³⁸ PGW M.B. at 41-43.

³⁹ *See*, Tr. 152, PGW-IR St. 1.1 at 5-6.

⁴⁰ PUC Order at 6, 10, 12 (ordering paragraph 4).

⁴¹ OTS M.B. at 3-4.

methodology does not include discretion to offset otherwise legitimate revenue requirements by potential help from the City.

- An even stronger case, if that is possible, can be made that the PUC does not have discretion to order, force or otherwise compel the City to “give up” the \$18 million payment that PGW is obligated to make under the Management Agreement. While some of the parties urge that the City’s \$18 million payment could be used in lieu of rate relief, they neglect even to cite the provision in the Gas Choice Act that absolutely guarantees that this payment be reflected in the Company’s rates.⁴²

⁴² 66 Pa. C.S. § 2212(f). The Management Agreement is an agreement between PGW and PFMC approved by ordinance. *See* PGW M.B., App. C, tab 5. AAGP (AAGP M.B. at 7-9) does cite Section 2212(f) and argues that while it precludes the PUC from requiring the City to forgo the City payment, the PUC may consider the forgoing of the payment in considering rates. This makes no sense. Simply put, the PUC is barred from doing indirectly what it may not do directly. Moreover, AAGP’s comparison to investor-owned utilities is also inapposite. There is no statutory provision such as Section 2212(f) that requires revenues to cover such a payment to investor-owned utilities. It is true, as AAGP contends, that the PUC does not guarantee the payment: that is between PGW and the City. But AAGP is surely correct when it says (inconsistently with its argument) (AAGP M.B. at 9):

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.

AAGP further contends that since the annual \$18 million payment is not a new expense, it is in rates already and that the Commission should not base its grant of interim relief on the necessity to make that payment. This argument, too, is illogical. The payment is one of the line items in PGW’s revenue requirements all of which, when added together, produce a \$52 million additional revenue requirement. Thus, the rate relief requested is not specifically directed to the City payment, but this payment is part of the revenue requirement that is required by the Management Agreement and Public Utility Code.

The Commission shall permit [PGW] to impose, charge or collect rates and charges as necessary to permit [PGW] to transfer or pay to the city that is the owner of [PGW], 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.

- Replacing PGW's needed rate relief with assumptions about the City's support, would punish the City for doing precisely what the parties have urged — stand in support of PGW in its time of difficulty. If the City had failed to acknowledge any responsibility to PGW, no party would be able to claim City dollars were available and should be used as an offset for rate relief. The obvious lesson that will be communicated is that it would be better to allow the Company to make its case to the Commission without any City help. A message that is contrary to the one that should result from this proceeding.
- Appropriating the City's support in lieu of a rate increase also inappropriately dictates to the City where it shall expend its limited tax dollars. PGW is made up of ratepayers who are, in most respects, identical to the taxpayers whose hard-earned tax dollars will be used to support PGW. In essence, the City's decision to provide a certain amount of funds to PGW means that other City projects — such as the needed upgrades to the public schools, reduction of urban blight — will not as likely be funded. It is clearly for the City of Philadelphia to make these determinations, not the parties to this rate proceeding or the Commission.

Considering the disastrous effect if some of these contingencies come to pass and the simple lack of any other available source of financial insurance, it would be unreasonable to the extreme to succumb to the pleas of the various parties and reduce the interim rate relief request as

a consequence of the City's good faith attempt to provide financial support in these times of stringency.

IV. THE RECOMMENDATIONS OF THE PARTIES ARE INADEQUATE TO MAINTAIN THE FINANCIAL STABILITY OF PGW UNTIL A PERMANENT BASE RATE DECISION CAN BE MADE

A. Introduction

As detailed in PGW's Main Brief, while recognizing that PGW needs at least a portion of its interim rate request, the other parties' reconsideration fall short of the amount necessary to satisfy the Company's clearly established revenue requirement. The deficiencies can be attributed to the parties' failure to recognize the need to provide PGW with sufficient projected income to assure that its end-of-year coverages will be satisfied and that it will have sufficient revenues to meet its cash needs through and at the end of its fiscal year. They rely instead on hoped-for loans and forced grants from the City. In their calculations, OCA and OTS have also understated PGW's likely bad debt expense for the test year, improperly adjusted PGW's pro forma revenues to eliminate the Company's warmer weather modification and have failed to recognize that PGW's projected expense levels already include an assumed \$14 million in hoped-for expense savings.

B. The Recommendations of the Parties Do Not Provide Sufficient Assurances That PGW Will Be Able to Meet Its Bond Ordinance Covenants and Inappropriately Rely On Hoped-For Assistance From the City.

The parties' recommendations have in common a refusal to recognize the need for rate relief that not only provides for adequate coverages and cash on a *pro forma*, normalized level but that also recognizes the need to build in some level of cushion to account for unbudgeted

contingencies. OCA's recommendation makes no provision for such likely occurrences, recommending a rate increase that would produce just the minimum 1.5x coverage necessary to be realized to avoid a technical default.⁴³ PGW demonstrated in its Main Brief that its interim rate relief request was designed not only to produce adequate coverage levels, but also to ensure that the Company had sufficient cash at the end of the fiscal year to pay its bills before it is able to collect additional revenues before next winter, and that both needs supported its rate relief.⁴⁴ Indeed, when the additional gas costs that the parties have acknowledged PGW will incur are factored in, PGW's end of year cash balance — even if the entire \$52 million is awarded — will be well below its established end of year cash needs.⁴⁵ Hence, the PUC cannot look at coverages alone in considering the level of need of rate relief.

But even if one were to focus only on coverage levels, PGW's \$52 million rate increase request contained a number of very aggressive assumptions, including \$14 million in productivity savings, which even OCA characterized as "speculative."⁴⁶ If those productivity savings fail to materialize, a rate increase that assumes those levels, but is designed to produce coverages at just 1.5x would leave the Company millions of dollars short of meeting these requirements. For example, PGW showed that, if these productivity savings do not materialize,

⁴³ OTS's recommendations do build in a slight coverage cushion, but their calculation utilizes unrealistically low assumptions about PGW's fiscal year expenses and higher than realistic levels of revenues in its calculation. This is discussed in the remainder of this section of this brief.

⁴⁴ See PGW M.B. at 15-35.

⁴⁵ *Id.* at 34-35; Table 3.

⁴⁶ OCA M.B. at 22.

OCA's \$25 million recommendation would drop coverage to only 0.8x on the 1998 bonds — a deficiency of over \$20 million.⁴⁷ Similarly, if PGW experienced two events, an inability to realize its aggressive productivity plan and a 12.5% warmer than normal winter, the Company's resulting earnings would plummet out of sight — it would realize only a 0.4x coverage on its 1998 bonds and a \$32.2 million shortfall in funds needed for coverage.⁴⁸ Considering the scrutiny that, as we have seen, the rating agencies in the investment community are now focusing on this proceeding, it simply does not make sense to take such chances with the Company. As indicated, virtually all of the parties acknowledged that a downgrading to below investment-grade level would cost the Company and its customers enormously and should be avoided.⁴⁹

Notwithstanding these facts, OCA and its expert attempted to justify their inadequate recommendation in part on a claim that PGW's requested \$52 million interim rate increase would provide earnings and bond ordinance coverages that were significantly higher than any experienced by the Company in past years.⁵⁰

OCA's references to PGW's historical coverages and earnings fail to account for the significant changes that have occurred throughout the 1990's. First, as Mr. Knudsen explained in

⁴⁷ PGW M.B. at 49; PGW Cross Examination Exh. 1 at 5. These schedules are calculated assuming PGW's level of bad debt expense and the 3% warmer weather adjustment. Even if these items were adjusted to reflect the OCA witness' claims, the coverage would still fall well short of the minimum legal requirements.

⁴⁸ PGW M.B. at 50; PGW Cross Examination Exh. 2 at 5. This deficiency can only be rectified by grants of "project revenue" not loans from the City. PGW-IR St. 2 at 16-17.

⁴⁹ PGW M.B. at 20-21.

⁵⁰ OCA M.B. at 32-33; OCA St. 1 at 21-22.

his testimony, PGW's coverage calculations changed dramatically in 1998 such that, in effect, the same amount of funds available to service the debt service now produce dramatically higher coverages for both of the 1975 and 1998 bonds.⁵¹ Indeed, PGW's 2.6x coverages that would be produced on a *pro forma* basis by the \$52 million rate increase would, if calculated using the pre-1998 method, produce approximately only a 1.7x coverage. The 1.7x coverage is within the range established by PGW's previous regulator, the Philadelphia Gas Commission ("PGC"), when it was attempting to focus on the level of coverages that it sought to permit the Company to obtain as a financial target.⁵²

With respect to earnings levels, OCA has also overlooked the fact that in the past, while PGW's earnings were lower than those that would be produced on a *pro forma* basis by the interim rate filing, the Company was operating with, at least, a reasonable amount of lending ability so that it could balance or rearrange its other operating expense and earnings needs.⁵³ As Mr. Knudsen testified, the situation has dramatically changed and PGW now has no lifelines left — i.e., it has fully utilized its maximum amount of commercial paper line of credit and has no

⁵¹ PGW St. 1.0 at 17-18.

⁵² While PGW's original calculation produced a 1.74x coverage using the pre-1998 coverage calculation method, its revised calculation — taking into account the Company's \$75 million increased gas costs which it will be required to recover eventually from customers — produced even lower coverages under the historic coverage calculation method, in the neighborhood of 1.7x. When OCA witness LeLash was asked about this testimony, he admitted that he had not reviewed Mr. Knudsen's analysis (Tr. 272-273), perhaps explaining why he felt justified in a recommendation that produced such low coverages.

⁵³ PGW-IR St. 1 at 7-8, n. 3.

funds available from its previous long-term capital placements. While it intends to go to the market in the spring to provide additional financing, the ability to place that bond issuance is largely dependent upon the level of rates that it is able to secure from this Commission. As indicated, the only additional source of support for PGW is the City loans, which these same parties wish to appropriate without considering what the Company would do if there were an additional emergency.

C. Establishing PGW Interim Rates To Cover Its Cash-Working Capital Needs is Required By Law, Is Necessary To Maintain PGW's Financial Condition And Is Fully Supported By The Record

OCA and CEPA, among others, have insisted that PGW's interim rates should, at most, be set only to allow PGW to maintain its bond ordinance covenants at their minimally required levels and no more, and that PGW's cash-working capital needs both throughout the 2000-2001 winter and in the months prior to next winter should be ignored.

OCA argues that the PUC Order authorizing this interim request does not require that the interim rate award be set to assure that the Company has adequate cash at the end of the 2000-2001 fiscal year,⁵⁴ and that, due to the expedited nature of the proceeding, it did not have sufficient time to investigate PGW's projected *pro forma* revenues and expenses for the 2000-01 fiscal year.⁵⁵ OCA also contends that adoption of the cash flow method of setting rates would somehow relieve PGW's owner from assuring adequate financing for the Company.⁵⁶ As PGW

⁵⁴ OCA M.B. at 17.

⁵⁵ *Id.* at 35.

⁵⁶ *Id.*

set forth in its Main Brief, these contentions simply are not true. In summary, the reasons these arguments must be rejected are as follows:

- As OTS concedes,⁵⁷ the Gas Choice Act plainly established that, in determining the level of rates that PGW may charge to its customers, the PUC must apply the ratemaking methodologies and requirements that were used prior to the PUC's assumption of jurisdiction over PGW. PGW's brief sets forth case after case decided by the PGC in which it reaffirmed this rate-making methodology, as well as cases by the Supreme Court of Pennsylvania which recognized this method and affirmed its reasonableness.⁵⁸ While both OCA and CEPA have suggested that the PUC is somehow free to disregard its legal obligation because the PUC is setting "interim" rates — this is obviously not the case. The Public Utility Code has established the legal requirements that the PUC must use in "determining [PGW's] revenue requirement" until all of its bonds have been retired or refunded; there is no exception for particular types of cases.⁵⁹ Indeed, the PUC's

⁵⁷ OTS M.B. at 3-4.

⁵⁸ *See*, PGW M.B. at 10-13.

⁵⁹ 66 Pa. C.S. § 2212(e). OCA also urges the Commission to consider the "extraordinary rate relief" cases under Section 1308(e), in lieu of the cash flow method, but concedes that such cases are not "directly applicable." PGW agrees that these cases are not on point. Indeed, Section 1308(e) was not invoked by PGW and the Commission has no authority to act *sua sponte* under this provision, having enunciated the standard it would use in its August 17 Order. *Masthope Rapids Property Owners Council v. Pa. Publ. Util. Comm'n*, 135 Pa. Commw. 437, 447, 581 A.2d 994, 999 (1990). Indeed, even OCA's reliance on the Commission's opinion in the 1980 *Metropolitan-Edison* case seeking extraordinary rate relief in the wake of TMI is misplaced. In that case, where the petition accompanied a full base rate case, the PUC, noting it had previously given the company relief to "rehabilitate itself" in the eyes of its bank creditors, accelerated consideration of the base rate case. Here the request is to keep PGW from having to "rehabilitate" itself by avoiding a default. The PUC also noted that Met-Ed had not met its burden of proof by identifying the specific needs or intended use of the interim rate increase it sought.

(continued...)

