

APPENDIX
A

BEFORE THE CITY OF PHILADELPHIA – GAS COMMISSION

IN THE MATTER OF THE FISCAL YEAR :
2001 CONSOLIDATED BUDGET/OVERSIGHT :
REVIEW OF PGW'S PROPOSED FY 2001 :
OPERATING AND CAPITAL BUDGETS AND : FILED
OUTYEAR FORECASTS; PGW'S PROPOSED :
FY 1997-1999 CAPITAL BUDGET RECONCIL- :
IATION; PGW'S PROPOSED \$52 MILLION : JUNE 19, 2000
BASE RATE INCREASE; PGW'S PROPOSED :
AMENDMENT TO REGULATION 12.1 OF TARIFF; :
PGW'S PROPOSED FY 2001 GAS COST RATE :

RECOMMENDED DECISION

FY 2001 Operating Budget and Outyear Forecasts

Before
JANET PARRISH, ESQ.
Senior Hearing Examiner

May 17, 2001

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I. PROCEDURAL HISTORY

A. INTRODUCTION

This budget proceeding has an unusually lengthy procedural history, which warrants a brief discussion and summary before it is set forth. The proceeding commenced slightly later than usual in mid-June 2000 when the Philadelphia Gas Works ("PGW") filed its proposed FY 2001 Operating Budget and other proposals, and the initial public hearings were completed by late August 2000. In the interim, as of July 1, 2000, the Philadelphia Gas Commission's ("the Commission" or "PGC") authority to adjudicate PGW's base rate increase, Gas Cost Rate ("GCR") and other tariff proposals was transferred to the PA Public Utility Commission ("PUC") by the Natural Gas Choice and Competition Act ("Gas Choice Act" or "NGCCA") (66 Pa.C.S. §2201 *et seq.*, in particular §2212 regarding city natural gas distribution operations). In early August 2000, PGW filed proposed base rate and GCR increases with the PUC.

When the Commission's hearings were recessed in August 2000, key components of PGW's filing, which had been directed to be filed by the Commission in its FY 2000 Operating Budget Order, had still not been submitted. Specifically, PGW had not filed the required Five Year Financial and Management Plan, which was to underlie the proposed budget and future years' forecasts, or the required organizational restructuring plan, thereby preventing the Commission from concluding its budget review. Consequently, in October 2000, the Commission was forced to approve interim spending authority for PGW for FY 2001, which – to enforce some appropriate cost-cutting controls – was generally limited to 95% of the prior year's approved operating expense line items.

As is discussed in more detail in my Memorandum to the Gas Commissioners dated October 6, 2000, PGW sought approval of both the Commission and City Council for a \$45 million "temporary advance" from the City of Philadelphia to enable it to pay operating expenses, including debt service payments, pending receipt of interim rate relief from the PUC. Concurring in the Commission's recommendation, City Council approved the loan, but limited it to \$20 million pending PGW's submission of an adequate Five Year Financial and Management Plan (Bill No. 000583). Finally, in December 2000, in order to gain access to the final \$25 million tranche of the City loan, PGW submitted to the Commission an outline of a Five Year Plan which, according to PGW and the City Administration, was incomplete, unfinished and in need of revision. In January 2001, this Plan outline, when taken together with the Administration's commitments to complete it and to participate in a PGW Recovery Team co-chaired by the Mayor, Council President

and Chair of the Commission, was deemed to constitute an adequate Five Year Plan as contemplated by the ordinance (Resolution No. 010027).

As of the issuance of this Recommended Decision, PGW has yet to complete or to submit a revised Five Year Plan, thereby continuing to preclude a meaningful review of the operating budget forecast for the future fiscal years 2002 through 2006. However, with close to two-thirds of the current fiscal year having gone by, it appeared that the most reasonable and realistic, though unsatisfactory, thing to do was to adopt a finalized FY 2001 Operating Budget.

Doing so was complicated by the fact that there had been some critical changes in operating assumptions resulting from rate-setting actions taken by the PUC (some of which resulted from a February 2001 settlement between the PUC and PGW/the City regarding PGW's interim base rate increase request, the PUC's initial Order regarding which had been appealed by PGW and the City to Commonwealth Court). It has not generally been the Commission's practice to revise PGW's operating budgets which have been proposed in mid-fiscal year, based on year-to-date actual data, except for significant changes in factors which do not fall within the realm of normal operational variation. Thus, PGW's initial revised filings dated February 23, 2001 (incorporating PGW's proposals included in its January 5, 2001 \$65 million permanent base rate increase filing with the PUC and various revisions to budgeted operating expenses based on year-to-date actual data¹) and March 6, 2001 (which was also tied to the January 5, 2001 PUC filing) were, after discussion among the Hearing Examiner and the parties, not deemed to be an appropriate basis for going forward. Ultimately, revised financial schedules dated April 3, 2001 were submitted and reviewed at public hearings held on April 19, 2001.

B. HISTORY OF THE PROCEEDING

At its regular meeting on June 6, 2000, the Commission indicated that, in accordance with past practice, it intended to conduct a consolidated review of PGW's proposed Operating and Capital Budgets for FY 2001 with associated outyear forecasts (see also PGC Exhibit 2).

On June 19, 2000, PGW filed with the Commission its proposed Operating Budget for FY 2001 and its proposed Capital Budget for FY 2001 and Forecast for Fiscal Years

¹See Direct Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042 (rev. 02/02/01) at 3-4.

2002-2006; its proposed Gas Cost Rate ("GCR") for FY 2001; and its proposed amendments to Rates GS, MS and PHA and Regulation 12.1 of PGW Gas Service Tariff No.10 ("Tariff") (proposed \$52 million base rate increase and proposed amendment to senior citizen discount) (PGW Exhibits 2 through 6; PGW Statements 1 through 5). PGW requested that all of these matters be consolidated for hearing and that the proceeding be conducted in accordance with Gas Commission Regulation No.1 (PGW Exhibit 2).

On June 21, 2000, the Commission notified PGW that it would initiate a consolidated proceeding to review the filings, but that the budget filings were not complete (PGC Exhibit 6). PGW supplemented its filings on June 30, 2000 (PGW Statements 6 and 7) and again on July 7, 2000 (PGW Exhibits 7 through 11, 14 and PGW Statements 8 through 11).

On July 10, 2000, Hearing Examiners Janet Parrish, Esq. and Tarleton D. Williams commenced formal proceedings² in these matters with a pre-hearing conference, of which written notice dated June 22, 2000 was given to all parties on the Commission's normal service list and of which public notice was published in various local newspapers as required by Regulation No.1 (PGC Exhibits 3, 4 and 5). PGW, the Public Advocate ("PA" or "the Advocate"), and the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") entered their appearances. The School District of Philadelphia (represented by Mondre Energy, Inc.), the Gas Works Employees Union ("GWEU"), the Consumers Education and Protective Association ("CEPA"), Tenants' Action Group of Philadelphia ("TAG"), and the Action Alliance of Senior Citizens ("AASC") also expressed their intent to participate in the proceeding.³ The purpose of the pre-hearing conference was to determine the dates of hearings, the procedures for taking testimony and other procedural matters.

The schedule and procedures established were intended to enable the Commission to review the filings in a reasonably expeditious manner, while ensuring that a fair opportunity was given for those representing PGW's ratepayers and other interested

²The balance of this procedural history as well as the discussion in this Recommended Decision will focus on the components of PGW's filings other than the proposed FY 2001 Capital Budget and Outyears Forecast, which were the subject of Recommended Decisions issued by Hearing Examiner Williams on November 27, 2000, March 27, 2001 and April 17, 2001.

³Ultimately, in addition to the Advocate, the active parties intervening in this matter were PICGUG, the School District, GWEU, CEPA, and Delaware Valley Healthcare Council of HAP/Delaware Valley Energy Options, Inc. ("DVHC"). Subsequently, both DVHC and the School District withdrew as active participants and requested inactive status (DVHC Exhibit 2; letter dated October 10, 2000 from Jackie Sparkman to Senior Hearing Examiner). TAG, Action Alliance of Senior Citizens and one individual also had inactive participant status.

parties to challenge or question PGW's proposals or present other alternatives for the Commission's consideration. The schedule and procedures also took into account that, effective July 1, 2000, under the terms of the Gas Choice Act, the Gas Commission no longer had authority to make final, binding determinations with respect to PGW's base rate increase request, its request to amend the Tariff provisions regarding the senior citizen discount,⁴ and the proposed FY 2001 GCR. Regardless, litigation initiated by City Council seeking to have these provisions invalidated was then and still is pending in the Commonwealth Court. The Commission therefore determined that it was prudent to continue to conduct this proceeding in accordance with Regulation No.1. Moreover, the intent was, as always, to make the necessary record in this proceeding to support any actions the Commission might deem appropriate within the scope of its continuing authority to review and approve PGW's proposed budgets and forecasts⁵ and to exercise its oversight responsibilities vis-à-vis the Philadelphia Facilities Management Corporation ("PFMC") (Transcript ("Tr.") 8-15, 54-58, 62-67).

The Hearing Examiners confirmed the proceeding schedule and procedures in a Pre-Hearing Memorandum Order dated July 13, 2000 (PGC Exhibit 8). On July 17, 2000, the Commission transmitted to the City Department of Records PGW's proposed Tariff changes for public inspection, in accordance with Section 8-407 of the Philadelphia Home Rule Charter (PGC Exhibit 12). Formal discovery occurred and informal discovery meetings were held on July 26 and 27, 2000, August 1, 2000 (via telephone conference call), and August 7, 2000 (PGC Exhibits 16, 18, 20 and 22).

On July 21, 2000, PGW filed the Direct Testimony of Janice Davis, the City's Finance Director, on behalf of the City of Philadelphia (PGW Statement 12). Pre-hearing memoranda were filed on July 31, 2000 by PGW (PGW Exhibit 17), the Advocate (PA Exhibit 2), the School District (SD Exhibit 2), the Union (GWEU Exhibit 2), PICGUG (PICGUG Exhibit 2), and CEPA (CEPA Exhibit 2).

On August 1, 2000, the Hearing Examiners issued a Supplemental Pre-Hearing

⁴While the PUC was given the exclusive authority to approve changes to PGW's base rates, GCR and Tariff, under the provisions of the Gas Choice Act, PGW's proposal to amend the senior citizen discount must be made to the City Council of Philadelphia (66 Pa. C.S. §2212(r)).

⁵Section 2212(s) of the Gas Choice Act provides: "Nothing contained in this Title shall be construed to abrogate or limit the executive or legislative powers of a city that owns a city natural gas distribution operation to legislate or otherwise determine the powers, functions, budgets, activities and mission of the city natural gas distribution operation or any related entity created under [§2212(m)], including but not limited to the ownership, governance, management or control thereof."

Order Regarding Schedule And Other Matters (PGC Exhibit 21). On August 2, 2000, PGW filed its revised proposed GCR (PGW Exhibit 18), in accordance with its GCR filing with the PUC. On August 3, 2000, PGW filed revised financial statements reflecting the impact of the increased GCR amount (PGW Exhibit 19).

On August 11, 2000, the Advocate filed the Direct Testimony of its witness Michael A. Bleiweis (Part I, Capital Budget) (PA Statement 1) and the Union filed the Direct Testimony of Joseph G. Given (GWEU Statement 1). On August 15, 2000, the Advocate filed the Direct Testimony of Michael A. Bleiweis (Part II, Operating Budget) (PA Statement 2); the Prepared Direct Testimony of Ralph E. Miller (PA Statement 3); and the Direct Testimony of Richard W. LeLash (PA Statement 4). On August 15, 2000, CEPA filed the Testimony of Lance Haver (CEPA Statement 1). PICGUG and the School District, the other active parties at that time, did not file any testimony.

After public notice was given of the hearing dates and proceeding schedule in accordance with Regulation No.1 (PGC Exhibits 10 and 15), and Commission-approved customer bill inserts were used to notify PGW customers of the nature of its requests and the public hearing dates (PGW Exhibit 20), public hearings were held on August 17, 18, 21, 22 and 23, 2000. Public input from 13 individuals (some representing organizations) was taken during the August 17, 18 and 23 hearings. In addition, an evening public input session was held on August 22, 2000, at which an additional ten individuals testified. During the hearings, all of the witnesses who pre-filed testimony were questioned by PGW, the Advocate, the Commission's Hearing Examiners, the Commission's Executive Director and the School District. Also testifying during the hearings on behalf of PGW were: Dennis E. Stinson, Senior Vice President, Operations; Sherry N. Rubin, Vice President & Chief Information Officer; John P. Straub, Vice President, Human Resources; Joseph F. Golden, Jr., Treasurer; Joseph Szlanic, Director, Technical Services, Information Technology Department; Paul J. Donohue, Director, Accounts Receivable; Patrick H. Durkin, Director, Gas Supply and Transportation; William Muntzer, Director, Marketing and Supply Services; William J. Ambrose, Jr., Director, Employees Services; Brian Schenk, Manager, Distribution Department; Abdol R. Nayak, Manager, Gas Processing Department; John G. Kelly, Project Manager for LNG Plant; William J. Gallagher, Manager, Corporate Planning; Randy Gyory, Manager, Program Management Office; Cristina Coltro, Manager, Energy Assistance Programs; David Griesing, Esq., Associate General Counsel; Joe Trainer, R.J. Rudden Associates; and Colbert G. Narcisse, Vice President, Merrill Lynch.

After these initial hearings, hearings were recessed to the call of the Hearing Examiners, pending PGW's completion of its budget filings in accordance with the Commission's Order (Tr. 1481-1482). PGW had represented that it would file the

required Five Year Strategic Plan, first in August (PGW Exhibit 14) and then, in the near future (e.g., Tr. 26-27, 95). By the September 26, 2000 Commission meeting, PGW had still not filed this Plan nor the other documents which the Commission required for completing its review of the proposed budget and forecast (Order dated October 17, 2000 at page 2). Consequently, the Commission authorized PGW to continue operating spending at levels which did not exceed 95 percent of the actual FY 2000 spending for approved line items, excepting natural gas expense, until the Commission took final action on the FY 2001 operating budget (Id. at ordering paragraph 1).

On December 18, 2000, PGW filed its proposed Strategic Plan and Five Year Financial Forecast⁶ (PGW Exhibit 29). This Hearing Examiner then scheduled an informal discovery meeting on January 8, 2001 and reconvened the hearings in this proceeding on January 11, 2001 (PGC Exhibit 28). On January 16, 2001, I issued a Memorandum to the Commissioners providing a Preliminary Assessment of PGW's Five Year Strategic Plan and Update on PGW's Cash Situation and Projections (PGC Exhibit 38). Subsequently, PGW and the City Administration acknowledged that PGW's Five Year Plan was unfinished and incomplete and committed to revise and complete it (Resolution dated January 22, 2001 at page 3; Transcript of January 22, 2001 Commission Meeting at 22-24).⁷ To date, the Plan has not been revised and remains unfinished and incomplete.⁸

On February 9, 2001, PGW agreed that it was appropriate to file a revised FY 2001

⁶When, in October 2000, City Council approved an ordinance authorizing a \$45 million "temporary advance" from the City of Philadelphia to PGW, it limited PGW to drawing no more than \$25 million from this restricted account "until such time as the Gas Commission has informed City Council; and City Council has concurred by Resolution, that PGW has submitted an adequate Five Year Financial and Management Plan" (Section 2(c) of Bill No. 000583).

⁷Additionally, that day, the Mayor and the President of City Council agreed to Chairwoman Tasco's suggestion that they form a Recovery Team to complete the recovery plan necessary to address and fix PGW's financial and operational crisis (Resolution dated January 22, 2001 at page 3). The Commission concluded that PGW had submitted an outline for a Five Year Financial and Management Plan, which together with the Mayor's and PGW's commitments to revise and complete the plan and with the creation of the Recovery Team, constituted an adequate Five Year Financial and Management Plan as contemplated by City Council Ordinance (Id.). On February 28, 2001, the Council President and the Chairwoman withdrew from the Recovery Team, stating that their "participation on the Recovery Team merely creates a perception of involvement, where none exists" and that "[a]ccordingly...[they] no longer wish[ed] to be considered members of what has become a phantom Recovery Team" (letter dated February 28, 2001 to Mayor Street from Council President Verna and Councilwoman Tasco).

⁸According to Mr. Knudsen, there are now additional uncertainties about PGW's future management and status which make it difficult to finalize a five year strategic plan (response to HE-46; Tr. 1990-1992).

operating budget, incorporating the impacts of PGW's dramatically increased GCR (PGC Exhibit 39). On March 6, 2001, PGW filed revised FY 2001 financial statements (PGW Exhibit 42), and on March 15, 2001, PGW filed the accompanying narrative (PGW Exhibit 43).

On March 20, 2001, this Hearing Examiner notified the Service List that, while further review of the outyear budget forecast was not possible without PGW's completed Five Year Strategic Plan, the Commission would move to conclude its review of the FY 2001 Operating Budget (PGC Exhibit 40). Accordingly, an informal discovery meeting was held on March 27, 2001. On April 2, 2001, this Hearing Examiner conducted a telephone conference call with PGW and the Advocate⁹ regarding the scope of the Commission's review and established a further schedule for concluding the Operating Budget review (PGC Exhibit 41). The parties agreed that PGW's revised FY 2001 Operating Budget should be based on its original filing, updated solely to reflect the base rate and GCR increases approved by the PUC and the associated impacts on bad debt expense and other directly related line items (Id.).

On April 5, 2001, PGW filed the Supplemental Direct Testimony of Thomas E. Knudsen together with supporting exhibits (PGW Statement 13). On April 12, 2001, the Advocate filed the Supplemental Direct Testimony of Michael A. Bleiweis (PA Statement 5). On April 19, 2001, the Hearing Examiners reconvened public hearings in this matter. Public input was received from six individuals. In addition, Messrs. Knudsen, Bogdonavage and Bleiweis were further questioned by the parties, the Hearing Examiners and the Commission's Executive Director. Also presenting testimony on behalf of PGW was Michael A. Bush, Manager, Accounts Receivable.

At the conclusion of these evidentiary hearings, the total number of transcript pages stood at 2,147 and there were a total of 105 exhibits (48 PGW exhibits; 42 PGC exhibits; five PA exhibits; and ten exhibits from other active parties). There were also 36 transcript requests ("TR-") directed to PGW,¹⁰ the responses to which are considered to be part of the record of this proceeding. Also considered part of the record are all responses, revised and supplemental responses to data requests propounded by (and not subsequently withdrawn by) the Advocate (PA-1 to PA-192); PICGUG (PICGUG-1 to PICGUG-25); the School District (SD-1 to SD-266); the Union (GWEU-1 to GWEU-8); this

⁹The remaining active parties – PICGUG, GWEU and CEPA – did not participate in this phase of the proceeding.

¹⁰One of these was also directed to one of the Advocate's witnesses.

Hearing Examiner (HE-1 to HE-48)¹¹; the Commission's Executive Director (ED-1 to ED-6); and by the parties during informal discovery (ID-1 to ID-25).

On May 3, 2001, PGW and the Advocate submitted their final position statements (respectively, "PGW Brief" and "PA Brief"). This Recommended Decision follows.

II. LEGAL STANDARD FOR REVIEW AND APPROVAL OF OPERATING BUDGET

The relevant standard for review and approval of PGW's proposed Operating Budget for FY 2001 is set forth in Section IV ¶2(a) of the Agreement Between The City Of Philadelphia And The Philadelphia Facilities Management Corporation For The Management And Operation Of The Philadelphia Gas Works ("Management Agreement"):

There shall be prepared annually an operating budget for the ensuing year and an operating forecast for four (4) years comprising the ensuing year and the three (3) years next following. Such budget and forecast shall be prepared by the Company with the aid of the Director of Finance; shall be consistent with the accounting methods prescribed in Section IV (1); and in general shall be in form and extent satisfactory to the Director of Finance and Gas Commission. The operating budget and forecast shall be subject to the approval of the Gas Commission.

