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June 29, 2001

James J. McNulty, Secretary
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VIA HAND DELIVERY

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

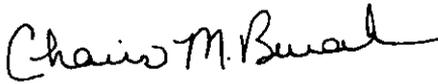
Dear Secretary McNulty:

Please find enclosed the original and nine (9) copies of the Reply 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.

Very truly yours,

MCNEES WALLACE & NURICK LLC

By 
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/
diskette version in Word 2000)
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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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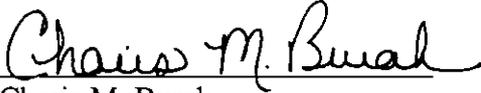
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Dated this 29th day of June, 2001, in Harrisburg, Pennsylvania.

COMMONWEALTH OF PENNSYLVANIA



ORIGINAL

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June 29, 2001

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

Dear Secretary McNulty:

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

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

Sincerely yours,

James A. Mullins
Assistant Consumer Advocate

Enclosure

cc: All parties of record
Hon. Cynthia Fordham

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY
COMMISSION :

v. :

PHILADELPHIA GAS WORKS :

DOCKET NO. R-00006042

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Dated: June 29, 2001

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I. INTRODUCTION

On June 21, 2001, the parties to this proceeding filed their Main Briefs in support of their positions. In its Main Brief, the OCA recommended that the Pennsylvania Public Utility Commission (“PUC” or “Commission”) allow the Philadelphia Gas Works (“PGW” or “Company”) to increase its rates by no more than \$21.5 million. The OCA demonstrated that this level of increase in this first full base rate proceeding under the Commission’s jurisdiction would implement the requirements of the Natural Gas Choice and Competition Act (“Act”) in a manner that was just and reasonable. In particular, this level of rate increase would allow the Company to satisfy its bond coverage requirements; meet all of its budgeted expenses, including its expenditures for its Mains Replacement Program; and continue its Transition to Excellence Plan. With this level of rate increase, the Company can also continue its progress toward resolving its financial crisis and its efforts to improve safety and customer service can continue.

What this level of rate increase does not do is unfairly burden ratepayers, who have already experienced nearly 50% increases in their gas bills during the winter of 2001, by providing all of the cash that the Company wishes to have on hand. If the Company requires cash beyond that identified in its budget or provided for by its commercial paper program or bond issuances, such additional assistance should be provided by its owner, the City. Through its rate request, PGW seeks to shield its owner, the City, from providing any further assistance to PGW. PGW argues that the City does not have the funds to help, beyond the assistance already provided. PGW M.B. at 57. But, as the public input testimony demonstrates, ratepayers simply do not have the funds to help. Rates that are unaffordable for PGW’s customers will only add to the burden of the City’s social costs. For instance, Pastor Arthur Johnson, Jr. of the Tacony Baptist Church testified that as a result of the large increases in the Church’s gas bills, the

Church had to close a community food bank that it operated. Tr. at 367-68. For over ten years, the Church operated a food bank in Northeast Philadelphia to help needy families and individuals. Pastor Johnson testified:

For the last ten years we have run a community food cupboard at the Tacony Baptist Church. I have been the one to pick up the food, to go and get the food with the Greater Philadelphia Food Bank and with the state emergency food programs. We had to close that food bank. We closed it February 20 and we are not able to open it again.

* * * * *

Now, we are not opening up the food cupboard because my first priority as pastor of the church is to keep the doors of church open, not feed the public, which we have been doing for ten years. So this is our problem.

Tr. at 368.

The OCA submits that as such vital services provided by the non-profit or private sectors disappear, the City will incur additional social costs which it has not considered within the context of assessing whether it has the ability to provide assistance to PGW's fiscal crisis. During cross-examination, PGW witness Davis admitted that the City has not done any assessment of whether the City will incur additional social costs as a result of the dramatic increase in gas rates for PGW customers. Tr. at 803-804. As is evident from Pastor Johnson's remarks, it is almost a certainty that the City will bear some of the fallout from the increase in natural gas rates in the City of Philadelphia.

The OCA submits that in resolving this case, the Commission must consider this public input testimony and be guided by the principle that rates must be just and reasonable and service must be adequate. When these principles are applied to PGW's request, it is evident that a rate increase of no more

than \$21.5 million should be allowed. This increase should also be subject to certain conditions, as specified in the OCA's Main Brief, to ensure that PGW continues its progress to improving safety and customer service.

The OCA will not respond to each argument forwarded by the parties in this Reply Brief. The OCA will only reply to those arguments where further response is necessary or would help to clarify an issue. The failure of the OCA to respond to an argument or issue should not be interpreted as acceptance of that argument or issue. As set forth herein, the OCA stands by its position set forth in its Main Brief and continues to recommend a rate increase of no more than \$21.5 million.¹

¹ The OCA's recommended \$21.5 million increase is inclusive of, not in addition to, the \$11 million interim base rate increase permitted by the Commission in its February 22, 2001 Order approving the settlement of the interim rate proceeding.

II. LEGAL STANDARD

As it did in the Interim Base Rate Case a few months ago, PGW continues to argue that Section 2212(e) of the Public Utility Code divests the Commission of any discretion in establishing the rates for PGW. PGW M.B. at 10. PGW argues that Section 2212(e) is highly specific and limits the Commission. Under this Section, PGW argues that the Management Agreement with the Philadelphia Facilities Management Corporation (PFMC) controls all aspects of PGW's base rate requests since this was the basis of the "ratemaking methodology" that is referenced in Section 2212(e). PGW argues that the Management Agreement requires that PGW's rates be set to meet all of PGW's identified needs, including all cash working capital requirements of PGW. PGW M.B. at 13-15. As set forth in the OCA's Main Brief, PGW's reading of the Act, and the Management Agreement, is flawed and should be rejected. The Act should be interpreted in a manner that accomplishes the intent of the General Assembly, *i.e.* to subject PGW to the regulation and control of the Commission with the same force as if the service were rendered by a public utility. 66 Pa.C.S. §2212(b).

PGW begins by arguing that the language of Section 2212(e) requires the Commission to adhere to the same ratemaking methodology that was applicable to PGW when the Commission assumed jurisdiction of PGW. PGW M.B. at 10. The OCA does not disagree. The OCA does disagree, however, with PGW's next step that adherence to this ratemaking methodology means that the Commission must simply "rubber stamp" the revenue requirement proposed by PGW or the budget approved by the Philadelphia Gas Commission. If the Commission reaches a result in the application of this methodology that differs from PGW's or the Philadelphia Gas Commission, PGW argues that Section 2212(e) is violated. PGW M.B. at 11.

PGW's arguments all rest upon a seriously flawed assumption – that the rates of PGW do not have to be just and reasonable either under its prior ratemaking methodology, the Management Agreement, or the Public Utility Code. The fundamental principle of public utility regulation, that is embodied in the Public Utility Code and applies to PGW, is that rates must be just and reasonable. 66 Pa.C.S. §1301. Court cases which have reviewed the rates of PGW established by the Philadelphia Gas Commission have clearly articulated that this standard must apply. See, Action Alliance v. Philadelphia Gas Comm'n, 406 A.2d 1155, 1158 (Pa. Commw. 1979) and Public Advocate v. Philadelphia Gas Comm'n, 674 A.2d 1056, 1061 (Pa. 1996)(Public Advocate). In Public Advocate, the Pennsylvania Supreme Court stated that “[w]hen examining the 1991-92 rates for PGW, this Court is mindful that no applicable constitutional requirement is more exacting than the requirement of ‘just and reasonable’ rates.” Id. at 1061. The Pennsylvania Supreme Court in that case went on to hold:

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

674 A.2d at 1062. Those standards are that the rates must be just and reasonable. Id. at 1061. See also, American Aniline Products v. Lock Haven, 288 Pa. 420, 424, 135 A. 726, 727 (1927).

In fact, even the Management Agreement which PGW relies upon is founded on the principle that rates be reasonable. On page 1 of the Management Agreement it states:

WHEREAS, the City desires to provide quality gas service to its citizens at *reasonable* rates. . .

Management Agreement, p.1 (emphasis added). Despite PGW's attempts to cast itself as different, the basic and fundamental principle of just and reasonable rates must be applied to PGW.

Recognizing that the Commission may conclude that PGW's rates must be just and reasonable, PGW tries to evade any review of analysis of this fundamental requirement by arguing that the "cash flow method" as defined by PGW automatically produces just and reasonable rates, citing Public Advocate for support. PGW M.B. at 15. But PGW's argument falls apart when its own definition of the "cash flow method" is examined. PGW has continuously argued that the cash flow method is set forth in Section 7 of the Management Agreement. PGW interprets this Section of the Management Agreement to require approval of all expenditures or costs that PGW identifies, without regard to whether they are reasonable, prudent or properly included in rates. The Management Agreement, however, does not specify the treatment of any particular dollar expenditures or identify any specific cash requirement for PGW. The Management Agreement lists categories of rates, charges, costs and other revenues, but it was within the purview of the Philadelphia Gas Commission to use its discretion and determine the *reasonable* levels of these various categories of expenses and revenues, including PGW's cash requirements. The Philadelphia Gas Commission Hearing Examiner recently commented on the Philadelphia Gas Commission's review to determine *reasonable* levels as follows:

While the Commission [PGC] 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 with 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 balance 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. Under the Management Agreement, this determination is left to be a matter of judgment, which is to be exercised in the overall exercise of rate-setting authority.*

PGC Hearing Examiner Recommended Decision, FY2001 Operating Budget and Outyear Forecasts at 19-20 (May 17, 2001)(emphasis added).

As can be seen, under the “prior ratemaking methodology,” the Philadelphia Gas Commission always exercised discretion to determine reasonable expenses and a reasonable amount of cash to be provided by ratepayers. As even PGW acknowledges, the PGC always determined a zone of reasonable revenues and expenses and balanced the interests of both customers and PGW. PGW M.B. at 14, fn. 34. Now, it is this Commission’s task to determine the reasonable level of revenues and expenses, including a reasonable amount of cash requirement, and balance the interests of customers and PGW. This Commission’s exercise of discretion to determine a level of just and reasonable rates is perfectly consistent with the prior ratemaking methodology, and thereby, the Act.

PGW, however, continues to argue that the Act requires that the Commission provide revenues to meet all of its identified operating expenses and cash requirements, without any consideration of reasonableness. PGW M.B. at 13-15. As to operating expenses, the OCA submits that it is now the task of this Commission to review these expenditures and allow only necessary, proper, reasonable and prudent expenditures to be recovered in rates.

As to the appropriate level of cash working capital that should be provided by ratepayers, PGW ignores the plain language of the Management Agreement which calls for only *reasonable amounts* of cash to be provided through rates. Management Agreement, Section 7(b)(iii). PGW attempts to garner support for its position that ratepayers must meet all of its cash requirements by citing to cases before the Philadelphia Gas Commission from the early 1980s. PGW M.B. at 13-15. From these cases, PGW argues that the Philadelphia Gas Commission has previously permitted it to meet all of its cash needs

through rates and so this Commission is bound to do the same.² PGW M.B. at 13-15. As detailed in CEPA's Main Brief, and as confirmed by PGW witness Bogdonavage on cross examination, these orders were *before* PGW's commercial paper program was implemented to provide it with the necessary cash working capital. CEPA M.B. at 29-31; Tr. at 607. Circumstances today, with a substantial commercial paper program and an impending bond issuance, compel a different conclusion than that reached by the Philadelphia Gas Commission in the early 1980s. In fact, the Philadelphia Gas Commission itself has reached a different conclusion than PGW. On June 19, 2001, the Philadelphia Gas Commission approved a FY 2001 budget for PGW³ that reflects only the \$11 million base rate award and the \$7 million bad debt expense increase awarded by this Commission in the Settlement and not the \$65 million increase proposed by PGW.⁴

² At page 16 of its Main Brief, PGW goes so far as to assert that the decisions of the Philadelphia Gas Commission constitute *stare decisis* and must be followed by the Public Utility Commission. The OCA submits, however, that this argument must be rejected. First of all, as the Commonwealth Court has held, "the Commission, as an administrative agency, is not bound by the rule of *stare decisis*." PECO Energy v. Pa.P.U.C., 756 A.2d 156, 163 n.6 (2000). While the Court went on to note that "an administrative agency, must render consistent opinions and should either follow, distinguish or overrule *its own* precedent," clearly this rule does not apply to decisions of another administrative agency – in this case the PGC, a City of Philadelphia agency. Id. (emphasis added). The OCA submits that while the decisions of the PGC can provide important information and guidance to the Commission, the Commission is not bound by those earlier decisions. Moreover, as noted above, the situation in effect at the time the PGC made its decisions in the cases relied upon by PGW has significantly changed.

³ A copy of the PGC's June 19, 2001 Motion approving a FY2001 Operating Budget for PGW was attached to the Company's Main Brief. For sake of convenience, a copy of the June 19, 2001 Motion is attached hereto and marked "Appendix A."

⁴ PGW has previously argued that the Public Utility Commission can do no more than set rates to recover the budgeted amount approved by the Philadelphia Gas Commission. Indeed, if PGW is correct, then only an \$11 million rate increase should be awarded since that is the level recently approved by the Philadelphia Gas Commission. The OCA has argued, however, that a more appropriate reading
(continued...)

The OCA submits that these very types of changes illustrate why the Commission must now apply its discretion when reviewing the revenues, expenses, and cash requirements of PGW. The OCA does not disagree that the Commission must follow the ratemaking methodology, or the bond covenants, but these methodologies and covenant requirements were always applied and interpreted by the PGC in a manner that balanced the interests of customers and PGW. These methodologies and covenants must now be applied and interpreted by the Commission. In so doing and in keeping with the Act, the OCA submits that the Commission must recognize fundamental principles of ratemaking so as to give meaning to the provisions of the Act and the Public Utility Code. 1 Pa.C.S. §1922.

The OCA submits that if PGW's arguments are adopted, and the Commission can only mechanically count up the dollars that PGW spent or that were approved sometime in the past by Philadelphia Gas Commission, then Section 2212 of the Public Utility Code is meaningless. Such an interpretation of the Code is contrary to the rules of statutory construction and it provides no protection to PGW's ratepayers. As such, PGW's arguments must be dismissed.

A. The OCA's Recommendation Does Not Deprive The City Of The \$18 million City Payment

PGW also argues that under Section 2212(f), the Commission must provide it sufficient revenue through rates to make the \$18 million payment to the City. PGW M.B. at 18. PGW argues that

⁴(...continued)

of the Act is one that gives meaning to all of the provisions of the Act and the Public Utility Code. Such a reading would treat an approved budget of PGW just like any other budget of a utility approved by a Board of Directors. The Commission should certainly accept evidence of the Philadelphia Gas Commission's approved budget level, but the Commission must review the budget and expenditures as well to ensure that rates are just and reasonable.

if the Commission then sets rates at a level that would require the City to grant back the \$18 million, the Commission has *de facto* deprived the City of the \$18 million payment. PGW M.B. at 19. PGW argues that the OCA's recommendation does just that and is an indirect disallowance of the City fee since it sets an inadequate level of revenue requirement. Id. The OCA submits, however, that the Company's argument miscomprehends the OCA's recommendation and is incorrect.

The OCA's revenue requirement recommendation is based on the Company's own FY 2001 budget which *includes* the \$18 million payment to the City. The OCA then proposes a revenue requirement level that fulfills the bond covenant requirement of a 1.5x coverage on the 1998 bonds *based on PGW's budget*. The OCA's recommendation is that if *additional* cash is needed for unexpected contingencies not included in the budget, the City should grant back the \$18 million City payment to provide the necessary cash flow – a result clearly called for in the Management Agreement which includes the provision of “project revenues” from the City as a source of funding for the Company.⁵ Management Agreement, Section VII.1. This is, in fact, the responsibility that the owner should accept. The OCA does not recommend that any of the \$18 million City payment be used to meet the bond coverage requirement as the Company suggests. As such, the OCA's recommendation does not require the City to return its payment to meet the debt service coverage requirements of the bonds. Thus, the Company's argument fails.

⁵ Project revenues represent funds supplied by the City, in this case the grant back of \$18 million payment, that qualifies for inclusion as above-the-line operating revenue in the coverage calculation. The City maintains a grant revenue fund as part of its operating budget. This fund is used to provide grants to various City agencies. Tr. at 785.

III. REVENUE REQUIREMENT

A. PGW's \$65 Million Rate Request Is Flawed.

1. Introduction

In its Main Brief, PGW argues that it requires a \$65 million rate increase and that this result is dictated by the Act and PGW's Management Agreement. PGW M.B. at 50-51. According to PGW, the Company's prior ratemaking methodology requires that ratepayer charges meet all of its expenditures and provide all of its cash working capital. *Id.* at 51. The Company argues that it requires the entire \$65 million increase to have sufficient cash on hand to pay these obligations and resolve its financial crisis. PGW seeks an award in this case that provides a "cushion" of revenues above those needed to satisfy the Company's debt service coverages applicable to its outstanding bonds. The Company also attempts to bolster its request for a \$65 million rate increase by reaching beyond its own FY2001 test year and urging the Commission to consider speculative, untested budgets for FY2002. Finally, the Company relies upon an Engineering Report that it had conducted for its bond issuance to support the need for at least a \$53 million rate increase arguing that anything less will impair its ability to access the capital markets. As explained in the OCA's Main Brief and herein, the Company's arguments should be rejected.

2. The Company's Attempt To Resolve Its Long-Term Financial Problems Through This One Case Should Be Rejected.

PGW desires a revenue award in excess of the level needed to satisfy the Company's debt service coverages. PGW M.B. at 50. According to the Company, this revenue "cushion" is necessary for PGW to accomplish a number of goals, particularly:

- reducing its level of dependence on commercial paper, and

- reducing the amount of long-term debt that the Company needs to issue

PGW M.B. at 24. PGW has become dependent on its commercial paper program and debt issuances, which have risen to almost \$1 billion, over the past 10 years. As OCA witness LeLash explained, these issuances have become necessary due to the failure of its owner to provide meaningful assistance in the past:

Over time, the City has failed to make any significant equity contribution to PGW and, as a result, the utility operation is effectively financed only with debt capital and retained earnings recovered from ratepayers. As expected, without ongoing equity infusions from its owner, PGW now faces a financial crisis because of a lack of adequate working capital.

OCA St. No. 1 at 7. This situation was exacerbated by three mild heating seasons to which the Company did not respond. As Mr. LeLash testified:

To some degree, PGW's current financial position can be attributed to the milder than normal weather experienced during the past three heating seasons prior to this winter. As a result of this weather, PGW did not fully recover its fixed costs, and that has contributed to more debt financing and working capital shortages. While the weather clearly was beyond the Company's control, the Company's failure to acknowledge PGW's deteriorating financial condition was not. To the degree there is a current financial crisis, it is of PGW's own making. Established regulatory remedies were available, and the Company, for as yet unspecified reasons, did not seek rate adjustments.

Id. at 9. Now, the Company tries to correct these past problems (which arose over many years), and address, in the long term, the problems created in the past in this one case.

However, as Mr. LeLash explained:

I do not believe that the focus of this proceeding should be over such a long time period. Rather, the focus should be on the short-term, that is, 12 to 18 months or, more specifically, until the Company makes its restructuring filing and the Commission authorizes unbundled rates,

hopefully in an environment where wholesale gas prices are more in line with historic levels.

OCA St. No. 1 at 24-25.

The OCA submits that in this case, it would be unjust and unreasonable to increase rates by \$65 million to correct these long standing deficiencies. The OCA has recommended that the Company receive an increase of \$21.5 million, which allows it to meet its bond covenants and begin to rectify its past problems. *If the Company desires more of a cash cushion, i.e., an additional allowance of cash working capital, this increased level of funding should be provided by its owner—the City of Philadelphia—and not by ratepayers.*

3. The Management Agreement Does Not Require Ratepayers To Meet All Cash Working Capital Requirements.

Throughout its Main Brief, PGW argues that ratepayers are responsible for providing all cash working capital to the Company and that its owner, the City, has no responsibility in this regard. PGW M.B. at 51. PGW concludes that OCA witness LeLash's recommendation is inadequate in that it does not provide PGW with the level of cash that it desires. *Id.* at 50-51. However, as explained below, in determining a revenue award in this case, the Commission must ensure that any award is reasonable and balances the interests of PGW and its ratepayers. The OCA's recommendation achieves this balance.

Contrary to PGW's argument that the Management Agreement requires ratepayers to provide for all of PGW's cash needs through their payment of rates, the Management Agreement says no such thing. Specifically, concerning cash working capital, the Management Agreement states:

The Gas Commission shall fix and regulate rates and charges for supplying gas to customers, other than the City and the Board of Education, without further authorization of City Council, which (together with revenues for gas

supplied to the City and to the Board of Education and other revenues of the Gas Works qualifying as ‘project revenues’ as such term is defined in Section 2 of the First Class City Revenue Bond Act) will, in each fiscal year produce revenues, at a minimum:

(b) Sufficient also ...

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

Management Agreement, §VII.1(b)[emphasis added]. The Agreement clearly states that only a *reasonable amount* of working capital is to be included in rates. The Management Agreement does not assume that customer rates will cover all Company costs as if no other sources of capital are available to PGW, e.g., private loans, City loans, City grants, etc. As can be seen, the Agreement mainly seeks to ensure that PGW will have sufficient resources to meet specified needs—these resources need not totally come from rates, though. Therefore, the provisions do not foreclose the use by PGW of other resources that may be made available to it.

Regarding a “reasonable” amount for cash working capital, it is now this Commission’s task to determine a reasonable amount given the circumstances facing ratepayers today. In this regard, the discussion in the Main Brief of CEPA is apt:

In obtaining passage of the Municipal Utility Financing Act, amending the Management Agreement, and passing the General Inventory Note Ordinance, the City recognized that PGW’s “reasonable” working capital was limited to the costs of debt service on the ample TXCP program which had been provided to the utility and on any supplementary borrowing that PGW might do in order to meet cash needs. Ratepayers have funded from the outset the full costs of maintaining this TXCP program, even when it was mismanaged. Through gross mismanagement, the City has exhausted the self-imposed limits which it set as a measure of

the working capital that PGW would reasonably need. It should not be allowed to come back to ratepayers for more working capital without at least assuming part of the burden of restoring PGW's fiscal balance.

CEPA M.B. at 31.

The OCA submits that the Management Agreement does not support PGW's view that "reasonable working capital" is whatever cash PGW needs over and above the debt service costs of this program. Rather, this Commission must now determine what is reasonable. The OCA submits that what is reasonable is for the owner, the City, to continue to assist PGW in meeting its cash needs until its financial situation stabilizes, its billing and business systems are fully functional, and its service improved.

4. The Commission Should Consider Various Factors When Interpreting The Management Agreement.

PGW continues to rely on the Management Agreement to support its \$65 million request and relieve the City of any obligation to assist PGW. As set forth above, PGW's interpretation of the Management Agreement is flawed. When reviewing the Management Agreement to determine what is reasonable, the Commission should consider the performance of all parties to the Management Agreement.

OCA witness LeLash explained:

[T]he Agreement provides that PFMC's "primary obligation shall be to apply the highest standards of management practice and diligence to the operation of the Gas Works" (Agreement, page 2). It was to do this so that the City could "provide quality gas services to its citizens at reasonable rates" (Agreement, page 1). Additionally, PFMC was to provide management personnel for the operation of the Gas Works (Agreement, page 3).

Given PGW's performance during the past several years, it would appear that a case could be made for the fact that PFMC has not met its contractual obligations for several years. Results would indicate that the highest standards of management practice and diligence were not applied.

And certainly, PFMC did not provide adequate management personnel given that PGW went without a chief executive officer for many years. Accordingly, it may not be proper to base a PGW rate increase solely on the terms of the Agreement, when the requirements of the same Agreement, which were intended to benefit ratepayers, have not been met.