Interim Rate Order reiterated and affirmed this standard. That the ratemaking methodology used previously by the PGC included an allowance for PGW's documented cash-working capital requirements is beyond cavil. Indeed, while CEPA claimed that PGW had not "proven" that the PGC had always used this approach (particularly in interim or emergency cases)⁶⁰ in setting its rates, just the opposite is true. PGW submitted considerable testimony on this point in which it specifically discussed both the procedural and substantive standards that the PGC previously had employed, in cases, including in an emergency rate proceeding.⁶¹ CEPA, on the other hand, submitted no testimony and was not able to point to a single PGC case or other contrary authority to support its position. This comparison should dispositively establish that the cash flow method is a ratemaking requirement that must be used in this proceeding.

- OCA's claim that the PUC need not examine PGW's cash-working capital needs at the end of its fiscal year⁶² may be a suggestion that the only period to which the PUC intended to look in setting rates in this interim period was the actual winter months (for PGW, December - March). But, the PUC's Order clearly indicated that its intention was to address PGW's revenue requirement needs not only in the 2000-01 winter, but beyond the winter, i.e., revenues "required to fund operations . . . until the Commission can conduct and rule on a full base rate proceeding."⁶³

(...continued)

That too is clearly different than this case, where Mr. Knudsen has detailed the need for and use of the interim rate increase at great length.

⁶⁰ CEPA M.B. at 23.

⁶¹ PGW-IR St. 1.0 at 15-17.

⁶² OCA M.B. at 17.

⁶³ PUC Order at 7 (emphasis added).

PGW demonstrated, on the record, that because almost two-thirds of its revenues are billed during just four months — December - March (and close to 75% are billed in November - March) — PGW’s winter revenue requirement must include and provide for its financial needs throughout the fiscal year and at the end of the fiscal year. If end-of-year requirements are not addressed during the winter, it will be impossible to obtain enough revenues by raising rates after the winter to keep PGW from technical default on its bonds or from failing to make its operating payments.⁶⁴ In other words, all revenue requirements prior to next winter must be addressed by a rate award in November 2000, prior to this coming winter, or it will be “too little too late.” Despite the OCA comment in its Brief, its *expert witness recognized that PGW’s end of year cash and earnings needs were part of its winter revenue requirement needs;*⁶⁵ and that the Company’s interim request was not designed to address any long-term financial issues for PGW,⁶⁶ but was only a bridge from the present to “next fall.”⁶⁷ Considering this evidence, and the ratemaking methods and requirements applicable to PGW, the Company’s end of year cash needs must be considered in determining the appropriate interim revenue requirement.

- Finally, OCA and CEPA are simply not correct in their claim that recognizing PGW’s cash- working capital needs in rates is somehow unreasonable and “unfair” to ratepayers, and would allow the Company’s owner to avoid its obligations as “owner.” These comments appear to be based upon a

⁶⁴ PGW M.B. at 13-15.

⁶⁵ Tr. 283-84.

⁶⁶ *Id* at 282.

⁶⁷ Tr. 281. The OTS also recognized that the relevant period for this case was the fiscal year 2000-2001 including the end of the year. OTS M.B. at 16.

misunderstanding of the Company's historical and existing regulatory scheme. The Management Agreement clearly mandates that PGW's cash-working capital needs may be secured from ratepayers because the activities and operations that produce PGW's needs are and continue to be so heavily regulated. PGW's operating and capital budgets are first approved by the Philadelphia Facilities Management Corporation, PGW's governing board, made up of appointees of the Mayor. Next, PGW's operating and capital budgets must be approved by the PGC, which continues to exercise this oversight function. PGW's operating and capital budgets, which served to generate its original \$52 million request, are scheduled to be reviewed and approved by the PGC in the next months. Thus, the level of cash needed is based upon all of these revenues and approvals. Finally, in the permanent rate case the Commission will have the opportunity to review, in greater detail, PGW's budgets and budgeting approval process for reasonableness, thereby alleviating any concern about the lack of time to do a detailed review of PGW's filing.

- While OCA's brief questions the "reasonableness" of PGW's claim for cash-working capital at year end from a policy standpoint, it has never challenged the reasonableness or accuracy of PGW's claim in this regard. As was indicated in PGW's testimony and its Main Brief, Mr. Knudsen testified that PGW has a need for \$35 - \$40 million in liquidity at the end of the fiscal year so that it can make crucially necessary gas purchases and debt service payments prior to next winter (2001-02).⁶⁸ PGW's liquidity needs will be provided, in part, by borrowing a portion (\$21.5 million) of the proceeds of a long-term debt issuance anticipated to be issued in the spring.⁶⁹ Thus, Mr. Knudsen testified without

⁶⁸ PGW M.B. at 21-23.

⁶⁹ *Id.*

challenge that PGW needs to obtain \$13.5 million - \$18.5 million from its operations at the end of fiscal year in order to be able to fund its operations and pay its creditors.⁷⁰ These dollars can only be generated by sufficient increases in base rates prior to the start of this coming winter. Significantly, when questioned about PGW's end of year cash needs, OCA witness LeLash did not dispute PGW's need to secure this level of end of year cash.⁷¹

By OCA's own admission, Mr. LeLash's calculation manages to achieve a positive end of year cash balance only by imputing into PGW's revenues a potential backstop loan that the City Administration has requested be made available.⁷² Without using the City emergency loan (which, as explained above, would be illegal and inadvisable), under Mr. LeLash's recommendation PGW would be left with negative \$8.8 million cash balance — inadequate from any perspective. These failures alone cause the recommendations of both the OCA and the OTS to be understated by tens of millions of dollars.

D. The OCA and OTS Recommendations Use An Inappropriately Low Level of Bad Debt Expense

OTS and, implicitly, OCA dispute the level of bad debt or "uncollectible account" expense included in PGW's calculation of its pro forma earnings and fiscal year cash flow analysis.⁷³ The level of bad debt expense assumed in the analysis will reduce end of year net

⁷⁰ *Id.*

⁷¹ Tr. 243 ("[A] number in that order of magnitude [i.e., \$35M - \$40M] certainly will be beneficial to the company. Whether you absolutely need that full level is a little bit more difficult to say.")

⁷² *See* Attachments to OCA M.B; OCA Sch. 2.1, 3.1.

⁷³ OTS M.B. at 12-16; OCA witness LeLash did not present detail on his \$25 million
(continued...)

income and funds available for debt service. A higher level of assumed bad debt expense will lower earnings and funds available and increase the level of interim rate increase necessary in order to meet certain target coverage levels. The assumed uncollectible factor, as a percentage of revenues, also affects (to a much smaller degree) the cash flow analysis. PGW's sources of cash — its billed revenues — are reduced to account for the fact a portion of those billed revenues will not be collected.

PGW's original calculation of its bad debt expense assuming a \$52 million rate increase was \$57 million.⁷⁴ In its update of its projected financial results,⁷⁵ it assumed a \$61.7 million level of bad debt expense to account for the projected additional gas costs it was going to have to collect in its GCR this fiscal year and to recognize that the higher level of overall increase would result in relatively more revenues becoming uncollectible, thereby justifying a slightly greater uncollectible percentage of 8.4%, comparable to the level PGW has experienced in the last several years.⁷⁶

(...continued)

revised revenue requirement recommendation, but testified that in calculating the coverages produced by the number he had set bad debt expense "close to" the level used by the OTS — \$52 million. Tr. 230.

⁷⁴ OTS implies that this level is excessive by comparing it to the Company's historic 1998-99 fiscal year realized level — without any rate increase. OTS M.B. at 12. But that is an apples to oranges comparison. PGW's calculation of its 2000-2001 fiscal year bad debt expense without GCR or an interim rate hike is \$47.3 million or \$5 million lower than OTS's proposal.

⁷⁵ PGW-IR Exh. 1.3, Sch. 3.

⁷⁶ PGW M.B. at 40, n. 129; PGW Cross Examination Exh. 1-2, p. 1. AAGP appears not to
(continued...)

OTS recommended a percentage of 7.392% based upon PGW's historical experience in the 1994-1998⁷⁷ time frame without considering PGW's more recent experience during the last few years or its likely experience this fiscal year. But, as Mr. Knudsen testified, the level of uncollectibles to be experienced in this fiscal year will be directly affected by the large rate increases that PGW customers will experience.⁷⁸ PGW's GCR rate will go up 20% - 30%, either immediately or in the next several months, and PGW's revised GCR claim represents a 25% increase by itself, even without consideration of any proposed interim increase. Mr. Knudsen testified that, in prior periods of rapidly escalating rates, not only did the absolute levels of bad debt increase but the relative levels jumped dramatically as well. For example, in the 1978-84 time frame — a period universally acknowledged as one of rapidly rising rates⁷⁹ PGW's bad debt percentage increased from 2.17% to as high as 5.55% a 155% increase; and its Bad Debts as a percentage of accounts receivable ballooned from 12.96% to 35.44%, an increase of 173%.⁸⁰ It is simply not realistic to utilize a bad debt expense percentage calculated from an old, historic

(...continued)

understand this when it contends that increases in natural gas costs should not be considered as a reason for increasing base rates, but should be considered in PGW's GCR case (AAGP M.B. at n. 7). PGW is not seeking to recover these costs in its base rates, but it must recover those incremental costs that will result from higher gas costs, such as bad debt expense, and must reflect the consequential cash flow impacts from these higher costs in its base rates, as it has done here.

⁷⁷ OTS M.B. at 13.

⁷⁸ PGW-IR St. 1.1 at 11.

⁷⁹ *See*, PGW-IR St. 1.1 at 11; Tr. 322.

⁸⁰ PGW-IR Exh. 1.3, Sch. 2.

period without recognizing PGW's most recent experience and the documented effect of rapidly increasing prices on the likely results.

OTS witness Weakley declined to utilize the Company's calculation because of several misunderstandings. First, he asserted that PGW's claim should be disregarded because PGW had not presented any schedules or analysis to support its claim.⁸¹ But that criticism is unfounded. PGW's 2000-2001 operating and capital budgets, which collectively form the base case for PGW's rate increase claim, contain literally hundreds of elements. PGW, in fact, provided ample back-up material to the parties before the PGC (in a proceeding in which PGW's request is being examined from the standpoint of whether its proposed operating budget is reasonable) and was prepared to present the same material in this case.⁸² PGW recognizes that the time frame for this case — by necessity — was tight, but OTS never requested this considerable back-up material be submitted. Otherwise, PGW would have provided it for the record.

Second, Mr. Weakley declined to consider PGW's most recent experience in making his recommendation due to a mistaken belief that PGW's "billing problem" during 1999 and 2000 — an inability to bill a small percentage of its customers — affected its bad debt experience in those years. However, those unbilled customers are not "uncollectible" or bad debts and thus would not affect the results. Indeed, PGW's billing problems likely will increase its bad debt

⁸¹ OTS M.B. at 12-13.

⁸² PGW responded at the PGC to at least five interrogatories from various parties that detailed its recent and historic bad debt experience and how it calculated its factor. *See, e.g.*, PGW answers to PA-65, PA-66, ID-8, SD-139 and PICGUG-23. Indeed the OTS actually used one of those answers to calculate its own out-of-date percentage. *See* OTS Exh. 1, Sch. 5.

expense in future years as customers who have been given an extended period to pay previously unbilled amounts fall into the uncollectible category. This phenomenon clearly justifies a higher percentage for bad debt because it is important, considering the consequences, that interim rates be set on the most realistic level of expenses and revenues possible.

Further, the OTS appeared to believe that the level of a projected bad debt expense that PGW will experience by the end of the year is “not relevant” because “by late August, the rate effective period for the Interim Rate Filing will be close to expiring. . . .”⁸³ But, as Mr. Knudsen explained, the Company’s practice is to set its level of write-offs (and, thus, its uncollectible/bad debt expense) for that year based upon an end of year evaluation of its experience over the winter.⁸⁴ Thus, the way in which PGW’s customers will respond to the high level of proposed GCR and interim rate increases will affect its fiscal year 2000-01 bad debt expense as well as bad debt expense in the future year and, most importantly, will affect its 2000-2001 year-end earnings — funds available for debt service and cash. Moreover, the available evidence for PGW is that in times of rapidly increasing prices, not only does the absolute amount of bad debt expense increase, but the percentage of uncollectible relative to revenues grow as well.⁸⁵

⁸³ OTS M.B. at 16.

⁸⁴ Tr. 190.

⁸⁵ Mr. Weakley appeared to misunderstand PGW’s use of the historic data. PGW used those data only to demonstrate that historically — for PGW — the uncollectible percentage rose as rates continued to increase, the percentage of uncollectible also increased, not that the 2000-2001 period was identical to those historic periods. Also considering PGW’s special demographics, Mr. Weakley’s rejection of this analysis based upon his analysis of other non-municipal utilities (Tr. 322) was in error.

Finally, OTS's recommendation on bad debt expense does not appear to completely recognize the crucial need to set rates to assure both that PGW will not run afoul of its debt service coverage levels and its end of year cash needs. Rather than a typical "bottom's up" approach used in most rate proceedings, the calculation here must assure that, at the end of the day, PGW meets these goals or a real calamity will result (contrasted to the typical rate case where a failure to accurately project an expense in a future test year might only shave a point or two from the utility's realized rate of return). In this context, if unrealistically low bad debt expense is calculated and an interim rate award is set at a level that is inadequately low, PGW will find itself in technical default on its bonds and without the revenues at the end of the year to pay its bills. It is for this reason that, when calculating the coverages and end of year cash produced by PGW's requested \$52 million increase, PGW utilized a realistic uncollectible factor of 8.4% — reflective of its most recent experience — and applied it not only to the \$97 million GCR increase and its proposed \$52 million base rate increase but to the additional gas costs — \$75 million (estimated at the time at \$70 million) — that PGW has identified in the GCR proceeding, a portion of which (\$23 million) it has asked to have immediately reflected in its revised claim (with the rest to be recovered shortly thereafter.)