This Agreement was adopted by an ordinance passed by the City Council of Philadelphia on December 29, 1972. The ordinance has statutory effect, School District of Philadelphia v. Zoning Board of Adjustment, 417 Pa. 277, 207 A.2d 864 (1965); Action Alliance, Etc. v. Philadelphia Gas Commission, 45 Pa. Cmwlth. 234, 241-42, 406 A.2d 1155, 1158 (1979). The Common Pleas Court of Philadelphia County has held that this Commission's final Order in the FY 1994 Operating Budget proceeding was not an appealable adjudication within the meaning of the Local Agency Law, 2 Pa.C.S. §751 et seq (Tenants Action Group, Inc, et al v. Philadelphia Gas Commission et al, C.P. Phila. No. 9312-0828, Order dated April 20, 1994, Avellino, J.).

Both through written and oral testimony, the City's Director of Finance informed the Commission that PGW's budget submission was in a form with sufficient detail to meet her requirements.

¹¹The response to HE-43 is outstanding.

Prior to the effective date of the Gas Choice Act, the Commission was obligated by Section VII of the Management Agreement to fix rates which will in each fiscal year produce revenues sufficient to pay all of PGW's operation and maintenance costs and expenses and the interest and amortization becoming due on PGW's debt (as detailed in Section VII ¶1(a)(i) through (v)). Moreover, rates must be set to produce revenues sufficient to make an annual payment of \$18 million to the City, to provide appropriations for prepayment of debt and capital additions approved by the Commission and City Council, and to provide cash working capital in such amounts determined necessary by the Company and approved by the Commission (as detailed in Section VII ¶1(b)(i) through (iii)). This rate-setting obligation was transferred to the PUC effective July 1, 2000 (66 Pa.C. S. §2212(b) and (e)).

The Gas Choice Act recognizes that, notwithstanding the transfer of the Commission's previous regulatory functions and authority to the PUC, the City retains its executive and legislative powers to "...determine the powers, functions, budgets, activities and mission of [PGW]..., including but not limited to, the ownership, governance, management or control thereof" (66 Pa. C. S. §2212(s)).¹²

The General Gas Works Revenue Bond Ordinance of 1975 ("1975 Ordinance") requires PGW to maintain a debt service coverage level of at least 1.5x. In light of enactment of the General Gas Works Revenue Bond Ordinance of 1998 ("1998 Ordinance"), PGW will no longer issue bonds under the 1975 Ordinance (PGW Exhibit 29 in FY 1999 Consolidated Budget Proceeding). The 1998 Ordinance maintains the 1.5x debt service coverage requirement, but provides more financial flexibility and increases the coverage cushion through transitioning PGW from a parity lien structure to a senior/junior lien structure (Id.).

¹²Under the terms of the Management Agreement and Sections 2212(f) and (s) of the Gas Choice Act, only the City (i.e., the Mayor and City Council) can determine whether to forego or grant back the annual \$18 million City payment currently provided for in Ordinance. I therefore do not address the Advocate's request for a Commission Order to "break the log jam" on this issue (PA Brief at 2, 15-21).

III. DISCUSSION

- A. **IN REVIEWING AND APPROVING PGW'S PROPOSED FY 2001 OPERATING BUDGET AT THIS POINT IN THE FISCAL YEAR, THE MOST REASONABLE BUDGETING ASSUMPTION IS THAT PGW'S FY 2001 REVENUES WILL REFLECT THE PUC-AUTHORIZED INTERIM BASE RATES AND GAS COST RATE FACTORS, CONSISTENT WITH THE GAS COMMISSION'S PRIOR BUDGET REVIEW PRINCIPLES AND PRACTICES AS WELL AS APPLICABLE LAW.**

This being the first operating budget review by the Gas Commission since the effective date of the Natural Gas Choice and Competition Act, and this review occurring contemporaneously with various rate-setting proceedings before the PUC, we are – as Knudsen put it – “in new territory here” (Tr. 1981). Particularly during the tail end of this proceeding, there was considerable discussion and difference of opinion as to the scope of the Commission's budget review and the manner in which it should or should not take into account the rate-setting actions of the PUC during the course of this fiscal year.

Knudsen posits that “...we are putting ourselves back sometime in the summer of last year and we are looking forward *as if you [the Commission] had the authority to recognize a level of rate relief that's required to meet certain basic needs of [PGW],* and you have to state what those needs are” (emphasis added) (Tr. 1981). More specifically, Knudsen asserted,

the appropriate approach is to go back in time, look at this year, look at the collateral issues around this year, meaning what should the year-end level of cash be, because you have certain obligations going forward into the subsequent fiscal period, and then if the programs are appropriate, which they were because you had certain limiting factors, you could not abrogate the collective bargaining agreement, you could not change certain programs...such as the senior citizen discount¹³ – in other words, there were things that were in place, in addition to the fact that the place was in chaos this year... – if you find that those elements of a budget are appropriate, then you have to find a level of revenue to support that and then you have to also assign a writeoff for bad debt, and that

¹³This alleged inability to change the senior citizen discount program did not stop PGW from budgeting a \$1.5 million increase in revenues which would allegedly result from closing the program to new applicants (see PGW Exhibit 3 at Ex. A-1; PGW Statement 2 at 5-6).

package then becomes your recommendation.
(Tr. 1987-1988).

PGW maintains that the evidence in this proceeding is that “there is a revenue deficiency in the FY 2001 Operating Budget of \$52 Million” (PGW Brief at 13; see also Tr. 1980-1982), and that the Commission should essentially disregard the PUC-authorized interim base rates now in effect, for reasons that I will review below. PGW argues that “...under the Gas Choice Act, [the] Commission *must assume* that the PUC will provide *rates consistent with the applicable legal standards*, including the Management Agreement” (emphasis added) (PGW Brief at 10). Or, as PGW also put it, “[t]he Commission has the obligation to approve a level of program expenditures and must, under the law [footnote omitted], assume that the PUC will set rates to generate revenue sufficient to comply with this local determination” (*Id.* at 2).

There are several reasons why, particularly given the posture of this proceeding, PGW’s approach is incorrect.

1. PGW’s Recommended Approach Is Not Consistent With Past Commission Practice For Reviewing Budgets At Mid-Fiscal Year.

As discussed earlier, the Commission was precluded from completing its review of PGW’s original filing within the Commission’s preferred time frame (i.e., within the first or second month of PGW’s fiscal year) due to the incompleteness of the filing. The filing remained incomplete as of the most recent hearings in April 2001.¹⁴ During the intervening period, there have been several occurrences that are not within the realm of normal operational variations, e.g., variation in weather or minor variances from projected expenses, which change underlying budget assumptions significantly.

¹⁴As mentioned earlier, PGW has not yet submitted a complete Five Year Financial and Management Plan to the Commission, notwithstanding the commitments made by both PGW and the Mayor earlier this year. Indeed, at the April 19, 2001 hearing, Knudsen was representing that it would be difficult for PGW to formulate such a plan, given all of the further uncertainties about its future (Tr. 1990-1992; see also response to HE-46: “All of this activity makes defining a future path for the utility difficult at best.”). Knudsen also stated that PGW “...should be in a position to submit the [revised/completed] package for review in two weeks time” (response to HE-46). About a month later, this “package” has yet to be delivered. It is therefore both surprising and disturbing that PGW recently [mis]informed the PUC that “All PGW activity before the Philadelphia Gas Commission is complete.” and that “FY 2001 Strategic Plan is complete; working on FY 2002 update.” (PGW Monthly Progress Report to the PUC in Docket No. R-00005654 dated May 10, 2001 at 1).

When such mid-fiscal year review of operating budgets has occurred in the past, the Commission has taken the position that such significant changes should be reflected for budgeting purposes, but that it is unnecessary to update every line item for year-to-date actual results in order to reflect changes within the scope of normal operational variation (see 2d of Two Orders dated October 29, 1996 regarding FY 1997 Operating Budget at ordering paragraph 1.A.).¹⁵

The parties in this proceeding agreed that the Commission should go forward on this basis. PGW therefore presented financial statements which reflected the PUC-approved \$11 million¹⁶ interim rate increase plus \$7 million bad debt expense recovery through the GCR (effective March 1, 2001) and a total of \$230 million¹⁷ in GCR increases approved by the PUC for FY 2001 (PGW Statement 13 at 2 and at revised Ex. A-1). Consistent with this position, Bogdonavage conceded that the \$45 million temporary advance to PGW from the City – which was approved by City Council subsequent to the original budget filing – was also such a “one-time event” which “should be imputed into the operating budget” to effectively “plu[g] that gap” in year-end cash balances¹⁸ (Tr.

¹⁵As noted in my Recommended Decision on PGW’s revised FY 1997 Operating Budget filed in response to this Commission Order, “...PGW projected a number of other changes, which were not strategic plan-related, but rather adjustments related to changes in weather, gas prices, and other normal operating conditions, and which reflected actual-estimated data available for the first five months of the fiscal year [citation omitted]. It would not have been appropriate to review these changes or suggest mid-year budget adjustments based upon them, and no effort was made to do so [citation omitted]...What would be appropriate, as witnesses for both the Company and the Advocate recognized, is to update either the compliance budget or the revised budget for the most current, quantifiable update on strategic initiatives [citation omitted].” (Revised FY 1997 Operating Budget Recommended Decision at 12); see also FY 1999 Operating Budget Recommended Decision at 17).

¹⁶The PUC approved an additional \$7 million for bad debt expense associated with the much higher gas cost rates being billed, which was to be recovered by August 31, 2001 through an increase in the GCR factor (even though this is not a gas cost) (PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619 at pp. 4, 6 and at ordering paragraph 1). PGW added this to the \$11 million base rate increase to show a total interim base rate increase of \$18 million in its revised financial statements (PGW Statement 13 at Rev. Ex. A-1).

¹⁷PGW showed this as a \$185 million “GCR Adjustment” in its revised financial statements, to reflect the increments approved by the PUC above the \$42 million GCR increase embedded in the revenue projections in the original budget filing (PGW Exhibit 3 at Ex. A-1; PGW Statement 13 at Rev. Ex. A-1). The \$185 million also reflects the increase from the originally budgeted natural gas expense of \$294.593 million to the revised natural gas expense of \$479.593 million (PGW Statement 13 at rev. Ex. A-1).

¹⁸Without taking into account the subsequently-authorized City loan, PGW’s revised financials projected a negative year-end cash balance of (\$48.7 million) (Tr. 1976). All else being equal, taking

1976-1977).

From this mid-fiscal year vantage point, the most realistic and reasonable budgeting assumption for the Commission to make, consistent with its past practice, is that PGW will have revenues during FY 2001 based on the interim rate relief approved by the PUC in its Order adopted February 21, 2001 (approving the Joint Petition for Settlement submitted by PGW, the City and the PUC Law Bureau) and on the GCR increases approved by the PUC.¹⁹ This is effectively what Black & Veatch concluded in their engineering report prepared in connection with PGW's planned revenue bond issuance (response to ID-23).²⁰

into account the \$45 million City loan proceeds reduces the budgeted negative year-end cash balance to (\$3.7 million) (Tr. 1976-1977). As Bleiweis observed, taking into account actual results through February 2001, PGW's projected year-end cash balance was \$33 million (PA Statement 5 at 7-8 and at MAB-14; Tr. 2026-2027). However, he conceded this would be reduced by about \$3.6 million – rather than increased – when the actual March 2001 cash receipts were factored in (Tr. 2027-2028). I take notice that, according to PGW's more recent daily cash receipts reports, in April 2001 receipts ran about \$4.2 million below projections which, all else being equal, would indicate a further reduction in the year-end cash balance to about \$25 million. By contrast, as of mid-May 2001, cash receipts for that month were running about \$6 million above projections. I also take notice that PGW's most recent projection, which takes into account all of the factors which go into determining the year-end cash balance, is that it will be \$34 million; however, factoring in its one-time ability to defer about \$11.5 million of natural gas purchase obligations to early FY 2002, PGW maintains that its net year-end cash balance would be \$22 million (Rebuttal Testimony of Joseph R. Bogdonavage dated May 2001 in PUC Docket No. 00006042 at 2). This falls within the \$20 to \$25 million range anticipated by the PGW/City-PUC interim rate settlement (Joint Petition for Settlement in PUC Docket No. R-00005654 at ¶25).

¹⁹It is also most realistic and reasonable to project natural gas expense, bad debt expense and similarly impacted revenue and expense items which are reflective of these significant rate increases (see discussion in Section III.B. below).

²⁰Based on the normal length of time for a PUC rate proceeding, Black & Veatch assumes that PGW will not have any further base rate increase until after the start of FY 2002, specifically in early October 2001 (response to ID-23; Tr. 2046-2047). Even if this case were to be settled, so that any further rate increase could begin to be collected sooner, PGW concedes this is unlikely to have a significant effect during the few remaining months of FY 2001 (Tr. 1987). Black & Veatch nevertheless concluded that PGW would have sufficient revenues to be able to satisfy its bond covenants for FY 2001, and that so long as PGW obtained \$53 million per year in permanent base rate relief on a levelized basis (compared to rate levels existing *prior to implementation of the interim rate increase in March 2001*) for FY's 2002 through 2006, it would continue to be able to satisfy those covenants (response to ID-23; see also Rebuttal Testimony of Thomas E. Knudsen dated May 2001 in PUC Docket No. R-00006042 at 6 and Rebuttal Testimony of Thomas J. Sullivan dated May 2001 in PUC Docket No. R-00006042).

2. PGW's Argument That The Interim Base Rates In Effect Are Not Legally Binding On The Commission Because They Are "Interim" Mischaracterizes The PUC's Orders And PGW's Filing.

PGW claims that "...this Commission is not bound, as a matter of law, by the level of rates approved in [the PUC interim rate] proceeding since those rates are, by definition, interim and subject to either a subsequent order to refund or an increase in the case now pending before the PUC [footnote omitted]" (PGW Brief at 15). PGW is correct that the interim rates "are subject to refund at the conclusion of a full base rate case if the [PUC] determines that a lower level of rates is just and reasonable" (see PUC Order in Docket No. R-00005654 adopted November 21, 2000 at ordering paragraph 2) – but this argument does not further PGW's position, because it only indicates that, for budgeting purposes, it might be assumed that PGW's revenues for this fiscal year will be even lower than shown in the most recent revised financial statements.

Contrary to PGW's representation, though, these interim rates could not be increased in the pending permanent base rate proceeding. This same PUC Order (at ordering paragraph 3) explicitly provides that "PGW must not seek to recoup additional revenues from ratepayers if the [PUC] ultimately determines that a higher level of base rates is just and reasonable." This condition was not modified by the PUC's subsequent interim rates order and therefore remains in effect (see PUC Order in Docket Nos. R-00005654 and R-00005619 adopted February 21, 2001 at ordering paragraphs 2 and 3).

PGW also mischaracterizes its interim rate filing as "not seek[ing] relief sufficient to provide cash or revenue for the full Fiscal Year 2001" and "not present[ing] a request to provide rates adequate to fund the entire operating and capital budgets for FY 2001" (PGW Brief at 16). In fact, PGW's interim rate filing sought a \$52 million increase in base rates, intended to provide a \$35 to \$40 million cushion of cash at the end of FY 2001 (PUC Order in Docket No. R-00005654 adopted November 21, 2000 at 7). PGW claimed that this amount of relief was required to ensure that it had sufficient liquidity at the end of the current fiscal year to meet its bond indentures and cover expenses at the beginning of the next fiscal year (Id.). It was the intervenors in that proceeding – not PGW – who urged the PUC to limit the interim rate relief to that necessary to maintain financial health through the winter heating season (Id.), as the PUC had indicated was the limited purpose of the interim rate proceeding (Id. at 8; see also Id. at 10, 12-13).

Nevertheless, since the PUC stated that any further rate relief was to come only through a full base rate proceeding (to be initiated by PGW filing no later than January 1, 2001) and after review of the then-pending management audit (Id. at 10, 12), and since, under state law, the PUC determination on the permanent base rate request is unlikely to

come before October 6, 2001 (that is, about one month into FY 2002) (response to ID-23; Tr. 2046-2047), I do not see how the FY 2001 revenue requirement will be addressed by anything other than the interim rate case.

In sum, there is nothing in this record to support an assumption that a roll-back of the interim rates is likely; and, under the PUC's Orders as well as applicable law, there is no basis on which it could reasonably be assumed that the interim rates in effect during the FY 2001 period will be increased retroactively. It is clear that PGW's interim rate filing and the PUC's adjudication thereof apply directly to the 2001 fiscal year. Thus, the most reasonable budgeting assumption is that adopted by Black & Veatch, which is that for planning purposes, revenues for FY 2001 will reflect the interim rates in effect from March 1, 2001 through August 31, 2001.

3. **For Budgeting Purposes, Once Rates Have Been Set For A Particular Fiscal Year, The Commission Must Utilize Revenue Projections For That Fiscal Year Based On Those Rates.**

PGW objects that for the Gas Commission to take the position outlined in the two preceding sections is to effectively turn the "preservation of powers" section of the Gas Choice Act on its head – as Knudsen characterized it, that

You are positing that they've given you so much revenue to work with, you go to the Company, you go as the determiner of budgets and cut the hell out of the place because that's the only way you're going to be able to make \$18 million work this year.²¹ (Tr. 1984).

In taking action on the proposed FY 2001 Operating Budget, the Commission should not adopt PGW's position for several reasons. As just discussed, PGW's rates for FY 2001 have been established by the entity with the legal authority to do so and, indeed, these interim base rates have been agreed to by PGW and the City (see Joint Petition for

²¹Knudsen's position would appear to be at odds with PGW's representation to the PUC that this level of interim rate relief combined with the other financial and operational steps outlined in the parties' Joint Petition for Settlement was expected to be sufficient to enable PGW to meet its financial obligations through January 2002 (see Joint Petition for Settlement at ¶29; also see ¶¶25 through 27). The PUC found this expectation to be "noteworthy" (PUC Order dated February 21, 2001 at 8). The PUC also noted PGW's agreement that "if these steps are not sufficient...[PGW] will consider additional rate relief to meet any shortfall only as a last resort and only after pursuing in good faith all other sources of revenue reasonably available" (emphasis in original) (Id.).

Full Settlement of Philadelphia Gas Works' Petition for the Establishment of Interim Rates and Related Appeal in PUC Docket No. R-00005654 and PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619).²² The Advocate maintains, "[o]nce rates for a particular fiscal year have been determined, as in this case, the Gas Commission must budget expenditures based on estimates of revenues from existing rates and other sources" (PA Brief at 7). PGW responds that "[i]t is...not appropriate [for the Commission] merely to match proposed expenditures to current rate resources" (PGW Brief at 19, n.28; see also *id.* at 19). But, PGW does not indicate how it would be proper or legal under the Gas Choice Act for the Commission to ignore rate orders duly adopted by PGW's rate setting authority or their impact on revenues in this particular fiscal year.²³

Certainly, if PGW had timely completed its budget filing and thus, this budget review had been able to be concluded at the beginning of the fiscal year, the Commission would have had to make its best judgment based on the information available at that time as to the reasonableness of PGW's projected revenues for FY 2001 and beyond, including those being requested from and anticipated to result from rate action by the PUC. Had that occurred, the question of what weight the PUC had to give PGW's approved Operating Budget under the Gas Choice Act would have been squarely framed. However, timing is everything. Under the current circumstances, wherein the PUC has taken rate action which is effective during FY 2001 prior to the Commission's taking final action on the proposed FY 2001 Operating Budget, this question becomes academic.²⁴

PGW relies heavily on the fact that, under the Gas Choice Act, the Gas Commission retains authority to approve (or, in the language of the Gas Choice Act,

²²One of the conditions of the settlement was that PGW, PFMC and the City would withdraw their appeal of the PUC's November 21, 2000 Order to the Commonwealth Court (Joint Petition for Settlement at ¶30; see also PUC Order adopted February 21, 2001 at ordering paragraph 3).

²³The much-cited Section 2212(e) of the Natural Gas Choice and Competition Act provides in pertinent part: "Notwithstanding any provision of this title to the contrary, *in determining the city natural gas distribution operation's revenue requirement and approving overall rates and charges*, the [PUC] shall follow the same ratemaking methodology and requirements that were applicable to the City natural gas distribution operation prior to the assumption of jurisdiction by the [PUC] and such obligation shall continue until the date on which all approved bonds have been retired, redeemed, advance refunded or otherwise defeased...." (emphasis added).

