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PA PUBLIC UTILITY COMMISSION
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Via Fed Ex Overnight

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

Re: PA PUC v. Philadelphia Gas Works
Docket No. R-00061931

Dear Secretary McNulty:

Enclosed please find for filing the original and nine (9) copies of the Reply Brief of Action Alliance of Senior Citizens of Greater Philadelphia and Tenant Union Representative Network, in the above-captioned proceeding. A coy of the Reply Brief is also on the enclosed CD. Copies of the Reply Brief have been served on the presiding officers and active parties as indicated in the attached Certificate of Service.

Very truly yours,

Philip A. Bertocci

DOCUMENT
FOLDER

Philip A. Bertocci, Esquire
Thu B. Tran, Esquire

Attorneys for Action Alliance et al.

Enclosures

cc: Certificate of Service

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION	:	
v.	:	Docket No. R-00061931
PHILADELPHIA GAS WORKS	:	

REPLY BRIEF

ON BEHALF OF ACTION ALLIANCE *et al.*

(ACTION ALLIANCE OF SENIOR CITIZENS
OF GREATER PHILADELPHIA AND
TENANT UNION REPRESENTATIVE NETWORK)

June 21, 2007

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

STATUTES **Page(s)**

REGULATIONS

COMMISSION DECISIONS

I -II. INTRODUCTION AND SUMMARY OF ARGUMENT.

In this Reply Brief, Action Alliance of Senior Citizens of Greater Philadelphia and the Tenant Union Representative Network (TURN)(hereinafter "Action Alliance") respond to the Main Briefs filed by the Philadelphia Gas Works (PGW), by the Office of Small Business Advocate (OSBA) and by the Philadelphia Industrial and Commercial Gas Users Group (PICGUG). In Section VIII(A) of this brief, Action Alliance replies to PGW's assertions regarding the adequacy of its service and submits that PGW's service is not "reasonably continuous" within the meaning of Public Utility Code Section 1501, as measured by reference to numerous statutory and regulatory standards. In Section VIII(B) of this brief, Action Alliance replies to PGW's claims regarding certain contested Tariff provisions. In Section VIII(C) of this brief, Action Alliance replies to the proposal by OSBA and PICGUG to shift the costs of PGW's Universal Service Programs exclusively to the residential class and contends that such a radical change is neither required nor reasonable, in light of the low household incomes of a significant portion of PGW's customer base.[1]

VIII. MISCELLANEOUS ISSUES.

A. The Commission Should Reject PGW's Efforts to Gloss Over the Inadequacy of Its Service.

1. PGW Must Show That Its Service Is Adequate.

PGW's Main Brief is devoted almost exclusively to a demonstration of its perceived financial needs, while glossing over and virtually ignoring the fact that thousands of its low and lower income heating customers are unable to maintain service under the Company's current

[1] In this Reply Brief, these issues have been treated under the rubric of "Miscellaneous Issues" in the standardized format.

customer service policies, which it proposes to continue even under increased rates.

In order to justify its request for a rate increase of $100 million, PGW must demonstrate that such a rate increase is "just and reasonable." To make such a showing, PGW must not only demonstrate that it has provided the evidence required under applicable constitutional, statutory and case law to establish the amount of rate relief to be granted, but it must also show that it is providing adequate service to customers. While Action Alliance and TURN agree with the OCA and OTS that PGW has not demonstrated a need for more than a base rate increase in the $22.5-25 million range, these consumer groups urge the Commission to deny any increase at all on the grounds that PGW's service is inadequate. AA Main Brief, at 6-13.

The evidentiary basis for this conclusion is the fact that PGW has adopted policies which, for two successive years, have resulted in over 9,000 heating customers whose gas service was terminated in the previous 11 months remaining unable to meet PGW's reconnection terms even by December 1, the beginning of the cold weather period. Over one half of these customers were low-income. Although PGW has only about 20% of the natural gas heating customers in the state, over one half of the state's natural gas heating customers without service as of December 1 were PGW customers. AA St.1, at 6. Action Alliance submits that this level of deprivation concerning a basic necessity of life rises to the level of a violation of one of the most fundamental legal requirements in the Public Utility Code, the Section 1501 requirement that service be "reasonably continuous and without unreasonable interruptions and delay." It is difficult to imagine how PGW can be providing ample opportunity to customers to retain service or to obtain reconnection, when so many do not succeed even with the approach of cold weather. AA Main Brief, at 4-5.

PGW attempts to minimize the significance of the Cold Weather Survey (CWS) results by asserting that the purpose of this survey is to "identify those customers without service at a specific time and to provide information regarding possible restoration for customers without gas service." PGW Main Brief, at 97. The fact that the purpose of the survey is practical – to further the Commission's universal service goals – in no way limits the usefulness of the statistics generated by the survey on a state-wide basis in judging the extent to which utilities under PUC jurisdiction have been successful in achieving universal service goals. When compared with the Cold Weather Survey results of other natural gas utilities across the state, PGW's performance is woeful. Those results flatly contradict PGW's claims that its universal service programs and policies provide adequate opportunities for low and lower income customers to gain admittance to low-income programs, and to obtain payment arrangements, budget billing terms and reconnection agreements. PGW Main Brief, at 96.

2. PGW Fails to Provide "Reasonably Continuous Service" as Required by Section 1501 of the Public Utility Code.

PGW dismisses Action Alliance's claim that service is inadequate on the grounds that Action Alliance "does not accuse PGW of specific violations of the law." PGW Main Brief, at 97. This is incorrect. In fact, based on the sheer magnitude of the numbers of households without service, Action Alliance has accused PGW of specific violation of Section 1501 requiring "reasonably continuous service without unreasonable interruptions or delay," AA St.1SR at 2; AA St.1 at 7-8. While Action Alliance does not accuse PGW of committing acts clearly and expressly forbidden by Chapter 14, like performing unauthorized residential service terminations in winter, it does as described more fully below express strong doubts concerning

whether many PGW collections policies are authorized by or consistent with Chapter 14.

In further support of the position that this level of service interruptions experienced by PGW customers is unreasonable, Action Alliance presents testimony that examines PGW practices in light of the numerous more specific legal and regulatory standards governing how universal service goals are to be achieved. Both the Commission and the General Assembly have as a matter of clear and longstanding policy embodied in law and regulation favored the utilization of functional alternatives to termination and the implementation of "[p]olicies, practices and services that help residential low-income retail gas customers and other residential retail gas customers experiencing temporary emergencies ...to maintain natural gas supply and distribution services." 52 Pa.Code § 56.1; 66 Pa.C.S. §§ 2202 (Definition: Universal service and energy conservation), 2203(7), 2203(8). Viewed in light of these standards, which no provision of Chapter 14 has superseded, PGW fails to provide "reasonably continuous service."

In judging the adequacy of PGW's service, Action Alliance submits that the Commission should focus on whether, in light of the Cold Weather Survey results, PGW has implemented reasonable policies consistent with the goals of universal service. Such an examination reveals that PGW's policies come up tragically short, when measured against specific, enumerated statutory and regulatory standards.

a. Payment Agreements for Customers Receiving Service – 52 Pa.Code § 56.1; 52 Pa.Code § 56.97(b).

PGW does not incorporate all the individualized factors which must be considered under Chapter 56 Section 56.97(b) in establishing a payment agreement for a customer whose service is on. The Company fails to take into account in setting the terms of the payment agreement the

"payment history of the ratepayer" and "length of time over which the bill accumulated." 52 Pa.Code § 56.97(b). In addition, as Mr. Geller points out, PGW does not fully consider the "ability of the ratepayer to pay," but rather determines minimum payments on the basis of the dictates of the PGW Payment Agreement Guidelines. AA Main Brief, at 22-23. The Commission has specifically held that Chapter 14 did not supersede this Chapter 56 requirement.[2]

b. Budget Billing Policies – 52 Pa.Code § 56.12(7).

Chapter 56 Section 56.12(7) requires utilities to implement an optional "budget billing procedure which averages estimated utility service costs over a 10-month, 11-month or 12-month period to eliminate, to the extent possible, seasonal fluctuations in utility bills." PGW's refusal to implement true-up policies which would allow for payment of true-up amounts over a period of three to twelve months depending on the amount of the true-up undermines the credibility of budget billing for customers. This refusal is inconsistent with the Commission's recommendations in In re: Insuring Consistent Application of 52 Pa.Code § 56.12(7) Equal Monthly Billing, PUC Docket No. M –0005925 (Final Interpretive Order, dated June 2, 2006). AA Main Brief, at 27-28. This policy, combined with the policy of requiring customers enrolling in budget billing to pay any arrearages or make a payment agreement involving upfront payments as a condition of enrollment, constitutes a significant barrier to expansion of budget billing. Id., at 28-29. Especially, in light of PGW's level of service terminations and CWS results, these policies are unreasonable.

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[2] Re: Chapter 14 Implementation, PUC Docket No. M – 00041802F0002 (Order entered March 4, 2005), at 14-15.

c. Medical Emergency Policies – 52 Pa.Code § 56.116.

Apart from regular payment agreements involving significant upfront payments, PGW does not offer "equitable arrangements" to customers receiving service under a medical certification. Due to this policy, which violates Chapter 56 Section 56.116, continuous service is jeopardized for disabled, sick and elderly customers who require more individualized attention. AA Main Brief, at 20-21.

d. Payment Arrangement and Reconnection Agreements – 66 Pa.C.S. §§ 1401 et seq.

The PGW policies that have the most direct impact on the Cold Weather Survey results are the policies utilized in establishing payment agreements enabling customers to avoid termination of service and in establishing reconnection agreements for customers whose service has been terminated. In the most concrete terms, whether a customer is able to prevent service termination by obtaining a payment agreement, or to obtain service reconnection depends upon the "dollar and cents" terms which PGW imposes as a condition of suspending a service termination or reconnecting service. PGW maintains that so long as its conduct in this area does not violate specific Chapter 14 provisions, its payment and reconnection agreement policies must be considered reasonable. In its Main Brief, Action Alliance, in contrast, contends that some of PGW's policies are in violation of Chapter 14 and thus unreasonable. Other policies are not authorized by Chapter 14, and are subject to longstanding standards of reasonableness contained in the Public Utility Code and Commission regulations. Still other policies, which may be authorized by Chapter 14, have been implemented in a manner which represents a misuse of discretion. As Mr. Geller testified, Chapter 14's intent was to "eliminate opportunities for

customers capable of paying to avoid the timely payment of public utility bills," not to deny access to utility service to low-income consumers without the ability to pay. AA St.1, at 21.

i. 66 Pa.C.S. § 1405(b).

PGW's policies concerning upfront payments and minimum monthly payments on arrears for persons seeking payment agreements are not authorized by Chapter 14. These standards are not consistent with the BCS standards set forth in Section 1405(b), which require no upfront payments, and which do not set minimum monthly payments on arrears. AA Main Brief, at 24. The Commission's position concerning the amount of upfront payments for reconnection agreements under Section 1407 indicates that upfront payments greater than one monthly installment payment on the arrears are not consistent with Chapter 14 standards. AA Main Brief, at 25, n.7. The requirement of upfront payments of between 20% and 50% for customers below 250%FPL depending on income, even if permissible, is a barrier to termination avoidance and a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 24-26.

ii. 66 Pa.C.S. § 1405(d).

Chapter 14 Section 1405(d) states that a public utility "may, at its discretion, enter into a second or subsequent payment agreement with a customer." PGW has adopted the blanket policy that, absent a change in income, it does not establish a "second or subsequent agreement." Section 1405(d) was not intended to permit a utility to adopt a policy of not granting a second or subsequent payment agreement to any customer. It is a misuse of discretion granted under Chapter 14 for PGW uniformly to refuse to exercise that discretion by establishing second payment agreements in cases where its previous payment agreements have proven, despite good faith efforts by customers, to be unaffordable. AA Main Brief, at 26-27. In PGW's case, there is

a particular need for exercise of discretion in favor of customers, because as discussed above, the Company's policies impose unreasonably harsh terms for first utility established payment agreements.

iii. 66 Pa.C.S. § 1407(c)(2)(i).

PGW has adopted policies requiring payment of the total outstanding balance due as a condition of reconnection in circumstances where Chapter 14 would require that the Company offer the customer a reconnection agreement under Section 1407(c)(2)(iii). These policies represent a barrier to reconnection to some customers who have previously defaulted on a payment agreement and then cured the default avoiding a service termination. These policies also represent a barrier to reconnection for non-CRP customers who had been terminated while on CRP. These policies, which reflect overly broad interpretations of the Section 1407(c)(2)(i) terms "default" and "payment agreement," may violate Chapter 14, and even if they do not, they are a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 29-33.

iv. 66 Pa.C.S. §1407(a).

PGW's policy of requiring a reconnection fee of $123.23, by far the highest in the state, is an unreasonable barrier to reconnection for customers whose service has been terminated. PGW's reconnection fee of $123.23 was established prior to the enactment of Chapter 14, when reconnection fees could in some circumstances be paid in installments as part of the payments on the outstanding balance. To require a reconnection fee of this magnitude, as a condition of service reconnection, is a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 33-35.

PGW's policy of requiring low and lower income customers whose service has been

terminated by means of a "dig-up" to make a payment of $372 as a condition of reconnection is not authorized by Chapter 14. Chapter 14 requires only upfront payment of the reconnection fee, part of the deposit, and a payment on the arrears no greater than one monthly installment under the reconnection agreement. This requirement is inconsistent with Chapter 14, and even if it is not, it represents a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 35-36.

v. 66 Pa.C.S. §§ 1404(a)(1); 1404(f)(2).

PGW's policy of requiring low-income non-CRP customers whose service has been terminated to pay a deposit as a condition of reconnection is inconsistent with Chapter 14 Section 1404(f)(2) which does not require a deposit for CRP customers. Requirement of a deposit from such low-income customers whose income is below 150%FPL but who will not benefit from PGW's percentage of income CAP program is a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 36-37.

vi. 66 Pa.C.S. § 1407(c)(2).

PGW refuses to reconnect service to low-income customers who have been determined to be eligible for a LIHEAP Crisis grant, in situations where the amount from the grant and other funds that the customer may be able immediately to provide are not sufficient to satisfy the amount dictated by the PGW Payment Agreement Guidelines. This policy is a misuse of discretion in light of the Cold Weather Survey results. AA Main Brief, at 37-38.

e. Universal Service Programs – 66 Pa.C.S. §§ 2203(7),(8); 52 Pa.Code §§ 62.1-62.8; 52 Pa.Code § 69.261 et seq.

PGW attempts to establish the adequacy of its Universal Service Programs by reference

only to the substantial costs and numbers of beneficiaries of these programs. PGW Main Brief at 95. However, as Mr. Geller points out, there are tens of thousands of low-income customers who do not participate in CRP or any other universal service program, as evidenced by the numbers without service at the approach of cold weather. AA St.1SR, at 14.[3] The Natural Gas Choice and Competition Act provides a clear mandate that natural gas utilities must fulfill universal service requirements. 66 Pa.C.S. §§ 2203(7),(8). Specifically, Universal Service Programs are meant to "protect consumers' health and safety by helping low-income customers maintain affordable natural gas service." 52 Pa.Code § 62.3(b)(1) (emphasis added). The components of Universal Service Programs include: "CAP, LIURP, CARES, Hardship Funds and other programs, policies and protections." 52 Pa.Code § 62.4(b). Relative to the need, PGW's Universal Service Programs to assist low and lower income customers obtain and maintain affordable natural gas service are not adequate. AA Main Brief, at 3-20.

In this proceeding, Action Alliance has identified specific deficiencies in PGW's Universal Service Programs, which counter the Company's view that its programs do all that may be reasonably expected.

PGW fails to make "automatic referrals to CAP when a low-income customer calls to make payment arrangements," in violation of 52 Pa.Code § 69.265(6)(i). AA Main Brief, at 14-16. PGW does not provide a "complete and thorough explanation of the CAP components" to CRP participants, as instructed by the Commission. 52 Pa.Code §62.265(6)(iv); AA Main Brief,

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[3] In PGW's Main Brief, the Company claims that the costs of universal service benefits range from $110 million to $210 million annually. PGW Main Brief, at 95. However, this is an error. The testimony by Mr. Gyory, which is cited in support of this statement, is that these costs are from $110 million to $120 million. PGW St. 6R at 3.

at 16. PGW's CARES program fails to provide a "casework approach," as CARES is defined by the Gas Choice regulations. 52 Pa.Code § 62.2 (definition: "CARES"); AA Main Brief, at 16-18. PGW makes only a nominal effort to solicit contributions from its customers for its hardship fund, UESF. Contributions by PGW customers to its Hardship Fund is the lowest of all Commission regulated gas and electric utilities in the state. Despite the obvious need exhibited by PGW customers for additional Hardship Fund support in avoiding terminations and obtaining assistance in reconnection, PGW has offered no plan for correcting this situation by actively soliciting through the use of a bill check off the substantial numbers of customers who could afford a monthly contribution to UESF. AA Main Brief, at 18-20.

3. PGW's Filing Fails to Recognize That Its Cold Weather Survey Results Are Unacceptable.

In its Main Brief, PGW blandly dismisses Action Alliance's claims by invoking its "responsibility to its entire customer base" and its need "to balance a broad range of issues associated with service in its customer base to ensure that all customers receive safe, adequate and reliable service." PGW Main Brief, at 98. PGW claims that there is no evidence that implementation of Action Alliance's recommendations would be effective. Id. However, despite all its claims concerning balancing, PGW nowhere presents an analysis showing that actions to more effectively address the needs of the 9,000 heating customers without service as of December 1 would have undermined the financial integrity of the utility. In fact, PGW has presented no evidence of such "balancing" in the past, and the Company does not incorporate such balancing in its rate increase request. That rate increase request focuses exclusively on the

Company's alleged financial needs, based on an overly aggressive, unrealistic plan drastically to reduce its debt-to-equity ratio, without regard either for the current affordability of its service or the Cold Weather Survey results.

B. The Commission Should Sustain Action Alliance's Objections to Certain Specific Proposed Tariff Revisions.

PGW devotes only few pages to Action Alliance's objections to certain proposed Tariff revisions, and avoids considering each objection on its merits. PGW Main Brief, at 98-100.

1. The Commission Should Reject PGW's Proposed Definition of "Applicable Law"(Proposed Tariff Definitions).

PGW continues to argue that it should be allowed to incorporate unspecified Company Policies presently existing and as amended in the future in its approved Tariff. PGW claims that this inclusion should be permissible because those policies are "reviewed extensively to ensure that they are consistent with the law and Commission regulations..." PGW Main Brief, at 99. What PGW does not say is that it is PGW which does the reviewing and makes its own determination whether the policy is consistent with law and regulations. Because the Tariff has the force of law, the Commission should not allow PGW to incorporate within its Tariff policies which the Commission itself has not reviewed. AA Main Brief, at 38-41.

PGW further argues that the mention of Company Policy in the Tariff provides "notice" of the existence of such policies to customers. This argument is without merit. A mere reference to unspecified "company policy" without providing the content of that policy provides no benefit to customers, but only allows the utility to arbitrarily give a false color of legality to whatever policies it might choose to adopt.

2. The Commission Should Reject PGW's Arguments Regarding the Other Contested Tariff Revisions.

PGW makes three arguments concerning why the Commission should reject Action Alliance's opposition to Tariff provisions concerning written notices of reasons for rejection of an application for service, the appropriate definition of the term "unauthorized use," liability for unauthorized use, unambiguous notice to the customer concerning the Commission's authority regarding service reconnection for customers responsible for unauthorized use, and home visits by PGW personnel to assist customers to apply for service in cases of severe hardship.

First, PGW argues that none of the proposed revisions "remove any rights currently held by PGW's customers." PGW Main Brief, at 99. In other words, PGW claims that even if it changes the requirements concerning the notice of rejection or home visits, its current policies will not change. This argument fails to recognize the difference between a policy and a Tariff requirement. PGW can change the policy without consulting the Commission. However, it must comply with the provisions contained in its approved Tariff, unless it obtains a waiver from the Commission. The proposed revisions do, therefore, remove protections contained in the current Tariff.

Second, PGW states that it is reasonable to remove provisions which "merely restate the law" to provide a "more streamlined, accurate and appropriate tariff for PGW and its customers." Id. at 99. This argument also must fail. It is incorrect that these provisions "merely restate the law." For instance, the removal of current Section 8.3.D, which establishes that PGW may not refuse gas service to a person not "responsible" for theft of service, sets forth in "black and white" a provision which is not explicitly stated anywhere else in the Public Utility Code or in

Commission regulations. AA Main Brief, at 47-48.

Third, PGW claims that it has removed "practices which were never required and were provided as a matter of discretion...." PGW Main Brief, at 99. This argument is without merit. If provisions concerning home visits or a notice of rejection were contained in PGW's approved Tariff, they have not been a matter of discretion, but rather a requirement having the force of law. If they had only been a matter of discretion, they never would have been included in the Tariff in the first place. With regard to the notice of rejection, Action Alliance submits that the notice provided by PGW's Tariff, which is broader in content than the Section 56.36 notice, is required as a matter of constitutional law due to PGW's status as a municipally owned utility. AA Main Brief, at 45-47.[4]

C. The Commission Should Reject the Proposal of OSBA and PICGUG to Shift the Costs of PGW's Universal Service Programs Exclusively to the Residential Class.