OCA St. No. 1 at 19.

PGW's attempt to use the Management Agreement to hamstring the Commission in this proceeding and shift the burden of its past mismanagement to ratepayers should be rejected. As OCA witness LeLash explained, the Commission should seek, through this proceeding, to define and to limit ratepayer responsibility:

Apparently, for a variety of reasons, PGW's past management and the City did not respond to the serious deterioration in the operation of the Company and the level of service being provided to its ratepayers. The consequences of this failure are not appropriately borne by ratepayers. Therefore, the responsibilities of PGW's ratepayers must be defined and hopefully limited. Should this demarcation not be established, then the City will be able to abrogate any real responsibility and the deficiencies of the past will, more than likely, continue.

OCA St. No. 1 at 17. The Company's \$65 million request, which is premised on ratepayers significantly supporting PGW's cash working capital requirements would relieve the owner of its obligations and shift them to ratepayers.

5. Neither the Court Cases Referenced, Nor The Joint Petition Require An Award Of \$65 Million.

Also in support of its position that a \$65 million increase is needed to provide a cash cushion, PGW argues that the Pennsylvania Supreme Court has found that rates that include an allowance for cash working capital are just and reasonable and its bond ordinances require that rates be set at levels to enable PGW to pay its obligations when they come due. PGW M.B. at 51. The Company again argues

that Public Advocate v. Philadelphia Gas Comm'n, 674 A.2d 1056 (1996) and the Joint Petition for Full Settlement of PGW's Petition for the Establishment of Interim Rates and Related Appeal ("Joint Petition"), respectively, support the conclusion that it must be awarded a \$65 million rate increase.

First, the main issue in Public Advocate v. Philadelphia Gas Commission was:

whether the fixed annual \$18,000,000 payment by the Philadelphia Gas Works ("PGW") to the City of Philadelphia ("City"), as required by a 1972 City ordinance, is constitutional and can be included in the calculation of PGW's rate increase for fiscal year 1991-92.

Id. at 1057-58. The Supreme Court held that the rates set by the Philadelphia Gas Commission were just and reasonable, therefore, it was proper for the PGC to have included the \$18 million payment. The Court did not speak to whether or not an allowance for cash working capital—or any other ratemaking item—was appropriate. The Court's main concern was whether or not the resultant rates were confiscatory. Id. at 1062. Therefore, the City's reliance on this case to bolster its argument for an allowance of cash working capital is misplaced.

As to the Joint Petition, first and foremost, it is a settlement and the following language sets forth the Joint Petition's applicability on a going-forward basis:

[T]he Joint Petitioners agree that this Settlement shall not constitute or be cited as controlling precedent in any other proceeding.

Joint Petition at ¶32; Pa.P.U.C. v. Comm'n v. Philadelphia Gas Works, Docket Nos. R-00005654 and R-00005619, Order at 6 (February 22, 2001). Thus, the Joint Petition should not be relied upon in this case.

Nevertheless, under the OCA's recommendation, as set forth in Schedule 1 attached to OCA witness LeLash's Direct Testimony, a rate increase of \$21.5 million *would* allow the Company to

meet its expenses, make the \$18 million payment to the City, achieve a bond coverage of 1.5x on the 1998 Ordinance Bonds, and achieve a 2.01x bond coverage on its 1975 bonds. Furthermore, as explained below, the Company would still have \$34 million in cash at the end of FY2001. The OCA submits that no more is necessary in this proceeding under the Act, the Public Utility Code or the Management Agreement.

6. PGW's Attempt To Reach Into FY2002 For Support Of Its Request Must Be Rejected.

The Company argues in its Main Brief that its FY2002 projections confirm the reasonableness of its requested \$65 million requested rate increase and demonstrate the inadequacy of the OCA's recommendation. PGW M.B. at 32-34. The OCA submits, however, that utilizing a test period outside of the current budget year, which forms the basis of this filing is entirely inappropriate since the Company has not even filed its FY2002 budget with the Philadelphia Gas Commission ("PGC"). Tr. at 632. Indeed, the Company's attempt to now utilize a future budget year, which is not utilized by the PGC, and in fact has not even been submitted to the PGC, is inconsistent with the Company's own interpretation of the ratemaking methodology required under the Act.

It is important to note that the PGC has never used cash requirements outside of the current year to set rates in the past. Tr. at 606. In spite of this, the Company attempts to look beyond the revised budget for FY2001, which is the test year in the current proceeding, and attempts to utilize projections for FY2002 to support its request for a \$65 million increase in base rates. Using FY 2002 projections, the Company asserts that it will have a negative \$30 million year-end cash balance. PGW JRB-3 at 1.

This entire projection is based totally on speculation. As this Commission has found, *speculative expenses in the post-test year period that are not known and measurable should not form the basis of a rate allowance.* Pa.P.U.C. v. ALLTELL, 59 Pa.P.U.C. 447, 461 (1985). The Company's projections for FY2002 are untested and unsubstantiated. The Company has not even filed its FY2002 budget with the PGC. For the first time in the rebuttal phase of the proceeding, the Company presented a cash-flow analysis for FY2002. See Schs. JRB-2 and JRB-3. No where in the Company's original filing did it present any analysis for FY2002. Instead, its entire request for a \$65 million base rate increase is premised upon a test year utilizing the operating budget for FY2001. PGW St. 3.0 (rev.) at 2. The OCA submits that the forecasts for FY2002, which the Company presented for the first time in its rebuttal case, are based on mere speculation and conjecture and cannot withstand scrutiny.

In addition to being beyond the Company's own test year in this case, the OCA submits that there are a myriad of problems with PGW's forecast for FY2002 that renders it wholly unreliable. For instance, the applicable cash flow statement, page 1 of Exhibit JRB-3, does not reflect the fact that the new debt issue is to provide more than the \$100 million assumed in the Company's projections.⁶ This could provide an additional source of cash for the Company to utilize. Tr. at 828. The Company's FY2002 forecast also includes unrealistically high gas costs. As shown in Mr. LeLash's surrebuttal testimony, current forecasts for prospective gas costs average \$1.36 per Dth below those included in the Company's projections for FY 2002. OCA St. 1-S at 11. The decline in wholesale natural gas costs will also reduce or eliminate the under recovery of GCR costs in the current year. This elimination of the under recovery

⁶ PGW witness Bisgaier testified at the time of the hearings that the bond issue would be between \$110 million to \$140 million. Tr. at 464.

of \$12.4 million will increase the Company cash balance dollar for dollar. Therefore, the Company's gas costs, the amount of capital tied up in inventories and receivables, and its bad debt expense are all overstated in its forecast. Accordingly, the Company's estimate of associated working capital balances are incorrect in several respects and are, without question, not known and definite enough to be the basis for setting rates.

Within the rate-setting process there are specific requirements which must be met in order to have forecasts utilized as the basis for rate-setting. In the Company's case, it seeks to use cash requirements to justify its ultimate revenue requirement. However, the determinants of cash requirements are far more speculative than many of the rate base and operating income elements which are typically addressed in base rate proceedings. The level of accounts receivable, for example, is an unknown. In its projections, the Company makes no reference to its level of collections prospectively, despite the fact that with improvements in the BCCS and with lower gas costs, there is a reasonable expectation that PGW's collections and thereby its cash position will be far more favorable in FY 2002 than it was in FY 2001. The OCA submits that with unknown levels of accounts receivable, inventories, and bad debt expenses, it is unreasonable to base current revenue requirements on the Company's speculation and various "worst case" scenarios concerning possible future events. In FY 2002, the Company might pursue a variety of measures that could greatly increase the Company's cash balance above the FY 2001 year-end level. It is for this reason that reliance upon a speculative, as yet unfiled budget for the next year should be accorded no weight.

This was confirmed by the PGC in a recent June 19, 2001 Motion in PGW's FY2001 Operating Budget proceeding. See Appendix A. In that Motion, the PGC concluded:

... we find ourselves in the uncomfortable position of once again not being able to approve – with or without modification – PGW’s proposed outyears forecast. This Commission has repeatedly, but unsuccessfully, directed PFMC to prepare a meaningful strategic plan for PGW, linked to its current and future budgets. ***In the absence of a completed plan, we are not able to adequately scrutinize assumptions underlying PGW’s forecast for Fiscal Years 2002 through 2006.*** Despite repeated assurances to both the Gas Commission and City Council that such a plan was forthcoming, PGW still has not completed the plan.

PGC Motion of June 19, 2001 at 2-3 (emphasis added). Therefore, the Company’s reliance on its FY2002 projections is completely inappropriate where the PGC has declared that it is unable to adequately scrutinize the underlying assumptions of that forecast.

7. PGW Cannot Possibly Know If, Or How, A Revenue Award Of Less Than \$53 Million Will Affect The Company’s Ability To Access The Credit Markets.

In its Main Brief, PGW states that:

[A] PUC award that is significantly different from the findings of the Engineering Report would prevent PGW from further accessing the credit markets or retaining its all important commercial paper program.

PGW M.B. at 56. The OCA submits that this is mere conjecture. As the OCA explained in its Main Brief, the Commission does not set rates based on the “independent” findings of the Engineering Report. The Commission must determine a level of rates that is just and reasonable.

Moreover, as set forth in the Main Brief of the OCA, the Black & Veatch Report is based on the same, flawed interpretation of the Act and the Management Agreement as the Company. Likewise, the Engineering Report seeks to remedy the same long-term problems as PGW does in this case. As set forth by the OCA, such a long term resolution of these long-standing problems through this case will not

result in rates that are just and reasonable. As such, PGW's reliance on the Black & Veatch Engineering Report is misplaced. Such a report cannot serve as the basis of a rate determination.

In addition, Ms. Bisgaier, at the time of the hearings expressed concern that the Commercial Paper program might not be renewed at the \$100 million level. Tr. at 461-464. A failure to do so would have prevented PGW from entering the bond market. Tr. at 464. However, in a late filed exhibit, the Company updated the record to indicate that, in fact, the Commercial Paper was renewed for an additional year at \$100 million.⁷ PGW Exh. BB-3.

B. PGW's Criticisms Of Mr. LeLash Are Without Merit And Should Be Rejected.

1. Mr. LeLash's Recommendation Does Not Result In A Negative Year-End Cash Balance For Fiscal Year 2001.

The Company argues in its Main Brief that the OCA's recommendation is inadequate and results in a negative year-end cash balance for FY2001. PGW M.B. at 51-52. Mr. LeLash, however, relied upon PGW witness Bogdonovage's Exhibit JRB-2 and page 4 in developing his proposed \$21.5 million revenue increase. Tr. at 813. PGW Exhibit JRB-2, page 2 shows that the Company will have a year-end balance of \$34 million for fiscal year 2001 not the negative balance that the Company now contends. OCA St. No. 1-S at 11-12; Tr. at 813.

⁷ In its Main Brief, the Company states that the new agreement requires PGW to reduce the amount of commercial paper outstanding to \$80 million by the end of FY2002. PGW M.B. at 24 n. 68. The OCA submits that this is an incomplete discussion. While the new agreement does require the Company to draw down the amount of commercial paper to \$80 million by August 10, 2002, the Company may request that the Letter of Credit be renewed for the full \$100 million for an additional year. If renewed for an additional year, the Company would again have access to the full \$100 million. See Exh. BB-3 §§2.2 and 7.13.

To derive the hypothetical -\$30 million or -\$20 million year-end cash balance for FY2001, the Company “adjusts” its own \$34 million positive cash balance for three elements. First, the Company identifies the City loan and deferral of supplier payments as one-time events that would lower PGW’s available cash if they had not occurred. PGW backs out the City loan and the deferred gas costs from its own schedules. Then, PGW backs out another \$43.5 million to reflect Mr. LeLash’s rate increase recommendation, which is less than the Company’s requested \$65 million.⁸ PGW M.B. at 51; Tr. at 585; PGW M.B. at 51. The Company’s one-sided attempt to alter its own FY2001 results should be given no credence.

Initially, the OCA would note that the Company does not seek to identify or address other anticipated or unanticipated events that raise the Company’s available cash. For example, in his rejoinder testimony, Mr. Bogdonovage states that: “The third series bond is supposed to generate about \$110 million of proceeds for capital expenditures.” Tr. at 583. However, in speaking about the same bond issuance, witness Bisgaier testified that: “PGW is planning to sell approximately \$110 million – it may go up as high as \$140 million.” Tr. at 464. If the bond issuance is ultimately made at \$140 million (rather than the \$100 million projected in PGW Exhibit JRB-2 or the \$110 million discussed during witness Bogdonovage’s rejoinder), this would provide PGW with significant additional capital that has not been taken into account. The Company’s attempt to reflect only certain components should be rejected.⁹

⁸ Mr. LeLash’s \$21.5 million recommendation subtracted from \$65 million equals \$43.5 million.

⁹ The Company’s hypothetical situation also ignores the responsibility of the City. As OCA witness LeLash testified, the City can provide bridge loans to help with cash deficiencies. OCA St. No. 1 at 27-28. The City could also restructure the repayment of the \$45 million City loan so that it does not
(continued...)

Regarding the city loan, in particular, the Company's attempt to characterize this loan as a one-time event that must be adjusted for in FY2001 completely ignores the City's responsibilities as the owner of PGW. Tr. at 814-815. Although PGW is ardent in its position that the City should not play a role in strengthening the Company's financial position, the OCA submits that the City should, in fact, assist PGW in its time of need. Importantly, the \$45.0 million City Loan does not need to be paid back "next year" as stated on page 52 of PGW's brief, but rather is due in January, 2003. See PGW St. 8, Exh. TJS-3 at B44. Accordingly, for all of 2001 and 2002 the Company has the City Loan available.

As for the \$11.5 million in deferred gas costs, gas costs have declined and this amount could be more than offset by the lower inventory and accounts receivable balances experienced in the future. Thus, to try to utilize this as a means to create a hypothetical cash shortfall is misplaced.

Regarding the \$43.5 million "shortfall" that would result from implementation of Mr. LeLash's proposed \$21.5 million revenue increase, a rate award which is \$43.5 million below that of the Company will not have an impact on the FY 2001 cash position. As Exhibit JRB-2, page 4 illustrates, with no rate increase in effect (other than the \$11 million resulting from the Joint Petition), the Company still ends fiscal year 2001 with a \$34 million positive cash balance. Therefore, neither a \$65 million¹⁰ or \$21.5 million increase can impact PGW's fiscal year 2001 cash position, since any rate award will go into effect after August 31, 2001.

⁹(...continued)
impact cash. Tr. at 814-815.

¹⁰ The Company also erroneously states that a \$65 million increase produces only \$10.2 million of cash at the end of August 2001, on a normalized, fully forecasted basis. PGW M.B. at 51.

Therefore, the Company's calculated -\$30 million year-end balance has no basis in fact.¹¹

Consequently, PGW's argument that Mr. LeLash's recommendation will result in a negative year-end cash balance for fiscal year 2001 should be rejected. Mr. LeLash's recommended \$21.5 million increase represents a sufficient award in the instant proceeding and if the Company desires more than a \$34 million year-end cash balance, such additional revenues should be provided by PGW's owner—the City of Philadelphia.

2. Mr. LeLash's Recommendation Is Reasonable And Meets The Requirements Of The Act.

As set forth fully in the OCA's Main Brief, OCA witness LeLash's recommendation satisfies PGW's debt obligations, including its debt service coverage. As shown on Schedule 1 attached to Mr. LeLash's Direct Testimony, a rate increase of \$21.5 million would allow the Company to meet its expenses contained in the Company's own budget, make the \$18 million payment to the City, achieve a bond coverage of 1.5x on the 1998 Ordinance Bonds, and achieve a 2.01x bond coverage on its 1975 bonds. Any additional cash cushion, beyond that produced by the Company's FY2001 budget should be provided by the owner.

C. Service Considerations Should Indeed Be Taken Into Account In Determining The Level Of Just And Reasonable Rates In The Instant Proceeding.

In its Main Brief, PGW argues that "an otherwise justified rate increase" for PGW cannot be denied based on poor service considerations. PGW M.B. at 53. However, the OCA submits that the

¹¹ The Company's calculation of a -\$20 million year-end cash balance for 2001 only "adjusts" for the City loan and deferred gas costs. However, this calculation—like the -\$30 million calculation—should also be disregarded by the Commission.

quality of service received by PGW's customers should be a determinant in whether or not customers should be required to pay higher rates. Whether rates are just and reasonable depends not only on the cost of providing service, but also on the quality of value of the service provided. Pa.P.U.C. v. Pa. Gas & Water Co., 61 Pa.P.U.C. 409 (1986).

The OCA has serious concerns about the quality of service provided by PGW. There was substantial public input testimony about the billing problems, poor call center performance, and inefficient dispatch of workers. Tr. at 194; 215 and 227-228. Moreover, the Company continues to have implementation problems with its BCCS. The Company's inability to gather and organize basic business information about itself and its customers, its ability to maintain its system of mains in an efficient and cost effective manner, and its ability to perform customer service and billing functions has left the Company in a position where it has not adequately met its customers' needs.

The OCA submits that the adequacy of service should be considered in determining the level of just and reasonable rates. Rates should follow service. OCA St. No. 1 at 60. The long-term deficiencies of PGW's service to its customers and future progress to improve service should be a primary determinant as to whether or not customers should have to pay higher rates and, if so, what conditions may need to be imposed to ensure that service is improved.

The Company argues that the PGC has never denied a rate increase based on service considerations. PGW M.B. at 53. But as the Courts have held, PGW's rates must be just and reasonable and service is a consideration in that determination. See D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Comm'n, 466 F.2d 394, 422 (D.C. Cir. 1972) and Smythe v. Ames, 169 U.S. 466 (1898). Moreover, PGW is now regulated by the Commission and this Commission has made clear

that service considerations have a bearing on the determination of just and reasonable rates. See also 66 Pa. C.S. §526.

In Pa.P.U.C. v. Pa. Gas & Water Co., 79 Pa. P.U.C. 349 (1993), the Commission denied a portion of the Company's rate request due to the Company's continuing record of inadequate service. In denying a portion of PG&W's rate request, the Commission stated:

Upon Commission review of the record in this proceeding, we find that PG&W is currently rendering inadequate water service to its customers within the meaning of Section 526(a) of the Public Utility Code 66 Pa. C.S. § 526(a). Therefore, we may reject in whole or in part the rate increase to which PG&W would have been entitled absent our consideration of service quality.

Id. at 359. Although it could have denied PG&W's **entire** rate request, the Commission continued:

Although our finding of inadequate water service allows us under law to reject completely any increase in revenues for PG&W, this "no increase" approach may be counter-productive in this particular instance wherein the Company clearly needs to dedicate additional funds to the improvement of its water distribution system—over and above those presently budgeted by the Company in this area.

Id.

In the instant case, the Commission's Stratified Management and Operations Audit of Philadelphia Gas Works by the Barrington-Wellesley Group, Inc. was admitted into the record. Stratified Management and Operations Audit of Philadelphia Gas Works (January 2001), Attachment 1 to Administrative Counsel Statement No.1. Further, Philadelphia Gas Works filed in March 2001 the Philadelphia Gas Works Implementation Plan for the Stratified Management and Operations Audit, which was also admitted into the record. Philadelphia Gas Works Implementation Plan for the Stratified Management and Operations Audit (March 2001). As the Management Audit has made clear, many areas

of the Company's customer service are inadequate. For example, the Management Audit found that "PGW's level of service, as measured by abandonment phone rates and response time of the call center, is one of the worst in the industry." Admin. Counsel St. 1, Att. 1 at VIII-7. Other problems identified with PGW's service include insufficient staffing levels to meet Call Center levels (only 62% or 48 of 78 employees are on average present at one time); inadequate training of employees on the billing system; lack of functioning billing system; overwhelmingly negative customer opinion of PGW; and poor responsiveness to customer complaints. *Id.* at VIII-11, VIII-16-17, VIII-26.

The public input testimony in this proceeding confirms these Audit findings and raises many concerns about the level of PGW's service. As in Pa.P.U.C. v. Pa. Gas & Water Co., here too, the Company's service problems are still pervasive and in need of improvement. Consequently, OCA submits that if PGW is granted a rate increase, it must be subject to conditions to ensure the provision of safe and adequate service and to ensure that the rates are just and reasonable.

D. The Company's Attempt to Limit the Commission's Consideration of the Management Audit Should Be Rejected.

On April 24, 2001, Secretary McNulty issued a letter appointing the Law Bureau to designate Commission Administrative Counsel in order to move the Management Audit into evidence in this proceeding. Secretary McNulty Letter (April 24, 2001). See also, Stratified Management and Operations Audit of Philadelphia Gas Works, Admin. Counsel St. 1, Att. 1. The Management Audit was admitted into evidence as Attachment 1 to Administrative Counsel St. 1. Tr. at 713, 723. In its Main Brief, PGW argues that the Management Audit cannot be used to deny in whole or in part, PGW's rate

increase. PGW M.B. at 74. PGW further argues that such use would be unfair and would violate its due process rights. PGW M.B. at 71.

The OCA submits that PGW's attempt to limit the use of the Management Audit should be rejected. The Management Audit is evidence in this proceeding and may be used as any other piece of evidence could be used in a ratemaking proceeding. The findings of the Management Audit provide important evidence to the Commission as to PGW's operations when it determines a level of rates that is just and reasonable.

PGW first argues that the Commission cannot adjust rates based on the Management Audit in that it would be inconsistent with the purpose of the Management Audit. The OCA submits that the Company's argument is misplaced. The Commission directed the Management Audit to be admitted into evidence into this proceeding and can rely upon it just as any other piece of evidence. Use of the Management Audit in a rate case proceeding is not inconsistent with the Commission's purpose in directing the Audit as PGW argues. As even PGW acknowledges, the purpose of the Audit is to obtain operating improvements and efficiencies. One of the tools that the Commission can use in this regard is the base rate review process. Indeed, it would be improper for the Commission to allow rates to be set to reflect known inefficiencies or poor operations. Such a result would only continue poor practices.

In fact, the Commission is specifically directed by 66 Pa.C.S. § 523(a) and (b)(1) to consider Management Audit findings in determining just and reasonable rates. Section 523(a) and (b)(1) require that:

- (a) Considerations.-The commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under

this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with this underlying rationale, in the final order of the commission.

(b) Fixed utilities.- As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:

(1) Management effectiveness and operating efficiency as measured by an audit pursuant to section 516 (relating to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.

66 Pa.C.S. § 523(a) and (b)(1). The Commission often has used evidence from Management Audits in rate proceedings. See Pa.P.U.C. v. West Penn Power Co., Docket No. R-922378 (Order entered May 14, 1993) ; Pa.P.U.C. v. People's Natural Gas Co., Docket No. R-0088096 (Order entered June 9, 1989) (utilization of Management Audit in base rate proceeding).

The Company also argues that the Management Audit represents only a "snapshot" of time and does not represent the current status of service. As the public input testimony demonstrates, however, significant improvements in service have not yet been realized by customers. In fact, the Commission's recent Tentative Order, Philadelphia Gas Works' Implementation Plan for the Stratified Management and Operations Audit-Outsourcing Call Center Overflow, Docket No. M-00011464 (Order entered April 19, 2001) concludes that these problems continue and additional steps are necessary to bring reasonable

service to PGW's customers. Stratified Management and Operations Audit -- Outsourcing Call Center Overflow, Docket No. M-00011464, Tentative Order at 2 (April 23, 2001).

The Company also argues that the use of the Management Audit to deny or to limit its rate increase request would violate PGW's due process rights. As set forth above, PGW's service and performance have been issues in this case all along and is an issue in every base rate case. The Company was provided an opportunity on the record to respond to the Management Audit and submitted testimony in this regard. The Management Audit simply adds to the substantial evidence of record about PGW's service.