²⁴The Advocate asserts that, since the issue of PGW's FY 2001 revenue requirement has already been decided by the PUC, "[p]rinciples of mootness bar the Commission from addressing this issue [citation omitted]" (PA Brief at 6). Perhaps a more apt characterization would have been that principles of *res judicata* or something like them apply; that is, the matter has already been decided, even if not wholly on the merits, and cannot be re-litigated in another forum.

“determine”) PGW’s operating budget (see 66 Pa. C.S. §2212(s)). I take notice that, in the pending permanent base rate proceeding (PUC Docket No. R-00006042), PGW asserts that the PUC may not, in the context of a rate making proceeding for PGW, make adjustments to expenses contained in its approved budget or which have been approved in prior budgets and that once the Gas Commission has approved PGW’s budget, “the PUC will be obligated to fund that budget” (see, e.g., PGW’s Motion in Limine at ¶¶22 and 24).²⁵ Similarly, in this proceeding, PGW maintains that “[n]othing in the Gas Choice Act modifies or affects in any way the authority granted to the Commission with regard to review and approval of the Operating and Capital Budgets under the Management Agreement or the City Charter” (PGW Brief at 15).

In this proceeding, I cannot and indeed do not need to resolve the difficult, first-impression question as to whether the City’s control over PGW’s budgets is as absolute as PGW asserts and as Section 2212(s) of the Gas Choice Act seems to provide,²⁶ or whether it will be held to yield at least in part to the impact of the PUC’s rate determinations or even possibly to the PUC’s authority under Section 1705 of the Public Utility Code (arguably applicable to PGW pursuant to Section 2212(c) of the Gas Choice Act²⁷) to review, reject and/or opine on utilities’ budgets, both in non-rate setting and rate-setting contexts.

²⁵PGW repeats this position in its objections to various interrogatories posed by CEPA et al in the PUC permanent base rate proceeding: “...Instead, this proceeding is to ensure that the identified expense has traditionally been included in PGW’s operating budget and to set rates so as to cover the operating budget as approved.”

²⁶PGW maintains that permitting the PUC to use the rate setting process to disallow expenditures approved by PGW’s budgeting authority, the Gas Commission, “would directly infringe on the City’s right to operate and manage the Gas Works, a right specifically guaranteed by...Section 2212(s)” (emphasis in original) (PGW’s Motion in Limine at ¶25).

²⁷Under the Gas Choice Act, effective July 1, 2000, the provisions of the Public Utility Code apply to PGW “with the same force as if [it] was a public utility...” but only “to the extent not inconsistent with this section [2212]” (66 Pa. C.S. §2212(c)). Thus, the question to be resolved (possibly, ultimately by the courts) is the extent to which and under what circumstances the PUC’s exercise of its rate-setting authority over PGW under Section 2212 or any other applicable sections of the Public Utility Code and/or the PUC’s application of its Section 1705 budget review and rejection powers are inconsistent with other provisions of Section 2212, in particular the “preservation of powers” to the City contained in Section 2212(s) (“Nothing contained in this Title shall be construed to abrogate or limit the executive or legislative powers of [the City] to legislate or otherwise determine the...budgets...of [PGW]....”).

4. PGW's Position Does Not Recognize The Differences Between Budget Review And Rate-Setting Processes Nor Take Into Account That The Scope Of Budget Review Is Different Once Disconnected From Rate-Setting.

Putting aside the question of the legal weight to be afforded PGW's approved budgets under the Gas Choice Act, PGW's position fails to recognize that, as a practical matter, the nexus between the budget approval and rate setting processes is different when two different entities each have responsibility for only one of these two processes than when a single entity, the Gas Commission, was responsible for both and thus had the ability to weigh them together.²⁸

Generally speaking, the Commission's budget review is to ascertain whether PGW's assumptions both as to revenues and expenses for a given fiscal year are reasonable or not, and to require appropriate adjustments, up or down. Historically, the Commission has focused primarily on whether the proposed budgeted expenses are reasonable and whether PGW will be able to satisfy its debt service coverage covenants.²⁹ Consistent with its obligations under the Management Agreement and the bond ordinances, the Commission has also made reference to the fact that PGW's projected revenues must be sufficient to cover the enumerated operating expenses, including the annual City payment. Formerly, if it determined that projected revenues were insufficient to cover approved operating expenses, debt service, City payment, etc., the Commission had the authority to increase rates and/or to mandate reductions in operating expenses.

PGW asserts that Section IV. of the Management Agreement (regarding operating budget approvals) must be read in conjunction with the Section VII. requirements (regarding rate-setting), but as PGW concedes, "[i]nterpretation of the Management

²⁸PGW characterizes the Gas Commission's former methodology for setting rates and approving a budget as follows: "The approach followed by the PGC was to rule upon whether specific activities and operations were properly included in the budget. Once that determination was made, the PGC was obligated to fund the operation at whatever level it had authorized" (Motion in Limine at ¶25). This overly simplistic description posits that the Commission's rate setting was completely disconnected from budget review or from any assessment of whether the revenue requirement associated with funding the proposed expenses would meet the "just and reasonable" standard which the Commission recognized was applicable (Memorandum Opinion and Order dated March 19, 1992 at 5).

²⁹In regard to the latter, the Commission indicated that it regarded a projected debt service coverage ratio in the range of 1.7x to 1.9x to be an appropriate target (under the 1975 Bond Ordinance) for budgeting purposes, but subsequently approved "tighter" operating budgets which projected debt service coverage ratios closer to the 1.5x minimum and therefore required PGW to operate with less of a cushion (see FY 1997 Operating Budget Recommended Decision at 37-38).

Agreement must also be reconciled with the Gas Choice Act” (PGW Brief at 9). From this, PGW concludes that “[p]erforce...this Commission *must assure* that the budget incorporates sufficient revenues to pay operation and maintenance expenses and costs associated with the programs and policies approved by this Commission...; the City payment; and a reasonable allowance for working capital” (emphasis added) (*Id.* at 9-10).

PGW’s interpretation of how the Gas Commission’s remaining duties under the Management Agreement are to be reconciled with the Gas Choice Act is incorrect. While the Commission retains the obligation to adopt reasonable budgets which project sufficient revenues to cover reasonable operating expenses, as already discussed, the Commission cannot *assure* that “sufficient revenues” are provided via PGW’s rates because it no longer has authority over the *legal determination* of PGW’s revenue requirement, which is now within the PUC’s purview (see 66 Pa. C.S. §2212(e)). In addition, there is no specific formula for the determination of PGW’s year-end cash balance³⁰ set forth in the provision for PGW’s rates and other project revenues to provide a reasonable and necessary amount of cash or equivalent working capital.³¹ Under the

³⁰PGW’s cash flow from operations is generally negative from September through December and, under its historic rate structure, PGW books about 65% of all of its revenues during the winter months of December through March (Knudsen Direct Testimony in PUC Docket No. R-00006042 (rev. 02/02/01) at 20). Therefore, PGW has asserted that it needs \$35 to \$40 million in “positive cash” at fiscal year-end to be able to meet its gas purchasing and debt service obligations during the fall and following winter (*Id.*). Black & Veatch projects, without comment on its adequacy, an ending cash balance for FY 2001 of \$425,000 (response to ID-23 at B-52, B-54) (significantly less than the \$22 million net year-end cash balance most recently forecast by Bogdonavage in his Rebuttal Testimony in PUC Docket No. R-00006042 at 2). Taking into account the assumed deposit into the Capital Improvement Fund of \$110 million during FY 2001 resulting from the anticipated revenue bond issuance, Black & Veatch projects year-end cash balances for FY 2002 through FY 2006 which represent from 3 or 4 weeks (a low of \$13.7 million) to 9 weeks (a high of \$37.5 million) of O&M expenses (response to ID-23 at B-52, B-54). The lower cash balances “reflec[t] PGW’s intent to repay its short-term debt obligations by 2005” (*Id.* at B-52). Black & Veatch opines that all of “[t]hese projected year-end cash balances should be sufficient for PGW to accommodate normal fluctuations in expenditures for utility operations” (*Id.*).

³¹The “formula” in the Management Agreement for the fixing of PGW’s rates and charges (which also takes into account other revenues qualifying as “project revenues”) provides that the revenues to thereby be produced in each fiscal year will be sufficient, among other things,

To provide cash, or equivalent, for working capital in such reasonable amounts as may be determined by [PFMC] to be necessary *and as shall be approved by the Gas Commission* (emphasis added).

(Section VII.1.(b)(iii)). To my knowledge, the Commission has not articulated a specific standard as to the appropriate targeted amount for fiscal year-end cash reserves. An allowance for cash/working capital is not explicitly referenced in the rates “formula” contained in the Bond Ordinances, however

Management Agreement, this determination is left to be a matter of judgment, which is to be exercised in the overall exercise of [the Commission's former] rate-setting authority.

Unlike the review of the current fiscal year's proposed Operating Budget, rate-setting requires the normalization of expenses to ascertain what rates would be reasonable not just for one year but for some period of time. This is also the case under the "cash flow method" applicable to PGW under the Management Agreement. As is set forth in Section VII.5., "Such rates may provide for sufficient revenue to stabilize them over a reasonable number of years."³²

It should be noted that PGW's financial statements for FY 2001 filed with the PUC in support of its \$65 million permanent base rate request show PGW's projected results for the fiscal year "...on a fully normalized or fully forecasted basis. This means that [PGW] has used levels of gas costs and bad debt expense that we believe are representative for the period in which the rates will be in effect" (Direct Testimony of Thomas E. Knudsen in PUC Docket No. 00006042 (revised 02/02/01) at 14 (emphasis added)). As Knudsen emphasized, "[i]t is important to note that these fully forecasted results do not include the most recent higher gas costs or the associated provision for uncollectible" (*Id.* at 8). Thus, unlike the original or revised FY 2001 Operating Budgets before this Commission, the PGW rate filing reflects a "normalized" natural gas expense for the FY 2001 "test year" which incorporates \$150 million in cost over original budget, rather than the revised budgeted natural gas expense, which reflects the full \$230 million in approved GCR increases (*Id.* at 8, 17-18; compare PGW Exhibit 43). Concomitantly, for rate-setting purposes, PGW has posited annual bad debt expense of \$65 million, rather than the \$72 million linked to its higher, actual GCR costs (Knudsen Direct Testimony (rev. 02/02/01) at 2; compare PGW Exhibit 43 and PGW Statement 13 at rev. Ex. A-1). In short, PGW's rates still have to be set to satisfy normalized expenses over some reasonable period of time, or else they would constantly be subject to change.³³

(see Section 403(b) of both the 1975 and 1998 Bond Ordinances).

³²Similarly, under Section 403(g) of the 1975 Bond Ordinance, the City covenants that "it has, by Ordinance, authorized the imposition of rates and charges by the Gas Commission *sufficient from time to time* to comply with Rate Covenant set forth in Section 403(b)...."

³³Knudsen opines that "PGW's rate allowances...also must assure that PGW's *actual results* satisfy the minimum financing requirements imposed by PGW's bond ordinances and its Management Agreement" (Knudsen Direct Testimony (rev. 02/02/01) at 16). In reality, this matter is not quite so absolute. This Commission has previously declined to be the guarantor of PGW's financial results, and has indicated that it may not be compelled to, in effect, increase rates after the fact to compensate for management's failure or inability to conform revenues and expenses to budget (FY

Finally, a rate making proceeding uses a different approach to assessing the necessity and reasonableness of projected expenditures, because it also requires a determination whether, in the end, the rates that would be required to fund such expenses (which, standing alone, could be considered reasonable for budgeting purposes) can also be considered "just and reasonable" for rate making purposes (Public Advocate v. Philadelphia Gas Commission, ___ Pa. ___, 674 A.2d 1056 (1996); Action Alliance, supra, 406 A.2d at 1158; see also Memorandum Opinion and Order dated March 19, 1992 In the Matter of a Proposed Base Rate Increase by the Philadelphia Gas Works for Fiscal Year 1991-1992 at 5).

For prudential reasons (given the pending City Council litigation challenging the legality of the Gas Choice Act), an effort was made, particularly during the outset of this proceeding, to conduct it as if it remained a Regulation No.1 proceeding and to keep the record as broad as possible (see PGC Exhibit 8). In the interim, that litigation has not been decided; the PUC has taken a series of rate-setting actions; and this Commission still has no rate-setting authority. This being the case, a full-blown ratemaking record – which was not required for the Commission's due diligence review of the proposed budget – was not made and is not before the Commission.³⁴

For all the foregoing reasons, the Commission should assume for budgeting purposes that the PUC-approved interim base rates plus the PUC-approved GCR increases

1995 Debt Service Coverage Gap/FY 1996 Operating Budget Recommended Decision at 28-29; and see Order regarding FY 1996 Operating Budget adopted November 9, 1995 at 1-2). In certain instances, PGW may have to look to other project revenues in order to satisfy its debt service coverage requirements. In other instances, the Commission has authorized rate adjustments which, while they were not rate increases, had the effect of generating additional revenues, sufficient to meet PGW's operating or debt service coverage requirements (Order of May 22, 1991; Memorandum Order in re: interim approval of increase in customer charge dated May 10, 1999).

³⁴Such a record is critical to the ratemaker because the beginning and end of the relevant inquiry is not, as PGW suggests, that it is in dire need of cash, or that its short-term financial objectives (see PGW Statement 13 at 4; PGW Brief at 17, 19) are generally proper. Rather, in a rate-setting context, the decision maker must also assess a broader array of issues which impact on the determination of just and reasonable rates. Among other issues which have relevance to PGW's situation, the decision maker could reasonably examine the extent to which the utility's owner's and/or manager's actions or decisions negatively impacted cash resources. Further, the amount of rate relief which is appropriate to enable the utility to meet its financial and operational objectives would also have to be weighed against the need to avoid a huge run-up in rates ("rate shock") which could be unduly burdensome to ratepayers, while exacerbating the downward financial spiral which the utility is entering, or has already entered. Thus, while PGW is obviously correct that it is past time to move away from the "one-time fixes" favored by the prior City Administration (see PGW Brief at 18), a determination of what would be just and reasonable rates under the applicable law and all of the circumstances requires some judgment, not merely a mathematical calculation.

are in effect for FY 2001, and project revenues (and relevant expenses) for FY 2001 accordingly. This is not to opine on the adequacy of the interim rates (which were the result of a litigation settlement between PGW/the City³⁵ and the PUC), nor on whether they meet the "just and reasonable" standard, and the Commission may wish to so state in its final Order in this proceeding.

B. THE COMMISSION SHOULD ADOPT PGW'S REVISED FY 2001 FINANCIAL STATEMENTS AS THE BASIS FOR THE APPROVED FY 2001 OPERATING BUDGET, AFTER MAKING CERTAIN ADJUSTMENTS TO PROJECTED REVENUES AND EXPENSES WHICH ARE, FOR THE MOST PART, NOT IN DISPUTE.

1. Recommended Adjustments To Projected Revenues For FY 2001

a. *Operating Revenues Should Be Premised Upon Normal Heating Degree Days of 4,555.*

PGW's initial operating budget filing was, as usual, premised upon normal weather of 4,600 heating degree days (PGW Statement 1 at 4). However, in light of recent experience with winter weather that was 10 to 15% warmer than normal with its accompanying negative impact on PGW's cash flows, PGW proposed that budgeted revenues be reduced by \$4 million to recognize the effect on marginal revenues that a 3% warmer than normal year would have (*Id.* at 4-5; PGW Exhibit 3 at Ex. A-1).

Thereafter, in its permanent base rate filing with the PUC, PGW adjusted its degree day forecast to reflect more precisely the 30 year historical average of 4,555 heating degree days, which is just less than 1% lower than the 4,600 norm which had been in use (PGW Exhibit 43 at 2; Tr. 1904-1905; see also Direct Testimony of Craig White in PUC Docket No. R-00006042, rev. 02/02/01, at 2-3 and Direct Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042, rev. 02/02/01, at 3). This "resulted in

³⁵As a departmental commission of the City, the Gas Commission would be constrained from opining on the reasonableness or the adequacy of this negotiated settlement. In fact, for the Commission to find that the interim rates agreed to by the City were insufficient to meet all of the mandated bond covenants – as PGW in effect is requesting – could presumably subject the City to a possible declaration of default by the bondholders.

approximately \$1.6 million less in marginal 'normalized' revenues and was the impetus for removing PGW's original \$4.0 million weather adjustment from the current filing" (Bogdonavage Direct Testimony at 3; see also Tr. 1904-1907).

The Advocate agrees that the marginal revenue adjustment should be \$1.6 million, rather than the \$4 million originally budgeted (Tr. 1907; see also PA Statement 5 at 5 and PA Statement 2 at 15-17).

The use of 4,555 heating degree days for budgeting purposes is consistent with the Commission's prior action, rejecting PGW's proposal to substitute a rolling ten year average of degree days for the conventional 30 year average (Order dated November 24, 1999 (regarding FY 2000 Operating Budget) at ordering paragraph A(1); see also Order dated November 24, 1999 (regarding FY 2000 GCR) at ordering paragraph 1). I therefore recommend that the Commission reduce PGW's budgeted marginal revenue decrease by \$2.4 million from (\$4.0 million) to (\$1.6 million).

b. *The Budgeted Revenue Increase Of \$1.5 Million Associated With An Assumed Closure Of The Senior Citizen Discount Program To New Applicants Should Be Rejected.*

PGW's original budget filing projected an increase in marginal revenues in the amount of \$1.5 million, reflecting an "assumption that a change in the administration of the Senior Citizen Discount program will be implemented" (PGW Statement 2 at 6). What this means is that PGW was proposing that the Senior Citizen Discount program be closed to new applicants, effective June 30, 2000 (Tr. 592, 598; see also PGW Exhibit 2 setting forth PGW's proposed amendments to Regulation 12 of the PGW Gas Service Tariff No.10, as amended ("Tariff")).

There were several defects in PGW's budget assumption. First, \$1.5 million was the approximate annualized effect of such a Tariff change; but given that new applicants would apply throughout the fiscal year, the more realistic anticipated revenue impact would be only \$750,000 (Tr. 592; PA Statement 2 at 19). In addition, effective July 1, 2000, the Commission no longer had the power to authorize such changes to PGW's Tariff, in light of the Gas Choice Act (PGC Exhibit 8). Rather, under Section 2212(r) of the Gas Choice Act, between the effective date of the law and the effective date of the PUC's restructuring order on PGW (likely to come during FY 2003 under Sections 2212(d), (g) and (j)), any changes to the Senior Citizen Discount program would have to be authorized by the City Council of Philadelphia, not the Gas Commission or the PUC (Id.;

Tr. 9-10). PGW, however, had not submitted any such proposal to City Council, nor did it have any immediate plans to do so (Tr. 593-594, 596-597). Knudsen therefore conceded during the August 2000 hearings that this budget item was "at best speculative" (Tr. 599).

As of this date, that situation has not changed; and all parties have agreed that any such change to this program would have to be authorized by City Council at this time (Tr. 1908; see also PA Statement 5 at 5). This being the case, PGW had "removed that reduction as a line item in [its] filing [before the PUC] that is still ongoing" (Tr. 1908; PGW Exhibit 43 at 2; see also Bogdonavage Direct Testimony in PUC Docket No. R-00006042, rev. 02/02/01, at 3). Nevertheless, PGW retained the budgeted \$1.5 million in increased revenues in its revised financial statements filed with this Commission (PGW Statement 13 at rev. Exhibit A-1; Tr. 1907-1908). During the hearing, PGW agreed that, for the reasons just discussed, this budget line item should be removed from the proposed FY 2001 Operating Budget (Tr. 1908-1909).

I therefore recommend that the Commission remove from PGW's proposed FY 2001 Operating Budget the projected \$1.5 million increase in marginal revenues assumed to result from a change to the Senior Citizen Discount program.

c. *Budgeted Revenues Should Reflect The \$18 Million Interim Base Rate Increase Authorized By The PUC.*

PGW's original budget filing with this Commission included a revenue line item, "Proposed Base Rate Increase," of \$52 million (PGW Exhibit 3 at Exhibit A-1; PGW Statement 1 at 8).