In this proceeding, the OSBA and PICGUG have proposed that the costs of PGW's Universal Service Programs, which are currently shared by all customer classes, should be shifted exclusively to the residential class. OSBA Main Brief, at 8-33; PICGUG Main Brief, at 22-25. In recommending this change, OSBA/PICGUG urge the Commission to reject the historical policy adopted by PGW's owner, the City of Philadelphia, that a portion of universal service costs continue to be allocated to industrial and commercial customers. At a time when many indicators, including the annual results of the Cold Weather Survey, show a pressing need for

[4] None of these arguments addresses why PGW should be allowed to provide a definition of "unauthorized use" in its Tariff which does not delineate the important distinction between "unauthorized use" and "user without contract." This distinction has been expressly upheld against all arguments to the contrary in post-Chapter 14 orders. See Re Chapter 14 Implementation, PUC Docket No. M – 00041802F0002 (Order entered March 4, 2005), at 8-10; Re Chapter 14 Implementation, PUC Docket No. M – 00041802F0002 (Order entered June 2, 2005), at 10-13.

more, not fewer, resources for PGW's universal services, the OSBA/PICGUG proposal would significantly diminish the size of the customer base contributing to universal service costs. Nothing in existing law, regulation or regulatory precedent requires that the Commission order such a radical change in the manner in which PGW's Universal Service Programs are funded. The Commission's recent CAP Policy Statement recognizes that PGW's policy of allocating universal service costs to all customer classes pre-dates the transfer of regulatory authority over PGW to the Commission.[5] Even while confirming the Commission's authority over PGW, the Gas Choice Act expressly acknowledges PGW's unique status as the only municipally owned natural gas utility regulated by the Commission.[6]

The record in this case contains ample evidence that PGW's residential customer base is reaching the limits of its ability to pay for gas service. Policy makers must be concerned not only with the level of low-income customers, constituting almost one third of PGW's customer base, but also with the numbers of lower income customers (with income below 250%FPL) who do not benefit from CAP or from LIHEAP energy assistance grants. As OCA witness Mr. LeLash testified, PGW's rates are consistently the highest in the state. OCA St.1, at 18-20. Noting the substantial size (and costs) of PGW's Universal Service Programs, PGW's Mr. Hershey testified that it is not reasonable to shift significant additional Universal Service costs to the shoulders of residential customers. PGW St.1R at 20. Mr. Geller testified that the number of low-income customers in PGW's customer base is "truly extraordinary when compared to other Pennsylvania

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[5] Re: Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms, PUC Docket No. M – 00051923 (Final Investigatory Order, entered December 18, 2006), at 31.

[6] See, e.g., provisions in the Gas Choice Act specifying a ratemaking methodology (§ 2212(e)), transfers to the City (§ 2212(f)); municipal liens (§ 2212(n)); senior citizen discount (§ 2212(r)); and recognition of owner's right to "determine the powers, functions, budgets, activities and mission" of the utility (§ 2212(s)).

natural gas utilities."AA St.1R, at 5. These "sheer numbers," considered "as a percentage of PGW's customer base, in comparison to all other utilities in Pennsylvania, justifies adoption of a rate design for universal services funding which spreads universal service costs as broadly as possible." AA St.1R, at 7. Under these circumstances, the Commission should not narrow the size of the customer base from which PGW's Universal Service Programs are funded. As Mr. Hershey testified, "[l]imiting the burden to that group [residential customers] would raise residential customer bills, making it more difficult for many customers who are poor or working poor to afford their bills, thus risking shut-off." PGW St.1R, at 17.

Finally, Action Alliance submits that in its review of the OSBA/PICGUG proposal, the Commission should give weight to the fact that the it is PGW and its owner, the City of Philadelphia, that are proposing that the costs of PGW's Universal Service Programs continue to be shared by all customer classes. The Gas Choice Act, while transferring jurisdiction over PGW to the Commission, nevertheless indicated an intent not to limit the authority of the City to determine the "powers, functions, budgets, activities and mission" of PGW. 66 Pa.C.S. § 2212(s). As Mr. Geller explains, the

> utility's owner, the City of Philadelphia, is also charged, along with the commission, with serving an important public interest concerning a community of well over one million people, not merely a private interest. In proposing that universal service costs should continue to be allocated to all firm customer classes, PGW asserts not a private profit-making interest, but a governmental determination focused on the public welfare.

AA St.1R, at 4.

For these reasons, Action Alliance submits that the Commission should reject the OSBA/PICGUG proposal to shift the costs of PGW's Universal Service Programs exclusively to

the residential class.

X. CONCLUSION.

For the foregoing reasons, and those set forth in its Main Brief, Action Alliance respectfully requests that the Commission deny PGW's request for a rate increase on the grounds that its service is inadequate.

In the alternative, as set forth in its Conclusion to its Main Brief, Action Alliance requests that in the event that the Commission grants any rate increase and/or grants any change in the use of the proceeds of off-system sales and capacity release credits, the Commission require that PGW take the measures set forth on pages 51 and 52 of Action Alliance's Main Brief as a condition of receiving such increased revenues.

Action Alliance further requests that the Commission deny PGW's proposals concerning revision of certain provisions of its Tariff as set forth in Section IV(E) of its Action Alliance's Main Brief and in the Form of Order attached to that brief as Appendix B.

Finally, Action Alliance requests that the Commission reject the OSBA/PICGUG proposal to shift the costs of PGW's Universal Service Programs exclusively to the residential class.

Respectfully submitted,

Philip A Bertocci

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v.	:	Docket Nos. R-00061931
Philadelphia Gas Works	:	

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the Main Brief upon the presiding officers and the active parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (service by a participant) and § 1.59 (number of copies to be served), in the manner and upon the persons listed below:

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June 21, 2007

COMMONWEALTH OF PENNSYLVANIA

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June 21, 2007

DOCUMENT FOLDER

ORIGINAL

HAND DELIVERED

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

Re: Pennsylvania Public Utility Commission v. Philadelphia Gas Works
Docket No. R-00061931

Dear Secretary McNulty:

Enclosed for filing are the original and nine (9) copies of the Reply Brief on behalf of the Office of Small Business Advocate in the above-docketed proceeding. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

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

Sincerely,

Sharon E. Webb
Assistant Small Business Advocate
Attorney ID No. 73995

Enclosures

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION	:	
v.	:	DOCKET NOS. R-00061931
	:	R-00061931C0001
PHILADELPHIA GAS WORKS	:	

REPLY BRIEF
ON BEHALF OF THE
OFFICE OF SMALL BUSINESS ADVOCATE

ORIGINAL

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Dated: June 21, 2007

Table of Contents

Table of Authorities

Cases

Statutes

I. INTRODUCTION-PROCEDURAL HISTORY

On December 22, 2006, Philadelphia Gas Works ("PGW" or the "Company") filed Tariff Supplement 16 to Gas Service Tariff – Pa. P.U.C. No. 2 ("Supplement No. 16") to become effective February 20, 2007. The PGW filing proposed an increase in its total operating revenues of $100 million per year.

The Office of Small Business Advocate ("OSBA") filed a Complaint on January 18, 2007.

On February 8, 2007, the Pennsylvania Public Utility Commission ("Commission" or "PUC") suspended Supplement No. 16 until September 20, 2007, in order to conduct an investigation into the lawfulness, justness and reasonableness of PGW's proposed rate increase. 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 Administrative Law Judges ("ALJs") Cynthia Williams Fordham and Angela T. Jones.

On February 23, 2007, a prehearing conference was held before ALJ Fordham and ALJ Jones. A second prehearing conference was held on March 2, 2007.

The following parties listed below are the known active parties involved with PGW's base rate filing: the OSBA; the Office of Consumer Advocate ("OCA"); the Office of Trial Staff ("OTS"); Action Alliance of Senior Citizens of Greater Philadelphia ("Action Alliance") and Tenant Union Representative Network ("TURN"); the Philadelphia Industrial and Commercial Users Group ("PICGUG"); PECO Energy Company ("PECO"); Interstate Gas Supply Inc. ("IGS"); the Philadelphia Housing

Authority ("PHA"); the School District of Philadelphia ("SDP"); and Hess Corporation ("Hess").[1]

Public input hearings were held on March 26, 2007; March 28, 2007; and April 9, 2007.

On April 6, 2007, the OSBA submitted the direct testimony of Robert D. Knecht.

On May 4, 2007, the OSBA submitted the rebuttal testimony of Mr. Knecht.

On May 15, 2007, the OSBA submitted the surrebuttal testimony of Mr. Knecht.

Evidentiary hearings were held before ALJ Fordham and ALJ Jones from May 21, 2007, through May 24, 2007.

Main Briefs were filed on June 12, 2007, by the Company; the OSBA; the OCA; the OTS; PHA; PICGUG; Hess; IGS; and Action Alliance and TURN.

The OSBA submits this Reply Brief in response to issues raised in the Main Briefs of other parties.

[1] The Archdiocese of Philadelphia ("Archdiocese") was an active party in this proceeding. However, because counsel for the Archdiocese was not present during the evidentiary hearings, the ALJs denied the Archdiocese intervenor status.

II. SUMMARY OF ARGUMENT

A. Revenue Allocation

Every cost of service study ("COSS") filed in this proceeding shows that commercial customers (and the other non-residential classes) are overpaying their cost of service at present rates and that the residential class is underpaying its cost of service at present rates. Despite that fact, PGW's proposed revenue allocation actually moves class rates farther away from allocated costs rather than closer to those costs. PGW's proposal is inconsistent with *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010 (Pa. Cmwlth. 2006), *appeals denied*, 916 A.2d 1104 (Pa. 2007).

There are only three revenue allocation proposals in the record of this proceeding: 1) PGW's proposal, which is inconsistent with *Lloyd*; 2) the OSBA's proposal, which would assign the underpaying residential class a percentage rate increase which is 1.2 times the system average and proportionately scale back the rate increases proposed by PGW for the overpaying non-residential classes; and 3) the OTS' proposal, which would provide first dollar relief to the overpaying non-residential classes. The Commission must reject PGW's proposal as inconsistent with *Lloyd*. The Commission should select the OSBA's proposal in order to comply with the principles laid down by the Commonwealth Court in *Lloyd*. However, if the Commission reduces the requested revenue increase to $73 million or less, the OTS' proposal would be an acceptable alternative.

B. Universal Service Costs

Historically, PGW's universal service costs have been recovered from all classes of customers in spite of the fact that only residential customers are permitted to

participate in the Company's universal service programs. Under Commission policy and the precedent with regard to other utilities, non-residential customers are not required to contribute toward universal service costs. Therefore, the requirement that PGW's customers contribute toward universal service costs should be phased out over three years, beginning with the Company's 2008 proceeding under Section 1307(f) of the Public Utility Code, 66 Pa. C.S. §1307(f).

If the Commission determines that the three-year phase-out proposed by the OSBA would be inconsistent with the principle of "gradualism," the Commission has the option to spread the phase-out over more than three years.

C. Off-System Sales and Capacity Releases

At the present time, PGW flows all of the capacity release and off-system sales revenues through to customers as part of the purchased gas cost ("PGC") rate. The Commission should reject PGW's proposal that the Company retain the margins from these transactions. To the extent that PGC customers finance the purchase of gas assets, the margins from the sale of those assets should be addressed in a PGC case under Section 1307(f) and should be allocated to customers rather than to the Company.

However, if the Commission determines that PGW should be permitted to deviate from past practice, the Commission should not allow PGW to retain more than 25% of the margins from capacity releases and off-system sales.

III. RATE BASE (omitted)

IV. REVENUES: Off-System Sales and Capacity Releases

In its Main Brief, PGW argues that it should be permitted to change the regulatory treatment of revenues derived from off-system sales and capacity releases. PGW currently returns 100% of that money to its purchased gas cost ("PGC") customers.[2] In this proceeding, PGW is proposing to reverse that practice and to begin retaining 100% of these revenues to help finance construction projects.[3] PGW argues that its retention proposal is "fundamentally misunderstood by the parties" and that PGW should be allowed to treat these funds differently than other natural gas distribution companies ("NGDC") by virtue of the fact that it is a cash flow company.[4]

PGW has estimated that, under its proposal, the Company would retain an estimated average of $10 million in margins from off-system sales and capacity releases per year.[5] PGW would then flow the proceeds through to customers by making the estimated $10 million per year available to fund construction projects.[6] PGW's stated rationale for the proposed change is that the Company, by funding necessary construction projects with the credits from off-system sales and capacity releases, could avoid issuing additional long-term debt and thereby avoid the debt service that would otherwise follow the issuance of such debt.[7]

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[2] PGW Main Brief at 73

[3] PGW Main Brief at 73

[4] PGW Main Brief at 74

[5] PGW Main Brief at 74, citing PGW Statement No. 2 at 15-16

[6] PGW Main Brief at 73

[7] PGW Main Brief at 74

This issue of the treatment of the proceeds from off-system sales and capacity releases by a natural gas distribution company ("NGDC") is not new.[8] For example, the Commission addressed the issue in Equitable Gas Company's 2005 proceeding under Section 1307(f) of the Public Utility Code, 66 Pa. C.S. §1307(f).[9] In that proceeding, the Commission approved an incentive mechanism by which ratepayers are to receive 75% of the margins from these transactions and the NGDC is to retain 25%. According to the Commission, a sharing of off-system sales and capacity release proceeds was initiated precisely to encourage NGDCs to maximize their use of excess or idle capacity and off-system opportunities in order to "recover a portion of fixed costs and *reduce the overall PGC rate.*"[10] Thus, as Mr. Knecht testified in this case, the objective of the incentive mechanisms approved by the Commission in other proceedings is to produce larger credits to PGC customers than they would obtain without a sharing mechanism.[11]

PGW's argument that it would actually be flowing through the credits to sustain construction projects and reduce the need for, and cost of, issuing long-term debt is not persuasive and should be rejected. Every NGDC in the Commonwealth could make a similar argument, *i.e.*, that it could reduce distribution rates if it retained the margins from off-system sales and capacity releases. An NGDC's costs of acquiring gas, pipeline capacity, and storage capacity are reviewed, and recovery is permitted or denied, in an annual proceeding under Section 1307(f). In contrast, an NGDC's distribution costs are

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[8] *See Pennsylvania Public Utility Commission v. National Fuel Gas Distribution*, 1980 Pa. LEXIS 31, at 33-35, 54 Pa. PUC 401, at 414-415, 40 PUR4th 101 (1980).

[9] *Pennsylvania Public Utility Commission v. Equitable Gas,* Docket No. R-00050272 (Order entered September 28, 2005) at 33-34

[10] *Id.* (emphasis added)

[11] OSBA Statement No. 2 at 26

reviewed, and recovery is permitted or denied, on an irregular schedule in a base rates proceeding under Section 1308 of the Public Utility Code, 66 Pa. C.S. §1308.

As the Commission found in the 2005 Equitable Gas proceeding, Section 1307(f) does not provide a specific statutory directive for sharing of the proceeds from off-system sales and capacity releases. However, Section 1307(f) must be read in conjunction with Section 1318 of the Public Utility Code, 66 Pa. C.S. §1318, which directs that an NGDC pursue a least cost procurement policy.[12] PGW's proposal is contrary to its statutory obligation under Section 1318. As Mr. Knecht testified, the proceeds should be returned to the PGC customers who paid for the assets which are being sold.

V. EXPENSES

The OSBA is not briefing this issue but reserves the right to address such issues in exceptions and replies to exceptions if necessary.

VI. TAXES (Omitted)

VII. RATE OF RETURN (Omitted)

[12] *Equitable*, Docket No. R-00050272, Order at 33-34

VIII. MISCELLANEOUS ISSUES: Universal Service Costs

The OCA has made the following arguments regarding universal service cost allocation in its Main Brief, which have already been adequately addressed by the OSBA in its Main Brief:

- The term "non-bypassable" in Section 2203(6) of the Public Utility Code, 66 Pa. C.S. §2203(6), means that every class must pay universal service costs rather than that both shoppers and non-shoppers must pay. *See* OSBA Main Brief at 20-24.
- Sections 2203(6), (7) and (8), and 2802(17) of the Public Utility Code, 66 Pa. C.S. §2203(6), (7), and (8) and §2802(17), support a requirement that universal service costs be collected from all rate classes. *See* OSBA Main Brief at 19-24 and 30-32.
- Universal service programs promote a "public good" and, therefore, universal service costs should be collected from all rate classes. *See* OSBA Main Brief at 25-30.

The OCA has advanced the above-mentioned arguments in every recent proceeding in which allocating universal service costs has been an issue. Significantly, the Commission has consistently disagreed with these arguments by the OCA and has consistently opted to follow its policy that universal service costs should be allocated only to residential customers. Therefore, the real issue in this proceeding is whether the Commission's policy should be applied to PGW.

In *Pennsylvania Public Utility Commission v. PPL Electric Utilities Corporation,* Docket No. R-00049255 (Order entered December 22, 2004), the Commission placed the

burden of proof squarely on the proponent advocating for the allocation of customer assistance program ("CAP") costs beyond the residential class. The Commission did not explicitly identify what kind of cost studies might fulfill the burden of proof; however, the Commission did indicate that it would have to be a cost study providing "concrete evidence" of the benefits of the utility's CAP to non-residential customers.[13] The OCA has failed to meet its burden of proof.

The OCA has made only two arguments in this proceeding as to why the Commission's generic policy should not be applied to PGW. First, the OCA has asserted that PGW's residential customers cannot absorb the significant costs that would be imposed upon them if the Commission allocated universal service costs solely to the residential class.[14] Second, the OCA has opined that even the OSBA's proposal of a three-year phase-out plan would impose an unacceptably large rate increase on the residential class.[15] Neither of these arguments addresses the Commission's requirement that proponents of allocating universal service costs to non-residential customers demonstrate the specific benefits of the universal service program to non-residential customers.

Moreover, as the OSBA has already pointed out in its Main Brief at 16-17, the OSBA's proposal would not have an unduly detrimental impact on the residential class. The OSBA is not proposing that all universal service costs be immediately recovered from only residential customers. Instead, the OSBA is proposing that those costs

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[13] *Pennsylvania Public Utility Commission v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (Order entered December 22, 2004) at 97-98

[14] OCA Main Brief at 94

[15] OCA Main Brief at 94

gradually be shifted to residential customers in order for PGW to comply with the Commission's policy that applies to all other Pennsylvania natural gas distribution companies ("NGDCs"). As OSBA witness Knecht testified:

> While I retain my proposal for a three-year phase-out, I show the implications of a one-year phase-out in Exhibit IEc-S1. Even under that proposal, the impact on the residential class is $0.80 per Mcf, which represents about 6.4 percent of the costs involved in a PGW GCR proceeding and about a 3.9 percent increase on a total bill basis. Such an increase, spread over three years, is simply not rate shock.
>
> Moreover, if [PGW witness] Mr. Hershey does consider an increase of $0.80 per Mcf spread over three years to be rate shock for residential customers, the impact of PGW's proposed rate increase on commercial customers of $2.42 per Mcf in a single year would have to be considered tantamount to getting the electric chair.[16]

Essentially, the OCA's argument against applying the Commission's generic policy to PGW is based on "gradualism." However, even if the Commission agrees with the OCA that a three-year phase-out plan would cause a larger than acceptable rate increase for the residential class, the Commission always has the option to spread the phase-out over a time period that is longer than the three years that the OSBA has proposed. As the Commonwealth Court has held, cost of service is to be the "polestar" of ratemaking concerns and is not to be trumped by "gradualism."[17]

The OCA has further argued in its Main Brief that the OSBA's reliance on certain cases and the Commission's generic policy statement are misplaced.[18]

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[16] OSBA Statement No. 3 at 13

[17] *See Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006), *appeals denied*, 916 A.2d 1104 (Pa. 2007).

[18] OCA Main Brief at 93

The only specific case which the OCA gives as an example is *Application of Equitable Gas Company For Approval of Natural Choice and Competition Act Restructuring Filing*, Docket No. R-00994784 (Order entered September 12, 2002). According to the OCA, the Commission affirmed in that case that the commercial class was providing some level of funding for the existing CAP.[19] However, the OCA's argument is the one that is misplaced. By reading the Commission's *whole* discussion in *Application of Equitable Gas Company For Approval of Natural Choice and Competition Act Restructuring Filing*, one can determine that the essential ruling in the case is that small commercial and industrial ("Small C&I") customers were to be removed *from participating* in Equitable's Drop Program and were also to be removed *from any cost responsibility* for Equitable's DROP program:

> We hereby deny the Petition for Clarification of the Office of Small Business Advocate. Because it appears that at least some portion of the transition cost surcharge was allotted to fund Equitable's universal service and energy conservation programs, we believe that OSBA's requests to correct certain language in the July 18th order regarding the purpose of Equitable's transition cost surcharge is not warranted. To the extent that there are any disagreements concerning whether any part of Equitable's transition cost surcharge was to be allocated to fund universal service and energy conservation costs, the Commission believes that the Equitable's next general rate case would be an appropriate forum to address such issues.
>
> In addition, we note that the *concerns raised in the petition of OSBA are effectively moot. The Commission's July 18th order expressly removes small business customers from participation in and cost responsibility for the DROP as small business customers will not be paying the $.0579*

[19] OCA Main Brief at 93

portion of the transition cost surcharge that will be used to fund DROP program costs. . . .[20]

The OCA has also argued that the OSBA's reliance on *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms Final Investigatory Order*, Docket No. M-00051923 (Order entered December 18, 2006) ("*CAP Final Investigatory Order*") is misplaced.[21] According to the OCA, the Commission in its *CAP Final Investigatory Order* intended to continue prior policies and PGW's prior policy was to allocate universal service costs to all rate classes.[22] However, as the OSBA has pointed out in its Main Brief, the Commission did not conclude that PGW should be a permanent exception to the Commission's generic policy. Rather, the Commission merely observed that PGW's current policy represented an exception to the generic policy. Furthermore, the Commission expressed no intention to rescind its prior decision to defer the matter to PGW's next base rate proceeding. *See* OSBA Main Brief at 8-16.