Failure to project bad debt expense accurately could have an enormous negative impact. For example, if PGW's bad debt expense (rather than the OTS recommendation) is used to calculate the coverages produced by the OTS recommendation, PGW's resulting coverages would drop 20-30 basis points. As Mr. Weakley testified, he viewed it important to maintain the level of coverages reflected in his original recommendation (2.51x for 1975 ordinance bonds and

2.38 x for 1998 ordinance bonds) as a “cushion.”⁸⁶ Accordingly, just to account for this one item, OTS’s recommendation would have to increase by \$9.6 million to maintain these coverage levels.

E. The Parties Have Failed to Take Account of The Fact That PGW’s Hoped-For Productivity Savings Are Unlikely to Be Fully Realized in The Next 12 Months

In addition to the other deficiencies, and as indicated above, the recommendations of both OCA and OTS fail to recognize (or fail to recognize sufficiently) that the *pro forma* income, funds available and cash flow analysis presented by the Company included an extremely aggressive goal of reducing its ongoing expenses by \$14 million during the fiscal year. That assumption was key in PGW’s holding its interim rate increase request to just \$52 million.⁸⁷ But the other parties overlooked this when they made alternative recommendations suggesting that PGW’s financial condition could be maintained with a far smaller increase.

To his partial credit, OCA witness LeLash recognized this omission and recommended that his original recommendation be increased, in part to account for his conclusion that PGW’s hoped-for productivity savings were unlikely to be realized in full in the fiscal year. But, by adding back only \$4 - \$5 million, Mr. LeLash still assumed that PGW would realize over 60% of the \$14 million hoped for savings — \$9 million - \$10 million. OTS witness Weakley, while agreeing that his recommendation was based upon the Company’s calculations as a starting point, and thus included PGW’s hoped-for productivity savings, did not adjust his recommended

⁸⁶ OTS Exh. 1, Sch. 3; Tr. 321; OTS M.B. at 18-19.

⁸⁷ PGW-IR St. 1.1 at 9.

\$27.5 million level of increase to account for the realization that the full amount of productivity savings will not be realizable in the fiscal year or shortly thereafter.⁸⁸

PGW's position has been very clear on this point. PGW is still committed to trying to find a large level of productivity savings, but the level it had set as a goal when it proposed a \$52 million rate increase is not an appropriate assumption when parties are attempting to find the minimum level of increase that could be awarded to PGW and still allow it to meet its debt service coverage requirements and cash flow needs until a permanent base rate increase can be realized.⁸⁹ While it has already achieved some savings,⁹⁰ the rest will be challenging and it is very unlikely, at the very least, that the great bulk of these will become a reality during the fiscal year or before next winter.⁹¹ Again, if realistic projections are not utilized, PGW could easily find itself in grave financial difficulty at year end, a difficulty which, because of PGW's seasonal billing problem (*i.e.*, most revenue billed in the winter), will not be reparable by the PUC at that time. If more realistic assumptions about the actual level of productivity savings are made, both the OCA and the OTS recommendations would have to increase. Assuming that PGW achieves \$4 million (as opposed to \$14 million) in savings, the OCA recommendation would increase —

⁸⁸ Tr. 324-26.

⁸⁹ Tr. 194-95.

⁹⁰ Tr. 236-38.

⁹¹ Tr. 194-95; OCA St. 1 at 42.

just for this item — to \$30 million.⁹² A similar revision for the OTS would increase its recommendation to \$37.5 million, again, just for this item alone.

F. PGW'S Base Case Weather Normalization Adjustment Is Reasonable and Oca's and OTS's Objections Should Be Rejected

OCA and OTS each objected to PGW's base case \$4.0 million weather normalization adjustment⁹³ and propose to decrease PGW's revenue requirement with respect to the adjustment.

OCA also objected to PGW's proposed grandfathering of its 20% senior discount.⁹⁴

First, PGW is not pursuing the senior citizen discount in this interim case. Second, PGW's conservatively small adjustment for weather is reasonable and should be accepted.⁹⁵

- The \$4.0 million marginal revenue loss-weather adjustment reflects approximately 125 BCF of lost firm sales and corresponding margins as a result of recent warmer-than-normal winter heating seasons. The assumption for the 2000-2001 budget year equates only to a 3% warmer winter heating season.⁹⁶
- In each of the last three years, PGW has experienced much warmer than normal weather — last year it was 15% warmer than normal⁹⁷ — as a result of which

⁹² OCA's revised recommendation of \$25 million includes \$9 million of productivity savings; if savings are only \$4 million, the rate increase must rise by \$5 million.

⁹³ OCA M.B. at 19-21; OTS M.B. at 10-11

⁹⁴ OCA M.B. at 21.

⁹⁵ This adjustment is explained in the testimony accompanying the PGW Operating Budget included as part of PGW-IR Exhibit 1.2 to PGW-IR St. 1.0 (Exhibit A-1, line 5).

⁹⁶ PGW-IR Exhibit 1.2 (Prepared Direct Testimony of Joseph R. Bogdonavage at 5.)

⁹⁷ Tr. at 256.

PGW lost \$25.0 million in margin and earnings in that year alone.⁹⁸ These weather conditions have, in large part, been the cause of PGW's financial predicament,⁹⁹ and should not be ignored. Management was rightly concerned that recent experience of weather that was 10% to 15% warmer than normal required some recognition of potential financial exposure.¹⁰⁰

Significantly, OTS also does not agree with using 4,600 degree days, because, it claims, it is based on outdated information,¹⁰¹ but is willing to accept PGW's "normal" level (without adjustment) for purposes of this interim case because the rates are subject to refund.¹⁰² This is all the more reason to accept PGW's normalization adjustment. PGW is not attempting to formulate a degree-day revision in this case, but simply trying to better reflect a normal level for this interim period — which is subject to refund. While OCA and OTS have focused on the fact that long-term averages have not changed the average degree day level significantly, the actual 30 year average, however, has dropped to 4569 degree days or 0.7% lower than the assumed

⁹⁸ PGW St. 1.0 at 12.

⁹⁹ OCA witness LeLash candidly admitted that PGW's current position can largely be attributed to the milder than normal weather experienced over the past three winters, as a result of which PGW did not recover its fixed costs. OCA St. No. 1 at 8.

¹⁰⁰ PGW-IR Exhibit 1.2 (Prepared Direct Testimony of Thomas B. Knudsen at 4-5.) Mr. Knudsen clarified that PGW is not now attempting to make a formulaic change to the method by which basic sales are computed in projecting revenues of 4600 degree days; it is simply proposing an adjustment to revenues to recognize the effect on margins of a conservatively 3% warmer than normal year.

¹⁰¹ OTS St. 1 at 4.

¹⁰² OTS M.B. at 10-11, n. 6; OTS St. 1 at 4-5.

“normal” and the 10 year average is now 4418 or 4% lower than “normal.”¹⁰³ In the base rate case to be filed by January 2001, the parties will have the opportunity to address a revision to the normal degree days applicable to PGW. But certainly, for the purpose of budgeting for an interim rate case, PGW should be permitted to reflect the gross undercollection it has suffered because of warmer temperatures in the last three years so that it may avoid a similar substantial undercollection this year. In any event, when the additional revenues from the grandfathering of the senior citizen discount, which PGW is not pursuing in this interim case, is netted against the \$4 million downward weather adjustment, the effect on the fiscal year is minor — \$2.5 million.

G. Summary of Deficiencies in OCA Recommendations

OCA’s \$25 million recommendation, therefore, is deficient from a number of standpoints:

- The OCA should not have reversed PGW’s reasonable warmer weather adjustment, but since the senior citizen discount will not be pursued in this case, the net effect of the two is minor;
- OCA’s position sets PGW’s earnings and funds available to produce just 1.5x — the legal minimum on one of PGW’s bonds, meaning that even a minor contingency event could result in a technical default and result in a downgrade to junk bond levels and a loss of its short-term borrowing ability. If productivity savings do not occur and the winter is as warm as last year, OCA’s recommendation will be a disaster;¹⁰⁴

¹⁰³ OCA St. 1 at 39.

¹⁰⁴ AAGP also supports certain of Mr. LeLash’s exhibits that would result in bond coverages
(continued...)

- The financial results shown for OCA's \$25 million calculation are unrealistically optimistic because they include an unreasonably low level of bad debt expense and an unrealistically high level of assumed productivity savings. Fixing these two items would result in increasing OCA's recommendation to \$39.5 million (\$5 million for additional unrealized productivity savings and \$9.6 million for additional bad debt expense). Even with these adjustments, PGW would still have 1998 bond coverages of just 1.5x;
- OCA's recommendation produces negative cash balances at the end of year and would not allow PGW to meet its obligations to its commercial paper lender. To reach the needed \$13.5 million - \$18.5 million level, OCA's year end recommendation would have to increase by \$22.3 million - \$26.5 million or a total interim increase of \$47.3 - \$51.5 million.

H. Summary of Deficiencies in OTS Recommendations

- OTS similarly inappropriately takes issue with PGW's warmer weather adjustment, but the effect is minor;
- OTS's recommendation utilizes an unrealistic low level of uncollectible expense — \$52 million — whereas PGW's analysis shows that with the additional gas costs that PGW will experience its bad debt expense will be \$61.7 million. If that

¹⁰⁴(...continued)

of over 2x, which AAGP considers a "cushion" (AAGP M.B. at 15). AAGP neglects to mention that these coverages are obtained only by Mr. LeLash assuming that the \$18 million payment to the City is granted back to PGW in addition to a \$20 million loan from the City.

level were used, OTS's recommendation would increase by approximately \$9.7million;

- OTS failed to recognize that its calculations included \$14 million in productivity savings. If just \$4 million in savings are assumed to occur in the fiscal year, OTS's calculated revenue requirement would increase by \$10 million. These two adjustments alone (*i.e.*, bad debt expense and reversed productivity savings) would mean that OTS's recommendation would have to be revised to \$47.2 million in order to produce the same coverages;
- OTS fails to recognize that the end of year cash balances produced by its \$27.5 million recommendation produces just \$2.5 million in year end cash. To reach the level that PGW established as being required, OTS's recommendation would have to increase to \$38.5 million - \$43.5 million.

I. Summary of Deficiency of Position of PICGUG

PICGUG's recommendation of \$15.6 million was not based on any accounting calculation of coverages or cash flow and, thus, is not supportable and should be disregarded. It appears to be based upon PICGUG's misguided assumption that a technical default on PGW's bonds would not have the disastrous effect of causing a downgrade to junk bond status and an end of PGW's access to the credit markets. The recommendation completely ignores PGW's end of year cash needs on the erroneous assumption that PGW could simply cancel critical construction and maintenance projects. These arguments are not supportable.¹⁰⁵

¹⁰⁵ See PGW M.B. at 47, n. 147, 58.

V. THERE IS NO BASIS - LEGALLY OR FACTUALLY - TO DENY OR REDUCE PGW'S INTERIM RELIEF BECAUSE OF ALLEGED INADEQUATE SERVICE

Both OCA and CEPA raised the issue of adequacy of service in the context of PGW's interim rate relief request. OCA, in its brief, advocates further action by the Commission to assure that PGW makes the improvements it has committed to make.¹⁰⁶ These additional conditions that OCA wishes to have the PUC impose will be dealt with elsewhere in this Reply Brief.¹⁰⁷ It is important to note, however, that the OCA is not calling for PGW's interim rate increase to be denied due to "inadequate service."

OCA's service issues concern PGW's billing, collections and customer service ("BCCS"); mains replacement; customer service; and upgrade of liquifaction capacity at the LNG facility.¹⁰⁸ These are all issues that PGW has fully addressed in its testimony and Main Brief.¹⁰⁹ Summarily, PGW has taken strides — and has committed to take additional steps — to make improvements in the BCCS and customer service and to expend the funds necessary to accomplish the mains replacement and LNG upgrade.¹¹⁰ The best way for the Commission to assure that PGW is able to fulfill these commitments is to give PGW the rate relief it requires.

¹⁰⁶ OCA M.B. at 41, 43.

¹⁰⁷ See Section VII of this Reply Brief, *infra*.

¹⁰⁸ OCA M.B. at 43-49.

¹⁰⁹ See PGW St. 1.0 at 14-15 and Appendix C; PGW St. 1.1 at 23-24; Tr. 145-47, 148-50, 195 concerning OCA Cross Exhibit 1; PGW M.B. at 53-56.

¹¹⁰ See PGW Cross Exhibit 4.

Notwithstanding its position that no adjustment should be made at this time, OCA cites a plethora of cases regarding the Commission's discretion to make adjustments to a Company's rate increase which are inapposite since, as has been shown,¹¹¹ Sections 523 and 526 of the Public Utility Code are not applicable to PGW and there is nothing in the cash flow ratemaking methodology utilized by the PGC that incorporated a similar requirement.¹¹² Moreover, and as highlighted above, the PUC is under a legal obligation to set rates that allow PGW to satisfy its bond covenants.¹¹³ By any measure, PGW needs at least a \$25 million interim rate increase to barely meet this standard.