In early August 2000 (that is, subsequent to the Gas Choice Act's becoming effective on July 1, 2000), PGW filed with the PUC its request for a proposed base rate increase in this same amount. PGW also filed a Petition with the PUC requesting an expedited proceeding to establish interim base rates, which was granted subject to certain conditions (see Order adopted November 21, 2001 in PUC Docket No. R-00005654 at 2, 4). That proceeding culminated in the issuance of a PUC Order on November 21, 2000, which granted interim base rate relief in the amount of \$11 million, subject to certain conditions precedent (id. at 24-26 and at ordering paragraphs 1 through 14). PGW and the City appealed the PUC's Order to the Commonwealth Court. In early February 2001, PGW/the City and the PUC's Law Bureau entered into a Joint Petition for Full Settlement of PGW's Petition for the Establishment of Interim Rates and Related Appeal, which was

ultimately approved by the PUC by Order adopted February 21, 2001.

Under the terms of the approved settlement, “[i]n exchange for [certain] commitments by PGW and the City [related to obtaining permanent management for PGW by September 30, 2001; streamlining PGW’s governance structure; and implementation of the PUC Management Audit],” in addition to receiving the initially approved \$11 million interim base rate increase, PGW was “permitted to recover an additional \$7 million through its GCR, compressed so as to be collected by August 31, 2001, to account for additional bad debt expense produced by dramatically higher than projected natural gas costs incurred by PGW” (PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619 at 3-4).³⁶ This combined total of \$18 million was reflected in PGW’s revised financial statements as a “Proposed Base Rate Increase” line item (PGW Statement 13 at rev. Exhibit A-1; see also *Id.* at 2; Tr. 1905).

For the reasons set forth in Section III.A. above, for purpose of the FY 2001 Operating Budget, the Commission should approve the revenue projection of \$18 million shown in PGW’s revised Exhibit A-1, not the \$52 million originally budgeted, to reflect the impact of base rate increases during FY 2001.³⁷

d. *Budgeted Revenues Should Reflect The Incremental Effect Of The Gas Cost Rate (“GCR”) Increases Authorized By The PUC.*

In the original budget filing natural gas expense was projected to increase by some \$41.6 million over FY 2000 to \$294.593 million (PGW Exhibit 3 at Ex. A-1). Accordingly, PGW projected a 73.8 cent increase in the FY 2001 GCR from \$1.0982 per mcf to \$1.8362 per mcf (PGW Statement 2 at 4).

By early August 2000, when PGW filed its proposed FY 2001 GCR request with the PUC, natural gas costs had risen and PGW was projecting a further \$55 million increase in these costs to \$349.068 million (PGW Exhibit 19). Based on these projections, the PUC approved a \$97 million increase in PGW’s GCR from \$1.0982 to

³⁶Under the terms of the settlement, PGW was also permitted to hold in reserve any GCR overcollection that it incurs, not to exceed \$25 million, to insure it had sufficient cash to meet its bond covenants through January 2002 (*Id.* at 4).

³⁷It should be noted that, even under the \$18 million “Proposed Base Rate Increase” scenario reflected in the revised financial statements, and without having made the adjustments I recommend herein (many of which PGW concurred in) which improve coverage, PGW projects it will fully satisfy its debt service coverage requirements (PGW Statement 13 at revised Exhibit A-3).

\$3.0445 per mcf, effective November 22, 2000 (Order adopted November 21, 2000 in Docket No. R-00005619).

When gas prices continued to escalate, PGW filed a quarterly update to its GCR pursuant to the PUC's November 22, 2000 Order, increasing its GCR-applicable gas costs by some \$133 million and thus, increasing the GCR to \$6.1985 per mcf effective January 1, 2001 (Pa. PUC v. PGW, Docket No. R-00005619 -- Quarterly Update filed December 29, 2000). This was also reflected as a further \$150 million increase to budgeted natural gas expense, to the total of \$479.593 million contained in PGW's most current projected Statement of Income (PGW Statement 13 at rev. Exhibit A-1). Consistent with the November 2000 and January 2001 approved GCR increases totaling \$230 million, PGW projects a \$185 million increase to both revenues and natural gas expense over what was shown in the original budget (*Id.*).

It should be reiterated that, when the PUC approved the interim rates settlement with PGW and the City, it authorized a further increase in the GCR (to \$6.6959 per mcf effective March 1, 2001) to reflect recovery through the GCR of \$7 million in additional bad debt expense (Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619). As mentioned earlier, PGW added the latter sum to the \$11 million interim base rate increase also made effective March 1, 2001, and showed them together on its revised financial statements as an \$18 million "Proposed Base Rate Increase" line item (PGW Statement 13 at rev. Exhibit A-1). Thus, this most recent adjustment did not increase the budgeted natural gas expense from \$479.593 million (*Id.*).

For the reasons set forth in Section III.A. above, for purpose of the FY 2001 Operating Budget, the Commission should approve, in addition to the originally budgeted non-heating and heating revenues, a GCR Adjustment revenue line item of \$185 million.

e. ***Unbilled Gas Adjustment Should Be Modified Accordingly To Reflect The Foregoing Interim Base Rate And GCR Increases.***

The concomitant impact of the above referenced rate increases on the line item capturing unbilled gas revenues³⁸ as of the end of the fiscal year was shown in the revised Exhibit A-1 to PGW Statement 13 to be a \$2.1 million increase over the originally budgeted \$1.5 million. There was no dispute about this impact.

³⁸The Unbilled Gas Adjustment line item captures the volume of gas used but unbilled at August 2001, calculated at the average price per mcf (PGW Statement 2 at 6).

I therefore recommend that Unbilled Gas Adjustment revenues for FY 2001 be budgeted at \$3.6 million, as shown in revised Exhibit A-1 to PGW Statement 13.

2. Recommended Adjustments To Projected Operating Expenses For FY 2001

a. *Budgeted Natural Gas Expense Should Reflect The PUC-Approved GCR Increases In Effect During FY 2001.*

As detailed in Section III.B.1.d. above, natural gas price increases since the original budget was filed have resulted in PUC approval of some \$230 million in GCR increases, the incremental effect of which on revenues was shown as a \$185 million "GCR Adjustment" in the April 3, 2001 updated financial statements (PGW Statement 13 at rev. Exhibit A-1). Concomitantly, a \$185 million increase in projected Natural Gas Expense, from \$294.593 million to \$479.593 million, was shown (Id.).

For the reasons set forth in Sections III.A. and III.B.1.d. above, the Commission should approve budgeted Natural Gas Expense for FY 2001 of \$479.593 million.

b. *Budgeted Gas Processing Expense Should Tie To Budgeted Natural Gas Expense.*

PGW's most current financial statements reflect a minor decrease in Gas Processing Expense from the originally budgeted \$13.835 million to \$13.787 million (PGW Statement 13 at rev. Exhibit A-1). Bogdonavage explained that this change was "reflective of the changes that happened because we used an update during the fiscal year for natural gas pricing and also the utilization of our storage....it's just one of the normal items, as we change natural gas, as we change the GCR, it's one of the fall-throughs that affects working capital" (Tr. 1911-1913). The Advocate had no objection (Tr. 1913).

Consistent with the foregoing recommendations to incorporate the GCR Adjustment to budgeted revenues and the concomitant increased Natural Gas Expense, I recommend that the Commission reduce budgeted Gas Processing Expense by \$48,000 from \$13.835 million to \$13.787 million, as shown in PGW Statement 13 at revised Exhibit A-1.

- c. ***Budgeted Bad Debt Expense Should Be Reflective Of Dramatically Increased Gas Cost Rates, But Be Set At A Level That Reflects The Expectation That PGW Will Pursue Aggressive Collection Of Bills.***

PGW's original FY 2001 operating budget projected \$46 million in bad debt expense, or 7.1% of budgeted operating revenues, compared to \$44 million estimated-actual bad debt expense for FY 2000 (PGW Exhibit 3 at Exhibit A-1; PGW Statement 2 at 8; PGW Statement 3 at 2). "The substantial rise in this expense reflects PGW's acknowledgment that, due to delayed customer billings as a result of problems with the billing system, the ability to collect a substantial portion of outstanding receivable balances at historical collection levels will be difficult" (PGW Statement 2 at 8-9). Still, as a percent of total gas revenues, bad debt expense was projected to decline from the FY 2000 estimated-actual level of 8.5% "due to anticipated improvements in the billing and collection system and adequate reserve balances for FY 2000" (PGW Statement 3 at 2). In reality, bad debt expense for FY 2000 was \$54.642 million, or close to 10.7% of total billed revenues³⁹ (PGW Statement 13 at rev. Exhibit A-1 and at Smyth Testimony – Schedule 1 (Revised)).

During the course of this fiscal year, as it filed for and received approval of increases to the GCR (which for the most part are being collected on a very compressed time frame), PGW increased its projected bad debt expense significantly (Tr. 1923-1925). As mentioned earlier, in its pending permanent base rate filing with the PUC (which incorporates somewhat lower, "normalized" gas expenses but also assumes a \$65 million base rate increase), FY 2001 bad debt expense is projected at \$65.3 million, or \$19.3 million higher than the original budget (PGW Exhibit 42 at revised Exhibit A-1; PGW Exhibit 43 at 3). But taking into account the actual GCR increases in effect for FY 2001 together with the \$18 million interim base rate increases, PGW increased projected FY 2001 bad debt expense by another \$7 million, to \$72.013 million, or just under 9% of total billed revenues⁴⁰ (PGW Statement 13 at rev. Exhibit A-1 and at Smyth Testimony – Schedule 1 (Revised)).

In other words, while in its original budget, PGW optimistically projected that it would collect 94% of all billed revenues, PGW downgraded this projection to 87% in its most current filing, or somewhat less than the 88% collections rate experienced for FY

³⁹\$54.642 million ÷ \$513.113 million = 10.65%.

⁴⁰\$72.013 million ÷ \$800.350 million = 8.99%.

2000 (Id. at Smyth Testimony – Schedule 1 (Revised); Tr. 1924-1925). Thus, the deterioration from the recent historical collections rate of 92% of all billed revenues is projected to persist during FY 2001 (Tr. 1921-1925). PGW therefore anticipates a fiscal year end customer receivables balance of nearly \$206 million, compared to \$141 million for FY 2000 and significantly lower balances in the preceding fiscal years⁴¹ (PGW Statement 13 at Smyth Testimony – Schedule 1 (Revised); Tr. 1926-1927). Similarly, PGW retreated from its original budget projection that the FY 2001 reserve factor would be 33%, i.e., an improvement over the actual FY 2000 reserve factor of 39%, and replaced it with a 35% reserve factor “to be conservative in [its] approach,” even though, as Bogdonavage conceded, it has no empirical evidence to back this projection (PGW Statement 13 at Smyth Testimony – Schedule 1 (Revised); Tr. 1937-1939).⁴²

These worsening projections were vetted during the August 2000 consolidated budget hearings; again, with respect to PGW’s \$45 million City loan request in early October 2000; further, with respect to its Five Year Strategic Plan in the January 11, 2001 hearing, and again, during the April 19, 2001 consolidated budget hearing. Factoring in deletion of the marginal revenue budget adjustments discussed in Sections III.B.1.a. and b. above, and utilizing the FY 2000 actual ending receivables balance and FY 2001 actual beginning reserve balance, FY 2001 customer receivables are projected to increase slightly to \$208 million, while the projected bad debt expense increases by \$770,000 to \$72.783 million (response to TR-30; Tr. 1918-1921).

Knudsen acknowledged that, in order to achieve its projection of collecting 87% of

⁴¹PGW’s fiscal year-end customer accounts receivable were \$97 million for FY 1999 and \$88 million for FY 1998 ((PGW’s Audited Financial Statements for the Years Ended August 31, 1999 and 1998).

⁴²Multiplying the projected year-end receivables balance by the reserve factor yields the estimated bad debt expense, as shown in the response to TR-30:

Bad Debt Expense	FY 2000 (Actual)	FY 2001 (6/19/00)	FY 2001 (Revised)
Year-End Net Receivable (\$000)	141,080	138,029	207,951
(times) Reserve Factor	38.73%	33.33%	35.00%
Total Bad Debt Expense (\$000)	54,642	46,000	72,783

However, as Bleiweis and Bogdonavage discussed and agreed, the projected bad debt expense is a representative estimate, subject to fine-tuning and finalization based on the post-fiscal year collectibility study done by PGW’s outside auditors and based on the judgments ultimately made (Tr. 1939-1943).

the billed amounts, PGW would have to substantially improve its collection efforts for the balance of the fiscal year (Tr. 1929-1930). He indicated that PGW would pursue collections through a new soft-core telephone dunning effort, plus field collections activities, including termination of service (Tr. 1930; see also Tr. 2049-2096). PGW also anticipates receipt of some \$22 to \$24 million in LIHEAP and Crisis grants on behalf of low-income customers, substantially above last year's receipts (Tr. 1928-1929).

The dramatic growth in PGW's receivables and bad debt expense projected for FY 2001 is alarming, because it indicates the downward cash spiral effect of increasing rates significantly – as billings increase and are not/cannot be paid, cash recovery does not keep pace, ultimately contributing to the need to raise rates again to pull in more cash from a decreasing pool of paying customers. On the one hand, PGW's projections – albeit not backed by empirical evidence – appear to be fairly realistic, taking into account all of the relevant factors (such as, increased rates, customer demographics, and the recent history of billing problems and lack of normal collections efforts). On the other hand, as I have consistently advised the Commission during the past two fiscal years, PGW has a significant amount of revenue tied up in uncollected and collectible billings, and has the responsibility to make reasonable efforts to turn these into cash.⁴³ In the past two years, however, PGW has done an abysmal job of doing so. Thus, keeping the budgeted bad debt expense "tight" – particularly at a time when PGW needs to maximize its year-end cash balance – should provide some incentive to PGW to maintain an aggressive stance towards collections.

I take notice that, in the most recent PGW testimony filed in the pending permanent base rate proceeding before the PUC, Knudsen has represented that PGW is

...working hard to reduce the bad debt expense. But, that action is projected to generate \$5-10 million, at best, under the circumstances. That would be an important contribution but not a solution [for PGW's need to generate cash]....

(Rebuttal Testimony of Thomas E. Knudsen in PUC Docket No. R-00006042 dated May

⁴³See, for example, PGC Exhibit 38 ("Preliminary Assessment Of PGW's Five Year Strategic Plan Dated December 2000/Update On PGW's Cash Situation And Projections" (Memorandum to Commissioners dated January 16, 2001)) at 3-4, 8-9; "Recommendations For Commission Action On PGW's Request For Approval Of \$45 Million Temporary Advance From City Of Philadelphia" (Memorandum to Commissioners dated October 6, 2000) at 3, 5, 9; "Recommendations For Commission Action On PGW's Petition To Increase Its Commercial Paper Authorization From \$85 Million To \$100 Million" (Memorandum to Commissioners dated November 5, 1999) at 1, 4-7.

2001 at 10-11). While it is not clear exactly what “action” Knudsen refers to here, a \$5 to \$10 million reduction in projected bad debt expense would be a commendable achievement and would wipe out the projected year-end negative earnings position, while improving PGW’s already positive year-end cash balance (see fn.18 in Section III.A.1. above).

I also take notice that, according to PGW’s most current revised estimates for FY 2001 (which incorporate the known and definite changes in projected natural gas expense for this period), bad debt expense is projected at \$69.995 million (Rebuttal Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042 dated May 2001 at 2 and at Exhibit JRB-2, p.1), or about \$2.8 million lower than in the most recent estimate before this Commission. I am not suggesting that it is appropriate to substitute this number for the one before this Commission, because there are other variances in the projected revenue and expense line items from the budget figures being reviewed here. Rather, I cite this as further indication that there is some “give” in PGW’s bad debt expense projection.

The Advocate made no specific recommendations with respect to projecting bad debt expense.

Taking into account all of the foregoing, I recommend that the Commission reduce PGW’s budgeted bad debt expense for FY 2001 by \$5.0 million from its revised estimate of \$72.783 million⁴⁴ (shown in the response to TR-30) to \$67.783 million.

- d. ***Although In The Future PGW Should Specify The Line Items In Which It Will Achieve Its Projected \$10 Million Cost Savings/Productivity Improvements, For Purpose Of The FY 2001 Operating Budget, This Line Item Is Consistent With The Commission’s Interim Spending Authority Order And Should Be Approved.***

PGW included in its original budget filing a projected \$10 million adjustment for unspecified Cost Savings/Productivity Improvements – in addition to a projected \$2.5 million adjustment for Personnel Reductions/Retirements (PGW Exhibit 3 at Exhibit A-1).

⁴⁴Although this revised estimate factors in actual receivables and reserve balance data that, standing alone, might not warrant a change from the original budgeted amount, it also factors in changed assumptions about the \$4.0 million degree day and \$1.5 million Senior Citizen Discount marginal revenue impacts which should be adopted, consistent with my recommendations about these two revenue line items.

PGW itemized the \$10 million Cost Savings as follows:

*Reductions to overtime	\$2.5-\$3.0 million
*Personnel Reductions/Retirements	\$2.5 million
*Further attrition, productivity	\$2.7-\$3.95 million
*Reductions in material, purchased services	\$1.0-\$1.5 million

(response to PA-17). This response showed that PGW was counting the \$2.5 million savings projected to come from Personnel Reductions/Retirements twice (Tr. 459-461). However, PGW maintained that in fact, it would strive to cut \$10 million *in addition to* the \$2.5 million (Tr. 460). PGW was also assuming at that time that it would be able to reduce health insurance costs by \$4 million, “reflecting anticipated changes in coverages for both active and retired employees” (Tr. 1953; PGW Statement 2 at 8).

Currently, PGW maintains the expectation that it will achieve the \$10 million in “undocumented savings” plus \$2.5 million due to retirements, but has “backed off of the [\$]4 and ha[s] [\$]3 million as the reduction in the health benefits” (Tr. 1953). In addition, Bogdonavage “backed off” the goal of achieving a total of \$15.5 million in budgeted savings:

– it’s not necessarily savings. They can be achieved in two ways. We can have the revenues come in also. Because of the billing system, we have had some problems identifying what revenues are still yet to be billed. So I wouldn’t say that they’re cost savings. Obviously PGW will do everything it can to hold down the costs.

(Tr. 1950; see also Tr. 1951-1952). As Bogdonavage acknowledged, PGW’s earlier projections were that it might not make its 1.5x debt service coverage requirement. Therefore, “...at that point in time we...said that PGW would have to do something, and at this point, we used an expense reduction rather than a revenue increase,” essentially as a “plug” in order to make coverage (Tr. 1952).

Bleiweis notes that it is not really proper to use such unspecified budget plugs, rather than detailing by line item where such cost savings will be achieved (PA Statement 5 at 3-4). Bogdonavage concurred that it would be beneficial for PGW’s budgeting process in the future to identify the specific areas where cuts were going to occur rather than a lump sum figure, as was done here (Tr. 1959):

Rather than trying to look at just a fictitious \$10 million number and try to manage to that, we will be able to manage

to a departmental spending level, which will be a lot more beneficial to everybody who is looking at the Company. (Tr. 1960-1961).

Bogdonavage opined that “[t]he [\$]2.5 [million personnel cost reductions] will definitely happen and probably will be far exceeded” (Tr. 1953). However, PGW has not made much headway towards meeting the \$10 million cost savings goal. PGW’s monthly status report to City Council and the Commission regarding achievement of this goal showed that through February 2001, i.e., halfway through the fiscal year, PGW had only achieved \$4.2 million of its total goal on a net basis⁴⁵ (PGW Exhibit 46; Tr. 1945). Bogdonavage opined that these net savings would continue to grow as PGW got closer to the end of the fiscal year and capital spending was increased during the traditional construction season (Tr. 1948-1949). After subsequently reviewing the March 2001 financial reports, he found that in fact PGW did not “ma[k]e much progress in the month of March” (Tr. 2130). Bogdonavage expects that savings will increase after March, however, “because of the amount of retirees that we expect to have leave the Company on May 1” (Id.). From this statement, it can be inferred that PGW is relying heavily on retirements to achieve cost savings,⁴⁶ but has not yet undertaken a serious or thorough effort to wring out other operating expense reductions.⁴⁷

For example, given PGW’s less than full embrace of some specific cost savings being recommended for consideration by the Advocate, at least in next year’s budget review (such as, the \$275,000 cost of the employee cafeteria⁴⁸ and the cost associated with some 40 management personnel’s use of PGW cars for personal and commuting purposes – see PA Statement 5 at 15-21; Tr. 2016-2025), it is apparent that such

⁴⁵Factored into the total \$4.216 million net savings was \$1.771 million for overall payroll/personnel savings (PGW Exhibit 46).

