



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

R-000060429001

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OCTOBER 4, 2001

R-00006042 "et al"

DANIEL CLEARFIELD ESQUIRE
WOLF BLOCK SCHORR AND
SOLIS-COHEN LLP
212 LOCUST STREET SUITE 300
HARRISBURG PA 17101

REP

DOCUMENT
FOLDER

Pennsylvania Public Utility Commission
V.
Philadelphia Gas Works

To Whom It May Concern:

This is to advise you that an Opinion and Order has been adopted by the Commission in Public Meeting on September 21, 2001 in the above entitled proceeding.

An Opinion and Order has been enclosed for your records.

Very truly yours,

James J. McNulty
Secretary

Enclosure
Certified Mail
FG

See Attached Listing for Additional Parties of Record

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Public Meeting held September 21, 2001

Commissioners Present:

Glen R. Thomas, Chairman
Robert K. Bloom, Vice Chairman
Aaron Wilson, Jr.
Terrance J. Fitzpatrick

Pennsylvania Public Utility Commission	:	R-00006042
	:	R-00006042C0001 <i>et al</i>
	:	C-00014826 – C-00014828
v.	:	C-00014843
	:	C-00014910
	:	C-00015037
Philadelphia Gas Works	:	C-00015044 – C-00015048
	:	C-00015050
	:	C-00015098

OPINION AND ORDER

BY THE COMMISSION:

TABLE OF CONTENTS

	<u>PAGE</u>
I. HISTORY OF THE PROCEEDING	2
II. DISCUSSION	7
A. LEGAL STANDARDS	7
1. Section 2212(e)-Prior Ratemaking Methodology-Cash Flow Method	7
2. Burden of Proof	16
3. Rates Must be Just and Reasonable	19
4. There is no Presumption that Rate Set Pursuant to the Management Agreement/Cash Flow Method are Just and Reasonable	27
5. PGW's \$18 Million Payment to the City of Philadelphia	29
B. REVENUE REQUIREMENT	35
1. Introduction	35
2. Recommended Revenue Requirement	37
3. Revenue Adjustments	44
4. Expense Adjustments	48
a. Rate Case Expense	48
(1) \$100,000 Payment to Lukens	49
(2) The Rate Case Expense Normalization	51
b. Budgeted Promotional Expenses	53
c. Bad Debt Expense	56
d. OCA Expense Adjustments Accepted by PGW	59
e. Lobbying Expenses	63
f. Operating Leases	66
g. Employee Consultants	67
C. RATE STRUCTURE/COST OF SERVICE	69
1. Cost of Service Study	69
2. Revenue Allocation Between the Rate Classes	71
3. Rate Design	74
a. Customer Charge	74
b. Commodity Charge	78

4. Recovery of Non-Gas Costs in GCR.....	80
5. Tariff Changes	87
a. Nonstandard Rates	87
b. BPS Price Ceiling	90
b. OTS' Proposed Revisions.....	91
c. PICGUG's Proposed Revisions.....	92
D. MANAGEMENT AUDIT AND QUALITY OF SERVICE.....	97
E. MISCELLANEOUS ISSUES.....	103
1. PGW's Senior Citizen Discount Program	103
III. CONCLUSION	106
IV. ORDER.....	107

Before the Commission for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Cynthia Williams Fordham, issued on August 7, 2001, relative to the above-captioned proceedings, and the Exceptions filed with respect thereto. Exceptions to the Recommended Decision were filed by the following Parties: Philadelphia Gas Works (PGW); Office of Consumer Advocate (OCA); Philadelphia Industrial and Commercial Gas Users Group (PICGUG); Consumers Education and Protective Association (CEPA), the Association of Community Organizations for Reform Now (ACORN), Action Alliance of Senior Citizens of Greater Philadelphia and Tenants' Action Group (TAG) (collectively CEPA *et al.*), all filed on August 22, 2001.

The Office of Small Business Advocate (OSBA) and the Office of Trial Staff (OTS) each filed a Letter on August 22, 2001, indicating that they would not be filing Exceptions to the Recommended Decision, but that they reserved the right to file Reply Exceptions.

The following Parties filed Reply Exceptions on the indicated dates: CEPA *et al.*, on August 28, 2001; the OSBA, PICGUG, the OCA, the OTS and PGW on August 30, 2001.

I. History of the Proceeding

On January 5, 2001, PGW filed Supplement No. 7 to Tariff Gas – Pa. P.U.C. No. 1 to become effective March 6, 2001. In its tariff, PGW proposed changes in rules, regulations and rates calculated to produce \$65,000,000 in additional annual revenues. PGW also filed the testimony of six witnesses. In addition, PGW filed a Petition for Waiver of Potentially Applicable Notification and Filing Requirements and Establishment of Expedited Hearing Schedule for Base Rate Proceeding (Petition for Waiver).

Comments to PGW's Petition for Waiver were filed by the OCA, the OTS, PICGUG and CEPA *et al.* PGW filed the revised testimony of its witnesses on February 2, 2001.

By Order entered February 8, 2001, the Pennsylvania Public Utility Commission (Commission) instituted an investigation into the lawfulness, justness and reasonableness of the proposed rate increase. Pursuant to Section 1308(d) of the Public Utility Code (Code), 66 Pa. C.S. §1308(d), Supplement No. 7 to Tariff Gas – Pa. P.U.C. No. 1 was suspended by operation of law until October 6, 2001, unless otherwise directed by Order of the Commission. In addition, the Commission ordered that the investigation include consideration of the lawfulness, justness and reasonableness of PGW's existing rates.

The matter was assigned to the Office of Administrative Law Judge (OALJ) for resolution by hearings and for issuance of a Recommended Decision. The Petition for Waiver was granted, in part, and denied, in part. PGW's request for waiver of 52 Pa. Code §53.45(a), which requires that a utility file with the Commission written notice thirty days prior to the filing, was granted. PGW's request to provide notice to customers under the alternative method set forth in 52 Pa. Code §53.45(b)(4) was also

granted. PGW's request for waiver from providing the information required at 52 Pa. Code §§53.52 and 53.53 was denied.

On February 8, 2001, the Commission's Law Bureau and the City of Philadelphia filed a *Joint Petition for Full Settlement of Philadelphia Gas Works' Petition for the Establishment of Interim Rates and Related Appeal (Joint Petition)* to settle PGW's challenges to the Commission's Order entered November 22, 2000, in the interim base rate case filed by PGW on August 8, 2000. In that proceeding, PGW sought an immediate \$52 million base rate increase designed to provide it with increased revenues until it was able to make its permanent base rate filing in early 2001.

Concurrently, PGW filed a request to increase its gas cost rate (GCR) by \$97 million. The GCR case was litigated on the same expedited schedule as the interim rate case. During the GCR proceeding, PGW presented updated gas costs that increased its requested GCR increase to \$172 million. After analysis of all the positions presented, the Commission, on November 22, 2000, awarded PGW an interim rate increase of \$11 million. (*Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-00005654 (Order entered November 22, 2000)). In addition, the Commission entered an Order in the GCR proceeding which authorized an increase in PGW's GCR of \$97 million, the amount requested by PGW in its original filing. (*Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-00005619 (Order entered November 22, 2000)).

On December 29, 2000, PGW filed a quarterly update that increased its GCR, effective January 1, 2001, by \$133 million, in addition to the \$97 million already approved in the Commission's November 22, 2000 GCR Order. Subsequently, PGW filed a Petition for approval to file updates to its GCR on February 1, and March 1, 2001. In an Order entered January 24, 2001, the Commission authorized PGW to provide monthly updates to its GCR in February and March of 2001. (*Pa. P.U.C. v. Philadelphia*

Gas Works, Docket No. R-00005619 (Order entered January 24, 2001)). PGW has not filed any updates to increase its GCR since the January 1, 2001 increase.

Since PGW deemed the \$11 million interim base rate award to be inadequate, PGW appealed the Commission's decision in the Commonwealth Court of Pennsylvania. The Commission's Law Bureau and PGW settled the appeal allowing the \$11 million base rate increase to be implemented, as well as allowing recovery of \$7 million of bad debt expense through the GCR. Both of the increases were compressed so that the full \$18 million annual amount of the increase would be recovered by the end of PGW's current fiscal year on August 31, 2001.

The *Joint Petition* filed on February 8, 2001, allowed PGW to increase its base rates by \$11 million (the amount awarded by the Commission initially) and also allowed it to include in its GCR an additional \$7 million to account for bad debt expense. Furthermore, PGW was permitted to retain up to \$18 million in over-recovered gas cost revenues that would typically be returned to customers. The *Joint Petition* allowed such recovery and treatment from March 1 through August 31, 2001. PGW was required to withdraw its Petition for Review with the Commonwealth Court. The Commission adopted the *Joint Petition* without modification on February 22, 2001.

A Prehearing Conference in the instant case was held on February 23, 2001. In accordance with the schedule set forth during the Prehearing Conference, testimony was filed by PGW, the OTS, the OCA, the OSBA and PICGUG.

On March 12, 2001, the OCA filed a Motion to Dismiss Objections and Compel Answers to certain of its Interrogatories. PGW filed an Answer to the Motion to Compel on March 16, 2001. On March 20, 2001, CEPA *et al.* filed a Letter Memorandum in support of the OCA's Motion to Dismiss Objections and Compel Answers.

PGW filed a Motion in Limine on March 21, 2001. On March 22, 2001, CEPA *et al.* filed a Motion to Dismiss Objections and Compel Answers to certain of its Interrogatories. On March 28, 2001, PGW filed an Answer to the Motion.

Two Public Input Hearings were held in this matter on March 28, 2001, and an additional Public Input Hearing was held on March 29, 2001, in Philadelphia. On April 2, 2001, the OCA, the OTS, PICGUG and CEPA *et al.* filed Answers to the Motion in Limine.

On April 6, 2001, PGW filed its Reply to Answers to the Motion in Limine or, in the Alternative, Request for Leave to Respond and the Response to the Answers of PICGUG, CEPA *et al.*, the OTS and the OCA. On April 13, 2001, the ALJ issued Order No. 3 denying PGW's Motion in Limine.

Order No. 4, granting the OCA's Motion to Dismiss Objections and Compel Answers, was issued on April 17, 2001. Order No. 5, granting, in part, CEPA *et al.*'s Motion to Dismiss Objections and Compel Answers, was issued on April 19, 2001.

By Secretarial letter, dated April 24, 2001, the Commission appointed the Law Bureau to designate a Special Administrative Counsel to enter an appearance in the rate proceeding, and to offer the Management Audit Report of the Barrington-Wellesley Group, Inc. into the evidentiary record herein. On April 26, 2001, counsel from the Law Bureau entered his appearance as Administrative Counsel. On May 17, 2001, Administrative Counsel filed Administrative Counsel Statement 1, the testimony of Perry L. Wheaton, the managing director of the Barrington-Wellesley Group, Inc. (BWG). The Stratified Management and Operations Audit of PGW was marked Administrative Counsel Attachment 1.

By Order No. 6, dated May 7, 2001, the ALJ consolidated certain of the Complaints that had been filed herein with Docket Nos. R-00006042 and R-00006042C0001 through R-00006042C0171. Evidentiary hearings were held on May 22, 23, and 24, 2001 in Philadelphia. During the evidentiary hearings, certain statements and exhibits were entered into evidence.¹

On June 20, 2001, PGW filed a Motion to Reopen the Record to include PGW St. 2.2, the verified statement of Barbara C. Bisgaier and Exhibit BB-3, the Credit Agreement as amended and restated as of June 12, 2001 between the City of Philadelphia and First Union Bank, PNC Bank, The Bank of Nova Scotia, Mellon Bank and Morgan Guaranty Trust Company of New York. No Party objected to the Motion. By Order No. 8, dated June 22, 2001, the ALJ ordered that the record be reopened on June 26, 2001, to accept PGW St. 2.2 and Exhibit BB-3.

PGW, the OTS, the OCA, the OSBA, PICGUG and CEPA *et al.* filed Main Briefs on June 21, 2001. PGW, the OTS, the OCA, the OSBA, PICGUG and CEPA *et al.* filed Reply Briefs on June 29, 2001. The record consists of 890 pages of transcribed testimony, the statements and exhibits referred to above, six Main Briefs, and six Reply Briefs.

Exceptions and Reply Exceptions to the Recommended Decision were filed as above noted.

¹ See pages 6-7 of the Recommended Decision for a complete list of the statements and exhibits entered into evidence herein.

II. DISCUSSION

The ALJ's Recommended Decision was issued on August 7, 2001. The ALJ's Findings of Fact are found on pages 8-20 of the Recommended Decision. We shall adopt and incorporate herein by reference the ALJ's Findings of Fact to the extent that they are not expressly or by necessary implication overruled or modified by this Opinion and Order. Initially, we are reminded that we are not required to consider expressly or at great length each and every contention raised by a party to our proceedings. (*University of Pennsylvania, et al. V. Pennsylvania Public Utility Commission*, 86 Pa. Commw. 410, 485 A.2d 1217, 1222 (Pa. Cmwlth. 1984)). Any exception or argument that is not specifically addressed herein shall be deemed to have been duly considered and denied without further discussion.

A. Legal Standards

1. Section 2212(e) – Prior Ratemaking Methodology – Cash Flow Method

a. Position of the Parties

The ALJ stated that the Parties differ on their interpretation of Section 2212(e) of the Gas Choice Act² (the Act). The ALJ noted that PGW continues to interpret this Section to mean the Commission must fund the budget approved by the Philadelphia Gas Commission (PGC). (R.D., p. 22).

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

PGW argued that, under the Act, the Management Agreement commits the Commission to setting rates to meet all of PGW's identified needs, without the application of any ratemaking principles or law. (PGW M.B., p. 16). PGW asserted that the Commission must simply accept any determination of the PGC, which approves PGW's budgets under the Management Agreement, and implement rates to achieve the budget approved by the PGC, without regard to whether the rates are just and reasonable. (PGW M.B., pp. 12-13; R.D., p. 22).

OTS argued that the concept of "prior ratemaking method" referenced in the statute only distinguishes between the ratemaking concepts of PGW's "cash flow method" and the Commission's traditional investor-owned rate base/rate of return regulation. OTS submitted that Section 2212(e) of the Act only requires the Commission to follow PGW's prior ratemaking method of using the "cash flow method" in setting rates. It does not mean that all of PGW's expenses must be covered by rates. (R.D., p. 22; OTS R.B., pp. 9-10).

OCA submitted that PGW's interpretation of the Act is untenable and renders the Act meaningless. (OCA M.B., p. 13). OCA, along with OTS, CEPA *et al.* and PICGUG contended that, if the Commission's only function is to "rubber stamp" a budget approved by the Philadelphia Gas Commission, there was simply no point in bringing PGW under Commission jurisdiction to be "subject to regulation and control by the commission with the same force as if the service were rendered by a public utility." (OCA M.B., p. 14; R.D., p. 22).

OCA also argued that the Commission must harmonize and reconcile the Code with the ratemaking methodologies in place for PGW. OCA, along with the other parties, contends that the fundamental principle of the Code, which is also the fundamental principle applicable to PGW's ratemaking methodology, is that rates must be just and reasonable. (R.D., p. 24; OCA M.B., p. 16). OCA further argued that PGW's

definition of the cash flow method fails to recognize that the owner of PGW, the City, as well as the ratepayers are responsible for maintaining the utility's operations. (R.D., p. 26; OCA R.B., p. 4).

The other Parties, namely CEPA *et al.* and PICGUG, dismissed PGW's argument that the Commission can only mechanically apply the Management Agreement and "rubber stamp" the findings of the PGC. (R.D., p. 25). The Parties argued that the Commission cannot simply be required to add up all of the dollars that PGW chooses to spend and pass them on to ratepayers. The Commission must have the authority and discretion to consider PGW's claim and to apply fundamental principles of ratemaking and regulation to any claim of PGW. (R.D., p. 25; CEPA, et al. R.B., p. 3; PICGUG R.B., pp. 3-5).

b. ALJ's Recommendation

The ALJ concluded that the requirements in Section 2212(e) of the Act must be offset by the requirements in Section 1301 of the Code that the rates must be just and reasonable. (R.D., p. 109). The ALJ also stated that, pursuant to Section 2212(e) of the Act, the Commission is charged with establishing overall rates and charges for PGW. (*Id.*, p. 21).

c. Exceptions

PGW excepts to the ALJ's Recommended Decision because the ALJ did not explicitly state that the Commission should use the prior ratemaking methodology, *i.e.*, cash flow methodology, to determine the rates in this base rate proceeding. (PGW Exc., p. 6). PGW noted that the ALJ adopted the OTS' revenue requirement recommendation, which explicitly utilized the cash flow method. (*Id.*).

PGW also excepts to the Recommended Decision in stating that the ALJ ignored PGW's evidence that decisions by the PGC are the best source for determining what PGW's prior ratemaking method was and how it should be applied. (PGW Exc., p. 8). Instead, PGW states that the ALJ incorrectly relied upon a decision from a hearing examiner of the PGC and overlooked the most pertinent part of the decision which confirms PGW's prior ratemaking method setting rates to cover the expenses identified in the Management Agreement. (*Id.*, p. 9).

PGW further states, in its Replies to Exceptions, that the OCA refuses to acknowledge that the required method of setting a specific level of rates for the company is the Cash Flow Method. (PGW R. Exc., p. 2). PGW also states that the OCA's position is contrary to Section 2212(e) of the Act as well as the Commission's traditional application of its own "just and reasonable" ratemaking standard. (*Id.*, pp. 2-3).

Finally, PGW requests that the Commission should explicitly acknowledge that: (1) PGW's prior ratemaking requirement is that rates must be just and reasonable and the prior ratemaking method is the Cash Flow Method as described at Section VII of the Management Agreement; and (2) until all PGW's bonds are defeased, Section 2212(e) of the Code requires the Commission to set rates for PGW by following the Cash Flow Method and complying with Section VII of the Management Agreement. (PGW Exc., p. 9).

The OCA points out that neither the Management Agreement nor the case law cited by PGW provide for a mechanical application of the Cash Flow Method without regard to the just and reasonable standard. (OCA R. Exc., p. 9). However, the OCA submits that the ALJ did not err in her discussion of the appropriate ratemaking methodology, *i.e.*, the Cash Flow Method. (*Id.*, p. 11).

CEPA *et al.*, in its Replies to Exceptions, states that the term “cash flow methodology” does not appear in any statute nor has it been comprehensively defined. CEPA *et al.*, also states that PGW’s capitalization of the term or talismanic use of it does not make it a statutory term. (CEPA *et al.*, R.Exc., p. 5). In addition, CEPA *et al.*, disputes PGW’s claim that PGC decisions, from a time prior to the existence of PGW’s Tax Exempt Commercial Program, are the “best source” for determining what PGW’s prior ratemaking method is and how it should be applied. (*Id.*). Finally, CEPA *et al.* requests that the Commission not grant PGW’s requests to acknowledge the so-called Cash Flow Method. (*Id.*, p. 6).

d. Disposition

On July 1, 2000, the Commission assumed jurisdiction over the public utility services being furnished by PGW within the City of Philadelphia. (66 Pa. C.S. §2212). Prior to the passage of the Act, PGW’s rates, terms and conditions of service, were exempt from the jurisdiction, regulation and control of the Commission. Instead, PGW was regulated by the PGC, a local agency of the City of Philadelphia provided for by the Philadelphia Home Rule Charter §§3-100, 3-909 and 5-902, 351 Pa. Code §§3.3-100, 3.3-909 and 5.5-902.

Presently, pursuant to Section 2212(e) of the Act, the Commission is charged with establishing overall rates and charges for PGW in this base rate proceeding before us. (66 Pa. C.S. §2212(e)). Section 2212(e) directs the Commission as follows:

Notwithstanding any provision of this title to the contrary, in determining the city natural gas operation’s revenue requirement and approving overall rates and charges, the commission shall follow the same ratemaking methodology and requirements that were applicable to the city natural gas distribution operation prior to the assumption of jurisdiction by the commission, and such obligation shall continue until

the date on which all proved bonds have been retired, redeemed, advance refunded or otherwise defeased.

(66 Pa. C.S. §2212(e)).

In addition, the Commission is directed to permit the city natural gas distribution operation to impose, charge, or collect rates or charges to provide minimal debt service coverage. (*Id.*). Further, Section 2212(c) provides that the provisions of the Act shall apply to the public utility service of a city natural gas distribution operation with the same force as if the city natural gas distribution operation was a public utility under section 102. (66 Pa. C.S. §2212(c)).

Next, we must review the Management Agreement between PGW and the Philadelphia Facilities Management Corporation (PFMC) which was enacted in 1972 by the Philadelphia City Council to determine what ratemaking methodology or requirements, if any, exist in this Agreement. Section VII of that Agreement concerns rates and provides as follows:

1. The rates for gas shall be continued as they exist at the commencement of operations under this Agreement and shall be changed by the Gas Commission when necessary so that they will produce revenues sufficient for the following purposes:
 - (a) To pay all of the costs and expenses of conducting Gas Works enterprise, including, but not limited to:
 - (i) All expenses of operation and maintenance of the Gas Works.
 - (ii) Charges for depreciation as prescribed in Section IV 1.(b).
 - (iii) Charges for employees' retirement costs as prescribed in Section IV 1.(c).
 - (iv) A management fee to Company

equal to the actual cost to Company of managing the Gas Works but not to exceed \$200,000 annually. Gas Works shall make an initial payment to Company in the amount of \$25,000 on or before January 1, 1973. Gas Works shall thereafter reimburse Company against vouchers on the first day of each calendar month for monies expended for the operation of the Gas Works in the previous calendar month.