[20] *Application of Equitable Gas Company For Approval of Natural Choice and Competition Act Restructuring Filing*, Docket No. R-00994784 (Order entered September 12, 2002) at 3

[21] OCA Main Brief at 93

[22] *Id.*

IX. RATE STRUCTURE

A. COST OF SERVICE

The OSBA generally accepts PGW's unbundled distribution corrected cost of service study as the methodology for setting base rates in this proceeding.

B. REVENUE ALLOCATION

The Commonwealth Court held in *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006), *appeals denied*, 916 A.2d 1104 (Pa. 2007), that cost of service is the "polestar" of ratemaking concerns. As set forth in the OSBA's Main Brief, every cost of service study ("COSS") submitted in this proceeding shows that the residential class is underpaying and that every other class (including commercial) is overpaying, based on cost of service at present rates.[23] The OSBA stands by the various arguments set forth in its Main Brief and responds only to selected arguments raised in the Main Briefs of other parties.

As OSBA witness Knecht testified, the process for determining class revenue requirements generally begins with a review of the revenues produced under existing rates from each class.[24] Consistent with *Lloyd*, most utilities and regulators adopt a policy in a base rates proceeding of attempting to move revenues more into line with allocated costs (the "cost of service" criterion).[25] Utilities generally address this criterion by assigning above-system average rate increases to those classes that under-recover,

[23] OSBA Main Brief at 43

[24] OSBA Statement No. 1 at 14

[25] OSBA Statement No. 1 at 14

i.e.,underpay, allocated costs, and by assigning below-system average rate increases to those classes that over-recover, *i.e.*, overpay, allocated costs.[26]

PGW's unbundled (corrected) cost of service study ("CCOSS") reflects that every class of customers is overpaying except for the residential class.[27] Despite that fact, PGW argues in its Main Brief that its proposed revenue allocation (at the full requested revenue requirement) is fair, and somehow appropriately balances the interests of its various rate classes, even though every overpaying rate class would receive an above-system average rate increase and the only underpaying class (*i.e.*, residential) would receive a below-system average rate increase.[28]

As discussed in the OSBA's Main Brief, PGW's only justification for its revenue allocation proposal throughout this proceeding has been that the proposal results in an *indexed rate of return* at proposed rates that is closer to unity for each class than at current rates.[29] In its Main Brief, PGW parrots the same indexed rate of return argument.[30] In summary, PGW believes that if the class indexed rates of return move closer to unity, then the proposed rates are closer to allocated costs than are current rates.[31]

Common sense must prevail and PGW's proposed revenue allocation must fail. As Mr. Knecht testified, there is a fundamental arithmetic problem with the indexed rate

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[26] OSBA Statement No. 1 at 15

[27] OSBA Main Brief at 38

[28] PGW Main Brief at 79

[29] OSBA Main Brief at 44

[30] PGW Main Brief at 79 (citations omitted)

[31] OSBA Statement No. 1 at 18

of return metric, in that it relies on a ratio of ratios.[32] In any event, PGW's argument is contrary to simple logic A class which is overpaying at present rates can not be moving closer to cost of service if it receives a larger than system average increase.[33]

As Mr. Knecht testified, certain utilities and the Commission have relied upon the indexed rate of return *and* common sense in the past.[34] Specifically, the utilities applied judgment and common sense in the preparation of their rate filings and ultimately proposed to assign above average rate increases to classes that were receiving subsidies, *i.e.*, underpaying their cost of service. Therefore, as Mr. Knecht pointed out, the indexed rate of return has not *always* produced illogical results; however, it can produce illogical results if a utility makes an illogical proposal, *i.e.*, to assign an above-system average rate increase to a class that is already providing a subsidy to the underpaying classes.[35]

In addition to defying common sense, PGW's proposed revenue allocation defies the results of the four other metrics identified by Mr. Knecht as ways to determine progress toward cost of service: dollar cross-subsidy, differential rate of return, revenue-cost ratio, and normalized revenue-cost ratio.[36]

In Table IEc-3 of his direct testimony, Mr. Knecht illustrated the impact of PGW's proposal, as measured by the dollar cross-subsidy and the revenue-cost ratio metrics. For ease of reference, the table is reprinted below.[37]

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[32] OSBA Statement No 1 at 19

[33] OSBA Main Brief at 39

[34] OSBA Statement No. 3 at 4

[35] OSBA Statement No. 3 at 4

[36] OSBA Statement No. 1, Exhibit IEc-5

[37] Reproduced from OSBA Statement No. 1 at 17

Table IEc-3 Impact of PGW Revenue Allocation Proposal for Firm Sales Customers on Interclass Cross-Subsidies				
	Dollar Values		Revenue-Cost Ratios	
	Present	PGW Proposed	Present	PGW Proposed
Residential	(16,456)	(29,887)	94.1%	91.8%
Commercial	12,551	23,737	131.6%	144.5%
Industrial	1,436	2,127	135.9%	141.3%
Municipal	1,142	2,023	134.9%	144.1%
Housing Auth.	1,328	2,001	138.8%	144.4%
Total	--	--	100.0%	100.0%
Interruptible sales and transportation customers are excluded from this comparison for reasons discussed below. Source: Exhibit IEc-4				

As shown above in Table IEc-3, the dollar value of the cross subsidies under PGW's proposal increases for each class from present to proposed rates, indicating that every class' rates are moving away from allocated costs. Similarly, the revenue-cost ratios shown in this table indicate that all of the ratios are farther away from 100 percent under proposed rates than under present rates, again indicating that rates for each class are moving away from allocated costs.[38]

Mr. Knecht also provided an analysis to reflect the differential rate of return metric.[39] For this metric, a negative number means that a class' rate of return is below the system average and, conversely, a positive number indicates that the class' rate of return is above the system average. Reprinted below is Table IEc-S1, which illustrates

[38] OSBA Statement No. 1 at 18

[39] OSBA Statement No. 3 at 3

that PGW's revenue allocation proposal will result in the differential rate of return for each class moving farther away from zero, *i.e.*, farther away from the system average.[40]

Table IEc-S1 **PGW Revenue Allocation Proposal** **Differential Rate of Return Analysis**				
	Class Rate of Return		***Differential Rate of Return***	
	Current Rates	***Proposed Rates***	***Current Rates***	***Proposed Rates***
Residential	4.4%	11.2%	-1.6%	-2.9%
Commercial	13.5%	28.1%	7.4%	14.1%
Industrial	16.0%	28.9%	10.0%	14.8%
Municipal	13.0%	26.4%	7.0%	12.4%
Housing Auth.	15.9%	28.9%	9.8%	14.8%
Total	**6.0%**	**14.1%**	**0.0%**	**0.0%**
Source: Exhibit IEc-4, Table 4-A				

PGW's proposed revenue allocation makes no progress, gradual or otherwise, toward aligning rates with allocated costs. The proposal is inconsistent with common sense and with the results of the revenue-cost ratio, dollar cross-subsidy, and differential rate of return metrics. Therefore, PGW's proposed revenue allocation must be rejected.[41] Furthermore, if the Commission awards PGW less than the full revenue requirement, a straight scaleback from PGW's proposed revenue allocation will produce rates which are unjust, unreasonable, and discriminatory.

[40] OSBA Statement No. 3 at 3-4

[41] OSBA Statement No. 1 at 18

C. TARIFF STRUCTURE

The OSBA is not briefing this issue but reserves the right to address it in exceptions and reply exceptions as necessary.

D. SUMMARY AND ALTERNATIVES: Revenue Allocation

For purposes of this proceeding, the OSBA generally accepts PGW's unbundled distribution CCOSS methodology for setting base rates.[42] Accordingly, if the Commission awards PGW less than the requested revenue increase of $100 million, the OSBA recommends "first-dollar relief" for the non-residential classes, each of which is overpaying its cost of service at both present and proposed rates under PGW's CCOSS.[43]

As explained by OSBA witness Knecht, a utility's proposed revenue allocation serves as the starting point for first-dollar relief. If the Commission awards the utility less than the requested rate increase, those classes that would be providing revenues in excess of costs at utility-proposed rates are assigned the "first-dollars" of overall rate relief.[44]

In addition to PGW, the primary support for the Company's revenue allocation comes from the OCA. In its Main Brief, the OCA touts the fact that (using PGW's COSS and revenue allocation) the residential class would be at 79% of the system average rate

[42] OSBA Main Brief at 35. The OSBA generally accepts this study's methodology regarding the allocation of distribution costs with the knowledge that the study contains certain errors and methodological biases which result in the over-allocation of costs to commercial customers. *See also* OSBA Statement No. 1 at 10-13.

[43] The OSBA's objections to PGW's proposed revenue allocation are summarized in Section IX (B) of this Reply Brief.

[44] OSBA Statement No. 2 at 4.

of return at proposed rates versus 73% of the system average at present rates.[45] Under the indexed rate of return metric advocated by PGW and the OCA, the goal is to get each class' rate of return to 100% of the system average. What the OCA fails to acknowledge is that the indexed rate of return for all customer classes except residential is well above 100% at both present and proposed rates. Specifically, while the residential class is at 73% at present rates, the commercial class is at 225%, the industrial class is at 267%, the municipal class is at 217%, and the Housing Authority is at 265%. At proposed rates, the residential class is at 79%, the commercial class is at 199%, the industrial class is at 205%, the municipal class is at 187%, and the Housing Authority is at 205%. For ease of reference, the OCA's table setting forth these indexed rates of return has been reproduced herein below:[46]

[45] OCA Main Brief at 73

[46] OCA Main Brief at 73

Class Rates of Return under
PGW and OSBA Proposed Class Rate Increases
Totaling to $100 Million

Residential	**Commercial**	**Industrial**	**Municipal**		**Housing Authority**	**Total**
Current Rate of Return	**4.4%**	13.5%	16.0%	13.0%	15.9%	**6.0%**
Index Rate of Return	**73.0**	225.0	267.0	217.0	265.0	100.0%
PGW Proposed Rate of Return	**11.2**	28.1	28.9	26.4	28.9	**14.1%**
Index Rate of Return	**79.0**	199.0	205.0	187.0	205.0	100.0%
OSBA Proposed Rate of Return	13.7	15.7	17.5	14.6	16.9	14.1%
Index Rate of Return	97.2	111.3	124.1	103.5	119.9	100.0%

Data Source: Exhibit 1Ec-4, Table 4-B

What the numbers portrayed by the OCA mean is that, even accepting the proposition that the indexed rate of return is a valid measure of progress, the residential class is the only class that is *underpaying* its cost of service. Therefore, if the Commission awards PGW a smaller total increase than the Company has requested, the revenues demanded from commercial customers, and customers in the other overpaying classes, should first be reduced so that they are not disproportionately higher than the revenues demanded from the residential class.

As calculated by Mr. Knecht on the basis of PGW's CCOSS, accomplishing that task would require that the first $27 million trimmed from PGW's requested revenue requirement be assigned to the overpaying classes, as follows: $21,873,000 to commercial; $1,631,000 to industrial; $1,942,000 to municipal; and $1,554,000 to the Housing Authority.[47] Once the commercial and the other overpaying classes' revenues are brought closer to being in line with the underpaying residential class, then any remaining reduction in the revenue requirement should be shared by all classes.

If the Commission adopts PGW's CCOSS, awarding first-dollar relief to the overpaying rate classes would have a positive impact in moving classes toward rates that reflect the actual cost of service. Furthermore, under the OSBA's first-dollar relief proposal, no customer class would receive a larger rate increase than proposed by PGW.[48] Finally, Mr. Knecht's first-dollar relief proposal is consistent with the principle of gradualism.[49]

The OCA witness, Mr. Galligan, presented an alterative COSS in this proceeding.[50] In its Main Brief, the OCA includes a table which portrays the total allocated costs at present rates for residential customers under Mr. Galligan's COSS. This table, while providing a comparison to PGW's COSS, illustrates a very important point which is contrary to the OCA's revenue allocation argument. That is, the residential class is receiving a subsidy even under the OCA's own COSS. Unless and until the rates of commercial customers, and the customers of the other overpaying

[47] OSBA Statement No. 1 Exhibit JEc-4, Table 4C

[48] OSBA Main Brief at 46. *See* also OSBA Statement No. 1 at 25.

[49] OSBA Main Brief at 47. *See* also OSBA Statement No. 1 at 28.

[50] OCA Main Brief at 54. *See* also Exhibit RAG-1.

classes, are brought closer to cost of service, the residential class should not be provided any dollars of relief. Therefore, even if the Commission accepts Mr. Galligan's COSS, Mr. Knecht's first dollar relief proposal should be adopted.

The size of the overall rate increase ultimately awarded by the Commission is unknown. Therefore, as a simple way to implement Mr. Knecht's first-dollar relief proposal regardless of the finally approved overall revenue requirement, the OSBA recommends that the Commission assign the residential class a rate increase which is 1.2 times the system average and proportionately scale back the percentage increases proposed by PGW for the overpaying classes.

X. CONCLUSION

In view of the arguments made in this Reply Brief and in the OSBA's Main Brief, the OSBA respectfully requests that the Commission:

a. Allocate any awarded rate increase such that the percentage increase for the residential class is 1.2 times the system average percentage increase and that the percentage increases for the non-residential classes are scaled back proportionately from the percentage increases proposed by PGW for those classes;

b. Phase out the funding of PGW's universal service programs by the non-residential classes over three years, beginning with PGW's 2008 proceeding under Section 1307(f) of the Public Utility Code; and

c. Reject PGW's proposal to retain all of the net revenues from off-system sales and capacity releases.

Respectfully submitted,

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Dated: June 21, 2007

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION	:	
v.	:	DOCKET NO. R-00061931
PHILADELPHIA GAS WORKS	:	

CERTIFICATE OF SERVICE

I certify that I am serving two copies of the Reply Brief, on behalf of the Office of Small Business Advocate, by e-mail and first class mail (unless otherwise noted) upon the persons addressed below:

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June 21, 2007

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ORIGINAL

Re: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works, Docket No. R-00061931

Dear Secretary McNulty:

Enclosed are an original and nine (9) copies of the Reply Brief of Hess Corporation in the above-captioned proceeding. Copies of the brief have been served in accordance with the attached Certificate of Service.

DOCUMENT FOLDER

Very truly yours,

John F. Povilaitis

Enclosure
JFP:ck

c. Certificate of Service

The Honorable Cynthia W. Fordham
The Honorable Angela T. Jones

2007 JUN 21 PM 3:02

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COMMONWEALTH OF PENNSYVANIA

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

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TABLE OF CONTENTS

I. Introduction

In its Main Brief in this proceeding, both Philadelphia Gas Works ("PGW") and the Office of Consumer Advocate ("OCA") present arguments as to why the Pennsylvania Public Utility Commission ("Commission") should not adopt Hess Corporation's ("Hess") proposals to spur natural gas competition in PGW's service territory. As mentioned by Hess in main briefing, these proposals support the objective of Code Chapter 22 to give customers viable competitive choices for their gas supply, and they also comport with the Commission's current gas policy objectives. Hess submits the following reply to the specific arguments raised in main briefing by these two parties in opposition to Hess' proposals to remove competitive barriers to competition in the PGW service territory.

II. Summary of Argument

A preponderance of the evidence in this case supports the conclusion that Hess' proposals will benefit PGW and its customers, as well as support the Commission's goal of improving the effectiveness of competition in the Philadelphia gas market. The counter-arguments made by PGW and OCA are unpersuasive, insufficiently supported and fail to recognize the cost savings and benefits that are related to Hess's proposals.

OCA has misconstrued Hess balancing and cash out recommendations as "delivery latitude" and mischaracterized Hess' competitive entry concepts as "subsidies". On the contrary, the expanded tolerance bands and reductions in penalties sought by Hess reduce costs to NGSs and their customers.

PGSW has not demonstrated that its overly strict and punitive rules for NGSs are necessary to avoid operational problems. Nor has PGW adequately documented the

alleged costs of Hess proposals or factored the benefits of Hess proposals into its analysis of the proposals' merits.

PGW's evidence that the costs of Hess recommendations are material is tentative and it speculates that operational problems will arise if those recommendations are adopted. Hess has presented a point-by-point rebuttal of PGW's concerns. It has shown its proposals on nomination deadlines will benefit PGW as well as NGSs. Hess balancing recommendations will not jeopardize PGW's system control or shift significant costs to firm service customers. To the contrary, costs impacting transportation customers would be reduced. To the extent anti-gaming tariff provisions are needed, PGW should propose such rules when gaming is shown to be a problem. The current rules, which date back to PGW's restructuring case and which PGW is reluctant to update, are punitive and impose unnecessary and unavoidable costs on NGSs.

Hess's proposals are lawful, supported by a preponderance of the evidence and are in the public interest. They should be adopted by the ALJs and the Commission.

III. Rate Base (omit)

IV. Revenues

Hess is not addressing this issue.

V. Expenses

Hess is not addressing this issue.

VI. Taxes (omit)

VII. Rate of Return (omit)

VIII. Miscellaneous Issues

A. The record does not demonstrate that Hess' proposals regarding balancing and cash outs will increase costs to ratepayers, and the record evidence is clear that Hess is not proposing any subsidies as part of this proceeding.

At pages 106 through 107 of its Main Brief, OCA voices concern about the financial impact on ratepayers of the supplier proposals to reduce competitive barriers to entry. More specifically, OCA cites to Hess' testimony that Natural Gas Supplier ("NGS") entry should occur only at no additional cost to ratepayers but then opines that Hess' proposals do not achieve this goal. However, the record evidence does not substantiate that Hess' proposals will result in additional costs to ratepayers.

The only specific cost issue raised by OCA witness LeLash with Hess' proposals relates to the balancing and cash outs proposals. Specifically, witness LeLash comments about what he characterizes as additional delivery latitude and how it would shift costs to "incumbent ratepayers."[1] However, as pointed out in main briefing, Hess witness Magnani successfully refutes this concern.[2]

Witness Magnani disputes the contention that Hess' proposals are designed to allow NGSs "delivery latitude." As noted by witness Magnani, Hess' proposals regarding balancing and cash outs are designed to correct inappropriate and overly punitive rules that punish NGS for behavior they are incapable of improving. As further noted by witness Magnani, the inability to improve is not the result of incompetence or inexperience, but rather, is due to the nature of the industry.[3] Equally as important, the greater tolerance band and reduced penalties that Hess seeks would not impose any

[1] OCA St. No. 1-R, p. 7, lines 10-19.
[2] Hess M.B. at 17.
[3] Hess St. No. SR-1, p. 9, lines 1-6.

additional costs on Local Distribution Company ("LDC") sales customers.[4] In actuality, the increased tolerance band and reduction in daily penalties would result in a reduced cost to NGSs and that opens the door to lower prices to transportation customers.[5] Therefore, OCA's concerns about the cost implications of Hess' proposals are unfounded and should be rejected.

More generally, in main briefing, OCA objects to the supplier proposals relating to competitive entry on the grounds that they represent requests for direct or indirect subsidies. However, as discussed above, Hess' proposals will not result in any financial impact on incumbent ratepayers and will actually reduce costs for transportation customers. Moreover, witness Magnani disputes the use of the term "subsidies" to describe the NGS proposals in this case. As noted by witness Magnani, Hess is simply requesting rates, terms and conditions/rules and procedures that effectuate the intent of Pennsylvania to open natural gas distribution systems to natural gas suppliers so that *all* customers have the opportunity to purchase supply services from the local distribution company or a competitive supplier.[6] As further noted by witness Magnani, "without reasonable terms under which those suppliers can operate, the local distribution systems are not truly open and the regulatory scheme is not really being implemented.[7]"

B. PGW has failed to meet its burden of proof that Hess' proposals to increase competition will jeopardize the safety and reliability of PGW's system and are cost-prohibitive; nor does PGW recognize the benefits of Hess' proposals.

At page 101 through 102 of its Main Brief, PGW objects to Hess' proposals on the grounds that they allegedly will jeopardize the safety and reliability of PGW's systems,

[4] Hess St. No. SR-1, p. 9, lines 10-11.
[5] Hess St. No. SR-1, p. 9, lines 18-24.
[6] Hess St. No. SR-1, p. 10, lines 14-16.
[7] Hess St. No. SR-1, p. 10, lines 16-19.

will result in unnecessary use storage assets and will be very expensive to implement. However, PGW has failed to meet is burden of proof on these issues.[8] PGW's claims of additional costs to implement Hess' proposals are tentative and have not been shown to be materially significant. Nor has PGW acknowledged that any short term costs it may incur to implement a new procedure are outweighed by the clear benefits to PGW and customers that would flow from implementation of Hess' recommendations.