In contrast to OCA, CEPA wishes to have the entire rate relief denied on the basis of service inadequacy.¹¹⁴ Clearly, CEPA's demand is simply illegal and cannot be adopted. In addition to these statutory differences, the PUC cases cited as precedent to support a disallowance for inadequate service are both factually and legally inapposite. Factually, they all involve water companies where quality and delivery (quantity) issues were involved under 66

¹¹¹ PGW M.B. at 51-53.

¹¹² CEPA contends that a "whereas" clause in the Management Agreement that the City desires to provide quality gas service and a provision in that Agreement that PGW is to apply the highest standards of practice and diligence to the operation of the Gas Works are somehow equivalent to 66 Pa.C.S. §§ 523 and 526. (CEPA M.B. at 6-7). But even OCA, which raised this issue, acknowledged that these provisions are not conditions for rate relief in the Management Agreement (Tr. 269-70). Clearly these provisions are not the equivalent of 66 Pa.C.S. § 526, a provision — as seen immediately below — which has been applied only to water companies providing poor quality water and having problems delivering water to their customers — issues not present here.

¹¹³ 66 Pa. C.S. § 2212(e).

¹¹⁴ CEPA M.B. at 3-14.

Pa.C.S § 526, and the service rendered was clearly inadequate. For example, in *National Utilities*,¹¹⁵ the water delivered was unsuitable for normal use because it was dirty, rusty and smelly, when there was sufficient water pressure to deliver the water and there were many occasions where the water was simply not delivered. That case clearly involved a service inadequacy issue of a far greater dimensions than this case, where there is no substantial claim of total inadequacy of gas service to customers.¹¹⁶

Moreover, in *PG&W*,¹¹⁷ where there was also inadequate water service — due principally to the need of PG&W to improve its distribution system — the Commission granted a rate increase to be used to finance the necessary acceleration of those distribution system improvements. The PUC issued similar rulings in *Tri-Valley*.¹¹⁸ While the inadequacy in *PG&W* was also of a far greater magnitude than PGW's billing and customer service problems, the PUC

¹¹⁵ *Pa. PUC v. National Utilities, Inc.*, 87 Pa.PUC 1 (1997); *National Utilities, Inc. v. Pennsylvania Public Utility Commission*, 709 A.2d 972 (Pa. Cmwlth. 1998).

¹¹⁶ The one exception to the § 526 water cases is the historic case of *D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Comm'n.*, 466 F.2d 394 (D.C. Cir. 1972), *cert. den.*, 93 S.Ct. 688 (1972). The order there, which required the utility to improve its deteriorating service by generating some capital and allocating it to debt retirement and bus purchases before a rate increase would be permitted, was held not to deny due process. There too, the case dealt with service deficiencies of light years' magnitude of difference from what the record shows here.

¹¹⁷ *Pa.PUC v. Pennsylvania Gas and Water Co.*, 79 Pa. P.U.C. 349 (1993).

¹¹⁸ *Pa.PUC v. Tri-Valley Water Supply, Inc.*, 1996 WL 481097 (Tentative Order entered May 16, 1996); 1996 WL 482989 (Order on Reconsideration entered May 28, 1996).

did grant rate relief. In this case, PGW has already committed to the capital improvements contained in its budget.¹¹⁹

OCA erroneously claims that the Commission must consider quality of service in determining whether a rate increase is just and reasonable.¹²⁰ This is incorrect. Ordinarily, a public utility has a constitutional and statutory right to a reasonable rate of return. A just and reasonable rate is one that gives the utility a fair rate of return. *Action Alliance of Senior Citizens v. Philadelphia Gas Comm'n*, 45 Pa. Cmwlth. 234, 406 A.2d 1155 (1979). While 66 Pa.C.S. § 526 permits the Commission to reject in whole or in part a rate increase for those utilities subject to that section where service is inadequate, that determination is not based on a just and reasonable standard, but has been deemed a reasonable action where a utility refuses, or has chronically failed, to take the steps to improve clearly inadequate service. Section 526 was held not to violate the Constitution in *National Utilities* where a rate increase was denied because of grossly inadequate water service. But the Commonwealth Court nevertheless pointed out, in *National Utilities*, that the utility did in fact have a rate of return — albeit reduced — even absent a rate increase, and suggested that if the utility was not achieving any return, or was unable to pay its debts or was not recovering sufficient revenues to remain in business, the result would have been different.¹²¹ Some or all of those results would occur if CEPA's recommendation were followed.

¹¹⁹ OCA M.B. at 43-50.

¹²⁰ OCA M.B. at 40.

¹²¹ *National Utilities*, 709 A.2d at 980, n. 12.

CEPA relies on Mr. LeLash's and public input testimony to support its position.¹²² The former, as we have shown,¹²³ consists basically of self-serving, isolated hearsay excerpts extracted by Mr. LeLash and CEPA from various draft¹²⁴ reports prepared by consultants retained by PGW – which are not part of the record. These draft reports were commissioned by PGW, not to serve as definitive audits of its services, but to assist PGW in improving those services. Indeed, a PUC management audit is presently under way; that audit will be an appropriate vehicle for determining PGW's progress in meeting its "Transition to Excellence" in its base rate case to be filed shortly.¹²⁵

Indeed, Mr. LeLash conceded that the purpose of those draft reports was not to determine whether PGW's service is inadequate under some quantitative standard promulgated by the PUC or other evaluating body,¹²⁶ and he specifically stated that there was nothing in those reports which referenced or attempted to evaluate PGW with respect to meeting standards enunciated by the PUC.¹²⁷

As for the public input testimony, it too did not come anywhere near the testimony necessary to establish inadequacy of service below a Commission standard as in *National*

¹²² CEPA M.B. at 9-14.

¹²³ PGW M.B. at 53-56.

¹²⁴ Mr. LeLash conceded this. Tr. 274, 285.

¹²⁵ PGW-IR St. 1.1 at 24.

¹²⁶ Tr. at 274-75.

¹²⁷ Tr. at 275; *See also*, PGW M.B. at 54-55.

Utilities or *PG&W*. Moreover, as ALJ Chestnut recognized,¹²⁸ while the Commission did not, in her opinion, restrict parties from raising issues such as adequacy of service, in view of the short time frame involved, it would be unfair to subject PGW to the impossible task of responding to allegations taken from public input and draft reports. The PUC should, therefore, not use this interim case as a vehicle for determining service adequacy, but should address that issue in the context of the management audit that is currently under way.

VI. THE CONTENTION THAT PGW WAITED TOO LONG TO BRING THIS CASE AND THAT ITS INTERIM RATE INCREASES SHOULD BE DENIED TO AVOID "RATE SHOCK" SHOULD BE REJECTED

OCA¹²⁹, CEPA¹³⁰ and PICGUG¹³¹ chastise PGW for waiting so long to seek rate relief and imply, therefore, that such relief should be denied. The OCA and other parties have also insisted on this basis that, since PGW's financial crisis allegedly is "of its own making," it is PGW's "fault" that it has been forced to request a 10% interim base rate increase at the same

¹²⁸ Order Denying CEPA et. al's Motion to Compel dated September 26, 2000 at 2-3.

¹²⁹ OCA M.B. at 39-40. OCA states that due to the delay, PGW claims it is faced "with higher capital costs" among other things. *Id.* at 40. To the extent that this is intended to mean that PGW has accumulated higher capital costs because of past deferrals, there is no quarrel with the statement. To the extent that this is intended to suggest that there is a cause and effect relationship between the delay and capital costs, which would not otherwise have been incurred, PGW has not made, and there is no basis for, such a claim.

¹³⁰ CEPA M.B. at 14-16. CEPA's only other allegation of service inadequacy is its claim that PGW violated the rights of customers by agreeing, in a Memorandum of Understanding with this Commission, to revise its customer dispute resolution practices to bring them in line with practices identified as reasonable by the Bureau of Consumer Services. (CEPA M.B. at 11-12). Presumably neither BCS nor this Commission would characterize this attempt to reach a process which is fair to PGW's customers and acceptable to the PUC as "inadequate service."

¹³¹ PICGUG M.B. at 5, 8-9.

time it has been required to request significant increases in its Gas Cost Rate. Accordingly, the parties seem to argue that the PUC should refuse to grant all or a portion of the entire interim request — even if fully justified — to avoid “rate shock.”

This is very fuzzy reasoning, to say the least. First, it is simply not logical to contend that PGW’s financial crisis is entirely “of its own making.” Mr. Knudsen testified that the principal reason for PGW’s present difficult straits is three successive warmer than normal winters.¹³² Mr. LeLash agreed.¹³³ These difficulties have been compounded by the huge spike in wholesale natural gas prices, again a problem of recent vintage and one that all would agree was not of PGW’s making. Obviously, PGW cannot control the winter weather or gas prices, as much as it would like to do so. Moreover, the effects of the winters combined with higher gas prices were cumulative and PGW tried to avoid asking for a base rate increase until it absolutely had to do so.¹³⁴ Ordinarily, this type of action by a utility would be applauded by consumer representatives, not used as a basis of condemnation.

Moreover, these parties seem to fail to recognize, that whatever the causes for the delay in requesting higher base rates, customers clearly have benefitted from the delay. As set forth in PGW’s Main Brief, and as conceded by OCA witness LeLash¹³⁵ and PICGUG witness

¹³² PGW St. 1.0 at 12; Tr. 138-39.

¹³³ OCA St. 1 at 8; Tr. 256.

¹³⁴ PGW-IR St. 1 at 3-6; 9-11.

¹³⁵ Tr. 292-93.

Baudino,¹³⁶ had PGW sought rate increases earlier and had they been granted, this would mean that PGW's customers would already have been paying higher rates for the past several years. Perhaps each incremental increase would not have been quite as great as the one sought in this case, but the customers would have been paying gas rates to meet the same revenue requirements over a longer period of time. Stated otherwise, even if the total cumulative increase would have been at the same level, ratepayers were able to defer it for several years. This is clearly no reason to deny an increase.

Mr. LeLash agreed that it would be prudent to have a cash cushion going into the winter period to meet requirements¹³⁷ – which is, in part, why PGW has now sought an increase. And he also agreed that it would have been prudent to seek a rate increase three years ago¹³⁸ — which is precisely what PGW is doing right now. Accordingly, it just doesn't make sense to suggest that PGW's request should be denied or reduced because PGW “waited too long.”¹³⁹

OCA and PICGUG also contend that the proposed 10% interim rate increase and the proposed 20% - 30% GCR increase will result in rate shock, and rates which are unaffordable for many of PGW's customers. OCA's concern about rate shock is speculative and unsupported by any citation; PICGUG's cites are inapposite and do not support its position here. First, the percentages are deceiving. PGW has not filed a base rate increase since August of 1991.

¹³⁶ Tr. 296.

¹³⁷ Tr. 259.

¹³⁸ Tr. 293.

¹³⁹ See PGW M.B. at 56-57.

Second, the base rate component is only 10%, or 1% per year since the last rate increase, while the GCR is simply a passthrough of PGW's actual costs. Finally, the Commission has approved phase-in plans for rate increases ranging from 7.9% to 132%, *Pa. P.U.C. v. Roaring Creek Water Co.*, 1995 Pa. PUC LEXIS 67, *102 (noting OCA's research). Accordingly, the proposed increase is well within the acceptable range of increases approved by this Commission. *Pa. P.U.C. v. Pa.-Amer. Water Co.*, 68 Pa. PUC 343, 469 (1988) (a two-year phase-in increase of 49% does not constitute rate shock).

Moreover, there is simply no support for OCA's and PICGUG's proposition that an otherwise justified rate increase should be denied because of its untoward effect on customers. In the *Roaring Creek Water Case*, *supra*, the Commission rejected a phase-in plan to implement a 53.7% rate increase and found that an immediate 53.7% increase – notwithstanding any alleged questions of affordability and rate shock – was in the public interest because concern for the utility's after-tax interest coverage outweighed any concern about the amount of the increase. 1995 Pa. P.U.C. LEXIS at *104. For the foregoing reasons, the Commission should reject OCA's and PICGUG's position that the proposed increase constitutes impermissible rate shock.

VII. OCA'S LIST OF "CONDITIONS" ON THE GRANT OF INTERIM RATE RELIEF HAVE ALREADY BEEN AGREED TO BY PGW OR ARE ITEMS THAT PGW IS FULLY COMMITTED TO, ASSUMING IT RECEIVES ADEQUATE RATE RELIEF

OCA's Main Brief recommends that the PUC award PGW an interim rate increase of "no more than \$25 million," but subject to a string of "conditions."¹⁴⁰ The first four are identical to

¹⁴⁰ The conditions, as set forth in OCA's Brief, are as follows: PGW must file a full base rate
(continued...)

those imposed by the PUC in its August 17th Order and have already been agreed to by PGW in a formal resolution of its governing board.¹⁴¹

With respect to the second four, PGW has already made clear that it is committed to each of them. The LNG Liquefaction Replacement Program and the 1.0% cast iron main replacement program are part of PGW's proposed capital budget and capital funds for these plans are reflected in that budget.¹⁴² Also included are funds to continue to improve its billing system and, in particular, to rectify the remaining budget billing problems. PGW does not need to be ordered to commit to do these things because it already indicated that it is fully committed.