- (v) Expenses of the Gas Commission.
- (b) To make base payments to the City including additional payments at such times as conditions may warrant and as may be determined and agreed upon by the Gas Commission and City Council.
- (c) To provide appropriations for debt reduction and capital additions not otherwise provided which are determined by the Gas Commission to be reasonable and which are approved by City Council.
- (d) To provide reasonable additions to the working capital as may be determined by Company and approved by the Gas Commission.
- (e) Anything to the contrary herein contained notwithstanding, the Gas Works, as had been the custom under prior contracts, shall continue to pay out of its revenues all of these expenses set forth in this Subsection VII, and all other expenses necessary and proper to the operation of the Gas Works excepting only the Company's own personnel and administrative costs which are payable out of the management fee.

We note that PGW's Management Agreement sets forth specific categories of expenses and revenues that are to be included in PGW's rate setting process. The Commonwealth Court has determined that this Agreement specifies the cash flow method as the ratemaking formula for establishing PGW's rates. The Commonwealth Court in *Action Alliance v. Philadelphia Gas Commission*, 406 A.2d 1155, 1157 (Pa. Cmwlth. Ct. 1979) has deemed the above process of fixing rates as the cash flow method. Also, the Commonwealth Court accepted the cash flow method as set forth in Section VII of the Management Agreement as an acceptable ratemaking method for PGW at a time when PGW was not regulated by the Commission. (*Id.*, p. 1158).

Furthermore, the Pennsylvania Supreme Court recognized the state's discretion to decide what ratemaking methodology best balances the interest of the utility and the public. *Public Advocate v. Philadelphia Gas Commission*, 674 A.2d 1056 (1996). In this case, the Court discussed the value of using different ratemaking theories by utilities. The Court stated as follows:

When determining rates to charge its users, utilities are not bound to use any single formula or combination of formulae. Different ratemaking formulas are allowed since the designation of a single theory of ratemaking as a constitutional requirement would have the effect of depriving consumers and investors from benefiting from alternative rate methods. The Constitution leaves the states free to decide what ratemaking methodology best balances the interest of the utility and the public.

(*Public Advocate*, 674 A.2d at 1061 (Pa. Cmwlth. 1996) (citations omitted)).

Based upon our review of Section 2212 of the Act and relevant case law, we believe that the standard of review in this base rate proceeding is clear. Specifically, it is our intention to review and decide this base rate proceeding in accordance with all of our statutory mandates as the General Assembly directed in Section 2212(c) of the Act.

Thus, as previously stated in our February 8, 2001, Order, we are reviewing PGW's request before us in the context of the "just and reasonable standard," while fulfilling our statutory obligations set forth in Section 2212 of the Code.

For the purposes of this ratemaking issue, the General Assembly clearly directs the Commission, in Section 2212(e) of the Act, to set rates in a base rate proceeding for PGW in accordance with its previous ratemaking methodology and requirements rather than by other ratemaking methods traditionally employed in reviewing public utility rate filings. In this instance, the previous ratemaking methodology, as contained in PGW's Management Agreement and affirmed by the Pennsylvania courts, is the cash flow method.

By adopting this ratemaking methodology in accordance with Section 2212(e) of the Act, the Commission is simply utilizing a different methodology than the traditional rate base/rate of return regulation. At the same time, the adoption of this ratemaking methodology to set rates for PGW allows the Commission's other statutory directives, such as minimum debt service coverage and just and reasonable rates, to be fulfilled in accordance with Sections 1301 of the Code and 2212(c) of the Act.

As discussed below, in following the cash flow method, the Commission is free to examine PGW's rates under the just and reasonable standard. The Commission is not required to accept the level of expense claimed by PGW or approved in a PGW budget by the PGC. If PGW fails to prove that a given expense item was prudently incurred and reasonable in amount, the Commission will make an appropriate adjustment in its rates chargeable to customers.

Accordingly, this Commission must, and intends to, exercise its discretion to determine a just and reasonable level of rates for PGW while balancing the interests of PGW's customers, as it does in all other rate cases before us. Only through the exercise

of this authority is the Commission in conformity with all the provisions of the Code, namely Sections 1301 and 2212, and sound ratemaking principles.

2. Burden of Proof

a. Position of the Parties

The OCA emphasized that PGW has the burden of proving the justness and reasonableness of every element of its rate increase request. (OCA M. B., p. 11). The OCA argued that Section 315 of the Code places the burden of proof upon the public utility to “show that the rate involved is just and reasonable.” (66 Pa. C.S. §315(a); OCA M.B., p. 11). Also, the OCA further pointed out that the Commonwealth Court has interpreted Section 315(a) to place the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility.³ (OCA M.B., p. 11).

The OCA submitted that it remains incumbent upon PGW to affirmatively demonstrate the reasonableness of every element of its claim and to demonstrate that its rates are just and reasonable. (*Id.*, p. 12). The OCA, the OTS, PICGUG, and CEPA, *et al.*, contend that PGW failed to satisfy the burden of proving that it is entitled to a rate increase of \$65 million. (OCA M.B., p. 1 *et seq.*; OTS M.B., p. 65, App. C; PICGUG R.B., pp. 3-8; CEPA *et al.*, M.B., p. 11).

b. ALJ’s Recommendation

The ALJ concluded that the utility requesting the rate increase has the burden of proving that the rate involved is just and reasonable. (R.D., p. 109). The ALJ

³ *Lower Frederick Township v. Pa. PUC*, 48 Pa. Commw. Ct. 222,226-27, 409 A.2d 505, 507 (Pa. Cmwlth. 1980). *See also, Brockway Glass v. Pa. PUC*, 63 Pa. Commw. Ct. 238, 437 A.2d 1067 (Pa. Cmwlth. 1981).

relied on Section 315(a) of the Code to reach this conclusion. (R.D., p. 31). As noted by the ALJ, Section 315(a) provides as follows:

Reasonableness of rates – In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility. 66 Pa.C.S. §315(a).

In addition, the ALJ relied upon case law to support her conclusion. As cited by the ALJ, it is long standing precedent that not only does the utility have the burden of proving the justness and reasonableness of a proposed rate hike but the evidence adduced by a utility to meet this burden must be substantial.⁴ (R.D., p. 31). Also, the ALJ noted that the Pennsylvania Supreme Court has clearly stated that the party with the burden of proof has a formidable task before its position can be adopted by the Commission. (*Id.*). The ALJ stated that even where a party has established a *prima facie* case, the litigant still must establish that “the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, *precluding all reasonable inferences to the contrary.*” (*Burleson v. Pa.P.U.C.*, 436; 461 A.2d 1234, 1236 (Pa. Cmwlth. 1983) (emphasis added). (R. D., pp. 32-33).

The ALJ also stated that it is well settled at the Commission and in the Courts that this burden does not shift to intervenors challenging a requested rate increase. (R.D., p. 32). The utility’s burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one. (*Id.*). The ALJ also concluded

⁴ *Id.*

that no similar burden is placed on an intervenor to justify a proposed adjustment to PGW's filing.⁵

The ALJ also noted that this standard has been recognized by the Commission in its rate determinations. (R.D., p. 32). In *Pa.P.U.C. v. Equitable Gas Co.*, 57 Pa. P.U.C. 423, 471(1983), the Commission determined that Equitable has the burden of persuasion on the issue of the reasonableness of an expense level. Also, in that same case, the Commission found that Equitable "must affirmatively establish, on the record, that the test year claim is a reasonable and appropriate amount." (*Id.*; *See also*, *University of Pennsylvania v. Pa. P.U.C.*, 410, 485 A.2d 1217 (Pa. Cmwlth. 1984); R.D., p. 32).

c. Exceptions

No party excepted to this recommendation by the ALJ.

d. Disposition

As stated previously, the Commission fully intends to abide by all of its statutory directives as set forth in the Code. Section 315 (a) of the Code, 66 Pa. C.S. §315(a), is clear that PGW bears the burden of proof in this base rate proceeding. Also, the Pennsylvania Courts and our previous rate determinations require that PGW demonstrate by substantial evidence that its overall rates be increased. Moreover, as to

⁵ The Pennsylvania Supreme Court has stated:

[T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations and that is the burden which the utility patently failed to carry.

(*Berner v. Pa. PUC*, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955)).

individual expense items, PGW bears the burden of proving that the expense item is prudently incurred and reasonable in amount.

3. Rates Must be Just and Reasonable

a. Position of the Parties

PGW argued that the rates set pursuant to Section VII of the City Ordinance are presumed to be just and reasonable and lawful. (PGW M.B., p. 16). PGW relied upon previous PGC decisions and state court cases to establish the overall rate-making requirement applicable to PGW that its rates must be just and reasonable. (*Id.*, p. 12). PGW also submitted that the PGC, in the past, has given effect to the overall just and reasonable requirement by determining the appropriate level of PGW's individual revenue and expense claims within a "zone of reasonableness." (*Id.*, p. 14).

The OCA submitted that the Act should be read giving meaning to all its provisions as well as the Code. The OCA contended that the task for the Commission is to harmonize and to reconcile the Code with the ratemaking methodologies in place for PGW. (OCA M.B., p. 15). First, the OCA submitted that 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. (OCA R.B., p. 4; 66 Pa.C.S. §2212(b)). Second, the OCA contended that the fundamental principle of the Code, which is also the fundamental principle applicable to PGW's ratemaking methodology, is that rates must be just and reasonable. (*Id.*). The OCA relied upon the Pennsylvania Supreme Court's holding in *Public Advocate v. Philadelphia Gas Commission*, 544 Pa. 129, 674 A.2d 1056 (1996) which applies the just and reasonable standard to the rates of PGW in a previous rate proceeding.

The ALJ stated that both the OCA and PICGUG submit that the requirements in Section 2212(e) must be offset by the requirements in Section 1301 that rates must be just and reasonable. (R.D., p. 33; OCA M.B., pp. 13-17); PICGUG R.B., p. 4). PICGUG argued that the Commission must determine that any rate increase granted to PGW, regardless of the results of the Cash Flow Methodology, will result in just and reasonable rates. (PICGUG R.B., p. 4). In addition, CEPA *et al.*, argued that the just and reasonable standard has long been recognized as the paramount standard in setting PGW's rates under the Management Agreement. (CEPA *et al.*, M.B., p. 8). CEPA *et al.*, further stated that, in general, ratemaking by the Commission has been subject to the constitutional requirement that rates be just and reasonable. (*Id.*).

b. ALJ Recommendation

The ALJ concluded that, regardless of the method used, PGW's rates must be just and reasonable. (R.D., p. 109). The ALJ also concluded that the requirements in Section 2212(e) of the Act must be offset by the requirements in Section 1301 of the Code that the rates must be just and reasonable.⁶ (*Id.*).

The ALJ cited the PGC presiding officer's April 13, 2001, Order to further support the conclusion that clearly rates must be just and reasonable for PGW. The presiding officer stated as follows:

A careful review of Action Alliance, *supra*, reveals that although the Commonwealth Court described the process of fixing rates for PGW as the cash flow method, the Court states that "[t]he parties all agree that the rates for gas services in Philadelphia must be just and reasonable." 406 A.2d at 1156-58...The Court remanded the matter to the

⁶ The ALJ cited two fundamental ratemaking cases to support the application of the just and reasonable standard to this base rate proceeding. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 607 (1944); *Public Advocate v. Philadelphia Gas Commission.*, 544 Pa. 129, 674 A.2d 1056 (1996).

PGC for preparation of an adjudication explaining why the proposed rates were just and reasonable.

In Public Advocate v. Philadelphia Gas Commission, *supra*, the Pennsylvania Supreme Court referred to the constitutional requirement of “just and reasonable” rates set forth in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607 (1944). The Court held “that the United States Court guidelines for determining the constitutionality of a rate are also applicable to examining rate disputes involving municipal utilities.” 674 A.2d at 1062.

Furthermore, the Commission’s February 8, 2001 Order in this proceeding indicates that the lawfulness, justness and reasonableness of the rates will be investigated (Order, p. 11, Ordering Paras. 1, 3).

...Consequently, the PUC should not rubberstamp the proposed rate increase. It is noted that the rate increase is based on a budget that has been submitted to but not approved by the PGC. Therefore, the record must contain information to allow the PUC to determine whether the rates are just and reasonable. Order #3, pp. 16, 17.

(R.D., p. 34).

Based on the PGC presiding officer’s reasoning, the ALJ concluded that it is clear that the rates determined in this proceeding must be just and reasonable. (*Id.*).

c. Exceptions

PGW excepts to the ALJ’s recommendation that Section 2212(e) is offset by Section 1301 of the Code. (PGW Exc., p. 10). PGW argues that the requirements of Section 2212(e) are paramount to any other provisions of the Code because of the phrase “notwithstanding any other provision of this title to the contrary.” (*Id.*, p. 11). PGW also argues that the ALJ failed to correctly cite the Pennsylvania Supreme Court’s decision in *Public Advocate* for the proposition that the rates set by the Management Agreement

Ordinance and its mandated Cash Flow Method for setting rates are presumed constitutional and just and reasonable. (*Id.*). Thus, PGW requests that the Commission reject the ALJ's Conclusions of Law numbers 4 and 5 and find that the rates set by the Cash Flow Method in Section VII of the Management Agreement Ordinance are presumed just and reasonable. (*Id.*, p. 12).

PGW also excepts to the ALJ's assertion that PGW's position is that the Commission must set rates pursuant to the Management Agreement Ordinance, and the Cash Flow method detailed therein, "without the application of any ratemaking principles or Law" and "without regard to whether the rates are just and reasonable." (PGW Exc., p. 8). PGW contends that it never made such an argument. Rather, PGW's position is that those principles and legal requirements, such as the just and reasonable requirement, are satisfied when the Commission utilizes the cash flow method in the Management Agreement to set rates. (*Id.*). PGW also clarifies that it never argued that the just and reasonable requirement did not apply to PGW rate setting or that the Commission was precluded from finding that specific elements of PGW's request were not just and reasonable. (*Id.*, p. 6).

OCA contends that the ALJ correctly finds that PGW's rates must be just and reasonable. (OCA Exc., p. 11). Also, the OCA asserts that the ALJ correctly determined, in concluding that PGW's rates are just and reasonable, that the interest of the ratepayers must be balanced against PGW's financial needs. (*Id.*; R.D., p. 35). In performing this balance, the OCA submits that the Commission must consider the quality of service being provided by the utility. (*Id.*, p. 12). OCA further submits that its proposed rate increase of \$10.5 million over and above the \$11 million interim rate increase strikes the appropriate balance and produces just and reasonable rates. (*Id.*).

The OCA, in its Reply Exceptions, further states that the ALJ correctly recognized that PGW's interpretation of Section 2212(e) of the Act reduces the

Commission to simply rubber stamping what PGW has requested or what the PGC has approved. (OCA R. Exc., p. 4). OCA submits that this result would render the Act meaningless. (*Id.*). OCA also submits that the Commission should simply state that rates for PGW must be just and reasonable in accordance with Section 1301 and other relevant sections of the Code. (*Id.*, p. 5).

PICGUG also states that the ALJ correctly finds that the requirements of Section 2212(e) of the Act must be offset by the requirements of Section 1301 of the Code. (PICGUG R. Exc., p. 22). PICGUG states that, regardless of the methodology used, any rate increase provided to PGW must be just and reasonable. (*Id.*).

CEPA *et al* submits that the ultimate test of the validity of a rate set for PGW is whether the rate is just and reasonable. (CEPA *et al.*, Exc., p. 4). CEPA *et al.*, explains that this constitutional standard provides wide discretion to the regulatory commission to set rates within a “zone of reasonableness” through a process, which balances the interests of customers and the interests of a utility. (*Id.*) CEPA *et al.*, also explains that part of this standard involves an appraisal by the regulator of the level of customer service provided by a utility, as well as the effectiveness of its management. (*Id.*). Thus, CEPA *et al.* argues that the Commission has the authority to modify or ignore rates proposed by PGW on the grounds that another result would be more reasonable and in accordance with the just and reasonable standard. (*Id.*, p. 5).

In its Reply Exceptions, CEPA *et al* states that PGW has attempted to narrow the Commission’s range of inquiry through this base rate proceeding. CEPA *et al.*, submits that the Pennsylvania Supreme Court defined the discretion of the regulatory body to set rates within a “zone of reasonableness” through a process which

balances the interest of customers and the interests of the utility.⁷ (CEPA *et al.*, R. Exc., p. 4).

d. Disposition

As we have stated in numerous rate proceedings and as affirmed by the Pennsylvania Courts, the fundamental principle of public utility regulation that applies to all jurisdictional utilities is that rates must be just and reasonable. (66 Pa.C.S. §1301). Under Section 1301, the Commission is directed to find that “every rate made, demanded or received by any public utility shall be just and reasonable, and in conformity with regulations and orders of the commission.” (*Id.*). Since the General Assembly was clear in placing PGW squarely under the jurisdiction of this Commission, the additional legislative mandates set forth in the Code, *i.e.*, Section 1301, also apply to PGW.⁸

Examination of the provisions of Section 2212 indicates that the General Assembly intended that other sections of the Code apply to PGW. First, the Legislature is clear in its intention that “a city natural gas distribution operation within its municipal limits shall be subject to regulation and control by the commission with the same force as if the service were rendered by a public utility.” (66 Pa. C.S. §2212(b)). Even more compelling is the legislative language of Section 2212(c) which states that “...the provisions of this title, other than Chapter 11, 19 and 21 shall apply to the public utility service of a city natural gas distribution operation with the same force as if the city natural gas distribution operation was a public utility under Section 102...” We note that the Legislature excluded certain chapters from applying to PGW but one of those exclusions is not Chapter 13, the just and reasonable rates provision. Thus, we believe

⁷ CEPA *et al.* cites to *Public Advocate v. Philadelphia Gas Commission*, 544 Pa. 129, 674 A.2d 1056 (1996) and states that the ultimate test of the validity of a rate set for PGW is whether in impact and effect, the rate is just and reasonable. (CEPA *et al.*, Exc., p. 4).

⁸ 66 Pa. C.S. §§ 102, 2212 *et seq.*

that our legislative mandate to scrutinize PGW's rates by the just and reasonable standard in Section 1301 of the Code is clear.

This requirement that PGW's rates must be just and reasonable has been affirmed by the Pennsylvania Courts even at the time that PGW was regulated by the PGC. (See, *Action Alliance v. Philadelphia Gas Comm'n*, 406 A.2d 1155, 1158 (Pa. Cmwlth. 1979) and *Public Advocate v. Philadelphia Gas Commission*, 674 A.2d 1056 (Pa. Cmwlth. 1996) (*Public Advocate*)). Further, 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.*, p. 1061). The Pennsylvania Supreme Court also held:

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. See also, *American Aniline Products v. Lock Haven*, 135 A.2d 726,727 (Pa. Cmwlth. 1927)).

Accordingly, the “just and reasonable” standard in Section 1301 is coextensive with the federal constitutional standard for determining utility rates.

The Commission further points out that the reasonable standard has always applied to PGW. Even when PGW was under the jurisdiction of the PGC for ratemaking purposes, the PGC always determined a zone of reasonable revenues and expenses and balanced the interest of both customers and PGW. (PGW M.B., p. 14, fn. 34; See also, *Action Alliance v. Philadelphia Gas Comm'n*, 406 A.2d 1155, 1158 (Pa. Cmwlth. 1979)).

Also, we must point out that 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)).

Thus, we conclude, as we did previously in our February 8, 2001, Order, that the basic and fundamental principle of just and reasonable rates must be applied to PGW.

In applying this standard, the Commission has the discretion to determine the prudent and reasonable levels of PGW's various categories of expenses and revenues, including the PGW's cash requirements. Section VII of the *Management Agreement* permits PGW to identify costs and expenditures for which it can seek approval to include in its base rates. However, the *Management Agreement* does not specify the treatment of any particular dollar expenditures or identify any specific cash requirement for PGW. Rather, it is squarely within the authority of the Commission *via* the Code to determine whether particular expenses and revenues are reasonable, prudent or properly included in PGW's rates.

Thus, we must determine the reasonable level of revenues and expenses, including a reasonable amount of cash requirement, and balance the interests of customers and PGW in this base rate proceeding to fulfill our statutory mandates under the Code. The Commission is not required to accept the level of expense claimed by PGW or approved in a PGW budget by the PGC. The Commission must, and intends to, exercise its discretion to determine a just and reasonable level of rates for PGW while balancing the interests of the company's customers as we do in all other rate cases before us. Only through the exercise of this authority is the Commission in conformity with all

the provisions of the Code, namely Sections 1301 and 2212, and sound ratemaking principles.