As stated at pages 8 through 9 of Hess' Main Brief, PGW has not shown by a preponderance of evidence that Hess' proposals jeopardize the viability of its system or that the proposals are cost-prohibitive. It is not sufficient to merely claim the sky will fall if pro-competition measures are adopted by the Commission. Such allegations must be backed by tangible evidence or they are mere speculation. As noted in main briefing, PGW has not attempted to quantify in dollars specific costs it alleges it will incur if it is required to implement Hess' proposed standards. Therefore, PGW has not met its burden of showing whether the alleged new costs are significant and materially higher or merely incidental, given the total size of PGW's revenue requirement. Nor has PGW acknowledged any offsetting expense decreases that would accrue to PGW if improved tariff rules and practices make its system more attractive to suppliers, the most important of which is a reduced merchant gas role for PGW.[9]

With respect to operational concerns, PGW has presented no evidence that Hess' proposals will definitely create operational problems, including safety, reliability or

[8] PGW has agreed to make certain incremental changes to its rules affecting suppliers regarding nomination deadlines, carrying cost interest rates, availability of the marketing file and enrollment correction procedures. PGW M.B. , pp. 101-102. Hess accepts these changes, however they are insufficient to accomplish the goal of improved, effective competition. Therefore these concessions do not obviate the need for the ALJs and the Commission to adopt Hess' recommendations.

[9] Hess M.B. at 8.

storage problems. Rather, operational problems are depicted as possibilities. If implementation of Hess' proposals permits any supplier to create an operational problem, PGW is always free to submit a tariff provision that will address and remedy the problem. Hess has presented evidence showing that changes in nomination deadlines will benefit PGW and its customers.[10] Moreover, allowing a later nomination deadline will reduce nomination errors which will benefit PGW by reducing its need to balance its system when imbalances are caused by nomination errors.[11] Clearly, PGW's position that new rules and standards for suppliers will create operation problems is mere speculation, driven by a preference not to revisit the supplier tariff rules and practices established in its restructuring case.[12]

In main briefing, PGW contends that its daily balancing requirements are crucial to the Company's ability to maintain control and reliability of its system and that Hess' proposals relax or weaken those requirements.[13] PGW further contends that its limited storage capacity is an additional reason why Hess' proposals should not be adopted (PGW M.B. at 102) and is reluctant to use what it views as its limited storage capacity to cope with system imbalances.[14] However, Hess sees no reason to believe that PGW's concerns in these regards will be realized.

At pages 18 through 19 of Hess' Main Brief, Mr. Magnani provided an illustration of how PGW's concerns about delivery swings jeopardizing its control of its system and increasing costs to firm customers is grossly exaggerated. As noted by witness Magnani, the difference in dekatherms ("dths") from a tolerance band of 5% to 10% is so small that

[10] Hess St. No. SR-1, p. 1, lines 22-31.
[11] Hess St. No. SR-1, p. 2, lines 1-5.
[12] Hess M.B. at 8-9.
[13] PGW M.B. at 103.
[14] PGW St. No. 11, p. 6, lines 3-17.

it is impossible to see how it could have any real impact on PGW's swing gas buy decisions or that it would impose any additional costs on anyone. As further noted by witness Magnani, Hess fails to see how an increased swing tolerance of 250 dths a day could have any appreciable impact on the entire PGW system of hundreds of thousands of dekatherms flowing daily, whether it be on reliability or costs for any customers. On the contrary, the changes Hess proposes would reduce costs for NGSs which in turn would reduce costs impacting transportation customers.[15] Therefore, the record evidence shows that PGW's concerns regarding Hess' balancing proposals are unfounded.

In the Commission's order adopting PGW's initial supplier penalty provisions, the suggestion was made that a collaborative be convened to further evaluate the imbalance and penalty issue.[16] The Commission declined to establish a collaborative but noted:

> This process is not necessary as the penalty issue will be reevaluated as customer choice evolves on PGW's system.[17]

This proceeding represents the reevaluation opportunity the Commission envisioned and the next step in the evolution of these rules calls for an increase in tolerance bands and a reduction in penalties imposed on suppliers.

PGW's example of a supplier gaming the rules by delivering no gas on a peak cold day doesn't really demonstrate the prudency of their current balancing rules and cash out penalties. When the market price is sufficiently high on a peak cold day, the supplier could fail to deliver on such a day, sell the gas elsewhere and still profit after paying the penalty. A zero NGS delivery on a peak cold day, absent an

[15] Hess St. No. SR-1, p. 4, lines 27-31, p. 5, lines 1-7.
[16] *PaPUC v. Philadelphia Gas Works*, Docket No. M-00021612 (March 31, 2003) at 35.
[17] Id.

exculpatory operational problem, is gaming. If there was evidence documenting NGSs have engaged in that behavior it would warrant a gaming penalty tailored to that type of behavior. PGW's balancing tolerances and penalties are unreasonable because they do not prevent gaming but do financially punish suppliers who are not engaging in gaming, but are confronted with standards and rules that make penalties unavoidable.

IX. Rate Structure

Hess is not addressing this issue.

X. Conclusion

Based upon the foregoing reasons and for the reasons set forth in Hess' Main Brief, a preponderance of evidence supports the granting of Hess' proposals to spur competition by NGSs in PGW's service territory. These proposals support the objective of Chapter 22 of the Code to give customers viable competitive choices for their gas supply, and they also comport with the Commission's current gas policy objectives.[18] Therefore, Hess' requests for improvements to PGW's tariffs that will benefit suppliers, customers and PGW itself, should be granted.

June 21, 2007

Respectfully submitted,

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[18] Hess notes that Interstate Gas Supply, Inc. ("IGS") has requested creation of a working group to develop modifications to PGW's billing practices and a market share threshold program. IGS M.B., pp. 11-12. Hess would participate in such a working group if convened, however Commission concurrence with the working group proposal should not substitute for adoption of Hess' proposals. Those proposals are more comprehensive in scope and detail than the subjects the working group would address.

COMMONWEALTH OF PENNSYVANIA

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the attached documents in accordance with the requirements of 52 Pa. Code § 1.54 et seq. (relating to service by a participant).

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COMMONWEALTH OF PENNSYLVANIA
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IN REPLY PLEASE
REFER TO OUR FILE

June 21, 2007

James J. McNulty, Secretary
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Harrisburg, PA 17105-3265

Re: Pennsylvania Public Utility Commission v.
Philadelphia Gas Works

Docket No. R-00061931

ORIGINAL

Dear Mr. McNulty:

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

As evidenced by the enclosed Certificate of Service, copies are being served on all active parties of record.

DOCUMENT
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Sincerely,

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PA Attorney I.D. #80409

Enclosure
RAK/clp

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2007 JUN 21 PM 12:46

37

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	**Docket No. R-00061931**
	:	
Philadelphia Gas Works	:	

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Dated: June 21, 2007

TABLE OF CONTENTS

TABLE OF CITATIONS

Cases

Commission Decisions

Statutes

I. INTRODUCTION

A. Status of the Proceeding

The procedural history of this case is detailed in the Office of Trial Staff's (OTS) Main Brief filed on June 12, 2007.[1] In its Main Brief, OTS presented the evidence and law in support of its recommendation that Philadelphia Gas Works (PGW or Company) be permitted the opportunity to recover no more than $25 million in additional annual revenues.

This Reply Brief is supplemental to the Main Brief filed on behalf of OTS and is limited to those matters raised by the Company in its Main Brief. Additionally, the Reply Brief will discuss matters previously addressed by OTS that require additional discussion and comment as a result of arguments presented by PGW in its Main Brief.

B. Burden of Proof and Evidentiary Standard

The Company retains the burden of proving the reasonableness of each and every element of its claim throughout the entire proceeding. This standard has been examined in detail and is well-established and recognized by the Commission and courts.[2] In the present proceeding, it is PGW's obligation to affirmatively prove the reasonableness of each and every element of its claim with substantial evidence. A review of the evidence and arguments presented by the parties demonstrates that the City has failed to sustain this burden. As such, the Company's request for $100 million in rate relief and

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1 OTS M.B., pp. 2-4.
2 OTS M.B., pp. 4-7.

approximately $10 million in off system sales and capacity release credits must be denied.

II. SUMMARY OF ARGUMENT

The Company has not satisfied its burden of proof with respect to its requested level of relief in this base rate proceeding. In fact, the Company's own test year data indicates that no increase to base rates is warranted.[3] Accordingly, OTS maintains that PGW's request to obtain $100 million increase in base rates and $10 million in capacity release and off system sales must be rejected. In lieu of this inflated ratemaking request, OTS asserts that its recommended $25 million rate increase is in the public interest because it balances the need of the Company to obtain additional revenue to pay the $45 million loan due to the City with the need of PGW ratepayers to moderate the effect of an increase in their monthly gas bill.

Adjustments to the Company's claimed Revenues have been accomplished and detailed in the OTS Main Brief.

OTS has reviewed the Company's Operation and Maintenance Expense claim and has identified certain areas that should not be recognized in this proceeding. Specifically, the Company's expense claims for its Management Incentive Program, Bad Debt, Marketing – Promotion, Lobbying, Injuries and Damages, Advertising and Regulatory Fines and Penalties must not be recognized in this proceeding. These claims are either inappropriate or overstated. In addition, based on OTS' recommendation, the Company

[3] See, PGW St. 2, JRB 1, p. 3. This is the test year data supplied with the Company's filing. The endless updates and calculations done under different rate relief scenarios should be disregarded. The Company's filing presents the basis for analysis in this proceeding.

has recognized, and agreed to adjust, its Prescription Plan expense and eliminate its Merger Activity claim. However, it is important to recognize that OTS is not recommending that its $25 million revenue recommendation be adjusted to reflect the correction of these claims. Instead, OTS maintains that it is in the public interest for the Company to apply the funds associated with these claims to its outstanding line of credit. This will assist the Company in lowering its overall debt position.

The Company's test year data indicates it is able to meet all of its required debt service coverages while maintaining an overall coverage of 1.34x, which exceeds investment grade as determined by the financial community. Regulation by means of the test year is the proper scope of review in this proceeding. The cash flow method of regulation does not differ from rate base/rate of return regulation with respect to the use of a test year as the basis for establishing rates. As such, the Company's attempt to abandon the test year concept in favor of its proposed five year planning horizon must be rejected.

The Company's aggressive plan to dramatically alter its capital structure within its five year planning horizon is not in the public interest. Although reducing its debt level is laudable, placing this burden solely on ratepayers and suggesting a truncated time frame is not appropriate. The responsibility for the provision of safe and reliable service at rates that are just and reasonable is shared by the City of Philadelphia, the Company and the ratepayers.

The Company's definition of working capital and liquidity is inappropriately narrow and places an unreasonable burden on ratepayers. Working capital includes

liquid assets as defined by OTS in its underlying testimony as well as its Main Brief. Furthermore, PGW's requested level of working capital is excessive and unreasonable.

The Company's proposed retention of revenues associated with off-system sales and capacity releases must be rejected as it violates the Public Utility Code mandate that the Company pursue a least cost procurement policy in obtaining gas for its customers. Revenues from off-system sales and capacity releases must continue to flow back to purchased gas cost (PGC) customers as those customers supplied the funds for those transactions. To do otherwise, increases gas costs for those ratepayers in violation of the Public Utility Code.

Gas safety issues have been resolved to the mutual satisfaction of the Company and OTS.

The Company's Rate Structure proposal must be adjusted to reflect corrections needed to its Cost of Service Study (COSS) as well as to adjust its revenue allocation to address existing inter-class subsidies. OTS maintains that once the COSS is corrected, any reduction to the Company's requested rate relief must first benefit the customer classes identified in OTS testimony and Main Brief. The record evidence indicates that PGW's Commercial, Industrial and Housing GS classes have been providing a subsidy to the other rate classes. First Dollar Relief must be targeted to these classes to reduce the level of subsidy and move the rate classes closer to the cost of providing service.

III. RATE BASE

The Company is regulated under the cash flow method as a means of determining the necessary amount of revenue needed to operate safely and reliably. An analysis of the Company's Rate Base is not required in this proceeding.

IV. REVENUES

Issues pertaining to revenue have been discussed in the OTS Main Brief and have been resolved to the satisfaction of OTS and the Company.[4]

V. EXPENSES

As described in testimony and in the Main Brief, OTS has analyzed the Company's filing and has identified several overstated expense claims. Normally, OTS would adjust its proposed revenue requirement recommendation to reflect the removal of these expenses. This is not the case in this proceeding. Acceptance or rejection of the OTS operating expense claim adjustments does not impact its overall revenue recommendation in this proceeding. OTS maintains that an allowance of $25,000,000 in additional revenue is justified in this proceeding to account for repayment of a loan to the City of Philadelphia, the owner of the utility. The identification of excess expense claims is necessary to provide guidance as to the reasonable and prudent use of the revenues the Company receives from its ratepayers. It is undisputed that a public utility is entitled to recover all reasonable and prudently incurred expenses associated with the provision of safe and reliable service. Recovery is not permitted when the claim is unsupported and

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[4] OTS M.B., pp. 14-16.

no demonstrable evidence has been presented to indicate how service to the ratepayers is enhanced by the activity.

The Company's claim for recovery of expenses is overstated and must be adjusted. OTS recommends that the following expenses not be recognized as being prudent, but maintains that rates recovered based on these claims instead be applied to lower the Company's outstanding line of credit. These identified efficiencies will enable the Company to address its debt position internally in addition to the recommended rate relief offered by the Office of Trial Staff.

OTS has challenged several claims for recovery of expenses due to their violation of sound regulatory principles as well as the Company's inability to support certain claims, with substantial evidence, as being essential to providing safe and reliable service. The Company maintains the burden of proving each and every element of its claim. As presented in the OTS Main Brief, the evidence necessary to support a claim must be substantial.[5] Attempts to shift the burden to an intervening party are unwarranted and should be afforded no weight. The Company's comments that "OTS did not attempt to seek more information..."[6] and "OTS had ample opportunity to test the updated claim – and made no attempt to do so"[7] are blatant examples of the Company's attempt to shift evaluation away from its inability to support its own claims by pointing out what it perceives that other parties did not do. Utility regulation in Pennsylvania requires the Company bear the burden of proving its claims throughout the entire

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5 OTS Main Brief, pp. 4-7.
6 PGW Main Brief, p. 67.
7 Id. at 71.

proceeding. OTS has raised the issues for further review; the Company has failed to support them with the type of substantial evidence that is necessary in regulatory proceedings. These "red herring" arguments presented by the Company must be ignored and the issues must be resolved based on the evidence presented in the record.

PGW has not demonstrated, with the requisite substantial evidence, that its Management Incentive Compensation expense claim provides a benefit to its customers that would allow it to be recovered in rates. As OTS Witness Markovich has opined, the expense has not been demonstrated to have any correlation to improvements in the operational, service level or the financial condition of PGW.[8] The OTS recommendation is to deny recognition of the claimed expense as, ultimately, a benefit to ratepayers has not been supported in the Company's argument. Analysis of the claimed expense reveals that the Company has failed to support the premise that the program is effective in retaining management personnel, nor has it supported the claims with evidence showing a benefit to ratepayers. As the record indicates, there have been no studies comparing retention rates and formal documentation of the program is lacking.

OTS wholeheartedly agrees with the case of *Bell Telephone Company of Pennsylvania*[9] cited by the Company on page 61 of its Main Brief. This is precisely the case in this proceeding. No evidence has been presented demonstrating that this program is necessary to retain management personnel nor has the expense been proven prudent for providing service to the public. Whether the amount claimed is reasonable fails to be

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[8] OTS St. No. 2, p. 6.

[9] Bell Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission, 408 A.2d 917

persuasive as the Company's evidence has failed to support why ratepayers should be charged for this vague, unsupported program.

The Company's Bad Debt Expense claim is not calculated properly and must be adjusted. Sound regulatory principles dictate that an expense claim associated with Uncollectible Accounts, or Bad Debt, must be calculated using a very simple formula. A Bad Debt allowance is calculated by simply applying a write-off percentage to a gas revenue determination. This methodology has been accepted by the Commission in the past and there is no credible evidence in this proceeding to change this fundamental application.

The Stipulation reached between the Office of Trial Staff and the Company has established the write-off percentage as 4.5%.[10] OTS maintains that the appropriate revenue determination is the jurisdictional revenues reported by the Company plus the $25,000,000 additional revenue recommendation. This total gas revenue determination of $970,191,000 is shown in Appendix D of the OTS Main Brief. The simple application of the agreed upon 4.5% to the overall revenue figure of $970,191,000 yields an allowance of $43,650,000. There are only two variables in the calculation of an appropriate Bad Debt allowance. In this proceeding, only the appropriate revenue calculation has not been agreed upon. The Company's representation that the dispute centers on only $1.2 million is true to the extent that it is addressing only the narrow application of the write-off percentage to total revenues versus gas revenues. The impact

[10] OCA has accepted the Bad Debt level as presented in the Stipulation. This is referenced in OCA's Main Brief on page 43.

of a bad debt allowance obviously is impacted by the level of additional revenue allowed in this proceeding and also whether these funds are then improperly multiplied by a factor to fund a bad debt reserve. The tables contained in Appendix D to the OTS Main Brief present the proper disposition of this issue, and all other issues, in this proceeding.

A Bad Debt allowance must only reflect the application to jurisdictional revenues. OTS has consistently argued this position and the Commission has resolved this dispute in prior proceedings.[11] The Commission does not regulate non-jurisdictional revenues. These programs and services that generate non-jurisdictional revenues are under the total control of the Company and its owner. As such, it is not appropriate to apply regulatory findings to this area of the Company's business. There is no evidence in the record supporting the premise that bad debt has not already been accounted for in the pricing of the programs and services that comprise the non-jurisdictional revenues. Applying a bad debt percentage to programs and services that may already have this type of protection built in is inappropriate. The Company has not presented substantial evidence to support its claim that the bad debt percentage should be applied to total revenue. The appropriate regulatory treatment of a bad debt allowance is to apply it to jurisdictional gas revenues.

The Company's practice of funding a bad debt reserve is unnecessary and should not be recognized in this proceeding. To the extent the Company believes that the calculation to determine an appropriate bad debt expense allowance needs to then be applied against an arbitrary reserve figure, such a position is misguided as a reserve account means nothing to a utility regulated under the cash flow method. The concept of

[11] Refer to OTS Main Brief, p. 21 for a discussion of bad debt expense as presented by the Commission.

a reserve account is an accrual accounting methodology that is not appropriate in a cash flow method proceeding. Furthermore, the claimed level of reserve is entirely up to the discretion of the Company. As described in OTS Surrebuttal Testimony PGW "can set the amount of a reserve balance on various criteria using estimates and reserve factors based on the company's and/or their auditor's idea of reasonableness."[12] The concept of funding a reserve is not sound regulatory policy and must be rejected.

The Company's bad debt allowance must be determined by applying the stipulated 4.5% to PGW's jurisdictional gas revenues. The resulting determination is the appropriate allowance in this proceeding. The application of the 4.5% to total revenues and the funding of a reserve must be rejected.

The Company's claimed Marketing expense is dramatically overstated and should not be recognized in this proceeding. The OTS adjustment to this claimed expense is adjusted based on the Company's Interrogatory response contained In OTS Exhibit Number 2-SR, Schedule 1, page 2 wherein the Company acknowledged "that the projects for customer B and customer D would not take place in the test year 2007."[13] OTS has adjusted the expense to recognize that these particular projects are no longer valid. The Company's argument that it "expects to incur costs in the Test Year at around these levels"[14] is not supported by the evidence in the record. The identified projects are clearly not going to occur in the test year. No other evidence has been presented to support maintaining the same level of claimed expense in this proceeding. The assertion

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12 OTS St. No. 2-SR, p. 12.

13 See OTS Main Brief, p.22, OTS St. No 2-SR, p. 18, OTS Ex. No. 2-SR, Sch. 1, p. 2.

14 PGW Main Brief, p. 72.

that PGW "is budgeting a similar amount for FY 2008"[15] is irrelevant. Under no circumstances should the full amount of the claimed expense be recognized in this proceeding as it is unsupported by credible evidence. Inclusion of the full amount requires recognition of an expense that will occur outside the test year. This is not sound regulatory policy and should be rejected.

PGW's claim for recovery of expenses related to lobbying is inappropriate and should not be recognized in this proceeding. OTS recommends rejection of the entire claim based on the Company's failure to support its necessity with substantial evidence. PGW has tacitly admitted that its evidence is lacking when it stated that "OTS did not attempt to seek more information or to audit PGW's claim after it was made in Mr. Bogdonavage's rebuttal testimony. If it had it would have been provided with sufficient documentation and support."[16] Clearly the Company is stating that additional evidence was available. However, the Company failed to provide this evidence on the record, preferring instead, to shift the burden to OTS to make its case for it. Moreover, if such evidence existed, the Company had ample opportunity to provide this evidence in its case-in-chief and the rebuttal stage of the proceeding. By its' own admission, it has failed to do so.

PGW's status as a municipal utility is of no consequence in evaluating this claim. This same type of claim has been denied in previous Commission proceedings and the Company has not presented any compelling reason why this should change in this

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15 Id.