For example, OCA witness LeLash discussed the 3,513 informal complaints at the Commission regarding PGW. Id. at 60. The numbers for those complaints increase at 300-700 per month. Id. The Vanguard Report discusses the problems with inadequate BCCS training. Id. at 57. The Report states that there is "limited personnel with basic understanding of the SPL code and underlying products" required for operation of the BCCS system. Id. The Billing and Customer Care System ("BCCS") is the heart of the customer service problem. The Management Audit identifies a problem that has already been identified by numerous other sources, most importantly by the customers who suffer the impact of inadequate staffing levels and inadequate training. See also OCA St. 1 at 58, 60.

The public input testimony given on March 28 and 29, 2001 in PGW's service territory fully supports the findings made by the Management Audit regarding call center customer service. The Management Audit found that "PGW's level of service, as measured by abandonment phone rates and response time of the call center, is one of the worst in the industry." Attachment 1 to Administrative Counsel St. No. at p. VIII-7. Consumers have experienced numerous problems with PGW's Call Center,

which is one of the quality of service issues outlined by the Management Audit. Tr. at 184, 188, 292-293, 352-353, 356, 360, 382, 391 (complaints regarding extraordinarily long wait times on the telephone); Stratified Management and Operations Audit of Philadelphia Gas Works, Admin. Counsel St. 1, Att. 1 at VIII-7; See also, OCA Main Brief at 65-67.

For example, in response to a question about whether the customer would “pick up the phone and call PGW and say what is going on,” the customer, Lea Ann Harris responded that she tried to go to the office but it was crowded. Tr. at 292-293. Another witness, Edward Moran, stated that he tried to call the company at “11 o’clock at night, 11:30, because I knew I didn’t want to spend a lot of time on hold. But still I spent 20 minutes on hold at 11:30 at night.” Tr. at 352. He further stated that “[s]o we have a customer service department, can’t solve problems, you have to wait on hold for 30 minutes to two hours and it doesn’t do anything.” Tr. at 353. The only way that Mr. Moran was able to get the problem resolved was by contacting the Public Utility Commission. Id. Michael DeVincent described the wait in terms of “I ate my lunch, read the newspaper and watched two television shows with the phone dangling at my ear.” Tr. at 360. Another customer, Anne Rossi, testified that she called PGW and was told it would be about a 55 minute wait, called again later and was told it would be about a 25 minute wait, and called a third time and was told it would be about a 25 minute wait before the line disconnected. Tr. at 382. She tried to call again and was again disconnected. Id. The testimony of these customers illustrates the lengthy wait times found by the Management Audit. See also, OCA M.B. at 65-67. The Audit’s findings and conclusions about the quality of PGW’s service are only reinforced by this testimony and the OCA’s testimony on the issue.

The OCA submits that the Management Audit should be used for the purpose of its design, as an independent evaluation of PGW's operations, but also submits that rates should not be set without any consideration of this evaluation. In fact, pursuant to Section 523(a) and (b), the Commission must consider these Audit findings in determining just and reasonable rates. 66 Pa. C.S. § 523(a) and (b). The conclusions made by the Management Audit are wholly supported by other evidence in the record, and PGW has had ample opportunity to address both the Management Audit and other evidence presented.

E. Potential Decreases To The Company's Gas Cost Rate Cannot Be Considered To Offset Any Base Rate Increase Established In This Proceeding.

In its Main Brief, PGW states that Mr. LeLash ignores the net effect on rates of the Company's proposed gas cost rate. The Company argues that if the gas cost rate decrease is considered, it offsets the \$65 million base rate increase, and residential customers will actually see a total bill decrease of nearly 3%. PGW M.B. at 55. The OCA submits, however, that this provides no justification for the Company's requested base rate increase.

First, the Commission must determine whether the rates awarded in this case are just and reasonable. This determination is separate and apart from the gas cost rate proceeding, which adjusts for actually experienced purchased gas costs. The record compiled in this case demonstrates that PGW is entitled to a \$21.5 million increase, not a \$65 million increase. Assuming rate relief at this lower level, residential customers would receive a decrease in excess of 3% – a decrease to which they are entitled given the dramatic increases in gas bills that they have experienced this past year. Consequently, PGW's attempt to combine the effects of the potential gas cost rate increase with a \$65 million base rate increase

only shows that a rate award of less than \$65 million will provide much-needed relief to customers of the Company.

Additionally, the 2002 gas cost rate referenced by the Company has not yet been finally determined. This decrease is based on projections of future gas costs that may or may not come to pass. Since PGW updates its GCR rate throughout the year, changes to this level of the GCR -- either up or down -- are to be expected.

Based on the above, the OCA submits that the Company's 2002 gas cost rate filing is not relevant for purposes of determining what the base rate increase should be in the instant proceeding.

IV. COST OF SERVICE

A. Cost of Service Study

1. Introduction

PGW and PICGUG challenge the OCA's modifications to the Company's cost of service study ("COSS"). See PGW M.B. at 60; PICGUG M.B. at 31. The specific modifications are: 1) the proposed allocation of PGW's investment in distribution mains, 2) the proposed allocation of the entire amount of administrative and general (A&G) salaries and office supplies and expenses on the basis of labor, and 3) the proposed allocation of the A&G credit of \$12 million of duplicate charges. However, the OCA's adjustments are necessary and reasonable and should be adopted.¹²

2. It Is Appropriate To Allocate Distribution Mains Investment In Accord With The Peak And Average Method.

OCA witness Miller recommended that the Company's distribution mains investment be allocated using peak and average demands rather than with a 25% customer component and a 75% demand component (based on design day demand) as proposed by the Company. OCA St. No. 1 at 21. The Company challenges this modification to the COSS arguing that allocating distribution mains investment based on the peak and average method fails to reflect cost causality for PGW's investment in mains. PGW M.B. at 60. In support of its assertion, the Company continues to argue that "gas distribution companies plan and invest in distribution mains to attach customers to the system regardless of how or when they take

¹² PICGUG only objects to the OCA's proposal to use the peak and average method for allocation of PGW's investment in distribution mains. PGW terms all three modifications as "misplaced", but only responds to OCA's modifications regarding allocation of PGW's investment in distribution mains and allocation of A&G salaries and office supplies and expenses.

service.” Id. However, the OCA submits that the Company’s argument should be rejected and the peak and average method should be used for allocating distribution mains investment.¹³ As set forth in the Main Brief of the OCA and the direct testimony of OCA witness Miller, mains are constructed to deliver gas, not merely to connect customers to the system. OCA M.B. at 40; OCA St. No. 2 at 22. Therefore, the entire investment in mains should be allocated on the basis of some measure of the gas they deliver or the loads they serve. This principle has been recognized by the Commission. See Pa.P.U.C. v. Peoples Natural Gas Co., 63 Pa.P.U.C. 6, 42 (1986).

Arguing that one reason for installing distribution mains is to attach customers to the distribution system, the Company classifies 25% of this investment as customer-related and allocates it on the basis of the number of customers in each customer class. However, as previously explained, in contrast to individual service lines, the length and cost of distribution lines is not a separate product or service provided by PGW, and has no independent value to PGW’s customers. OCA M.B. at 40-41; OCA St. No. 2 at 22. In other words, PGW would not connect a customer to the distribution system if that customer were not going to purchase gas.

¹³ PICGUG also advocates use of a customer component design-day demand, rather than the peak and average methodology. Since PICGUG relies mainly on the reasoning of PGW to support its position, the OCA’s arguments in response to the Company’s assertion apply to PICGUG as well. PICGUG does additionally state that “the OCA’s claim that PGW’s COSS is improper because a zero-intercept study was not performed is incorrect.” PICGUG M.B. at 32. As set forth in the OCA’s Main Brief, the peak and average method has previously been accepted by the Commission and should be applied in this proceeding as well. OCA M.B. at 41. If a customer allocation is to be used at all, which the OCA does not advocate, a zero-intercept analysis is necessary to properly identify the customer component of the mains. The Commission, however, has recognized that distribution mains should be allocated on the basis of energy and demand. See Pa.P.U.C. v. Peoples Natural Gas Co., 63 Pa. P.U.C. 6, 42 (1986).

In his COSS, Mr. Miller allocated the investment in distribution mains on the basis of the peak and average demand method. OCA St. No. 2 at 21. This method of allocation recognizes both the peak load and the average, or energy, load that is delivered to customers. This method has been accepted by the Commission. See Pa.P.U.C. v. Peoples Natural Gas Co., 63 Pa.P.U.C. at 42; see also Pa.P.U.C. v. West Penn Power Co., 73 Pa.P.U.C. 454, 518 (1990) and Pa.P.U.C. v. Philadelphia Elec.Co., 61 Pa.P.U.C. 589, 678 (1986). Therefore, the OCA submits that the Company's opposition to application of the peak and average method for purposes of allocating distribution mains investment should be rejected.

3. In The Absence Of A Special Study To Determine How Administrative And General Costs Should Be Allocated, Such Costs Should Be Allocated Evenly Between Plant And Labor.

In its Main Brief, PGW argues that administrative and general ("A&G") salaries and related office expenses should be allocated based on labor. PGW M.B. at 60-61. In support of this argument, PGW states that: 1) direct labor costs best reflect how PGW incurs costs in its business, 2) the Federal Energy Regulatory Commission ("FERC") generally accepts allocation of A&G expense based on direct labor costs, and 3) such an allocation is the norm in gas and electric utilities and is not restricted to pipeline companies. Id. at 61. These assertions have previously been addressed by the OCA in its Main Brief. OCA M.B. at 42-44.

As previously explained, some A&G expenses are more closely related to PGW's plant investment and should be allocated on that basis. OCA M.B. at 42; OCA St. No. 2 at 21. Among these activities are financial services, which include plant and general accounting and the treasury, and corporate information and legal services. As OCA witness Miller testified, labor is not the factor that causes PGW to incur these costs. OCA St. No. 2 at 23-24.

Furthermore, because utilities as a whole are capital intensive, the allocation of overhead costs like A&G salaries and office expense as related entirely to labor ignores this fundamental structure of the industry. Therefore, an allocation of part of these A&G costs on the basis of plant investment, as proposed by Mr. Miller, recognizes these realities of the way a utility works.¹⁴ Consequently, the Commission should reject this argument of the Company.

Regarding PGW's argument that FERC-accepted allocations should be used, FERC's use of direct labor to allocate A&G salaries is not relevant to PGW because the situation of interstate pipelines is very different from that of gas distribution companies, including PGW. A natural gas distribution company has many small customers and a labor allocator overemphasizes the customer accounts function. An interstate pipeline, on the other hand, has a much smaller customer accounts component so there is less problem with the labor allocator. OCA St. No. 2-S at 6-7. For a gas distribution company, the FERC methodology does not properly capture the large number of customers. Consequently, the Company's reliance on FERC-approved allocations for interstate pipelines is misplaced.

In light of the above, the OCA submits that the Commission should reject PGW's allocation of A&G salaries and related office expense based on direct labor costs. The Company asserts that this is the "norm" for electric and gas utilities, but provides no support for this assertion. Therefore, absent a special study to determine a more precise allocation, a 50/50 allocation between plant and labor is appropriate.

B. Class Revenue Responsibility

¹⁴ Contrary to the Company's assertion, direct labor costs do not best reflect how PGW incurs costs in its business. OCA St. No. 2-S at 6.

In their Main Briefs, the Office of Trial Staff (“OTS”), Office of Small Business Advocate (“OSBA”) and the Philadelphia Industrial and Commercial Gas Users Group (“PICGUG”) recommend that the revenue responsibility of the residential class be substantially increased over the level recommended by the OCA or PGW. See OTS M.B. at 58; OSBA M.B. at 6-7; and PICGUG M.B. at 26. However, the OTS, OSBA and PICGUG base their class revenue responsibility recommendations on the PGW class cost of service study and, as previously explained, the OCA disagrees with the Company’s class cost of service study. See OCA M.B. at 40-47. OCA witness Miller’s COSS more accurately reflects the costs caused by each class, therefore, the alternative class revenue responsibility recommendations of OTS, OSBA and PICGUG should be rejected since they are based on PGW’s flawed COSS. PGW’s allocation of several major items in its COSS fails to recognize proper cost causation, however, Mr. Miller’s COSS incorporates appropriate changes to recognize proper causation. After such recognition, the cost responsibility of classes is more accurately reflected. The OCA submits that more extreme class revenue responsibility recommendations of the OTS, OSBA, and PICGUG are not consistent with the results of Mr. Miller’s class cost of service study.¹⁵ Therefore, the OCA submits that the revenue responsibility recommendations of OTS, OSBA and PICGUG should be rejected.

C. Rate Design

1. PGW’s Residential Customer Charge Should Be Set At \$11.50 Per Month.

¹⁵ PICGUG even goes so far as to argue that the entire rate increase should be borne by the residential class. PICGUG M.B. at 26. However, as Company witness White testified, increasing the residential allocation beyond the recommendation of the Company “would only serve to increase the burden on the customers who are having the most difficulty paying their bills.” PGW St. 4.1 at 17.

In its Main Brief, PGW continues to propose a \$15 residential customer charge. PGW M.B. at 63. In support of its proposal, PGW argues that its proposed charge is less than the customer-related or “direct” costs produced in its cost of service study (“COSS”) and is needed in order to reduce the Company’s weather sensitivity. Id. at 63-64. However, the residential customer charge should be based on specific direct customer costs and PGW’s residential customer charge is not.¹⁶ OCA M.B. at 52-55.

Furthermore, the principles of gradualism should be applied to such a charge.

In a case involving National Fuel Gas Distribution Company, the Commission denied a 15% increase in the company’s residential customer charge based on gradualism concerns. See Pa.P.U.C. v. National Fuel Gas Dist. Corp., 73 Pa.P.U.C. 552, 621-23 (1990). The Commission stated:

We continue to believe that customer charges should be based upon cost causation to the extent that gradualism will allow.

Id. at 623. PGW’s proposal here represents an 88% increase over year-ago levels. The OCA submits that such a proposal clearly violates the principles of gradualism.

As for weather sensitivity, this concern is irrelevant for purposes of setting a residential customer charge. The OCA is well aware that PGW favors an increase in the customer charge in order to mitigate the impact of weather on the Company’s ability to collect revenues. However, as just explained, the residential customer charge should be based on direct customer costs, not weather sensitivity concerns of the Company. Therefore, the OCA submits that the residential customer charge proposed by Mr. Miller

¹⁶ See Pa.P.U.C. v. West Penn Power Co., 73 Pa. P.U.C. 454, 526 (1990); Pa.P.U.C. v. Columbia Gas of Pa., 74 Pa. P.U.C. 282, 344 (1990) (billing and collection costs, meter reading costs, and costs of meters and services are direct customer costs to be recovered through a customer charge).

should be adopted, *i.e.*, \$11.50 per month. This proposed customer charge is based on specific direct customer costs in accord with Commission precedent.

D. Tariff Provisions

1. The OCA's Proposed Modifications To PGW's Non-Standard Rates Provision Should Be Adopted.

In its Main Brief, PGW requests that its Non-Standard Rates Provision be adopted by the Commission. PGW M.B. at 66. However, as set forth in the OCA's Main Brief, the OCA recommends three modifications to the Company's proposal: (1) Section 2.3b should state, in its entirety, that "*The negotiated rate(s) shall not be less than 110% of the incremental gas cost for gas sold under the negotiated contract plus an adjustment for all applicable taxes, as determined by the Company*"; (2) there should be a further provision (in a new Section 2.3c) that the negotiated rate shall not be less than the rate that would otherwise be available to the customer, unless the contract also contains a minimum take or a full requirements provision;¹⁷ and (3) a further provision should state that PGW may use a specific gas source purchased for a period of more than one month to determine the incremental gas cost for a negotiated contract, but only if the contract also includes a commitment by the purchaser to take and pay for at least 80% of the gas in that specific purchase. See OCA. M.B. at 58-59. With the addition of these modifications, the OCA submits that the Company's proposal can be adopted.

¹⁷Also, if the provision qualifying the negotiated contract for a discount rate is a minimum take provision, the minimum take requirement must be at least 80% of the maximum volume for which the discounted rate is offered.

V. CONCLUSION

For the reasons set forth above, and for the reasons set forth in the OCA's Main Brief and Testimony, the OCA submits that the Commission should allow PGW a base rate increase of no more than \$21.5 million, inclusive of, not in addition to, the \$11 million interim base rate increase permitted by the Commission in its February 22, 2001 Order approving the settlement of the interim rate proceeding, subject to the following conditions:

- PGW should be required to maintain at least a 1% replacement rate in its mains replacement program;
- PGW should continue its commitment to correcting the problems with the BCCS, particularly the need to rectify the budget billing problems;
- PGW should continue to work with the Commission to implement the recommendations as per the Philadelphia Gas Works Implementation Plan for the Stratified Management and Operations Audit (March 2001);
- PGW should improve its customer service in a timely manner, particularly its call center performance; and
- PGW should continue its progress on its Transition to Excellence Plan.



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APPENDIX A

Gas Commission Meeting (June 19, 2001)

MOTION

**Proposed PGW FY 2001 Operating Budget
and
Five Year Forecast of Operating Budgets (FY 2002 - FY 2006)**

Gas Commission Exhibit # 4

INTRODUCTION

PGW's Fiscal Year 2001 has been a year of transition. The Pennsylvania Natural Gas Customer Choice Act of 1999 made PGW subject to rate regulation by the Pennsylvania Public Utility Commission effective July 1, 2000, while preserving the City's and the Gas Commission's authority over PGW's budgets. The following observations are in order before I offer the specifics of my Motion.

First, both the parties and the Hearing Examiner have discussed at length issues related to the interaction of PGW's rate making and budget setting processes under the Gas Choice Act, and specifically, the effect of the PUC's approval of interim base rates for Fiscal Year 2001. However, as the Hearing Examiner observed, in this budget proceeding, we do not need to reach, nor can we resolve, the legal issue of what weight the PUC must give to PGW's approved budgets.

Rather, at this point in the fiscal year, for budgeting purposes, the Gas Commission should adopt as the most realistic estimate of additional revenues for Fiscal Year 2001 the \$18 million from interim rate increases which have been approved by the PUC. Approving the litigation settlement agreement between PGW/the City and the PUC, the PUC Order of February 21, 2001 authorized PGW to recover an additional \$7 million of Bad Debt Expense through its GCR plus \$11 million as an interim base rate increase during the remainder of the current fiscal year. Any PUC determination on PGW's \$65 million permanent base rate increase request is unlikely to come prior to October 6, 2001 (i.e., one month after the start of FY 2002). And, there is no basis in the record to assume that the interim rates in effect during FY 2001 will be increased by the PUC retroactively.

Second, we find ourselves in the uncomfortable position of once again

not being able to approve – with or without modification – PGW's proposed outyears forecast. This Commission has repeatedly, but unsuccessfully, directed PFMC to prepare a meaningful strategic plan for PGW, linked to its current and future budgets. In the absence of a completed plan, we are not able to adequately scrutinize assumptions underlying PGW's forecast for Fiscal Years 2002 through 2006. Despite repeated assurances to both the Gas Commission and City Council that such a plan was forthcoming, PGW still has not completed the plan.

Third, and perhaps most importantly, it must be observed that, between the time this Commission completed its review of PGW's FY 2000 operating budget and now, PGW's financial condition has continued to deteriorate. The record is clear that, despite a normal winter and the interim rate relief previously mentioned, PGW's commercial paper/letter of credit will remain essentially fully drawn as of August 31, 2001, i.e., at the end of this fiscal year. In addition, the \$45 million "temporary advance" from the City approved earlier this fiscal year will be fully drawn and is expected to remain so throughout FY 2002. Finally, in addition to its normal cash requirements for natural gas purchases during the first several months of FY 2002, PGW will need to pay for some \$11.5 million of natural gas supply, payment for which is being deferred from the second half of FY 2001 into early FY 2002. Thus, PGW's cash flexibility is severely constrained, and what limited flexibility remains is attributable to the City loan and to the new bonds issued this month.

Clearly, major additional infusions of cash are needed for PGW to move forward towards financial recovery. The actions of PGW/the City and the PUC earlier this year, however, have essentially "locked in" PGW's revenues for Fiscal Year 2001, and have precluded this Commission from independently projecting, for budgeting purposes,

PGW's revenue needs. Given all of this, I believe we should adopt the various adjustments to proposed operating expenses recommended by the Hearing Examiner, none of which were excepted to by the parties. These reductions, if achieved, would improve PGW's cash situation by over \$6 million.

Achievement of a major part of these additional cost reductions – that is, the \$5 million reduction to budgeted bad debt expense – will require sustained effort on PGW's part. It is disturbing that ongoing serious operational deficiencies in the areas of IT, collections and customer service continue to contribute to PGW's deteriorating financial condition. It is also severely troubling that, even though PGW has been operating with a series of interim managers since November 1998, a permanent resolution to PGW's management needs has still not been put in place.

With this preface, which I urge the Commission to incorporate in its final Order in this matter, I will now proceed to offer my Motion.

MOTION

My motion is in six (6) Parts and is as follows.

1. I move that the Gas Commission reject the FY 2001 Operating Budget as proposed by PGW.
2. I move that the Gas Commission approve an FY 2001 Operating Budget for PGW that reflects the following:

No.	Motion - Part 2 (continued)
2.1.	Approve \$18,000,000 as the revenue line item for a "Base Rate Increase".
2.2.	In addition to the heating and non-heating revenues originally budgeted by PGW, approve a "GCR Adjustment Revenue" line item of \$185,000,000.
2.3.	Increase the \$2,100,000 "Unbilled Gas Adjustment" revenue line item by \$1,500,000 to reflect the incremental effect of \$230,000,000 in GCR increases.
2.4.	Approve a "Natural Gas Expense" line item budgeted at \$479,593,000 to reflect the \$185,000,000 increase to the \$294,593,000 line item originally budgeted by PGW. This increase reflects the incremental effect of \$230,000,000 in GCR increases.
2.5.	Reduce the budgeted \$13,835,000 "Gas Processing Expense" line item by \$48,000 to reflect the impact of updated information on natural gas pricing and storage. A line item of \$13,787,000 will result.
2.6.	Decrease the (\$4,000,000) budgeted for "Net Marginal Revenue" by \$2,400,000 thereby decreasing the projection to (\$1,600,000). This will reflect the change from 4,600 HDD to 4,555 HDD as a normal year based on a 30-year historical average of Heating Degree Days.
2.7.	Eliminate the projected \$1,500,000 increase in marginal revenues expected to result from closing the Senior Citizen Discount Program to new participants effective June 30, 2000.
2.8.	Reduce the budgeted \$72,783,000 "Bad Debt Expense" line item by \$5,000,000 to reflect the impact of dramatically increased gas cost rates, while demonstrating the expectation that PGW will significantly improve its collection efforts and thereby turn billed revenues into much-needed cash. A line item of \$67,783,000 will result.
2.9.	Approve a negative expense line item to reflect cost savings and productivity improvements totaling \$10,000,000 to be achieved during the budget year to reflect PGW's commitment to paring unnecessary expense and protecting its debt service coverage position.
2.10.	Eliminate \$601,000 budgeted for operating leases expense. The acquisitions involved are to be capitalized.

No.	Motion - Part 2 (continued)
2.11.	Eliminate \$632,000 budgeted for IT-related equipment rental. This will reflect that these acquisitions have been deferred by PGW.
2.12.	Eliminate \$41,000 budgeted for the "Quarter Century Service Club Dinner". This celebration, attended by PGW employees and retirees, is not related to providing safe and reliable service.
2.13.	Amortize the \$1,000,000 expenditure for "BCCS Remediation" over three (3) years.
2.14.	Amortize the \$300,000 expenditure for "Emergency Operations" over three (3) years.
2.15.	Amortize the \$530,000 expenditure for "Marketing Studios" over five (5) years.
2.16.	Amortize the \$2,000,000 expenditure for "Training Costs - V.P. of Customer Affairs" over five (5) years.
2.17.	Amortize the \$825,000 expenditure for "Rate Case Expense" over two (2) years.