Thus, as stated previously, this Commission applies the ratemaking formula known as the Cash Flow Method to calculate the rates for PGW. In using that formula, we further analyze PGW's rates to determine if they are just and reasonable in accordance with our statutory directives set forth by the Legislature in the Code.

4. There is no Presumption that Rates Set Pursuant to the Management Agreement/ Cash Flow Method are Just and Reasonable

a. Position of the Parties

PGW contended that the rates established pursuant to the Management Agreement and the Cash Flow Method are presumed to be just and reasonable. (PGW M.B., p. 16). PGW also argued that, since rates set pursuant to Section VII of the Management Agreement are presumed just and reasonable, the ratemaking standard in Section 2212(e) of the Act is satisfied. (*Id.*).

PICGUG dismissed PGW's assertion that rates are presumed to be just and reasonable if they are established pursuant to the Management Agreement/Cash Flow Method. (PICGUG R.B., pp. 3-5).

b. ALJ Recommendation

The ALJ also dismissed PGW's argument that rates established pursuant to the Management Agreement and the Cash Flow Method are presumed just and reasonable. (R.D., p. 34). Rather, the ALJ recommended that the Commission determine whether the rates set for PGW are just and reasonable. (*Id.*, p. 35). The ALJ relied on

Pennsylvania case law which clearly holds that there must be a determination that PGW's rates are just and reasonable.⁹ (*Id.*, p. 34).

At the same time, the ALJ also rejected PGW's argument that the Black and Veatch Engineering Report proves that it needs at least \$53 million in rate relief. (R.D., p. 34). Again, the ALJ reasoned that the Commission does not set rates based on engineering reports, rather, the Commission must determine whether PGW's rates are just and reasonable. (*Id.*, p. 35).

c. Exceptions

PGW excepts to the Recommended Decision by stating that the ALJ erred in concluding that no presumption exists that rates set pursuant to the Management Agreement's Cash Flow Method are just and reasonable. (PGW Exc., p. 10). PGW states that the ALJ ignored the Pennsylvania Supreme Court case which holds that rates set by the Management Agreement Ordinance and its mandated Cash Flow Method are presumed constitutional and just and reasonable.¹⁰ (*Id.*, p. 11). PGW requests that the Commission reject the ALJ's Conclusions of Law Numbers 4 and 5 and find that the rates set pursuant to the Management Agreement's Cash Flow Method are just and reasonable. (*Id.*, p. 12).

The OCA and PICGUG, in their Reply Exceptions, rejoin that the ALJ correctly found that Section 1301 of the Code must be applied to PGW's claim. (OCA R.Exc., p. 4; PICGUG R.Exc., p. 23). In addition, the OCA points out that the Supreme Court's analysis in *Public Advocate*, 674 A.2d at 1062, demonstrates that the Commission must exercise its discretion to determine a level of rates that is just and reasonable. Thus, the OCA submits that the Court does not presume that the

⁹ *Action Alliance*, 406 A.2d 1155, 1158 (Pa. Cmwlth. Ct. 1979).

¹⁰ *Public Advocate*, 674 A. 2d at 1061.

Management Agreement produces just and reasonable rates as argued by PGW. (OCA R.Exc., p. 8).

CEPA *et al.*, submits also that PGW's citation of the *Public Advocate*¹¹ case does not support PGW's position that rates are presumed to be just and reasonable. (CEPA *et al.*, R. Exc., p. 8). Rather, CEPA *et al.*, submits that this same case holds that the properly enacted ordinance and the rates set in accordance with that ordinance have the presumption of constitutionality, not just and reasonableness. (*Id.*, p. 9). CEPA *et al.*, states that PGW is misleading by excluding the additional and all important analysis conducted by the court – whether the overall rate is just and reasonable. (*Id.*).

d. Disposition

We conclude that there is no presumption that, if PGW's rates were set pursuant to the Management Agreement/Cash Flow Method, the rates would be just and reasonable as prescribed in Section 1301 of the Code. As stated previously, we must determine a reasonable level of rates for PGW, based on our review of their underlying expense components, while balancing the interests of its customers and PGW in this base rate proceeding to fulfill our statutory mandates under the Code.

5. PGW's \$18 Million Payment to the City of Philadelphia

a. Position of the Parties

PGW's position is that the Management Agreement and Section 2212(f) of the Act requires it to make the annual \$18 million payment to the City of Philadelphia. 66 Pa. C. S. §2212(f); PGW R.B. at 13-14; R.D. at 27. The City and PGW contend that PGW's access to tax exempt bonds and its exemption from various federal, state and

¹¹ 674 A. 2d at 1056, 1061.

local taxes and fees justify the payment. (PGW M.B., p. 4; R.D., p. 27). Additionally, PGW cites *Public Advocate v. Philadelphia Gas Commission*, 654 A. 2d 1156, 1159-60 (Pa. 1996) to support its position that the Pennsylvania Supreme Court has ruled that the \$18 million payment to the City is just and reasonable. (PGW M.B., p. 12).

CEPA *et al.* and PICGUG contend that, by systematically refusing to consider a waiver or grant back of the City payment, the City has failed to fully recognize and accept its ownership responsibilities and its accountability for PGW's present financial and operational circumstances. Under the circumstances, CEPA *et al.*, argues that the refusal to commit to an outright waiver or "grant back" of the \$18 million is unreasonable. (CEPA *et al.*, M.B., pp. 32-34). CEPA *et al.*, also argues that the Commission can order waiver of the \$18 million or grant back of that amount because it is not precluded under the law as applied to the circumstances of this case. (*Id.*).

The ALJ noted that the appropriateness of such a waiver or grant back is recognized even by those who have not actually recommended ordering such action. (R.D., p. 28; OCA R.B., p. 10). 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 payment to provide the necessary cash flow which OCA believes is permitted by the Management Agreement. (*Id.*). The OCA clarified its position that the City payment is not to be used to meet the bond coverage requirement or the debt service coverage requirements of the bonds. (*Id.*).

Thus, CEPA *et al.*, OCA and PICGUG urge the Commission to deny any base rate increase pending commitment by the City to waive or grant back the \$18 million payment. (CEPA *et al.* M.B., pp. 32-34; OCA M.B., pp. 22, 26; PICGUG M.B., pp. 24-25). PICGUG also submits that, as owner of PGW, the City should shoulder the responsibility for the fiscal mismanagement that has taken place over several years and

agree to waive or grant back PGW's annual \$18 million payment to the City. (PICGUG M.B., pp. 24-25; PICGUG R.B., p. 8).

b. ALJ's Recommendation

The ALJ recommended that the Parties' requests for the Commission to require the City to waive the \$18 million payment should be rejected. (R.D., p. 28). The ALJ based her recommendation on the evidence in the record and applicable case law, which demonstrate that the PGW receives benefits from the City which exceed \$18 million due to its status as a municipal utility. (*Id.*).

In addition, the ALJ noted that the City continues to have the option to grant the \$18 million payment back to PGW. (*Id.*). However, since the City has not agreed to exercise the option, the \$18 million grant should not be considered when calculating the amount PGW can use to pay its expenses. (*Id.*, pp. 28-29).

c. Exceptions

In its Exceptions, CEPA *et al.* submits that the Commission should deny PGW's request for an increase in base rates until it establishes the condition precedent that the City of Philadelphia commit to waive or grant back the \$18 million payment. CEPA *et al.*, submits that this action is squarely within the Commission's authority under the Code to grant just and reasonable rates. (CEPA *et al.*, Exc., pp. 5-6). Thus, CEPA *et al.*, disagrees with the ALJ's rejection of this condition and views it as a misapplication of law. In addition, CEPA *et al.*, contends that the ALJ's reasoning that this payment is commonplace for municipal utilities is an error of law. (*Id.*, p. 6).

PGW, in its Replies to Exceptions, states that CEPA *et al.*, and OCA are incorrect in their view that the Commission could legally condition PGW's rate increase on a grant back or waiver of the payment to the City. (PGW R. Exc., p. 19). First, PGW

argues that Section 2212(f) of the Act requires the Commission to set rates to permit PGW to pay the City its annual payment of \$18 million. (*Id.*) Second, PGW submits that the Pennsylvania Supreme Court has previously decided the constitutionality of PGW's annual \$18 million City payment in the affirmative.¹² (*Id.*, p. 20). Third, PGW contends that CEPA *et al.*'s position can only be achieved if the Commission determines that Section 2212(f) is unconstitutional which is a function beyond the Commission's authority. Finally, PGW submits that the evidence in the record, *i.e.*, the Commission directed audit, supports the contested payment. (*Id.*).

CEPA *et al.* also contends that the ALJ misses the point when the Recommended Decision suggests that the \$18 million is justifiable on the grounds that PGW receives benefits due to its municipal status greater than \$18 million annually. (*Id.*, p. 8). CEPA *et al.*, submits that the ALJ ignores the record evidence of gross mismanagement and inadequate service. (*Id.*).

In its Reply to Exceptions, CEPA *et al.* questions what PGW's \$18 million payment to the City represents – a licensing fee, dividend or payment in lieu of taxes. CEPA *et al.*, also submits that there is no merit to the argument that the \$18 million represents a payment to PGW customers as citizens of the City. (CEPA *et al.*, R.Exc., p. 2). CEPA *et al.*, again argues that it is sound public policy for the Commission to invite the City to accept substantial financial responsibility before providing increased base rates so that the incentives of better future management and customer benefits of municipal ownership are achieved. (*Id.*, p. 3).

The OCA, in its Replies to Exceptions, clarifies that its level of rate increase for PGW allows PGW to make its \$18 million payment to the City. (OCA R.Exc., p. 5).

¹² *Public Advocate v. Philadelphia Gas Commission*, 674 A.2d 1156, 1159-60 (Pa. 1996).

d. Disposition

Section 2212(f) of the Act provides direction to the Commission regarding PGW's obligation to meet the \$18 million payment to the City. Section 2212(f) provides as follows:

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

(66 Pa. C.S. §2212(f)).

Section 2212(f) also provides some discretion to the Commission concerning the City payment but under limited circumstances. The Commission is permitted to review and approve only that portion of the City payment that exceeds 110% of the amount authorized. (66 Pa. C.S. §2212(f)).

Also, the Pennsylvania Supreme Court has ruled on whether the \$18 million payment to the City, as required by a 1972 City Ordinance, is constitutional and can be included in the calculation of a PGW rate increase. The Supreme Court concluded that there is no dispute that the 1972 Ordinance in question was properly enacted by City Council. Thus, the Court held that it is presumed that rates set in accordance with the 1972 City Ordinance, which includes the fixed annual payment in dispute, are constitutional. (*Public Advocate v. Philadelphia Gas Commission*, 674 A.2d 1056, 1061 (Pa. Cmwlth. 1996)). In addition, the Supreme Court also determined that the \$18 million payment by PGW to the City represented approximately a nine percent rate

of return on equity in the 1991-92 rate case decided by the PGC. The Court thus concluded that “such a rate of return is reasonable and rationally related to the City’s asserted equity in PGW.” (*Id.*, p. 1062).

The Commission must abide by its statutory directives as stated by the General Assembly. Concerning the City payment, the Legislature sets forth the Commission’s authority concerning the transfer or payment of \$18 million by PGW to the City. As stated above, Section 2212(f) of the Act directs the Commission to set rates to permit PGW to meet its \$18 million City payment. At the same time, Section 2212 (f) does not grant the authority to the Commission to order the City to waive or grant back the \$18 million payment. We believe that such condition, as advocated by several Parties, clearly is not within the Commission’s authority under the Act.

However, we urge the City of Philadelphia, as owner of PGW, to continue to take measures to insure the financial health of PGW. It is the expectation of this Commission that the City of Philadelphia, as owner of PGW, continue to assist PGW in its cash flow requirements so that a financial crisis does not take place. One way of insuring PGW’s overall financial health is to grant back or waive, in part or in total, the City payment when necessary. We hope that the City of Philadelphia will be as diligent in its concern for the financial health of PGW as the Commission is in granting the rate relief described herein.

In addition, we are guided by the Pennsylvania Supreme Court’s review of this payment when PGW was under the jurisdiction of the PGC. The Pennsylvania Supreme Court already concluded that the payment from PGW to the City is constitutional and reasonable since it is in compliance with a properly adopted city

ordinance. Also, this same Court recognized that this payment is rationally related to the City's asserted equity in PGW.¹³

Thus, we conclude that PGW's payment of \$18 million to the City of Philadelphia should be included in its rates requested in this proceeding.

B. Revenue Requirement

1. Introduction

PGW stated that the test year revenues were calculated on a fully normalized basis using PGW's most current thirty-year average degree-day count. PGW's resulting sales levels, at proposed rates, were projected using PGW's standard forecasting model to estimate usage per customer. The forecasting model calculated the relationship between degree-days and usage per customer using historic (pre-2000) customer data, due to the lack of accurate year 2000 ancillary customer usage information. To be consistent with the data used to forecast usage, PGW initially used the pre-2000 customer counts to estimate customer charge revenues. PGW's witness reviewed the historical customer counts and concluded that the most recent customer count data for March 2001, more accurately identified the number of meters that should be billed a customer charge and thus was a more accurate basis for calculating normalized Test Year revenues for the customer charge portion of the rates. Using the revised customer counts would result in *pro forma* increases in PGW's customer charges. (R.D., p. 36).

PGW submitted that it is not subject to a "rate of return/rate base" method of calculating revenue requirement, but noted that its annual Budget/Test Year includes

¹³ *Public Advocate v. Philadelphia Gas Commission*, 674 A.2d 1056, 1062-3 (Pa. 1996).

projections of construction expenditures based upon its approved FY 2001 construction budget. Additionally, PGW's fully forecasted Budget/Test Year assumed that it would successfully issue \$75 million in new, long-term debt in the May-June time frame to fund construction projects over the next several years. The PGW witness explained that, in addition to enabling these projects to go forward, the new debt was also used to reimburse PGW for construction projects that had already been undertaken and financed from operating funds in the FY 2001. As a result, the reimbursements for past construction would allow it to replenish its operating working capital. PGW's FY 2001 cash flow projection included the maximum amount it was able to include from the Construction Fund in FY 2001 regardless of the total amount of the bond that is issued. (*Id.*).

In its January filing, PGW updated its initial FY 2001 budget to account for the following:

- a) Gas Costs – PGW increased the level of natural gas expense \$150 million over the original Budget/Test Year level.
- b) Bad Debt Expense – PGW projected that the expense would be \$65.3 million in 2001. In light of this projected increase, PGW increased its revenue requirement from its \$52 million request to the \$65 million.
- c) Cash Working Capital – PGW projected its cash working capital requirement for the test year at \$65 million. (R.D., pp. 37-38).

PGW maintained that the proposed \$65 million increase is projected to produce approximately \$34 million in net income and to produce debt service coverage for the more demanding of its debt service coverage requirements, as reflected in its

1975 Bond Ordinance. PGW claimed that while these coverages are higher than the "minimum" required amount (1.5x), these additional amounts are necessary to provide a margin of error as well as to provide the cash working capital that PGW needs to pay its bills. (R.D., p. 39).

2. Recommended Revenue Requirement

a. Position of the Parties

The OTS recommended that PGW receive \$33 million increase in addition to the \$11 million interim rate relief. (OTS St. 1, p. 3; OTS Ex. 1, Schedule 1; OTS M.B., pp. 39-41).

The OCA recommended that PGW receive \$21.5 million in annual revenues including the \$11 million interim rate increase in place. (OCA St. 1.0, p. 10). This is an increase of \$22,176,566 for the full tariff revenue requirement. (OCA M.B. 48; OCA Ex. 2-B Table REM-2).

CEPA *et al.*, objected to any rate increase since it concluded that PGW is not providing adequate, efficient and reasonable service. (CEPA *et al.*, M.B., pp. 7-12).

PICGUG claimed that PGW should realize that requiring customers to pay higher rates without providing better service does not satisfy the Code's requirements of "just and reasonable rates." (PICGUG R.B., p. 6).

b. ALJ Recommendation

The ALJ recommended that the Commission approve the OTS' recommendation for a \$33 million increase in addition to the \$11 million interim rate increase.

The ALJ noted that, although there are service problems, the entire rate increase should not be denied pending resolution of the problems. The ALJ concluded that in light of the prior rate relief in March 2001, the \$33 million is a reasonable revenue increase. (R.D., p. 69).

c. Exceptions

CEPA *et al.*, excepts to the ALJ's recommendation that PGW be "authorized to file a Tariff supplement designed to produce \$33 million in additional revenue in addition to the \$11 million interim relief implemented in March 2001." CEPA *et al.*, argue that the recommendation is contrary to law, because the ratemaker must take adequacy of service into account when applying the "just and reasonable" standard to a rate increase request. (CEPA *et al.*, Exc., p. 3). Furthermore, CEPA *et al.*, argues that the ALJ's failure to make a Finding of Fact concerning the inadequacy of PGW's service is contrary to the weight of the evidence. CEPA *et al.*, submit that no weight was given in the Recommended Decision to the inadequacy of service. (CEPA *et al.*, Exc., p. 5).

PICGUG submits that the ALJ correctly concluded that PGW's fiscal needs will be met with a \$33 million revenue increase because PGW has failed to provide any substantive evidence that would justify its requested rate increase. As such, PGW has failed to provide any arguments that would negate the ALJ's well-reasoned recommendation to grant PGW a \$33 million revenue increase. (PICGUG R.Exc., pp. 23-24).

The OCA also excepts to the ALJ's recommendation that the Commission adopt a proposed revenue requirement increase of \$33 million over existing rates. Furthermore, the OCA opines that PGW is entitled to a revenue increase of no more than \$10.5 million over the current interim rate increase of \$11 million (\$21.5 million total base rate increase from last year at this time). (OCA Exc., p. 4; R.Exc., p. 17).

PGW avers that the ALJ erred in calculating and adopting the revenue requirement recommended by the OTS which requires a rate increase that is actually \$2.1 million higher than the cited \$33 million. The ALJ explicitly recommends that the Commission approve the OTS' recommendation for a \$33 million increase in rates in addition to the \$11 million interim rate increase presently in effect. PGW notes that the OTS' recommendation was derived by starting with PGW's proposed \$65 million rate increase proposal and subtracting its various expense adjustments. However, the result of subtracting each of the OTS' expense adjustments from PGW's proposed \$65 million increase is a \$35.1 million increase in rates, in addition to the \$11 million interim relief, not a \$33 million increase as recommended by the ALJ.

The following calculations, by PGW, demonstrate this \$2.1 million error:

<u>Expense Adjustment</u>	<u>PGW proposed \$65 million</u>
Net decrease from increased customer counts and average usage (\$33,856,232 million increased revenues \$20.479 million increased gas costs) ¹⁴	-\$13,377,232
Normalization of rate case expense and elimination of Lukens testimony expense ¹⁵	-\$ 362,000
Reduction to allowed promotional expenses (\$1.645 million - \$385,000) ¹⁶	-\$1,260,000
Lower bad debt expense allowance	<u>-\$3,872,000</u>

¹⁴ R.D., p. 49; OTS St. 2.0 (Kubas) pp. 19-24. PGW contends that the ALJ further erred by overstating this adjustment. In the Recommended Decision, the ALJ cited the increase in PGW's revenues for the increased residential and commercial customers and usage as a total of \$34.263 million. However, the increases cited by the ALJ were derived using PGW's proposed customer charges. As the OTS indicated in footnotes using the OTS' customer charges which were adopted by the ALJ, the total revenue increase is \$33,856,232.

¹⁵ R.D. p. 51; OTS Exh. 1, Sch. 5.

¹⁶ R.D. p. 59; Tr. 744-45.

(\$65 million - \$61.128 million) ¹⁷	
<u>Sub-Total</u>	<u>\$46,128,768</u>
Interim rate increase	<u>-\$11,000,000</u>
<u>Total Rate Increase</u>	<u>\$35,128,768</u>

PGW argues that the evidence and the law require the Commission to find that the full \$65 million increase is justified. Additionally, PGW asserts that the Commission should reject the ALJ's recommended adoption of the OTS' individual expense adjustments as contrary to the evidence and law governing this case. Nonetheless, PGW contends that, if the Commission were to adopt the ALJ's endorsement of the OTS' recommended revenue requirement, it must properly calculate that revenue requirement and allow PGW to increase its rates by \$35,128,768 in addition to the \$11,000,000 interim rate increase. (PGW Exc. pp. 29-31).

In its Reply Exceptions, the OTS rejoins that the ALJ did not err in calculating and adopting the revenue requirement recommended by the OTS. The OTS argues that the "expense adjustment" presented by PGW in its Exceptions is woefully inadequate, because it failed to represent the correct expense adjustment for this proceeding. The OTS maintains that the "expense adjustment" presented by PGW needs to be revised to reflect the proper expense adjustments in conjunction with the ALJ's recommended revenue requirement. (OTS R.Exc., pp. 19-20).