16 PGW Main Brief, p. 67.

proceeding. Although, as Mr. Bogdonavage indicates the Commission may waive the application of any provision of Section 2212 of the Public Utility Code,[17] the necessity of such a waiver is not supported by the record evidence. Notwithstanding the Company's waiver request presented in Main Brief, OTS maintains that this claimed expense should not be recognized in this proceeding.[18]

The Company's claim for recovery of expense for its Injuries and Damages claim must be adjusted. Any portion of the expense claim associated with PGW's involvement in a class action suit are premature and do not merit consideration in this proceeding. This non-recurring expense is not ripe for review. Review of this claim is not appropriate until this speculative expense becomes a reality. When this occurs, OTS maintains that the appropriate regulatory treatment is to amortize this expense over a reasonable amount of time. PGW inappropriately suggests that its claimed expense amount is the same as if the total expense were amortized over 5 years.[19] In an obvious attempt to obviate the fact that the expense claim is not ripe for disposition, the Company attempts to shift the focus of the OTS challenge to the overall amount of the claim when it stated that "OTS had ample opportunity to test the updated claim – and made no attempt to do so."[20] This statement misses the point entirely. The issue is ripeness, not total claimed expense. Ironically, PGW concedes that the appropriate treatment of the claimed expense is to amortize it;[21] however, the appropriate regulatory treatment of a non-recurring expense is

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17 66 Pa.C.S.A. §2212.
18 PGW M.B., p. 68.
19 PGW M.B., p. 71.
20 Id.
21 Id.

to amortize it, when it occurs. The issue is not ripe for disposition and its recognition in this proceeding must be rejected.

The Company's claimed Advertising expense should be reduced by $35,000 to reflect the portion associated with customer satisfaction, education and promotion. This claim has been sufficiently addressed in the Direct and Surrebuttal testimonies of OTS Witness Markovich.[22] As this expense is not directly related to the provision of safe and reliable service, it should not be recognized.

PGW's claim for recovery of costs associated with Regulatory Fines and Penalties does not merit consideration in this proceeding. Simply stated, it is not sound regulatory practice to allow a Company to recover the costs of its violations from its ratepayers. The Company's argument that it can only collect these funds from ratepayers is baseless. This claim is not a prudent expense and should not be considered in this, or any future, proceeding.

The Company's claimed Merger Activity expense and the revised Prescription Plan expense have been thoroughly detailed in previous documents and need not be repeated here.

OTS continues to opine that the above discussed expenses should not be endorsed as being appropriate for recovery from ratepayers in this proceeding. Notwithstanding this position, OTS does not believe that its recommended revenue allowance should be adjusted to reflect the rejection of these expenses. Instead, OTS maintains that the public interest would be better served by the Company applying the revenues associated with

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[22] OTS St. No. 2, p. 23. OTS St. No. 2-SR, p. 23.

these expenses to lowering the balance on its line of credit. The OTS position in this proceeding allows the rates to reflect the totals associated with the claimed expenses but doesn't believe the Company's claims merit consideration. In other words, OTS is willing to forgo reducing its revenue recommendation in order to apply funds associated with these expense claims to lowering the outstanding balance on the Company's line of credit. OTS maintains that identifying these imprudent expenses will allow the Company to redirect its efforts and utilize funds to reduce its debt. In the long run, a lower debt ratio will benefit ratepayers.

VI. TAXES

As a municipal utility, PGW has no tax liability. Therefore, there is no impact on ratepayers.

VII. DEBT SERVICE COVERAGE

Before a discussion of the Company's revenue requirement can begin, it must be made clear that the overarching issue in this proceeding is whether PGW, as a cash flow company, must adhere to the concept of a test year. PGW and the statutory parties have a widely divergent opinion on this matter. PGW claims that it is improper to require the Company to strictly adhere to this ratemaking convention. OTS and OCA maintain that the determination of just and reasonable rates necessitates following this well-established ratemaking principle.

Rates are calculated based on the ratemaking device of a test year. The purpose of setting rates is to predict the operating results of a utility for the period during which the rates will be in effect. The test year methodology does this by matching the revenues of

the utility with reasonable expenses that it expects to incur. Claims for expenses outside of the test year are generally not permitted to be recovered through rates because it violates the just and reasonable standard mandated by the Public Utility Code.[23] It is proper to exclude those expenses from base rates on the ground that current ratepayers should not be required to pay for something that may or may not occur at some future date. The test year construct is a well established statutory regulatory tool upon which rates for all utility industries in Pennsylvania have been, and should continue to be, calculated.

The Company contends that strict adherence to the test year construct alone is not in the public interest.[24] OTS, as the party charged with a statutory duty to represent the public interest, disagrees. The test year is a rate setting mechanism that must be followed to ensure that PGW rates are just and reasonable. Otherwise, parties in base rate proceedings, and ultimately the Commission, will have no standard against which to test PGW's ratemaking claims for justness and reasonableness. This is clearly not in the public interest. Therefore, OTS contends that the PGW's request for $100 million in rate relief based on the desire to improve its debt service coverage, generate internal funds, and improve its capital structure is well outside the test year and must be rejected.

The Company counters that the Commission regularly exercises its discretion to go beyond the test year to consider "known and measurable" changes.[25] OTS does not dispute this ratemaking concept, as it is precisely the concept that OTS relied upon to

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23 66 Pa.C.S. § 1301.
24 PGW M.B., p. 7.
25 PGW M.B., p. 25.

formulate its recommendation in order to provide PGW funds to repay a $45 million loan due to the City in 2008. However, OTS maintains that the Company's application of this ratemaking tool to achieve its desired capital structure in a five year period is inappropriate. Generally, few exceptions to expense claims outside the test year are permitted and recognized through rates if the expense is "known and measurable". While OTS would agree with the Company that there are no specific rules concerning the cut-off time period for recognizing such expenses, the Commission generally looks approximately six months beyond the test year.[26] Looking much further beyond the test year increases the likelihood that the projections are speculative and less reliable rather than known and measurable. A number of scenarios have been put forth illustrating how PGW's five year projections are speculative and, therefore, are not known and measurable.[27]

In contrast, OTS properly applied the "known and measurable" concept in the formulation of its recommendation in the instant proceeding. Specifically, PGW has a $43 million loan payment due to the City in fiscal year 2008 and a $2 million payment due to the City in 2007. Although the Company's future test year ends August 31, 2007, OTS went beyond the scope of the test year to recognize the loan repayments because it is a known and measurable and because PGW, as a cash flow company, must have the funds to extinguish the City loan built into rates prior to the repayment of the loan. By

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[26] PGW M.B., p. 25. OTS M.B., p. 17. In Main Brief, the Company highlights the Electric Choice Act, which allowed electric utilities to collect stranded costs, as an example of the Commission allowing utilities to project twenty years or more into the future. PGW M.B., p. 26. Electric utilities were permitted to do so precisely because it was mandated by the Public Utility Code. This example is distinguishable from PGW's request because no law contained in the Public Utility Code requires PGW to have a 50/50 capital structure by 2012.

[27] OTS M.B., p. 36. OCA M.B., p. 21-22.

doing so, OTS properly applied the concept of "known and measurable" recovery outside the scope of the test year.

A careful reading of the Company's Main Brief and record evidence in this proceeding demonstrates that all of the Company's projections for success if it receives its requested $100 million rate increase or failure if it receives the recommended rate increase put forth by OTS are outside the scope of the Company's future test year. Accordingly, OTS asserts that the relief requested will result in unjust and unreasonable rates and must be denied.

A. Debt Service Coverage

It is undisputed in this proceeding that the Company is able to meet its debt service coverage during the future test year.[28] Despite this, OTS recommended a $25 million rate increase to enable the Company to satisfy a loan payment due to the City. Moreover, the OTS recommendation did not subtract the $11.3 million in expense adjustments presented in this proceeding. Because of this, OTS maintains that the recommended $25 million increase must be accepted in lieu of PGW's requested $100 million rate increase and approximately $10 million in off system sales and capacity release credits.

Throughout testimony and brief, the Company attempts to scare the Commission with a multitude of worst case scenarios and bleak predictions from the investment community. However, even the Company recognizes that the recommended $25 million increase will allow it to cover its expenses and meet its debt service coverage

[28] OTS M.B., p. 30.

requirements in the test year.[29] The Company laments that,"[b]y the OCA/OTS's own admission an increase at this inadequate level will simply force PGW to continually file for a series of base rate increases just to survive..."[30] PGW should not be granted a special exemption from filing base rate cases by setting rates on a five year planning horizon, rather than on the basis of a future test year. No other NGDC's under Commission regulation are permitted to evade base rate review in this manner, and the Company has not provided sufficient evidence as to why it is appropriate to do so specifically for PGW. In fact, the antithesis is likely true given that PGW is a cash flow company. PGW is now under Commission regulation, and part of that requires filing base rate proceedings before the Commission. Instead, the Company has an all or nothing mentality—it wants all of its increase now so that its financial situation is greatly improved five years from now. This is not how the Commission regulates utilities and is not in the best interests of PGW ratepayers. A more moderated, incremental approach put forth by OTS will move the Company closer to reducing debt and avoid rate shock to the Company's customers.

Moreover, PGW's attempt to compare what it should receive in rate relief in this proceeding based on the outcome of its previous base rate cases is inappropriate from a ratemaking perspective and highlights the Company's rejection of the test year concept. The Company engaged in this "bringdown" analysis by comparing the results of prior PGW base rate proceedings with what it needs in this proceeding just to put it in the

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[29] PGW M.B., p. 37.
[30] PGW M.B., p. 37.

position it was in after the prior rate cases. According to this analysis, the Company contends that to attain the earnings level equal to what was established in the last two rate cases would require a minimum increase of $70-$71 million.[31] This analysis is inappropriate because a just and reasonable level of rate relief is determined on a case by case basis.[32] The starting point for every rate case begins with the utility's filing, wherein the claims are based on the selected test year. All of the ratemaking components must be reviewed at the time of the base rate filing because the circumstances of the utility continuously change from year to year. Following the Company's logic would render base rate proceedings virtually meaningless as the rate setting process would simply require a review of past cases to determine future rates. The Company implies that OTS is hypocritical in this approach because OTS rejected an expense claim based on how the Commission ruled on that issue in a prior litigated base rate proceeding.[33] This comparison highlights the Company's fundamental misunderstanding of the base rate process. The Commission does look at prior base rate cases to determine how to rule on ratemaking elements at issue to insure that ratemaking principles are applied consistently from case to case. This, however, in no way implies that the Commission looks to the overall revenue granted in prior rate cases as a baseline for revenue in future rate cases. The Company is trying to compare OTS' consistent application of ratemaking principles from prior rate cases with PGW's attempt to use the actual dollar amount received in prior rate cases as an indication of what it should receive in this proceeding. These are

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31 PGW M.B., pp. 6, 30-35.
32 OTS St. 1-SR, p. 11-12.
33 PGW M.B., p. 35, FN 89.

entirely different concepts and are in no way analogous. It is abundantly clear that setting rates in Pennsylvania involves an extensive analysis of all ratemaking claims in every base rate proceeding to ensure that the rates are set, and continue to be set, at a just and reasonable level. As such, the earnings from prior base rate cases in no way sets a floor of what is appropriate in this proceeding as suggested by the Company.

However, to the extent that PGW finds a comparison to prior rate cases to be instructive, its calculations are in error. First, the Company analyzed the net income from its two prior rate cases and determined that to be put in the position that it was in 2001-2002 requires a minimum rate increase of $70.2-$71.5 million.[34] PGW sought to compare the fact that the PUC approved rates in those two proceedings produced a net income of approximately $88 million.[35] The Company compared the $88 million from the prior rate cases in a misguided attempt to highlight the inadequacy of the OTS recommendation. OTS took issue with this comparison because PGW should not combine the net incomes of the two prior cases against the proposed increase in this case.[36] As explained in OTS testimony, the "rate increase and resulting net income from the first rate case are subsumed in the historical test year data of the second rate case."[37] To account for them separately as PGW did is essentially a double count. Therefore,

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34 PGW M.B., p. 35.
35 PGW St. 2R, pp. 16-17.
36 OTS St. 1-SR, p. 12-13.
37 OTS St. 1-SR, p. 12.

OTS looked at the prior rate case in 2002, which showed a net income of $44 million.[38] The OTS recommended $25 million rate increase produces a net income of $41 million.[39] Therefore, the Company's net income comparison does not indicate that the OTS recommendation is inadequate.[40]

Second, a comparison of the debt service coverage in the prior base rate proceeding highlights that the OTS recommendation is not far from what was approved by the Commission in that proceeding. For example, the Company's debt service coverage in last rate case was 1.7x.[41] The debt service coverage with the OTS recommended $25 million increase is 1.6x.[42] The Company, by requesting $100 million in rate relief, is actually going far beyond what the Commission approved in its prior base rate proceeding. As shown on the Company's schedules, if its full request is granted, the Company will have debt service coverage of 2.75x in the future test year and coverage in excess of 2x through 2012.[43] Therefore, while there is not much disparity between the prior base rate proceeding and the OTS recommendation, PGW's ratemaking claim far exceeds what was approved in prior base rate proceeding.

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38 Petition of Philadelphia Gas Works for Extraordinary Rate Relief, Docket No. R-00017034F0002, Table I (Order entered April 12, 2002). The Company contends that OTS erred by relying on this exhibit as it was part of black box settlement. PGW M.B., p. 36. This contention is wholly misplaced as OTS relied on the Commission Order—the net income number was taken directly out of a table attached to that Order. As such, it was entirely appropriate for OTS to rely on the net income represented by the Commission at the conclusion of that proceeding. Additionally, the Company asserts that OTS relied on the wrong number, rather than the actual net income figure of $61.9 million. PGW M.B., p. 36. Again, the Company is arguing with the Commission's findings in the prior proceeding. Thus, the resulting net income of $44 million was properly included in OTS testimony.

39 OTS M.B., Appendix D, p. 2. See also, OTS St. 1-SR, pp. 12-14 (In testimony, the net income was determined to be $51,726,000. As a result of various ratemaking adjustments that number has been revised to $41 million as shown in Appendix D of the OTS Main Brief.)

40 OTS St. 1-SR, p. 13-24.

41 Petition of Philadelphia Gas Works for Extraordinary Rate Relief, Docket No. R-00017034F0002, Table II.

42 OTS M.B., Appendix D.

43 PGW M.B., Appendix A, pg. 8.

The OTS $25 million rate increase recommendation allows the Company to satisfy its debt service coverages, meet its operating expenses, and provides for a margin that the Company can use at its discretion, which OTS recommends be used to reduce its debt. As such, the OTS recommendation accounts for all of the requirements established in the Management Agreement that must be recovered through rates.

B. Capital Structure and Internally Generated Funds

The Company asserts that its high level of debt is a critical issue in this proceeding, which necessitates a dramatic shift in its current capital structure as it projects a test year debt of 83% at present rates that is expected to increase to 89% by 2012.[44] If PGW receives its entire rate request, it projects to have 54% debt by Fiscal Year 2012.[45]

As discussed in testimony and brief, OTS maintains that the Company's request to achieve this capital structure within a five year deadline is not in the pubic interest. First, projections to 2012 are clearly outside the scope of the test year. A variety of factors may occur to change PGW's debt position in the next five years such as the City's forgiveness of the $45 million loan, decrease in gas costs, or continued improvement in PGW's collection efforts. Second, as noted by the Company, "PGW is requesting sufficient funds so that, for the first time in a generation, it can be a self-sustaining, viable gas distribution enterprise."[46] The Company's artificial five year deadline is inappropriate given that the Company, admittedly, has not been self-sustaining for a significant period

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[44] PGW M.B., p. 42.
[45] PGW M.B., p. 46.
[46] PGW M.B., p. 5, quoting PGW St. 1, p. 3.

of time. To be clear, there is no mandate that requires PGW to achieve its desired capital structure in a five year time frame. PGW's testimony and brief is full of imminent threats of not being able to meet its debt service coverages, loosing investment grade status, or the possibility that it will no longer be able to access long term debt if its capital structure does not vastly improve by reducing its debt percentage. Despite the push to achieve this goal in the next five years, the Company recognizes that it has not been self-sustaining for a generation. Although this problem was created over a long period, PGW nevertheless maintains that it must be rectified in a five year time frame because "PGW is in real danger of collapsing from the weight of its debt burden..."[47] OTS asserts that it is simply not in the ratepayers interest to permit PGW to implement a $100 million rate increase to achieve this goal in its requested five year period. The recommended $25 million rate increase addresses the need of the Company to satisfy its debt coverage requirements, cover operating expenses, and allows it to repay the $45 million loan. According to the OTS analysis, the $25 million rate increase will provide PGW with $90 million of internally generated funds.[48] This is clearly a movement in the right direction to address the Company's debt and it does so at a pace that is appropriate for ratepayers, unlike PGW's demand to quickly fix a generation worth of operational issues in five years.

Moreover, OTS is concerned that PGW's rate request requires its ratepayers to bear the sole responsibility for correcting its capital structure. The Company vigorously

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47 PGW M.B., p. 5, quoting PGW St. 1, p. 3.
48 OTS St. 1-SR, pp. 9-10.

maintains that the City of Philadelphia, the owner of PGW, can do no more to assist the Company.[49] To that end, the Company points out that the City's total contribution to PGW has been $126 million through the grant back of the $18 million City payment and $27 million in interests savings on the $45 million loan.[50] Therefore, according to PGW, the City will have provided $153 million in financial assistance to the Company from 2000 to 2011. In contrast, as discussed by OCA witness LeLash, the Company is requesting to collect $660 million from ratepayers in the next five to six years.[51] While OTS recognizes that the Commission can not require the City to forgive the loan, the Company's unwillingness to entertain this assistance is concerning because it relieves the owner of PGW of any financial responsibility and shifts the entire, substantial burden to ratepayers. The Commission recognized the importance of the City's relationship to PGW in the following Order:

> 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.[52]

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[49] PGW M.B., pp. 54-58.
[50] PGW M.B., p. 55.
[51] OCA M.B., p. 27.
[52] Pennsylvania Public Utility Commission v. Philadelphia Gas Works, Docket No. R-00006042, p. 34 (Order entered October 4, 2001).

Despite this, the Company contends that the City is unable to provide any financial assistance and that, even if it could, doing so would be bad policy for the City.[53] OTS disagrees because, as the owner of PGW, the City has a responsibility to help the Company now and in the future. Forgiveness of the loan would not require an additional infusion of cash by the City, but would result in a significant equity infusion for PGW. While OTS recognizes that the City has financially assisted PGW, the OTS proposal simply recommends that the assistance between the Company and its owner continue. Doing so is in the public interest because it will help PGW achieve its desired capital structure and avoid placing the entirety of that burden on PGW ratepayers.

C. Liquidity and Working Capital

The Company contends that it requires cash working capital to permit it to pay expenses and debt service when due in advance of receiving the revenues from customers.[54] OTS maintains that the Company improperly defines liquidity and is requesting an unreasonable level of cash working capital.

As previously discussed in OTS Main Brief, the Company is regulated by the cash flow method. The requirements of the cash flow method are detailed in the Management Agreement between the City of Philadelphia and the Philadelphia Facilities Management Corporation. In testimony, OTS noted that, under the cash flow method, PGW's rates must include "reasonable additions to the working capital", which was taken from a

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[53] PGW M.B., p. 56.
[54] PGW M.B., p. 39.

Commission Order quoting the 1972 Management Agreement.[55] In rejoinder, the Company entered into the record a Management Agreement amended in 1996, which changed the language to state that PGW rates must, "...provide cash, or equivalent, for working capital in such reasonable amounts as may be determined by the Company to be necessary and as shall be approved by the Gas Commission."[56] Although the language is different in the two versions, it does not impact the OTS analysis.

The two main issues are how working capital is defined and what level of working capital is reasonable. The Company defines liquidity as cash plus commercial paper, which is inappropriately narrow and inflates its ratemaking claim.[57] As discussed in OTS testimony and brief, liquidity comes from a variety of assets that can readily be converted into cash or cash equivalent, such as gas inventories, money markets, and short-term treasury bonds.[58] This definition is supported by the Management Agreement which states that PGW should receive cash or equivalent for working capital. Even the Company recognized that there are additional sources, other than cash and commercial paper, of liquid assets.[59] Therefore, the Company's narrow definition of liquidity improperly inflates its $100 million request for rate relief.

The second issue is to determine what level of working capital is reasonable. The Commission has addressed this issue and stated that:

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55 Pennsylvania Public Utility Commission v. Philadelphia Gas Works, Docket No. R-00006042, p. 13 (Order entered October 4, 2001).
56 PGW Rejoinder Exh. 1, Section VII, 1(b)(iii).
57 PGW M.B., p. 40.
58 OTS M.B., pp. 40-41.
59 Tr., p. 585.

> The Agreement clearly states that only a reasonable amount of working capital is to be included in rates. The Management Agreement does not assume that customer rates will cover all PGW's capital and cash needs as if no other sources of capital or revenues are available to PGW.[60]

The Company contends that "PGW is NOT looking to ratepayers as the sole source of necessary cash flow."[61] To that end, PGW highlights that it utilizes all sources of cash flow, such as depreciation, bond proceeds to finance construction, and earnings from investments. While PGW may utilize these cash sources, it in no way supports granting the Company's full rate increase. OTS and OCA both argue that there are other alternatives to a $100 million rate increase that can improve PGW's cash flow. Specifically, if the City forgives repayment of the $45 million loan, the Company will have additional equity to improve its cash position. Additionally, OTS identified $11.3 million in operating efficiencies that, if implemented by the City, would further increase its cash flow. This combined approach is in the public interest because it improves the Company's liquidity and capital structure while moderating the rate increase for ratepayers.