3. I move that the Gas Commission reject PGW's proposed Operating Budget Forecast for Fiscal Years 2002 to 2006.
4. I move that the Gas Commission instruct PGW to identify in its proposed FY 2002 Operating Budget the specific line items wherein cost reductions and productivity improvements are projected to occur and to link such cost reductions and productivity improvements to specific PGW departmental goals.
5. I move that the Gas Commission instruct PGW to file no later than September 4, 2001 a Three Year Financial And Management Plan covering Fiscal Years 2002 through 2004. This Plan shall outline PGW's corporate goals (including but not limited to, unbundling and restructuring), strategic directions, resource requirements, and related financial implications.
6. I move that the Gas Commission instruct PGW to file a Compliance Operating Budget for FY 2001 consistent with this Motion within five (5) business days of today's meeting.

This concludes my motion.

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 Reply Brief, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 29th day of June, 2001.

SERVICE BY FIRST CLASS MAIL, POSTAGE PREPAID

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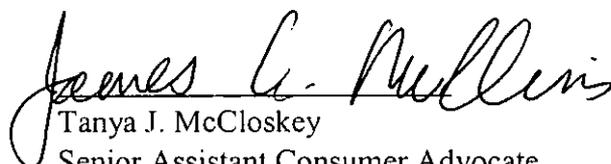
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June 29, 2001

VIA HAND DELIVERY

DOCUMENT
FOLDER

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

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

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works, enclosed please find an original and nine copies of its Reply Brief with regard to the above referenced matter. All parties of record have been served as evidenced by the attached Certificate of Service.

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

Very truly yours,



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

DC/lww
Enclosure

cc: Hon. Cynthia Fordham w/enc. (and disk)
All Parties of Record w/enc.

DSH:27859.1

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

ORIGINAL

Pennsylvania Public Utility
Commission

v.

Philadelphia Gas Works

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Docket No. R-00006042

PHILADELPHIA GAS WORKS' REPLY BRIEF

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I. INTRODUCTION

Philadelphia Gas Works (“PGW” or “the Company”) hereby submits this response to the Main Briefs of the Office of Trial Staff (“OTS”), the Office of Consumer Advocate (“OCA”), the Office of Small Business Advocate (“OSBA”), the Consumer Education and Protective Association, et al. (“CEPA”), and the Philadelphia Industrial and Commercial Gas Users Group (“PICGUG”).

PGW has shown that its requested increase is consistent with the applicable ratemaking standard set out in the Public Utility Code. Moreover, it has demonstrated that it needs the entire \$65 million proposed rate increase in order to satisfy all of its budgeted expenses and construction expenditures, as well as to provide critically needed working capital during and at the end of its budget/test year. Higher gas costs and increasing uncollectibles, as well as the effects of three years of warmer than normal weather, have left PGW with no options other than funding a substantial portion of its cash needs through rates. Accordingly, the full request is absolutely necessary if PGW is to continue to improve its service and operations, have the funds necessary to pay all of its obligations, satisfy all of its bond covenants and meet investor expectations.

The positions of the other parties can be characterized as falling into two categories: disagreements about what is required by the law; and disagreements about what is required by the evidence. On the law, it should be beyond cavil that Section 2212 of the Code plainly requires that PGW’s rate increase request be determined using the Cash Flow Method — its prior ratemaking methodology. While the overall applicable requirement is that PGW’s rates must be just and reasonable, the specific methodology required to be used is the Cash Flow Method. While OCA and CEPA struggled to find ways to ignore this requirement, the OTS frankly admitted this

obvious fact.¹ By ignoring the requirements of the Cash Flow Method, OCA and CEPA were able to justify refusing to set rates that satisfied PGW's cash needs, even though cash working capital was always considered in PGW's prior rate proceedings. As explained below, this unfortunate view would not only cause the Commission to violate the clear requirements of Section 2212, it would run counter to the agency's prior ruling involving the Company's interim rate request in which the Commission recognized PGW's end-of-year cash requirements,² and endorsed a settlement package that included a potential cash reserve fund specifically designed to ensure that PGW had cash balances at the end of its fiscal year and in the September - January 2001-02 time frame that were sufficient to pay its bills and satisfy its bond covenants.

In terms of the evidence presented, the parties' positions consistently failed to take account of the fact that on a normalized, FY 2001 budget/test year basis, which already assumed that the \$65 million rate increase was collected for a full year, PGW's critical end-of-year cash balance was shown to be only \$10.2 million. In contrast, PGW testified that the appropriate target amount of end-of-year cash was \$35-\$40 million. The parties failed to understand therefore that PGW's claimed revenue requirement was already \$25-\$30 million too low below the level it needed to meet its target cash levels. They also failed to take account of the fact that PGW's pro forma budget already included over \$16 million in projected productivity and force

¹ OTS M.B. at 7-8.

² The Joint Petitioners also recognized that for the actual end-of-year, FY 2001 time frame "PGW must have a \$20-\$25 million positive cash balance at the end of the year." Joint Petition at 7, ¶ 25. The Commission approved each and every term of the Joint Petition, including this finding.

reduction savings, even though PGW's ability to fully realize this level is questionable. Clearly, PGW's proposed rate increase was fully justified.

Further, CEPA in a direct attack, and the OCA, somewhat indirectly, continue to assert that PGW's rate request should be thrown out due to alleged "inadequate service."³ Importantly, this type of adjustment was never made by the PGC, but it is also inconsistent with Commission precedent. In the few times that the PUC has made a rate disallowance for inadequate service, it was in response to a total failure of the utility to deliver the product that it had been certificated to provide. No one has challenged the fact that PGW procures and delivers natural gas to customers safely and reasonably. An independent engineering report concluded that the Company was reasonably operated and managed. Moreover, the Company has voluntarily agreed to adopt virtually all of the recommendations for service improvements made by the PUC's own Management Auditors, and, in fact, the parties have recognized that it has made some strides in improving service.⁴ This is not the profile of a utility in total failure, but rather one that has specific areas that need to be improved and is sincerely striving to meet the needs of its customers — and succeeding in many respects. Such efforts should to be recognized by giving PGW the resources it has proven it needs to reestablish financial stability and move forward to restructuring as contemplated by the Gas Choice Act. This rate increase is a key component in that process.

³ CEPA M.B. at 10-11; OCA M.B. at 26.

⁴ OCA St. 1.0 (Lelash) at 53; OCA M.B. at 64.

Finally, both the OCA and CEPA have claimed that the rate increase should be rejected in whole or in part because of the perceived effect it will have on customers in light of recent GCR increases. What no party mentions, however, is the evidence that:

- This is the first base rate increase for PGW in ten years;⁵
- During that time, PGW's rates have tracked the average for gas cost increases nationally;⁶ and
- PGW's typical winter residential bill before the base rate increase but including the interim \$18 million increase was just slightly higher than the average for Pennsylvania natural gas distribution companies.⁷

Most importantly when the proposed base rate increase is offset by the decreases that will result from PGW's proposed FY 2002 GCR reduction, a residential customer will see almost a 3% decrease in his or her total rate, even if the full \$65 million increase is approved by the PUC. This reduction could be even greater if, as the OCA claims, FY 2002 gas costs will mitigate even further.

PGW is as concerned as anyone about the impact of higher rates on its customers; that is why it has one of the largest low income assistance plans of any Pennsylvania utility. But refusing to acknowledge PGW's legitimate revenue requirement needs in order to temporarily shield ratepayers from higher base rates is short sighted and not in accordance with the law. PGW respectfully urges that the arguments of the opposing parties be rejected.

⁵ PGW Exh. JRB Rejoinder-1.

⁶ Tr. 623; PGW Exh. TEK Rejoinder-1 at 4.

⁷ PGW Exh. TJS-2 at 13-32.

II. RATEMAKING STANDARD

A. The OCA's Refusal to Acknowledge PGW's Prior Ratemaking Method Defies the Law and the Commission's Prior Order Regarding PGW.

The OCA, really alone among the parties,⁸ continues to assert that the only statutory standard that the Commission must follow in setting PGW's rates is a "just and reasonable" requirement. The OCA argues that the Commission, therefore, is free to "balance the interests" of PGW and its customers and, in essence, arrive at what the OCA claims is an appropriate "balancing" of PGW's request, giving effect to concerns about the level of recent GCR increases and perceived service levels.⁹

The OCA's position reflects a refusal to acknowledge that the "ratemaking methodology" that had been used in the past by the PGC to set rates for PGW was the Cash Flow Method.¹⁰ The OCA also failed to acknowledge that the Commission is required to establish rates sufficient to satisfy all of PGW's bond covenants.¹¹ In contrast, the OTS frankly admitted that:

⁸ Compare CEPA M.B. at 27-34 (claiming that, while PGW needs adequate working capital and sufficient revenues to satisfy its bond covenants, the Company does not have to get it through rate increases). CEPA's assertion is, however, incorrect. Section 2212 specifically indicates that the PUC is obligated to set rates to allow PGW to satisfy its bond covenants; the fact that revenue from other sources could satisfy PGW's bond obligations or the requirements under the Management Agreement is irrelevant — PGW has no other sources of revenue other than obtaining additional revenues through rate increases.

⁹ OCA M.B. at 15-16, 24.

¹⁰ *Id.*

¹¹ While the OCA acknowledged the need to satisfy PGW's debt service coverage covenant, it totally ignored PGW's rate covenant even though this requirement was specifically recognized by the PUC Law Bureau in the Joint Petition (Joint Petition, pp. 4-5, ¶ 10). The Petition was approved by the Commission with a specific acknowledgment that it was required to allow PGW to "charge or collect rates . . . as necessary to permit [PGW]

“[b]y all accounts, the ratemaking methodology applicable to PGW prior to the assumption of jurisdiction by the Commission on July 1, 2000 was the ‘cash flow method.’ . . . The ‘cash flow method’ of ratemaking is established in Section VII of the Management Agreement. . . . In addition to providing cash for working capital, the Management Agreement, by all accounts, requires the Commission to set rates so that PGW’s bond covenants are honored.¹²

The OTS’ *express (and refreshingly honest) recognition of the requirements of Section 2212(e)* stands in contrast to OCA’s stubborn refusal to admit what was established overwhelmingly in the record.¹³

In contrast, the OCA claimed that in interpreting the requirements of Section 2212(e) the Commission must “give . . . meaning to all provisions of the Act and the Public Utility Code. 1 Pa. C.S. § 1922.”¹⁴ Curiously, the OCA neglected to point out that the “[prior] ratemaking methodology and requirements” language in section 2212(e) is preceded by the unambiguous directive that it applies “notwithstanding any other provision of this title . . .”¹⁵ The rules of statutory construction that do apply, therefore, are that specific or special statutory provisions

to comply with its covenants . . . of any approved bonds.” Feb. 22, 2001 Order, R-00005654 at 7, n. 1.

¹² OTS M.B. at 7-8.

¹³ See PGW M.B. at 10-16.

¹⁴ OCA M.B. at 15.

¹⁵ 66 Pa. C.S. § 2212(e)(emphasis added). The title referred to is Title 66, the title that contains the Public Utility Code, 66 Pa. C.S. A., p. 1.

(i.e., 2212(e)) prevail over general sections (Section 1301),¹⁶ and the rule that the unambiguous language of a statute may not be ignored in favor of some interpretation.¹⁷

OCA's claim is also clearly inconsistent with the Commission's Order approving the Joint Petition for Interim Rate Settlement in which the Commission specifically acknowledged its obligation to set rates using the same ratemaking "methodology and requirements" as were utilized by PGW's prior ratemaking authority.¹⁸ In addition, OCA's attempts to deprive PGW of any cash working capital through rates is squarely at odds with the Commission's approval of the interim rate settlement terms that declared PGW's actual FY 2001 end of year cash needs to be \$20-\$25 million and which provided a reserve fund to attempt to ensure that PGW would have this level of year end cash in order to satisfy its bond covenants.¹⁹

Essentially, OCA's position is, notwithstanding the plain language in the Code, PGW should have its rates considered under the general just and reasonable standard applicable to non-municipal utilities. But, if the General Assembly had intended this result, why would it have enacted a special section and bothered to create special requirements for PGW? If the PUC thought that the same general rules that apply to investor-owned utilities applied to PGW, why would it have specifically acknowledged the prior ratemaking methodology language in the interim rate settlement order?

¹⁶ 1 Pa. C.S. § 1933.

¹⁷ 1 Pa. C.S. § 1921(b).

¹⁸ Feb. 22, 2001, Opinion and Order, R-00005654 at 7, n. 1.

¹⁹ *Id.* at 9, ¶ 1; Joint Petition at 7, ¶¶ 25 and 27.

OCA's interpretation not only reads Section 2212(e) out of the law, it is also inconsistent with standard ratemaking practice. When the PUC sets rates for non-municipal utilities, it always uses a specific methodology — *e.g.*, the rate of return/rate base method — by which it determines just and reasonable rates.²⁰ To the extent that the PUC engages in any “balancing,” it does so when it sets individual revenue and expense allowances within a “zone of reasonableness.” This is exactly the same approach used by the PGC (when applying the Cash Flow Method) and exactly what the OCA did not do. The OCA's suggested interpretation does not withstand scrutiny.

B. The PGC FY 2001 Budget Approval Decision Is Consistent With PGW's Position With Respect to the Prior Ratemaking Methodology and Requirements.

Other than simply ignoring the statute, OCA's only other support for its argument is a reference to a Recommended Decision issued by a PGC Hearing Examiner regarding PGW's FY 2001 Budget. But that recommendation has been superceded by the decision of the full Gas Commission. While the Gas Commission's Order has not yet been issued, a copy of the motion adopted by the Commission is attached (Appendix “A”). The PGC's decision approved the FY 2001 Budget with several minor alterations, but declined to make any finding one way or the other that the approved level of budgeted revenues and expenses produced a revenue deficiency. The Gas Commission simply determined that the level of revenues PGW would realize in FY

²⁰ See, P.L.E. Public Utilities § 42, pp. 408-09.

2001 were essentially “locked in” and therefore, it did not have to reach this issue.²¹ The motion did not indicate that it was adopting any portion of the Recommended Decision.

OCA claims that the PGC decision undermines PGW’s legal arguments concerning the potentially binding nature of the PGC budget approval,²² but OCA misunderstood PGW’s position. If the PGC had issued an order approving PGW’s FY 2001 budget and had made a finding that a rate increase was necessary to fund it, an issue would have been created regarding the weight to be assigned to the PGC’s determination.²³ On the other hand, the PGC decision does substantially approve the level of revenues and expenses set out in PGW’s original, January filing, and provides independent support for their reasonableness. If the parties had challenged the reasonableness of individual expense items in any substantial way, the PGC’s determination would have been deserving of presumptive validity since to have denied an expense item that had been approved by the PGC would have interfered with the City’s right to manage the Company — a right fully protected by the Code. But neither the OCA nor CEPA made such item-by-item adjustments.²⁴ Thus, while reliance on the Hearing Examiner’s Recommended Decision would

²¹ PGC Motion at 2-3. The PGC also determined that it did “not need to reach, nor can we resolve, the legal issue of what weight the PUC must give to PGW’s approved budgets.”

²² OCA M.B. at 14-15.

²³ Contrary to OCA’s suggestion that PGW’s budget simply represents “all of the dollars that PGW chooses to spend and pass them onto ratepayers” (OCA M.B. at 16), the PGC motion makes clear that its process of reviewing and approving the Company’s budget was open and adversarial and far from a “rubber stamp.”

²⁴ The OTS’s major adjustment focused on an appropriate level of pro forma revenues, an issue that does not directly impact on the decision of the PGC as to what budgeted activities or expenses PGW may undertake. Its bad debt expense adjustment is, however, inconsistent with the FY 2001 budget the PGC has approved. *See Appendix A.*

generally be inappropriate, one part that does provide useful guidance, however, is her observation that:

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, 2002 (66 Pa. C.S. § 2212(b) and (3)).²⁵

Moreover, the PGC's decision did observe that "PGW's cash flexibility is severely constrained, and what limited flexibility remains is attributable to the City loan and to the new bonds issued this month [C]learly, major additional infusions of cash are needed for PGW to move forward towards financial recovery."²⁶

The PGC and PGC Hearing Examiner's observations, quoted above, are completely consistent with every rate case decided by the PGC since 1977.²⁷ PGW presented un rebutted evidence in the record that the Cash Flow Method was always used by the PGC,²⁸ and that at

²⁵ Recommended Decision, May 17, 2001, at 9 (emphasis added).

²⁶ PGC Motion (Appendix "A" hereto), p. 3.

²⁷ PGW St. 1.0 (Knudsen) at 19; PGW St. 1.1 (Knudsen) at 2.

²⁸ *Id.*

least three of PGW's eight rate proceedings since 1977 were principally concerned with setting rates to provide PGW with sufficient cash working capital to pay its bills.²⁹

Indeed, in one of the PGC cases discussed on the record, the PGC specifically rejected the very same argument that the OCA is here advancing — that rates should be set only to satisfy PGW's debt service requirements and any cash working capital needs should be dealt with by contributions by the City.³⁰ Since OCA's exact position was rejected by the PGC in prior cases, how can it be consistent with PGW's prior ratemaking methodology and requirements? When confronted with the fact that this position actually is just a rehash of a twenty-year old discredited argument, Mr. Lelash had no real response.³¹ The OCA's position is deserving of no weight.

C. The OCA's Position Also Ignores the Act's Requirement that PGW's Revenues Must Satisfy its Bond Covenants.

Incredibly, OCA's artful conclusion that the only ratemaking standard is whether the rates are "just and reasonable" completely ignores an equally important requirement of Section

²⁹ Tr. 579-90; PGW Exh. JRB Rejoinder-1. OCA's allegation that PGW's prior ratemaking methodology does not need to include an allowance for cash working capital because, in its more recent cases, the PGC focused on debt service is a non sequitur. As OCA points out, one of the reasons the most recent cases were focused more on debt service is because, when those cases were going on, PGW's commercial paper program was not fully extended. But it now is fully utilized and even will have to be paid down by 20% by end of year 2002. Tr. 462; PGW Exh. BB-3. Accordingly, since PGW has fully utilized all available lines of credit and it has no other source of cash working capital, its only alternative is to obtain cash from rates. The fact that PGW's needs were supplemented by its permanent commercial paper program in the past is now irrelevant.

³⁰ See PGW M.B. at 14-15, 53 and 57; PGW Exh. JRB Rejoinder-2, 1982 Executive Summary at 5 and 1982 Supplemental Opinion and Order at 4 and 7.

³¹ Tr. 865-867.

2212(e): that PGW's rates must be set so that revenues satisfy its bond covenants. As detailed in PGW's Main Brief, the Company has at least three bond covenants, one of which requires that the Company's rates be set so that its revenues permit it to pay all of its obligations when they come due.³² This means that PGW's rates must be set to allow it to recover the revenues it needs to pay its bills both during the year and to have sufficient cash at the end of the fiscal year to be able to pay significant obligations in the first four months of the next fiscal year.³³ As described below, OCA's \$21.5 million recommendation simply does not satisfy this legal requirement.³⁴

D. The Parties' Attacks on the Annual City Payment Are Neither Supported by Law Nor the Evidence, and Are Being Offered in the Wrong Forum.

CEPA, OCA, and even PICGUG have all expended a considerable amount of energy arguing that the Commission should either order the City to waive or grant back the \$18 million annual payment³⁵ or set PGW's rates so low that the City would be forced to do so to allow the Company to meet its financial obligations.³⁶ The parties' arguments ignore the Public Utility

³² PGW M.B. at 16-18. The requirements of PGW's "rate covenant" were set out in the Interim Rate Joint Petition, pp. 4-5, ¶ 10 and adopted by the PUC in its Order (R-00005654, Opinion and Order at 9, ¶ 1). This characterization was never challenged by any party and constitutes a binding finding of the Commission.

³³ PGW St. 1.0 (Knudsen) at 20. This is an obligation of the budget test year because these cash amounts must be in place at the end of that year or PGW will not be able to build up enough cash from receipts in the beginning of the next fiscal year to pay its bills. *Id.*

³⁴ *See also*, PGW M.B. at 49-57.

³⁵ *See* CEPA M.B. at 34.

³⁶ *See* CEPA M.B. at 6; OCA M.B. at 3, 26 and 28; PICGUG M.B. at 24-25.

Code, suggest an unlawful result, are not supported by the evidence, and are directed at the wrong forum.

No matter how hard they try, these parties can not change the fact that Section 2212(f) of the Code requires that the Commission “shall permit [PGW] to impose, charge, or collect rates and charges as necessary to permit [it] to transfer or pay to the” City its annual payment of \$18 million.³⁷ Under the Code, the Commission has no discretion to deviate from this requirement — much less order a First Class City of this Commonwealth to abandon a sum guaranteed to it by the Legislature via statute.³⁸

There being no doubt that the \$18 million payment is required by statute, the proposed PUC-ordered grant back or waiver could only be based on a claim that Section 2212(f) and its required City payment are unconstitutional. But, the Pennsylvania Supreme Court has already decided the constitutionality of PGW’s annual \$18 million City payment in the affirmative. In *Public Advocate v. Philadelphia Gas Comm’n*, the Supreme Court faced the exact same argument offered here, that the annual \$18 million payment to the City “violated just and reasonable rate protections” and “constituted an unlawful taking of customer’s property for

³⁷ 66 Pa. C.S. § 2212(f) (emphasis added). Given this language, it is hard to imagine how CEPA can make the assertion that a PUC-ordered grant back or waiver of the \$18 million is “not precluded under the law as applied to the circumstances in this case.” No circumstances exist which can change the language in the Code. Amazingly, CEPA does not make a single reference to Section 2212(f) in its Main Brief.

³⁸ In addition to Section 2212(f) of the Code, Section 2212(l) states that “[n]otwithstanding any other provisions of this title, no assisted city shall be required to take action under this title” if the effect of the action would cause the city to deviate from its PICA plan. The unrefuted evidence in this proceeding is that the loss of some or all of the revenue from the annual payment would be a financial hardship on the City and could cause a unilateral variation in its PICA plan. PGW St. 7.0 (Davis) at 4.

public purposes.”³⁹ The Court rejected these claims, finding that the City payment, which was required by an ordinance having the effect of a statute, was just and reasonable and constitutional.⁴⁰ Accordingly, the Commission is constrained by *stare decisis* to reach the same conclusion as the Supreme Court in *Public Advocate*.⁴¹

Moreover, as discussed below, deciding the constitutionality of a provision of the Public Utility Code is beyond the Commission’s jurisdiction and scope of authority.⁴² Thus, the parties have absolutely no basis on which to argue for, and the Commission has no authority to order, a waiver or grant back by the City of the \$18 million on some constitutional ground.

Looking past the legal deficiencies of the parties’ arguments, the unrefuted evidence in this proceeding supports the presumption that the City payment is just and reasonable and constitutional. The Commission directed audit by the Barrington & Wellesley Group, on which the other parties rely heavily, found that the \$18 million City payment was reasonable and

³⁹ 674 A.2d 1156, 1159-60 (Pa. 1996). As CEPA, Action Alliance of Senior Citizens, and the Tenant Action Group were litigants in *Public Advocate* on the side of the Public Advocate, the Commission should recognize that they are precluded from re-litigating these issues by the doctrine of collateral estoppel. *Malone v. West Marlborough Twp. Board of Supervisors*, 603 A.2d 708, 711 (Pa. Cmwlth. 1992).