Accordingly, the OTS contends that there must first be a recognition that it has recommended that the social costs of \$60,937,000 (senior citizens discount, CWP and CRP) be removed from the GCR and included as expenses in base rates. Since the ALJ recommended that these adjustments be deferred to the restructuring proceeding (R.D., pp. 84-87), the \$60,937,000 must be removed from both revenues and expenses as shown on OTS Exhibit No. 1, Schedule 1. The OTS maintains that the iteration process requires

¹⁷ R.D. p. 60; OTS Exh. 1, Sch. 4.

that the write-off ratio of 7.6160% be employed to determine the bad debt expense attributable to the final base rate gas revenues that were to be determined in this proceeding. The total base rate revenues based on the ALJ recommended decision is \$741,687,000. The final base rate adjustment of \$2,055,000 is to account for the rate making revenue impact associated with the customer count and usage adjustment as accepted by the ALJ. Moreover, the OTS argues that the \$2,055,000 is the added revenues PGW would experience at their proposed rates, using the OTS witness' customer number and sales volumes. (OTS R.Exc., p. 20).

The OTS submits that, in order to properly recognize the above adjustments to PGW's "expense adjustment" schedule presented in its Exceptions, the schedule should be revised as follows:

Expense Adjustment

PGW proposed base rate increase	\$65,000,000
Net decrease from increase customer counts and Average usage (\$33,856,232 - \$20,479,000)	(13,377,000)
Normalization of rate case expense and Elimination of Lukens testimony expense	(362,000)
Reduction to promotional expenses	(1,260,000)
Lower bad debt expense allowance	<u>(3,872,000)</u>
Sub-Total	\$46,128,768
Interim rate increase	<u>(11,000,000)</u>
Company's calculation of the total rate increase	\$35,128,768
Iteration of bad debt expense	(4,938,000)
Ratemaking revenue impact	<u>2,055,000</u>

Base Rate Increase Per ALJ

\$32,245,768

The OTS claims that, based upon the adjustments needed to reflect the final approved revenue requirement, there is no need to increase the recommended increase of \$33 million by an additional \$2.1 million. Accordingly, the OTS submits that PGW's Exceptions should be denied. (OTS R.Exc., pp. 19-21).

In its reply to the OCA, PGW argues that the OCA's overall revenue level is inconsistent with the Commission's traditional application of "just and reasonable" ratemaking standard for investor owned utilities. PGW notes that the Commission uses a variety of methods in setting "just and reasonable rates" for investor-owned utilities including such methods as the operating ratio, which, like the Cash Flow Method, sets rates to cover all appropriate expenses plus a gross profit margin to permit a profit and to cover the utility's cash flow needs.¹⁸ PGW avers that the Commission has never, in the name of "just and reasonable rates," simply plucked a number out of the air merely to meet a utility's debt service coverage requirement, as the OCA has here, even though the evidence plainly shows the resulting rate level would produce a completely inadequate level of cash working capital for PGW.

PGW argues that the OCA's recommendation ignores PGW's prior rate making methodology — the Cash Flow Method. Unlike the OTS and the ALJ, the OCA continues to claim that the only standard that the Commission has to follow in setting rates for PGW is whether the resulting rates are somehow "just and reasonable." PGW avers that the OCA clearly reads this overall requirement as allowing it to recommend

¹⁸ See, e.g., *Popowsky v. P. U.C.*, 674 A.2d 1149 (1996) (operating ratio a legally acceptable methodology for establishing just and reasonable rates for fixed utilities); *Kelly, et al. v. Peddlers's View Utility Co.*, 1997 Pa. PUC LEXIS 21, *25 (Rec. Dec.) (operating ratio method used to establish just and reasonable rates for water company); 52 Pa. Code 63.115(a) and 22 Pa. Bull. 1557. (Reseller proposed rate justified by application of Operating Ratio method).

any amount that it thinks “fair” and would even permit the Commission to ignore the extensive evidence documenting PGW’s *pro forma* test year (or budget year) revenue requirement, including its extensive cash flow needs. Unlike the OTS, PGW maintains that the OCA refused to acknowledge that, while the overall ratemaking requirement is that rates must be just and reasonable, the required method of setting a specific level of rates for PGW is the Cash Flow Method. (PGW R.Exc., pp. 1-8).

d. Disposition

Section 2212(e) of the Act obligates the Commission not to take an action that would adversely affect the debt service coverage of PGW’s bonds. This requirement has the effect of imposing a statutory floor that the Commission has carefully considered in adjudicating this matter. In order to determine the appropriate rate increase, the Commission is required to ensure that PGW is able to maintain an adequate level of *financial health required to fund operations and meet debt service requirements*.

The PGW bond covenants are contained in two principal documents, the 1975 Bond Ordinance and the 1998 Bond Ordinance. The rate covenants obligate PGW to collect in each fiscal year rates sufficient, together with all other revenues, to cover its net operating expenses, 150% of annual debt service on gas works revenue bonds issued under the 1975 Ordinance and the 1998 Senior Bonds and 100% of debt service with respect to the 1998 Subordinate Bonds.

So long as PGW refrains from incurring expenses that are imprudent or unreasonable in amount, consistent with the determinations in this order, we expect that an allowable annual revenue requirement increase of \$28 million over PGW’s existing rates will allow PGW to satisfy its debt service coverage requirements. Specifically, the increased revenues allowed by this order, indicate that debt service coverages will be approximately 2.87 coverage for the 1975 ordinance bonds and approximately 3.01

coverage for the 1998 ordinance senior bonds. Furthermore, coverage for the 1998 ordinance subordinate bond will be more than adequate.

For these reasons, the Commission grants PGW a rate increase of \$28,067,000, in addition to the previously granted \$11 million interim base rate increase, subject to the adjustments and conditions set forth below.

3. Revenue Adjustments

a. Positions of the Parties

PGW utilized a two step process in developing normalized usage for the residential and commercial heating class. The first step developed by PGW was the base-load usage, which is a non-heating load, determined by averaging sales during July, August and September of 1998. The second step is the development of normal heating usage, which PGW calculated by adjusting actual historic sales using a computer model and a normal year of 4,555 heating days to determine the normal heating usage. The mathematical calculation for the two-step process is that base load usage plus the normal heating usage equals the total usage for that particular class.

By using the two-step process, PGW claimed an average usage of 100.94 Mcf per residential heating customer¹⁹ and for commercial customers, PGW claimed an average of 445.21 Mcf²⁰ per customer. In determining its total usage and customer counts, PGW also utilized the historic sales period of September 1, 1999 through August 31, 2000, together with adjustments, projections and customer counts for the future test year ending August 31, 2001.²¹ (R.D., pp. 38-39).

¹⁹ 41,679,007 Mcf divided by 412,910 customers.

²⁰ 8,486,143 Mcf divided by 19,061 customers.

²¹ The Company is requesting total adjusted proposed operating revenues of \$755,484,000 for the future test year ending August 31, 2001. (PGW Volume II, Exhibit A-1-1).

The OTS proposed an adjustment to operating revenues, based on the average number of customers and average usage per customer, which resulted in an increase in projected revenues at proposed rates of \$27,114,000 for the residential class and \$7,149,000 for the commercial class.²²

First, the OTS submitted that PGW's projection of 412,910 residential heating customers and 19,061 commercial heating customers is incorrect and recommended that the projected number of residential heating customers be increased by 11,189, and the number of commercial heating customers be increased by 51. The OTS asserted that the actual number of residential heating and commercial heating customers that PGW served in calendar year 2000 should be the guide in determining the projected number of customers and projected sales in this instant proceeding. (R.D., p. 46).

The OTS next calculated the annual normalized usage per residential heating customer, for January 2000 through December 2000 to be 103.91 Mcf by dividing the total normalized usage of 44,069,567 Mcf by the average of 424,099 customers. A comparison of the OTS' annual normalized usage of 103.91 Mcf and PGW's annual normalized usage of 100.94, results in a difference of 2.97 Mcf, which, when combined with the OTS' recommended increase in the number of residential customers, results in an increase in projected revenues at proposed rates of \$27,114,000. (R.D., pp. 41, 47).

With respect to the commercial heating customers, the OTS formulated its recommendation of an average usage per customer of 477.11 Mcf by dividing normalized usage of 9,094,190 Mcf for January through December 2000 by 19,061 customers. The difference between the OTS' recommendation and PGW's claimed usage of 445.21 is

²² Revenue adjustment numbers are exclusive of reductions to the residential and commercial monthly customer charge proposed by the OTS.

31.90 Mcf for the average commercial heating customer, which, when combined with the OTS's recommended increase in the number of commercial customers, results in an increase in projected revenues at proposed rates of \$7,149,000. (R.D., pp. 42, 48).

In the rebuttal phase of the proceeding, PGW's witness testified that for the most recent five month period from November 2000 through March 2001, PGW's forecasting model was only off by 2%. The OTS contended that PGW's analysis only utilized five months, while the OTS' analysis covered twelve months and that the months included by PGW occurred during a period of record high gas prices, resulting in reduced consumption. (R.D., pp. 42-43).

b. The ALJ's Recommendation

The ALJ concluded that PGW had agreed to revise its numbers due to billing problems that resulted in the use of the incorrect number of customers. The ALJ also noted that PGW concurred with the OTS position that additional customers should be added. Accordingly, the ALJ recommended adoption of the OTS position that increased the number and average usage of PGW's residential heating and commercial heating customers. (R.D., p. 50).

c. Exceptions

PGW submits that the ALJ erred by finding that PGW's residential and commercial customer counts should be increased as proposed by the OTS. PGW avers that it never concurred that additional customers should be added to its *pro forma* revenue calculation. Instead, as explained by its witnesses, PGW's new billing system is able to more accurately determine the number of customer charge billings by ensuring that each meter carries a customer charge. PGW maintains that it has not suddenly found some 11,000 residential heating customers — it is now simply able to more accurately bill

customer charges for all customers. Obviously, such a revision, which PGW itself agreed should be made, only increases pro forma revenues for additional customer charges — not additional sales. Thus, PGW argues the Commission must reject the ALJ's recommendation that the OTS' adjustment be granted. Instead, and at most, only the \$1.54 million in increased revenues identified by PGW as appropriately tied to the additional customer charge billings should be included in pro forma revenues.²³ (PGW Exc. pp. 22-23).

PGW also argues that the ALJ erred by granting the OTS' recommendation to increase the average annual usage of PGW's residential and commercial heating customers. PGW maintains that its proposed average customer usage was based on an extremely accurate model that projected sendout for the period of November 2000 through March 2001 within 2% of the actual sendout. (PGW Exc., p. 21).

In its reply, the OTS rejoins that the ALJ correctly found that PGW's residential and commercial customer counts should be increased as proposed by the OTS. With respect to the customer count, PGW argued that "Mr. Kubas' recommended increase in total customers may be reasonable." (PGW St. No. 4.1, p. 8). The OTS submits that it is clear that PGW endorsed the OTS' recommended increase in total customers as being reasonable and that PGW's initial customer counts were incorrect. (OTS R.Exc., pp. 14-15).

²³ PGW indicated, during the proceedings, it would accept a nearly \$2 million increase in projected revenues based on the additional 9,709 meters to which a residential customer charge and 700 meters to which a commercial customer charge would be assigned. However, PGW noted that the \$2 million figure was based on the granting of PGW's proposed \$15 and \$25 residential and commercial customer charges. PGW notes that the ALJ only recommended a \$12 and \$18 customer charge for those classes. (R.D., p. 110, ¶3). Accordingly, the amount of appropriate additional revenues would be reduced. Ultimately, PGW argues that its revenue request still should not be reduced

The OTS also contends that the ALJ was correct to increase PGW's average annual usage for residential and commercial heating customers based upon the record evidence presented in this proceeding. The OTS contends that in this proceeding, PGW simply identified the inputs without the numerical identification of the factors that were inputted into the computer model. Such evidence is insufficient when compared to analysis performed by the OTS and adopted by the ALJ. (OTS R.Exc., pp. 9-13).

d. Disposition

In consideration of this issue, we agree with the ALJ's recommendation that the number and average use of PGW's residential and commercial heating customers be increased based on the OTS' calculations. We conclude that PGW's analysis was flawed in that it utilized five months (November 2000 through March 2001) in its forecasting model rather than a twelve-month period. We find that the OTS' calculations were adjusted for aberrations due to PGW's billing problems wherein PGW used the *incorrect number of customers*. Accordingly, PGW's Exceptions on this issue are denied.

4. Expense Adjustments

a. Rate Case Expense

PGW claimed \$825,000 for rate case expense as an annual expense for the future test year. The OTS recommended two adjustments to this claim: (1) the disallowance of the \$100,000 consulting fee paid to Lukens Energy Group and (2) normalization of the remaining rate case expense over a two year period.

because the end of year cash balances produced by the full \$65 million increase are already at barely minimal levels. (PGW Exc., Footnote 88, p. 23).

(1) \$100,000 Payment to Lukens

i. Positions of the Parties

PGW requested, as part of its rate case expense, \$100,000 for payments for Lukens Energy Group, Inc., which PGW engaged to review the cost-of-service study and develop a revenue requirement that would be warranted if it were an investor owned utility.

The OTS averred that the \$100,000 expense for the Lukens Energy Group should not be included in the annual expense allowance to be charged to PGW rate-payers. Only prudently incurred expenses are to be incorporated in rate case expense claims, and it is the burden of the public utility to prove that the expenses incurred are just and reasonable. (*Allegheny Center Associates v. Pa. P. U. C.*, 570 A.2d 149 (1990)). The OTS claimed that PGW had failed to sustain its burden of proving that the expenses associated with the Lukens Energy Group Inc. are relevant and, thus, should be included a rate case expense claim. The OTS opined that there was no need for PGW to present testimony that its ratepayers would be required to pay significantly higher rates if it were not a municipally owned utility, since that is not an issue in this proceeding. (R.D., p. 53).

PGW argued that the recommended disallowance is contrary to PGW's ratemaking method and the Code's requirement that the Commission ensure that PGW's rates are sufficient to satisfy its bond covenant. In addition, PGW stated that the PGC never denied rate case expense based on such reasons. (R.D., pp. 53-54).

ii. ALJ's Recommendation

Noting that it is clear that there are differences between municipally owned utilities and investor owned utilities, the ALJ recommended that the \$100,000 expense for the Lukens Energy Group Inc., be disallowed. The ALJ reasoned that it was not necessary for PGW to sponsor expert testimony concerning the revenue requirement for an investor owned utility, and ratepayers should not be required to pay for it. (R.D., p. 54).

iii. Exceptions

In its Exceptions, PGW contends that the ALJ erred by disallowing \$100,000 of PGW's rate case expense incurred in conjunction with the testimony of the Lukens Energy Group, Inc. The ALJ recommended that the \$100,000 in expenses be denied because the expense and the testimony was "not necessary." PGW maintains that the Lukens testimony examined the benefits to ratepayers of PGW's municipal status compared to the methods employed for investor-owned utilities. PGW avers that it was a reasonable expense and helped to create a context for part of PGW's claims. Moreover, generally, the proponent of a rule or order is permitted to present its case as it sees fit. (PGW Exc., p. 26).

In its reply, the OTS submits that PGW's articulation of the reason why the expense was disallowed is wholly inadequate. The OTS avers that it was not necessary for PGW, which is a municipal owner utility, to provide expert testimony concerning the revenue requirement for an investor owned utility. (OTS R.Exc., pp. 17-18).

iv. Disposition

The ALJ recommended that the \$100,000 rate case expense for the Lukens Energy Group Inc., be disallowed because it was not necessary for PGW to sponsor expert testimony concerning the revenue requirement for an investor owned utility.

Based on a careful review of the record, and of the positions of the Parties, we find that the testimony was relevant. It is unusual for this Commission to utilize the Cash Flow Methodology for a utility the size of PGW. The testimony sponsored by PGW was helpful and relevant in understanding the different nature of PGW in relation to an investor owned utility, especially since the bulk of the Commission's attention is focused on investor owned utilities.

Based on the foregoing, we find that PGW's Exception has merit. Therefore, we shall grant the Exception of PGW which results in an upward adjustment to rate case expense of \$100,000.

(2) The Rate Case Expense Normalization

i. Positions of the Parties

The OTS and the OCA recommended that the remaining rate case expense be normalized over a two-year period. The OTS witness explained that the Commission views prudently incurred rate case expense as an ongoing expense (even though recurring at irregular intervals) relative to the rendering of utility service; therefore, rate case expense is subject to normalization for ratemaking purposes, not amortization.

The OTS witness noted that PGW has included \$825,000 in the test year budget for rate case expenditures. The OCA noted that though FY 2000 Rate Case

Expense was amortized over a two-year period and included in the FY 2001 budget, FY 2001 Rate Case Expense was not amortized in the FY 2001 budget. The OCA witness concluded that it is normal ratemaking procedure to normalize such expenses over the period between rate cases. Since it is expected that PGW will file its next base rate case with its restructuring filing in 2003, it is proper to normalize Rate Case Expense over two years, the same period utilized by PGW.

ii. ALJ's Recommendation

The ALJ noted that PGW does not have a recent history of filing base rate cases since the last base rate increase was in 1991.²⁴ PGW filed this instant request for a base rate increase in January 2001, and the result of its restructuring filing will not become effective until either late 2002 or early 2003. Therefore, two years is a reasonable normalization period to be imposed in this proceeding for rate case expense. The ALJ noted that PGW used a two year period for its rate case expense incurred during its Interim Filing with the knowledge that PGW would be filing this base rate increase before the expiration of two years. The ALJ adopted the OTS and OCA request that the recommended two year normalization period for PGW's rate case expense should be adopted. (R.D. p. 55).

iii. Exceptions

No Party excepted to the ALJ's normalization recommendation.

iv. Disposition

We shall adopt the ALJ's recommended two year normalization period for PGW's rate case expense. However, as noted, *supra*, we have revised the expense claim

to include the \$100,000 expense for the Lukens Energy Group, Inc. This results in a total downward adjustment of \$313,000 to reflect the two year normalization for rate case expense.

b. Budgeted Promotional Expenses

i. Positions of the Parties

PGW claimed \$1,645,000 for promotional expenses with an allocation of \$1,210,000 to Major Accounts and \$435,000 to residential conversion incentives. The promotional dollars are used to compete against alternate fuel sources and are designed to offset the equipment costs to the customer. PGW's marketing department expects an increase in these expenditures due to the planned initiative to aggressively promote the use of natural gas in the market place. (R.D., p. 56).

Initially, the OTS recommended that the total claim for promotional activities be denied because other utilities do not recover such costs in their distribution rates. However, PGW argued that it did not have the ability to compete against alternate fuel sources by flexing rates. In recognition of the inability to flex its rates, the OTS modified its recommendation to allow \$385,000 for Promotional Activities to be recovered from PGW's ratepayers. The OTS reasoned that, although PGW budgeted approximately \$1.6 million for Promotional Activities during each of the last two years, the incentive payments have totaled only \$558,103 for approximately twenty-one customers.

Furthermore, PGW had not expended more than \$383,193 for Promotional Activities in any one year. In fact, PGW only expended \$383,193 in 1999 and \$94,120 in 2000. Consequently, the OTS opined that PGW's Promotional Activity claim should be

²⁴ This analysis excludes the interim rate Filing at Docket No. R-00005654.

limited to \$385,000. Therefore, the OTS recommended that PGW should be allowed to recover \$385,000 for Promotional Activities, resulting in a \$1,260,000 reduction to PGW's claimed level of expenses. (R.D., pp. 56-57).

PGW argued that the OTS' recommendation violates the legal standards governing this proceeding. Section VII of the Management Agreement/ Ordinance requires that rates be set to cover all of PGW's operating expenses. Furthermore, the PGC has authorized these costs in PGW's prior, as well as FY 2001, budgets. PGW contended that the PGC has never disallowed these amounts. Lastly, PGW submitted that the Commission is required to ensure that PGW's rates allow it to satisfy its bond covenants, which include a covenant to pay its obligations when they come due. PGW argued that, if the Commission were to only allow revenues sufficient to pay \$385,000 of PGW's \$1.6 million expense, it will not have complied with the mandates of Section 2212(e) of the Code. (R.D., pp. 56-58).

ii. ALJ's Recommendation

The ALJ concluded that PGW failed to show that it has expended more than \$385,000 in one year for promotional expenses. Therefore, the ALJ found that PGW has not demonstrated that it is just and reasonable to include \$1.6 million for promotional expenses. The ALJ recognized that PGW only spent \$94,000 on promotional activities in 1999-2000. However, she concluded that the record evidence demonstrates that it is appropriate for PGW to have \$385,000 in promotional expenses. (R.D., pp. 58-59).

iii. Exceptions

PGW contends that the Commission should reject the ALJ's limitations on PGW's promotional expenses. PGW further contends that the sole basis for the ALJ's

reduction of PGW's proposed promotional expenses was that it did not spend the full, budgeted amounts in the prior two years during which the program was in place. PGW maintains that the ALJ's reliance on the past fails to comprehend that, under PGW's prior ratemaking method, its rates are tailored to its future or anticipated need for cash. Under the ALJ's logic, PGW would never be able to spend more on its promotional efforts than it did in the infancy of its program. Given the excellent return that PGW's program has produced, and the requirements of the Cash Flow Method, PGW avers that the Commission must reject the ALJ's recommended disallowance and grant the full \$1.6 million of promotional expenses. (PGW Exc., pp. 27-28).