⁴⁶Of course, there are potential down sides (such as, inadequate personnel levels) and offsetting costs to be incurred (such as, the need to obtain purchased services or re-hire recent retirees as consultants, see Tr. 2131-2135) as a result of a dramatic number of retirements or other attrition.

⁴⁷It does appear, however, whether by default or design, that PGW is again not likely to spend the full budget of \$6.7 million for the Marketing Department (Bogdonavage Rebuttal Testimony in PUC Docket No. R-00006042 at Exhibit JRB-2).

⁴⁸Even though in its responses to PA-168, PA-169 and PA-185, PGW set out a formula for calculating the “subsidy” associated with the cafeteria, during the hearings, Knudsen quibbled over semantics: “Subsidy is maybe a misnomer...subsidy I don’t think is quite the right term” (Tr. 2018). Although insisting he was “not saying there is no subsidy,” he maintained it should not be called that (Tr. 2022).

potential areas for cost reduction have not been factored into the \$10 million goal. Bleiweis also questions the necessity of the budgeted \$240,000 (33%) increase in Dues & Subscriptions expenditures over the FY 2000 estimated- actual amount of \$714,000 (PA Statement 5 at 21, citing PGW Exhibit 3 at Exhibit C-4). Though I agree with Bleiweis that the \$10 million cost savings goal for FY 2001 is therefore "conservative," that is, that additional cuts should be achievable (PA Statement 2 at 20-21), on this record and in the absence of a Five Year Plan with detailed departmental goals, it is not possible to specify a more aggressive goal.⁴⁹

While, taken individually, the items identified by the Advocate and other expense areas do not represent huge dollars, to achieve PGW's overall goal will require relentless pursuit of such opportunities to pare unnecessary expense. Such a comprehensive effort would also signal that PGW is not still just about business as usual. I believe that this was the intent of the Commission's grant of FY 2001 interim operating spending authority, directing PGW to hold its non-gas operating expenditures to 95% of last year's actual spending levels (Order dated October 17, 2000 at ordering paragraph 1).

I therefore recommend that the Commission approve an Operating Budget line item capturing the total projected \$10 million in Cost Savings/Productivity Improvements for FY 2001. I further recommend that the Commission require PGW to specify in its proposed FY 2002 Operating Budget the specific line items wherein the projected cost reductions and productivity improvements will occur, which must be linked to specific PGW departmental goals as set forth in a revised and completed Five Year Financial and Management Plan.

e. *The Advocate's Proposed Accounting And Miscellaneous Operating Expense Adjustments Are Largely Unopposed By PGW, And Should Generally Be Approved.*

The Advocate's witness Bleiweis proposed a series of budget adjustments totaling \$6.6 million which, if adopted, would have the effect of doubling the projected debt service cushion (i.e., the funds available above the 1.5x minimum debt service coverage)

⁴⁹In August 2000, the City Finance Director opined that PGW's \$10 million goal was indeed "aggressive" and that its proposed operating budget reflected "pain" (Tr. 461-462). More recently, PGW maintains that its cost-cutting targets are more aggressive than those recommended by the Management Audit performed for the PUC (after eliminating certain Management Audit recommendations PGW rejects as not feasible or not within its control) (response to ID-25 at letter dated March 22, 2001 from Thomas E. Knudsen to Thomas Sheets).

from \$6.5 million to \$13.1 million (PA Statement 5 at 8-15 and at Schedule MAB-3; Tr. 2000). Bleiweis testified that, while his recommended adjustments would help coverage (and in some instances, cash), he had proposed them primarily because they were “proper accounting” (Tr.1998-1999). In summary, Bleiweis proposed the following:

1. **BCCS Remediation** – the budgeted one-time expenditure of \$1 million should be amortized over five years, reducing FY 2001 expense by \$800,000.
2. **Marketing Consultant Studies** – the non-recurring budgeted expenditure of \$530,000 should be amortized over five years, reducing FY 2001 expense by \$424,000.
3. **Various Non-Recurring Expenses** – the budgeted one-time expenditures of \$300,000 for Emergency Operations (related to renegotiation of the labor agreement) and \$2 million for Training Costs– V.P. Customer Affairs should be amortized over five years, reducing FY 2001 expense by \$1.840 million.
4. **Rate Case Expense** – the budgeted \$825,000 expenditure for the FY 2001 rate case should be amortized over two years, the expected period between rate cases, reducing FY 2001 expense by \$412,000.
5. **Non-Recurring Material Purchases** – the budgeted expenditure of \$150,000 for non-recurring material purchases in preparation for a possible work stoppage should be amortized over three years, the length of the most recent labor agreement, reducing FY 2001 expense by \$100,000.
6. **Operating Leases** – \$601,000 for operating leases should be eliminated from the Operating Budget because such costs are now being included in PGW’s FY 2001 Capital Budget (see also Order and Resolution dated May 3, 2001 at Resolution paragraph 1).
7. **CRP Regulatory Asset** – the budgeted \$3.75 million amortization amount should be reduced by \$1.6 million to reflect an anticipated offset to this charge from receipt of Crisis grants, based on the prior five year average.
8. **Information Technology Equipment Rentals & Leasing** – the budgeted \$632,000 expenditure for PC’s, laptops and additional computer storage space should be eliminated because these acquisitions and projects have been deferred.
9. **Lobbying Expense** – the budgeted \$115,000 expenditure for lobbying consulting services should be eliminated because such expenses are ownership expenses which are not allowed by the PUC for ratemaking purposes.
10. **Employee Activity Costs** – the budgeted \$41,000 for the Quarter Century Service Club Banquet, a celebration attended by PGW employees and retirees, bears no

relation to safe, reliable and affordable service and should be canceled.

During the hearings, Bogdonavage indicated that PGW was largely in agreement with the proposed adjustments, but had a few reservations that it needed to verify (Tr. 2000-2008, 2015-2016). PGW was given the opportunity to finalize its response via a transcript request, TR-32 (Tr. 2016). That response shows that PGW agrees with nearly all of Bleiweis' proposed adjustments, except that:

- (1) PGW proposes a three-year, rather than a five-year, amortization period for BCCS Remediation costs, consistent with past practice;
- (2) PGW opposes a three-year amortization for \$150,000 of Non-Recurring Material Purchases, because it duplicates an amount included in the other Non-Recurring Expenses line item of \$300,000 for Emergency Operations in connection with the labor agreement renegotiations (which, PGW maintains, should be amortized over three years, not five years as Bleiweis suggested); and
- (3) PGW opposes a disallowance of the \$115,000 Lobbying Expense (response to TR-32; see also Tr. 2000-2001, 2006-2007).

Under PGW's position, there would be a \$6.3 million expense reduction, compared to the Advocate's \$6.6 million (response to TR-32), which has a comparably salutary impact on coverage for FY 2001.

PGW's three-year amortization for BCCS costs is based on past practice and is reasonable. As to the overlap between the two Non-Recurring Expense items, this was probably an inadvertent error on Bleiweis' part. Moreover, although he recommended a five-year amortization period for the Emergency Operations item, it is clear from his recommendation of a three-year amortization period for the labor negotiations-related Material Purchases item that he would agree with PGW's three-year amortization period.

Thus, the record clearly supports the deferral of \$3,303,500 in FY 2001 expenses to future fiscal years (see response to TR-32).⁵⁰ In addition, the parties are in agreement that \$1.274 million in cash expenditures budgeted for FY 2001 should be eliminated from

⁵⁰BCCS Remediation (\$667,000) + Marketing Studies (\$424,000) + Emergency Operations (\$200,000) + Training Costs – V.P. Customer Affairs (\$1,600,000) + Rate Case Expense (\$412,500) = \$3,303,500.

the Operating Budget.⁵¹ Their disagreement boils down to the \$115,000 Lobbying Expense item.

Knudsen testified that

...[PGW has] retained or [is] paying for the City's lobbyists in Harrisburg to assist us in getting our message before the legislators and the Governor in a way that we might not be able to otherwise, and...we did get \$248 million of rate relief from the PUC this year, and I am willing to pay a certain cost in order to get that.

(Tr. 2007).

The Advocate argues that, because the cost of such "political lobbying" would not be permitted to be recovered in rates under the Pennsylvania Public Utility Code, 66 Pa. C.S. §1316, it should be disallowed here (PA Brief at 23-24). But, under the Gas Choice Act, it is far from certain that this provision is either applicable or dispositive here.

Further, the Advocate maintains, political lobbying is different from the direct costs expended in presenting a rate case to a regulatory body (which are properly charged to ratepayers), because its function is to enhance ownership interests with no direct benefit to ratepayers (Id. at 24). Here, the Advocate asserts,

[t]he purpose of such lobbying was to serve the City's interest in protecting, even overprotecting, it (sic) bond ratings through higher rates, and attempting to assure that PGW would continue to make its \$18 million City Payment. Such lobbying activities should not be funded through rates, because they provide no direct benefit to ratepayers.

(Id.).

While I believe there is some validity to the Advocate's position, I cannot fully agree with his conclusion that there is absolutely no benefit to the ratepayers from this expenditure. Clearly, there was and still is a period of transition to the new regulatory scheme of the Gas Choice Act. I have put on the public record concerns about some of the approaches PGW and PFMC have taken to make this transition functional, which I believe are detrimental to the interests of both the ratepayers and PGW, and to this extent, have serious reservations about requiring PGW's ratepayers to absorb this cost. But it is impossible to differentiate exactly how much of this relatively small cost was

⁵¹ \$601,000 for eliminated operating leases + \$632,000 for deferred IT costs + \$41,000 for postponed Quarter Century Service Dinner = \$1.274 million.

expended on such questionable purposes versus what was spent to facilitate PGW's having a fair opportunity in a new environment to make its case as to what financial resources it believed were required at this time. To the best of my knowledge, because of recognition of market realities, PGW's GCR requests were largely unopposed despite concerns about the dramatic increases in customer billings that would result; but had they not been granted, PGW would not have been able to bill in a timely manner for natural gas costs it was incurring in the current fiscal year. It cannot be said that avoiding this result had no long-term benefit whatsoever for PGW's ratepayers. I therefore, albeit somewhat reluctantly, recommend that the Advocate's request to eliminate the budgeted \$115,000 Lobbying Expense from the FY 2001 Operating Budget be rejected.

In addition, I recommend that the \$1 million expenditure for BCCS Remediation and the \$300,000 expenditure for Emergency Operations be amortized over three years; that the \$530,000 expenditure for Marketing Studies and the \$2 million expenditure for Training Costs – V.P. Customer Affairs be amortized over five years; and that the \$825,000 Rate Case expense be amortized over two years, as shown in PGW's proposed adjustments in its responses to TR-32. Further, I recommend that \$601,000 for Operating Leases which are being capitalized; \$632,000 for deferred IT acquisitions; and \$41,000 for the Quarter Century Service Dinner be eliminated from the FY 2001 Operating Budget, as shown in the response to TR-32.

C. PGW'S OPERATING BUDGET FORECAST FOR FY 2002 THROUGH FY 2006 CANNOT BE APPROVED IN LIGHT OF PGW'S FAILURE TO COMPLY WITH THE COMMISSION'S REQUIREMENT FOR A FIVE YEAR FINANCIAL AND MANAGEMENT PLAN.

Since February 1999, the Commission has been attempting to have PFMC submit an adequate Five Year Financial and Management Plan for PGW, which is linked to the proposed Operating Budget and Forecast (see PGC Exhibit 29). The Commission rejected the future years forecast submitted with the proposed FY 2000 Operating Budget because it reflected outdated or inaccurate assumptions and was not tied to a meaningful five year plan, and again directed that such a plan be filed in conjunction with the FY 2001 Operating Budget filing (Order dated November 24, 1999 at ordering paragraphs B, D and E).⁵²

⁵²The Commission also disapproved the operating forecast for FY 2000 to FY 2004 submitted with the proposed FY 1999 Operating Budget (Order dated May 10, 1999 at ordering paragraph 3).

However, as set forth in the Procedural History in this Recommended Decision and in my Memoranda to the Commissioners dated October 6, 2000 and January 16, 2001 (PGC Exhibit 38), PGW: (1) did not submit such a plan when it filed the proposed budget and forecast in June 2000; (2) repeatedly represented that it would file the plan in late summer or early fall (e.g., PGW Exhibit 14; Tr. 26-27, 95; October 5, 2000 hearing on \$45 million temporary advance Tr. 151-152), but did not do so; (3) finally submitted an incomplete plan in December 2000, in an effort to gain access to the final \$20 million tranche of the City's \$45 million temporary advance, and claimed it would be finished by March 2001 (Tr. 1530-1531); (4) despite the assurances of the Mayor and PGW (see Resolution dated January 22, 2001 at 3), has not since completed the plan; and (5) most recently, indicates that "uncertainties now surrounding the future of PGW" make it difficult at best to define a future path for the utility, but that a revised and completed "package" (addressing both "the goal structure and departmental implementation plans to which the Commission objected in its response earlier this year" and the "changes required by the [PUC] Management Audit") "...should be...submitted]...for review in two weeks time" (response to HE-46; Tr. 1990-1992).⁵³ It is now almost exactly four weeks from the date this last representation was made, but no such revised "package" has been submitted to the Commission.

Thus, consistent with the Commission's prior actions and directives, PGW's outyear operating forecast was not scrutinized in this proceeding to date. I therefore cannot reasonably recommend to the Commission approval of a proposed outyear forecast, whose underlying assumptions were not connected to a future financial and management plan and thus, could not seriously be vetted (see PA Statement 5 at 2). I therefore recommend that the Commission reject PGW's proposed Operating Budget Forecast for Fiscal Years 2002 to 2006.

This forecast, too, was founded on a number of key assumptions which PGW conceded were no longer valid, and, as Knudsen (then-witness for the Public Advocate) testified, contained many key projections which were "neither realistic nor sustainable" (FY 1999 Operating Budget Recommended Decision at 22).

⁵³It bears repeating that PGW's May 10, 2001 Monthly Progress Report to the PUC in Docket No. R-00005654 (at 1) contains the misrepresentations that "All PGW activity before the Philadelphia Gas Commission is complete." and that "FY 2001 Strategic Plan is complete; working on FY 2002 update." These misrepresentations cannot be reconciled with the record in this proceeding.

IV. SUMMARY OF RECOMMENDATIONS

The table on the following page summarizes the impact on PGW's FY 2001 Statement of Income of the recommended adjustments to PGW's proposed FY 2001 Operating Budget contained in this Recommended Decision. In total, these recommended adjustments will improve PGW's fiscal year-end cash and coverage positions. I therefore recommend that the Commission enter an Order adopting these recommendations for the reasons stated herein.

Respectfully submitted,



JANET PARRISH, ESQ.
Senior Hearing Examiner

Dated: _____

May 17, 2001

TABLE 1
PGW Statement of Income (Excerpts) (Dollars in Thousands)

Line Item	Original Budget (6/19/00)	Interim Budget (95% of FY 2000 Actual)	Revised Budget (4/03/01)	Recommended Adjustments to Rev Budget	Recommended Budget
Non-heating Rev	106,778	n/a	106,778	0	106,778
Gas Trans Serv Rev	3,509	n/a	3,509	0	3,509
Heating Revenues	463,816	n/a	463,816	0	463,816
Base Rate Increase	52,000	n/a	18,000	0	18,000
GCR Adjustment	-	n/a	185,000	0	185,000
Net Marginal Rev	(4,000)	n/a	(4,000)	2,400	(1,600)
Change in Sr Cit Disc	1,500	n/a	1,500	(1,500)	0
Unbilled Adjustment	1,500	n/a	3,600	0	3,600
Total Gas Revenues	625,103	n/a	778,203	900	779,103
Total Other Revenues	24,348	n/a	28,729	0	28,729
Total Operating Rev	649,451	n/a	806,932	900	807,932
Natural Gas Expense	294,593	294,593*	479,593	0	479,593
Gas Processing Exp	13,835	13,248	13,787	0	13,787
Bad Debt Expense	46,000	45,600	72,013**	(5,000)	67,783
Personnel Reduce/Ret	(2,500)	n/a	(2,500)	0	(2,500)
Advocate's Adjustments	n/a	n/a	n/a	(4,578)	(4,578)
Cost Savings/Produce	(10,000)	n/a	(10,000)	0	(10,000)
Total Operating Exp	529,557	491,081*	740,522	(9,578)	730,944
Operating Income	119,894	n/a	66,410	10,478	76,888
Other Income	5,774	n/a	5,774	0	5,774
Inc Before Interest	125,668	n/a	72,184	10,478	82,662
Interest Expense	57,780	n/a	57,780	0	57,780
Net Income Before City Payment	67,888	n/a	14,404	10,478	24,882
Net Earnings/(Loss)	49,888	n/a	(3,596)	10,478	6,882

Sources: PGW Exhibit 3; PGW Statement 13 (Rev. Ex. A-1); responses to TR-30 & TR-32; PGW's Interim Monthly Spending Plan for FY 2001 (filed 11/13/00).

* / The Commission's Order dated October 17, 2000 authorized continuing operating spending during FY 2001 at levels not to exceed 95% of actual spending in FY 2000 for line items in the approved FY 2000 operating budget, except for natural gas expense. 95% of the preliminary FY 2000 actual non-gas operating expenditures totaled \$196.488 million; \$196.488 + \$294.593 (originally budgeted natural gas expense for FY 2001) = \$491.081 million.

** / PGW later revised bad debt expense to \$72.783 million (response to TR-30).

CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00006042

I hereby certify that I have this day served a true copy of the foregoing documents, Office of Consumer Advocate Main 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 21st day of June, 2001.

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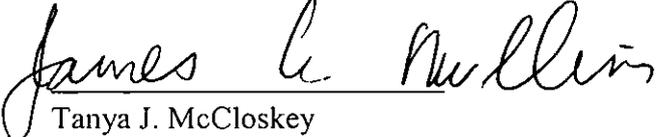
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June 21, 2001

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
The Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

VIA HAND DELIVERY

**Re: Pennsylvania Public Utility Commission v. Philadelphia Gas Works;
Docket No. R-00006042**

Dear Secretary McNulty:

Please find enclosed the original and nine (9) copies of the Main Brief of the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") in the above-referenced matter. In addition, please find an electronic version of the brief on diskette in Word 2000.

As evidenced by the attached Certificate of Service, all parties to the proceeding are being served with a copy of this document. Please date stamp the extra copy of this transmittal letter and kindly return it to our messenger for our filing purposes. Thank you.

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Very truly yours,

MCNEES WALLACE & NURICK LLC

By *Charis M. Burak*
Charis M. Burak

Counsel to the Philadelphia Industrial and
Commercial Gas Users Group

CMB/lhe

c: Administrative Law Judge Cynthia Williams Fordham (via e-mail and federal express w/
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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PENNSYLVANIA PUBLIC
UTILITY COMMISSION

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

v.

Docket No. R-00006042

PHILADELPHIA GAS WORKS

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

The Budd Company
The Building Owners' and Managers'
Association of Philadelphia
Jefferson Health System
Nabisco, Inc.

Newman & Company, Inc.
Sunoco, Inc.
Temple University
12th Street Gym
Smurfit Stone Container Corporation

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Dated: June 21, 2001

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I. INTRODUCTION

On January 5, 2001, the Philadelphia Gas Works ("PGW" or "Company") filed Supplement No. 7 to Tariff Gas – Pa. PUC No. 1 ("Supplement No. 7") with the Pennsylvania Public Utility Commission ("PUC" or "Commission"). Supplement No. 7 proposed to implement a \$65 million base rate increase through a flat increase to the Company's Customer Charge and a volumetric increase to customer rates. PGW's accompanying testimony also presented several proposals to modify the Company's tariff, including: (1) the ability to offer non-standard rate arrangements to interruptible industrial and commercial customers; and (2) the need to "clarify" the maximum price PGW could charge to Rate Schedules BPS-S and BPS-L. See Direct Testimony of Thomas Knudsen, PGW Statement No. 1.0 (hereinafter "PGW St. No. 1.0"), pp. 3-5; see also Direct Testimony of Craig White, PGW Statement No. 4.0 (hereinafter "PGW St. No. 4.0"), pp. 10-15.