To support its requested rate relief, the Company states that 200 days of liquidity is appropriate for a municipal gas utility and that, even with the full increase, PGW would have only 72 days of liquidity.[62] OTS contends that 200 days of liquidity is wholly unreasonable.[63] PGW provided exhibits to bolster the reasonableness of the 200

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60 Pennsylvania Public Utility Commission v. Philadelphia Gas Works, Docket No. R-00006042, p. 29 (Order entered December 6, 2001).
61 PGW M.B., p. 39.
62 PGW M.B., p. 44.
63 OTS M.B., pp. 42-43.

days of liquidity.[64] The exhibits fail to do so because the definition of liquidity on the PGW exhibits does not mirror the Company's inappropriately narrow definition. The information on the exhibit was self-reported from hundreds of municipal utilities, some of which reported tremendously high liquidity levels of 274 years and 95 years. Such liquidity levels would be highly unusual for municipal utilities under the definition posited by PGW. Rather, it is more likely that the liquidity levels are high based on a broader, more correct interpretation of liquidity as put forth by OTS. Moreover, few of the utilities on the exhibit provided gas service and none solely provided gas service. The utilities provided this information for an American Waterworks Association survey, as such, the overwhelming majority of the listed utilities engage in the provision of water service.[65] It is inappropriate to rely on the information contained in the Company's exhibits as a comparison to a municipal utility providing gas service.

Additionally, the contention that 200 days of liquidity, as defined by PGW, is appropriate is wholly unreasonable and not in accord with the Management Agreement. As previously discussed, the Company improperly narrows the definition of liquidity to support its ratemaking claim. PGW's attempt to alter this fundamental accounting definition to make it more acceptable to the Company must be rejected. Under the appropriate definition of liquidity, which includes all cash and cash equivalents, OTS maintains that PGW likely has in excess of its 200 days of liquidity. Accordingly, the

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64 PGW 3R, Ex. BB-3, 4.
65 Tr., p. 757.

Company has failed to satisfy its burden that its $100 million rate request results in just and reasonable rates.

VIII. MISCELLANEOUS ISSUE: Off-System Sales/Capacity Release

OTS maintains that PGW's request to obtain off system sale and capacity release credits must be denied. PGW contends that its proposal regarding this revenue is "fundamentally misunderstood" by the parties.[66] To be clear, there is no misunderstanding. Rather, OTS strenuously objects to PGW's attempt to take credits that belong to §1307(f) customers to fund various construction projects. OTS participates in all NGDC's annual §1307(f) proceedings before the Commission. Throughout its extensive involvement in such proceedings, OTS has consistently fought attempts by utilities to pillage the PGC like the one proposed by the Company.

The primary reason that OTS opposes the Company's proposal is that it violates the Public Utility Code mandate that the Company pursue a least cost fuel procurement policy in the determination of just and reasonable rates.[67] PGW's proposal violates this statutory obligation because none of the revenue from these transactions will be used as a credit against purchased gas costs. It is well-settled Commission policy that an NGDC's least cost procurement obligation includes the requirement that the utility pursue capacity releases and off-system sales in order to reduce PGC costs. The Company argues that PGW's proposal must be viewed in a larger context than the least cost fuel procurement policy and posits that its proposal presents "least cost opportunities" because, by not

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[66] PGW M.B., p. 74.
[67] 66 Pa.C.S. §§ 1307(f), 1317, 1318.

having to use long term debt for construction projects, ratepayers will avoid debt service interest costs and the additional amount that must be charged to comply with PGW's bond ordinance requirements.[68] To reiterate, the Public Utility Code specifically mandates least cost fuel procurement, not "least cost opportunities". Therefore, while creative, the Company's standard is simply not supported by the law. It is undisputed that, by taking gas cost savings to fund its capital program, gas costs will be higher than if the credits were applied to the PGC.[69] Because of this undisputed fact, OTS maintains that the Company's proposal violates its statutory obligation. Although inconvenient to PGW, OTS and the Commission are constrained by the law. The Company's proposal simply does not comply with its least cost fuel procurement obligation and must be rejected.

Additionally, OTS expressed concern that the projects funded by the off system sales and capacity release credits will provide benefits to all ratepayers, not just PGC customers.[70] OTS maintains that this cost shifting is inappropriate because it is undisputed that the money to fund the off system sales and capacity release transactions comes solely from PGC customers.[71] PGW does not dispute this, but asserts that sales customers will be the primary beneficiaries of these projects.[72] This position is flawed because PGC customers should be the sole, not primary, beneficiaries through a reduction to purchased gas costs. If PGW has construction projects that require funding, the proper

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68 PGW M.B., p. 74, 75.
69 Tr. 496.
70 OTS St. No. 4, p. 8.
71 OTS St. 4, p. 8. OTS St. 4-R, p. 6. Tr., 498.
72 PGW M.B., p. 76.

ratemaking treatment is to include the costs of those projects in a base rate proceeding so that the costs can be allocated to all customer classes. As such, PGW should have increased its base rate request by $10 million in the instant proceeding to include the costs of those projects rather than propose to keep $10 million in off system sales and capacity release revenues. It must be emphasized that this is not simply a matter of $10 million in additional revenue. Rather, the Company's proposal violates well established regulatory principles, and OTS maintains that PGW should not be permitted to circumvent the traditional base rate process by corrupting the §1307(f) process. Accordingly, the Company's proposal must be rejected by the Commission.

IX. RATE STRUCTURE

Proper review of a proposed Rate Structure is a two step process in every regulatory proceeding. In this proceeding, the Company has presented, what it describes as, a fully developed Cost of Service Study (COSS) to be used as a guide in allocating costs to the various rate classes. OTS acknowledges that there are several factors that must be considered when designing a rate recovery proposal; however, the basis for any determinations must be an accurate Cost of Service Study that fairly represents the costs to be allocated to each class. Once an accurate basis is established, the next step is to allocate revenue to each respective class in accordance with regulatory law and established ratemaking principles.

OTS has identified flaws in both the Company's COSS and its proposed revenue allocation. Correction of these flaws is necessary to develop an equitable revenue allocation proposition that balances the interests of all parties. There is strong legal

guidance in the premise that designing rates in regulatory proceedings is based on the concept of cost causation. The class the causes the cost, should pay proportionately. Additionally, other principles such as gradualism must be considered in order to address the impact that sudden changes in rates will have on customers.

The recommendation of OTS Witness Kubas addresses the flaws in the Company's COSS. Mr. Kubas also recommends an alternative revenue allocation that addresses inter-class subsidies by gradually allocating a smaller increase, or no increase, to the classes providing a subsidy. OTS has presented a targeted scale back in the form of first dollar relief in the event that the ultimate recommendation in this proceeding is to grant the Company less than its original request. In fact, revenue concessions and other acknowledged adjustments to its expense claims have ensured that the Company will receive less than its original request. The Company's comment that "[t]he primary objections to the Company's proposed allocation come from the OSBA"[73] is somewhat misleading. OTS has maintained that a targeted scale back proposal is necessary to relieve the imbalance present in the corrected COSS. To the extent the Company's position presented in its Main Brief is based on the OTS analysis beginning only with a scale back in rates ignores the adjustments acknowledged throughout the evidentiary hearing. The Company's own admissions guaranteed a scale back in requested revenue relief. The Company's opinion that only OSBA has contested its revenue allocation underscores its lack of recognition as to the appropriate regulatory principles that must be applied when setting jurisdictional rates. The fact that less than the full requested

[73] PGW M.B., p. 80.

increase will be granted means that the OTS scale back recommendation is appropriate. First Dollar Relief must be granted to the rate classes identified in the OTS testimonies and its Main Brief.[74]

The Company's distribution mains investment should be allocated on a volumetric basis utilizing the average and excess (A&E) demand method. The Company's analysis is based on a faulty allocation of fixed costs associated with mains to the customer cost function. The Company's proposal ignores the findings in the Pennsylvania-American Water case from 1994 where direct customer costs were discussed. Mains were not included in that discussion as they are not costs that are associated with the customer function. The application of the holding from a water company proceeding is appropriate in this case because the principles are the same. The issue is what is properly included in the customer cost function in a cost of service study. There is no distinguishing the Pennsylvania-American case from the facts in this proceeding, therefore, its application is appropriate here. The costs of distribution mains should be removed from the customer cost function of the Company's COSS.

Once these costs are properly removed from the customer function, a reasonable allocation based on volume is necessary. As identified by OTS in Main Brief, the Commission has most recently addressed this subject in the PPL Gas proceeding wherein the distribution main costs were classified as 40% commodity and 60% excess demand. The "respected authorities"[75] alluded to in the Company's Main Brief have not been

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[74] OTS St. Nos. 3 and 3-SR, OTS Ex. No. 3. OTS M.B., pp. 52-63.
[75] PGW M.B., p. 77.

identified and clearly do not include the Pennsylvania Public Utility Commission. This being the case, it appears that the Company is requesting that the Commission change the way it views the assignment of these costs. As described in the OTS Direct Testimony "[m]ains were built to deliver gas, and the cost of mains cannot be assigned to one specific customer. Therefore, no portion of the fixed costs or depreciation expense associated with mains should be allocated to the customer cost function."[76]

Once costs have been classified properly, it is then necessary to allocate these costs on a reasonable basis. OTS maintains that the A&E method is the most reasonable method for allocating the costs of distribution mains among the various classes that share their use.[77] Because mains deliver gas during both peak and average times, giving equal weight to these factors in allocating costs is not only reasonable, it is the most desirable. This straightforward basis acknowledges the uses of mains for the delivery of gas and applies the weight associated with each appropriately. The 50/50 allocation recommended by the Office of Trial Staff is appropriate and should be applied in this proceeding.

This adjustment, along with the Company's acceptance of the proper allocation of Account 385 – Industrial Measuring and Regulating Station Equipment Costs, corrects the flaws in the Company's COSS rendering it as a reasonable guide for the allocation of revenue among the various rate classes.

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[76] OTS St. No. 3, p. 12.
[77] Id., pp. 13-14.

The Company's proposed revenue allocation is fatally flawed and must be rejected. The overall recommendation presented by the Company does nothing to address the inter-class subsidies that currently exist. In fact, the Company is proposing to raise the rates of the Commercial class to a higher degree than it projects for the Residential class. What makes this recommendation more egregious is that, before the recommended increase, the Commercial class rates currently produce revenue that results in this class paying more than twice the system average rate of return. Inequities such as this clearly cannot be permitted. Proper regulatory treatment of the allocation of revenue requires adherence to cost causation principles. The concept of gradualism can be introduced as a means of supporting the transition to cost based rates but it cannot be the primary focus. Furthermore, the customer base in PGW's service territory cannot serve as a justification for the disparity in the proposed revenue allocation. Unfortunate as it is, the Residential class must bear a proportional burden in the allocation of revenue in this proceeding. The existing inter-class subsidies require that an increased level of rates be assigned to the Residential class, but no more than the Company proposes. The OTS proposal does not result in any more of an increase to the Residential Class than the Company is proposing.

Very simply put, if the average rate of return for a customer class exceeds the Company average, that class should receive a lesser or no increase in its rates. Conversely, customer classes below the system average rate of return will experience a greater than average proposed increase. This fundamental premise is necessary in order to move customer classes toward their respective costs of service. The Company's

proposed revenue allocation violates this very basic principle. It proposes to increase classes that are already providing a subsidy at a higher percentage than the average requested in this proceeding. It defies logic to suggest that this recommendation serves to move customers toward the cost of providing service.

The OTS recommendation is detailed in its Main Brief[78] and its application in this proceeding is appropriate. Any scaled back rates must provide First Dollar Relief to the classes identified in the OTS testimony and summarized in the Main Brief. The degree of scale back in rates will trigger different applications, but the basic premise is the same. The classes currently providing a subsidy must receive the first relief in any reduction in rates. Based on the OTS revenue recommendation as well as OCA's recommended revenue allowance, the Residential class and possibly the Municipal and Interruptible classes should be assigned the rate increase. At the OTS recommended $25 million rate increase, no increased level of rates should be assigned to the Commercial, Industrial or Housing GS classes.

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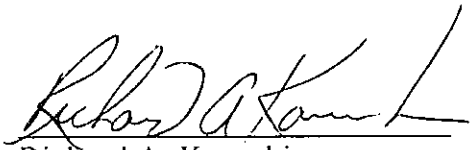
[78] OTS M.B., pp. 58-63.

X. CONCLUSION

For the reasons stated herein and further articulated in Main Brief, the Office of Trial Staff respectfully requests that the Administrative Law Judges and the Commission adopt its recommendations in this proceeding.

Respectfully submitted,



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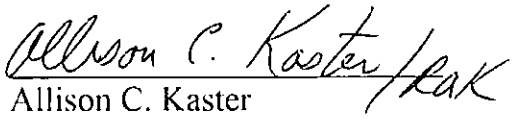

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Dated: June 21, 2007

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Reply Brief**, dated June 21, 2007, either personally, by first class mail, electronic mail, express mail and/or by fax upon the persons listed below, in accordance with the requirements of § 1.54 (relating to service by a party):

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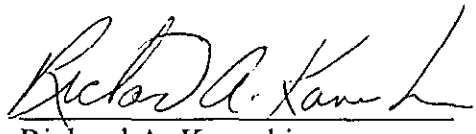

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Docket No. R-00061931

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June 21, 2007

ORIGINAL

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RE: Pennsylvania Public Utility Commission
v.
Philadelphia Gas Works
Docket No. R-00061931

Dear Secretary McNulty:

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

Copies have been served on the parties of record as indicated on the enclosed Certificate of Service.

Sincerely,

DOCUMENT FOLDER

Darryl A. Lawrence
Assistant Consumer Advocate
PA Attorney I.D. # 93682

Enclosures
cc: Hon. Cynthia W. Fordham, ALJ
Hon. Angela T. Jones, ALJ

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

ORIGINAL

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Dated: June 21, 2007

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Regulations

Administrative Decisions

I. INTRODUCTION

On June 12, 2007, Main Briefs were filed by Philadelphia Gas Works (PGW or Company), the Office of Consumer Advocate (OCA), the Office of Trial Staff (OTS), the Office of Small Business Advocate (OSBA), the Action Alliance of Senior Citizens of Greater Philadelphia and Tenant Union Representative Network (Action Alliance), the Philadelphia Industrial and Commercial Gas Users Group (PICGUG), Interstate Gas Supply, Inc. (IGS), the Philadelphia Housing Authority (PHA), the School District of Philadelphia (School District) and Hess Corporation (Hess). The OCA now files its Reply Brief in response to PGW and certain arguments raised by other parties. The OCA believes that its Main Brief (M.B.) provides the Administrative Law Judges (ALJ) and the Pennsylvania Public Utility Commission (PUC or Commission) with a comprehensive discussion of the issues in the this proceeding. The OCA's Main Brief fully addresses and responds to virtually all of the contentions made by the Company and other Parties in their Main Briefs.

It is not the purpose of this Reply Brief to respond to all of the arguments contained in the Main Briefs of the other Parties. The OCA will limit its Reply Brief to those issues requiring additional clarification or response. Thus, the absence of an OCA reply to specific arguments contained in the Company's and the other Parties' Main Briefs should not be considered acquiescence to a specific argument or position. The OCA would note that based on a review of these Main Briefs, the OCA is not revising any of its adjustments or positions. The OCA respectfully refers the ALJs, Commission and other interested parties to its Main Brief for a full discussion of these issues.

The OCA submits, however, that the Company's request for a $100 million increase in annual base rate revenues is substantially overstated. In its Main Brief, as it has throughout these

proceedings, the Company has attempted to justify this huge revenue increase based not on the traditional test-year concept, but rather on PGW's five-year forecast and its overly ambitious debt-reduction plan that is seeking to establish a 50/50 capital structure by the year 2012. As stated in the OCA's Main Brief, and further clarified below, the OCA submits that there are serious flaws as to PGW's stated justifications, spanning both legal and policy issues.

As to the legal issue, the OCA and OTS have shown in their respective testimonies and Main Briefs why the Commission sets rates based on the test-year concept. The test-year method captures the best approximation of what the Company's future revenues and expenses will look like, based on data that is known, measurable and reasonably current. PGW, however, would ask that the ALJs and the Commission look far beyond the test year, and incorporate events that may or may not occur 3 to 5 years from now in order to find that the Company's $100 million revenue request is somehow supportable. The OCA submits that such an approach is directly at odds with decades of Commission precedent, and if taken, will result in rates that are unjust and unreasonable.

In addition, the Company spends a considerable amount of time and discourse in its Main Brief by pointing to possible negative economic consequences that could befall the Company in 2009, or 2012, or some other timeframe far into the future as a result of adopting the OCA's or OTS's recommended revenue increases. The OCA has not suggested in its filed testimony or its Main Brief that the OCA's recommended revenue increase will provide for all of the Company's financial needs for time immemorial. The OCA has stated that an annual revenue increase of $22.5 million, as set out in the OCA's testimony and Main Brief, will provide sufficient revenue to PGW for the immediate, foreseeable future based on the future test year. As conditions change, and future

events become known and measurable, PGW will be free to file a base rate case at some future date based on its then current needs.

As a matter of policy, the OCA submits that PGW did not arrive at this particular place in time, factually or economically, overnight. On the contrary, the OCA has shown in its filed testimony and in its Main Brief that PGW's current financial situation is based on the decisions that the Company and its owner the City of Philadelphia (City) have made over at least the last 15 years. The OCA submits that for the Company to suggest that now is the time to "fix" PGW, in a span of five years and substantially on the backs of ratepayers, is neither a pragmatic nor reasonable approach to deal with a situation that has been on-going for such a significant period of time. In addition, the OCA has shown in its filed testimony and its Main Brief that PGW's stated goal of achieving a 50/50 capital structure by 2012 is neither reasonable, nor particularly necessary for PGW to attempt to accomplish in such a short time span considering its current capitalization.

The Company attempts to buttress the reasonableness of its $100 million annual revenue increase and its ambitious debt-reduction plan by pointing to its recent successes as to its collection ratio and increasing enrollments in its CRP program. PGW noted in its Main Brief that Representative Parker commended PGW for increasing its collection ratio and enrollment in CRP during her Public Input testimony. PGW M.B. at 2, fn 2. However, Representative Parker also testified, as follows:

> In 2004 PGW urged the State Legislature and the PUC to help them improve their financial condition by tightening up customer service and collection rules which they felt were too lenient on customers. PGW told the House Consumer Affairs Committee that they would become financially self-sufficient in four years time using these stricter rules in combination with supplemental state funding for LIHEAP, additional costcutting at PGW and enrolling more low income customers on PGW's customer assistance program, CRP. ... Act 201 of 2004 provided PGW with the additional collection tools they wanted. PGW is now collecting 96 cents of every dollar billed

> ... Also there are more customers on CRP now than ever before ... And the state did finally appropriate about $20 million in funds to supplement LIHEAP last year. ... But here we are three years later in 2007 facing a $100 million rate increase request from PGW even though thousands of poor Philadelphia residents are without gas service.

Tr. at 103-104. In 2004, PGW predicted that it would be self-sufficient in four years' time. Id. Now, not even three years later, PGW is asking for an annual revenue increase of $100 million, and in return PGW alleges that by 2011 to 2012, it will have successfully brought the Company to a solid financial state. The OCA submits that PGW's prediction about what may or may not occur some four to five years into the future is not a reasonable basis upon which to grant a revenue increase that will cumulatively amount to almost *2/3 of a billion dollars* over this timeframe.

PGW also continues in its Main Brief to propose that the Company should keep 100% of the revenues from off-system sales and capacity releases, estimated to be $10 million annually, to fund capital projects and/or to reduce its debt level. The OCA is opposed to any change in the current use of these revenues, that being to provide a direct reduction to the Gas Cost Rate (GCR), as is shown in the OCA's filed testimony and its Main Brief.

Accordingly, the OCA submits that a revenue increase of $22.5 million, at this time, is appropriate to set just and reasonable base rates for the provision of natural gas utility service by PGW. The proper allocation of this revenue increase is set forth in the OCA's Main Brief and below. In addition, the OCA supports the continued use of revenues from off-system sales and capacity releases to provide an immediate cost reduction to the GCR, and also the implementation of an Electronic Funds Transfer program, a Budget Billing program and an expanded direct vendor program with the Philadelphia Housing Authority (PHA) to aid in smoothing PGW's cash flow

requirements. The OCA also recommends that PGW collect data to ensure that its universal service surcharge is not overstated.