⁴⁰ *Public Advocate*, 674 A.2d at 1061-63. As the City payment is now required by Section 2212(f) of the Code, it maintains its presumption of constitutionality. *Id.* at 1061.

⁴¹ See *Commonwealth v. Tilghman*, 673 A.2d 898, 903 (Pa. 1996) (precedent is binding on lower courts and different parties in cases involving substantially similar facts).

⁴² *Feigley v. AT&T Communications of PA, Inc.*, C-00981434, Opinion and Order entered (April 20, 2001) at 27 (quoting ALJ Cocheres Recommended Decision).

common for municipal utilities such as PGW.⁴³ No party submitted any evidence to challenge or refute that finding.

Beyond a PUC-ordered grant back, the parties' suggestion that the Commission set PGW's rates so low as to indirectly force the City to grant back the \$18 million would be equally illegal. Such an action would no less serve to deprive the City of its payment than an outright denial of the payment. The PUC cannot do indirectly that which it is legally barred from doing directly.⁴⁴

Even if the PUC were to consider trying to force the City to forego the City payment, its decision would be defective for want of substantial evidence. The only record evidence in this proceeding is that the City has already provided substantial relief to PGW, including a \$45 million interest free emergency line of credit and many other concessions.⁴⁵ It simply does not have the ability to provide PGW with any additional financial assistance or to give up its annual \$18 million payment.⁴⁶ The parties offered nothing to rebut this testimony, other than conclusory assertions by counsel and individuals not involved in City finances.

Moreover, even if the Commission had the authority to force the City to forego its fee or to make additional contributions, Philadelphia's citizens would not avoid the effects. PGW

⁴³ Administrative Counsel Attach. No. 1 at X-12. The Management Audit found that the \$18 million payment just barely covered the lost taxes from PGW's municipal status. *Id.*

⁴⁴ *See Pennsylvania Department of Public Welfare v. State Civil Service Comm'n*, 707 A.2d 589, 590-91 (Pa. Cmwlth. 1998) (holding that Civil Service Commission's action impermissibly attempted to do indirectly what court precedent forbade it from doing directly).

⁴⁵ PGW St. 7.0 (Davis) at 2-3; Tr. 800.

⁴⁶ *Id.* at 8-10.

ratepayers and Philadelphia taxpayers are in most respects one and the same.⁴⁷ Forcing the City to further subsidize PGW operations simply means that Philadelphia taxpayers will have to forego some existing service or initiative, or taxes will need to be increased to produce the additional revenue. The need for the additional revenues will not go away. The only effect will be that Philadelphia citizens who receive no benefit from PGW will be forced to subsidize gas service for their neighbors.

These and the various other arguments of the parties on this issue really address policy decisions regarding the distribution of City resources, the amount of financial support the City gives to PGW, and the extent of its perceived ownership responsibilities. But the parties' arguments have been made in the wrong forum. These decisions are all matters of City policy -- and as such are beyond the scope of this proceeding and the authority this Commission.⁴⁸ Even matters regarding PGW's policies, which are the province of ownership, governance and control of PGW, have been placed beyond the Commission's reach.⁴⁹

⁴⁷ Tr. 479 and 790, l. 14.

⁴⁸ OCA acknowledged this fact, while cross examining PGW witness Davis, by asking Ms. Davis: "Am I correct that it is a decision of the City through its City Council and Mayor as to how to spend expected city revenues from taxes and the PGW payments?" Tr. 772. Similarly, CEPA recognized this fact in a line of questions to Ms. Davis focusing on the fact that the decision to grant back the \$18 million is a policy decision made by the City. Tr. 789. PGW is at a loss to understand why these parties are now asking the Commission to make a decision which they have admitted is a policy decision within the province of the City of Philadelphia.

⁴⁹ 66 Pa. C.S. § 2212(s) declares that nothing in the Public Utility Code shall be construed to abrogate or limit the Mayor or City Council's ability to determine the "powers, functions, budgets, activities and mission" of PGW, including but not limited to PGW's "ownership, governance, management, [and] control."

Instead, as recognized by the Supreme Court in *Public Advocate*, the proper forum for the parties' arguments about City policy is before the City.⁵⁰ The parties and the public are free to petition the City government to change its policies regarding the level of financial support it provides to the Company, as opposed to other agencies, services or projects, and the public has ultimate recourse through the election process. Nowhere in the Public Utility Code, though, is it even remotely suggested that this Commission may usurp the functions of determining City policy and the distribution of City monies.⁵¹

E. CEPA Has Misapplied the Constitutional Confiscation Standard.

CEPA has attempted to circumvent the legal requirements of Section 2212(e) and (f) by arguing that a "higher authority" — the U.S. Constitution — permits the Commission to disregard the Code's directive that rates must be set to meet PGW's "prior ratemaking methodology and requirements" and its bond covenants. Instead, CEPA argues that the Commission need only be concerned with "the broad federal constitutional standard which requires that regardless of the particular ratemaking 'theory' or methodology, the resulting rate

⁵⁰ 674 A.2d at 1063. There, the court stated: "[C]onsumers are not left without a remedy if they are dissatisfied with rates charged by PGW. . . . If the residents desire a change in PGW's rate making method, they can either pressure the City Council to amend the 1972 ordinance or have their voices heard through the election process."

⁵¹ Indeed, such action by the PUC would also be inconsistent with Article III, Section 31 of the Pennsylvania Constitution. Article III, Section 31 prohibits the General Assembly from delegating to any special commission the power to make, supervise, or interfere with any municipal improvement, money, property or effects, or to perform any municipal function whatsoever.

must in ‘total effect’ or ‘impact’ be ‘just and reasonable.’”⁵² CEPA then cites a D.C. Circuit Court decision for the proposition that quality of service is relevant to determining whether the “end result” is “reasonable.”⁵³ CEPA’s argument turns these constitutional review standards on their head.

CEPA is correct that an appellate review standard clearly exists in which courts will examine the rates set by the PUC for PGW in terms of whether they constitute an unlawful confiscation of property.⁵⁴ But, to reach that question, a reviewing court would have to rule that the statutory requirements set forth in Section 2212 are unconstitutional because they produce a result that confiscates ratepayers’ property.

This argument fails, first because, as indicted above, CEPA overlooks the fact that the Commission is bound to carry out the requirements of the Public Utility Code, and certainly does not have the authority to ignore them by concluding that they affect an unconstitutional taking. The Commission recently confirmed that “the Court has not precluded [the PUC] from making constitutional determinations, unless those determinations concern the validity of the Public Utility Code.”⁵⁵ That is precisely what CEPA is demanding the Commission do here.

Second, even if the Commission were to consider whether rates set pursuant to Section 2212 were constitutional, CEPA’s argument would fail. As noted, so long as the Commission

⁵² CEPA M.B. at 8, *citing*, *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

⁵³ *Id.*, *citing* *D.C. Transit System Inc. v. Washington Metropolitan Area Transit Commission*, 466 F.2d 394, 422 (D.C. Cir.) *cert. denied*, 409 U.S. 1086 (1972).

⁵⁴ *See, Public Advocate*, 674 A.2d at 1061.

⁵⁵ *Feigley v. AT&T Communications of PA, Inc.*, C-00981434, Opinion and Order entered (April 20, 2001) at 27 (quoting ALJ Cocheres Recommended Decision, emphasis added).

adheres to and sets PGW's rates in accordance with the statutory requirements, both in the Code and by reference in the City's ordinance, the PUC's decision will be presumed to satisfy this appellate standard.⁵⁶ Moreover, in the *Public Advocate* case, the Supreme Court found that rates set using the Cash Flow Method were just, reasonable and constitutional.⁵⁷

Third, CEPA's reliance upon the *D.C. Transit* case is misplaced. In that case the D.C. Circuit Court of Appeals upheld a regulatory commission's rate order as not constituting a confiscation of investor property when the regulatory commission, in accordance with its statutory scheme, denied a request because of poor utility service. The case is inapposite because, in this instance, the Commission has been instructed by the Legislature to set rates that comport with PGW's prior ratemaking method, which does not provide for a rate adjustment based on quality of service and has been determined to produce just and reasonable rates.

III. REVENUE REQUIREMENT

A. OCA's Recommendation Has Been Shown to be Illegal and Unsupported By the Evidence.

As anticipated in PGW's Main Brief, the OCA has reiterated its position that PGW's revenue requirement should be set solely to meet just one of its bond covenants — its debt service coverage covenant. It claims that its \$21.5 million recommended rate increase produces

⁵⁶ The Supreme Court has declared: "As a legislative body, it is presumed that any laws enacted will be constitutional, even those laws effecting rates for gas service." *Public Advocate*, 674 A.2d at 1061 (citing *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 216 (1989); see *School Districts of Deer Lakes and Allegheny Valley v. Kane*, 345 A.2d 658, 662 (Pa. 1975) (one of the most fundamental rules of statutory interpretation is the presumption that legislatures act constitutionally).

⁵⁷ *Public Advocate*, 674 A.2d at 1062.

sufficient cash working capital because PGW is projecting it will end FY 2001 with positive cash balance on an actual basis,⁵⁸ and that PGW's past financial results show that it has only infrequently achieved the levels of year end cash that PGW's witnesses testified were appropriate.⁵⁹ OCA's arguments must be rejected because they are inconsistent with PGW's prior ratemaking methodology, would cause PGW to violate its bond covenants, and would throw the Company into a financial crisis more or less immediately after the Commission issued a decision in this case.

OCA's witness specifically refused to follow this previous ratemaking methodology, which, as explained above, requires that rates be set to include a reasonable amount of cash working capital. In contrast, the OTS forthrightly admitted that PGW's rates had to produce necessary working capital.⁶⁰

PGW's CFO, Mr. Knudsen, testified that, for PGW to operate in the most efficient and financially prudent manner possible, it needed \$35-\$40 million in year end cash.⁶¹ OCA and others contested this need by indicating that PGW had not achieved this level on a regular basis in the past.⁶² But that fact does nothing to diminish the unrebutted testimony that this is the level that, ideally, PGW needs to function at a reasonable level of financial stability. OCA's argument is akin to the frequently rejected contention that an investor owned utility's rates should not be

⁵⁸ OCA M.B. at 27.

⁵⁹ *Id.*

⁶⁰ OTS M.B. at 7-8.

⁶¹ PGW St. 1.0 (Knudsen) at 20.

⁶² OCA M.B. at 27.

set to give it an opportunity to earn its cost of capital because, historically, it has not been able to actually achieve that level.

But wholly apart from this, the OCA overlooked the critical fact that, even at the full \$65 million increase, PGW's pro forma end of year cash level will only be \$10.2 million. While OCA contested the need to set rates to produce \$35 - \$40 million in end-of-year cash working capital, no one contended that \$10 million was sufficient. Indeed, PGW is going to have to struggle mightily to be able to meet all of its obligations even at the full \$65 million award.⁶³ At a \$21.5 million increase, that \$10 million ending cash balance decreases to negative \$30 million — clearly a disaster.⁶⁴

The OCA insisted that its recommendation was adequate from a cash standpoint based upon PGW's projected actual results of operation for FY 2001. PGW presented its most recent actual data for seven months and combined that with five months of projected result. This analysis included PGW's actual, 2001 GCR levels and the entire interim rate increase.⁶⁵ But, as the OCA itself stated, rates should be set based upon a FY 2001 Test Year, which is based upon

⁶³ PICGUG also appears not to comprehend this fact when it criticizes PGW for not reducing its requested rate increase after the PUC's approval of the interim settlement. PICGUG M.B. at 24. However, as PGW has explained, even at the full \$65 million, it remains \$25-\$30 million short of its end of year cash needs. PICGUG also erroneously claims that the \$11 million in interim relief "will allow PGW to meet its minimum bond . . . requirements and avoid default. *Id.* PICGUG is flatly wrong. Even OCA recognized that PGW needs at least \$10.5 million above the \$11 million interim relief award to meet its debt service coverage requirements. OCA St. 1. (Lelash) at 30-31.

⁶⁴ PGW M.B. at 51.

⁶⁵ OCA M.B. at 33-34.

“forecast of the pending budget year.”⁶⁶ OCA incorrectly relies upon PGW’s projected actual, non-pro forma results.

Moreover, even if the actual results are examined, if the end-of-year cash balance is adjusted to remove the non-recurring⁶⁷ emergency City loan and one time gas costs deferrals, PGW’s FY 2001 end-of-year cash will be a disastrous **NEGATIVE** \$20 million.⁶⁸ In addition, the other major source of year end cash for FY 2001 — about \$24 million — is from capital expenditure reimbursements made possible by PGW’s recently completed, \$120 million bond issuance.⁶⁹ PGW is not scheduled to issue another bond until 2003.⁷⁰ OCA’s failure to recognize the need to normalize budget results to determine the reasonableness of PGW’s claimed level of cash working capital is perplexing. Obviously, PGW’s actual FY 2001 cash working capital level is irrelevant to the level that PGW will experience on an ongoing basis the standard that even OCA agrees should be used to set rates for PGW.⁷¹

OCA appears to try to skirt the flaws in its analysis by claiming that the Commission should set rates only for the “next 12 to 18 months, until [PGW’s] subsequent restructuring

⁶⁶ OCA M.B. at 30, and n. 11.

⁶⁷ The OCA agrees that non-recurring items must be removed entirely when establishing a revenue requirement. OCA M.B. at 32.

⁶⁸ PGW M.B. at 34.

⁶⁹ Tr. 586.

⁷⁰ *Id.* PGW Exh. TJS-2 at B-54.

⁷¹ OCA M.B. at 30.

filing.”⁷² But, the OCA itself has acknowledged that the rates set here will be in effect for at least two years, not 12 months.⁷³ PGW clearly cannot survive for that period at the wholly inadequate rate levels upon which OCA is insisting.

More troubling is the fact that the only evidence of PGW’s cash needs during the first year in which the rates will actually be in effect — FY 2002 — shows that OCA’s recommendations would cause the Company to have **a negative \$30 million** balance at the end of the fiscal year and would cause it to actually default on a bond payment in August 2002.⁷⁴ The OCA has dismissed this evidence by claiming that FY 2002 is not the test year, and that the budget underlying these data has not yet been submitted to or approved by the PGC.⁷⁵ But, this is the only data showing a projection of what PGW actually will experience when these rates will be in effect. OCA should not be allowed to have it both ways: pointing to actual data for FY 2001 when it thinks that data favors its position (even though it does not), and then rejecting projected actual data for FY 2002 when the results do not suit its argument. Moreover, the main driver of the difference in results between the FY 2001 and the FY 2002 budgets — PGW’s gas costs reflected in its GCR — has been filed with the Commission and represents the best existing evidence of the level of costs it will experience during that period. In turn, PGW’s gas costs are

⁷² OCA M.B. at 27.

⁷³ OCA M.B. at 38. (PGW rate case expense should be amortized over two years — the period “between cases” anticipated for PGW). The OTS also agreed that two years is the appropriate period to assume that these rates will be in effect. Tr. 748-49.

⁷⁴ PGW M.B at 49-57.

⁷⁵ OCA M.B. at 30.

the main driver of its bad debt expense and incremental cash working capital needs.⁷⁶ PGW's FY 2002 projected/actual data clearly is firm enough to check the reasonableness of the parties' revenue requirement claims; and, this check shows that OCA's recommendation would be a disaster in FY 2002. The PUC plainly cannot reasonably set rates in this case which are likely to result in a cash working capital crisis less than 12 months after it makes its decision. Either on a normalized FY 2001 or on an actual projected FY 2002 basis, OCA's recommendation is demonstrably illegal and unreasonable.

B. OCA's Criticism of the Engineering Report's Independent Finding That PGW Requires a \$53 Million Rate Increase Is Flawed.

Contrary to OCA's assertion,⁷⁷ Mr. Sullivan, the representative of Black and Veatch that prepared the Engineering Report, testified that he calculated his independent revenue requirement finding based primarily upon the need to satisfy PGW's bond covenants, reduce its outstanding level of commercial paper, and provide for a reasonable level of cash working capital.⁷⁸ All of these are absolute necessities for PGW, and are either directly required by Section 2212(e) (bond covenants) or are indirectly required by the investment and lending

⁷⁶ OCA also claims that the gas costs included in that analysis are overstated by 23% (OCA M.B. at 31, n. 12), but overlooks Mr. Bogdonavage's testimony that even if this analysis had used Mr. Lelash's 23% lower GCR, PGW would still have a cash flow problem at the end of FY 2002. Tr. 598-99.

⁷⁷ OCA M.B. at 31.

⁷⁸ PGW St. 8.0 (Sullivan) at 2-3. The only other factor that the Report considered was the need to increase the level of internally generated construction funding, but the Engineering Report assumes that this will not begin to occur until well beyond the period in which the rates set here will be in effect. *See*, PGW Exh. TJS-2 at B-54.

community. PGW's need for a reasonable level of cash working capital is an immediate requirement of the Company. Moreover, the record shows that PGW needs to reduce its outstanding level of commercial paper in order to satisfy investors' expectations.⁷⁹ Indeed, as a result of the latest revision to its Commercial Paper Credit Agreement, that "expectation" has now become a requirement. As part of its renewal agreement, PGW is now required to reduce its level of outstanding commercial paper to \$80 million by the end of Fiscal Year 2002 (August 2002).⁸⁰ The Engineering Report already includes an assumption of virtually the same level of commercial paper paydown (\$25 million).⁸¹ This creates an additional, firm cash need at the end of FY 2002 which has to be considered when setting PGW's going forward cash needs.

The OCA's other criticism of the Engineering Report — that it did not consider the requirement that rates be just and reasonable — is actually a pointed condemnation of its own inadequate recommendation. As discussed above, the Engineering Report established PGW's revenue requirement using the same Cash Flow Method that is used for virtually all municipal utilities⁸² and the same method mandated by the Management Agreement and Section 2212 of the Code. OCA's statement amounts to a frank admission that if those rules were followed, a

⁷⁹ Tr. 464 and 466-67.

⁸⁰ PGW Exh. BB-3, p. 32.

⁸¹ PGW Exh. TJS-2 at B-54, Table 17, line 16.

⁸² Tr. 497. The statement by OCA that Mr. Sullivan's "application and understanding of the [Cash Flow] methodology was developed with the assistance of the Company" is simply not true. Mr. Sullivan worked with PGW to identify the "inputs" used to calculate resulting revenue requirement for PGW (Tr. 518), but the method itself "is the method that we would use in virtually any study that we would do for a municipal system." Tr. 497.

revenue requirement of at least \$53 million would have to be awarded. The only way that OCA is able to avoid agreeing with this conclusion is by ignoring these legal requirements and claiming that it would not be “just and reasonable” to impose this result. Of course, as has been pointed out, a revenue requirement produced by the Cash Flow Method has been found by the PGC and this State’s Supreme Court to produce just and reasonable rates.⁸³ The OCA’s arguments therefore must be rejected.

C. OTS’ Recommendation Falls Short of the Minimally Acceptable Levels.

While the OTS forthrightly recognized that PGW’s rates must include an allowance for cash working capital, it erroneously concluded that its \$44 million rate increase recommendation would produce an adequate level of cash both during and at the end of the budget year, claiming that its recommendations would produce between \$9.2 - \$21.7 million in end of year cash.⁸⁴ Moreover, OTS’ brief appears to imply that some aspect of the interim rate settlement is inconsistent with PGW’s claim that it needs the full, proposed rate increase to fund its required level of end of year cash.⁸⁵ The OTS is wrong on both counts.

First, OTS’ claim that its \$44 million recommendation would produce over \$21 million in end-of-year cash is incorrect. Its original (prior to considering the interim increase) calculation showed just \$9.2 million at year end.⁸⁶ Even if this calculation were adjusted to include the

⁸³ PGW Exh. JRB Rejoinder-2, 1982 Supplemental Opinion and Order at 7. *Public Advocate*, 674 A.2d at 1061-1063.

⁸⁴ OTS M.B. at 39-40.

⁸⁵ *Id.* at 9.

⁸⁶ OTS Exh. 1, Sch. 2.

effects of the interim base rate increase the result would be \$14.7 million in end of year cash — not the \$21.7 that OTS claims.⁸⁷ That is because, in its Brief, OTS increased its cash working capital calculation for the full \$18 million interim increase (both the base rate and the GCR portion) even though its net revenue requirement recommendation only includes the \$11 million base rate amount.⁸⁸ OTS' claim would be correct only if it were recommending a \$51 million total increase — not just \$44 million.

Moreover, and as explained in PGW's Main Brief,⁸⁹ OTS' calculation of its "pre-interim" end of year cash is driven substantially by proposed adjustments that PGW has demonstrated are unreasonable: a \$12 million net increase to budget/test year revenues for a non-existent increase in usage per customer (increasing funds available by the same amount); and a \$4.2 million decrease in PGW's claimed bad debt expense (which has the effect of artificially decreasing PGW's need for cash). When these two adjustments are eliminated from the cash calculation, OTS' recommendation would revert from a \$14.2 positive cash balance, (including the interim base rate increase), to a negative \$2 million (\$14.2 million minus \$16.2 million).

Thus, while OTS properly recognized that a reasonable level of end of year cash working capital was part of PGW's revenue requirement, the only way to actually provide the Company with the absolute minimum cash levels that both PGW and OTS' budget revenue requirement calculations originally produced (\$10-\$12 million) is to provide a rate increase of between \$56-

⁸⁷ OTS M.B. at 40.

⁸⁸ Tr. 746; OTS M.B. at 3; PGW St. 1.1 (Knudsen) at 1.

⁸⁹ PGW M.B. at 40-46.

\$58 million. (\$44 million award + an additional \$12 to \$14 million to produce sufficient year-end cash of positive \$10-\$12 million).

Second, the OTS also suggests that the cash working capital deficiencies that PGW has identified as resulting from OTS' proposed rate award is somehow inconsistent with the statement in the Petition for Interim Settlement that "PGW expects that the above financial and operational steps set forth [in the Settlement] will be sufficient to enable them to meet their financial obligations through January, 2002," and the Settlement's provision that "if PGW identifies a cash deficiency that would cause a Bond Ordinance covenant violation, PGW will be permitted to utilize the reserve fund to cover the deficiency."⁹⁰

The OTS, unfortunately, misunderstands the Settlement and the present status of PGW's FY 2001 GCR. First, the package of rate and "reserve fund" relief authorized in the settlement was specifically designed to help PGW meet its actual cash working capital needs through the end of FY 2001 and for the first four months of FY 2002. While PGW's actual cash situation has to be considered, PGW relied on its fully forecasted, pro forma end-of-year cash balances to justify its revenue requirement, not its projected actual results. More importantly, however, even if this statement were applied to PGW's claimed cash needs in the case it does not discount PGW's need for the full \$65 million increase. The ability to meet its obligations through this package expressly assumed that PGW would receive rate relief in this case. In the sentence just before the one quoted by OTS, the Settlement provides that:

[a]fter the PUC rules on PGW's permanent base rate request or any additional settlement thereof, PGW will make a projection of its

⁹⁰ OTS M.B. at 9.

debt service and cash obligations through January 2002. To the extent that PGW identifies a deficiency that would cause a Bond Ordinance covenant violation, PGW will be permitted to utilize the reserve fund (or portion thereof) to cover the deficiency.⁹¹

In other words, the Settlement permitted a “back stop” (the reserve fund) if, even after receiving a rate increase here, PGW was still at risk of not being able to satisfy its bond covenants. Finally, OTS incorrectly assumes that a “reserve fund” actually has been created by virtue of GCR overcollections in FY 2001. In fact, the contemplated overcollection never materialized and the FY 2001 GCR is undercollected not overcollected.