In its reply, the OTS contends that the ALJ correctly reduced PGW's proposed promotional expenses. The OTS rejoins that the sole basis for PGW's Exception is its argument that "under PGW's prior ratemaking method, its rates are tailored to its future or anticipated need for cash." The OTS notes that PGW failed to produce any evidence that would justify allowing \$1.6 million for promotional expenses. (OTS R.Exc., pp. 18-19).

iv. Disposition

We agree with the ALJ's conclusion that PGW has not demonstrated that it is just and reasonable to include \$1.6 million for promotional expenses. The record evidence demonstrates that PGW has not expended more than \$383,193 in any one year; therefore, we find that it is appropriate for PGW to recover \$385,000 in promotional expenses from its ratepayers.

Based on the foregoing, we find that PGW's Exception on this issue is without merit. Therefore, we shall deny PGW's Exception and reduce its promotional expense by \$1,260,000.

c. Bad Debt Expense

i. Positions of the Parties

PGW made a claim for bad debt expenses, which the Commission normally defines as uncollectible account expense. For ratemaking purposes, utilities generally compute uncollectible account expense on an annual prospective basis. While the uncollectible account expense is a prospective claim, the proper calculation begins with an historic analysis of actual net write-offs to gross revenues to develop an historic write-off ratio. For calculating purposes, net write-offs are gross write-offs less recoveries of amounts previously written off.

PGW's bad debt expense is based on funding the bad debt reserve balance. PGW projected the ending accounts receivable balance by assuming that 90.5% of billed revenues would be collected and by estimating amounts that will be written-off during the year. PGW then took the estimated ending accounts receivable balance and applied a reserve factor of 35% resulting in its claimed bad debt expense for the future test year. PGW's revised claim for bad debt expense is \$65 million. (R.D., p. 60).

The OTS proposed that the appropriate allowance for PGW's uncollectible account expense should be \$61.1 million.²⁵ The OTS recommended a write-off percentage of 7.6160% based on a five-year average of actual net write-offs to gross revenues. When the write-off percentage is applied to the projected total future test year sales revenues of \$802.6 million, the result is an allowance of \$61.1 million.

²⁵ See OTS Exhibit No. 1, Schedule 4.

The OTS proposed the use of a five-year analysis of prior years uncollectible accounts expense because such a historic analysis reflects present customer payment tendencies and is sufficiently long enough to levelize any fluctuation in write-off activity by PGW. The OTS' bad debt recommendation is consistent with the Commission's decision in the interim rate proceeding of *Pennsylvania Public Utility Commission, et.al. v. Philadelphia Gas Works*, R-00005654 (Order entered November 22, 2000). (R.D., p. 59).

ii. ALJ's Recommendation

Finding that revenues and expenses must be based on calculations that can be reviewed to determine whether they are reasonable, the ALJ concluded that PGW's bad debt expense was not substantiated and that the OTS had proposed an amount based on historical data. Therefore, the ALJ recommended a downward adjustment of \$4,169,000 to the bad debt account expense. (R.D., p. 61).

iii. Exceptions

In its Exception, PGW contends that the ALJ ignored both the evidence and the Commission's obligation under Section 2212(e) of the Code, 66 Pa. C.S. §2212(e), by endorsing the OTS' proposed bad debt expense allowance of \$61.1 million, based on a five-year historic analysis, which she found is the traditional method of calculating bad debts expense for investor-owned utilities. (PGW Exc., p. 24).

PGW contends that it is not an investor-owned utility, that it is unlike other utilities because of the demographics of the population served, of which 150,000 people live at or below 150% of the poverty level, and that it has a traditionally high level of uncollectible accounts that is significantly affected by increases in gas costs. Therefore, PGW asserts that the use of a calculation method employed by investor-owned utilities,

with dissimilar demographics, and historic averages, which do not reflect recent increases in gas prices, results in completely unreasonable results. (*Id.*).

PGW also avers that the ALJ's decision gives short shrift to the following evidence which clearly supported a bad debt expense of at least \$65 million: (1) Historic data used is not representative of the current high level of arrearages; (2) the actual bad debts percentage for 1999-2000 was 10.2% of revenues; (3) applying OTS' bad debts ratio of 7.6% to total gas revenues for 1999-2000 would leave PGW \$12 million short of actual booked bad debt expense; and (4) the PGC's approval of the FY 2001 budget of nearly \$68 million in bad debt expense ratifies the reasonableness of PGW's proposed \$65 million claim. (*Id.*, pp. 24-25).

Furthermore, PGW contends that its \$65 million claim for bad debt expense is substantiated by its prior ratemaking method and requirements. (*See*, 66 Pa. C.S. §2212(e) and PGW M.B., p. 28-29). (*Id.*, p. 24).

In its reply, the OTS rejoins that its bad debt recommendation is consistent with the Commission's decision in the interim rate proceeding in *Pennsylvania P.U.C., et al. v. Philadelphia Gas Works*, R-00005654 (Order entered November 22, 2000). In that proceeding, the Commission determined that with the adoption of a similar bad debt adjustment it met its obligation under Section 2212(e). (OTS R.Exc. , pp. 15-17).

iv. Disposition

Based on a careful review of the recommendation of the ALJ and of the positions of the Parties, we conclude that the revenues and expenses must be based on calculations that can be reviewed to determine whether they are reasonable and that a proper calculation begins with an historic analysis of actual write-offs. The ALJ concluded that PGW's bad debt expense was not substantiated and that the OTS had

proposed an expense level of \$61.1 million based on historical data. We agree with the ALJ's recommendation and find that the OTS' calculation, which was based upon the use of a five-year analysis of prior years uncollectible accounts expense, rather than a "budgeted" amount, is the more accurate method of determining the level of bad debt expense. Accordingly, we find that the Exception of PGW on this issue is without merit and, therefore, the Exception is denied.

d. OCA Expense Adjustments Accepted by the PGW

i. Positions of the Parties

The OCA witness proposed ten downward adjustments to PGW's claimed level of expenses in FY 2001. As for one-time expenditures to be normalized, the OCA made adjustments to Billing Collection and Customer Service (BCCS) Remediation (\$800,000), Consultant Studies/Costs (\$424,000), Non-Recurring Expenses (\$1,840,000), and Rate Case Expense (\$412,000).²⁶ Regarding expenditures which are not representative of future operating conditions and, therefore, to be eliminated, the OCA made adjustments to Employee Consultants (\$258,000), Equipment Rentals and Leasing Information Technology (\$632,000), Lobbying Expenses (\$115,000), Operating Leases (\$601,000), and Non-Recurring Material Purchases (\$100,000). Finally, the OCA made an additional adjustment to partially offset PGW's amortization of its regulatory asset for Customer Responsibility Program (CRP) arrearages (\$1,637,000). In total, the above adjustments result in a downward adjustment of \$6.8 million to PGW's revenue requirement. (R.D., p. 62).

PGW accepted the OCA's recommended adjustments for BCCS Remediation, Consultant/Studies Costs, Non-Recurring Expenses, Equipment Rentals & Leasing Information Technology, and amortization of PGW's regulatory asset for CRP

²⁶ The rate case expense adjustment was discussed, *supra*.

arrears. PGW also accepted the OCA's adjustment for Non-Recurring Material Purchases. However, PGW maintained that the Non-Recurring Material Purchases be amortized over three years, rather than normalized. (R.D., p. 62).

PGW made an upward adjustment of \$150,000 to its projected expenses for Non-Recurring Material Purchases in anticipation of the work stoppage in May 2001. The OCA witness proposed that this expense be normalized over a three year period. PGW stated that it accepted the adjustment, but as an *amortization* over three years rather than a *normalization*. The OCA submitted that a normalization for ratemaking purposes is appropriate because renegotiation of the union contract and the need for material purchases are normal operating expenses. (R.D., pp. 63-64).

ii. ALJ's Recommendation

The ALJ recommended adjustments to the BCCS Remediation, Consultant Studies/Costs, Non-Recurring Expenses, Employee Consultants, Equipment Rentals and Leasing Information Technology and the adjustment to partially offset PGW's amortization of its regulatory asset for CRP arrears because they were accepted by PGW. Furthermore, the ALJ noted that, although PGW accepted the adjustment for Non-Recurring Material Purchases, PGW wanted to amortize it over three years rather than normalize it over the three years. The ALJ found that the OCA's recommendation of normalization for this type of expense is appropriate and recommended normalization over three years. (R.D., p. 64).

iii. Exceptions

The OCA noted that although the ALJ recommended adoption of the OTS' proposed \$33 million increase, the ALJ also recommended acceptance of the OCA's ten expense adjustments totaling \$6.8 million. (OCA Exc., p. 10).

The OCA also proposed an adjustment to increase PGW's bad debt expense by \$6.8 million. The ALJ, however, rejected the OCA's proposal. (R.D., pp. 61-62). This rejection is of import because the OCA's recommended increase of PGW's bad debt expense offsets the effect of the OCA's other adjustments to PGW's revenue requirement. The OCA states that, since the ALJ has rejected its proposal to increase bad debt expense, she has removed the "offset." (OCA Exc., pp. 10-11). However, the OCA contends the effect of its various adjustments remain and must be applied to the \$33 million rate increase recommendation. If the \$33 million recommendation of the ALJ is adopted, and the overlap between the OCA and OTS rate case expense adjustment is eliminated, the OCA states that the level of rates must be reduced to \$26.6 million in accord with the remainder of the Recommended Decision. (OCA Exc., pp. 10-11; CEPA *et al.*, p. 12).

PGW argues that the ALJ erred by recommending that the Commission grant the OCA's various expense adjustments, while at the same time rejecting the OCA's recommended bad debt allowance of \$71.8 million. The OCA presented its \$6.8 million downward expense adjustments in conjunction with a concomitant \$6.8 million increase in PGW's bad debt expense allowance. PGW contends that these adjustments were clearly intended to offset each other.²⁷ (PGW Exc., p. 28).

PGW further argues that, by granting the OCA expense adjustments without its proposed offsetting revenue requirement increase, the ALJ potentially thwarted her recommendation that the Commission adopt OTS' revenue requirement and proposed \$44 million rate increase (including interim relief). However, if the Commission adopts the ALJ's revenue requirement recommendation, and also desires to uphold the granting

²⁷ PGW's acceptance of the majority of these adjustments was based upon this understanding. If the adjustments will not be offset by an allowance of additional

of the OCA expense adjustments, then the Commission must allow PGW an additional \$6.8 million in revenues from rates in order to achieve a net rate increase of \$44 million, including the \$11 million interim rate relief.²⁸ (PGW Exc., pp. 28-29).

In its reply to the *Exceptions of the OCA and CEPA et al.*, PGW addressed the claim that the ALJ failed to adjust the revenue requirement recommendation for the OCA's expense adjustments by arguing that it is erroneous and must be rejected. PGW avers that the OCA and CEPA *et al.* Exceptions should be barred as they constitute a new position offered for the first time during the exception phase of this proceeding. PGW contends that the only way to reconcile the two positions is to instruct PGW to account for these adjustments for future ratemaking purposes (many of them are multi-year amortization of costs) and to permit PGW to raise its rates by \$44 million (over pre-interim levels). (PGW R.Exc., pp. 13-14).

In its Reply Exceptions, the OCA argues that its downward expense adjustments and its increase in bad debts expense were not intended to offset each other. The OCA submits that PGW has overstated the intent of its bad debt expense adjustments. The OCA agrees that, if the Commission adopts its proposed increase in the bad debt expense, it would have the "effect" of offsetting the OCA downward expense adjustments that were adopted by the ALJ; however, each of the adjustments should be decided on its own merits. (OCA R.Exc., pp. 20-21).

iv. Disposition

Based on a careful review of the recommendation of the ALJ and of the positions of the Parties, we conclude that PGW's argument that the OCA's adjustments

revenues through rates, then the adjustments are not valid. PGW excepts to the adjustments, and to the ALJ's recommendation that they be accepted.

²⁸ The cumulative net increase would actually be \$46.1 million.

were in conjunction with a concomitant increase in bad debt expense is without merit. We accept nine of the OCA's adjustments and adjust rate case expense as proposed by the OTS and discussed elsewhere in this Order.

We shall adopt the OCA's recommended adjustments for one-time expenditures to be normalized as follows: (1) BCCS Remediation (\$800,000), (2) Consultant Studies/Costs (\$424,000), and (3) Non-Recurring Expenses (\$1,840,000). Regarding elimination of expenditures which are not representative of future operating conditions, we shall adopt the OCA's adjustments to Equipment Rentals and Leasing Information Technology (\$632,000) and Non-Recurring Material Purchases (\$100,000). We have discussed adjustments to Employee Consultants, Lobbying Expenses, and Operating Leases separately in this Order. Finally, we shall adopt the OCA adjustment to partially offset PGW's amortization of its regulatory asset for CRP arrearages (\$1,637,000).

Accordingly, we find that the Exceptions of PGW on this issue are without merit, and said Exceptions are denied. We shall grant, in-part, and deny, in-part, the OCA's Exceptions as discussed above.

e. Lobbying Expenses

i. Positions of the Parties

PGW claimed recovery for \$115,000 in lobbying expenses. PGW's witness testified that the PGC historically permitted the inclusion in rates of lobbying expenses, and, therefore, maintained that the Commission should continue to include these expenses. PGW further claimed that it will violate its bond covenants if rates are not sufficient to cover its obligations in FY 2001. (R.D., p. 64).

The OCA disagreed with PGW's position that lobbying expense is an appropriate item for recovery from ratepayers. Furthermore, OCA contended that PGW's assertion that the PGC's allowance of recovery of lobbying expenses requires the Commission to allow such recovery would have the PGC continue to set rates on a *de facto* basis, contrary to the intent of the Act. The OCA noted that the Commission has disallowed the recovery of lobbying expenses from ratepayers because the inclusion of these costs were unjust and unreasonable. (R.D., p. 65).

ii. ALJ Recommendation

The ALJ noted that the Commission has ruled that lobbying expenses do not have a direct ratepayer benefit and as such cannot be included in rates. (*Pa. P.U.C. v. Pennsylvania-American Water Co.*, 79 Pa. P.U.C. 25, 66 (1993); *Pa. P.U.C. v. Duquesne Light Co.*, 59 Pa. P.U.C. 67, 118 (1985); (*Pa. P.U.C. v. National Fuel Gas Dist. Corp.*, 84 Pa. P.U.C. 134, 196 (1995); *Pa. P.U.C. v. Metropolitan Edison Co.*, 60 Pa. P.U.C. 349, 382 (1985)). (R.D., pp. 65-66). Accordingly, the ALJ recommended that the OCA's proposed adjustment to remove lobbying expenses be granted. (*Id.*).

iii. Exceptions

PGW submits that the ALJ erred in disallowing its lobbying expenses by relying solely on past Commission precedent which found that such costs cannot be recovered through rates. PGW maintains that all of the cited cases were decided under Chapter 13 of the Code. Pursuant to Section 2212(e) of the Code, 66 Pa. C.S. §2212(e), those precedents are not applicable in this proceeding. PGW argues that its prior ratemaking methodology and requirements are what the Commission "shall" follow in setting PGW's rates. (PGW Exc., pp. 26-27).

PGW notes that, historically, the PGC has included lobbying expenses as a legitimate expense in rates. In addition, the PGC has budgeted for these expenses in PGW's FY 2001 budget and this amount was approved by the PGC. PGW avers that, at the relatively modest lobbying expense of \$115,000, the PGC has regularly found this expense to be within the zone of reasonableness. Accordingly, the Commission must reach the same conclusion. (*Id.*).

In its Reply Exceptions, the OCA argues that the ALJ's decision to disallow PGW's lobbying expense should be upheld, averring that the Commission should not tolerate unreasonable or imprudent expenditures that burden ratepayers, regardless of past treatment of these expenditures by the PGC. (R.Exc., pp. 18-19).

iv. Disposition

Based on a careful review of the recommendation of the ALJ and of the positions of the Parties, we conclude that Section 2212 of the Act, 66 Pa. C.S. §2212, does not require the Commission to permit the recovery of a particular budget category that was previously allowed by the PGC. Section 2212 provides that the Commission must "follow the same ratemaking methodology and requirements that were applicable" to PGW prior to this Commission assuming jurisdiction over its operations. We have consistently interpreted that provision as obligating the Commission to use the cash flow method, rather than a rate of return analysis, to determine whether PGW's rates will meet the constitutional and statutory standard of being "just and reasonable."

We do not believe, however, that PGC's allowance of the recovery of a certain budget category, such as lobbying expenses, is an element of the cash flow method to which the Commission must adhere. Rather, the cash flow method previously utilized by the PGC is described in Section VII of the 1972 Management Agreement as requiring the approval of rates that will produce revenues that are sufficient to (1) pay

reasonably incurred operation and maintenance (O&M) costs and expenses as they become due throughout the fiscal year; (2) make the \$18 million annual payment to the City; (3) satisfy debt service requirements; and (4) provide cash working capital. Although some expenditures, such as employees' retirement costs, are specifically identified for recovery, lobbying expenses are not so designated. Therefore, we do not view the recovery of lobbying expense as being required by Section 2212's mandate that the Commission adheres to the prior ratemaking method. Rather, we are free to examine both the reasonableness of the amount and the category of O&M expense being claimed by PGW.

Based on the foregoing, we find that PGW's Exception on this issue is without merit. Therefore, we shall deny PGW's Exception and eliminate its lobbying expense of \$115,000.

f. Operating Leases

i. Positions of the Parties

The OCA recommended that the operating leases be capitalized rather than expensed and explained the issue as follows:

Included in PGW's FY 2001 Operating Budget is \$462,000 for operating leases for vehicle replacements and \$139,000 for operating leases for computer-related equipment. However, the Company has proposed that such expenditures be included under capital, rather than operating leases, mainly for the positive effect such inclusion would have on debt coverage.

(OCA St. No. 1, p. 39).

The OCA submitted that the \$601,000 expense in FY 2001 should be eliminated from the operating budget because these costs have been capitalized by PGW. The ALJ observed that PGW did not respond to this adjustment. Thus, the OCA requested that a downward adjustment of \$601,000 be adopted.

ii. ALJ Recommendation

The ALJ concluded that, inasmuch as PGW failed to demonstrate that the operating leases should be expensed rather than capitalized, the OCA's recommendation to eliminate the \$601,000 expense from the operating budget should be adopted. (R.D., p. 67).

iii. Exceptions

No Party excepted to the ALJ's recommendation.

iv. Disposition

Finding it otherwise reasonable, we shall adopt the ALJ's recommendation to eliminate the \$601,000 expense for operating leases from the operating budget.

g. Employee Consultants

i. Positions of the Parties

PGW made a claim for \$258,000 for former employee consultants. The OCA submitted that these former employee consultant salaries should be eliminated stating that:

PGW has hired several former employees on a temporary basis as consultants in order to retain needed operational experience. The reply to OCA-III-49 lists four employees whose contractual salaries are included in the FY 2001 test year budget. Of those listed, only one is expected to remain with the Company for an extended period of time, as a gas supply consultant. Since the other consultants will not be remaining with the Company and their duties are expected to be performed by other PGW employees, their budgeted salaries should be eliminated for ratemaking purposes.

The ALJ noted that PGW did not rebut this adjustment during the proceeding. Therefore, the OCA requested that a \$258,000 downward adjustment for the elimination of the former employee consultant salaries be adopted as reflected in OCA St. 1, Schedule 10. (R.D., p. 67).

ii. ALJ Recommendation

The ALJ recommended that, since PGW failed to demonstrate that the \$258,000 expense for former employee consultant salaries is necessary, the OCA recommendation to eliminate this expense should be adopted. (R.D., p. 67).

iii. Exceptions

No Party excepted to the ALJ's recommendation.

iv. Disposition

Finding it otherwise reasonable, we shall adopt the ALJ's recommendation to eliminate the \$258,000 expense for employee consultants from the operating budget.

C. Rate Structure/Cost of Service

1. Cost of Service Study

a. Positions of the Parties

PGW's proposed \$65 million rate increase in this proceeding consists of increases in both the customer charge and the volumetric rates of each customer class. The proposed customer charge increase will generate \$44.5 million of the overall proposed rate increase, while the remaining \$20.5 million will be generated through a volumetric rate increase. With respect to the volumetric rate increase, PGW proposed an allocation based upon its Cost of Service Study (COSS). The COSS is an unbundled, fully allocated COSS, which was completed in December, 2000. (R.D., p. 70).

According to the COSS, the residential classes (heat and non-heat) are receiving significant subsidies from the commercial and industrial customer classes. Specifically, the residential classes are paying less than their cost to serve, while the commercial and industrial customers are paying more than their cost to serve. Even in light of this subsidy, PGW's recommended rate allocation for the proposed rate increase is fairly consistent among the classes. PGW proposed a 10.5% overall increase for the residential classes, while the commercial and industrial classes would receive an increase of about 8.8%. (R.D., p.71).

The OCA recommended that the following three major allocations in the COSS be modified: (1) the classification of 25% of distribution mains investment as customer-related and the allocation on the basis of the number of customers in each customer class; (2) the allocation of the entire amount of administrative and general (A & G) salaries (account 920) and office supplies and expenses (account 921) on the

basis of labor; and (3) the allocation of A & G credit of \$12 million for duplicate charges in accordance with the allocation of Construction Work in Progress. (R.D., p. 71).