II. OVERALL REVENUE REQUIREMENT

A. Introduction

Unlike PGW's prior rate requests, PGW does not come to the Commission at a time when it is at risk for imminent downgrading of its bonds or subject to any operational crisis. Rather, PGW's Main Brief discusses three primary reasons for PGW's requested increase of $110 million ($100 million in base rates plus $10 million in GCR credits): 1) an experienced increase in non-gas operating expenses and interest expenses; 2) inadequate earnings in **FY2009** to meet debt service coverage and below investment grade coverage in FY2008; and 3) the need for long-term liquidity without borrowing. PGW M.B. at 5 (emphasis added). As OCA witness LeLash testified, PGW's proposed use of the $660 million in additional revenues that PGW would receive under its proposal over the six year time horizon of the proposal shows that only 3.4% goes to increased operating expenses over the six year period, with 54.2% going to a debt reduction program and 36.8% going to capital expenditures. OCA St. 1 at 13. PGW's request here, as PGW recognized in its testimony, is to achieve a 50%/50% debt-to-equity ratio by 2012 funded by PGW's ratepayers. PGW St. 2 at 12.

The OCA agrees that PGW requires some rate relief at this time based on the future test year and a known and measurable obligation to repay a $45 million City loan over two years. In light of these requirements, the OCA has recommended an annual increase of $22.5 million. With a $22.5 million rate increase, PGW would have a debt service coverage on its 1998 Ordinance Bonds of 2.36x, $36 million of net earnings, and $53 million of cash. See, OCA Tables attached to OCA's Main Brief. PGW witness Bogdonavage confirmed that with a $25 million rate increase, PGW maintains debt service coverage at 2.47 times and a $50 million cash balance with $95 million outstanding of its maximum available $150 million of commercial paper. OCA St. 2-S at 5; PGW

Exh. JRB-8. At the $25 million level of rate increase, the outstanding commercial paper declines by FY2009 to $75 million and year end cash remains at $50 million. Tr. 597-598.

Where PGW and the OCA differ is the question of what is a just and reasonable level of rate increase at this time. PGW seeks to look at least five years beyond the future test year to make this determination, arguing that it is in the public interest to base PGW's rates on its speculative five year forecast and its plans to achieve certain financial goals. The OCA and the OTS base their recommendations on traditional ratemaking principles that are grounded in the principle of the test year concept used by the Commission in PGW's prior rate cases, and every other rate case, for establishing just and reasonable rates.

PGW's criticisms of the OCA position and its arguments in support of its own position are wholly without merit. PGW's arguments can be generally categorized as follows: 1) that use of the test year concept will not result in revenues sufficient to meet coverage ratios far enough into the future, necessitating another rate filing very soon; 2) the rates must be set to provide at least the same cash and coverage levels as resulted from PGW's last base rate case; 3) rates must be set to provide PGW its stated level of cash at year end; and 4) PGW must be independent of assistance from its owner, the City. The OCA has discussed these arguments in its Main Brief at pages 14 to 25 and will not repeat those arguments here. The OCA will, however, provide a brief additional Reply to some of PGW's positions taken in its Main Brief.

B. The Test Year Is The Proper Basis For Establishing PGW's Rates.

In its Main Brief, PGW continues its arguments against the use of the future test year as a means of establishing its rates, arguing that using its five year forecast to set rates is reasonable for PGW and will best determine the appropriate rate relief. PGW M.B. at 25. In support of its position of reaching far beyond the future test year, PGW cites Commission precedent allowing out-

of-period expenses that are known and definite, or extraordinary and non-recurring. PGW also analogizes its request to the recovery of stranded cost under the Electric Choice Act. PGW M.B. at 25-26. Finally, PGW argues that adhering to the test year will require PGW to file for another base rate case soon as coverage levels will fall close to the minimum by FY2009. PGW M.B. at 48-49.

Initially, the OCA would note that PGW's reliance on the Electric Choice Act's determination of stranded cost over a twenty year (or longer) period actually highlights the flaws in PGW's approach. The Electric Choice Act provided the Commission with specific statutory authority to determine stranded cost over the remaining life of the assets that were at issue. 66 Pa.C.S. §2803 (definition of transition and stranded cost). In contrast, Section 2212(e) of the Natural Gas Choice Act that brought PGW under the Commission's jurisdiction provides that PGW's revenue requirement is to be set using the methodology and requirements that were applicable to PGW prior to the Commission's assumption of jurisdiction. 66 Pa.C.S. §2212(e). As the Commission found in PGW's prior cases, that methodology is the cashflow method, and the Commission, as well as PGW, have consistently applied the cashflow method using a future test year to derive the revenue requirement. See, Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-0006042, 2001 Pa. PUC Lexis 103 (Oct. 4, 2001)(2001 PGW Base Rate Order); Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005654, 2000 Pa. PUC Lexis 66 (Dec. 20, 2000).

PGW's reliance on Commission Orders regarding allowance of extraordinary and non-recurring out-of-period expenses is also misplaced. PGW M.B. at 25. As PGW's description of these cases makes clear, these cases apply to extraordinary and non-recurring expenses, not the ordinary operating expenses and debt service coverage ratios that are at the very heart of PGW's operations. See, *e.g.*, Pa. P.U.C. v. Pennsylvania Power & Light Co., 85 Pa. PUC 306 (1995)(expense permitted for a one time change in SFAS 106 financial accounting method).

Additionally, PGW's discussion of Commission cases that have allowed for the recovery of known and certain expenses outside of the future test year fails to recognize that these cases look at items of expense that the utility will incur shortly after the close of the future test year, not five years after the test year as PGW proposes here. See, *e.g.*, Pa. P.U.C. v. Philadelphia Electric Company, 56 Pa. PUC 191, 205 (1982)(pollution control expense allowed when project would be completed within 9 months of the end of the future test year). PGW has cited no precedent, and could likely find none, that establishes rates based on a five year financial forecast and business plan.

The pro forma test year, adjusted for known and measurable items that will shortly follow the test year, is a fundamental basis for setting just and reasonable rates. The use of adjusted test year data results in financial data that is representative of future periods. OCA St. 2 at 8. PGW's complaint that the use of the future test year means that it may have to file for additional base rate relief in the near future is not a criticism of the test year method. It is one possible result as all parties work to resolve PGW's long-standing financial problems over a reasonable time horizon.[1] PGW's financial difficulties developed over decades and a measured step by step approach is necessary to address the multitude of problems. PGW's reliance on speculative future assumptions that are not known and definite by any measure is an unreasonable basis upon which to set rates.

Using the test year method, adjusting for the known and definite obligation to repay the $45 million City Loan in two years, a rate increase of $22.5 million is reasonable.[2] With this

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[1] PGW argues at page 37 of its Main Brief that the OCA has admitted that PGW will be forced to continually file a series of base rate cases under the OCA's recommendation. The OCA has not taken that position, but has recognized that additional base rate filings may be necessary given PGW's long-standing financial problems. PGW's own calculations under the OCA/OTS revenue requirement recommendation show that PGW will have sufficient coverage and cash through at least FY2009 even without recognizing the expense reduction adjustments recommended by the OCA and OTS. PGW Exh. JRB-8.

[2] PGW claims that its problems are already present in the future test year. PGW M.B. at 28. The future test year data, even without adjustment, shows adequate debt service coverage and liquidity. OCA St. 2 at 12-14. PGW also argues that by FY2008, its debt service coverage would fall to 1.52x. PGW M.B. at 38. This calculation, however, does not include the revenue increase recommended by the OCA and OTS.

level of rate increase, PGW will be able to repay its City Loan, achieve the required financial measures and continue with the paydown of its debt.[3] To the extent that PGW wishes to further improve its condition, it can seek the assistance of its owner, the City. As other expenses and items become known and measurable in the future, PGW can seek further base rate relief as needed.

C. PGW's Reliance On Prior Base Rate Case Results To Set Current Rates Is Misplaced.

PGW also argues in its Main Brief that the Commission must set its rates to achieve at least the level of earnings, coverage and cash that resulted from the Commission Orders in PGW's prior base rate requests. See, *e.g.*, PGW M.B. at 6, 10, 30-36. PGW argues that based on this measure, it needs $70 million in rate relief. PGW M.B. at 6. The OCA submits, however, that the standard is not the financial results of a prior case, but the just and reasonable standard. Under PGW's theory, for example, once the Commission established a return on equity for a utility, it would never again be allowed to establish a different return on equity for that utility. Such a result has no basis in ratemaking.

The OCA submits that the revenue requirement in each case must be based on the specific and unique circumstances, and test year data, applicable to that case. The revenues, expenses or earnings in a prior rate case are not the same as in a current rate case. Prior items cannot dictate any subsequent revenue requirement. Additionally, underlying factors, such as gas prices, weather variations, capital and cash requirements, all change from year to year. But, under PGW's logic, the Commission should hold every item constant. PGW's theory, taken to its logical conclusion, would suggest that the Commission never authorize revenues in excess of the level awarded in 2001 to PGW.

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[3] As noted in the OCA's Main Brief, PGW will be able to pay down $36.7 million of its long term debt in the future test year without any revenue increase. OCA M.B at 2; OCA St. 2 at Sch. MAB-10.

The OCA submits that what should be carried forward from year to year is the rate setting methodology and the regulatory principles needed to guide the Commission's decision in establishing just and reasonable rates. Here, it is PGW that seeks to vary from these rate setting methodologies and principles established in prior cases by relying on speculative, prospective data five years after the end of the future test year. PGW's attempt to deviate from the now settled ratemaking methodology and principles should not be allowed.

The OCA would also note that PGW's use of the Settlement of PGW's 2002 Emergency Rate Relief proceeding to set some standard financial results is both improper and selective. As PGW acknowledges, the revenue requirement in that case stemmed from a "black box" Settlement that was the result of compromise on the part of all parties. PGW M.B. at 34, fn. 82. The Settlement is not to be used or considered as precedent. PGW's attempt to now use that Settlement as a standard measure is inconsistent with the Settlement's own terms.

Additionally, PGW acknowledged that it did not use other items from the 2002 case or Settlement, such as expense items or net income since the Settlement indicated that it did not include specific determinations of most items. Moreover, the Settlement made no representations or determination as to the appropriate levels of debt service coverage or cash working capital. PGW M.B. at 34. PGW's attempt to selectively use portions of a comprehensive "black box" settlement must be rejected.

The OCA submits that the revenue requirements in this case must be based on the pro forma test year data adjusted for known and definite items, and the circumstances of this case. PGW's attempt to dictate a result here based on the combined impact of its 2001 base rate case and its settled 2002 base rate case is improper. Those cases established the ratemaking methodologies and principles that should apply to the Commission's consideration, but those cases do not dictate a

specific result in this case. PGW's attempt to create a new standard from these Orders should be rejected.

D. PGW's Cash Position Under The OCA and OTS Recommendations Is Adequate And Better Than It Has Been Since 1995.

Throughout its Main Brief, PGW argues that the revenue requirement recommendations of the OCA and OTS do not provide it with sufficient cash or liquidity, and no internally generated funds to pay for capital expenditures. See, *e.g.*, PGW M.B. at 11-12, 42. PGW also argues that if it paid back all of its commercial paper at once, its cash balances would be negative. PGW M.B. at 40-41. Therefore, PGW now seeks to have ratepayers provide all of its cash working capital requirements as cash on hand, relying on the Management Agreement for support. PGW M.B. at 52.

Initially, the OCA submits that PGW's current rates do produce considerable cash at year end. As shown on OCA St. 2, Schedule, MAB-10, under PGW's current rates, it will end the fiscal year with about $50 million in cash on hand. Additionally, as shown on OCA St. 1, Schedule 2, funds from operations have averaged over $53 million per year for the last four years and, since 1993, PGW has had internally generated funds of $656 million. OCA St. 1, Sch. 2. PGW arrives at its "negative cash balances" by ignoring its line of credit through its commercial paper program, and assuming it must repay all of its outstanding commercial paper immediately. PGW's own witness, however, testified that liquidity for PGW was defined as a combination of its year end cash and its available commercial paper.[4] Tr. 595. PGW is creating negative cash balances through a definition that even PGW does not use.

[4] PGW also does not recognize depreciation when considering its cash position. As Mr. LeLash explained, the funds from depreciation are fungible cash that can be used to reduce long-term debt, and in the past, to make the City payment. At the current time, such funds, that are provided by ratepayers, can go to reduce about $37 million of long-term debt each year. OCA St. 1-S at 8.

Meeting working capital requirements with short-term borrowing facilities, as PGW has done for years, is a valid procedure used by most regulated utilities and fulfills the Management Agreement. The Management Agreement in the segment entitled "Working capital" provides:

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

PGW Rejoinder Exh. 1 (emphasis added). As can be seen, the equivalent of cash, *i.e.*, funds from short term borrowing, can and is used to fund working capital. PGW's attempt to now suggest that ratepayers must provide all cash working capital requirements as cash in hand without any reliance on its commercial paper program cannot be supported.[5]

When properly viewed, PGW has about $53 million of cash on hand at the end of the future test year under the OCA's recommendation and about $60 million of available commercial paper. OCA St. 2, Schedule MAB-10. This level of working capital provides about 45 days of liquidity. OCA St. 2-S at 10.

The OCA submits that PGW's argument that ratepayers must meet all of PGW's cash requirements as cash on hand through rates is flawed. When properly viewed, the OCA's recommendation provides the Company with sufficient year end cash that along with its available commercial paper, provides the Company with a reasonable level of liquidity.

E. Ratepayers Cannot Assume The Obligations Of PGW's Owner, The City.

PGW argues that the OCA and OTS improperly rely on the City, as owner of PGW, to support PGW rather than providing it with a reasonable level of rate increase. PGW argues that

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[5] PGW also argues that a minimum standard of liquidity for a municipal utility is 200 days of cash. PGW M.B. at 44. In fact, as Mr. LeLash points out, the standard in the industry is 45 days, or what is referred to as the 1/8th method. OCA St. 1-S at 10. PGW bases its argument on Exhibit BB-3 presented by PGW witness Bisgaier. As cross examination of Ms. Bisgaier showed, this Exhibit did not include companies that were comparable to PGW. Tr. 757-761. OCA witness LeLash also noted that the Exhibit showed that some utilities had between 1,000 and 100,000 days of liquidity, which should raise some red flags. OCA St. 1-S at 10.

the OCA and OTS insist that the City should provide additional contributions whether the City has the money or not. PGW M.B. at 3, 54-56. The OCA's revenue requirement, however, is not based on any additional contributions from the City. The OCA's revenue requirement is based on the future test year and the known and certain obligation to repay the $45 million City Loan in two years. The OCA's position actually recognizes PGW's obligation to the City.

What the OCA notes, however, is that the City requirement that PGW repay its loan in two years is inconsistent with PGW's own initiatives to reduce its long term debt. OCA St. 1-S at 3. As Mr. LeLash testified:

> While the City was given credit for addressing capital requirements with the loan it made in 2000, it seems paradoxical that, in the face of continued working capital concerns, it is now withdrawing $45 million from PGW. It also seems illogical for Ms. Wilkerson to claim that the City's provision of capital to PGW would erode the City's ability to provide fundamental services. To PGW's customers, affordable natural gas service for winter heating is also a fundamental and essential service.

OCA St. 1-S at 3.

The OCA submits that the interests of ratepayers and PGW must be balanced in considering a just and reasonable level of rates. As the Courts have held, ratepayers cannot finance all of the capital requirements of a utility. D.C. Transit System, Inc. v. Washington Metropolitan Transit Commission, 466 F.2d 394, 402-403 (D.C. Cir. 1972). Even PGW witness Krellenstein stated that it is not uncommon for municipal utilities to reduce, defer, or grant back payments if the utility is incurring financial distress. OCA St. 1 at 15.

Under the OCA's revenue requirement, PGW is provided sufficient revenue to meet its obligations. PGW's financial position could be further improved by actions of the City. While PGW cites to the testimony of PGW witness Wilkerson that the City cannot afford to make contributions to PGW (PGW M.B. at 55), PGW dismisses the testimony that the affordability of

rates to its customers should also be considered (PGW M.B. at 8). As many as 50% of PGW's ratepayers have incomes below 250% of the Federal Poverty Level, an income found to be needed to meet the basic necessities of life. OCA St. 1 at 5.

It is the OCA's position that the Commission must balance the interests to arrive at a result that is just and reasonable. As the Commission noted in its 2001 PGW Rate Order:

> . . . 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 the owner of PGW, continue to assist PGW in its cash flow requirements so that a financial crisis does not take place.

2001 PGW Base Rate Order at 34. The Commission should insist on the same here.

F. Off-System Sales And Capacity Release Revenues.

1. Introduction.

In its Main Brief, PGW contends that allowing the Company to keep the revenues from off-system sales and capacity releases will be a benefit to ratepayers, because instead of returning the money as a dollar-for-dollar offset to the GCR, by retaining the funds PGW can actually return $1.50 to ratepayers for every $1 generated by these revenues. PGW M.B. at 73-74. The OCA has submitted the testimony of Mr. LeLash to rebut this general proposition. In particular, Mr. LeLash demonstrated that based on the ratepayers' discount rate, or opportunity cost, giving up $1.00 today to be repaid (possibly) $1.50 in a future period does not make the ratepayer better off. OCA St. 1 at 23-24. Additionally, the OCA has submitted valid reasons in its Main Brief why increasing gas costs to the already strained PGW ratepayers is not a sound idea. OCA St. 1 at 22-24; OCA St. 1S at 15-17; and OCA M.B. at 33-35. Mr. LeLash has shown that PGW already has the highest overall costs for natural gas service in Pennsylvania, and as such, increasing the gas cost rate is not recommended. OCA St. 1 at 22. The OCA submits that there are at least two

additional reasons, beyond those already discussed in the OCA's filed testimony and its Main Brief, why the Company's proposal should be rejected.

2. PGW's Proposal To Keep 100% Of All Revenues Obtained From Off-System Sales Or Capacity Releases Would Subject Ratepayers To Immediate, Higher Gas Costs In Exchange For A Speculative Benefit At Some Future Date.

Currently, off-system sales and capacity release revenues are used to decrease the GCR. This decreased cost impacts ratepayers' pocketbooks on an immediate basis; their monthly bill to PGW is less than what it would be without these revenues. As such, the current use of these revenues provides a *guaranteed* benefit to ratepayers. And from the Public Input testimony in this proceeding, it is a benefit that PGW's ratepayers sorely need. As stated by some of these customers:

> The bill came in about $470 for one month and I was like, wow, I have been living in my home for 36 years and never had a gas bill that high.
>
> I am going to be retired at the end of this year. I am going to retire and I am going to be on a budget. With these bills coming in now how can I keep up with my gas bill?

Tr. at 109.

> My wife and I are going to be making a total of $33,000 a year. Do you think I can afford all these utility increases? Not hardly.

Tr. at 217.

> I am a senior citizen and I am retired and my gas bill this month was $265. Last month it was $204. The gas company gives me a senior citizen discount of $65. The $65 got eaten up in the increase from one month to another.

Tr. at 219.

> We're paying with lives as well as dollars. My own real income has gone down. I'm struggling month to month to pay my bills on a

> limited income. My mortgage payments have gone up. My medical bills have increased and my utility bills continue to take more and more of my Social Security income. Some months, I have to choose whether or not I'm going to be able to buy my medication or pay my gas bills.

Tr. at 313.

Conversely, PGW is proposing that ratepayers should forego this immediate, guaranteed benefit in return for an alleged greater benefit (by way of reduced expenses) at some future time.[6] PGW asserts that it has exclusively used long-term debt since 1993 to fund construction projects. PGW M.B. at 73. PGW states that if its proposal is accepted, it would allocate these revenues to a special construction fund and that the revenues could only be used for construction projects approved in its capital budget. PGW M.B. at 74. Construction projects could be funded at least in part by these revenues instead of long-term debt, which according to PGW would correspondingly reduce the amount of long-term debt that PGW would have to issue to fund construction projects, and so the theory goes – ratepayers would pay reduced expenses to fund the long-term debt. However, there are no guarantees that this claimed reduced level of expense will occur.

First, long-term debt can be used for many purposes besides just construction projects. PGW could allocate these revenues to the special construction account. However, due to some unforeseen circumstance, the Company could find itself issuing that debt anyway and using

[6] In its Main Brief, IGS supports PGW's proposal to keep these revenues. IGS M.B. at 5. The OCA has addressed this issue in its Main Brief. OCA M.B. at 32-35, 107. The OCA notes, however, that also in IGS's Main Brief is a discussion of LNG assets. IGS M.B. at 2, fn 1. The OCA submits that the conclusions IGS draws as to the use and availability of LNG assets to shopping customers is in error, as OCA witness LeLash explained during cross-examination. Tr. at 882-887.

those funds for some other purpose.[7] In the end, ratepayers would not only lose their guaranteed GCR offset but would also still pay for the same amount of long-term debt.[8]

Second, if PGW's proposal is accepted, the ratepayers would bear this additional burden of a higher GCR without any benefit of the reduced expense as to long-term debt at least until the next base rate case. For example, if PGW currently has approximately $1.1 billion[9] in long-term debt, this $1.1 billion figure will not be reduced for purposes of setting the current rates. The long-term debt amount will not change for ratemaking purposes until PGW files its next base rate case. In this interim period, ratepayers will pay a higher GCR and receive no benefit from PGW's proposal until years down the road, if at all, as already discussed above.

3. Conclusion.

The current treatment of revenues from off-system sales and capacity releases provides a direct, immediate and guaranteed benefit to ratepayers. The OCA submits that the guaranteed bird-in-the-hand, as opposed to the proverbial 2 in-the-bush (of course, here it is only 1.5) is more reasonable for PGW's ratepayers. For all the reasons provided, the OCA submits that PGW's proposal as to this issue should be rejected.