Of course, PGW's plans to address these issues are all part of its operating and capital budget plans, which all assume that PGW will be awarded \$52 million in interim rates. It should be common sense, as OCA's own witness admitted, that PGW's ability to live up to its

(...continued)

case with the Commission on or before January 1, 2001; any interim rate ultimately granted is 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; PGW will not seek to recoup additional revenues from ratepayers if the Commission ultimately determines that a higher level of rates is just and reasonable; PGW commit to its "Transition to Excellence" plan for improvement and make a demonstration throughout the interim rate period that it is providing safe and adequate service; PGW should be required to achieve a 1% replacement rate in its mains replacement program as provided for in the Company's base case capital budget; PGW should commit to correcting the problems with its BCCS, particularly the need to rectify the budget billing problems, and provide periodic reports to BCS on the progress it is making correcting the BCCS problems; PGW should proceed with its LNG Liquefaction Replacement Program to ensure that PGW's system supply and reliability are maintained; and PGW must show improvement in its customer service functions and report on its progress to the Commission. OCA M.B. at 52.

¹⁴¹ PGW-IR Exh. 1.5.

¹⁴² PGW Cross-Examination Exh. 4.

commitment will be affected by the extent of its financial health.¹⁴³ The simple fact is that OCA's \$25 million does not provide sufficient cash flow, earnings or funds available to be able fully to assure the PUC that PGW will be able to complete all of these tasks.

Similarly, PGW has stated over and over again that it is fully committed to improving all aspects of its service, but many of the steps necessary to achieve such improvements — additional training for call center or outside plant personnel, additional support for consumer complaint handling, etc. — all require PGW to have funds to carry out these programs. The only way to assure this is to assure that PGW has sufficient funds throughout the winter.

Besides the funding issue, there are concerns about tying a broad tier of "improvements" in its customer service function to a rate increase that is so clearly necessary to maintain the Company's financial health. PGW is willing to join with the parties for a collaborative discussion about benchmarks, but it would appear to make more sense to establish such benchmarks on the basis of the management audit findings scheduled to be issued later this year.

¹⁴³ Tr. 279.

VIII. CONCLUSION

Only PGW's requested \$52 million rate increase request meets its demonstrated financial requirements and provides reasonable assurance that it will be able to deal with unbudgeted contingencies, such as warmer weather, without threatening its ability to continue to improve its service or upgrade its system. There is only one reasonable, prudent course for the PUC — grant the requested \$52 million in full.

Respectfully submitted,



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Attachment A

MOODY'S RATINGS WATCHLIST

PGW EXHIBIT 4

MOODY'S PLACES PGW ON WATCHLIST AS CASH CRUNCH NEARS
PUC RATE FILING KEY TO INTEREST PAYMENT IN JANUARY 1, 2001

Gas Utilities
PA

Opinion

NEW YORK, Oct 17, 2000 -- Moody's Investors Service has placed Philadelphia Gas Works (PGW) revenue bonds on its Ratings Watchlist for possible downgrade as the utility faces a cash crunch beginning in November that could get worse should the November 9, 2000 rate decision before the state Public Utilities Commission (PUC) be held up. Further, the utility's liquidity could also worsen should warm winter weather occur over the next several months. Moody's rates PGW's \$869.5 million senior lien obligations Baa2 and subordinate bonds, Baa3 both with a negative outlook. PGW's next interest payment date is January 1, 2001. If these issues are not resolved in PGW's favor, PGW could find itself in technical default then and have to use its debt service reserve to meet the required payment. Moody's will continue to monitor this situation.

PGW, which has been battered by successive warm winters, (warm winter weather impacts gas sales and revenue) as well as past management problems, has filed for a major rate hike to mitigate the financial impact of the recent significant increase in gas costs. In addition, PGW filed for a base rate hike that should assist the utility's ongoing liquidity. While Moody's believes the PUC's interim rate proceeding should result in a November 9 decision that should grant some level of rate increase, should the decision be delayed or the increase granted not be sufficient, PGW's financials could worsen.

In addition, to soften the overall rate impact, the city council is expected to approve an ordinance to provide PGW a \$45 million non-recourse loan with a two-year payback schedule. The ordinance is currently before the Philadelphia City Council.

For further information on PGW's credit position, please refer to Moody's Municipal Research Report dated August 2000.

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CERTIFICATE OF SERVICE

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

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October 20, 2000

James J. McNulty, Secretary
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VIA HAND DELIVERY

**Re: Pennsylvania Public Utility Commission v. Philadelphia Gas Works;
Docket No. R-00005654**

Dear Secretary McNulty:

Enclosed for filing with the Commission are the original and nine (9) copies of the Reply Brief of the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") in the above-referenced proceeding. Also enclosed, please find a diskette containing PICGUG's Reply Brief in Word format.

As shown by the attached Certificate of Service, all parties to this proceeding are being duly served. Please date stamp the extra copy of this transmittal letter and kindly return it for our filing purposes.

Very truly yours,

MCNEES, WALLACE & NURICK

By *Charis M. Burak*
Charis M. Burak

Counsel to the Philadelphia Industrial and
Commercial Gas Users Group

Enclosures
CMB/lhe

c: Administrative Law Judge Marlane Chestnut (via federal express) (with diskette)
Andrew Tubbs, Esq. (via hand delivery) (with diskette)
Certificate of Service

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC
UTILITY COMMISSION

v.

PHILADELPHIA GAS WORKS

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Docket No. R-00005654

**REPLY BRIEF OF THE PHILADELPHIA INDUSTRIAL
AND COMMERCIAL GAS USERS GROUP**

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The Building Owners' and Managers'
Association of Philadelphia
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TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| I. INTRODUCTION | 1 |
| II. ARGUMENT | 3 |
| 1. PGW fails to comprehend PICGUG’s recommendation that PGW’s interim relief should be the nominal amount needed for the Company to maintain the minimal, adequate level of financial health required to fund operations and meet debt service requirements | 3 |
| 2. PGW has not provided substantial evidence that without rate relief, the Company’s bonds will be automatically downgraded | 5 |
| 3. PGW’s system improvements should focus upon prudent expenditures needed to maintain safe and reliable service to PGW’s customers | 7 |
| 4. PGW’s “interest-free loan” to ratepayers could result in rate shock of exorbitant proportions | 8 |
| III. CONCLUSION | 10 |

I. INTRODUCTION

On August 8, 2000, the Philadelphia Gas Works ("PGW" or "Company") filed a Petition with the Pennsylvania Public Utility Commission ("PUC" or "Commission") claiming that the Company is facing a financial crisis and would be unable to meet its expenses and bond coverages as of January 1, 2001. As a result, PGW petitioned the PUC for several requests, including: (1) establishment of an interim rate increase for the Company to be in effect during the winter season, until a full base rate proceeding can be held; and (2) establishment of a procedural schedule that would allow the PUC to render a decision regarding interim rates no later than November 8, 2000. In accordance with the procedural schedule established by Administrative Law Judge Marlane Chestnut ("ALJ Chestnut"), on October 13, 2000, the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") filed with the Commission and served on all parties its Main Brief in this proceeding (hereinafter, "PICGUG Main Brief"). PICGUG received Main Briefs from PGW (hereinafter, "PGW Main Brief"), the Office of Consumer Advocate ("OCA") (hereinafter, "OCA Main Brief"), the Office of Trial Staff ("OTS") (hereinafter, "OTS Main Brief"), the Apartment Association of Greater Philadelphia ("AAGP") (hereinafter, "AAGP Main Brief"), and CEPA, et al. (hereinafter, "CEPA Main Brief").

As discussed more fully in PICGUG's Main Brief, several concerns raised by PGW present valid reasons for further examination of PGW's request. These concerns include: (1) a negative cash position facing PGW; (2) the inability to invest in ongoing system improvements; and (3) the loss of PGW's commercial paper program. These concerns must be greatly tempered, however, in light of several mitigating circumstances, including: (1) a financial crisis of PGW's own making; (2) possible rate relief by the City

of Philadelphia ("City"); (3) a less dire financial picture than that presented by the City; and (4) the resulting rate shock to customers from PGW's requested increase.

PICGUG files this Reply Brief to address and clarify several of the aforementioned positions in light of PGW's Main Brief.¹ Specifically, PICGUG submits that (1) PGW's rates should be increased only to the minimal extent necessary for PGW to maintain a minimum, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season; (2) PGW should consider the short-term deferral of construction expenditures of those items that are not for the safety and reliability of customer service; (3) PGW has not provided irrefutable evidence that failure of PGW to meet its bond covenants will automatically result in a downgrade of PGW's bonds; and (4) PGW's failure to file for a rate increase prior to the current fiscal crisis may result in rate shock to PGW's customers.

¹ This Reply Brief does not address all of the issues raised in PGW's Main Brief, as many of these issues were addressed previously in PICGUG's Main Brief. Accordingly, PICGUG does not believe it necessary to reiterate these arguments herein.

II. ARGUMENT

1. *PGW fails to comprehend PICGUG's recommendation that PGW's interim relief should be the nominal amount needed for the Company to maintain the minimal, adequate level of financial health required to fund operations and meet debt service requirements.*

The PUC clearly stated that any interim level of rate increase approved for PGW must be based upon substantial evidence by PGW that this increase is needed for the Company to maintain the minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season.

Petition of Philadelphia Gas Works for Establishment of Interim Rate Procedures and for a Declaratory Order; Docket No. P-00001831, Order Establishing Interim Rate Procedures (hereinafter, "Interim Rate Order") (Aug. 17, 2000), pp. 7-8.

As a result, PICGUG has argued consistently throughout this proceeding that while PGW has repeatedly asserted the severity of its current fiscal crisis, several mitigating circumstances, including possible rate relief by the City and the resulting rate shock to PGW customers, should temper any rate increase provided to PGW. See PICGUG Main Brief, pp. 3-4. This result was confirmed by PICGUG witness Baudino, who stated the following.

[I]t would be reasonable for the Commission to grant the minimum level of interim relief to PGW necessary to maintain service until next year, when the Commission can conduct a full base rate proceeding. However, there are several very important and unresolved issues relating to PGW's request for rate relief. Because of these issues, I believe that the Commission has a great deal of latitude in deciding how much relief to grant to PGW in this interim proceeding.

Direct Testimony of Richard Baudino, PICGUG St. No. 1 (hereinafter, "PICGUG St. No. 1"), p. 4. In addition, PICGUG has repeatedly submitted that PGW has failed to set forth substantial evidence that the full \$52 million rate increase requested is necessary to maintain a minimum level of financial health and meet debt service requirements. See PICGUG Main Brief, pp. 3, 9 & 14.

PGW, however, has failed to comprehend PICGUG's position with respect to the level of interim rate relief that should be granted to the Company. Specifically, PGW has posited that PICGUG recommends a \$15.6 million interim rate increase based upon no specific analysis. See PGW Main Brief, p. 39. PGW fails to recognize that PICGUG's position regarding the level of interim rate increase defers to the PUC with respect to the exact increase required for PGW to meet the aforementioned standard. As noted by PICGUG, "the Commission has substantial latitude in the amount of rate relief that it grants in this proceeding." See PICGUG St. No. 1, p. 13. As a result, the \$15.6 million increase set forth by PICGUG witness Baudino is nothing more than an example of rate relief that could be provided by the PUC, rather than a definitive amount. See id.

Moreover, PGW fails to comprehend PICGUG's concerns by stating that PICGUG witness Baudino's recommendation is driven by PGW's possible rate relief from the City and claims that the consequences of financial failure would not be as dire as PGW contends. See PGW Main Brief, p. 39. As discussed in Mr. Baudino's testimony, PGW's request for interim rate relief must be examined in light of the possible consequences that could result from financial failure, as well as the circumstances mitigating this failure and the "overall rate impact on the customers with the combined GCR and the interim rate relief that the Company is seeking." Evidentiary Hearing

Transcript, September 28, 2000 (hereinafter, "Tr.") at 300. Unfortunately, PGW overlooks those issues raised by PICGUG with respect to the interim rate request, and focuses only upon two concerns raised by PICGUG. PICGUG submits that while the concerns highlighted by PGW were included in Mr. Baudino's analysis, other mitigating circumstances, including the significant rate shock that would be placed upon customers due to PGW's request for a \$149 million rate increase, must be considered. See PICGUG Main Brief, pp. 4-12.

As a result, PICGUG contends that the PUC must examine the financial concerns of PGW in light of the mitigating circumstances surrounding these concerns, as well as the determination that PGW has failed to present substantial evidence that the entire \$52 million increase requested by the Company is required in this proceeding. Only in light of all of these factors can the PUC determine the appropriate, minimal level of rate increase necessary for PGW to maintain operations throughout the winter heating season.

2. *PGW has not provided substantial evidence that without rate relief, the Company's bonds will be automatically downgraded.*

As discussed in PICGUG's Main Brief, PGW's financial mismanagement raises concerns regarding the ability of the Company to meet its bond rating requirements. See PICGUG Main Brief, pp. 7-8. While PICGUG recognizes the uncertainty surrounding PGW's bonds, PICGUG also submits that PGW can not predict with absolute certainty, nor has PGW provided unrefuted evidence, that PGW's bonds would automatically be downgraded if the Company's request for interim relief is not granted. See PICGUG St. No. 1, pp. 10-11.