PICGUG, the OSBA and the OTS accepted the COSS presented in this case. These Parties believe that the COSS was performed in a reasonable manner. Although they do not agree with all of the PGW witness's allocations, they agree that the COSS can be used as a guide to determine the cost responsibility for PGW's customer classes. The OTS requested that the Commission order PGW to provide a cost of service study for present rates as well as proposed rates in the restructuring case.

PICGUG objected to the COSS adjustments proposed by the OCA. PICGUG supports PGW's position regarding the classification of 25% of PGW's investment in distribution mains as customer-related and 75% of the investment classified as demand related. PICGUG rejected the OCA's suggestion that the peak and average demand method be used to allocate the entire amount of the investment. PICGUG asserted that natural gas distribution companies plan and invest in distribution mains to attach customers to the system regardless of how or when they take service. (R.D., p. 73).

b. ALJ's Recommendation

After considering the arguments of the Parties regarding the COSS, the ALJ reasoned that since the COSS was being used merely as a guide in this proceeding, the adjustments requested by the OCA were not warranted. The Parties used the COSS that was presented to make their arguments. The ALJ concluded that additional revisions in the COSS were unnecessary. Consequently, the ALJ denied the OCA's recommendation to change the cost of service study. The ALJ recommended that the Commission should accept the OTS' recommendation and order PGW to provide a cost of service study for present rates as well as proposed rates during the restructuring proceeding.

c. Disposition

No Party filed Exceptions to the ALJ's recommendation relative to this issue. Finding the ALJ's recommendation to be reasonable and in accordance with the evidence, we shall adopt it. We agree with the ALJ that the COSS was merely being used as a guide in this proceeding. Specifically, the Parties used the COSS that was presented to make their arguments. As such, we find that the adjustments to the COSS requested by the OCA are not warranted. We determine that PGW should provide an updated cost of service study for present rates as well as proposed rates during the impending restructuring proceeding.

2. Revenue Allocation between the Rate Classes

a. Positions of the Parties

PICGUG and the OSBA noted that, pursuant to the COSS submitted in this proceeding, PGW's residential customer classes are receiving significant and unjustified subsidies from the commercial and industrial classes. PICGUG argued that, in order to begin to remove the existence of this subsidy, any rate increase granted to PGW in this proceeding must be allocated in full to the residential customer classes. PICGUG objected to the PGW's proposed rate structure that continues to allocate a portion of the proposed rate increase to the commercial and industrial customer classes. (R.D., p. 73).

The OTS recommended that PGW increase rates to the LBS Large Direct, TriGen Direct and NGV Direct customer classes to recover costs allocated to them. The OTS also suggests that the rates to GTS Trans customer class be reduced. The OTS' recommended revenue allocation retains the current volumetric charge for all classes except the residential class. Since the residential class is being subsidized by the other

customer classes, the OTS proposed that the residential class receive a volumetric decrease after the other classes obtain the maximum reduction. (R.D., p. 76).

The OSBA stated that the residential class' base rate would have to be increased to 26.65% to fully recover its cost of service. The OSBA proposed a modest increase for the commercial and industrial classes and submitted that the residential class should bear most of the increase. (R.D., p. 76).

b. ALJ's Recommendation

The ALJ indicated that all of the Parties want to move the customer classes closer to their cost of service. The ALJ concluded that the concept of gradualism should be considered in this case. Consequently, the residential class should not bear the entire increase. The ALJ further concluded that the OTS' recommendation to retain the current volumetric charge for all classes except the residential class is an appropriate solution. In addition, it is the ALJ's position that the rates of the LBS Large Direct, TriGen Direct and NGV Direct customer classes should be increased to recover the costs allocated to them. Furthermore, the rates of the GTS Trans customer class should be reduced.

c. Exceptions

PICGUG excepts to the ALJ's determination that the residential classes should not bear the entirety of any recommended rate increase. PICGUG maintains that PGW's COSS indicates that the residential customer classes are receiving a significant and unjustified subsidy from the commercial and industrial classes. Specifically, PICGUG argues that the commercial and industrial customers are receiving service from PGW at rates significantly above their cost to serve, while the residential customers are receiving service at rates significantly below their cost to serve. (PICGUG Exc., p. 2).

The OCA and PGW rejoin that PICGUG's Exception to the ALJ's determination that the residential classes should not bear the entirety of any recommended rate increase issue is misplaced. Moreover, the OCA maintains that PICGUG's Exception on this issue must be rejected because PICGUG relied heavily on PGW's COSS which overstates the costs that should be allocated to the residential class. PGW maintains that PICGUG's Exception must be rejected because PGW serves the highest number of low-income customers in the Commonwealth. (OCA R.E., p. 23-24; PGW R.Exc., pp. 24-25).

PGW excepts to the ALJ's proposal to reduce the rates for the GTS Trans customer class and increase rates for the LBS Large Direct, TriGen Direct and NVG Direct classes, purportedly so that these classes will recover the costs allocated to them. PGW argues that the rates for these classes are not cost of service based, but rather are either interruptible or heavily negotiated rates and thus, they are pegged to alternative fuel costs. Specifically, PGW indicates that the GTS Trans rates are negotiated rates under which PGW is bound by contract to provide service to the customers at the negotiated price and the present arrangement is reflected in its tariff. PGW continues that the LBS and NGV Direct classes are not firm customers. Therefore, as identified in PGW's tariff, their rates are not cost of service based, but rather are based on the price of natural gas and the price of alternative fuels. (PGW Exc., p. 38).

The OTS rejoins that PGW's Exception on this issue is misplaced. PGW excepts to the ALJ's recommendation to reduce rates for the GTS Trans customer class and increase rates for the LBS Large Direct, TriGen Direct and NGV Direct classes. The OTS replies that the ALJ's decision on this issue will enable these classes to recover the costs allocated to them. The OTS argues that the ALJ's decision enables PGW to recover the cost of service from its customers so that another customer class will not subsidize these customers. The OTS further argues that PGW's position that LBS Large Direct, TriGen Direct, and NGV Direct customer classes are interruptible or negotiated rates is

irrelevant to whether PGW is recovering the cost of service from these customers. (OTS R. Exc. I, p. 22).

d. Disposition

After careful consideration of this issue, we determine that the rates of PGW's customer classes should indeed be moved closer to their cost of service. To that end, we find that the concept of gradualism should be considered in this case. In order to implement the process of gradualism, we find that the residential class should not bear the entire base rate increase in this proceeding although it should gradually be moved closer to its cost of service. We, accordingly, agree with the ALJ that the residential class shall receive a volumetric increase while most other classes retain the current volumetric charge.

We also agree with the ALJ with respect to the LBS Large Direct, Tri-gen Direct and NGV Direct classes and we find that rates should be reduced for the GTS Trans customer class. Accordingly, we deny the Exceptions of PICGUG and PGW.

3. Rate Design

a. Customer Charge

i. Positions of the Parties

PGW's customer service charges before the interim rate increase in March 2001, the interim customer charges and the proposed customer service charges are as follows:

	<u>Residential</u>	<u>Commercial</u>	<u>Industrial</u>	<u>Municipal</u> <u>GS</u>	<u>Municipal</u> <u>MS</u>	<u>PHA-GS</u>	<u>PHA-PHA</u>
Present	\$ 8	\$10	\$20	\$10	\$ 0	\$ 8	\$ 0
Interim	\$11.66	\$14.57	\$29.14	\$14.57	\$ 0	\$11.66	\$ 0
Proposed	\$15	\$25	\$50	\$25	\$25	\$15	\$25

(R.D., pp.76-78)

PGW proposed to increase the Customer Charge of the Commercial class from \$10.00 to \$25.00. PGW's rationale for this customer charge increase includes, among its other arguments, a comparison of PGW's customer charge to other natural gas utilities throughout Pennsylvania. (R.D., p.76).

The OSBA proposed an increase in the Commercial customer charge from \$10.00 to \$17.50, and applies the residual increase necessary to recover the class revenue target to the Commercial commodity charge, which increases from \$7.1200 per Mcf to \$7.1897 per Mcf. In the interest of gradualism, the OTS proposed a residential customer charge of \$12, a commercial charge of \$18 and industrial customer charge of \$50. The OCA suggested that the residential customer charge be \$11.50. (R.D., p. 78).

ii. ALJ's Recommendation

Based on the evidence, the ALJ concluded that it is reasonable to accept OTS' proposal to increase the residential customer charge to \$12.00, increase the commercial charge to \$18 and increase the industrial charge to \$50. (R.D., p. 78).

iii. Exceptions

PGW excepts to the ALJ's recommended proposal arguing that, even at its proposed \$15.00 level for the residential class, it is recovering less than 50% of the fixed costs incurred to serve the residential customers. PGW further argues that its proposed customer charges of \$15.00 to the residential class, \$25.00 to the commercial class, and \$50.00 to the industrial class will bring customer charges closer to costs while honoring the concept of gradualism and will reduce PGW's sensitivity to weather swings. (PGW Exc. No. 14, p. 39).

The OSBA argues that PGW's Exception to the ALJ's recommended proposed customer charges is flawed. The OSBA submits that the ALJ's decision to increase the Commercial customer charge 80%, from \$10.00 to \$18.00 is sufficient and that the principal of gradualism is implemented by the ALJ's recommendation to increase the Commercial customer charge 80%. The OSBA concludes that an increase in the Commercial customer charge of 150% from \$10.00 to \$25.00, as recommended by PGW, is not an example of gradualism at work. (OSBA R. Exc. No. 2, pp. 6-7).

The OTS argues that PGW's Exception to the ALJ's recommended proposed customer charges is misplaced. The OTS submits that PGW's exceptions appear to be premised on the fact that for every customer class, the proposed monthly customer charges are lower than the customer related costs on a per customer –month basis as set forth in PGW's COSS. Specifically, the OTS notes that no local distribution company in Pennsylvania is charging the total customer related costs, or residential charges would be in the range of \$50.00. In conclusion, the OTS recommends that we reject PGW's Exceptions relating to customer charges. (OTS R.Exc. No. 10, p. 23).

The OCA argues that PGW's Exception on this issue is incorrect. The OCA submits that PGW errs in basing its claim for a \$15.00 residential customer charge

on its COSS and on its argument that an increased customer charge is needed to produce additional revenues so that it is not dependent upon cold winter weather to generate sufficient annual revenues. The OCA argues that PGW's COSS severely overstates the customer-related costs for the customer charge. Moreover, the OCA submits that the customer charge should not be used as a means of protecting PGW's revenues from the effects of the weather. (OCA R.Exc., pp.21-23).

The OCA excepts to the ALJ's recommended customer charge of \$12.00 to the residential class. The OCA submits that, based on PGW's direct customer costs and the principal of gradualism, a residential customer charge level no higher than \$11.50 should be implemented in this proceeding. The OCA further submits that, since ALJ Finding of Fact No. 42 shows that the average residential customer charge for the seven largest natural gas companies in Pennsylvania is \$10.35 per month, a residential charge of \$12.00 recommended for PGW customers by the ALJ is out of line with this statewide average. Accordingly, it is the OCA's position that PGW's customers should have their customer charge reduced to the \$11.50 level, which would be more representative of direct customer costs. (OCA, Exc. No.6, pp. 24-26).

PGW rejoins to the OCA's Exception to the ALJ's recommended customer charge of \$12.00. The OCA recommends a customer charge of no more than \$11.50. PGW argues that even at its proposed \$15.00 customer charge, PGW is recovering less than 50% of the fixed costs incurred by it to serve the residential customers. Moreover, PGW argues that its customer charge recommendation of \$15.00 should be accepted because the additional revenues will help mitigate PGW's current and substantial reliance on cold weather to generate sufficient annual revenues. Accordingly, the OCA's Exception should be denied. (PGW, Exc. VII, p.23).

iv. Disposition

We find that the ALJ's recommendation is reasonable and that PGW's proposal to increase the Commercial customer charge from \$10.00 to \$25.00 is excessive. PGW's proposal would result in a 150% increase to the Commercial customer charge. This is not the "application of the concept of gradualism" that PGW advocates. Further, a review of the record in this proceeding indicates that a \$25.00 Commercial customer charge is far beyond that of nearly every Pennsylvania natural gas utility. (R.D., p. 77). With respect to the Residential customer charge, we reject the OCA's \$11.50 recommendation and find that a \$12.00 residential customer charge will enable PGW to recover a preponderance of its fixed costs to serve its residential customers. We find that a \$12.00 Residential customer charge will gradually move these customers toward their cost of service. As a result of the foregoing, we accept the ALJ's Recommendation on this issue and deny the Exceptions of PGW and the OCA.

b. Commodity Charge

i. Position of the Parties

PGW's current and proposed volumetric charges are as follows:

	<u>Residential</u>	<u>Commercial</u>	<u>Industrial</u>	<u>Municipal</u> <u>GS</u>	<u>Municipal</u> <u>MS</u>	<u>PHA-GS</u>	<u>PHA-PHA</u>
Present	6.6130	7.1200	7.1200	7.1200	6.4130	6.6130	7.1260
Proposed	6.9051	7.6864	7.8170	7.6864	7.0667	6.9051	7.2476

The OSBA recommended a commodity charge of \$7.1897 for the commercial class if the entire \$65 million increase were awarded. The OSBA requested that the charge be scaled back proportionately if the increase was less. The OTS

suggested that the proposed volumetric charge for residential customers be increased from \$6.6130 to \$7.0051 with the other classes remaining at \$7.12. The OCA proposed a commodity charge of \$10.3895. (R.D., p. 79). The OCA's recommended commodity charge transforms to \$6.559 if the GCR is excluded from the OCA's recommended rate to compare with the other Parties recommendations. (OCA St. 2, Ex. 2-B, Table REM-1).

ii. ALJ's Recommendation

In light of the cost of service, the ALJ deemed it reasonable to keep the non-residential classes at their present rates and grant a small increase for the residential class. (R.D., p. 79).

iii. Exceptions

The OCA excepts to the ALJ's recommended residential volumetric commodity charge. The OCA submits that the aforementioned recommendation is based on the ALJ's adoption of a \$44 million rate increase, the OTS proposed allocation of this increase primarily to the residential class, and the adoption of a \$12.00 per month customer charge for the residential class. Since the OCA excepts to these recommendations which form the basis of the residential commodity charge, the OCA, accordingly, excepts to the resulting commodity charge. (OCA, Exc. No. 7, pp. 26-27).

iv. Disposition

We agree with the ALJ's recommendation to keep the non-residential classes at their present rates and grant a small increase to the residential class. Again, we favor adherence to the principle of gradualism on rate structure issues. Accordingly, we deny the Exceptions of the OCA on this issue.

4. Recovery of Non-Gas Costs in GCR

a. Introduction

PGW's firm rate customer bills contain two volumetric charges plus a monthly customer charge. The volumetric charges consist of a base rate charge and a GCR. This is very similar to the way other natural gas distribution companies structure their rates. However, in PGW's case, some components of its GCR are markedly different than those of other natural gas distribution companies in the Commonwealth.

Section 1307(h) of the Code, 66 Pa. C.S. §1307(h), provides a definition of natural gas costs for purposes of rate filings made under that Section. That definition provides, in part, that "'natural gas costs' and 'gas costs' include the direct costs paid by a natural gas distribution company for the purchase and delivery of natural gas to its system in order to supply its customers." Several Parties have argued that a number of components of PGW's GCR are more properly included in the base rate component of PGW's volumetric rate. It has also been argued that an element in PGW's base rates should be allocated to the GCR.

In addition to more standard components, PGW's present GCR includes the following: Natural gas and purchased electric expenses; Non-fuel costs associated with the Company's Customer Responsibility Program (CRP); The Conservation Works Program; and, The Senior Citizen Discount Program. (PGW M.B. pp. 66, 67).

We compare the components listed above to the detailed description of "natural gas costs" found in Section 1307(h) of the Code:

Such costs may include costs paid under agreements to purchase natural gas from sellers; costs paid for transporting natural gas to its system; costs paid for natural gas storage service from others, including the costs of injecting and withdrawing natural gas from storage; all charges fees taxes and rates paid in connection with such purchases, pipeline gathering, storage and transportation; and costs paid for employing futures, options and other risk management tools.

It is readily apparent that there is nothing in the Code's definition of "natural gas costs" which suggests that matters such as purchased electricity, the CRP and the Senior Citizen Discount Program are included in that phrase. Yet, PGW has included these costs in its GCR.

This issue is relevant in the context of this matter by virtue of our Order entered in *Pa. Public Utility Commission v. Philadelphia Gas Works*, Docket Nos. R-00005654 and R-00005619 (Order entered February 22, 2001). In that matter, this Commission approved a Joint Petition for Full Settlement of certain appellate litigation arising out of our prior decision entered November 22, 2000, on PGW's interim base rate increase request at Docket No. R-00005654. That Order permitted PGW to raise rates to charge and collect an \$11 million interim base rate increase by August 31, 2001. In addition, PGW was permitted to recover an additional \$7 million through its GCR to account for additional bad debt expense. Other provisions also operated to PGW's benefit.

Although we approved the foregoing provisions which operated to PGW's benefit, we also imposed certain conditions on PGW. In that vein, we stated the following:

We assure the parties that our approval for the recovery of a portion of bad debt expense through the GCR under the limited and specific circumstances described in the Joint Petition does not reflect any intent to permit such treatment in

future GCR proceedings. In fact, we note that in our November 22, 2000 GCR Order, we expressly directed PGW to address in its base rate filing the appropriateness of including non-gas costs in its GCR. Consistent with that directive, the Joint Petition recognizes that the appropriate amount of this expense will be subject to review and revision in PGW's pending base rate proceeding.

(February 27, 2001 Order, pp. 6, 7).

b. Parties' Positions

Notwithstanding our prior directives regarding this issue, PGW failed to introduce any substantive proposal regarding inclusion of non-gas costs within its GCR rate in this proceeding. (R.D., p. 81).

PICGUG advocated a reallocation of non-gas costs from PGW's GCR, but believed that a full reallocation could not be completed in this proceeding due to PGW's failure to present any proposals. PICGUG argues that while certain specific costs can be moved at this time, the bulk of the issue must await PGW's restructuring proceeding which will include a full base rate proceeding as well as unbundling proposals. (PICGUG M.B., pp. 34, 35).

PICGUG, the OTS and the OCA all agreed on removing some specific cost elements from the GCR in this proceeding. All three Parties asserted that the expense of approximately \$965,000 for the purchase of electricity should be removed from the GCR in this proceeding and placed in base rates. (OTS M.B., p. 44; OCA M.B., p. 57; PICGUG M.B., pp. 34, 35). The OCA and PICGUG also noted that PGW is currently recovering \$3.18 per Mcf of gas costs through base rates. Both PICGUG and the OCA recommended removing that gas cost from base rates and placing it in the GCR,

consistent with their general positions on appropriate GCR components. (OCA St. 1, pp. 48, 49; PICGUG M.B., p. 34).

The OTS and PICGUG also asserted that a bad debt expense should be removed from the GCR. In the *Joint Petition* approved by the Commission in the February 22, 2001 Order, PGW was permitted to collect \$7 million to defray bad debt expense. PGW was also permitted to retain up to \$18 million in over-recovered GCR revenues for bad debts. Given this treatment, both Parties argued that this element could be removed from the GCR mechanism. (R.D., pp. 83, 84).

In addition to the foregoing adjustments to the GCR, the OTS argued that the Senior Citizen Discount program, the Conservation Works Program and the Customer Responsibility Program should all be excluded from PGW's GCR mechanism at this time. (R.D., pp. 84-87).

PGW stated that it had historically collected these charges through the GCR because it assured dollar-for-dollar recovery. In addition, the Philadelphia City Council mandated some of the programs involved in these costs and the GCR methodology was accepted by the PGC. PGW argued that the GCR mechanism assured that costs were collected in the year in which they were incurred with little build-up or over/under collection. (PGW M.B., p. 67).

c. ALJ Recommendation

The ALJ agreed with the OTS that each of the cost elements it had identified were not properly included in PGW's GCR. However, the ALJ also agreed with PICGUG that the failure of PGW to advance specific proposals for the treatment of the elements made consideration of the OTS proposals problematic in this proceeding. The ALJ did find that certain cost elements could be addressed in this proceeding.

The ALJ found that the recovery of purchased electricity costs should be excluded from the GCR and placed into base rates. She also found that the expense for bad debts should be excluded from the GCR. (R.D., pp. 83, 84). The ALJ also found that the expenses for the Senior Citizen Discount Program, the Conservation Works Program and the Customer Responsibility Program should be removed from the GCR and placed into base rates. However, the ALJ recommended that those issues should be deferred to the Company's restructuring proceeding to allow PGW and the other Parties to fully address those issues. (R.D., pp. 85-87). The ALJ did not specifically address the OCA and PICGUG arguments relating to removal of the \$3.18 per Mcf charge from base rates to the GCR.

d. Exceptions

PGW excepts to the ALJ's recommendation that the costs for purchased electricity and bad debts be recovered in base rates rather than the GCR. PGW asserts that it has historically collected those charges through the GCR. In addition, PGW argues that the purchased electricity costs are substantially related to the operation of its LNG plants and gas moving equipment. (PGW Exc., pp. 31, 32).