On February 2, 2001, the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") filed a Complaint in this proceeding. PICGUG is an *ad hoc* association of energy-intensive industrial and commercial customers receiving service from PGW under various rate schedules. PICGUG members use substantial volumes of natural gas in their businesses, and natural gas costs comprise a significant element of their respective costs of operation. Because any change in PGW's rates would impact the price PICGUG members pay for service, PICGUG is an active party to this proceeding. The membership of PICGUG is listed on the cover page of this Main Brief.

On February 23, 2001, Administrative Law Judge Cynthia Williams Fordham ("ALJ Fordham") convened a Prehearing Conference, in which the procedural schedule for this proceeding was developed. Pursuant to the procedural schedule, PICGUG filed Direct

Testimony in this proceeding on April 10, 2001.¹ PICGUG received Direct Testimony from the Office of Consumer Advocate ("OCA"), the Office of Trial Staff ("OTS"), and the Office of Small Business Advocate ("OSBA"). On May 8, 2001, PICGUG received the Rebuttal Testimony of PGW, OCA and OSBA. On May 16, 2001, PICGUG filed Surrebuttal Testimony and received Surrebuttal Testimony from the OCA, OTS and OSBA. Evidentiary hearings were held in this proceeding on May 22-24, 2001, for the purpose of cross-examining witnesses.

Pursuant to the procedural schedule and 52 Pa. Code Section 5.502, PICGUG files this Main Brief to address many of the issues in this proceeding. For reasons discussed more fully herein, PICGUG posits that PGW's transportation rules and regulations must be significantly modified in order to provide PGW customers the same ability to transport natural gas as that provided to large industrial and commercial customers on other Natural Gas Distribution Company ("NGDC") systems. PICGUG also posits that PGW has not presented substantial evidence that a \$65 million increase is just and reasonable. PICGUG submits that the PUC should grant PGW the minimum level of rate relief, if any, necessary for the Company to maintain just and reasonable rates. Further, PGW's residential customers are currently being subsidized by the Company's commercial and industrial customers. Accordingly, any rate increase granted to PGW must be allocated, in full, to the residential customer classes in order to move towards eliminating this subsidy. Finally, the PUC should reallocate certain non-gas costs, such as electricity and bad debt expenses currently contained in the Company's Gas Cost Rate ("GCR"), to base rates, in order to prevent the distortion of PGW's current gas costs.

¹ Prior to the filing of Direct Testimony, PGW filed a Motion in Limine on March 21, 2001, requesting that the scope of this proceeding be significantly narrowed. On April 2, 2001, PICGUG, along with other intervening parties, filed an Answer in Opposition. On April 13, 2001, ALJ Fordham issued an Order denying PGW's request.

II. STATEMENT OF QUESTIONS INVOLVED

1. Should PGW's inadequate, antiquated and discretionary transportation rules and regulations be modified in order to permit large industrial and commercial customers the opportunity to transport natural gas on the Company's system?

Suggested Answer: Yes.

2. Should PGW be granted a \$65 million rate increase in light of the recent interim rate relief provided by the PUC, the ability of the City of Philadelphia to waive its annual \$18 million payment from PGW, and the lack of substantive evidence presented by the Company indicating that such an increase will result in just and reasonable rates for PGW's customers?

Suggested Answer: No.

3. If the PUC grants any rate increase to PGW, should it be allocated in full to the residential customer classes in order to eliminate the current subsidization of these classes by the commercial and industrial customer classes?

Suggested Answer: Yes.

4. Should a portion of the non-gas elements of PGW's GCR, which are currently distorting the reflection of true gas costs paid by the Company, be reallocated to base rates as part of this proceeding?

Suggested Answer: Yes.

III. SUMMARY OF ARGUMENT

PGW's full base rate proceeding has provided both the parties and the PUC the first opportunity to fully examine and analyze the Company's overall system and financial needs. Although an expedited interim base rate proceeding has occurred since jurisdiction over PGW transferred to the PUC, the current base rate proceeding has provided parties the first true opportunity to review PGW's systems and operations. Most likely, the next such opportunity will not occur until the Company's restructuring proceeding, the filing for which is due no later than July 1, 2002. See 66 Pa. C.S. § 2212(g).

Because PGW's restructuring proceeding is over one year away, it is imperative that the PUC ensure that the proper rates and services are in place for PGW's customers during this interim period. As discovered throughout the course of this proceeding, PGW's rates and services contain flaws that prohibit customers from obtaining adequate, much less efficient or competitive, service from the Company. For these reasons, the PUC must ensure that the appropriate measures are implemented in this proceeding in order to meet customers' needs, until further steps can be taken during the course of the Company's restructuring proceeding.

Specifically, PGW's transportation regulations effectively prevent a customer's ability to transport due to requirements that are impossible for most customers to meet. Similarly, PGW's transportation rates are not cost-based, but rather, above the cost of the Company to serve. As a result, large industrial and commercial customers are placed at a competitive disadvantage in comparison to customers obtaining natural gas service from other NGDCs in Pennsylvania. See Direct Testimony of Richard Baudino, PICGUG Statement No. 1 (hereinafter "PICGUG St. No. 1"), pp. 13-22.

As part of this proceeding, PGW is requesting a base rate increase of \$65 million, even though the Company has failed to present any evidence to substantiate this request. While PGW has continually suggested that the Company faces numerous financial woes, review of PGW's filing indicates that the interim rate increase previously approved by the Commission will allow the Company to meet its financial needs. In addition, further rate relief is available through a waiver by the City of Philadelphia ("City") with respect to its annual \$18 million payment from the Company. Obviously this alternative for rate relief, in comparison to further burdening PGW customers with additional rate increases, would be preferable. As a result, the Company has failed to provide any evidence that the aforementioned rate increase is just and reasonable, as required by PUC regulations. See id. at 4-7.

Moreover, the Company's proposed allocation of this rate increase would further promulgate the current subsidization of the residential customer classes by the commercial and industrial customers classes. Because of the magnitude of this subsidy, even full allocation of the proposed \$65 million rate increase to the residential customer classes would not completely eradicate this subsidy. In light of the Company's forthcoming restructuring proceeding, in which PGW will need to unbundle its rates, it is imperative that the PUC move towards eliminating this subsidy. As such, any rate increase granted to PGW in this proceeding must be allocated in full to the residential customer classes. See id. at 8-12.

Finally, PGW continues to improperly recover many non-gas expenses through the Company's GCR. While other NGDCs throughout Pennsylvania collect only pure gas costs through the equivalent Purchased Gas Cost ("PGC") mechanism, PGW recovers numerous non-gas costs via the GCR, such as electricity and bad debt expenses. In addition, PGW also collects the non-gas expenses related to the Company's Customer Responsibility Program ("CRP") and

Conservation Works Program ("CWP") through the GCR. As a result, PGW retains a guaranteed recovery of these costs while avoiding any incentive to efficiently and effectively manage the costs of these programs. See Direct Testimony of Richard Lelash, OCA Statement No. 1 (hereinafter "OCA St. No. 1"), pp. 48-50.

Although PGW had an obligation, set forth in the PUC's ruling in the interim base rate proceeding, to set forth proposals regarding the reallocation of these non-gas costs, PGW chose not to meet this obligation by failing to address these issues in this proceeding. In spite of PGW's failure to follow the Commission directive, steps must be taken to begin to remove these improper non-gas costs from the Company's GCR. While PGW's lack of cooperation may hinder reallocation of the majority of these costs in this proceeding, several of these expenses, such as bad debt and electricity, can be reallocated to base rates in order to begin the steps necessary for full removal of non-gas costs from the GCR. See id.

PGW's base rate proceeding provides the opportunity for the Commission to begin the long overdue steps of modifying and improving PGW's rates and services to meet the needs of the Company's customers. Although further modifications will be required, as part of the Company's restructuring, that proceeding is still many months away. As a result, the PUC must order PGW to provide at least incremental relief prior to restructuring so that PGW customers can attempt to compete with similar customers served by other NGDCs in Pennsylvania. Without such modifications, PGW's customers will merely continue to suffer with unreasonable rates and inadequate service.

IV. MISCELLANEOUS ISSUES

1. *PGW's Transportation Rules and Regulations Must Be Modified in Order to Permit Large Commercial and Industrial Customers the Opportunity to Transport Natural Gas on PGW's System.*

PGW's current transportation requirements are inadequate, antiquated and too discretionary to actually permit, let alone promote, any form of true transportation on the Company's system. Most, if not all, NGDCs in Pennsylvania have been permitting large industrial and commercial customers to transport natural gas on their systems since the mid-1980's. While PGW technically permits such customers to transport natural gas, the rigidity of PGW's transportation rules and requirements results in a system that actually prohibits many, if not almost all, customers from having the ability and means to transport their own natural gas. See PICGUG St. No. 1, p. 14.

Specifically, the strictness of PGW's requirements prevents all but the largest customer accounts from transporting natural gas on the Company's system. Even those customers able to meet PGW's requirements are not able to combine multiple accounts or enter into Buyers Groups, which would provide for more cost-efficient transportation. In addition, PGW's discretionary tactics and unwillingness to provide necessary information inhibit these customers' ability to transport on a day-to-day basis. These tactics are compounded by PGW's stiff penalties for failure to meet the Company's rigid requirements. As a result, PGW's transportation regulations are nothing more than an attempt to prevent customers from transporting natural gas on the Company's system. See id. at 14-22.

With the onset of the Natural Gas Choice and Competition Act ("Competition Act"), PGW is required to present a restructuring filing no later than July 1, 2002. See 66 Pa. C.S. § 2212(g). This filing must set forth the means for unbundling all of the Company's rates in order

to provide all customers the ability to transport natural gas on the Company's system. Because other NGDCs were already providing large industrial and commercial customers the opportunity to transport natural gas prior to restructuring, these NGDCs' restructuring proceedings were limited to merely expanding transportation programs to include residential and small commercial customers. Conversely, because PGW effectively prohibits most customers from transporting on the Company's system, PGW's restructuring proceeding will require significant and profound changes to the Company's transportation regulations in order to provide all customers the ability to transport natural gas on the Company's system. See Transcript of Evidentiary Hearings, May 23, 2001 (hereinafter "Tr."), pp. 704-06.

Because of the massive changes that will be required as part of PGW's restructuring proceeding, PGW should be required to modify its transportation rules at the present time in order to provide an orderly and working transportation system for large industrial and commercial customers, similar to those present on other NGDCs' systems prior to restructuring. By providing these modifications in this proceeding, PGW will be making the initial steps towards the overall restructuring of the Company's natural gas transportation system. Moreover, providing a sound basis for large industrial and commercial transportation customers in this proceeding will allow for an easier transition of PGW's entire system during the Company's restructuring proceeding.

- a. The PUC Has the Ability to Modify PGW's Transportation Requirements in Order to Maintain the Necessary Standards For PGW's Rates and Services.

As discussed more fully herein, PICGUG presents several recommendations in this proceeding regarding the modification of PGW's transportation rules and regulations. The purpose of these recommendations is to expand the Company's current transportation

requirements, which are so rigid and archaic as to prevent almost all of PGW's large industrial and commercial customers from transporting on the Company's system.² Contrary to PGW's claims, these proposed modifications are proper in light of the Competition Act and the Public Utility Code. See Rebuttal Testimony of Craig White, PGW Statement No. 4.1 (hereinafter "PGW St. No. 4.1"), p. 18.

According to Section 2212(b), "commencing July 1, 2000, 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). Section 2212(d) supplements this provision with the following:

A city natural gas distribution operation shall continue to provide natural gas supply and natural gas distribution services to its customers under the prior tariff and the policies or programs existing on the date that the commission assumes jurisdiction over the city natural gas distribution operation until the effective date of the final order entered by the commission approving the restructuring plan and new tariff of the city natural gas distribution operations unless such effective date has been stayed by a court of competent jurisdiction, in which event the prior tariff will continue in force until such stay has been dissolved. Subject to subsection (s), the commission shall resolve all questions, disputes or conflicts arising under the prior tariff. Nothing in this section shall prevent a city natural gas distribution operation from requesting or, if so requested, the commission from approving modifications to the prior tariff at any time prior the effective date of the final order approving the restructuring plan and new tariff.

66 Pa. C.S. § 2212(d). The purpose of this provision was to provide PGW with some level of comfort regarding the rates and services that will be provided by the Company during the

² Currently, only eight customers have transportation contracts on PGW's system. See Tr. at 703.

transition time between jurisdiction over PGW shifting to the PUC and the conclusion of the Company's restructuring proceeding.

The Public Utility Code, however, provides that:

[e]very public utility shall furnish and maintain adequate, efficient, safe and reasonable services and facilities...Such services and facilities shall be in conformity with the regulations and orders of the commission. Subject to the provisions of this part and the regulations or orders of the commission, every public utility may have reasonable rules and regulations governing the conditions under which it shall be required to render service.

66 Pa. C.S. § 1501. Accordingly, a public utility must ensure reasonable and adequate service for all of its customers through rules and regulations established by the Commission.

Although one of the purposes of the Competition Act was to provide PGW some level of comfort prior to and during its restructuring proceeding, PGW should not be permitted to take advantage of this provision by continuing to provide inadequate and unreasonable transportation service to its customers, contrary to Commission rules and regulations. The changes proposed by PICGUG to the Company's transportation rules and regulations are timely, and, even more importantly, past due. Compared to other Pennsylvania NGDCs that have permitted industrial customers to transport natural gas since the mid-1980's, PGW's restrictive and anachronistic regulations provide unreasonable barriers to transporting that cannot and should not be permitted. See Surrebuttal Testimony of Richard Baudino, PICGUG Statement No. 1S (hereinafter "PICGUG St. No. 1S"), p. 5. In addition, allowing only PGW to propose modifications to its tariff will not provide an appropriate solution, as PGW does not recognize the problems inherent in its transportation system. Rather, only allowing all parties the opportunity to indicate such problems and propose the necessary solutions will ensure PGW's ability to provide adequate and reasonable service during this transition period.

Moreover, the modifications proposed by PICGUG would not so substantively modify PGW's transportation rules and requirements as to move forward with full customer choice prior to the Company's restructuring proceeding. Instead, the proposed modifications would merely place PGW's transportation programs at the same level as other NGDCs, prior to the onset of the Competition Act. As a result, the interests of PGW must be balanced with the requirements of the Commission and the needs of PGW's customers in order to ensure that PGW is providing the same level of service as that of other NGDCs in Pennsylvania. To allow PGW to provide inadequate service until after the conclusion of its restructuring proceeding, in approximately 2003, is both unfair and unjust to PGW customers.

b. PGW's Volume Eligibility Requirement For Transporting Natural Gas Must Be Lowered From 75,000 Mcf to 5,000 Mcf to Meet PUC Requirements.

PGW's current transportation requirements unreasonably inhibit the ability of customers to transport natural gas on the Company's system through excessive volumetric requirements. See PICGUG St. No. 1, pp. 14-16. PGW's tariff states that "[t]ransportation service shall be provided by the Company within its service territory as agent for the individual Customer or for a Buyer Group of no more than three individual Customers who contracts for transportation and delivery by the Company of at least 75,000 Mcf of gas per year." PGW Tariff Gas – Pa. PUC No. 1, p. 113. Because this excessive requirement in effect prohibits most large industrial and commercial customers from transporting on PGW's system, the PUC must lower PGW's minimum volumetric requirement to 5,000 Mcf. See PICGUG St. No. 1, pp. 14-16.

PGW's minimum volumetric requirement is especially stringent in comparison to other NGDCs in Pennsylvania. For example, PECO Energy Company ("PECO"), an NGDC providing natural gas service to suburban areas outside of Philadelphia to customers with whom PICGUG

members must compete, allows for a minimum consumption level of 5,000 Mcf per year for transportation eligibility. See PICGUG Direct Examination Exhibit No. 1. Interestingly, while PGW has rejected the notion of providing transportation service similar to that currently provided by other NGDCs, PGW has aligned itself with the other NGDCs for purposes of its Customer Charge. Specifically, PGW has proposed that the Company's Customer Charges should be increased in order to compare more favorably to other NGDCs' customer charges throughout Pennsylvania. See PGW St. No. 4.0, pp. 5-7. If PGW intends to charge the rates set forth by other NGDCs, then the Company should also be required to provide services equivalent to these higher rates.

In addition, the Commission's regulations provide greater opportunity for customers to transport natural gas by permitting more reasonable minimum volumetric requirements. Pennsylvania regulations provide that the "minimum volume of transported natural gas that entitles a customer to transportation service may not be greater than 5,000 Mcf per customer or buyer group per year." 52 Pa. Code § 60.3(a). Because this minimum volumetric requirement is much lower than that currently provided by PGW, the Company's transportation rules and regulations do not comply with Commission regulations. See Direct Testimony of Paul Metro, OTS Statement No. 3 (hereinafter "OTS St. No. 3"), pp. 30-31. As a result, PGW should be required to modify its minimum volumetric requirement to meet that set forth by the Commission. See id.

PGW's stringent volumetric requirements are especially disheartening in light of Pennsylvania's recent move towards greater, rather than less, competition in the natural gas marketplace. See PICGUG St. No. 1, p. 13. With the passage of the Competition Act, Pennsylvania has attempted to provide greater opportunity for customers, including residential

and small commercial, to transport natural gas on the various NGDCs' systems. Unfortunately, PGW's antiquated transportation requirements move the Company away from competition to a time when no customers, including large industrial and commercial customers, were permitted to transport their own natural gas.

As a result of PGW's anachronistic requirements, large industrial and commercial customers are facing great economic injury. For almost twenty years, other large industrial and commercial customers have had the opportunity to transport their own natural gas on other Pennsylvania NGDCs' systems. As a result, these customers have a greater edge in the competitive arena. Unfortunately, PGW's unwillingness to move forward with the other NGDCs has left PGW's customers at a competitive disadvantage. If a customer does not meet PGW's volumetric requirements, the customer has no choice but to accept natural gas sales service from PGW, while other large industrial and commercial customers in the marketplace have the opportunity to shop for and seek out Natural Gas Suppliers ("NGS") that can offer cost-efficient savings. As a result, PGW's service to its transportation customers continues to remain inadequate and unreasonable.

Although PGW continues to fall behind in comparison to surrounding NGDCs, the Company claims that PICGUG's proposed modifications are inappropriate and would result in a shock to PGW's system if large numbers of customers were to begin transporting. See PGW St. No. 4.1, pp. 18-19. PGW fails to provide any evidence, though, that the Company could not handle increased transportation on its system. Rather, PGW provides vague and unsubstantiated assertions that increasing the number of transportation customers on the Company's system is not feasible. See id.; see also PICGUG St. No. 1S, pp. 5-6. As a result, PGW's argument is nothing more than a futile attempt by the Company to persuade the PUC that it is not capable of doing a

job that other Pennsylvania gas utilities have been doing successfully for years. See PICGUG St. No. 1S, pp. 5-6.

Moreover, even PGW has admitted that the Company's current transportation customers are responsible for purchasing their own natural gas, arranging for the transportation of that natural gas to PGW's city gate, and interacting with the interstate pipeline supplier for this natural gas. See Tr. at 706-07. In addition, the Company has stated that a transportation customer has an obligation to determine, for itself, whether it is in balance with PGW's system. See id. at 699-701. Therefore, based upon PGW's concessions that a transportation customer handles the majority of the issues associated with transporting the natural gas, it is unclear as to why PGW's minimum volume requirements could not be lowered to allow additional customers to transport. Moreover, considering the fiscal problems PGW faces, allowing more customers to maintain responsibility for transporting their own natural gas should ease PGW's burden and allow the Company to focus upon other issues it currently faces.

According to the Company, the more appropriate time to address these issues is during PGW's restructuring proceeding. See PGW St. No. 4-1, p. 18. Interestingly, PGW readily admits that significant changes will be required in order for the Company to handle the increase in transportation customers that could result due to restructuring. The Company has no plans, however, to phase-in these transportation requirements, and instead plans to present the restructuring filing as a whole to the PUC. See Tr. at 704-06. In light of the modifications that will be required to PGW's system, and the problems that PGW claims would occur if large amounts of customers suddenly started transporting, the PUC should have grave doubts regarding the ability of PGW to handle the full migration that could accompany restructuring in just one phase. For these reasons, PICGUG has presented modifications to the Company's tariff

that would permit PGW to gradually open its transportation system to large industrial and commercial customers prior to the onset of restructuring and full unbundling.