D. OTS’ Revenue and Expense Adjustments Are Unsupportable, and Cannot Be Used to Reduce PGW’s Rate Increase.

As noted above, OTS’ various adjustments to both PGW’s revenues and expenses are essential to the calculation of its \$44 million recommended rate increase. However, as demonstrated in PGW’s Main Brief, those adjustments are both contrary to the legal standards governing this proceeding and the record evidence, and therefore cannot be the basis for a decrease in the Company’s \$65 million request.⁹² Fundamentally, OTS’ proposed adjustments suffer from a lack of understanding of PGW’s operations and data.

⁹¹ Joint Petition, p. 8, ¶ 27 (emphasis added).

⁹² PGW M.B. at 38-49. PGW will not further address OTS’ adjustments to its promotional expenses or the rate case expense other than to point out that both OCA and CEPA’s Main Briefs demonstrate the faulty logic behind OTS’ denial of the Lukens’ testimony expense. While OTS is correct that “[e]veryone should have known or should know what ratemaking methodology is applicable to PGW,” these two parties clearly needed help in that regard and have never acknowledged that which OTS so frankly admits. OTS M.B. at 31. The appropriateness and relevance of Lukens’ testimony, in light of OCA and CEPA’s arguments, is inescapable.

1. Average Annual Usage

As OTS witness Weakley acknowledged, the entire point of this endeavor of projecting revenues and expenses for the future test year is to as accurately as possible approximate, on a normalized basis, the level that the Company will experience during the period in which the rates will actually be collected.⁹³ To that end, PGW plainly demonstrated on the record that (1) its model for projecting sales and average annual usage is extremely accurate — within 2% of actual.⁹⁴ OTS' witness Kubas, in contrast, insisted that PGW's pro forma sales should be increased by 7%, or 4.2 Bcf based on actual 2000 data.⁹⁵

The record evidence, however, shows that his adjustment is unreasonable:

- OTS' proposal represents a 4.2 Bcf increase in firm sales. Such an increase constitutes a 7% increase in prior year firm sales — not the 2.67% increase portrayed by OTS — and translates into a 14% increase in PGW's design day peak demand.⁹⁶
- PGW has never experienced the 7% increase in firm sales and would not even have the capacity contracts and storage available to accommodate the increase under design conditions.⁹⁷
- Contrary to OTS' suggestion, PGW's residential usage has decreased by 10% per customer per year since 1984.⁹⁸

⁹³ Tr. 749-50.

⁹⁴ Tr. 551.

⁹⁵ OTS St. 2.0 and 2-SR (Kubas); Tr. 551.

⁹⁶ Tr. 551.

⁹⁷ Tr. 551-52.

⁹⁸ Tr. 551.

- OTS' projections are actually based on faulty data.⁹⁹ OTS claims that year 2000 actual data must be used because PGW stated that it had corrected its billing system during 2000.¹⁰⁰ However, OTS continues to ignore the testimony that PGW's data collection system was not producing accurate ancillary reports in 2000.¹⁰¹ Comparisons of billings to sales for the period ending February 2001 evidenced these inaccuracies, and even reflected months as having negative sales.¹⁰² Finally, the application of estimating factors to year 2000 data, which normally produce results within 5-6% of actual data, resulted in a 30% variation.¹⁰³
- PGW's model is extremely accurate, projecting sendout for the period of November 2000 through March 2001 within 2% of the actual sendout.¹⁰⁴ OTS continues to be confused about PGW's model, suggesting in both Mr. Kubas' testimony and in its Main Brief that PGW compares sendout to sales.¹⁰⁵ OTS is simply not correct. PGW's model projected sendout -- which was gathered from PGW's nine (9) city gate stations and verified by the pipeline's data as opposed to using readings from some 520,000 meters -- and then applied a percentage for unaccounted for gas in order to get the estimated sales. PGW then verified this projection by comparing the projected sendout with the actual sendout for November 2000 through March 2001.¹⁰⁶ As PGW's witness Mr. White testified,

⁹⁹ See PGW M.B. at 44.

¹⁰⁰ OTS M.B. at 13-14.

¹⁰¹ PGW St. 4.1 (White) at 4-5; Tr. 553-54.

¹⁰² PGW Exh. CW-R-1; PGW St. 4.1 (White) at 4.

¹⁰³ Tr. 553-54. Faced with the realization that its own analysis was hopelessly flawed, OTS has taken to making a strawman attack on PGW's model and data, suggesting that the Company has created some mystery about how it arrived at its numbers. OTS M.B. at 17, 19-20. To the contrary, PGW set forth its data in its initial filing. OTS and the parties were free to request any additional information they desired. PGW then verified that data on rebuttal -- identifying the factors and inputs and stating that they remained constant (admitted by OTS at page 15 of its brief).

¹⁰⁴ PGW St. 4.1 (White) at 2-3; Tr. 548-50.

¹⁰⁵ Tr. 549; OTS M.B. 14.

¹⁰⁶ Tr. 548-50 and 573.

this model has been an “accurate forecaster of sales, sendout and revenues for many years.”¹⁰⁷

- OTS’ claim that PGW’s projections cannot be used because they only consider five months worth of data is erroneous. PGW’s forecast is based on a full year, 1999. PGW verified its projection by comparing forecasted to actual sendout for a five month period.¹⁰⁸ This five month period, November to March, is appropriate to use because PGW experiences 72% of its firm sales during that same period, the vast majority of which is weather sensitive.¹⁰⁹

OTS’ adjustments should be rejected.

2. Customer Counts

The OTS misunderstood why a customer count adjustment was necessary. As Mr. White explained in his testimony, PGW’s new billing system is now able to determine accurately the number of customer charge billings by ensuring that each meter carries a customer charge.¹¹⁰ PGW has not had any real increase in the number of customers. Contrary to what OTS would have the PUC believe, the Company has not suddenly found some 11,000 customers.¹¹¹ Thus,

¹⁰⁷ Tr. 552. OTS’ suggestion that the model must be inaccurate because of the financial difficulties that PGW has experienced recently (OTS M.B. at 16) fails to understand that the Company’s financial problems have been caused by warm weather, (PGW St. 4.0 (White) at 6) high gas costs and increasing bad debt expenses, not its projections of normal sales.

¹⁰⁸ Tr. 548-550.

¹⁰⁹ Tr. 550.

¹¹⁰ Tr. 555.

¹¹¹ This fact, in addition to the accuracy of PGW’s model and the real decreases in residential usage since 1984, all explain why OTS’ suggestion to add revenues to PGW for the usage of these “additional customers” is erroneous. See PGW M.B. at 46, n. 162; OTS M.B. at 24.

OTS' criticisms that PGW only looked at one month's data to determine its revised customer counts is based upon a misunderstanding.

3. Bad Debt Expense

PGW has demonstrated in its Main Brief that OTS' bad debt expense allowance is both inconsistent with the Public Utility Code and unsupported by the evidence.¹¹² The essential facts that demonstrate this are as follows:

- OTS has rigidly attempted to apply the traditional method for determining bad debt when Section 2212(e) of the Code requires that PGW's prior ratemaking method and requirement be used instead.¹¹³
- None of the five years utilized by OTS to calculate its bad debt ratio is representative of current conditions in which PGW faces arrearages at a level of 40% of all customers and accounts receivable of over \$200 million.¹¹⁴
- OTS' bad debt ratio of 7.6% was far off of the actual bad debt percentage for the 1999-2000 total gas revenues, which was 10.2%.¹¹⁵
- Applying OTS' bad debt ratio to PGW's actual total gas revenues for 1999-2000 would leave PGW \$12 million short of its actual booked bad debt expense for that year.¹¹⁶
- The OCA has recognized that PGW should increase, not decrease, its bad debt allowance, recommending nearly \$72 million in bad debt expense.¹¹⁷

¹¹² PGW M.B. at 40-41.

¹¹³ OTS M.B. at 34-37.

¹¹⁴ Tr. 754-55.

¹¹⁵ Tr. 757-58.

¹¹⁶ Tr. 758-59.

¹¹⁷ OCA St. 1.0 (Lelash) at 11 and 44-45. The fact that OCA and PGW actually agree on something in this proceeding should be dispositive of the issue.

- The PGC's recent motion endorsing the adoption of a FY 2001 budget for PGW ratifies the reasonableness of PGW's proposed \$65 million bad debt expense by allowing a nearly \$68 million bad debt expense in the budget.¹¹⁸

These facts clearly show that OTS' recommendation on bad debt expense is outside of the "zone of reasonableness," and therefore the PUC must reject it.

E. The PUC May Not Reject PGW's Rate Increase on the Basis of "Affordability."

OCA, CEPA and even PICGUG have argued that the Commission should reject all or part of PGW's proposed rate increase, due to the alleged¹¹⁹ overall unaffordability of PGW's rates.¹²⁰ These parties assert that affordability of rates is a key consideration in determining the justness and reasonableness of rates, and that due to the increases in PGW's GCR and the interim increase, the PUC must deny PGW's proposed increase as unreasonable. However, the parties'

¹¹⁸ See Appendix A hereto; OCA M.B. at Appendix A, p. 31.

¹¹⁹ "Alleged" is the key word in describing PGW's rates as unaffordable as the record evidence reveals that (1) PGW's rates are consistent with gas rates nationally and in Pennsylvania and (2) PGW's proposed increase in conjunction with its proposed FY 2002 GCR would result in a overall decrease in rates for virtually all customers. Tr. 622-28; PGW Exh. TEK Rejoinder-1, at 3-4; PGW Exh. TJS-2 at B-32.

¹²⁰ See OCA M.B. at 1-2 and 18; CEPA M.B. at 21-23; PICGUG M.B. at 24-25. OCA and CEPA rely extensively on the testimony from the public input hearings to support their claims that PGW's rates are not affordable. However, their reliance is misplaced. 75 customers testified over the two days of hearings. Of that figure, only 41 customers raised concerns about the affordability of rates. Obviously, 41 customers represent an infinitesimal fraction of PGW's total of over 500,000 customers. Tr. 60-436. There is no evidence that the experience of these 41 customers is indicative of the experience of the rest of PGW's 500,000 some customers. In addition, no party presented any empirical evidence whatsoever to support their claims. See, e.g., Tr. 854.

claims are inconsistent not only with PGW's prior ratemaking method and requirements, but also with the PUC's own prior decisions.

First, as detailed in PGW's Main Brief,¹²¹ while under the PGC's jurisdiction, PGW's rates had to meet a requirement of being just and reasonable, which was met whenever rates were set pursuant to Section VII of the Management Agreement.¹²² In applying the ratemaking method and the just and reasonable requirement, the PGC never denied a PGW's requested rate increases based on the claimed unaffordability of its rates.¹²³

In both the 1982 and 1983 PGC decisions, the Gas Commission acknowledged the financial hardships faced by customers due to rate increases:

One would have to be made of stone not to have been moved by the emotional and often eloquent statements made at the hearings in this matter by the many individuals and associations who presented their views to the Commission. The immediate concern of most of the speakers was the proposed rate increase. . . . Still others used the proceeding as a forum to vent their anger and express their feeling of helplessness against the conditions which surrounded them. . . . We feel sympathy for them, but unfortunately, our feelings do not determine the matter.¹²⁴

The referenced public comment likely resembled the comments heard by the ALJ in this proceeding during the public input hearings. However, instead of focusing on affordability, the

¹²¹ PGW M.B. at 12-16.

¹²² PGW Exh. JRB Rejoinder-2, 1982 Supplemental Opinion and Order at 7.

¹²³ PGW Exh. CE-2 at request 10.

¹²⁴ PGW Exh. JRB Rejoinder-2, 1982 Opinion and Order at 1-2. *See* PGW Exh. JRB Rejoinder-2, 1983 Opinion and Order at 3-5.

PGC determined that it had a “duty to apply the law” and authorize just and reasonable rates,¹²⁵ which it went on to do by applying the Cash Flow Method in Section VII of the Ordinance/Agreement.¹²⁶ Likewise, the PUC must, consistent with its Section 2212(e) obligation, reject the contentions of these parties that it cannot grant the requested \$65 million increase due to alleged unaffordability.

Second, even if the PUC applied its standard ratemaking approach to PGW, affordability concerns would not justify the denial or limitation of a rate increase.¹²⁷ In *Pa. PUC v. PG&W*, the OCA made the same affordability arguments the parties have proffered here, claiming that the affordability of rates should affect their justness and reasonableness.¹²⁸ However, this Commission rejected OCA’s call for a reduction in PG&W’s revenue requirement of approximately \$1 million based on alleged unaffordability.¹²⁹

The legal deficiencies of the parties’ assertions aside, the record evidence does not support their claim that PGW’s rates are excessively high. As Mr. Knudsen established, even assuming an award of the entire proposed rate increase, PGW’s rates would still be consistent with the rates of the industry nation-wide.¹³⁰ Looking to the average monthly bill for a

¹²⁵ PGW Exh. JRB Rejoinder-2, 1982 Opinion and Order at 2.

¹²⁶ PGW Exh. JRB Rejoinder-2, 1982 Opinion & Order at 5; 1982 Supplemental Opinion and Order at 7.

¹²⁷ *Pennsylvania Public Utility Comm’n v. Pennsylvania Gas & Water Company*, 1993 Pa. PUC LEXIS 61.

¹²⁸ *Id.* at *189-191, *206.

¹²⁹ *Id.* at *206, *211.

¹³⁰ Tr. 623-24; PGW Exh. TEK Rejoinder-1 at 4.

residential customer during a typical peak winter month, PGW's current rates result in a bill that is less than six dollars off the average bill for the a representative group of Pennsylvania natural gas utilities and its bill was even less than those of two in the group.¹³¹ If PGW's unique social programs, including its 20% senior citizen discount, are removed from the calculation, PGW's average monthly bill for residential service in winter would be reduced by \$23.60, and become the lowest of any major Pennsylvania natural gas utility.¹³²

Futhermore, when the effect of the Company's proposed, 2002 GCR filing is combined with the granting of the full \$65 million rate increase, PGW's rates for residential customers would actually decrease from present levels by 2.8% with virtually all other classes also experiencing a reduction.¹³³ Assuming that OCA's predictions regarding PGW's projected FY 2002 gas costs are correct, and they decrease by another 23%,¹³⁴ the rate decreases that the Company's customers would experience would increase dramatically, possibly even doubling. Thus, even if the PUC chose to ignore PGW's prior ratemaking method and requirements, and its own past precedent, the evidence will not permit the Commission to disallow PGW's proposed rate increase on the ground that its rates are not affordable. These arguments must be rejected.

¹³¹ PGW Exh. TJS-2 at B-32. Again, these comparisons include all 2001 GCR and interim increases.

¹³² *Id.* Of course, PGW is not suggesting the elimination of these programs (although certain parties are proposing to eliminate the senior citizen program). Nonetheless, PGW's costs for these programs are more substantial than the costs incurred by the other utilities for comparable programs. *Id.*

¹³³ Tr. 624; PGW Exh. TEK Rejoinder-1 at 3.

¹³⁴ OCA St. 1-S (Lelash) at 10-11; OCA M.B. at 31, n. 12.

F. Claims About PGW's Service Cannot Be the Basis of the Denial of PGW's Rate Increase.

1. Introduction.

CEPA's main position in this proceeding is that PGW should receive no increase whatsoever because of the alleged inadequate service claimed to be documented in the Management Audit and in the public input testimony.¹³⁵ The OCA stopped short of this assertion, but did claim that

ratepayers should not be asked to pay for the rate increase before the Company has given guarantees that: the current level of service is actually being improved¹³⁶

The OCA then argued that any rate award should be "conditioned" upon PGW's promise to fulfill certain service commitments, including, implementing the accepted recommendations of the management audit and several others.¹³⁷ These recommendations must be rejected because they contain several legal and policy flaws. In addition, they fail to recognize the service improvements that have already taken place, and steps that PGW is in the process of taking, to address all of its service issues.

¹³⁵ CEPA M.B. at 1-21.

¹³⁶ OCA M.B. at 24.

¹³⁷ *Id.* at 72. These conditions are discussed in Section V of this Brief, *infra*.

2. The Arguments of CEPA and OCA Are Legally Barred and Inappropriate From A Policy Standpoint.

a) The Recommendations Violate the Public Utility Code.

As explained in detail in its Main Brief, PGW's rates must be set to cover each item set forth in the Management Agreement.¹³⁸ While the PGC exercised discretion to set the rate level for each revenue and expense item within a zone of reasonableness, which could include consideration of the efficiency of the Company in providing the particular expense item, not once in the entire history of PGC ratemaking did that agency deny a rate increase for PGW in whole or in part on some broad finding of "inadequate service."¹³⁹

Moreover, the evidence shows that accepting the CEPA or OCA recommendation would cause PGW to violate its bond covenants. Even OCA has admitted that a \$21.5 million increase is minimally required just to meet PGW's debt service coverage covenant.¹⁴⁰ A complete or substantial denial (*e.g.* \$21.5 million) of PGW's rate claim would result in PGW not having sufficient cash to pay all of its obligations — a violation of its rate covenant.¹⁴¹ These

¹³⁸ PGW M.B. at 12-16.

¹³⁹ *See*, PGW St. 1.1 (Knudsen) at 12-13; PGW Exh. CE-2 at Request 10. Ironically, CEPA claims, without any evidentiary support, that PGW's service has been inadequate for years. If that in fact is true, the absence of a single PGC order denying a rate on that basis should be dispositive proof that such an adjustment is simply not permitted under PGW's "[prior] ratemaking methodology and requirements." 66 Pa. C.S. § 2212(e).

¹⁴⁰ OCA St. 1.0 (Lelash) at 30-31.

¹⁴¹ PGW M.B. at 16-18 and 49-57.

recommendations are simply not consistent with the Code¹⁴² and, indeed, would require the PUC to completely ignore the law.

b) The Proposed Rate Adjustment Would Require the PUC to Misuse the Results of the Management Audit.

CEPA and OCA rely principally on the findings and conclusions in the Management Audit to justify their claim of “inadequate service.”¹⁴³ But, as discussed in PGW’s Main Brief, using the Audit to make a rate adjustment is completely inconsistent with the basis on which the Audit was conducted in the first place.¹⁴⁴ Undoubtedly, any use of the Management Audit must be intrinsically linked and limited to the purpose and public policies for which it was conducted under the Code¹⁴⁵ — namely, promoting “management effectiveness and operating efficiencies”¹⁴⁶ within the Company. The law plainly prohibits parties from using the Management Audit in a manner that is not explicitly authorized in the Public Utility Code and

¹⁴² The Code authority for making such adjustments is Section 526. That section is superceded by Section 2212(e) which specifically indicates that it applies “notwithstanding any other provision of this title [the Public Utility Code] to the contrary.”

¹⁴³ OCA and CEPA also rely extensively on the testimony from the public input hearings to support their claims. However, their reliance is misplaced. Only 75 customers testified over the two days of hearings. Of that figure, only half, or 38 customers, complained about PGW’s service. Obviously, 38 customers represent an infinitesimal fraction of PGW’s total of over 500,000 customers. Tr. 60-436. There is no evidence that the experience of these 38 customers is emblematic of the experience of the rest of PGW’s 500,000 some customers.

¹⁴⁴ PGW M.B. at 71-77.

¹⁴⁵ 66 Pa. C.S. §§ 516 and 2204(i).

¹⁴⁶ 66 Pa. C.S. § 516(a).

that would essentially turn the underlying objectives and public goals of the audit process on its head.

In rejecting the use of management audits in rate proceedings, public utility commissions have repeatedly held that management audits should not be the basis for rate denials. For example, the Illinois Commerce Commission has found that:

Use of management audits in proceedings affecting rates would transform the audit process into one which is adversarial in nature, and would be detrimental to the Commission's management audit process. Such a use of the management audit process would seriously impair the cooperation between the utility which is being audited and the Commission's Staff and its auditor.¹⁴⁷

Further, other state utility commissions have barred the use of management audits in rate proceedings, where they were not explicitly permitted, even though the use of other types of audits were expressly authorized in a rate setting context.¹⁴⁸

The parties should be similarly barred from such improper use of the Management Audit in the instant rate case. No provision of the Code even remotely, much less explicitly, authorizes the use of management audits in rate proceedings.¹⁴⁹ In contrast, the Legislature has authorized

¹⁴⁷ *Contel of Illinois: Proposed General Increase in Rates*, 1991 Ill. PUC LEXIS 18, *210-*211, 119 P.U.R.4th 284 (Illinois Commerce Commission January 16, 1991). *See The People's Gas Light and Coke Company: Proposed General Increase in Rates For Gas Services*, Docket No. 90-007, 1990 Ill. PUC LEXIS 593 (Illinois Commerce Commission November 9, 1990), *affirmed*, *Governor's Office of Consumer Services v. Illinois Commerce Commission*, 242 Ill. App. 3d 172, 607 N.E.2d 1322 (Ill. App. Ct. 1992)).

¹⁴⁸ *Contel of Illinois: Proposed General Increase in Rates*, Docket No. 90-0128, 1991 Ill. PUC LEXIS at *210-*211, 119 P.U.R.4th 284; *The People's Gas Light and Coke Company: Proposed General Increase in Rates For Gas Services*, Docket No. 90-007, 1990 Ill. PUC LEXIS at*147-*148.

¹⁴⁹ *See, e.g.*, 66 Pa. C.S. § 516(a), (c) and 2204(i).

the use of other types of audits in rate proceedings. For instance, in Section 1320 (5), the Legislature specifically authorized “the commission . . . [to] take the [fuel purchase] audit report into consideration at the utility’s next request for a rate adjustment.”¹⁵⁰ Had the Pennsylvania Legislature intended to authorize the use of management audits in rate cases, it certainly could have promulgated similar provisions.

Remarkably, in conducting the Management Audit, the auditors themselves explicitly acknowledged and acted in accordance with the very same limitations:

We did not look at the total rate case process as part of the management audit.¹⁵¹

Perry Wheaton, the Managing Director of BWG stated that rather than propose rate adjustments, the “overall objective of the audit was to determine what improvements could be made in the management and operations of PGW.”¹⁵² Indeed, Mr. Wheaton stated that he made absolutely no analysis whatsoever of the ratemaking implications of any of the findings of the audit:

Again it was not part of our [audit] — we did not look at the total ratesetting process of either the PGC or the PUC.¹⁵³

Unquestionably, as confirmed by the auditors themselves, the purpose of the Audit was not — nor should the Audit be used to — determine just and reasonable rates.¹⁵⁴

¹⁵⁰ 66 Pa. C.S. § 1320(5).

¹⁵¹ Tr. at 717.

¹⁵² Administrative Counsel St. No. 1 at 2 (response to Question 7).

¹⁵³ Tr. at 718-19.

¹⁵⁴ Tr. at 721-22.

c) The Recommendations are Inconsistent with PUC Precedent.

The “evidence” in the record does not reflect the kind of service failures that have justified PUC rate adjustments in the past. Even if the PUC had authority to deny all or part of PGW’s otherwise justified rate increase (which it does not), and even if the evidence on which the parties rely could be used for this purpose (which is not permissible), the evidence itself does not come close to justifying such an adjustment.

In every case in which the PUC has actually made such an adjustment, it involved a near total failure of the utility to perform its core function. In virtually all of the cases cited by OCA and CEPA, the utility had not provided the service it was charged with providing. For example, in two cases, the utility had provided customers with completely undrinkable water, which varied from shades of yellow to red to black and ruined clothing.¹⁵⁵

Unlike those cases, all of the evidence in the record found that PGW has, and is continuing to provide, gas service in a safe and reasonable manner. PGW’s gas procurement practices were found to be reasonable;¹⁵⁶ its safety record is reasonable.¹⁵⁷ An independent review also found that the Company was reasonably operated and managed.¹⁵⁸ In addition, even OCA acknowledged that the Company has made improvements in the area of service.¹⁵⁹ It is not

¹⁵⁵ See *Pa. PUC v. Pa. Gas & Water Co.*, 1989 Pa. PUC LEXIS 170, *10; *Pa. PUC v. Sunshine Hills Water Co.*, 77 Pa. PUC at 6-7.