Furthermore, PGW contends that Section 2212(d) of the Code requires this Commission to defer to PGW's treatment of these costs until its restructuring case. PGW also argues that a deferral of all the GCR issues to the restructuring case makes more sense than a piecemeal approach in which some GCR components are addressed while others are deferred. (*Id.*).

The OCA excepts to the ALJ's failure to adjust base rates to reflect the removal of a gas cost charge from base rates and placing that charge in the GCR. According to the OCA, these costs can be removed from the base rate commodity charge

and included in the GCR in the final design of the commodity charge. The OCA argues that the correct amount to be rolled out of the base rate charge is \$3.1638 per Mcf. This represents the current base cost of gas of \$3.18 per Mcf minus \$0.0162 per Mcf for the cost of purchased electricity included in the GCR at present rates. (OCA Exc., pp. 27, 28).

In its Reply Exceptions, PGW again argues that any effort to adjust its GCR or move gas costs from base rates to the GCR should wait for the restructuring proceeding. PGW states that the elements raised by the OTS, OCA and PICGUG are “symbiotic” and it is, therefore, irrational to shift some of the costs while others remain static. According to PGW, the only thoughtful and comprehensive manner to address these cost allocation concerns is during its restructuring case. (PGW Rep. Exc., pp. 23, 24).

The OTS responded to PGW’s Exception relating to reallocation of the purchased electricity cost from the GCR to base rates. The OTS cites to our Order at R-00005619 in PGW’s GCR proceeding where we directed PGW to make specific recommendations on this issue in this proceeding. Consistent with that direction, the OTS notes that it proposed removal of \$965,000 of purchased electricity cost from the GCR. According to the OTS, this is an easily quantifiable amount which presents less complications than reallocation of the social program costs it advanced before the ALJ. The OTS argues that PGW’s Exception on this issue should be denied. (OTS R.Exc., pp. 21, 22).

In its Reply Exceptions, the OCA rejoins that PGW’s argument that Section 2212(d) of the Code, 66 Pa. C.S. §2212(d), prohibits this Commission from allocating costs between rate components in a base rate case. The OCA argues that the reallocation of purchased electricity costs will better prepare the Company for

restructuring. However, the OCA notes that it would not object if this change were deferred to PGW's restructuring proceeding. (OCA R.Exc., p. 21).

e. Disposition

As noted above, the ALJ recommended that we adopt the position advanced by the OTS and remove the purchased electric cost from the GCR and place it in base rates. (R.D., pp. 83, 84). However, she also ruled that the remaining non-gas cost expenses challenged in this proceeding remain in the GCR until PGW's restructuring filing. (R.D., pp. 85-87).

We disagree with the ALJ's recommendation on the purchased electric cost. The ALJ is correct that this challenged cost does reflect non-gas costs. Accordingly, it should be recovered in base rates, not the GCR. However, for the balance of the challenged non-gas costs in the GCR, except for purchased electric cost, the ALJ recommended that we defer consideration of this issue to PGW's restructuring proceeding. (*Id.*).

PGW has traditionally recovered this cost as part of its GCR since it is substantially related to the operations of its LNG plants and gas moving equipment. We agree with PGW that the decision on the treatment of this cost should be deferred until the restructuring proceeding. This approach will afford us the opportunity to review all of the non-gas costs currently recovered through the GCR in a comprehensive fashion. This is more desirable than the piecemeal approach advocated by the ALJ.

5. Tariff Changes

a. Nonstandard Rates

i. Positions of the Parties

PGW proposed to modify its tariff by adding a new Section 2.3 in order to allow it to enter into individual contracts with commercial and industrial customers at negotiated prices and/or terms and conditions of service for an agreed upon period of time. (PGW St. 4.0, p. 10). This flexibility would allow PGW to offer individual, alternative pricing solutions to customers when they are faced with competitive fuel offerings, or to lure them back when they use an alternative fuel. Since this arrangement offers rates and/or terms of service that are different than PGW's standard schedule, PGW characterizes these arrangements as "non-standard contracts." (PGW St. 4.0, pp. 10-12).

The OCA supported PGW's proposal that it be allowed to negotiate non-standard rates for some of its customers. The OCA also suggested three changes to Section 2.3. (referenced *infra.*). The OCA argued that those revisions are necessary in order to ensure that the sales customers are not disadvantaged by the contracts PGW negotiates under section 2.3. (OCA M.B., p. 59).

ii. ALJ's Recommendation

The ALJ stated that, after reviewing the proposed modifications, her recommendation was that PGW's proposal on this issue be adopted without revision. She further stated that, in her opinion, the OCA's suggestions on this issue would be too restrictive. (R.D., p. 88).

iii. Exceptions

The OCA excepts to the ALJ's recommendation on this issue. The OCA reiterates that its three proposed modifications to PGW's proposal are necessary to ensure that sales customers are not disadvantaged by any contracts entered into under this new tariff provision.

Specifically, the OCA recommends that Section 2.3b on the negotiated rate should be modified so that it is identical to the provisions of PGW's interruptible rate schedules. Secondly, the OCA recommends that an additional provision be added to ensure that PGW obtains a benefit of additional sales volume in exchange for any discounts below the interruptible rates otherwise available to the customer. Thirdly, the OCA recommends a provision that is designed to prevent a customer from walking away from a negotiated price if gas prices were to fall below the negotiated price. Without such a provision, argues the OCA, PGW could obtain long-term supply for the customer at a specified rate, and the customer subsequently would be free to walk away, leaving PGW saddled with the long-term supply arrangement. (OCA M.B., pp. 58-59).

The OCA also asserts that these modifications to PGW's proposal should be adopted because such adoption would ensure that sales customers are not disadvantaged by any contracts entered into by PGW under its tariff provisions. (OCA Exc., pp. 29-31).

CEPA *et al.*, also excepts on this issue, arguing that the OCA's proposals with regard to the issue of non-standard rates should be adopted. (CEPA *et al.*, Exc., pp. 14-15).

PGW rejoins that, as noted by the ALJ, the OCA's proposed modifications are too restrictive, and should be rejected. PGW points out that it is its clear intent to be

flexible in order to offer individual alternative pricing solutions to customers when they are faced with competitive fuel offerings, or to lure them back when they use an alternative fuel. PGW also asserts that its ability to charge market-based rates in competitive markets is critical to its ability to compete effectively. Accordingly, argues PGW, the OCA's Exception on this issue should be denied. (PGW R. Exc., p. 24).

iv. Disposition

On review of this issue, we conclude that PGW's proposal on this issue is reasonable and appropriate. Accordingly, we agree with the recommendation of the ALJ on this issue. (R.D., p. 88).

As above recounted, PGW proposed to modify its tariff by adding a new Section 2.3 in order to allow it to enter into individual contracts with commercial and industrial customers at negotiated prices and/or terms and conditions of service for an agreed upon time period. We concur with PGW that the added flexibility would allow it to offer individual, alternative pricing solutions to customers when they are faced with competitive fuel offerings, or to lure them back when they use an alternative fuel.

Also, as above recounted, the OCA suggested three changes to Section 2.3 that it deems necessary in order to ensure that the sales customers are not disadvantaged by the contracts that PGW will negotiate under Section 2.3. On review of those OCA-proposed modifications, we find them to be overly restrictive. We note in this connection that it is the clearly stated intent of PGW, as we have noted just above, to be flexible in order to offer individual alternative pricing solutions to customers when they are faced with competitive fuel offerings. Also, we note that PGW's ability to charge market-based rates in competitive markets is critical to its ability to compete effectively. Accordingly, the ALJ's recommendation on this issue is adopted, and the Exceptions filed thereto by the OCA and by CEPA *et al.* are denied.

b. BPS Price Ceiling

i. Positions of the Parties

PGW proposed to clarify the rate schedules for BPS-S and BPS-L in order to remove any confusion over the maximum price that it could charge BPS customers.

At the present time, the rate schedules can be read to limit the maximum price that PGW can charge its BPS customers to 90% of the General Service (GS) rate for commercial customers, even if that rate is below PGW's cost of gas. To eliminate this confusion, PGW proposed to eliminate the 90% provision. PGW stated that it preferred that it be permitted to charge at least 110% of the cost of gas used to serve the BPS-S and BPS-L classes. (PGW M.B., p. 66).

The OCA concurred with the decision to remove the BPS price ceiling of 90% of the GS rate from the tariff. (OCA M.B., pp. 59, 60).

ii. ALJ's Recommendation

The ALJ stated that, after reviewing the proposed modifications on this issue, and based on the fact that the OCA concurred with those proposed modifications, she recommended adoption of PGW's request. (R.D., p. 89).

iii. Exceptions

No Party excepts to the ALJ's recommendation on this issue.

iv. Disposition

Since no Party excepts to the ALJ's recommendation on this issue, and since we find that recommendation to be otherwise reasonable, it is adopted.

c. The OTS' Proposed Revisions

i. Positions of the Parties

Initially, the ALJ noted that PGW and the OTS have agreed to meet in an attempt to resolve OTS' proposed tariffs issues. (R.D., p. 89).

In this proceeding, the OTS raised several tariff issues addressing PGW's service. Those issues were as follows: (1) PGW's tariff needs to have tariff language that defines the curtailment rules and priority of service; (2) PGW's NGV tariff should be eliminated; (3) PGW provides interruptible service to apartment complexes that may not have alternate fuel; (4) PGW's transportation tariff does not comply with the Commission's Transportation Regulations; and (5) PGW does not read all of its customers' meters on a timely basis. (OTS St. 3, pp. 25-26).

In response, PGW argued that it is willing to continue to work with the OTS at the conclusion of this base rate proceeding, in a workshop environment, to determine whether a specific plan and tariff provision could be mutually agreed to. (PGW St. 4.1, p. 14). Accordingly, PGW and the OTS have agreed to meet in a workshop environment in order to find a mutually agreeable solution to the tariff issues addressed by the OTS. (PGW M.B., p. 70; OTS M.B., p. 53).

ii. ALJ's Recommendation

As above noted, PGW and the OTS have agreed to meet in an attempt to resolve OTS' proposed tariffs issues. (R.D., p. 89).

iii. Exceptions

No Exceptions have been filed to the ALJ's recommendation on this issue.

iv. Disposition

Since no Party excepts to the ALJ's recommendation on this issue, and since we find that recommendation to be otherwise reasonable, it is adopted.

d. PICGUG's Proposed Revisions²⁹

i. Positions of the Parties

PICGUG asserted that PGW's current transportation requirements are inadequate, antiquated and too discretionary to actually permit any form of true transportation on PGW's system. PICGUG claimed that other NGDCs in Pennsylvania have been permitting large industrial and commercial customers to transport natural gas

²⁹ On September 20, 2001, PGW and PICGUG filed a proposed Settlement Stipulation addressing gas transportation rules and regulations. The OCA and the OSBA indicated that they did not object to the proposed Settlement Stipulation. CEPA *et al.* and the OTS have not yet commented on the proposed Settlement Stipulation.

We note that, while we encourage the settlement of contested issues, the process is designed to afford all Parties the opportunity to file timely comments. The proposed Settlement Stipulation was submitted to us on the eve of the Public Meeting on which we were to consider the ALJ's Recommended Decision herein. Accordingly, all

on their systems since the mid-1980's. While PGW technically permits such customers to transport natural gas, the rigidity of PGW's transportation rules and requirements results in a system that actually prohibits many customers from having the ability and means to transport their own natural gas. (PICGUG St. 1, p. 14; PICGUG M.B., p. 7). It should be noted that only eight customers have transportation contracts on PGW's system. (Tr. p. 703).

PICGUG submitted that the Act requires PGW to present a restructuring filing no later than July 1, 2002. According to PICGUG, this filing must set forth the means for unbundling all of PGW's rates in order to provide all customers the ability to transport natural gas on its system. (66 Pa. C.S. §2212(g)). Since other NGDCs were already providing large industrial and commercial customers the opportunity to transport natural gas prior to restructuring, their restructuring proceedings were limited to merely expanding transportation programs to include residential and small commercial customers.

Conversely, argued PICGUG, because PGW effectively prohibits most customers from transporting on its system, PGW's restructuring proceeding will require significant and profound changes to its transportation regulations in order to provide all customers the ability to transport natural gas on its system. (Tr. pp. 704-06; PICGUG M.B., pp. 7, 8).

Inasmuch as massive changes will be required as part of PGW's restructuring proceeding, PICGUG contended that PGW should be required to modify its transportation rules now in order to provide an orderly and working transportation system for large industrial and commercial customers. That system would be similar to those present on other natural gas distribution companies' systems prior to restructuring.

Parties were not afforded the opportunity to file timely comments to it. Therefore, we reject the proposed Settlement Stipulation.

Specifically, PICGUG requested the following changes to PGW's transportation rules in its present tariff:

- i. Reduction of the minimum volume eligibility to 15,000 Mcf from 75,000 Mcf;
- ii. Customers may aggregate multiple services and multiple accounts to meet the 15,000 Mcf threshold;
- iii. Unrelated customers may form buyers' groups of up to ten (10) individual customers to reach the 15,000 Mcf/yr threshold;
- iv. Transportation customers should be able to make intra-day nominations;
- v. PGW is obligated to provide information on daily imbalance information to transportation;
- vi. PGW is obligated to provide timely lost and unaccounted for gas information to transportation customers.

(PGW Exc., p. 32).

ii. ALJ's Recommendation

The ALJ recommended the adoption of all the changes requested by PICGUG to PGW's transportation rules as outlined above. (R.D., pp. 96-104).

iii. Exceptions

PGW excepts to the ALJ's recommendation on these issues. PGW contends that the implementation of the ALJ's recommendation on these issues would amount to an order directing the full unbundling of PGW's gas system. PGW asserts that the Legislature has mandated that unbundling occur at the conclusion of the restructuring proceeding, *i.e.*, by September of 2003.

PGW further contends that if it were to be ordered prematurely to attempt such massive change to its tariff in such a rushed timeframe as proposed by the ALJ, system reliability would be threatened, thus causing potential harm to the very customers the changes are intended to benefit. PGW recommends that, in lieu of the massive revisions to PGW's tariff recommended by the ALJ, the Commission order the initiation of a collaborative process to assist in the planning and development of PGW's unbundling plan to be implemented at restructuring. (PGW Exc., pp. 32-37).

PICGUG rejoins that PGW's arguments on this issue are without merit and should be rejected. Specifically, PICGUG argues that implementation of the ALJ's recommended modifications would not result in a virtual unbundling of PGW's Tariff, but will rather place PGW at the same level as other natural gas distribution companies prior to restructuring. (PICGUG R. Exc., pp. 3-12).

The OCA also excepts to the ALJ's recommendation on this issue. The OCA argues that that recommendation may be premature, particularly in light of the ALJ's recommendation to defer other issues, such as issues regarding the recovery of senior discount costs and universal service program costs through the GCR to the restructuring proceeding. The OCA submits that these issues should be regarded as a whole in the restructuring proceeding, consistent with the ALJ's recommendation regarding other fundamental tariff and allocation issues. (OCA Exc., pp. 28-29).

PICGUG rejoins that the ALJ correctly determined that PGW's rigid and antiquated transportation rules must be modified in order to allow large commercial and industrial customers the opportunity to utilize PGW's transportation service. PICGUG also asserts that those modifications are also necessary in order to provide a basis for PGW's forthcoming restructuring proceeding. (PICGUG R. Exc., pp. 16-20).

CEPA *et al.* also excepts to the ALJ's recommendation on these issues. CEPA *et al.* notes that those recommendations, if adopted, would, *inter alia*, require the extension of present transportation service to a newly defined customer class and would also impose significant new operations requirements upon the utility.

CEPA *et al.* further argues that the Commission is without authority to make these changes in PGW's Tariff, unless PGW were to request such changes. Section 2212(d) of the Act provides that PGW's "prior tariff" shall apply in the period between assumption of PUC jurisdiction over PGW's Tariff and the effective date of PGW's restructuring plan. CEPA *et al.*, further asserts that the transportation related amendments recommended by the ALJ were not proposed by PGW, were not implicit in the amendments proposed by PGW, and are not necessary to enable the Commission to fulfill its responsibilities in ruling on the proposed Base Rate increase. (CEPA *et al.*, Exc., pp. 9-10).

iv. Disposition

On review of the ALJ's recommendation concerning these proposed tariff changes, we disagree with her conclusion. While it is understandable that customers are frustrated that the full unbundling available from Pennsylvania's investor owned gas utilities is not immediately available from PGW, the fact is that such a transition does not happen overnight. The General Assembly has recognized this by mandating that PGW's

existing tariff should stay in place until completion of the mandated restructuring proceeding pertaining to PGW.

Specifically, we note that the Commission is without authority to make the proposed changes to PGW's tariff, unless PGW were to request such changes. Section 2212(d) of the Act provides that PGW's "prior tariff" shall apply in the period between assumption of PUC jurisdiction over PGW's Tariff and the effective date of PGW's restructuring plan. We also note that the transportation related amendments recommended by the ALJ were not proposed by PGW, were not implicit in the amendments proposed by PGW, and are not necessary to enable the Commission to fulfill its responsibilities in ruling on the proposed Base Rate increase.

Accordingly, the ALJ's recommendation on PICGUG's proposed tariff changes is rejected. The Exceptions filed by PGW, by the OCA and by CEPA *et al.*, Relative to this issue are granted.

D. Management Audit and Quality of Service

1. Management Audit

a. Positions of the Parties

The Barrington Wellesley Group, Inc. (BWG) carried out a Stratified Management and Operations Audit of PGW (Management Audit) from June 2000 through October 2000. The final Audit Report, which was filed with the Commission in January 2001, contained approximately 76 recommendations. On or about March 22, 2001, PGW submitted a formal response to the Audit Report in the form of its Plan for Implementation of the Recommendations in the Stratified Management and Operations

Audit (Implementation Plan). In the Implementation Plan, PGW accepted 73 of the 76 recommendations. (PGW M.B., pp. 72-73).

PGW does not oppose the inclusion of the Management Audit in the record in order to provide background information; however, PGW does oppose making the implementation of the recommendations in the Audit Report conditions to the Commission's approval of the instant matter. PGW asserts that the audit has served its purpose of identifying areas of improvement in service and management, and that virtually all of those recommendations have been accepted and are being implemented.

PGW notes that while there was considerable discussion during the proceedings concerning the potential use of the Audit to attempt to justify a denial of PGW's requested rate increase, no party actually made such a proposal on the record. Therefore, according to PGW, due process and the notions of fairness bar entertaining such a proposal now that the record has closed. PGW also notes that the Audit took place at a time of dynamic change for the company; therefore, the Audit failed to incorporate changes in operations that were already in the works. (PGW M.B., pp. 75-76).

CEPA *et al.* contends that BWG's Management Audit presents irrefutable evidence of PGW's massive, system-wide customer service failures and compels the conclusion that PGW's service is so inadequate as to require postponement of any future increase in base rates. (CEPA *et al.* M.B., pp. 13-18)

b. ALJ Recommendation

The ALJ discusses CEPA *et al.* and PGW's positions on the issue of the management audit but makes no recommendations concerning this issue. (R.D., pp. 104-105).

c. Exceptions

The OCA excepts to the ALJ's failure to impose conditions on any rate increase based on the results of the management audit. The OCA argues that PGW committed to many of the changes and improvements identified in the audit and that the Commission should include appropriate conditions in its Order to ensure continued progress toward these improvements. (OCA Exc., p. 17).

2. Quality of Service

a. Positions of the Parties

PGW claims that its base rate request cannot be dismissed due to alleged service inadequacies. PGW further claims that it is providing reasonable service and that no evidence exists to support an argument that the proposed rate increase is unreasonable or would result in rate shock. (PGW M.B., pp. 53-55).

PICGUG asserts that PGW's history of inadequate service must be considered as a factor in determining whether the company's \$65 million rate increase request should be granted. PICGUG claims that PGW must recognize that requiring customers to pay higher rates without providing better service does not meet the standard of Section 1301 of the Code which provides for "just and reasonable rates." 66 Pa. C.S. §1301. (PICGUG R.B., p.6).

CEPA *et al.* asserts that PGW's proposed increased base rate is not just and reasonable because PGW has failed, and is currently failing to provide adequate, efficient, and reasonable service. CEPA *et al.* cites to the results of the Management Audit as irrefutable evidence of PGW's inability to provide adequate service. The Management Audit gave PGW's Customer Service and Billing and Collection

departments grades of “major improvement necessary.”³⁰ CEPA *et al.* noted that PGW does not plan on meeting the goal of bringing its Customer Service Call Center into conformity with industry standards of service until 2003. (CEPA *et al.* M.B., pp. 7-17).

The OCA argues that rates should follow service as explained below:

The regulatory process has consistently followed the principle that a utility operation is only entitled to rate increases if its service is adequate and reasonable. Such a principle enforces the requirement that, in providing a monopoly service, utility owners have a responsibility to maintain and operate the utility in the most efficient and reasonable manner possible. Failure to fulfill these requirements can result in the withholding of rate relief. In effect, regulation requires that utility owners provide effective management and sufficient capital to fulfill the on-going obligation to serve.