In light of PGW's constant claims of systemic problems regarding PICGUG's proposed lowering of the volumetric requirement, PICGUG has proposed an alternative recommendation in this proceeding. Specifically, if the PUC is concerned with PGW's ability to handle the volume of additional transportation customers that would be eligible for enrollment if the transportation requirement were lowered to 5,000 Mcf, then the Commission could consider the higher alternative of 15,000 Mcf. See PICGUG St. No. 1S, p. 7. Although this level is three times greater than that provided for in Commission regulations, this minimum volumetric requirement would still allow the Company to expand transportation services to more of the Company's larger customers. Moreover, lowering the requirement to 15,000 Mcf would continue to allow the Company more experience in handling transportation customers prior to PGW's forthcoming restructuring proceeding, which will require the unbundling of all of the Company's rates.

c. PGW's Transportation Customers Must Be Permitted to Aggregate Facilities Serviced by Multiple Accounts.

Currently, PGW's transportation regulations fail to provide any provisions that would allow a customer to aggregate facilities served by multiple accounts and account numbers, in order to qualify for transportation service. See PICGUG St. No. 1, p. 16. As discussed in Section II(2)(b) *supra*, PGW's minimum volume requirement for transportation service is significantly and unreasonably higher than the requirements of other NGDCs in Pennsylvania. Moreover, this minimum requirement is based upon an individual account, rather than allowing a customer to aggregate accounts for purposes of meeting this requirement.

Many large industrial and commercial customers have numerous facilities, each with various accounts. Obviously, many of these customers would have a greater ability to meet PGW's minimum volume requirement if the pooling of accounts were permitted. As a result, PGW's system would be open to greater competition in the natural gas marketplace. In addition, as noted by PGW, the transportation customer has the responsibility for purchasing and arranging these natural gas deliveries. See Tr. at 706-07. By allowing a customer to compile all accounts and/or facilities, PGW is further eliminating the burden upon the Company to arrange for the sale and delivery of natural gas to all of these accounts.

Moreover, the ability to aggregate facilities provides a large industrial or commercial customer greater cost-efficiency. Specifically, by combining these facilities, the customer can obtain the best price for natural gas overall from an NGS, rather than having to separately negotiate each transportation contract. In addition, an even greater burden could be lifted since many customers may currently have less than a handful of accounts that would meet the transportation requirements. As a result, these customers are able to transport natural gas for some facilities, while other facilities receive service under PGW's sales schedules. Allowing a customer to handle all of its accounts under one rate schedule would obviously provide greater efficiency to the customer and his business.

- d. PGW Should Expand the Buyers Group Level for an Inclusion of a Minimum of Two Individual Customers and a Maximum of at Least Ten Individual Customers.

PGW's requirement that "[t]ransportation service shall be provided by the Company...for a Buyer Group of no more than three individual Customers" is also antiquated and unreasonable. See PGW Tariff Gas – Pa. PUC No. 1, p. 113; see also PICGUG St. No. 1, pp. 16-17. By limiting a Buyers Group to three customers or less, PGW is effectively stifling transportation on

the Company's system. As mentioned previously, PGW has an unreasonably high minimum volumetric requirement and does not permit customers to aggregate facilities with multiple accounts. This limitation of three customers to a Buyers Group is merely one more hindrance to a customer attempting to transport natural gas on PGW's system.

Unlike PGW, other NGDCs in Pennsylvania allow for larger Buyer Groups. For example, PECO permits a Buyers Group of up to ten individual customers, with eleven or more individual customers permitted to form a Buyers Group at the discretion of PECO. See PICGUG Direct Examination Exhibit No. 1; see also PICGUG St. No. 1S, pp. 6-7. PECO's requirements for Buyers Groups are obviously more expansive than PGW's, thus providing greater benefits to its customers. Specifically, a larger Buyers Group enables a customer or marketer to acquire a larger volume of gas and potentially reduce the cost for everyone in the group. See PICGUG St. No. 1, p. 17. Similarly, a larger Buyers Group allows for the offsetting of imbalances among customers, thereby reducing the potential daily and monthly imbalance for the group. See id.

In light of PGW's restrictive transportation regulations, a larger Buyers Group would enable a greater number of customers to meet PGW's minimum volumetric requirement. Similarly, by increasing the size of the Buyers Groups, PGW customers with more than one account would have the opportunity to compile those accounts in cost-efficient manner. For these reasons, the PUC should require PGW to enlarge its Buyers Group requirement to permit a minimum of at least ten customers per Buyers Group, with the ability of eleven or more customers to form a Buyers Group upon approval by PGW. This modification would help to offset PGW's current, and more stringent, transportation requirements.

- e. PGW's Transportation Customers Must Be Permitted to Make Intra-day Nominations Consistent With Upstream Pipeline Supplier Approval, or, in the Alternative, PGW Must Provide Specific Criteria Regarding When an Intra-day Nomination Will Be Approved.

As discussed previously, PGW has in place stringent requirements for allowing a customer to transport on the Company's system. Once those requirements are met, however, the transportation customer still faces further, and unreasonable, restrictions that inhibit the customer's ability to transport natural gas quickly and efficiently.

Specifically, PGW's tariff provides that a customer

may modify the quantities it intends to have delivered to Company's City Gate in accordance with the monthly and daily nomination procedure of the delivering pipeline. All delivery arrangements must be coordinated with the Company's Gas Control Dispatcher in a manner deemed acceptable by the Company. Company shall, within the limitations of its system, assist in this balancing effort.

See PGW Tariff Gas – Pa. PUC No. 1, p. 117. PGW's tariff seems to indicate that a customer may modify its nominations on PGW's system, as long as these modifications are in accordance with the monthly and daily nomination procedure of the delivering pipeline. In reality, however, the guarantee of this nomination is not automatic. Instead, PGW, based upon its sole discretion, determines whether operational conditions on the Company's system will allow for such a nomination modification. See Tr. at 691-95.

As a result, transportation customers on PGW's system may request intra-day modifications from PGW, however, the customers have no knowledge as to whether this modification will be granted. See PICGUG St. No. 1, pp. 17-18. Because PGW retains sole and unfettered discretion over this decision, PGW can choose to deny a nomination based upon operational conditions or the flip of a coin. See *id.* Although PGW indicates that it has never denied an intra-day nomination, PGW has only eight customers with transportation contracts at

this time. See Tr. at 694-695, 706. As a result of the limited number of customers with transportation contracts, PGW most likely does not encounter numerous intra-day nominations on a regular basis. See id. at 706.

As required by the Competition Act, PGW will be unbundling its rates as part of the Company's restructuring proceeding to allow for transportation by the residential, commercial and industrial classes. When this occurs, hopefully the number of customers and marketers on PGW's system will increase dramatically. In addition, however, this leads to the conclusion that PGW's requests for intra-day nominations will also increase. As a result, PGW must have in place some mechanism by which a transportation customer can determine whether an intra-day nomination will be accepted. PGW's first alternative would be to follow the policy set forth in the Company's tariff (i.e., an intra-day nomination meeting the delivering pipeline's requirements will be approved by PGW) minus the discretionary aspect adhered to by PGW. See PICGUG St. No. 1, p. 18. Because PGW claims that following the provisions set forth in the Company's tariff will threaten the Company's operational system, an alternative would be for PGW to explicitly state the conditions and/or criteria under which it will accept intra-day nomination changes from transportation customers in light of any system integrity concerns. See Tr. at 693; see also PICGUG St. No. 1, p. 18. Setting forth such criteria will not implicate the integrity of PGW's system, but rather, eliminate the undue discretion the Company currently maintains with respect to accepting nomination changes from its customers, while also clarifying the Company's transportation requirements to the benefit of its customers.

f. PGW Must Be Required to Provide Daily Imbalance Information to Transportation Customers.

Similarly, PGW fails to provide any method by which transportation customers can check nominations or be notified of imbalances, even in light of the fact that PGW imposes severe

penalties for customers out of balance. See PICGUG St. No. 1, pp. 19-21. In order to alleviate the additional burden placed on transportation customers, PGW should be required to implement a means of communications by which a customer can check on nominations or be notified of imbalances twenty-four hours a day, seven days a week, similar to that provided by other NGDCs. See id.

PGW's tariff provides that imbalances may be permitted within a range of +/- 10% on a daily basis if adjusted within +/- 5% by month's end. See PGW Tariff Gas – Pa. PUC No. 1, p. 117. The Company provides customers the option of obtaining emergency gas when gas is not available under the applicable retail sales service, with the cost of this service placed at \$10 for each thousand cubic feet of gas used and a minimum charge for this service of \$100 per occurrence. If the customer uses this service after being notified that the service is unavailable, or uses this service in excess of authorized limitations, such usage is billed at a rate of \$20 for each Mcf. See id. As a result, a customer out of balance on PGW's system using "unauthorized use" natural gas is subject to very stiff penalties. See PICGUG St. No. 1, pp. 19-21.

Based upon the aforementioned imbalance penalties, it is essential that the Company provide timely daily information regarding imbalances to its customers. For example, PECO provides its transportation customers and marketers with daily imbalance information via the Internet. See PICGUG St. No. 1, p. 20. Similarly, Columbia Gas of Pennsylvania, Inc. ("Columbia") has an electronic bulletin board that is used for nomination and scheduling gas deliveries on its system. See id.; see also PICGUG Direct Examination Exhibit No. 2. Unfortunately, PGW does not have any such mechanism. Currently, PGW customers may attempt to contact PGW in an effort to review their metering or determine how much gas is being burned at their facility. See Tr. at 700-01. PGW does not, however, provide a mechanism by

which customers can contact the Company twenty-four hours a day, seven days a week to determine this information. See id.

Although PGW has indicated that the Company is in the process of developing a web site that will allow transportation customers the opportunity to perform online nominations, PGW does not plan to have this web site available until September 1, 2003. See PICGUG St. No. 1, p. 20. Moreover, PGW has not provided any details regarding the web site, its accessibility or any information that would be provided on the site. See id. While PGW's undertaking is a positive step, it is not reasonable to require transportation customers to wait until 2003 to receive the needed information, especially in light of the stiff penalties invoked by PGW for customer imbalances. See id. at 21.

Interestingly, PGW has suggested that it is the customer's responsibility, not PGW's, to obtain and review the necessary information regarding imbalances. According to PGW, "the customer has an obligation to know where they are. If they want to review the metering or determine how much gas is burdened in their facility, it would behoove them to do so that so they would not overrun their nomination." Tr. at 700. Amazingly, however, PGW does not indicate how a customer can handle such responsibility when PGW does not provide the necessary means by which to access this information. PGW's suggestions are especially interesting in light of the fact that other NGDCs, such as PECO and Columbia, believe it necessary to provide such information to their transportation customers through a twenty-four hour a day, seven day a week mechanism.

Even more intriguing is the fact that PGW suggests that transportation customers must handle their own responsibilities because "[t]his is an unbundled world." Id. Throughout this proceeding, PGW has argued that system integrity will be compromised if the Company's

transportation requirements are modified to increase the ability of large industrial and commercial customers to transport on the Company's system or to meet the transportation requirements of other NGDCs throughout Pennsylvania. If PGW truly believes that transportation customers maintain their own facilities and responsibilities with respect to transporting natural gas, then modifying PGW's system to meet PUC requirements should not be problematic. Moreover, PGW's claim that it is an "unbundled world" is especially ironic in light of the fact that the natural gas marketplace in Pennsylvania, with the exception of PGW's service territory, is unbundled. If PGW insists upon treating its customers as though PGW's system is unbundled, then PGW must provide the rules, regulations and requirements set forth by other NGDCs that provide for an unbundled natural gas marketplace. For PGW to make these claims, however, in light of the Company's rigid and unyielding requirements is nothing more than another hollow argument by the Company.

g. PGW Must Be Required to Provide Timely Lost and Unaccounted for Gas Information to Transportation Customers.

Although transportation customers are impacted by the Company's lost and unaccounted for gas factor ("LUGF"), this factor is not stated in PGW's tariff, nor is there any mechanism by which PGW is required to provide this information to transportation customers. See PICGUG St. No. 1, p. 19. In order to allow transportation customers to plan nominations and deliveries accurately, PGW should provide the Company's LUGF factor on January 1 of each year, with this factor to remain in effect for twelve months. See id. This proposal would not jeopardize PGW's system or result in any significant burden on PGW, but provide additional information needed by transportation customers to ensure accurate and efficient natural gas deliveries.

2. *PGW Has Not Presented Substantive Evidence that a \$65 Million Rate Increase Is Necessary to Maintain the Company's Financial Health or Will Result in Just and Reasonable Rates for PGW Customers.*

Although PGW has faced financial concerns in the past several months due to years of fiscal mismanagement, these financial concerns have been tempered by the recent settlement entered into between the Company and the PUC in PGW's interim base rate proceeding.³ Moreover, PGW's fiscal concerns could be further eased through an agreement by the City of Philadelphia ("City") to forgo its yearly \$18 million payment from PGW, thus further limiting PGW's financial burden. Rather than examining this alternative or relying on the interim rate increase, PGW continues to request an additional \$65 million; however, PGW has failed to provide any evidence that this request would result in just and reasonable rates, as required by the Public Utility Code.

On August 8, 2000, PGW filed a Petition for Interim Relief with the PUC, requesting a rate increase of \$52 million. After full litigation and an appeal to the Commonwealth Court of Pennsylvania, the PUC issued an Order on February 22, 2001, approving a settlement between the PUC and PGW, which provided PGW with \$11 million of base rate relief and \$7 million GCR relief.⁴ See PICGUG St. No. 1, p. 5.

PGW's requested rate relief in the current proceeding, for \$65 million, was filed on January 5, 2001, almost two months prior to the Commission Order of February 22, 2001. Even after the aforementioned interim rate relief was granted, however, PGW failed to propose any

³ See Pa. Pub. Util. Comm'n v. Philadelphia Gas Works, Docket No. R-00005654; Order (Feb. 22, 2001).

⁴ Previously, PGW received a \$97 million GCR increase as a result of the Company's interim GCR proceeding, which occurred simultaneously with the Company's interim base rate proceeding. See Pa. Pub. Util. Comm'n v. Philadelphia Gas Works; Docket No. R-00005619, Order (Nov. 22, 2000).

modifications to its \$65 million rate request in order to account for the interim rate relief received by the PUC. PGW claimed at the time of its filing that a \$65 million rate increase was warranted in light of the failure of the Company to receive adequate interim rate relief from the PUC. See PGW St. No. 1, pp. 6-8.

The Company later received this "adequate" rate relief (as evidenced by PGW's agreement to the settlement), however, PGW chose not to modify, or more importantly, reduce, its current \$65 million rate increase request. Instead, the Company continued forward with the proposed \$65 million rate increase in an attempt to correct past fiscal errors and provide financial cushion for the future. See OCA St. No. 1, p. 9. The interim rate relief provided by the PUC, however, will allow PGW to meet its minimum bond indenture requirements and avoid default. See PICGUG St. No. 1, pp. 5-6. To provide PGW further, long-term relief, in light of the unreasonable rate increases currently faced by PGW customers, is unreasonable and unnecessary. See OCA St. No. 1, pp. 12-14.

PGW's cash flow and net earnings projections also include an \$18 million payment to the City. As noted previously, PGW's financial problems stem from the fiscal mismanagement that has taken place over the past several years. As owner of PGW, the City should shoulder the responsibility for this mismanagement by indicating a willingness to waive or grant back the Company's \$18 million yearly payment. See PICGUG St. No. 1, p. 6. While the City claims that it is unable to provide this type of assistance to PGW due to budgetary constraints, a moratorium on the City's payment would significantly ease the burden on PGW ratepayers as a result of the Company's continuing base rate and GCR increases.⁵ See PGW Statement No. 7, p.

⁵ Over the past several months, PGW customers have seen a GCR increase of \$237 million (including a \$7 million increase for Bad Debt Expense) and an interim base rate increase of \$11 million. See OCA St. No. 1, p. 12.

4; see also PICGUG St. No. 1, p. 6. Moreover, because PGW's financial problems are a result of actions and inactions that happened during the City's regulation of PGW, it is only appropriate for the City to claim responsibility for these problems by foregoing its \$18 million payment.

The Pennsylvania Public Utility Code also provides that "[e]very rate made, demanded, or received by any public utility...shall be just and reasonable." 66 Pa. C.S. § 1301. Throughout the course of this proceeding, however, PGW has failed to present any evidence that a \$65 million rate increase would result in just and reasonable rates for PGW customers. Instead, PGW's overall tone of this proceeding has been nothing short of a cry for additional funds in order to provide even further cushion to PGW's cash needs. Considering the rate increases that PGW's customers have faced over the few months, it is not PGW, but rather its customers, that require fiscal relief. See PICGUG St. No. 1, p. 6.

PGW has sufficient cash flow to meet the Company's minimum bond indenture requirements and avoid default. Further rate relief can be provided by the City, as owner of PGW, through the grant-back of the Company's \$18 million annual payment. In light of the Company's failure to provide substantive evidence to the contrary, providing the Company an additional \$65 million rate increase would not result in just and reasonable rates for PGW's customers. Based on these conditions, the PUC should not grant PGW's proposed rate increase for \$65 million. If the PUC finds that a rate increase is required in order to maintain PGW's financial health, this increase should be determined based upon the aforementioned conditions and limited to the minimum rate increase needed to address PGW's fiscal concerns.

V. RATE STRUCTURE

1. ***Any Rate Increase Granted to PGW Must Be Allocated in Full to the Residential Customer Classes in Order to Move Towards Eliminating the Current Subsidization of the Residential Classes By the Commercial and Industrial Classes.***

Pursuant to PGW's Cost of Service Study ("COSS") submitted in this proceeding, PGW's residential customer classes are receiving significant and unjustified subsidies from the commercial and industrial classes. See PICGUG St. No. 1, p. 8. Specifically, the commercial and industrial customer classes are receiving service from PGW at rates significantly above their cost to serve, while the residential customer classes are receiving service at rates significantly below their cost to serve. See id. at 8-9. In order to begin to remove the existence of this subsidy, any rate increase granted to PGW in this proceeding must be allocated in full to the residential customer classes. The Company's proposed rate structure continues to allocate a portion of the proposed rate increase to the commercial and industrial customer classes, even in light of this subsidy. In order to begin to move away from such subsidization, a larger portion of the rate increase must be passed to the residential customer classes. See id. at 9-12.

Removing this subsidy is also vital in light of PGW's forthcoming restructuring proceeding. In the restructuring proceeding, PGW will be required to unbundle its rates in order to provide all customers the opportunity to transport natural gas on the Company's system. See Direct Testimony of Brian Kalcic, OSBA St. No. 1 (hereinafter, "OSBA St. No. 1"), p. 5. Currently, PGW's transportation rates are not cost-based and, as a result, contribute to the subsidization of the residential customer classes. Thus, the Company's current transportation customers are placed at a competitive disadvantage compared to transportation customers on other NGDCs' systems. See PICGUG St. No. 1, pp. 21-22. In order to ensure full and successful transportation in the future, PGW's first step must be to provide cost-based transportation rates in

this proceeding, while also taking the necessary steps to begin to remove the subsidy currently being provided to the residential customer classes.

Moreover, the OCA's claims that PGW's COSS is improper must be rejected as unsubstantiated and unsupported. See PICGUG St. No. 1S, pp. 2-4. The OCA's proposed modifications to the Company's COSS fail to recognize the cost causation principles behind the Company's allocations and would improperly allocate costs away from the Company's residential customer classes to the commercial and industrial customer classes. See id. For these reasons, the OCA's proposal must be rejected.

a. PGW's Residential Classes Are Being Improperly Subsidized By the Company's Commercial and Industrial Customers.

Pursuant to the Company's filing, PGW proposes a \$65 million rate increase in this proceeding consisting of increases in both the customer charge and the volumetric rates of each customer class. The proposed customer charge increase will generate \$44.5 million of the overall proposed rate increase, while the remaining \$20.5 million will be generated through a volumetric rate increase. See OTS St. 3, p. 10. With respect to the volumetric rate increase, PGW proposes an allocation based upon the Company's COSS.