PGW, however, claims that PICGUG witness Baudino's "proposal" for a \$15.6 million rate increase misunderstands the consequences of PGW's failure to meet its coverages.¹ See PGW Main Brief, pp. 47-48. Once again, PICGUG submits that the \$15.6 million figure referenced in Mr. Baudino's testimony was merely illustrative of the level of rate increase that could be approved by the PUC. In addition, the argument set forth in PGW's Main Brief agrees with Mr. Baudino's assertion that PGW has sufficient debt coverage, which can be enhanced further by the City's proposed loan of \$45 million and waiver of PGW's \$18 million payment. See id.

Moreover, contrary to PGW's assertions, PICGUG is aware of the consequences that may occur if PGW fails to meet its coverages, however, the basis of PICGUG's argument, which was conveniently overlooked by PGW, focuses upon bond rating agencies' rating requirements. See id. at 47. As addressed by Mr. Baudino, failure of PGW to meet its bond covenants would not be viewed positively by the rating agencies, however, this failure would not automatically trigger a bond downgrading. See Tr. at 310-11. Rather, a bond rating agency will examine both current and prospective data, including PGW's forthcoming base rate proceeding. See id. Moreover, the PUC's standard in this proceeding takes into account the ability of PGW to comply with its covenants to the holders of any approved bonds. See Interim Rate Order, p. 8. As

¹ PGW also questions Mr. Baudino's expertise with respect to dealing with rating agencies and municipally-owned utilities. See PGW Main Brief, p. 48. PGW fails to note, however, that Mr. Baudino has significant experience with respect to rate of return on equity, including debt service coverage and bond rating agencies issues. Moreover, while this experience has been with investor-owned utilities, the requirements for a municipal utility are sometimes less stringent than those for an investor-owned utility. See Tr. at 312-13. Finally, PGW's reference that Mr. Baudino was not aware of the Philadelphia Water Department's technical failure to meet its bond covenant in 1991 is irrelevant to this proceeding, and must be ignored as such by the PUC. See PGW Main Brief, p. 48.

discussed previously, PICGUG submits that any rate increase approved by the PUC should be examined in light of this standard.

3. *PGW's system improvements should focus upon prudent expenditures needed to maintain safe and reliable service to PGW's customers.*

PICGUG has consistently noted that PGW must continue to invest in system improvements and main replacements in order to ensure adequate and reliable service for its customers. See PICGUG Main Brief, pp. 10-11; see also PICGUG St. No. 1, pp. 8, 14. In fact, PICGUG members' need for adequate service is the primary motivation for PICGUG's support of some rate relief for PGW in this proceeding. See PICGUG Main Brief, p. 11. PICGUG has also proffered, however, that PGW should defer short-term construction expenditures for those items not related to safety and reliability, in order to ensure that more pressing concerns, such as main replacements, are addressed in the coming fiscal year. See id. According to PGW, expected net construction expenditures of \$62.3 million are projected for the coming fiscal year. See PICGUG St. No. 1, p. 8.

Even with PICGUG's various clarifications regarding this position, PGW still seems to misunderstand PICGUG's position. In fact, PGW attempts to confuse PICGUG's position by suggesting that PICGUG has no basis to challenge PGW's expenditures as unreasonable or unnecessary, and that 90% of these claimed construction expenditures are related to safety and reliability. See PGW Main Brief, p. 58. Due to the expedited nature of this proceeding, PICGUG has not had the opportunity to perform an in-depth review of PGW's proposed construction expenditures. As a result, PICGUG has suggested that PGW review carefully, especially in light of PGW's previous fiscal

mismanagement, to determine whether any projects included in this construction forecast may be deferred. See PICGUG St. No. 1, p. 8. PICGUG's basis for this deferral is not whether the projects are unreasonable or unnecessary, but whether the projects pertain to the provisioning of safe and reliable service. See id. As discussed previously, PICGUG has encouraged PGW to improve its main replacement systems in order to ensure safe and reliable service to customers. See PICGUG Main Brief, pp. 10-11.

Moreover, PGW insinuates that PICGUG's proposal is unreasonable in light of PGW's assertion that approximately 90% of the projects are for items that are safety and reliability oriented. See Tr. at 304. Based upon PICGUG's proposal, however, and assuming the accuracy of PGW's 90% assertion, deferring the remaining 10% of projects unrelated to safety and reliability would produce approximately \$6.23 million in additional cash flow for the upcoming fiscal year. Considering PGW's current fiscal crisis and the pleas for immediate relief, \$6.23 million should provide at least enough relief for PGW to seriously consider PICGUG's proposal.

4. *PGW's "interest-free loan" to ratepayers could result in rate shock of exorbitant proportions.*

As discussed more fully in PICGUG's Main Brief, one of the mitigating circumstances to be considered by the PUC is that the current fiscal crisis facing PGW is of the Company's own making. See PICGUG Main Brief, pp. 4-6. Specifically, PGW failed to file for a rate increase for the past several years, resulting in the Company's current plea for immediate financial relief. See id. As a result, the combined effect of PGW's interim rate increase request of \$52 million in this proceeding and GCR increase request of \$97 million, if these were to come to fruition, would result in a total increase of \$149 million to ratepayers during the winter heating season. See PICGUG Main Brief, p.

8. Moreover, should PGW's proposed revision to the GCR be included in this calculation, the combined result would increase to \$224 million. See id. Interestingly, PGW contends that the failure by the Company to respond more quickly to these fiscal concerns should not be a mitigating circumstance for rate relief, but rather that the Company should be applauded because this failure to file for rate relief effectively constituted an "interest-free loan" to PGW's ratepayers. See PGW Main Brief, p. 57.

PGW's position is nothing short of preposterous. By subjecting ratepayers to a substantial increase in natural gas rates of between \$149 and \$225 million, the Company is guaranteeing a resulting rate shock that will significantly and detrimentally impact the finances of PGW customers. See PICGUG Main Brief, pp. 8-9. While PGW may believe that the "loan" provided by the Company should ameliorate these increased expenses, PICGUG submits that PGW's position should be ignored as unreasonable and ridiculous. Rather, the PUC should utilize the principle of gradualism in setting any interim rates for PGW in order to ensure that PGW's rates are increased in a gradual manner that limits the negative fiscal impact and rate shock to PGW's customers. See id. at 8-9.

III. CONCLUSION

WHEREFORE, the Philadelphia Industrial and Commercial Gas Users Group respectfully requests that the PUC grant Philadelphia Gas Works the minimum interim rate increase needed, if any, for PGW to maintain the minimal, adequate level of financial health required to fund operations and meet debt service requirements through the winter heating season, consistent with the additional relief requested in PICGUG's Main and Reply Briefs.

Respectfully submitted,

McNEES, WALLACE & NURICK

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Counsel to the Philadelphia Industrial and
Commercial Gas Users Group

Dated: October 20, 2000

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I hereby certify that I have this day served a true copy of the foregoing document upon the participants listed below.

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Charis M. Burak

Dated this 20th day of October, 2000, in Harrisburg, Pennsylvania.

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October 20, 2000

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Room B-20, North Office Building
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Filed by Federal Express

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OCT 25 2000

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Re: Pa. Public Utility Commission v. Philadelphia Gas Works
(Gas Cost Rate)
Docket No. R-00005654

OCT 20 2000

A PUBLIC UTILITY COMMISSION
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Dear Secretary McNulty:

Intervenors CEPA et al. will not file a Reply Brief in the above-captioned matter. With the following statement, they join in and support the positions taken by the Office of Consumer Advocate (OCA) in its Reply Brief filed this date.

As representatives of residential consumers, CEPA et al. have watched apprehensively as natural gas prices have steadily risen over the past six months. They see little action on the part of local, state or national elected officials to protect them in the months to come. With the possible exception of inadequate increases in LIHEAP funds, they see no evidence of a determination to restrain this run up in prices, to initiate measures which would further the maintenance of price stability at a level which bears some rational relationship to the actual costs of obtaining and transporting natural gas, or to assure that a basic necessity of life remains affordable to people who use natural gas for heating and cooking purposes.

CEPA et al. have no illusions about the adequacy of the \$120 million GCR increase which PGW has requested. In its filings in this proceeding, the company itself has made projections indicating that natural gas costs may require an additional \$50

69

million GCR increase above this \$120 million. Rebuttal Testimony of Craig White, PGW-GCR St. 1.1 at 4-6. Even with a \$120 million GCR increase, customers will face a 25% increase in their total gas bills on the basis of natural gas cost increases alone. After the Commission has ruled on PGW's interim base rate request, we predict that PGW will be obliged to file for a further increase in the GCR.

CEPA et al. submit that it is fair to infer that the fear that a request for a GCR increase greater than \$120 million would negatively impact its Interim Base Rate Increase request has prevented the company from seeking an increase more in keeping with its own projections.

Very truly yours,


PHILIP A. BERTOCCI

Attorney for CEPA et al.

cc: Certificate of Service

Honorable Marlane R. Chestnut, Administrative Law Judge

CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00005619

I hereby certify that I have this day served a true copy of the foregoing letter of CEPA, Action Alliance of Senior Citizens, ACORN and Tenants' Action Group, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 20th day of October, 2000.

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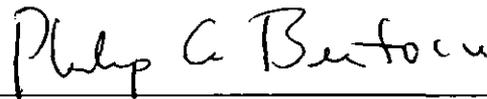
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October 25, 2000

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Re: Pennsylvania Public Utility Commission v.
Philadelphia Gas Works (Interim Rate Increase Request)
Docket No. R-00005654

Dear Mr. McNulty:

Please be advised that the Office of Small Business Advocate will not be filing a Supplemental Brief in the above-docketed proceeding. As evidenced by the enclosed certificate of service, a copy of this letter has been served on all active parties in this case.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Angela T. Jones
Assistant Small Business Advocate

Enclosures

cc: Hon. Marlane Chestnut
Administrative Law Judge

Parties of Record

57

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY
COMMISSION

v.

PHILADELPHIA GAS WORKS

:
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Docket No. R-00005654

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CERTIFICATE OF SERVICE

I certify that I am serving a copy of the foregoing document on behalf of the Office of Small Business Advocate by first class mail (unless otherwise indicated) upon the persons addressed below:

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Angela T. Jones
Assistant Small Business Advocate

Dated: October 25, 2000

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October 25, 2000

10/25/00 4:52

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P.O. Box 3265
Harrisburg, PA 17105-3265

Re: Pa. Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00005654

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Dear Secretary McNulty:

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

Copies of this document have been served upon all parties as evidenced by the attached Certificate of Service.

Sincerely yours,

Tanya J. McCloskey
Senior Assistant Consumer Advocate

56

Enclosure

cc: All parties of record
Hon. Marlane Chestnut, Administrative Law Judge

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY
COMMISSION

v.

PHILADELPHIA GAS WORKS
(Interim Base Rate Proceeding)

Docket No. R-00005654

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OFFICE OF CONSUMER ADVOCATE'S
SUPPLEMENTAL REPLY BRIEF

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Dated: October 25, 2000

734453

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

734454

Pennsylvania Public Utility Commission :
 :
 v. : Docket No. R-00005654
 :
 Philadelphia Gas Works :

OFFICE OF CONSUMER ADVOCATE'S
SUPPLEMENTAL REPLY BRIEF

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The Office of Consumer Advocate (OCA) has received the additional information submitted for the record including the opinion from Moody's Investor Service and the update on the status of the \$45 million loan from the City of Philadelphia to the Philadelphia Gas Works (PGW). Pursuant to Post-hearing Order #2, Administrative Law Judge Chestnut granted PGW's Motion to Take Official Notice or in the Alternative, to Reopen the Record to include these items as PGW Exh.4 and PGW Exh. 5. The ALJ also allowed for supplemental reply briefs to be filed by October 25, 2000 limited to a discussion of the late-admitted exhibits. In accordance with the ALJ's Post-hearing Order #2, the OCA hereby submits this supplemental reply brief to address these late-filed exhibits.

In its Reply Brief, PGW quotes from the announcement that Moody's Investor Service has now placed PGW's revenue bonds on its "Ratings Watchlist" for possible downgrade and quotes a portion of the Moody's opinion. PGW argues that the Moody's action highlights the absolute need for the full \$52 million rate increase requested by PGW. PGW R.B. at 5. The OCA submits, however, that this is an overbroad reading of the

Moody's opinion. In fact, the Moody's opinion first recognizes the significant increase in gas costs, and notes that PGW has sought to recover these costs through a rate hike. PGW Exh. 4. This is the rate increase associated with Gas Cost Rate, an increase which the parties to these proceedings recognize must be put into place for the winter heating season.

As to the interim base rate increase request, Moody's is clear that it views this request as assisting in PGW's ongoing liquidity. Moody's, however, does not suggest that the full level of interim rate increase requested by PGW is necessary to avoid a downgrade of the bonds. The Moody's opinion states:

While Moody's believes the PUC's interim rate proceeding should result in a November 9 decision that should grant *some level* of rate increase, should the decision be delayed or the increase granted not be sufficient, PGW's financials could worsen.

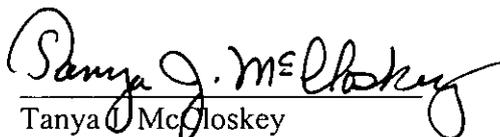
PGW Exh. 4, p. 1 (emphasis added).