(OCA St. 1, pp. 13 and 60).

The OCA recommends that the Commission require that PGW meet the following conditions if granted any rate increase:

- (1) PGW should be required to maintain at least a 1% replacement rate in its mains replacement program;
- (2) PGW should continue its commitment to correcting problems with the Bureau of Consumer Services, particularly the need to rectify the budget billing problems;
- (3) PGW should continue to work with the Commission to implement the recommendations of the Stratified

³⁰ “Major Improvement Necessary” was the lowest of five grades delineated in the Management Audit and signified that “the area is not functioning effectively or efficiently and many significant and high priority recommendations need to be implemented to achieve adequate performance. Implementation of the recommendations will have a major effect on PGW’s cost levels and performance.” (CEPA *et al.* M.B., p. 13).

- Management and Operations Audit consistent with the Philadelphia Gas Works Implementation Plan;
- (4) PGW should improve its customer service in a timely manner, particularly its call center performance; and
 - (5) PGW should continue progress on its Transition to Excellence Plan.

(OCA M.B., p. 72).

b. ALJ Recommendation

The ALJ noted that although service problems existed, the entire rate case should not be denied pending resolution of those problems. (R.D., p. 69).

c. Exceptions

The OCA excepts to the ALJ's failure to recognize quality of service issues as part of the process for determining the just and reasonable level of rates. The OCA states that the Public Input Testimony, the testimony of its witness, the Vanguard Report, and the Management Audit raise many concerns about the level of PGW's service. The OCA contends that the ALJ, after having noted that PGW has service problems, does not consider this important fact in balancing the interests of the ratepayers. The OCA submits that were service issues fully considered it would be apparent that the maximum rate increase merited is the \$21.5 million suggested by the OCA (\$10.5 million plus the \$11 million interim increase agreed upon in the Settlement). Additionally, to ensure that progress continues toward improving customer service and to ensure that the ratepayers are afforded basic protections as a result of this proceeding. The OCA recommends that the five aforementioned service-related conditions be adopted if any rate increase is granted. (OCA's Exc., pp. 11-19).

CEPA *et al.* excepts to the ALJ's failure to make a Finding of Fact concerning the inadequacy of PGW's service. CEPA *et al.* argues that the Recommended Decision failed to grant OCA's proposals regarding the inadequacy of call center performance, continued BCS problems related to billing in accordance with the Tariff, and the existence of a virtually unprecedented 3,513 outstanding informal complaints concerning PGW pending before the Commission's BCS. CEPA *et al.* incorporates OCA's Exception No. 4 by reference, arguing that the ALJ erred by failing to recommend concurrent service conditions in connection with any base rate increase. (CEPA *et al.* Exc., pp. 4-5, 12).

In its Reply Exceptions, PGW rejects the arguments of OCA and CEPA *et al.* which alleged that service inadequacies bar the \$44 million rate increase recommended by the ALJ. PGW states that the arguments are wholly unsupported by facts or the law governing this case. PGW argues that not once in the history of PGC ratemaking was a rate increase for PGW denied on the basis of inadequate service. Therefore, according to PGW, the arguments of the OCA and CEPA *et al.* 's, arguments that the service inadequacies control the legal standards governing this proceeding, are incorrect. (PGW R. Exc., pp. 14-16).

d. Disposition

Section 1501 of the Code, 66 Pa. C.S. §1501, requires all public utilities to "furnish and maintain adequate, efficient, safe and reasonable service and facilities," and Section 526(a) permits the Commission to give consideration to quality of service in the rate making process:

- (a) General rule.--The Commission may reject, in whole or in part, a public utility's request to increase its rates where the commission concludes, after hearing, that the service rendered by the public utility is inadequate

in that it fails to meet quantity or quality for the type of service provided.

(66 Pa. P.S. §526(a)).

We agree with the sentiments offered by the OCA and CEPA *et al.* In fact, we note that PGW recognizes the various commitments it has made through the Management Audit process, as well as, the Interim Rate Settlement and 2000-2001 GCR proceeding. Through PGW's continued adherence to the commitments and ongoing implementation of the various conditions set forth in those Orders, including the monthly filing of status reports, we are satisfied that the quality of service issues will be adequately monitored and addressed.

Accordingly, the OCA's Exception relative to this issue is denied.

E. Miscellaneous Issues

1. Senior Citizen Discount Program

a. Positions of the Parties

Pursuant to a City of Philadelphia Ordinance, PGW provides a Senior Citizen Assistance Program (SCA Program) to its customers who are 65 years of age or older. The SCA Program provides a 20 % discount to over 90, 000 customers and is not income contingent. The SCA Program costs PGW between \$13 and \$16 million annually during the fiscal years 1997 - 1999. (Administrative Counsel Ex. 1 at VIII-34).

The OTS opined that the SCA Program does not satisfy the just and reasonable standard of Section 1308 of the Code, 66 Pa. C.S § 1308, as it has no income requirements. The OTS noted that as the baby boom generation nears eligibility, so many

customers will become eligible for the discount that the future cost of the SCA Program may become completely unmanageable. The OTS further noted that PGW has not monitored the SCA Program since 1998 to ensure that all participants meet eligibility requirements. The OTS recommends that: (1) the SCA Program should be closed to new customers; (2) the SCA Program be phased out over a five-year period, reducing the discount by four percent per year; and (3) the SCA Program customers be re-certified based on income eligibility.

The OTS noted that PGW would require approval from the Philadelphia City Council to phase out the SCA Program and recommended that PGW submit a proposal to the City Council requesting such. (OTS M.B., pp. 50-52).

PGW explains that it cannot eliminate the SCA Program because it was statutorily created by the Philadelphia City Council and, therefore, only an act of the City Council can change or abolish it. (PGW St. 1.2, pp. 7-8; PGW Ex. TEK-5, ¶15).

b. ALJ Recommendation

The ALJ noted that the OTS was the only party requesting the elimination of the SCA Program. The ALJ further noted that City Council would have to approve legislation to modify or eliminate the SCA Program, and the Parties have not addressed the issue in detail. For these reasons, the ALJ concluded that the OTS' recommendation should be denied. The ALJ further concluded that this issue would be more appropriately addressed in the restructuring proceeding. (R.D., pp. 107-108).

c. Exceptions

CEPA *et al.* agrees with the ALJ's recommendation regarding the SCA Program. However, CEPA *et al.* excepts to the ALJ's statement that Section 2212(r)(2)

of the Act, 66 Pa. C.S. §2212(r)(2), “authorizes the Commission to approve a Senior Citizen Discount Program or discontinue the current program.” *CEPA et al.* points out that, although the Philadelphia City Council can restructure the tariff and effectively change the conditions under which senior citizens may receive the discount, the Commission itself lacks the authority to do the same. (*CEPA et al. Exc.*, pp. 11-12)

d. Disposition

We agree with the ALJ’s recommendation and recognize the position noted by *CEPA et al.* that under Section 2212(r)(2) of the Act, this discount must continue for those customers participating in the program as of the date of the filing of PGW’s new tariff and restructuring proceeding, until the program is modified by ordinance of the governing body of the City. Under Section 2212(r)(1), the Commission **may** approve a discount program for senior citizens who are not receiving the discount on the date of the filing of the new tariff and restructuring proceeding, assuming the rates and terms of the program are just and reasonable. Accordingly, the issue of the senior citizens discount program should be addressed in the PGW restructuring proceeding.

III. Conclusion

We have carefully reviewed the record as developed in this proceeding, including the ALJ's Recommended Decision and the Exceptions filed thereto. While we agree with the ALJ that several of the OTS' recommended adjustments are appropriate for inclusion, we note that the ALJ's recommendation fails to account for several other adjustments that were offered by the OCA. We agree with several of these additional adjustments, which result in an allowable revenue increase of \$28,067,000, which is in addition to the previously granted \$11 million interim base rate increase.

As such, we hereby grant and/or deny the Exceptions filed by the various Parties hereto, as discussed *supra*. Accordingly, the ALJ's Recommended Decision is adopted, as modified by this Opinion and Order.

IV. ORDER

THEREFORE; IT IS ORDERED:

1. That the Exceptions filed by CEPA *et al.* on August 21, 2001, to the *Recommended Decision of Administrative Law Judge Cynthia Williams Fordham herein*, are granted in part and denied in part, consistent with this Opinion and Order.

2. That the Exceptions filed by the Office of Consumer Advocate on August 22, 2001, to the *Recommended Decision of Administrative Law Judge Cynthia Williams Fordham herein*, are granted in part and denied in part, consistent with this Opinion and Order.

3. That the Exceptions filed by Philadelphia Gas Works on August 22, 2001, to the *Recommended Decision of Administrative Law Judge Cynthia Williams Fordham herein*, are granted in part and denied in part, consistent with this Opinion and Order.

4. That the Exceptions filed by Philadelphia Industrial and Commercial Gas Users Group on August 22, 2001, to the *Recommended Decision of Administrative Law Judge Cynthia Williams Fordham herein*, are denied.

5. That the Philadelphia Gas Works' Supplement No. 7 to Tariff Gas – Pa. P.U.C. No. 1 filed January 4, 2001 and docketed at R-00006042 is approved in part and denied in part consistent with this Opinion and Order.

6. That within thirty (30) days of the entry of the Commission's Opinion and Order, the Philadelphia Gas Works is hereby authorized to file a Tariff supplement

designed to change rules, regulations and rates calculated to produce \$28,067,000 in additional revenue in addition to the \$11,000,000 interim relief implemented in March 2001.

7. That, in accordance with Section 2212(e) of the Gas Choice Act, we herein set rates for Philadelphia Gas Works in accordance with its previous ratemaking methodology and requirements. In this instance, Philadelphia Gas Works' previous ratemaking methodology, as contained in its Management Agreement and affirmed by the Pennsylvania courts, is the cash flow method.

8. That the tariff filed by the Philadelphia Gas Works will include a residential customer charge of \$12, a commercial customer charge of \$18 and an industrial customer charge of \$50.

9. That the tariff filed by the Philadelphia Gas Works will include a recalculated volumetric charge for the residential customers based upon the rate design and revenue levels provided by this Opinion and Order, that the Office of Trial Staff's recommendation to increase rates to the LBS Large Direct, TriGen Direct and NGV Direct customer classes is granted, that the Office of Trial Staff's recommendation to reduce the rates to the GTS Trans customer class is granted, and that the volumetric charge for the other classes remain the same.

10. That the Philadelphia Gas Works shall include in its compliance filing, documentation supporting the recalculated residential volumetric charge.

11. That the recommendation that the Commission require the City to waive the \$18 million payment from the Philadelphia Gas Works is denied.

12. That the Office of Trial Staff's recommendation to increase

the number and average use of the Company's residential heating and commercial heating customers based on the Office of Trial Staff's calculations is granted.

13. That the Office of Trial Staff's recommendation to disallow the \$100,000 rate base expense for the Lukens testimony is denied.

14. That the recommendation to normalize the rate case expense over a two-year period is granted.

15. That the budgeted expense for promotional activities will be reduced to \$385,000 in accordance with the Office of Trial Staff's recommendation.

16. That the Office of Trial Staff's recommendation for bad debt account expense adjustment is granted.

17. That the Office of Consumer Advocate's recommendations for adjustments for BCCS Remediation, Consultant Studies/Costs, Non-Recurring Expenses, Employee Consultants, Equipment Rentals and Leasing Information Technology, Lobbying Expenses, Operating Leases, Non-Recurring Material Purchases and to partially offset the Company's amortization of its regulatory asset for CRP arrearages are granted.

18. That Philadelphia Gas Works file a cost of service study for present and proposed rates during the restructuring proceeding.

19. That the recommendation to transfer the electricity cost and the bad debt expenses, which are currently contained in Philadelphia Gas Works' Gas Cost Rate (GCR), to base rates is deferred until the restructuring proceeding.

20. That the recommendation to transfer the other non-gas costs, such as the Customer Responsibility Program, the Conservation Works Program and the Senior Citizen Discount, from the GCR to base rates is deferred until the restructuring proceeding.

21. That Philadelphia Gas Work's request to modify its tariff to allow it to enter into individual contracts with commercial and industrial customers at negotiated prices and/or terms and conditions of service for an agreed upon period of time is approved.

22. That Philadelphia Gas Work's request to modify its tariff to clarify the rate schedules for BPS-S and BPS-L is approved.

23. That the Philadelphia Industrial and Commercial Gas Users Group's recommendations to lower the volume eligibility requirement for transporting gas, to permit customers to aggregate facilities serviced by multiple accounts, to expand the buyers' group to a maximum of ten individual customers, to permit transportation customers to make intra-day nominations, and to require the Philadelphia Gas Works to provide daily imbalance information is deferred until the restructuring proceeding.

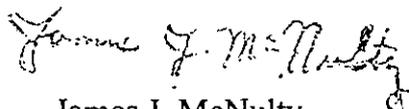
24. That the Office of Trial Staff's recommendation to eliminate the Senior Citizen's Assistance Program is denied.

25. That Philadelphia Gas Works continue to monitor and address its quality of service issues. Specifically, that Philadelphia Gas Works continue to adhere to the commitments and the ongoing implementation of the various conditions outlined in the Management Audit process, as well as the Interim Rate Settlement proceeding and the 2000-2001 GCR proceeding.

26. That the Formal Complaints filed by the Office of Consumer Advocate at Docket No. R-00006042C0023; CEPA *et al.* at Docket No. R-00006042C0027; the Philadelphia Industrial Commercial Gas Users Group at Docket No. R-00006042C0060; and the Office of Small Business Advocate at Docket No. R-00006042C0070 are sustained to the extent consistent with this Opinion and Order, and, otherwise, are denied and dismissed.

27. That after acceptance and approval by the Commission of the tariff revisions filed by the Philadelphia Gas Works, the Investigation at Docket No. R-00006042 and the Complaints at Docket Nos. R-00006042C0001 through R-00006042C0171; C-00014826- C-00014828; C-00014843; C-00014910; C-00015037; C-00015044-C-00015048; C-00015050 and C-00015098 shall be terminated and the record marked closed.

BY THE COMMISSION,



James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: September 21, 2001

ORDER ENTERED: **OCT 04 2001**

PA PUC v. Philadelphia Gas Works
Docket Number R-00006042
Income Statement FYE August 31, 2001

	<u>PGW Revised Budget</u>	<u>Commission</u>	
		Adjustments	Allowance
<u>OPERATING REVENUES:</u>			
1. Non-Heating	121,544		121,544
2. Gas Transportation Service	3,656		3,656
3. Heating	535,415	34,263	569,678
4. Proposed Base Rate Increase	65,000	(36,933)	28,067
5. CRP/CWP/Senior Discount		0	0
6. Interim Increase		11,000	11,000
7. Electric Costs from GCR			0
8. Unbilled Revenue Adjustment	<u>1,844</u>		<u>1,844</u>
9. TOTAL GAS REVENUES	727,459	8,330	735,789
10. Other Operating Revenues	<u>28,026</u>		<u>28,026</u>
11. TOTAL OPERATING REVENUES	<u>755,485</u>		<u>763,815</u>
<u>12. OPERATING EXPENSES</u>			
13. Natural Gas	394,576	20,479	415,055
14. Other Raw Materials	<u>10</u>		<u>10</u>
15. Sub-total Fuel	394,586		415,065
16. Contribution Margins	360,899		348,750
17. Gas Processing	13,968		13,968
18. Field Services	33,061		33,061
19. Distribution	13,601		13,601
20. Customer Affairs	31,208		31,208
21. Electric Costs		0	0
22. Social Programs		0	0
23. Admin and General <small>(Rate Case Expense)</small>	45,407	-313	45,095
24. Marketing and Point of Sale Expenses	6,713	-1,260	5,453
25. Bad Debt Expense	65,297	-4,169	61,128
26. BCCS Remediation		-800	-800
27. Consultant Services		-424	-424
28. Non-Recurring Expenses		-1,840	-1,840
29. Employee Consultants		-258	-258
30. Equipment Rentals and Leasing		-632	-632
31. Lobbying Expenses		-115	-115
32. Operating Leases		-601	-601
33. Non-Recurring Material Purchases		-100	-100
34. Amortization-Regulatory Asset		-1,637	-1,637
35. Health Insurance	26,290		26,290

PA PUC v. Philadelphia Gas Works
Docket Number R-00006042
Income Statement FYE August 31, 2001

	<u>PGW Revised Budget</u>	<u>Commission Adjustments Allowance</u>
36. Capitalized Fringe Benefits	-5,333	-5,333
37. Capitalized Administrative Costs	-6,815	-6,815
38. Regulatory Asset Amortization	3,750	3,750
39. Amortization of Restructuring Costs	965	965
40. Y2K & Deregulation Amortization	888	888
41. Pensions	1,376	1,376
42. Taxes	6,548	6,548
43. Amort. Of Non-Recurring IT Costs	0	0
44. Personnel Reductions/Retirements	-2,500	-2,500
45. Cost Savings/Productivity Improvements	<u>-10,000</u>	<u>-10,000</u>
46. <u>Sub-total Operating Expenses</u>	224,424	212,276
47. Depreciation	33,381	33,381
48. Cost of Removal	2,500	2,500
49. To Clearing Accounts	<u>-3,344</u>	<u>-3,344</u>
50. <u>Sub-total</u>	32,537	32,537
51. <u>TOTAL OPERATING EXPENSES</u>	<u>651,547</u>	<u>659,878</u>
52. <u>OPERATING INCOME</u>	103,938	103,938
53. Other Income	<u>6,106</u>	<u>6,106</u>
54. <i>Income Before Interest Expense</i>	110,044	110,044
55. <u>Interest Expense</u>		
56. LT Debt	47,871	47,871
57. Other	6,102	6,102
58. AFUDC	-346	-346
59. Loss from Extinguishment of Debt	<u>4,162</u>	<u>4,162</u>
60. Total Interest	57,789	57,789
61. Net Income	52,255	52,255
62. City Payment	<u>18,000</u>	<u>18,000</u>
63. Net Earnings	<u>34,255</u>	<u>34,255</u>

PA PUC v. Philadelphia Gas Works
Docket Number R-00006042
Debt Service Coverage
FYE August 31, 2001

FUNDS PROVIDED

1. Total Gas Revenues	735,789
2. Other Operating Revenues	28,026
3. Total Operating Revenues	763,815
4. Other Income less Restricted Funds	6,557
5. AFUDC (Interest)	346
6. TOTAL FUNDS PROVIDED	<u><u>770,718</u></u>

FUNDS APPLIED

7. Fuel Costs	415,065
8. Other Operating Costs	244,813
9. Total Operating Expenses	<u>659,878</u>
10. PMA Lease Cost	0
11. \$20.1M Capital Lease Cost	3,980
12. \$23.0M Capital Lease Cost	3,997
13. Less: Non-Cash Expense	<u>37,272</u>
14. TOTAL FUNDS APPLIED	<u><u>630,583</u></u>
15. Funds Available to Cover Debt Service	140,136
16. Add-back Lease Costs	<u>7,977</u>
17. Funds Available Excluding Lease Costs	148,113
18. 1975 Ordinance Bonds Debt Service	<u>51,611</u>
19. Debt Service Coverage 1975 Bonds	<u><u>2.87</u></u>
20. Net Available after Prior Debt Service	96,502
21. PMA & Other Capital Leases	<u>7,977</u>
22. Net Available after Prior Capital Leases	88,525
23. 1998 Ordinance bonds Debt Service	29,449
24. Debt Service Coverage New Bonds	<u><u>3.01</u></u>
25. Net Available after Debt Service	59,076
26. 1998 Ordinance Subordinate Bond Debt Service	1,990
27. Debt Service Coverage Subordinate Bond	<u><u>29.69</u></u>

PA PUC v. Philadelphia Gas Works
Docket Number R-00006042
Cash Flow Statement
FYE August 31, 2001

SOURCES	
1. Net Income	52,255
2. Depreciation and Amortization	42,827
3. Earnings on Restricted Funds	451
4. Impact of Refunded Debt Service	-
5. Increased/(Decreased) Other Liabilities	3,682
6. Available From Operations	<u>99,215</u>
7. Funds Required for Capital	34,000
8. Capital Leasing	6,000
9. Temporary Financing	-
10. TOTAL SOURCES	<u><u>139,215</u></u>
USES	
11. Net Construction Expenses	62,293
Funded Debt Reduction:	
12. Revenue Bonds	34,192
13. PMA Leases/Subordinate Debt	1,065
14. Capital Leases	6,901
15. Temporary Financing	-
16. Notes Payable - CNG Acquisition	59
17. Temporary Financing Repayment	-
18. Distribution of Earnings	18,000
19. Additions to (Reductions of) Non-Cash Working Capital	<u>14,891</u>
20. Cash Needs	137,401
21. Cash Surplus (Shortfall)	1,814
22. TOTAL USES	<u><u>139,215</u></u>
23. Cash - Beginning of Period	8,425
24. Cash - Surplus (Shortfall)	<u>1,814</u>
25. ENDING CASH	<u><u>10,239</u></u>
26. Internally Generated Funds	22,293
27. Outstanding Commercial Paper	97,000