In this proceeding, PGW submitted the testimony and accompanying COSS prepared and presented by Howard Gorman of R.J. Rudden Associates, Inc. ("Rudden"). According to Mr. Gorman, "Rudden was retained by PGW to perform an unbundled, fully allocated COSS, which was completed in December 2000." Direct Testimony of Howard Gorman, PGW Statement No. 5.0 (hereinafter "PGW St. No. 5.0"), p. 2. One of the purposes of the COSS was to assign the

total costs incurred by PGW to each customer class, and to compare the costs assigned to each customer class to the revenue produced by the rates proposed by the Company.⁶ See id.

According to the Company's COSS, the residential classes (heat and non-heat) are receiving significant and unjustifiable subsidies from the Company's commercial and industrial customers. Specifically, PGW's residential classes are paying less than their cost to serve, while PGW's commercial and industrial customers are paying more than their cost to serve. See PICGUG St. No. 1, p. 9; see also OSBA St. No. 1, p. 4. Even in light of this subsidy, however, PGW's recommended rate allocation for the rate increase proposed in this proceeding is fairly consistent among the classes. PGW proposes a 10.5% overall increase for the residential classes, while the commercial and industrial classes would receive an increase of about 8.8%. See PICGUG St. No. 1, p. 9. Based upon this increase, however, the significant subsidy provided to the residential classes by the commercial and industrial classes would still remain. Specifically, the residential classes will receive a subsidy of \$36.6 million at the Company's proposed rates, and the commercial and industrial customers will provide the bulk of this subsidy. See id. at 9-10.

b. As a Result of this Subsidy, the Residential Customer Classes Must Receive a Larger Portion of the Proposed Increase.

Because the aforementioned subsidy results in unreasonably higher rates for PGW's commercial and industrial customers, the Company's proposed rate allocation must be modified.

⁶Based upon review and analysis of the COSS, PICGUG believes that the COSS was generally performed in a reasonable manner. See PICGUG St. No. 1, p. 8. Although PICGUG does not agree with all of the allocations performed by Mr. Gorman, PICGUG has not proposed any modifications to the COSS during this proceeding. Moreover, PICGUG believes that the COSS may be used as a reasonable guide to determine cost responsibility for PGW's customer classes. See id.

Specifically, PGW's residential classes should be assigned the total revenue requirement granted to PGW in this proceeding.⁷ Under this proposal, the overall rates for the residential classes would increase from the 10.5% proposed by PGW to 13.2%, resulting in a 2.7% increase from that originally proposed by PGW.⁸ See PICGUG St. No. 1, p. 11. Although this modification would still result in a remaining subsidy of \$23 million in the residential classes, allocating the entire rate increase to the residential classes would require the Company to take the first step in moving the residential classes to their cost to serve, while the commercial and industrial customers would be provided some rate relief from the unreasonably high rates they are currently facing. See id.; see also Rebuttal Testimony of Brian Kalcic, OSBA Statement No. 2 (hereinafter "OSBA St. No. 2"), p. 3.

Should the PUC decide not to allocate the full rate increase to the residential customer classes, the Commission could alternatively allocate a larger increase to the residential classes than that already recommended by the Company. For example, the residential class could receive three times the percentage increase given to the other classes. See PICGUG St. No. 1, p. 11. Another option would be to target the residential class with an increase of 1.25 times the system average increase of 15.1%, with a downward adjustment to the Company's proposed across the board increase to the firm non-residential classes. See OSBA St. No. 1, pp. 7-8. Either of these proposals would mitigate the increase to the residential customer classes. Although these options would result in a remaining subsidy to the residential classes, this

⁷ Another alternative would be for PGW's commercial and industrial customers to receive a rate decrease; however, PICGUG is not proposing such an alternative in this proceeding. See PICGUG St. No. 1, p. 10.

⁸ Obviously, this increase would be lower if the PUC decreased PGW's rate increase from the requested \$65 million.

modification would move towards the proper direction in eliminating the subsidy underwritten by the commercial and industrial customer classes. See PICGUG St. No. 1, pp. 11-12; see also OSBA St. No. 1, p. 8.

- c. Eliminating the Subsidy Existing in The Residential Customer Classes Is Extremely Important in Light of the Company's Forthcoming Restructuring Proceeding.

Based upon PGW's COSS, the Company's transportation customers (i.e., those receiving service under Rate GTS) are paying transportation rates that are \$1.5 million, or 57.8%, greater than the allocated cost to serve. See PGW Exhibit HSG-1, Schedule 3, p. 3. As a result, transportation customers, similar to commercial and industrial sales customers, are providing a significant subsidy to the residential customer classes. See PICGUG St. No. 1, p. 21.

Even more importantly, however, PGW's GTS schedule provides that the maximum rate that the Company can charge is the non-gas rate from the transportation customer's applicable rate schedule. See PGW Tariff Gas – Pa. PUC No. 1, p. 114. Because the transportation customers as a whole are paying rates grossly in excess of their costs to serve, these customers are at a severe disadvantage. Rather than negotiating from a cost-based rate level, transportation customers must negotiate downwards from a grossly inflated tariff rate that is far above the cost to serve. See PICGUG St. No. 1, pp. 21-22. As a result, PGW transportation customers must bridge a large gap in order to obtain economic, reasonably priced, cost-based transportation service. See id.

The impact of this issue is further recognized by the onset of PGW's restructuring filing, which will require to the Company to unbundled its rates. "Ideally, such customer choice should be made available to all PGW customers via cost-based transportation rates." See OSBA St. No. 1, p. 5. Because neither PGW's current transportation or sales rates are cost-based, any

unbundling at this time would not result in the appropriate cost-based transportation rates. See id. As a result, the Commission should implement significant modifications that would result in reducing the subsidy to the residential classes through and including modifying current transportation rates to reflect the cost to serve.

d. The OCA's Proposed Modifications to PGW's COSS Are Improper and Should Be Rejected.

As discussed previously herein, PGW's COSS was generally performed in a reasonable manner and may be used as a reasonable guide to determine cost responsibility for PGW's customer classes. See PICGUG St. No. 1, p. 8. The OCA, however, disagrees with the Company's COSS and proposes several improper and unnecessary modifications. See Direct Testimony of Ralph Miller, OCA Statement No. 2 (hereinafter "OCA St. No. 2"), p. 3. According to the OCA, the aforementioned subsidies do not exist because PGW's COSS fails to recognize "proper cost causation." See Rebuttal Testimony of Ralph Miller, OCA Statement No. 2R (hereinafter "OCA St. No. 2R"), p. 2. For these reasons, the OCA suggests a modification to PGW's allocation of the Company's investment in distribution mains.⁹

PGW's COSS classifies 25% of the Company's investment in distribution mains as customer-related, with the remaining 75% of the investment classified as demand related. See PGW St. No. 5.0, p. 18. According to PGW, the dual purpose of mains is: "(1) to attach a customer and enable the customer to receive a minimal level of service; and (2) to provide adequate capacity for the maximum demand level by the customer. The former purpose is customer related, while the latter is demand related." See id. at 17. Conversely, the OCA claims

⁹ The OCA also presents two other modifications to the Company's COSS. PICGUG only addresses the OCA's *distribution main* allocation in this Main Brief and does not take a position with respect to the OCA's other reallocation proposals at this time.

that there should not be any customer component of distribution mains investment, and the entire amount of the investment should be allocated in accordance with the peak and average demand method. See OCA St. No. 2, p. 21.

As explained by PGW, connection of customers to PGW's distribution system is a common service for most utilities, including PGW, because the Company must have a distribution system to deliver gas from the city gate to each customer regardless of when and how the customer uses the natural gas service. See Rebuttal Testimony of Howard Gorman, PGW Statement No. 5.1 (hereinafter "PGW St. No. 5.1"), p. 1. As a result, the OCA's claims that attachment is not a separate product or service provided by PGW are incorrect. See OCA St. No. 2, p. 22.

Similarly, the OCA's claim that PGW's COSS is improper because a zero-intercept study was not performed is also incorrect. Because PGW has the fewest feet of main per service among a group of its peers, zero-intercept studies can not be used for comparison. Instead, PGW utilized proxy data, which was the best information available. See PGW St. No. 5.1, p. 2.

Finally, the OCA suggests that the peak and average demand method should be used to allocate the entire amount of this investment, even though this methodology is completely inappropriate for an NGDC. See OCA St. No. 2, p. 21; see also PICGUG St. No. 1S, p. 2; PGW St. No. 5.1, pp. 2-3. NGDCs plan and invest in distribution mains to attach customers to the system regardless of how or when they take service. See PICGUG St. No. 1S, p. 2. Mains must be in place and sized to serve the system during peak winter periods, and classifying costs partly on the basis of annual throughput fails to account for the fact that the gas distribution system is designed and sized to meet winter peak demands, not average usage throughout the year. See id. Moreover, mains are sized to provide capacity for the maximum demand level imposed on the

system by firm service customers, while the peak average allocation would not reflect the cost causality of the investment in mains. See PGW St. No. 5.1, pp. 2-3.

If the OCA's proposal were adopted, the cost of mains responsibility would be improperly shifted away from residential customers and onto high load factor industrial customers.

Because the residential class has the highest percentage of customers on PGW's system, Mr. Miller's failure to recognize the customer component of distribution mains reallocates those customer-related costs to commercial and industrial customers. Further, since industrial customers use gas more evenly throughout the year than residential customers, allocating a portion of distribution mains costs based on throughput places even more costs on industrial customers.

See PICGUG St. No. 1S, p. 3. In addition, the peak and average methodology would assign more of the cost of the demand component of mains than that under the design-day method, even though the mains, and the investment, are sized to meet customers' maximum demands and not their average demands. See PGW St. No. 5.1, pp. 2-3. As a result, the OCA's proposal is improper, unfounded and must be rejected.

2. *PGW's GCR Must Be Modified in this Proceeding in Order to Remove a Portion of the Improper Costs Currently Contained Therein.*

Currently, PGW's GCR recovers expenses for electricity, the CWP, the CRP, and bad debt. See OCA St. No. 1, p. 46. As a result, the GCR, the purpose of which is to reflect the gas costs paid by the Company, is distorted through this containment of non-gas costs. Moreover, the use of the GCR mechanism to recover the aforementioned non-gas costs guarantees that PGW will recover all of its CRP and CWP costs while providing no incentive for the Company to either control program costs or manage the size of the programs. See Direct Testimony of David Keim, OTS Statement No. 4 (hereinafter "OTS St. No. 4"), p. 3.

Although the PUC directed PGW to address the appropriateness of including non-gas costs in its GCR, PGW chose not to address these costs in any substantive manner or provide any recommendations in its filing concerning the recovery of non-gas costs. See Pa. Pub. Util. Comm'n v. Philadelphia Gas Works, Docket No. R-00005619, Order (Nov. 22, 2000), p. 10; see also PGW St. No. 4.0, p. 10. While the GCR must be revised to remove non-gas costs, PGW's lack of proposals regarding this issue may hinder a full reallocation of these costs. Because PGW believes that its restructuring filing will include a base rate filing, as well as the necessary unbundling proposals, many of these cost reallocations can be done during the Company's restructuring proceeding. See OCA St. No. 1, p. 48.

In order to begin the primary steps for this reallocation, the PUC should consider performing some selective reallocation in this proceeding, while leaving the more complex reallocations for the Company's restructuring proceeding. See id. Specifically, both bad debt and electricity expenses, which are currently being recovered through the GCR, are non-gas costs that could be recovered in base rates. See id. at 48-49. Conversely, PGW is currently recovering \$3.18 per Mcf of gas costs through the base rates. Because this amount is a "gas cost," it would be more properly recovered in the GCR. See id. at 49. By removing the rolled-in gas costs from the base rates to the GCR and reallocating the bad debt expense and electricity expense from the GCR to the base rates, the Commission will be providing the first steps in ensuring that PGW's GCR only recovers gas costs, similar to other NGDCs throughout Pennsylvania. See id. at 48-49.

Because of PGW's failure to present any proposals regarding this matter, a full reallocation of non-gas costs from the GCR may not be practical at this time. See id. at 49. For example, the OTS proposes that the costs from the Company's CRP and CWP should be

recovered through base rates instead of the GCR mechanism. See OTS St. No. 4, pp. 3, 6. Although this proposal is more complex than simply removing the bad debt and electricity expenses from the GCR, the OTS provides no explanation for how this reallocation will be accomplished. Moreover, although the OTS claims that the net impact of the proposed adjustments would be zero on a customer's bill, the OTS's failure to provide further explanation results in great difficulty for determining whether the reallocation is appropriate. See id.

Because the OTS's proposal to reallocate the costs of the CRP and CWP does not provide the information needed to determine whether this proposal is appropriate, the Commission should defer this proposal until the Company's restructuring proceeding, at which time further analysis can be performed. In place of this proposal, the Commission should reallocate simply the Company's bad debt expense and electricity expense from the GCR to base rates, while removing the \$3.18 per Mcf rolled-in cost of gas from base rates to the GCR. These proposals will provide a preliminary step towards the removing all non-gas costs from the GCR, with the remaining steps to follow during PGW's forthcoming restructuring proceeding.

VI. FINDINGS OF FACT

1. PGW's current minimum volume eligibility requirement of 75,000 Mcf is unreasonably high in comparison to other NGDCs' requirements and the PUC regulations. See PICGUG Direct Examination Exhibit No. 1; see also PICGUG St. No. 1, pp. 14-16; PICGUG St. No. 1S, pp. 5-6; OTS St. No. 3, pp. 30-31; 52 Pa. Code § 60.3(a).

2. PGW will need to modify its transportation requirements in the near future in light of the Company's forthcoming restructuring proceeding; however, the Company has no plans at this time to phase-in these requirements during this interim period. See Tr. at 703-06.

3. PGW's transportation customers are responsible for purchasing their own natural gas, arranging for the transportation of that natural gas to PGW's city gate, and interacting with the interstate pipeline supplier for this natural gas. See Tr. at 706-07.

4. PGW's transportation requirements fail to provide any provisions that would allow a customer to aggregate facilities served by multiple accounts and account numbers, even though such a provision would provide greater cost-efficiency for the customer and result in a greater number of customers becoming eligible for PGW's transportation service. See PICGUG St. No. 1, p. 16.

5. PGW's limitation of three customers per Buyers Group effectively stifles competition on the Company's system, and this limitation must be increased in order to be on the same level as other NGDCs in Pennsylvania. See PICGUG St. No. 1, p. 17; see also PICGUG St. No. 1S, pp. 6-7; PICGUG Direct Examination Exhibit No. 1.

6. PGW fails to follow the provisions set forth in its tariff by deciding on a discretionary basis whether a customer's intra-day nomination will be approved regardless of the determination of the delivering pipeline with respect to these nominations. See PICGUG St. No. 1, pp. 17-18; see also Tr. at 691-95.

7. Although PGW enforces stringent penalties for out-of-balance customers, the Company fails to provide transportation customers with the necessary information regarding balancing and nominations. See PICGUG St. No. 1, pp. 19-21.

8. Other NGDCs in Pennsylvania provide balancing and nomination information to transportation customers twenty-four hour a day, seven days a week. See PICGUG St. No. 1, pp. 19-21; see also PICGUG Direct Examination Exhibit No. 2.

9. PGW fails to provide timely lost and unaccounted for gas information to transportation customers, even though these customers are impacted by this factor. See PICGUG St. No. 1, p. 19.

10. PGW's previous financial concerns have been offset by the recent interim base rate increase granted to PGW as part of a settlement entered into between PGW and the PUC. See PICGUG St. No. 1, pp. 5-6.

11. This interim rate relief will allow PGW to meet its minimum bond indenture requirements and avoid default. See PICGUG St. No. 1, pp. 5-6.

12. To provide PGW further, long-term relief, in light of the rate increases recently implement for PGW customers, is unreasonable and unnecessary. See OCA St. No. 1, pp. 12-14.

13. PGW's financial concerns could be further offset through the waiver or grant back by the City of its annual \$18 million payment. See PICGUG St. No. 1, p. 6.

14. PGW's residential customer classes are currently being subsidized by the commercial and industrial customer classes. See PICGUG St. No. 1, p. 9; see also OSBA St. No. 1, p. 4.

15. Allocating the entire \$65 million rate increase requested by PGW to the residential customer classes would still result in a remaining subsidy of \$23 million. See PICGUG St. No. 1, p. 11.

16. PGW's transportation customers are currently paying \$1.5 million above the allocated cost to serve, which results in a subsidy to the residential customer classes. See PGW Exhibit HSG-1, Schedule 3, p. 3; see also PICGUG St. No. 1, p. 21.

17. PGW's current tariff requires transportation customers to negotiate downwards from a tariff rate that is far above the cost to serve, rather than negotiating upwards from a cost-based rate. See PICGUG St. No. 1, pp. 21-22.

18. PGW's restructuring proceeding will require the Company to unbundle all of its rates in order to implement transportation among all customer classes. See OSBA St. No. 1, p. 5.

19. PGW's Cost of Service Study properly classifies 25% of the Company's investment in distribution mains as customer-related, with the remaining 75% of the investment classified as demand-related in order to recognize the dual purpose of mains as enabling the customer to receive a minimal level of service and to provide adequate capacity for the maximum demand level by the customer. See PICGUG St. No. 1S, p. 2; see also PGW St. No. 5.0, p. 18, PGW St. No. 5.1, pp. 2-3.

20. PGW improperly recovers non-gas expenses through the GCR. See OCA St. No. 1, p. 46.

21. Recovery of these expenses provides no incentive for the Company to either control program costs or manage the size of the CRP and CWP programs. See OTS St. No. 4, p. 3.

VII. CONCLUSIONS OF LAW

1. The provisions of Section 2212 of the Competition Act must be balanced with the Public Utility Code, which requires that every public utility maintain reasonable services in conformation with the regulations and orders of the Commissions. As such, PGW's tariff must be modified, regardless of any requests by the Company, in order to provide adequate transportation rules and regulations for large industrial and commercial customers on PGW's system. See 66 Pa. C.S. § 2212(b) & (d); 66 Pa. C.S. § 1501.

2. PGW has failed to provide any substantive evidence that the Company's requested \$65 million rate increase will result in just and reasonable rates, pursuant to the requirements of the Public Utility Code. See 66 Pa. C.S. § 1301. Consequently, PGW must be provided only the minimal rate increase needed to maintain the Company's financial health.

VIII. CONCLUSION

WHEREFORE, the Philadelphia Industrial and Commercial Gas Users Group respectfully requests that the Pennsylvania Public Utility Commission:

1. Modify PGW's Transportation Rules and Regulations to:
 - (a) lower the volumetric transportation requirement to 5,000 Mcf per year;
 - (b) permit transportation customers to aggregate facilities served by multiple accounts and account numbers for purposes of qualifying for transportation service;
 - (c) expand PGW's Buyers Groups to allow for an inclusion of a minimum of two individual customers and a maximum of at least ten individual customers;
 - (d) allow transportation customers to make intra-day nominations if their upstream pipeline suppliers allow such changes to be made, or, in the alternative, require PGW to establish criteria to be utilized by a transportation customer in order to determine whether an intra-day nomination will be granted by PGW;
 - (e) require PGW to provide daily imbalance information to transportation customers on a seven day a week, twenty-four hour a day basis; and
 - (f) require PGW to provide lost and unaccounted for gas percentage information.
2. Permit PGW's request for a rate increase only to the minimum level necessary to establish just and reasonable rates.
3. Allocate any rate increase granted to PGW fully to the residential customer class.
4. Deny the Office of Consumer Advocate's proposed modifications to PGW's Cost of Service Study.
5. Reallocate the electricity and bad debt expenses currently contained in the Company's GCR to base rates.
6. Reallocate the \$3.18 Mcf rolled-in gas costs currently contained in base rates to the Company's GCR.

7. Permit any other relief that is consistent with this Main Brief.

Respectfully submitted,

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Dated: June 21, 2001

CERTIFICATE OF SERVICE

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

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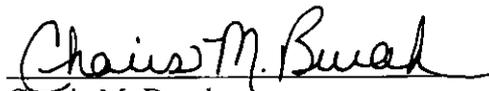
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Dated this 21st day of June, 2001, in Harrisburg, Pennsylvania.