The OCA submits that its recommendation, which accepts PGW's GCR claim subject to certain conditions, and provides for an interim base rate increase of \$25 million is sufficient for this interim period to meet debt service coverage and fund operations. The OCA's recommendation, which assumed only a \$20 million loan from the City, also provides the Company with positive cash balances in each and every month, allowing the Company to end the year with an \$11.2 million cash balance even if the City payment of \$18 million is made and the City does not grant the \$18 million payment back to PGW as project revenues. The Company's condition improves substantially if the City returns the \$18 million payment as project revenues to the Company.

As the Moody's opinion also recognizes, however, City Council is now expected to approve an ordinance to provide PGW a \$45 million loan with a two-year payback period, rather than the \$20 million loan assumed in the OCA's analysis. PGW Exh. 5 provides the current status of the ordinance. At this time, PGW Exh. 5 indicates that the ordinances have received favorable Committee recommendation and were placed on the First Reading Calendar. It is expected that the ordinances will be placed on the Final Passage Calendar at City Council's next meeting on October 26, 2000. This additional loan should also assist the Company in meeting any unexpected problems and can provide a cash bridge as the new rates are implemented and billed to customers.

For the foregoing reasons, and for the reasons set forth in its Main Brief and Reply Brief, the OCA submits that its recommendation in this proceeding is reasonable and should be adopted.

Respectfully submitted,



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Dated: October 24, 2000
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CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission
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Philadelphia Gas Works
Docket No. R-00005654

I hereby certify that I have this day served a true copy of the foregoing document, the Office of Consumer Advocate's Supplemental Reply Brief, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 25th day of October, 2000.

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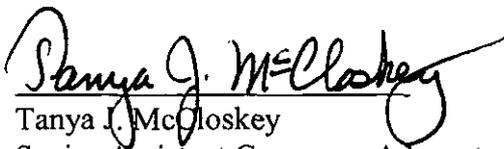
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October 25, 2000

VIA HAND DELIVERY

James McNulty, Secretary
PA Public Utility Commission
Commonwealth Keystone Bldg. 2nd Fl.
400 North Street
Harrisburg, PA 17120

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RE: Pa PUC v. PGW, Docket No. R-00005654

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works, and in accordance with Post-Hearing Order No. 2 in the above case, enclosed for filing please find an original and three copies of its Exhibit 5 in the above matter. Exhibit 5 provides an update of the status of the City of Philadelphia Administration's request for approval from Philadelphia City Council of a \$45 million loan to PGW.

As per the attached Certificate of Service copies of PGW Exhibit 5 are being served on all active parties.

Very truly yours,

Daniel Clearfield
For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

DC/lww
Enclosure

cc: Hon. Marlane Chestnut w/enc.
All Parties of Record w/enc.
Andrew Tubbs, Esq.

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PGW EXHIBIT 5

**UPDATE OF STATUS OF THE CITY OF PHILADELPHIA ADMINISTRATION'S
REQUEST FOR APPROVAL FROM PHILADELPHIA CITY COUNCIL OF A \$45
MILLION LOAN TO PGW**

On October 19, 2000, the attached bills, as amended, received favorable Committee recommendation and were placed on the First Reading Calendar. It is expected that these two bills will be placed on the Second Reading and Final Passage Calendar at City Council's next meeting on October 26, 2000.

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City of Philadelphia

City Council
Chief Clerk's Office
402 City Hall
Philadelphia, PA 19107

BILL NO. 000590
(As Amended, 10/17/00)

Introduced September 21, 2000

Councilmember Krajewski

**Referred to the
Committee of the Whole**

PA.P.U.C.
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AN ORDINANCE

Amending an ordinance approved April 11, 2000 (Bill No. 000005), adopting the Operating Budget for Fiscal Year 2001, by making, in accordance with Section 2-301(a) of the Philadelphia Home Rule Charter, certain additional appropriations needed to meet the unanticipated emergency created by a cash flow crisis at the Philadelphia Gas Works.

WHEREAS, The Operating Budget of the City was adopted by Council and approved by the Mayor on April 11, 2000, in accordance with the requirements of the Philadelphia Home Rule Charter ("Charter"); and

WHEREAS, The Operating Budget as adopted provided for General Fund appropriations of two billion eight hundred thirty million four hundred fifty five thousand nine hundred eighteen dollars (\$2,830,455,918); and

WHEREAS, The City of Philadelphia (City) owned Philadelphia Gas Works (PGW) has requested of the Public Utility Commission a rate increase to bolster its fragile financial position; and

WHEREAS, Said rate increase would not take effect in time to infuse PGW with sufficient cash to enable the company to buy natural gas for the coming winter and meet payroll obligations; and

WHEREAS, The City has proposed a loan of forty five million (\$45,000,000) dollars to PGW to allow the company to bridge the gap between when the natural gas is purchased and when the revenue from the proposed rate increase would begin to be realized; and

City of Philadelphia

BILL NO. 000590, as amended continued

WHEREAS, Section 2-301 of the Charter expressly permits Council to make additional operation appropriations "to meet emergencies which could not be anticipated when the operating budget ordinance was passed;" and

WHEREAS, The cash crisis at PGW could not have been reasonably anticipated by City Council at the time of the adoption of the Operating Budget Ordinance for Fiscal Year 2001 (Bill No. 000005); and

WHEREAS, The Council wishes to avoid curtailment of essential natural gas services by providing for a loan to PGW; and

WHEREAS, The payment of the loan requires an increase in appropriations in the Operating Budget for Fiscal Year 2001 pursuant to section 2-301(a) of the Charter; now, therefore

THE COUNCIL OF THE CITY OF PHILADELPHIA HEREBY ORDAINS:

SECTION 1. Section 2 of the ordinance approved April 11, 2000 (Bill No. 000005), adopting the Operating Budget for Fiscal Year 2001, is hereby amended to increase the appropriations made from the General Fund by forty five million dollars (\$45,000,000) from two billion eight hundred thirty million four hundred fifty five thousand nine hundred eighteen dollars (\$2,830,455,918) to two billion eight hundred seventy five million four hundred fifty five thousand nine hundred eighteen dollars (\$2,875,455,918), which additional increase is appropriated as follows:

| | | |
|------|---|--------------|
| 2.38 | DIRECTOR OF FINANCE | |
| | Advances and Other Miscellaneous Payments | \$45,000,000 |
| | Total | \$45,000,000 |

Section 2. This Ordinance shall take effect immediately in accordance with provisions of Section 2 of Bill No. 000583 as amended.



City of Philadelphia

City Council
Chief Clerk's Office
402 City Hall
Philadelphia, PA 19107

BILL NO. 000583
(As Amended, 10/17/00)

Introduced September 21, 2000

Councilmember Tasco
(By Request)*

Referred to the
Committee of the Whole

AN ORDINANCE

Authorizing the amendment of the Philadelphia Facilities Management Corporation Agreement to provide for a temporary change in the amount of temporary financing that the City may provide to the Philadelphia Gas Works under certain terms and conditions, and authorizing the temporary advance of up to \$45,000,000 to the Philadelphia Gas Works pursuant to that Agreement under certain terms and conditions.

WHEREAS, The Philadelphia Gas Works is in the process of management reorganization in order to benefit ratepayers and residents of the City of Philadelphia; and

WHEREAS, The Philadelphia Gas Works has submitted a plan of cost containment and rate increases to the Pennsylvania Public Utility Commission, and has submitted proposed budgets and budget forecasts to the Philadelphia Gas Commission; and

WHEREAS, The Philadelphia Gas Works is in a fiscal crisis, and that any appropriate rate relief will not come sufficiently soon to enable the responsible and prudent operation of the Philadelphia Gas Works through the winter of 2000-2001; and

WHEREAS, The existing ceiling on the amount the City of Philadelphia is able to loan certain money to the Philadelphia Gas Works in anticipation of future revenues may be insufficient during the coming year or two; and

WHEREAS, The Council of the City of Philadelphia anticipates that the above Commission will act on the above requests in accordance with the law, to ensure both the responsible operation and the long-term viability of the Philadelphia Gas Works, in

*Information on file in Room 402 City Hall

City of Philadelphia

BILL NO. 000583, as amended continued

compliance with the requirements of bond ordinances and the agreement pursuant to which the Philadelphia Gas Works is operated; and

WHEREAS, The City has in the past authorized the amendment of the Philadelphia Facilities Management Corporation Agreement to permit the City to advance up to forty-five million dollars to the Philadelphia Gas Works to be repaid within 24 months, and to loan up to forty-five million dollars to be repaid within 12 months; and

WHEREAS, The new management of the Philadelphia Gas Works has represented that it will be able to operate through the current fiscal year with loans from the City of no more than forty-five million dollars, and will be able to repay those amounts within 24 months; and

WHEREAS, The City is willing and able to advance up to forty-five million dollars to the Philadelphia Gas Works to be repaid within 24 months, provided the Philadelphia Gas Commission and the Director of Finance approve such advances; now, therefore

THE COUNCIL OF THE CITY OF PHILADELPHIA HEREBY ORDAINS:

SECTION 1. The City Council of the City of Philadelphia ("City") hereby authorizes the amendment of that certain Agreement Between the City of Philadelphia and the Philadelphia Facilities Management Corporation for the Management and Operation of the Philadelphia Gas Works, originally dated December 29, 1972, authorized pursuant to an Ordinance of City Council, approved December 29, 1972 (Bill No. 455), and to resolutions of the Board of Directors of the Philadelphia Facilities Management Corporation adopted on December 13, 1972, as further amended by Ordinance on numerous other occasions, as follows:

To revise Paragraph 3 of Section IV (Accounting Methods) to read as follows, with new text double-underlined in bold:

3. Temporary Financing

Short-term loans not exceeding twenty million dollars in amount or twelve months in duration may be negotiated in anticipation of revenues, except that short-term loans exceeding twenty million dollars but not exceeding forty-five million dollars in amount may be negotiated in anticipation of revenues for Fiscal Year 1982 of the Philadelphia Gas Works and may be outstanding during the period July 1, 1981 through June 30, 1982. If such loans are required, plans therefor shall be submitted to the Gas Commission and the Director of Finance for approval of amount of loan. The amount of

City of Philadelphia

BILL NO. 000583, as amended continued

any such loan shall also be subject to the approval by resolution or by ordinance of City Council.

The Gas Works may also receive temporary advances from the City in anticipation of revenues which are anticipated to be received by the Gas Works provided that such advances do not exceed twenty million dollars in amount or twenty-four months in duration; provided further, however, that during the period June 30, 1981 through June 30, 1983 and the period September 1, 2000 through August 31, 2002, such advances may exceed twenty million dollars in amount but shall not exceed forty-five million dollars in amount. The amount of each such advance shall be subject to the prior approval of the Director of Finance and the Gas Commission and to the approval by resolution or ordinance of City Council.

In addition to the foregoing authorized borrowings, loans not exceeding one hundred million dollars in aggregate principal amount at any time outstanding may be incurred for financing accounts receivable and the purchase of inventory for the Gas Works, as authorized by applicable law. If such loans are required, plans therefor shall be submitted to the Gas Commission and the Director of Finance for approval of the aggregate principal amount of such loans which may be outstanding at any single time. Such aggregate principal amounts shall also be subject to the approval by resolution or by ordinance of City Council.

SECTION 2. Pursuant to Section IV.3 of the PFMC Agreement as amended above, the City is hereby authorized to make a temporary advance to the Philadelphia Gas Works (hereinafter "PGW") in the amount of forty-five million dollars, or such lesser amount as may be approved by the Director of Finance and the Gas Commission; provided, however, that total temporary advances authorized by this Ordinance and any other ordinance or resolution shall not exceed forty-five million dollars at any one time, and provided further that:

- a. Such advance will be placed in a restricted account, against which PGW can draw in any month when PGW and the Director of Finance certify that its cash flow is insufficient to meet operating requirements, and which shall be repaid on an ongoing basis as soon as PGW's cash flow is sufficient to permit its repayment; and
- b. Interest on the account shall accrue to the City; and
- c. PGW is hereby limited to drawing no more than twenty-five million dollars from this restricted account until such time as the Gas Commission has informed City Council, and City Council has concurred

City of Philadelphia

BILL NO. 000583, as amended continued

by Resolution, that PGW has submitted an adequate Five Year Financial and Management Plan; and

d. During the term of the temporary advance, PGW shall file with the City Council, the Gas Commission, and the Director of Finance:

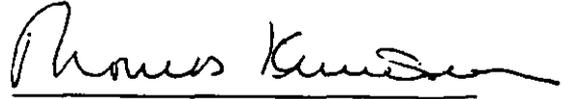
(i) No later than the fifth business day of each month, an update of its "Budget of Cash Receipts and Disbursements" report covering the preceding month; and

(ii) Monthly status reports regarding achievement of interim PGW management's stated goals for productivity/cost savings and collection of billed revenues.

The outstanding principal balance due by the Gas Works on such temporary advances shall be repaid no later than twenty-four months following the date of PGW's first draw of the full amount of the temporary advances authorized pursuant to this Ordinance, but in any event, no later than June 30, 2003.

VERIFICATION

I, Thomas Knudsen, hereby state that: (1) I am the Interim Chief Financial officer for Philadelphia Gasworks; and (2) the facts above set forth in the foregoing document are true and correct (or are true and correct to the best of my knowledge, information and belief) and that I expect to be able to prove the same at a hearing held in this matter. I understand that the statements herein are made subject to the penalties of 18 Pa. C.S. § 4904 (relating to unsworn falsification to authorities).