¹⁵⁶ Administrative Counsel Exh. No. 1 at 6; Administrative Counsel Attach. No. 1 at IX-22 – IX-24.

¹⁵⁷ Administrative Counsel Exh. No. 1 at 6.

¹⁵⁸ See PGW St. 8.0 (Sullivan) at 2.

¹⁵⁹ OCA M.B. at 64; OCA St. 1.0 (Lelash) at 53.

reasonable under these circumstances therefore, to consider rejecting all or a substantial portion of the Company's revenue requirement.¹⁶⁰

d) Neither CEPA Nor The OCA Presented Their Positions On the Record.

Due process, to say nothing of common fairness, dictated that the other parties should have timely advised PGW of the evidence they were submitting in support of their claims against the rate increase, and in particular, the parts of the Management Audit Report they intended to use in support of any rate adjustment. The parties were required to have advised PGW of such evidence sufficiently in advance of the close of the Record,¹⁶¹ so that PGW was afforded an opportunity to respond to the evidence and rebut such evidence with evidence of its own.¹⁶²

¹⁶⁰ In other contexts, the PUC and the courts have agreed that the level of service should not be the determining factor in deciding the outcome of a rate case, but can be considered when determining particular aspects, such as rate of return. *See e.g., Pa. PUC v. Pocono Water Co.*, 1989 Pa. PUC LEXIS 72, 29 (1989). In the cases cited by OCA and CEPA, the utilities' rate requests were not denied in their entirety, but rather, the utilities' rate of return was denied or decreased. *See Pa. PUC v. Sunshine Hills Water Co.*, 77 Pa. PUC at 16; *Pa. PUC v. Pa. Gas & Water Co.*, 1988 Pa. PUC LEXIS at 16. *See, Pennsylvania-American Water Co.*, 1989 Pa. PUC LEXIS at 16. The PUC never considered a total or substantial denial — to the point where the “[c]ompany’s ability to operate” was “destroyed”); *Sunshine Hills Water Co.*, 77 Pa. PUC at 11.

¹⁶¹ 52 Pa. Code § 5.243(e) provides:

No participant will be permitted to introduce evidence during a rebuttal phase which is repetitive, which should have been included in the participant's case-in-chief or which substantially varies from the participant's case-in-chief unless the evidence is introduced in support of a proposed full or partial settlement between or among any of the participants.

¹⁶² *Smith v. Pa. PUC*, 162 A.2d 80, 83 (Pa. Super. 1960) (due process requires, *inter alia*, that the parties have the opportunity to offer evidence in explanation or rebuttal of

Despite repeated requests by PGW to do so, no party to this proceeding identified any specific proposed adjustments that it intended to support with the Audit.¹⁶³ Now, CEPA and OCA, for the first time, contend that the Management Audit supports a view that most or all of some of the rate increase should be denied. As Judge Fordham has previously ruled, the parties are certainly barred from introducing a new adjustment for the first time at the briefing stage.¹⁶⁴ This prohibition should logically extend to the use of record evidence for a purpose other than for which it was admitted into the record.

e) A Rate Adjustment For Allegedly Inadequate Service in this Case Would Be Counter-Productive and Illogical.

It should be obvious that the very service issues that the parties desire PGW to address will require a substantial investment of resources. All the parties acknowledge this in various ways. Yet, none explain how PGW is to accomplish all these improvements without adequate revenues. Denying PGW's rate request will unquestionably stymie its ability to move forward with the very service improvements the parties are demanding.

evidence submitted); *Enron Capital & Trade Resources Corp. v. Peoples Natural Gas Co.*, Docket No. R-00973928C0001, Recommendation Decision of Administrative Law Judge Larry Gesoff dated November 13, 1997, 52 (due process requires notice and a meaningful opportunity to respond).

¹⁶³ There was one limited exception. In response to PGW's requests that the parties identify in, *inter alia*, their surrebuttal testimony, whether they intended to use the Management Audit Report to support rate adjustments or a modification to any recommendation, OTS, in the Surrebuttal Testimony of David F. Keim, referred to Page VIII-34, ¶ 31 of the Management Audit to support its claim that non-gas costs do not belong in the GCR. OTS Statement No. 4SR, pp. 3-4.

¹⁶⁴ Further, 52 Pa. Code § 5.243(e) bars a party from raising a position in a brief that should have been introduced as part of a party's case-in-chief.

All of these legal and policy reasons strongly support the view that an adjustment to PGW's otherwise justified rate award because of "service" is illegal and inappropriate. If the PUC is going to consider its past decisions on quality of service, PUC would direct the PUC to its decision in *Pa. PUC v. Pa. Gas & Water Co.*, 1991 Pa. PUC LEXIS 47, *1. In that case, the PUC held four, well attended public input hearings during which participants claimed that they could not afford the rate increase and that service was bad.¹⁶⁵ As is the case here, the Commission found that much of the testimony was repetitive and that the company had made improvements.¹⁶⁶ In granting PG&W a 110% increase in rates, the PUC noted that the company's "history" was not a "decisive factor" and stated that "there comes a point where we must put the past behind us."¹⁶⁷ As CEPA noted, PGW's biggest problems have come from past management and even OCA has recognized that PGW has made improvements in service.¹⁶⁸ We have reached the point "where we must leave the past behind."

IV. COST OF SERVICE/REVENUE ALLOCATION AND RATE STRUCTURE

A. Cost of Service

As noted in its Main Brief, Company witness Howard Gorman performed an unbundled, fully allocated cost of service study (COSS) using widely accepted practices. The study was based on Fiscal Year 2001, the fully forecasted budget test year. OTS, OSBA and PICGUG

¹⁶⁵ *Id.* at 5 and *81-83.

¹⁶⁶ *Id.* at *81 and *91-92.

¹⁶⁷ *Id.*

¹⁶⁸ Tr. 652; OCA St. 1.0 at 53.

generally supported the Company's COSS and recognized that it may be used as a guide to determine cost responsibility for the Company's customers.¹⁶⁹

OCA is the only party in this proceeding that faults the Company's COSS. It argues that the Company's COSS fails to recognize proper cost causation. OCA's major disagreements are the Company's use of a customer component in the distribution mains investment; the Company's allocation of the entire amount of administrative and general salaries and related office expenses as a labor overhead; and its handling of the credit to reverse overheads initially charged to expense when some of these overheads are capitalized.

The Company has refuted these arguments in its Main Brief, and so has PICGUG.¹⁷⁰ Beyond these issues, OCA, in its Main Brief, points to other areas where its witness' allocation differs from the Company's' and asserts that since Company witness Mr. Gorman did not address these miscellaneous modifications, then they have been accepted by the Company and hence, should be accepted by the Commission.¹⁷¹ OCA cites, for example, its allocation of the expense for Distribution Operation Supervision and Engineering on half of distribution plant to recognize the engineering component of this account. The areas of which OCA speaks are identified and rebutted below:

OCA's modifications should be rejected:

- Investment in Storage Plant – Mr. Miller used the WINTER-3 factor to allocate all of PGW's investment in storage plant, because the LNG plant is used to support gas sales throughout the three peak winter months.¹⁷² However, the size

¹⁶⁹ OTS M.B. at 55; OSBA M.B. at 2; PICGUG M.B. at 31.

¹⁷⁰ PGW M.B. at 58-62; PICGUG M.B. at 31-33.

¹⁷¹ OCA M.B. at 46.

¹⁷² OCA St. 2, p. 25

of the investment in storage plant directly affects the quantity of gas PGW can use to meet demand on the peak day. To allocate storage based on WINTER-3 does not reflect the investment in the LNG plant or how the Company uses it.

- Distribution Compressor Equipment and Measuring and Regulating Equipment – Mr. Miller also used the peak and average demand allocation factor for distribution compressor equipment, and measuring and regulating equipment.¹⁷³ However, the Company contends that the particular piece of equipment is sized to meet the peak demand. Therefore the cost should be allocated on that basis.
- General Plant – Mr. Miller allocated general plant investment in proportion to the total of production, storage and distribution plant because most general plant, in his opinion, is used principally in support of production, storage and distribution activities.¹⁷⁴ The Company strongly disagrees. Substantially all of General Plant falls into Structures and Improvements, Office Furniture, Transportation Equipment, Communications Equipment and Power Equipment. These are all used by people and therefore should be allocated based on direct labor.
- Distribution Operations Supervision and Engineering – Mr. Miller allocated this expense half on distribution plant to recognize the engineering component of this account.¹⁷⁵ But this is incorrect because approximately 80% of this account relates to Dispatching and the balance to Supervision- Labor, supplies, expense. The proposed allocation of 50% to plant is made without any support whatsoever.
- Maintenance of City Gate Measuring and Regulating Equipment – Finally, Mr. Miller allocated the O&M expense for city gate M&R stations on total throughput, the same basis on which he allocated load dispatching and other distribution, and M& R station expenses.¹⁷⁶ In the Company's view, this should be allocated on the same basis as the equipment itself, peak day. The costs incurred to maintain the equipment vary with the size and complexity of the equipment. Other City Gate equipment is not related to the M&R Equipment.

¹⁷³ Id.

¹⁷⁴ Id.

¹⁷⁵ Id.

¹⁷⁶ Id.

Accordingly, all of OCA's contentions with respect to the COSS should be rejected.

B. Revenue Allocation

As noted, the Company seeks a net revenue increase of \$65 million above its "present" rates in effect as of February 2001 (pre-interim increase). The rate increase request consists of increases in both the customer charges and volumetric rates for each of the customer classes. The customer charge increase generates about \$44.5 million and the volumetric increase about \$20.5 million. Initially, the Company proposed to distribute the \$65 million increase evenly to all customer classes by even increases of 15.14%. However, in an attempt to eliminate over/under recoveries, the Company proposes now to increase rates to the residential class by 15.65% and to all other classes by 13.44%. If the Commission grants a lesser increase, the Company proposes a scale-back.

OCA generally agrees with the overall allocation of the revenue increase as proposed by the Company.¹⁷⁷ OSBA and PICGUG both recommended that the residential class bear more of the \$65 million increase than proposed by the Company, OSBA recommending \$61 million to the residentials and PICGUG the entire \$65 million.

The allocations that PICGUG¹⁷⁸ and OSBA suggest are fundamentally unfair, self-serving and fail to consider the interests of the other classes. The Company's allocation is fair and clearly balances the interests of its various rate classes. In allocating the proposed increase, the

¹⁷⁷ OCA M.B. at 47.

¹⁷⁸ PICGUG proposes to give the entire rate increase to the residential class. PICGUG St. No. 1 at 11.

Company was ever mindful of the reasonableness of the rates to be charged and also with the likelihood that it will collect the charges when made. Increasing the burden on the residential class as these parties suggest would only create more instability in this class and result in a higher level of uncollectibles and bad debts.¹⁷⁹ Moreover, the allocations suggested by OSBA and PICGUG clearly violate the concept of gradualism.

OTS' objections to the revenue allocation take two forms.¹⁸⁰ First, OTS recommends increasing rates to LBS Large Direct, Tri-Gen Direct and NGV Direct customer classes. Second, OTS also recommends reducing the rates to the GTS Transportation customer class.

In response, the Company notes that these are not firm customers, but rather interruptible customers that have alternate fuel capabilities. Their rates are not based on gas costs but rather on the price of alternative fuels. Base rate changes do not directly affect these customers. Accordingly, OTS proposals to modify their rates should be rejected.

For the above reasons, the Company requests that its allocation — based on either a full or partial rate award — be accepted.

1. Scale Back

As part of its revenue allocation, the Company proposes a simple scale back of its revenue allocation if the Commission grants it an increase that is less than its full \$65 million increase.

¹⁷⁹ PGW St. 4.1 at 17;

¹⁸⁰ OTS M.B. at 56-57.

C. Rate Structure

The parties have proposed various tariff changes many of which have been rebutted in the Company's Main Brief. The Company reiterates its general position that unless initiated by the Company, all tariff changes must await the Restructuring Case.¹⁸¹ However, there are a few proposed tariff changes that the Company shall offer additional responses.

1. Customer Charge

As noted in its Initial Brief the Company proposes to increase the customer charges of all of its customers in an attempt to minimize its exposure to weather sensitivity.¹⁸² It is important to note that for every customer class, the proposed monthly customer charges are lower than the customer related costs on a per customer-month basis in the Company's COSS.¹⁸³

The parties do not object to the customer charge being increased, but rather dispute the appropriate level.¹⁸⁴ They argue that the increase proposed by the Company is arbitrary and violates the principles of gradualism.

The Company has responded to these arguments in its Main Brief. Suffice it to say, PGW has an unusually high number of heating customers, more than any other LDC in the State. The increased revenues from the customer charges will lessen the Company's exposure. Moreover, relative to the cost of service, the Company's increase to the customer charges is less than half of the cost of service.

¹⁸¹ See e.g., PGW M.B. at 68-69.

¹⁸² PGW M.B. at 62-63; PGW St. No. 4 (White) at 6-7; PGW Exh. HSG-1, Sch. 2.

¹⁸³ PGW St. 5.0: PGW Exh. HSG-1, Sch.2.

¹⁸⁴ See e.g., PGW M.B. at 61.

Accordingly, the Company requests that its customer charges to all classes be approved as proposed.

2. Gas Cost Rate

OCA and OTS continue their attack on the Company's GCR. OCA suggests that the Company remove the purchased gas component of \$3.18 out of base rates and roll it into the GCR. OCA would, in turn, remove from the GCR calculation any recovery for bad debts. Similarly, PICGUG and OTS question the propriety of including non-gas costs (such as expenses CWP and CRP) or electricity costs in the GCR claiming they should be in base rates. While PICGUG agrees that full scale reallocation of these costs would not be proper in this case, it suggests that we reallocate the Company's bad debt expense and electricity expense for the GCR to base rates.

The Company has pledged to examine these costs in the Restructuring Case. As the Company has noted before, the Restructuring case will include a base rate filing and various unbundling proposals. Hence, any cost reallocations can and should, be done at that time. Second, PGW is a municipal utility that, unlike investor owned utilities, has no shareholders to bear the risk of revenue recovery. Hence, to protect itself against this risk, the Company recovers these costs in its GCR. Third, while OTS has claimed the including non-gas costs in PGW's base rates would give the Company an "incentive" to be "efficient" OTS has not presented any evidence that the charges are the product of any inefficiency. The charges are large because of a City policy judgment that low income customers should receive assistance in paying their bills, to a much greater extent than provided by other gas companies. Forcing PGW to file a base rate case every time that support increases would be inefficient and costly. Finally, no party has

provided a real explanation of how the proposed reallocations should be accomplished. This suggests that it would be best to do the reallocation at one time rather than piecemeal as the parties suggest.

3. OTS Tariff Changes

In its Brief, OTS has expressed its willingness to meet “ in a workshop environment in order to find a mutually agreeable to the [five] tariff issues addressed in OTS witness Metro’s testimony.”¹⁸⁵ In response, the Company sincerely accepts OTS’ offer and looks forward to the opportunity to again work with Commission staff to arrive at a consensus.

4. Transportation Issues

PICGUG requests a revision to the Company’s transportation tariff to permit large commercial and industrial customers the opportunity to transport natural gas on PGW’s system.¹⁸⁶ It argues that the Company’s transportation tariff requirements are so strict that all but the largest customer accounts are prevented from transporting natural gas. PICGUG recommends that the Company start to expand its transportation requirements now instead of waiting for the Restructuring Proceeding.

Every tariff change that PICGUG proposes was discussed in PGW’s Main Brief. All tariff modifications proposed by the other parties should be deferred to the Restructuring proceeding. Hence, further discussion is unnecessary.

¹⁸⁵ OTS M.B. at 53.

¹⁸⁶ PICGUG M.B. at 7.

V. MANAGEMENT AUDIT --THE PROPOSED RATE ADJUSTMENTS ARE NOT SUPPORTED BY THE AUDIT ITSELF BECAUSE PGW IS PRESENTLY IMPLEMENTING MANY OF ITS RECOMMENDATIONS.

Both OCA and CEPA attempt to use certain parts of the Management Audit to claim that PGW's service is completely inadequate,¹⁸⁷ i.e., billing, credit and collection system (BCCS), customer service (call center); main replacement and governance. However, the Audit, as well as PGW's response, does not support their contentions.

As a general matter, PGW has accepted the overall Call Center recommendations, and with one exception all of the subordinate Call Center recommendations.¹⁸⁸ It appears as though both OCA and CEPA virtually ignore the fact that the Company is diligently implementing many of the recommendations found in the Management Audit. In so doing, they have shown a clear misunderstanding of how the Audit and the Implementation Plan should be read together as one document. When read together, it is abundantly clear that the Company is presently remediating the problems that OCA and CEPA have identified.

A. PGW is Taking Great Strides to Drastically Improve its Billing, Credit, and Collection System (BCCS).

OCA and CEPA claim that PGW is continuing to experience billing, credit and collection system (BCCS) problems, particularly those regarding budget billing, and calls on the Company to make improvements.¹⁸⁹ The Company is doing just that. The Implementation Plan shows that

¹⁸⁷ OCA M.B. at 62; CEPA M.B. at 12.

¹⁸⁸ Implementation Plan Section VIII. Chapter VIII of the Audit is devoted to customer service, billing and collection issues.

¹⁸⁹ OCA M.B. at 69; *see also* CEPA M.B. at 12.

the Company has accepted the Auditor's recommendation to correct all BCCS, inaccuracies, and, most importantly, is taking concrete steps to achieve those objectives.¹⁹⁰ The record clearly delineates specific actions that PGW is taking to correct the problems such as:

- Effective April 1, 2001, the Company began to intensify its collection activity on delinquent accounts that have accrued during the winter and has actually started to terminate those customers who are delinquent but have an ability to pay.¹⁹¹
- The Company began a process to develop an RFP on outsourcing of collection activities.
- A Quality Control Section will be formally established within the BCCS by August 2001.
- The Project Management Office (PMO) will continue to monitor the system for quality assurance. As anomalies occur, the PMO will identify and resolve the problem.

The Company gives this recommendation a high priority.

B. The Record Shows that PGW is Improving its Customer Service.

OCA and CEPA also fault the Company's level of service as measured by abandonment phone rates and response time of the call center.¹⁹² OCA even cites studies from last year showing customer dissatisfaction.

¹⁹⁰ Stratified Management Audit Implementation Plan, Recommendation VIII-2. Within Chapter VIII of the Audit, there are about 17 recommendations involving the Company's billing, credit and collection system. The Company's Implementation Plan details the action steps that it is presently taking to improve the system.

¹⁹¹ See, "PGW will start turning off service to those in arrears", Philadelphia Inquirer, June 26, 2001, p. B-5. And, " ' The shutoffs by PGW is a reflection by them to collect unpaid bills from thousands of customers', [CEPA attorney Philip] Bertocci said." Philadelphia Daily News, June 27, 2001.

¹⁹² OCA M.B. at 69; CEPA M.B. at 14.

Again the record shows how diligent the Company has been correcting its abandonment rates and response time.¹⁹³ The Implementation Plan shows that the Company is currently filling 50 jobs where applicants are tested and trained; has increased the call center staff to 128 employees; has filled senior management positions with qualified personnel; has taken steps to reduce absenteeism; and has installed wait time technology.¹⁹⁴ The Intervenor's positions are based on stale data and simply do not reflect the Company's ongoing improvement efforts.¹⁹⁵ Moreover, OCA fails to mention that all emergency calls are answered under 30 seconds¹⁹⁶.

Finally, it should be noted that the Commission is currently investigating the call center issue in a separate proceeding in which the parties — including OCA and CEPA — will be focused solely on resolving this issue. Hence, no further action need be taken in this proceeding.

C. PGW is Aggressively Pursuing Its Main Replacement Program.

OCA argues that it is critical that the Company obtain at least a 1% replacement rate for its cast iron mains.

In response, the Company reiterates its position that it is very concerned about the safety of its system and never compromises safety. Moreover, the Company has included in its plan of action to increase the amount of cast iron main replacement to the 18 miles per year level. That

¹⁹³ See Implementation Plan, Recommendations VIII-1, which contains the response to three distinct recommendations.

¹⁹⁴ *Id.*

¹⁹⁵ Despite these concrete changes, CEPA still criticizes the Company's staffing levels, absenteeism and behavior during customer house calls. CEPA M.B. at 17-19. Again, all of these issues are addressed by the Company in Section VIII of its Implementation Plan.

¹⁹⁶ PGW St. 1.2 at 6; PGW Exh. TEK-6.

the Company is presently just under one-half of its annual goal, may indeed be due to last winter's extreme weather conditions or other variables.¹⁹⁷ The Company will continue to try to meet this standard diligently.

D. It is Beyond PGW's Control to Implement the Governance Changes that CEPA Proposes.

CEPA argues at length that the Commission should defer granting a rate increase until City of Philadelphia governs PGW more effectively. CEPA notes that:

At the root of PGW's problem is a problem of governance. In order for PGW to provide any hope of improved customer service, the various elements of PGW governance—the Mayor, PFMC, City Council, the Philadelphia Gas Commission, the Director of Finance and The City Controller—must work together to break the existing leadership stalemate.¹⁹⁸

Remarkably, CEPA itself acknowledges that the governance issue is beyond the Company's control. Hence, it is hard to understand how CEPA can recommend that the Company do something over which it has absolutely no control, and is clearly within the purview of other City entities.¹⁹⁹

E. The Commission Does Not Need to Condition PGW's Rate Increase as Requested by OCA.

OCA contends that any rate relief granted in this proceeding must be subject to the following five conditions:

¹⁹⁷ Implementation Plan Recommendation IX-2.

¹⁹⁸ CEPA M.B. at 20.

¹⁹⁹ PGW Exh. TEK-3, p. 2. The Company plainly noted in its Implementation Plan that it has no control over this issue.

- PGW should be required to maintain at least a 1% replacement rate in its mains replacement program;
- PGW should continue its commitment to correcting the problems with the BCCS, particularly the need to rectify the budget billing problems;
- PGW should continue to work with the Commission to implement the recommendations as per the Philadelphia Gas Works Implementation Plan for the Stratified Management and Operations Audit (March 2001);
- PGW should improve its customer service in a timely manner, particularly its call center performance; and
- PGW should continue its progress on its Transition to Excellence Plan.

OCA's suggestions are unnecessary. First, as noted the Company is correcting every single deficiency that OCA has alleged. Second, the Company has already agreed to most if not all of these actions through the Audit process or in commitments as part of the Interim Rate Settlement.²⁰⁰ Finally, it is respectfully submitted that the PUC does not have the legal authority to condition the granting of an otherwise justified rate increase on the Company's acceptance of conditions.²⁰¹

²⁰⁰ Joint Petition for Interim Rate Settlement at 7, ¶ 21; Attach. B; R-00005654 Opinion and Order at ¶2; letter of March 1, 2001 (agreeing to conditions 1-8, 11 and 13 of Commission's original, November 22, 2001 Order).