Thomas Knudsen

Dated: 10/23/00

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P.A.P.U.C.
SECRETARY'S BUREAU

CERTIFICATE OF SERVICE

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

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Daniel Clearfield, Esq.

Dated: October 25, 2000

October 25, 2000

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James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Room B-20, North Office Building
Commonwealth & North Streets
Harrisburg, Pa 17105

Sent by Federal Express

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Re: Pennsylvania Public Utility Commission v. Philadelphia Gas Works
Docket No. R-00005654

OCT 25 2000

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Dear Secretary McNulty:

Enclosed for filing with the Commission are the original and nine (9) copies of the Supplemental Reply Brief of CEPA et al. in the above referenced proceeding. Also enclosed please find a diskette containing CEPA et al.'s Supplemental Reply Brief in Word 6.0 format.

This filing is made pursuant to 52 Pa.Code §1.11(a)(2).

Very truly yours,

Philip A. Bertocci
PHILIP A. BERTOCCI

Counsel for CEPA et al.

Enclosures

cc:Administrative Law Judge Marlane R.Chestnut
Certificate of Service

86

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY :
COMMISSION :

Docket No. R-0000 5654
R-0000 5654 C0001- C0004

v.

PHILADELPHIA GAS WORKS :

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OCT 25 2000

SUPPLEMENTAL REPLY BRIEF of CEPA,
Action Alliance of Senior Citizens, ACORN and
Tenants' Action Group

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Philip A. Bertocci, Esquire
Edward A. McCool, Esquire
Attorneys for CEPA, et al.

Community Legal Services, Inc.
1424 Chestnut Street, 4th Floor
Philadelphia, PA 19102
(215) 981-3702

Date: October 25, 2000

DOCUMENT
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TABLE OF CONTENTS

I. INTRODUCTION..... 1

II. ARGUMENT.....2

 A. MOODY’S ANNOUNCEMENT IS NOT REASON TO REVISE
 UPWARD ANY DETERMINATION THAT THE COMMISSION
 MIGHT OTHERWISE MAKE CONCERNING THAT JUST AND
 REASONABLE INTERIM RATE LEVEL NECESSARY TO
 MAINTAIN A “MINIMAL, ADEQUATE LEVEL OF FINANCIAL
 HEALTH” THROUGH THE WINTER HEATING SEASON.....2

 B. THE COMMISSION SHOULD MAKE ITS DETERMINATIONS AS
 IF THE \$45 MILLION CITY ADVANCE IS FULLY AVAILABLE,
 SUBJECT ONLY TO THE CONDITION THAT IT BE REPAID
 WITHIN A REASONABLE TIME.....4

 C. CONCLUSION.....7

I. INTRODUCTION.

On October 18, 2000, PGW filed a Motion to Take Official Notice or, in the Alternative, to Reopen the Record (hereinafter "Motion") in order to make part of the record an announcement by Moody's Investors Service issued October 17, 2000 (hereinafter "Moody's Announcement").

On October 19, 2000, the Office of Consumer Advocate (OCA) and the Commission's Office of Trial Staff (OTS) filed a Joint Answer stating that they did not oppose the Motion on condition that material concerning the status of the proposed ordinances relating to provision by the City of Philadelphia of a \$45 million advance receive similar treatment. OCA and OTS also specified that the parties should be provided the opportunity to respond in a Supplemental Reply Brief to any arguments made by PGW concerning the Moody's Announcement. Other parties, including the Office of Small Business Advocate (OSBA), the Philadelphia Industrial and Commercial Gas Users Group (PICGUG) and CEPA et al. filed letters supporting the Joint Answer. PGW gave notice that it did not oppose the conditions proposed by the non-PGW parties.

On October 20, 2000, Marlane R. Chestnut, Administrative Law Judge issued Post Hearing Order #2, admitting the Moody's Announcement as PGW Exhibit 4 and requiring PGW to file as PGW Exhibit 5 an Affidavit concerning the status of the proposed \$45 million City advance as of October 20, 2000 on or before October 25, 2000. By letter dated October 20, 2000, PGW provided to the parties an "Update on City Council Activity" which contained copies of two proposed Ordinances pending before the Philadelphia City Council. It is understood that this "Update on City Council Activity" will admitted to the record as Exhibit 5.

The Order also requires parties responding to Moody's Announcement and the

Update on City Council Activity to file Supplemental Reply Briefs on or before October 25, 2000. That Order specifies that the parties filing Supplemental Reply Briefs are limited to discussing the “late admitted exhibits,” and responding to “the arguments concerning them contained in other parties’ reply briefs.” This Supplemental Reply Brief is filed pursuant to that Order.

II. ARGUMENT.

A. Moody’s Announcement is not reason to revise upward any determination that the Commission might otherwise make concerning that just and reasonable interim rate level necessary to maintain a “minimal, adequate level of financial health” through the winter heating season.

PGW argues that the Moody’s Announcement provides added support to its contention that unless the Commission grants PGW the full amount of its requested \$52 million interim base rate increase, a “technical default” on PGW’s bonds will occur, which “will clearly result in a downgrade to junk bond status with serious negative consequences for PGW.” PGW Reply Brief at 5, 7.

CEPA et al. disagree. This addition to the record is not evidence which makes it any more likely than before that only by granting the \$52 million requested interim rate increase (or substantially that amount) can the PUC prevent a “technical default” on PGW’s bonds and a “downgrade to junk bond status.”

Moody’s Announcement indicates several “issues” facing PGW in the next two months, a “cash crunch” beginning in November, the negative effects on PGW cash flow of possible warmer than normal weather, the requirement that PGW make a major interest payment on its bonds on January 1, 2001 and the possibility that the PUC may not render a “rate decision” on November 9, 2000.

The Announcement also indicates that PGW has two rate increases before the PUC, both of which have the potential to assist the utility's "liquidity" problems. The Announcement further recognizes that the \$45 million non-recourse loan before City Council may be expected to mitigate the "overall rate impact" on customers caused by PGW's "liquidity" problems.

However, the Announcement does not say that only a base rate increase in the neighborhood of \$52 million would be deemed sufficient. It only says that the interim rate proceeding should provide "some level of rate increase." And it offers no opinion concerning how the terms and conditions associated with the granting of a natural gas cost rate increase would impact on the level of interim rate increase that might be deemed "sufficient."

Second, the Announcement does not suggest that the exclusive means of addressing PGW's "cash crunch" must be through an interim base rate increase. Indeed, in its recognition that use of the proceeds of a \$45 million loan to address PGW's "cash crunch" would lessen the "overall rate impact," the Announcement implies just the opposite.

Third, even if the problems identified are not all resolved in PGW's favor, the Announcement anticipates that PGW will in fact have resources in a "debt service reserve" to avoid both a monetary and a technical default on its \$25.9 million debt service payment due in January 1, 2001.¹ So long as the issue is satisfaction of a rate covenant, as opposed to a debt service coverage covenant, whether these funds come from rates,

¹ In this proceeding, PGW has not identified a "debt service reserve" as such. This term must be interpreted to denote generally the diverse cash resources available to PGW, including but not limited to the \$45 million City advance and a City grant.

from the \$45 million City advance, or from a City grant is immaterial. Under the terms of PGW's bonds and the First Class City Bond Act, payment of part or even all of the \$25.9 million from the \$45 million advance and/or from a City grant would not constitute a default of any kind, "technical" or monetary. CEPA et al. Main Brief at 20, 21.

In sum, CEPA et al. contend that even if the Commission determines that some interim base rate increase is necessary, Moody's Announcement is not reason to revise upward any determination that the Commission might otherwise make concerning that *just and reasonable interim rate level necessary to maintain a "minimal, adequate level of financial health"* through the winter heating season.

B. The Commission should make its determinations as if the \$45 million City advance is fully available, subject only to the condition that it be repaid within a reasonable time.

The Update on City Council Activity contains the texts as amended of two City of Philadelphia proposed Ordinances. Bill No. 000590 is a proposed amendment to the \$2.8 billion FY 2001 City of Philadelphia Operating Budget approving additional appropriations for the \$45 million City advance "needed to meet the unanticipated emergency created by a cash flow crisis at the Philadelphia Gas Works."

Bill No. 000583 is a proposed amendment to the Management Agreement which provides for terms and conditions upon which it is proposed that the \$45 million City advance shall be made. This proposed Ordinance provides that the City is authorized to make a temporary interest free advance to PGW in the amount of \$45 million. The advance is subject to several conditions, including: (1) that PGW may draw from this \$45 million fund in any month when PGW and the City Director of Finance certify that PGW's cash flow is insufficient to meet operating requirements; (2) that money drawn

from this \$45 million fund will be repaid on an ongoing basis as soon as PGW's cash flow is sufficient to permit its repayment; (3) PGW is limited to drawing no more than \$25 million until the Gas Commission and City Council have both reviewed a yet to be filed PGW Five Year Financial and Management Plan and determined that such Plan is "adequate"; (4) the outstanding principal balance due is to be repaid no later than twenty-four months following the date of PGW's first draw of the full amount, but in any event, *no later than June 30, 2003.*

PGW reports that these proposed ordinances have received a favorable Committee recommendation and that it is "expected" that these two bills "will be placed on the Second Reading and Final Passage Calendar at City Council's next meeting on October 26, 2000.²

In their Main Brief, the City and PGW give lip service to the principle that the owner of any utility, whether owned by private investors or by a municipality, should take steps to secure a line of credit to address a cash flow crisis without placing unnecessary burdens on ratepayers.. PGW Main Brief at 36. However, by their actions, the City and PGW continue to seek to escape their responsibilities to ratepayers. They insist that the PUC should make its interim base rate determination as if the City was incapable of providing a \$45 million advance. PGW Reply Brief at 12-16.

On the one hand, the City and PGW argue that the advance should not be taken into consideration because its requested \$52 million interim rate increase is really much too small -- an argument that should be rejected out of hand in accordance with standard regulatory practice. PGW Main Brief at 5, 35. On the other hand, the City, apparently

² It has been reported that final passage will not occur until at least November 2, 2000. Philadelphia Daily News, 10/18/00.

forgetting that it is the owner of a utility which for years has paid it \$18 million annually from ratepayer funds regardless of performance, pleads that it has other “legitimate” uses for its financial resources – an argument available to the owner of any utility and that is quite irrelevant to the Commission’s determination of what rate a utility may justly and reasonably charge its ratepayers. PGW Reply Brief at 3.

In its Reply Brief, the City takes pains to remind the Commission that the \$45 million is “still not approved,” that it is only a “potential backstop.” PGW Reply Brief at 1, 12, 26. Moreover, the proposed Ordinances suggest that the Philadelphia Gas Commission and City Council now seek to clothe the \$45 million with various conditions which could be utilized, even after final passage, to prevent all or part of the City advance from becoming available at all. For instance, Ordinance 000583 provides that less than \$45 million may be made available “as may be approved by the Director of Finance and the Gas Commission.” Ordinance 000583 (Section 2). In addition, the Ordinance further limits the amount of the City advance to \$25 million so long as the Gas Commission and City Council have not determined that PGW’s yet to be filed “Five Year Financial and Management Plan.” is “adequate.”³

CEPA et al. submit that for too long, the City has failed to reach a consensus concerning PGW’s direction so as to render the utility capable of developing clear and coherent direction in the best interests of ratepayers. The provision of a \$45 million interest free short term advance is one of several reasonable steps that PGW’s owner

³ CEPA et al. support the concept that PGW must formulate a new strategic plan. However, the ordinance establishes a requirement, with no definitions or standards to define what is meant by an “adequate” Five Year Financial and Management Plan. This lack of specificity is not reassuring. It does not give grounds for confidence that the City is truly committed to bringing those needed City resources to the actual, instead of the virtual, assistance of PGW ratepayers.

should be expected to take under present circumstances. In reviewing PGW's interim rate increase request, the PUC should adhere to the same standards of ownership responsibility to which it holds investor owned utilities. It should take notice that in this proceeding, PGW has not developed a single schedule which attempts to factor in the manner in which a \$45 million City advance would affect PGW's rate request. It should make its determinations as if the \$45 million is fully available, subject only to the condition that it be repaid within a reasonable time.⁴

C. Conclusion.

For the foregoing reasons, together with reasons set forth in the Main Brief and Reply Brief, CEPA et al. respectfully request that the Commission deny PGW's Interim Rate Increase request in its entirety.

Respectfully submitted,



PHILIP A. BERTOCCI, ESQUIRE
EDWARD A. MCCOOL, ESQUIRE

Attorneys for CEPA et al.

COMMUNITY LEGAL SERVICES, INC.
1424 Chestnut Streets, 4th Floor
Philadelphia, PA 19102
215-981-3702

⁴ For reasons not within the scope of this Supplemental Reply Brief, and fully developed in previous briefs, CEPA et al. also contend that the Commission should consider that the \$18 million City payment is also fully available to PGW in the form of a waiver or as a "grant back."

CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

Docket No. R-00005654

I hereby certify that I have this day served a true copy of the Supplemental Reply Brief of CEPA, Action Alliance of Senior Citizens, ACORN and Tenants' Action Group, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 25th day of October, 2000.

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

SERVICE BY E-MAIL AND FIRST CLASS U.S. MAIL

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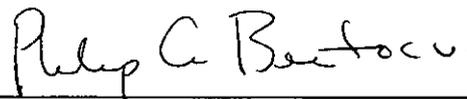
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