²⁰¹ Courts have repeatedly prohibited public utility commissions from conditioning otherwise justified rate increases upon the completion of service improvements. *See e.g., Public Util. Comm'n of Texas v. Houston Lighting and Power Co.*, 1986 Tex. App. 8328, 715 S.W.2d 98 (1986), *aff'd and rev'd on other grounds*, 748 S.W.2d 439 (Tex. 1987); *In re General Telephone Company of the Southwest*, 98 N.M. 749, 652 P.2d 1200 (1982); *South Central Bell Telephone Co. v. Utility Regulatory Commission*, 637 S.W.2d 649 (Ky. 1982); *Arkansas Public Service Comm'n v. Continental Telephone C. of Arkansas*, 262 Ark. 821, 561 S.W.2d 645 (1978); *General Telephone Co. of Michigan v. Public Service Comm'n*, 341 Mich. 620, 67 N.W.2d 882 (1954); *Florida Telephone Corp. v. Carter*, 70 So.2d 508 (Fla. 1954); *The Elyria Telephone Co. v. Ohio Public Util. Comm'n*, 158 Ohio St. 441, 445-46, 110 N.E.2d 59, 62 (1953). ("A situation is present where the company needs an increase in rates to attract capital to buy new equipment and

VI. CONCLUSION

Philadelphia Gas Works respectfully requests that the Pennsylvania Public Utility Commission reject the contentions of the other parties and authorize it to file tariffs which produce \$65 million in additional base rate revenue (after accounting for the interim rate increase) in accordance with the Company's revenue allocation and rate structure recommendations.

Respectfully submitted,

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Date: June 29, 2001

to meet increased demands, and the commission says, in effect, "we will give you the new rates to attract the new capital to purchase new equipment when you show that you installed the new equipment.")

APPENDIX A

Gas Commission Meeting (June 19, 2001)

MOTION

**Proposed PGW FY 2001 Operating Budget
and
Five Year Forecast of Operating Budgets (FY 2002 - FY 2006)**

Gas Commission Exhibit # 4

INTRODUCTION

PGW's Fiscal Year 2001 has been a year of transition. The Pennsylvania Natural Gas Customer Choice Act of 1999 made PGW subject to rate regulation by the Pennsylvania Public Utility Commission effective July 1, 2000, while preserving the City's and the Gas Commission's authority over PGW's budgets. The following observations are in order before I offer the specifics of my Motion.

First, both the parties and the Hearing Examiner have discussed at length issues related to the interaction of PGW's rate making and budget setting processes under the Gas Choice Act, and specifically, the effect of the PUC's approval of interim base rates for Fiscal Year 2001. However, as the Hearing Examiner observed, in this budget proceeding, we do not need to reach, nor can we resolve, the legal issue of what weight the PUC must give to PGW's approved budgets.

Rather, at this point in the fiscal year, for budgeting purposes, the Gas Commission should adopt as the most realistic estimate of additional revenues for Fiscal Year 2001 the \$18 million from interim rate increases which have been approved by the PUC. Approving the litigation settlement agreement between PGW/the City and the PUC, the PUC Order of February 21, 2001 authorized PGW to recover an additional \$7 million of Bad Debt Expense through its GCR plus \$11 million as an interim base rate increase during the remainder of the current fiscal year. Any PUC determination on PGW's \$65 million permanent base rate increase request is unlikely to come prior to October 6, 2001 (i.e., one month after the start of FY 2002). And, there is no basis in the record to assume that the interim rates in effect during FY 2001 will be increased by the PUC retroactively.

Second, we find ourselves in the uncomfortable position of once again

not being able to approve – with or without modification – PGW's proposed outyears forecast. This Commission has repeatedly, but unsuccessfully, directed PFMC to prepare a meaningful strategic plan for PGW, linked to its current and future budgets. In the absence of a completed plan, we are not able to adequately scrutinize assumptions underlying PGW's forecast for Fiscal Years 2002 through 2006. Despite repeated assurances to both the Gas Commission and City Council that such a plan was forthcoming, PGW still has not completed the plan.

Third, and perhaps most importantly, it must be observed that, between the time this Commission completed its review of PGW's FY 2000 operating budget and now, PGW's financial condition has continued to deteriorate. The record is clear that, despite a normal winter and the interim rate relief previously mentioned, PGW's commercial paper/letter of credit will remain essentially fully drawn as of August 31, 2001, i.e., at the end of this fiscal year. In addition, the \$45 million "temporary advance" from the City approved earlier this fiscal year will be fully drawn and is expected to remain so throughout FY 2002. Finally, in addition to its normal cash requirements for natural gas purchases during the first several months of FY 2002, PGW will need to pay for some \$11.5 million of natural gas supply, payment for which is being deferred from the second half of FY 2001 into early FY 2002. Thus, PGW's cash flexibility is severely constrained, and what limited flexibility remains is attributable to the City loan and to the new bonds issued this month.

Clearly, major additional infusions of cash are needed for PGW to move forward towards financial recovery. The actions of PGW/the City and the PUC earlier this year, however, have essentially "locked in" PGW's revenues for Fiscal Year 2001, and have precluded this Commission from independently projecting, for budgeting purposes,

PGW's revenue needs. Given all of this, I believe we should adopt the various adjustments to proposed operating expenses recommended by the Hearing Examiner, none of which were excepted to by the parties. These reductions, if achieved, would improve PGW's cash situation by over \$6 million.

Achievement of a major part of these additional cost reductions – that is, the \$5 million reduction to budgeted bad debt expense – will require sustained effort on PGW's part. It is disturbing that ongoing serious operational deficiencies in the areas of IT, collections and customer service continue to contribute to PGW's deteriorating financial condition. It is also severely troubling that, even though PGW has been operating with a series of interim managers since November 1998, a permanent resolution to PGW's management needs has still not been put in place.

With this preface, which I urge the Commission to incorporate in its final Order in this matter, I will now proceed to offer my Motion.

MOTION

My motion is in six (6) Parts and is as follows.

1. I move that the Gas Commission reject the FY 2001 Operating Budget as proposed by PGW.
2. I move that the Gas Commission approve an FY 2001 Operating Budget for PGW that reflects the following:

No.	Motion - Part 2 (continued)
2.1.	Approve \$18,000,000 as the revenue line item for a "Base Rate Increase".
2.2.	In addition to the heating and non-heating revenues originally budgeted by PGW, approve a "GCR Adjustment Revenue" line item of \$185,000,000.
2.3.	Increase the \$2,100,000 "Unbilled Gas Adjustment" revenue line item by \$1,500,000 to reflect the incremental effect of \$230,000,000 in GCR increases.
2.4.	Approve a "Natural Gas Expense" line item budgeted at \$479,593,000 to reflect the \$185,000,000 increase to the \$294,593,000 line item originally budgeted by PGW. This increase reflects the incremental effect of \$230,000,000 in GCR increases.
2.5.	Reduce the budgeted \$13,835,000 "Gas Processing Expense" line item by \$48,000 to reflect the impact of updated information on natural gas pricing and storage. A line item of \$13,787,000 will result.
2.6.	Decrease the (\$4,000,000) budgeted for "Net Marginal Revenue" by \$2,400,000 thereby decreasing the projection to (\$1,600,000). This will reflect the change from 4,600 HDD to 4,555 HDD as a normal year based on a 30-year historical average of Heating Degree Days.
2.7.	Eliminate the projected \$1,500,000 increase in marginal revenues expected to result from closing the Senior Citizen Discount Program to new participants effective June 30, 2000.
2.8.	Reduce the budgeted \$72,783,000 "Bad Debt Expense" line item by \$5,000,000 to reflect the impact of dramatically increased gas cost rates, while demonstrating the expectation that PGW will significantly improve its collection efforts and thereby turn billed revenues into much-needed cash. A line item of \$67,783,000 will result.
2.9.	Approve a negative expense line item to reflect cost savings and productivity improvements totaling \$10,000,000 to be achieved during the budget year to reflect PGW's commitment to paring unnecessary expense and protecting its debt service coverage position.
2.10.	Eliminate \$601,000 budgeted for operating leases expense. The acquisitions involved are to be capitalized.

No.	Motion - Part 2 (continued)
2.11.	Eliminate \$632,000 budgeted for IT-related equipment rental. This will reflect that these acquisitions have been deferred by PGW.
2.12.	Eliminate \$41,000 budgeted for the "Quarter Century Service Club Dinner". This celebration, attended by PGW employees and retirees, is not related to providing safe and reliable service.
2.13.	Amortize the \$1,000,000 expenditure for "BCCS Remediation" over three (3) years.
2.14.	Amortize the \$300,000 expenditure for "Emergency Operations" over three (3) years.
2.15.	Amortize the \$530,000 expenditure for "Marketing Studies" over five (5) years.
2.16.	Amortize the \$2,000,000 expenditure for "Training Costs - V.P. of Customer Affairs" over five (5) years.
2.17.	Amortize the \$825,000 expenditure for "Rate Case Expense" over two (2) years.

3. I move that the Gas Commission reject PGW's proposed Operating Budget Forecast for Fiscal Years 2002 to 2006.
4. I move that the Gas Commission instruct PGW to identify in its proposed FY 2002 Operating Budget the specific line items wherein cost reductions and productivity improvements are projected to occur and to link such cost reductions and productivity improvements to specific PGW departmental goals.
5. I move that the Gas Commission instruct PGW to file no later than September 4, 2001 a Three Year Financial And Management Plan covering Fiscal Years 2002 through 2004. This Plan shall outline PGW's corporate goals (including but not limited to, unbundling and restructuring), strategic directions, resource requirements, and related financial implications.
6. I move that the Gas Commission instruct PGW to file a Compliance Operating Budget for FY 2001 consistent with this Motion within five (5) business days of today's meeting.

This concludes my motion.

CERTIFICATE OF SERVICE

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

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Daniel Clearfield, Esquire

Dated: June 29, 2001



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

IN REPLY PLEASE
REFER TO OUR FILE

June 29, 2001

ORIGINAL

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

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

Dear Secretary McNulty:

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

Copies are being served on all active parties of record.

DOCUMENT
FOLDER

Sincerely,

Johnnie E. Simms
Senior Prosecutor
Office of Trial Staff

JES:alb

c: Parties of Record
Honorable Cynthia W. Fordham

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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v. :
:
Philadelphia Gas Works :

Docket No. R-00006042

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Dated: June 29, 2001

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I. INTRODUCTION

On June 22, 2001, the Office of Trial Staff (“OTS”) filed its Main Brief in this proceeding setting forth evidence and law in support of \$33,000,000 in additional annual revenues for Philadelphia Gas Works (“PGW” or “Company”). Main Briefs were also filed by PGW, the Office of Consumer Advocate, the Office of Small Business Advocate, the Philadelphia Industrial and Commercial Gas Users Group and Consumers Education and Protective Association.

OTS’ Reply Brief is limited to those matters raised by the other participants in their Main Briefs and not specifically addressed by OTS in its Main Brief and those matters previously addressed by OTS, but which require additional discussion as a result of the Main Briefs of the other participants. For ease of review, OTS for the most part herein will use the same headings as utilized by PGW in its Main Brief in addressing issues raised by OTS in the proceeding. The absence of a reply to a particular argument by a party in this Reply Brief does not mean that OTS agrees with the merit of the argument, but rather, reflects OTS’ belief that the issue was sufficiently address in our Main Brief.

II. ARGUMENTS

1. **OTS' Downward Bad Debt Adjustment Is Not Against the Weight of the Evidence and Is Consistent with the Public Utility Code.**

In its Main Brief, at pages 34 through 37, OTS discussed the justifications for adjusting PGW's Bad Debts as proposed in the testimony and exhibits of OTS witness Weakley. OTS has reviewed the Main Brief of PGW, and OTS believes that the adjustment was adequately addressed in its Main Brief. However, there is need to make abbreviated remarks concerning certain aspects of PGW's arguments.

In that regard, PGW argues that "while OTS' five year analysis may be common in PUC proceedings involving investor-owned utilities, it is inconsistent with the tailoring of PGW's rates to its cash needs as required by Section 2212(e) of the Code and the prior ratemaking method." (PGW Main Brief at page 40). In response, OTS submits that the Company has conveniently overlooked the fact that the Pennsylvania Public Utility Commission ("Commission") utilized OTS' five-year analysis in determining PGW's bad debt expense in the Interim rate proceeding in Pennsylvania Public Utility Commission, et. al. v. Philadelphia Gas Works, R-00005654 (Order entered November 22, 2001). Simply put, the Commission only a few months ago determined that a five-year analysis was appropriate in determining PGW's bad debt expense, and by adopting the five-

year analysis, the Commission obviously concluded that the analysis satisfied Section 2212(e) of the Public Utility Code and PGW's prior ratemaking method.

PGW also argues that OTS witness Weakley failed to recognize that higher gas costs have caused a higher percentage of non-paying customers (PGW Main Brief at page 40). The Company's argument suggests a misunderstanding of OTS' normalization of the Company's bad debt expense in this proceeding. The Commission determined in the Interim Rate proceeding that the purpose of a Bad Debt adjustment is to determine "a normal level of expense by leveling fluctuations in this expenses such as: write off or collection activities by PGW, economic conditions, or increased consumption due to weather." Moreover, the Commission determined that a five-year period is a sufficient length of time to levelize any aberrations due to economic conditions, such as a period of high gas prices. In fact, OTS excluded fiscal year 2000 due to PGW's abnormally low write-offs for bad debts.

The Company's argument regarding its level of 40% arrearages that may be attributed to high gas prices, is a snap shot of a short period that will levelize over a period of time, and those arrearages should return to historic levels. Moreover, for the Company's argument regarding the effects of high gas prices to have any validity, there would have to be evidence of continuing high gas prices and high delinquencies over a prolonged time period. In the instant proceeding, there is no evidence that there will be a continuation of high gas prices, in fact the evidence suggests a lowering of gas prices (Tr. 558-560).

The Company argues that “PGW’s actual booked bad debt expense for 1999-2000 was \$54.64 million, or over \$12 million more than what Mr. Weakley’s rationale would have allowed” (PGW Main Brief at page 41). PGW fails to recognize that “booked bad debt expense” is used solely for the utilities’ financial statements and differs from what the Commission utilizes for ratemaking purposes as evidenced by the Commission’s Order in PGW’s Interim Rate proceeding.

Finally, in an effort to convince the Administrative Law Judge and the Commission to reject OTS’ adjustment to PGW’s bad debt, the Company invokes OCA witness Lelash as an ally on the bad debt issue. Such an attempt at an allegiance between Mr. Lelash and PGW is preposterous, since in every other instance, the Company throughout its Main Brief attempts to discredit every adjustment made by Mr. Lelash to the Company’s Filing.

Aside from the fact that OTS’ bad debt adjustment is consistent with the Commission’s ruling in the Interim Rate proceeding, the Company has not presented any new arguments to validate a rejection of the adjustment. Consequently, OTS’ recommended bad debt expense adjustment, which results in a write-off percentage of 7.6160%, should be applied to the total revenues approved by the Commission in this proceeding.

2. OTS' Proposed Adjustment to Increase Customer Counts and Annual Usage Per Customer Are Based On the Company's Data, Therefore Should Be Adopted.

In Section E, paragraph 2(c) on page 42 of its Main Brief, the Company argues that OTS' increased customer counts and annual usage per customer were based on inaccurate data or unreliable data. In response, OTS submits that the data utilized by OTS witness Kubas was supplied by the Company either in its Filing or in responses to interrogatories. Consequently, to the degree that the data is inaccurate or unreliable, then the problem resides with PGW, as the Company provided the data to Mr. Kubas.

After Mr. Kubas had made an adjustment to PGW's customer counts, the Company indicated its willingness to accept a \$2 million increase in projected revenues. (PGW Main Brief at page 43). The problem with PGW's acceptance of a \$2 million increase in revenues is that the Company's acceptance is based on a one-month analysis to determine the normal number of customers. (OTS Main Brief at page 24). As shown on OTS Exhibit No. 2, Schedule 2, page 4, the Company's response to OTS Interrogatory RS-28, indicates that the number of PGW's customers varies each month. Accordingly, any analysis based on one month is not reflective of a normal year for PGW because it does not account for the normal fluctuation in customer numbers that occur through the year. In contrast, Mr. Kubas utilized Company provided data (reliable or unreliable depending on the Company's description) for a period of twelve months, which is

reflective of a normal year for PGW because it accounts for the variances in customer numbers that occur throughout the year.

Further, the Company argues that OTS' recommendation that "the projected average annual usage per residential heating and commercial heating customers be increased by 2.97 Mcf and 31.9 Mcf, respectively, over PGW's calculated amounts is not at all justified" (PGW Main Brief at page 43). The problem with PGW's "calculated amounts" is that the Company failed to provide any details regarding the input for the "calculated amounts, such as, the amount of base load per customer and the amount of heat load per customer that was utilized, which would allow the Commission to make a independent informed determination whether PGW's calculated amounts are accurate or reasonable (OTS Main Brief at page 26). It appears to be PGW's argument that the "calculated amounts" are derived from a computer model, thus no one can question whether the "calculated amounts" are correct. However, the issue is not whether the "calculated amounts" are correct, but rather, whether the inputs placed in the computer model are correct, and without knowing the inputs there is no way of determining whether the calculated amounts are correct. Accordingly, PGW's argument is without merit.

In a number of areas, the Company has made arguments relying solely on verbal statements, often in the context of rejoinder testimony without any schedules or exhibits supporting the testimony. Case in point, the Company argues that OTS' proposed increase represents 4.2 Bcf of additional sales, or a 7%

increase in prior year firm sales and translates into a 14% increase in the Company's design day peak demand (PGW Main Brief at pages 43-44). While the Company reference a "14% increase" there is absolutely no schedule or exhibit illustrating how the "14% increase" was calculated by the Company. As PGW witness White testified, "if I were to extrapolate that to a design year that would be better than a 14 percent increase in my total firm sales." PGW failed to recognize that the Commission is required to rely on an evidentiary record to determine its recommendation in this proceeding. In that regard, the Company's witnesses mere statements of calculations without supporting exhibits should be given no weight in this proceeding. The Company's propensity for making statements regarding its calculations without supporting exhibits continued with its argument that "since 1984, PGW average annual usage has gone down by 10% per year, and it has never experienced the kind of increases that Mr. Kubas assumed" (PGW Main Brief at page 44). Once again, there are absolutely no supporting exhibits and/or schedules supporting the Company's statement regarding the "10% per year" calculation, such as, base load per customer information, heat load per customer information, a chart illustrating the average use over the past several years to support the 10% claim. Consequently, there is no independent evidence other than Mr. White's "statement" to test whether the average annual residential usage has gone down 10% per year is accurate or even reasonable.

One aspect of the Company's argument suggests that PGW did not fully understand OTS' analysis in this proceeding. Case in point, the Company argues

that OTS witness Kubas' was in error for using reported actual sales data for the year 2000, because PGW witness White testified that the Company's data collection system was not producing accurate reports in the year 2000 (PGW Main Brief at page 44). In support of its position that the data collection system was not producing accurate reports in 2000, the Company prepared an Exhibit (PGW Exhibit CW-R-1) comparing the reported customer billings to sales for the most recent period ending February 2001 which, according to PGW, shows the inconsistency due to some months actually having negative sales. Id. In response, OTS submits that an examination of OTS Exhibit No. 2, Schedule 5, page 2, depicting PGW's actual sales for January 2000 through August 2000, shows that for this time period, the residential and commercial heating class sales are all positive. Further, OTS Exhibit No. 2, Schedule 5, page 4, depicting PGW's actual sales for September 2000 through December 2000, shows that for this time period, the residential and commercial heating class sales are all positive. Notably, the same schedules reflected in OTS Exhibit No. 2 on pages 2 and 4, respectively, show sales that are, in fact, negative for several months during 2000, but the negative sales are associated with classes of customers, such as the Housing Authority, the Municipal and NGV, which were not relied upon nor addressed by OTS in this proceeding. Consequently, the Company's argument that the Commission should not rely on year 2000 data to determine average use for the residential and commercial classes due to negative sales during the year 2000 is not valid, and is simply a red herring.

PGW is requesting that the Commission adopt its position which is based on a forecasting computer model, without affording the Commission the independent ability to test the accuracy of the computer model, since the Company provided none of the inputs involved in the forecasts. In contrast, OTS witness Kubas has provided detailed Exhibits and Schedules to support his position that there should be an upward adjustment of approximately \$32.5 million resulting from changes to PGW's projected average annual usage per residential and commercial customers.

3. OTS' Adjustments to PGW's Promotional Activities and Rate Case Expense.

A. Legal Standard

In responding to both the Promotional Activities and Rate Case Expense adjustments, PGW argues that the adjustments are in violation of prior ratemaking method, and that its rates must cover all of the Company's expenses. With respect to prior ratemaking method, OTS submits that the Company has misinterpreted the "prior ratemaking method", because the concept "prior ratemaking method" only distinguishes between the ratemaking concepts of PGW's "cash flow method" versus the Commission traditional investor-owned "rate base/rate of return" method. Pursuant to 66 Pa. C.S. A. Section 2212(e), the Commission is only obligated to follow the PGW's prior ratemaking method of using the "cash flow method" in setting rates. The Public Utility Code does not prohibit the

Moreover, the Company's argument that all expenses must be covered by rates fails to recognize the reality of ratemaking. In that regard, using the Company's claimed Promotional Expenses as an example, the Company will not be in violation of Section VII of the Management Agreement as the Company will simply have less money available from ratepayers to pursue its Promotion Activities. In fact, as the Company readily admits, since the inception of the Promotion Program, PGW has only expended a total of \$558,103 and no more than \$383,193 in any one year, while budgeting \$1.6 million every year (OTS Main Brief at pages 37-39).

In addressing the rate case expense adjustment, PGW also argues that the PGC never denied rate case expense based on the relevance of someone's testimony. Presumably, the PGC never encountered testimony from a witness discussing the difference between a municipal owned utility from an investor owned utility, because such testimony is totally irrelevant for the purpose of setting rates for PGW using the cash flow method. While PGW argues on page 47 of its Main Brief that it should be allowed to determine what is necessary to meet its burden of proof and prove its own case, OTS submits that is correct with certain limitations. One limitation imposed is that the Commission must determine what reasonable rate case expense will be charged to ratepayers, and OTS submits that total irrelevant testimony addressing a issue that is not remotely related to any issue in this proceeding is not just and reasonable.

OTS submits that total irrelevant testimony addressing a issue that is not remotely related to any issue in this proceeding is not just and reasonable.

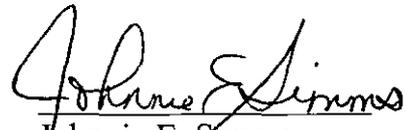
Notably, PGW argues that "other parties, particularly the OCA and CEPA, have drawn parallels to investor-owned utilities" (PGW Main Brief at page 48). OTS respectfully submits that such an argument is nonsensical, assuming arguendo, if the Company was addressing the direct case of OCA and CEPA, then the direct testimony of Mr. Lukens would have been presented in the rebuttal phase of the proceeding not in the Company's case-in-chief. The Company's argument is even more nonsensical when one considers that CEPA did not sponsor any witnesses in this proceeding. Simply put, the Company's argument regarding the OCA and CEPA is a red herring at best, as it is simply an attempt to create some nexus between "any" remote issue in this proceeding and the direct testimony of Mr. Lukens. The problem with the Company's argument is that Mr. Lukens direct testimony was filed with the initial Filing and not in the rebuttal phase of the proceeding, if the purpose of the direct testimony as suggested by PGW was to address issues sponsored by OCA and CEPA.

Consequently, the Company's arguments are without merit and should be rejected.

III. CONCLUSION

For the reasons presented in this Reply Brief and the Main Brief, OTS respectfully requests that the Philadelphia Gas Works receive no more than \$33,000,000 in additional revenues.

Respectfully submitted,


Johnnie E. Simms
Senior Prosecutor

Dated: June 29, 2001

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission :

v. : Docket No. R-00006042

Philadelphia Gas Works :

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Reply Brief** of the Office of Trial Staff, dated June 29, 2001, either personally, by first class mail, electronic mail, or by fax upon the persons listed below:

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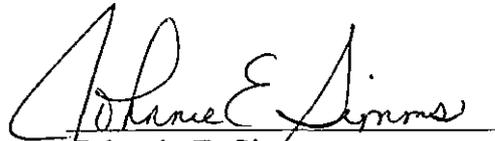
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