G. Conclusion.

PGW's arguments that the revenue requirement recommended by the OCA is insufficient to meet its needs are not valid. A rate increase of $22.5 million per year provides reasonable rate relief to PGW based on the future test year and its current known and measurable obligations. This amount of rate relief allows PGW to repay its $45 million City Loan, end the year

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[7] For example, in PGW's Main Brief the Company provides that it intended to reduce its short and long-term debt after the 2001 and 2002 rate cases, and the implementation of its Weather Normalization Clause. The intended use of these funds for debt-reduction purposes did not occur. PGW M.B. at 9.

[8] As OCA witness LeLash also pointed out, if the City provided additional capital to PGW, the cost to ratepayers would be lower. OCA St. 1 at 23.

[9] PGW St. 2R at JRB-7.

with about $50 million in cash, an amount it has not seen since 1995, and it allows PGW to meet all of its bond indenture requirements. Were the City not to demand the $45 million back, PGW's financial circumstances could be further improved. In addition, the guaranteed benefit of the off-system sales and capacity release revenues should continue to be credited to the GCR. As such, the OCA submits that its revenue requirement recommendations should be adopted.

III. EXPENSES

A. Introduction.

As set forth in its Main Brief, the OCA opposes PGW's claims for: (1) management incentive bonus program expense; (2) lobbying expense; and (3) regulatory penalties expense. See, OCA M.B. at 36-44. These adjustments are included in Schedules MAB-1 through MAB-6 of OCA St. 2. See also, OCA M.B. at Appendix A at Rev. Sch. MAB-1. PGW previously adopted OCA's adjustments regarding Authority expenses and utility merger expense. See also, OCA M.B. at 36; PGW M.B. at 72-73. The OCA, in its Main Brief, accepted the OTS and PGW Stipulation regarding bad debt expense that was submitted for the record as PGW Hearing Exhibit 5. OCA M.B. at 36.

The OCA reiterates that the expense adjustments are not reductions from the Company's claimed rate increase. The expense adjustments offered show that the Company's coverage ratio and its year end cash position are higher when only properly allowable expenses are included in the future test year.

B. Expense Adjustments.

1. Management Incentive Bonus Program Expense.

The OCA and OTS oppose PGW's proposed inclusion of $500,000 in its pro forma test year expense for a management incentive bonus program. See, OCA M.B. at 36-40; OTS M.B.

at 18-19. The OCA submits that the management incentive bonus program should be excluded for ratemaking purposes because no formal guidelines have been offered to define the program, and the Company has failed to establish that the program expense was reasonable. OCA M.B. at 37; OCA St. 2 at 15.

PGW argues in its Main Brief that PGW witness D'Attilio "demonstrated that the program was eminently reasonable and a well supported approach to providing salary increases to PGW's senior managers." PGW M.B. at 60. The OCA submits that PGW has not demonstrated that this expense is just and reasonable in that PGW has not provided sufficient documentation to support its claim.

OCA witness Bleiweis recommended that the incentive bonus expense not be allowed for ratemaking purposes. Mr. Bleiweis testified:

> As stated above by both myself and the Philadelphia Gas Commission, to date, there are no formal guidelines that define the program. I am familiar with similar bonus programs for other utilities that specifically state how performance is to be measured. PGW must utilize similar standards for their bonus program in order to be credible.

OCA M.B. at 38; OCA St. 2 at 17.

PGW argues in its Main Brief that it has provided sufficient information and answered questions regarding "this very modest program." PGW M.B. at 62. PGW's argument is without merit. As OCA witness Bleiweis explained in Surrebuttal Testimony, a compilation of responses to interrogatories, which PGW relies on, does not rise to the level of a formal, documented program. Mr. Bleiweis testified:

> PGW did not provide a copy of the program in response to an OTS request because such a document does not exist. It has been my experience in many rate proceedings that utilities provide each eligible employee with a document detailing exactly how bonuses are determined. Such is not the case with PGW.

> Further, to the best of my knowledge, no formal guidelines for the program exist even today. Since there are no formal guidelines, it is logical to conclude that there is no formal bonus program. The informality of the program can be shown by Mr. D'Attilio's admission that there is no written support for the calculation of the actual bonuses since these would have to be "replicated". Thus, any costs associated with the "bonus program" should be eliminated for ratemaking purposes.

OCA St. 2-S at 8. As the OCA noted in its Main Brief, the Philadelphia Gas Commission in its October 4, 2006 Order reviewing PGW's operating budget reached the same conclusion for the same reason. The Philadelphia Gas Commission gave PGW the opportunity to resubmit a program but PGW has not done so to date.[10] OCA M.B. at 39-40; OCA St. 2 at 18.

PGW also asserts that OCA's and OTS's arguments would have the Commission act as a "super board of directors" and that the Commission's authority to deny employee compensation expenses for ratemaking is limited to a circumstance where the Commission finds that the program is not necessary in order to attract and to retain qualified employees or is otherwise imprudent. PGW M.B. at 61. The OCA submits that these arguments are incorrect. First, the standard, as set forth in Roaring Creek is that an incentive compensation plan to be considered an allowable expense should be geared towards ratepayer benefits, including goals for better operational efficiency of the utility. Pa. P.U.C. v. Roaring Creek Water Co., 1994 Pa. PUC LEXIS 41 (1994); See also, Pa. P.U.C. v. Philadelphia Suburban Water Co., 219 P.U.R. 4th 272 (2002). The Company has simply failed to meet its burden of proof as to the Commission criteria for allowance of this expense. Second, a Commission determination as to whether an expense is allowable for

[10] In its Main Brief, PGW argues that the OCA has taken the position that the incentive compensation expense should be excluded because it was not approved by the Philadelphia Gas Commission. PGW M.B. at 62. That is not the OCA's argument. The OCA has argued that the expense should be excluded because there is insufficient documentation of a specific program. OCA M.B. at 37-40. The OCA points to the conclusion of the Philadelphia Gas Commission to show that the Philadelphia Gas Commission also found insufficient documentation.

ratemaking purposes does not make it a "super board of directors." The Commission disallows many expenses that it finds to be unsupported, imprudent or otherwise unreasonable. The Commission here is only ruling on what is recoverable from ratepayers.

For the reasons stated above and in its Main Brief, the OCA submits that the $500,000 incentive bonus program expense should be disallowed for ratemaking purposes in this case. OCA M.B. at App. A, Rev. Sch. MAB-1.

2. Lobbying Expenses.

PGW included in its claim $100,000 in lobbying expenses. PGW argued in its Main Brief that because PGW is owned by the City of Philadelphia and has no shareholder, this essentially means that PGW is "owned" by the citizens who are essentially the same as PGW's ratepayers. PGW M.B. at 67-68. From this, PGW concludes that lobbying expense must be allowed. PGW's attempt to extend "ownership" responsibility to ratepayers is not proper. Moreover, the Commission has already found that PGW's lobbying expenses are not proper for ratemaking purposes. 2001 PGW Base Rate Order at 65-66.

The OCA submits that extensive Commission policy reasons and legal precedent support denial of this lobbying expense claim, including Section 1316 of the Public Utility Code.[11] 66 Pa.C.S. § 1316. PGW's request for a waiver of these provisions should be denied. OCA witness Bleiweis has recommended an adjustment of $100,000 for the lobbying expense related to WolfBlock Government Relations. See, OCA M.B. at 40, Appendix A at Rev. Sch. MAB-1; OCA St. 2 at MAB-1, MAB-3. This adjustment should be adopted.

3. Bad Debt Expense.

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[11] See also, OCA M.B. at 41-41; 66 Pa. C.S § 1316; 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 Distribution 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).

In the OCA's Main Brief, the OCA accepted the OTS and PGW Stipulation regarding bad debt expense for the purposes of this proceeding. Since the OTS and PGW continued to dispute the issue of whether the bad debt rate was to be applied to total revenues or only gas revenues, the OCA has provided schedules for both applications. The OCA has included the effects of this Stipulation on a total revenue basis in its Revised Schedules MAB-9 (Statement of Income), MAB-10 (Cash Flow Statement), and MAB-11 (Debt Service Coverage) attached to its Main Brief. The OCA has shown the effect of the Stipulation on gas revenues on Revised Schedules MAB-12 (Statement of Income); MAB-13 (Cash Flow Statement); and MAB-14 (Debt Service Coverage) attached to its Main Brief. The OCA takes no position in this proceeding as to whether the Stipulation should apply to total revenues or gas revenues only.

Another bad debt expense issue that PGW raises in its Main Brief concerns incremental additions of participants in its Customer Responsibility Program (CRP). The OCA addresses this issue at Section VII below regarding the Universal Service Surcharge Cost Recovery. This is not a bad debt expense issue, but is a double-recovery issue for incremental CRP customers.

4. Regulatory Penalties Expense.

PGW also included $50,000 for regulatory penalties in its pro forma test year expenses. OCA M.B. at 43-44. The OCA opposed the inclusion of such regulatory penalties as an item of expense recoverable from ratepayers. PGW acknowledges in its Main Brief Brief that the Commission's general policy is to exclude such costs from pro forma operating expenses. PGW M.B. at 69. PGW argues, however, that it "deserves individual consideration for its claim." PGW M.B. at 69. The OCA submits that this claim must be denied.

PGW argues that because it is a municipal utility with no shareholders, that all revenues produced "ultimately accrue to the benefit of PGW customers" and that "all expenses

incurred ultimately inure to the detriment of the PGW customers." PGW M.B. at 69. PGW, however, continues to fail to acknowledge the responsibility of its owner, the City.

The OCA submits that it would not be in the public interest to include regulatory penalties expense as an item recoverable from ratepayers. Regulatory penalties are to deter conduct which violates Commission regulations and laws. As OCA witness Bleiweis testified:

> What PGW is saying is by budgeting this amount, it expects that the company will be fined by the PUC for failure to comply with the Public Utility Code and related regulations.
>
> Regulatory fines are an ownership expense and, therefore, are not recoverable through rates. Customers cannot be expected to subsidize a utility's failure to comply with PUC standards or reasonable and efficient service. Similarly, PGW's Operating Budget should be based upon the assumption that PGW will provide reasonable service and avoid incurring regulatory penalties.
>
> To allow PGW to budget for regulatory penalties is to equate such penalties with circumstances beyond PGW's control, like warmer than normal weather. However, it is within PGW's power and responsibility to take the necessary steps to avoid incurring regulatory penalties.

OCA St. 2 at 28.

Inclusion of such an expense also has the perverse result of requiring some of the ratepayers who have been harmed by PGW violations to pay the penalty associated with the harm to them. The OCA submits that PGW's claim for regulatory penalty expense is unreasonable and must be denied.

IV. RATE STRUCTURE

A. Cost Of Service Study.

1. Introduction.

The central point of disagreement among the Parties as to the different cost of service studies advocated for in this proceeding relates to how the distribution mains investment should be allocated. The OCA presented the Direct, Rebuttal and Surrebuttal testimony of Richard Galligan in this proceeding. OCA St. 3, 3R and 3S. Mr. Galligan presented a cost of service study (COSS) based on the Peak and Average methodology. OCA St. 3 at 20. In his Direct testimony, OCA witness Galligan explained why the allocation of distribution mains investment as 80% on average demands and 20% on peak demands is reasonable for a natural gas distribution company. OCA St. 3 at 20. Mr. Galligan further explained in detail the many reasons why the Peak and Average method, as presented in Mr. Galligan's COSS, should be used by the Commission as a guide to setting rates in this proceeding. OCA St. 3 at 14-21; St. 3R at 11-14; and St. 3S at 2-12. The OCA submits that the primary reason why Mr. Galligan's Peak and Average COSS should be used as a guide to setting rates in this proceeding is because this methodology most closely tracks the principle of cost-causality, *i.e.*, the way that costs are actually incurred by PGW to provide natural gas service to the different customer classes. OCA M.B. at 50.

OTS witness Joseph Kubas presented a COSS based on the Average and Excess (A & E) Method. See OTS St. 3. While the A & E method and the Peak and Average method are slightly different, OTS witness Kubas agrees with Mr. Galligan on the basic concept that the allocation of distribution mains costs should include some percentage assigned to average demand, and that there is no customer component of distribution mains costs. OTS St. 3 at 12-14. Mr. Galligan explained the difference in the OTS approach, as follows:

> Mr. Joseph Kubas performed a class cost of service study on behalf of the OTS. The study Mr. Kubas performed is an "Average and Excess" study. Mr. Kubas allocated distribution mains and related expense 50 percent on the basis of commodity, or average demands, and 50 percent on the basis of the excess of peak demands over average demands. In contrast, I allocated 80 percent of distribution mains and related costs on average demands for the reasons stated in my direct testimony. While the exact weights afforded to average demands differ in Mr. Kubas' and my own cost studies, both studies recognize the importance of allocating a substantial portion of mains on the basis of average demands.

OCA St. 3-R at 11.

OSBA's witness, Robert Knecht, took issue with PGW's COSS on several fronts, including PGW's alleged use of "bundled" items in its COSS and Mr. Knecht's claim that PGW's COSS contain errors that over-allocate certain costs to commercial customers. OSBA St. 1 at 2. Mr. Knecht had PGW prepare an "unbundled" COSS. OSBA M.B. at 34. However, even with the alleged errors and biases that Mr. Knecht claims are still part of the unbundled COSS, the OSBA accepts this COSS and basically agrees with PGW as to the allocation of distribution costs. OSBA M.B. at 34-35.

PGW responds in its Main Brief that OCA and OTS are in error as to the proper allocation of distribution mains costs because, first, PGW opines that there is a direct relationship between the number of customers being served on the system and the costs of the distribution system. PGW M. B. at 77-78. Second, PGW believes that it is proper to allocate fully 75% of the costs of distribution mains on the basis of peak day demands. PGW M.B. at 78-79. The OCA provides a thorough discussion of these topics in its Main Brief, but in the following sections the OCA will further respond to these two issues raised by PGW in its Main Brief. OCA M.B. at 45-63.

2. PGW's Assertion That There Is A Customer Component Of Distribution Mains Is In Error.

PGW's Main Brief reasserts that there is a customer component of distribution mains, because the number of customers served is directly correlated to the cost of the distribution system used to serve those customers. PGW M.B. at 77-78. PGW opines that the more customers that are connected to the system, and the farther apart these customers are located all equates to higher costs. PGW M.B. at 78.

First, the OCA submits that the evidence in this case does not support these two PGW's assertions. Second, the assertions that somehow the number of customers or the geographic location of such customers, on the PGW system, has anything to do with the distribution mains costs has already been adequately discussed and soundly rebutted by OCA witness Mr. Galligan. OCA St. 3 at 9-12; St. 3S at 2-10. For purposes of clarification, the OCA will further discuss this issue.

In his Direct testimony, OCA witness Galligan supplied the following example to show why the number of customers being served by the distribution system is not directly correlated to the cost of the distribution system:

> Mains are not sized for the number of customers served from them, but for the loads placed upon them. This is made clear in the following example: along one city block are located 10 residential customers with a coincident peak demand of one Mcf each. The main running down the street would have to be capable of delivering 10 Mcf at peak. On another city block is only a small plastics factory that exhibits a maximum demand of 10 Mcf. The main for that one customer has to be sized to deliver 10 Mcf when the plastics factory demand peaks. It is clear that the mains investment is driven by the loads placed upon it -- not by the number of customers served from it. Finally, imagine that the plastics factory is torn down to make room for five large residences, each of which exhibits a demand at time of coincident peak of 2 Mcf. Again, the main which is sized to deliver 10 Mcf is adequate. One customer, five customers, or ten

> customers do not determine the amount of mains investment; rather, mains investment is a function of the loads to be served.

OCA St. 3 at 9. The OCA submits that this simple example accurately illuminates the issue, and shows that the number of customers connected to the distribution system does not drive the cost of the system needed to serve those customers, as the real cost-driver is the peak and average loads placed on the system.

In his Rebuttal testimony, PGW witness Gorman attempted to challenge the clear logic of Mr. Galligan's example by claiming that the example provided would not be valid if, instead of all ten residential customers being on one block, the ten residential customers were located on ten separate blocks. PGW St. 8R at 9. In his Surrebuttal testimony, Mr. Galligan responds:

> My example comports with reality -- a number of residential customers on the same block. Mr. Gorman's one-residential-customer-to-a-Philadelphia-city-block example is not realistic. PGW's average footage of distribution mains per customer is 32 feet. Mr. Gorman's example of one residential customer per city block would result in one customer about every 500 feet (at a city block of about $1/10^{th}$ of a mile). I do not believe Mr. Gorman's example of one residential customer per city block comports with either reality, or with PGW's customer extension rules. Mr. Gorman's example does not describe PGW's system, is based on unrealistic assumptions and does not invalidate the point in the example I presented.
>
> What my realistic example showed was that a city block with 10 residential houses on it, each with a peak demand of 1 Mcf, would have to have a main sized to deliver that 10 Mcf of peak demand. A city block with a small plastics factory with a demand of 10 Mcf, too, would have to have a main sized to deliver 10 Mcf. Finally, if the plastics factory were torn down and replaced with five large residences, each with a peak demand of 2 Mcf, the distribution main would, again, have to be sized to meet the 10 Mcf of peak demand. This conclusion, that distribution mains are sized to meet load requirements, not the number of customers, is not invalidated by Mr. Gorman's unrealistic example.

OCA St. 3S at 3-4. The OCA submits that the testimony presented in this case, and the analysis and arguments put forth by the OCA in its Main Brief, shows that PGW's 25% allocation of distribution mains investment on the basis of the number of customers connected to the system is in error. This allocation based on the number of customers, much like Mr. Gorman's unrealistic example of one residential customer per city block, only provides further support for the use of Mr. Galligan's Peak and Average COSS as a guide to set rates in this matter, because the Peak and Average methodology accurately depicts the way that PGW actually incurs costs to serve the different customer classes.

3. PGW's Allocation Of 75% Of Distribution Mains Investment On The Basis Of Peak Design Day Demand Does Not Comport With The Principle Of Cost-Causality.

In its Main Brief, PGW asserts that the OCA's theory of distribution mains costs being properly allocated on both Peak and Average demands is incorrect, as "[t]he costs of mains are causally related only to peak demands, and not to annual demands." PGW M.B. at 78. The OCA has discussed this issue in its Main Brief, and provided substantial analysis and legal precedent that supports the OCA's position to use the Peak and Average method as a guide to the setting of rates in this proceeding. OCA M.B. at 50-63. The OCA will provide further commentary herein in order to clarify this issue.

In his Direct testimony, Mr. Galligan discusses why allocating 75% of the total distribution mains costs to peak demands does not comply with the principles of cost-causality, because in reality, this is not the main reason why the distribution system exists:

> Design Day demands represent the maximum demands that are expected under the most severe weather assumptions used for planning purposes. Generally, gas distribution companies, like PGW, utilize demands associated with design day conditions that are expected to occur infrequently, say, on one day in a 10- or 15-year period. While a portion of PGW's distribution mains cost is associated with, and hence, should be allocated on peak demands, it is obviously wrong to profess that all demand related distribution

> mains cost is caused by what consumers do on one day in a 10- to 15-year period. Quite simply, if PGW's customers had a demand for gas only at the time of peak, there wouldn't be a PGW gas distribution system. The costs of delivered gas supplies on that one peak day would be prohibitively high, and the cost of delivering gas through a local, in-ground, gas distribution system on that one day simply could not compete with alternative energy costs.

OCA St. 3 at 12-13. As Mr. Galligan explains, if PGW's statement were true, "[t]he costs of mains are causally related only to peak demands, and not to annual demands" then the PGW system could not be economically viable and would never have been built. OCA St. 3 at 13. Mr. Galligan goes on to explain that the Peak and Average method for allocating distribution mains costs aligns with the principles of cost-causality, because it accurately depicts how PGW's customers use the system and how PGW incurs costs to serve those customers:

> PGW's distribution system exists, and related costs are incurred, to deliver gas to its customers whenever, over the course of each year, its customers demand gas. In other words, PGW's system was built and costs were incurred to deliver gas both at the time of peak system demand and generally throughout the year. Because costs are incurred to deliver gas generally throughout the year, and additional costs are incurred to meet peak demands, PGW's delivery costs must be allocated on the basis of both annual and peak demands if those costs are to be allocated in accord with the principle of cost causality.

OCA St. 3 at 14.

PGW's basic argument as to why these costs should be allocated on the basis of peak demand only is that, all things being equal, it takes a larger diameter pipe to meet peak demands than it does to meet average demands. Larger diameter pipes cost more than their smaller counterparts. Thus, when PGW is laying a distribution pipe it is the expected peak demand that dictates what size pipe must be installed. However, what Mr. Galligan points out is that (1) the decision to lay the pipe in the ground in the first instance would never be made if there was not some level of expected average, annual demand to which the costs of the pipe, no matter what size,

could be charged against, and (2) the carrying capacity of a pipe does not proceed in a linear fashion as its size increases, as Mr. Galligan explains:

> PGW's customers are projected to move approximately 70,369,397 Mcf across PGW's system during the test period. This equates to an average demand of about 192,793 Mcf each day. PGW's estimated design day peak demand is 723,500 Mcf. PGW could not have met its customers' annual gas demands with a system capability any smaller than 192,793 Mcf. In other words, if there were no variance in the daily demands on PGW's system, the capacity of that system would have to be designed to accommodate the daily movement of 192,793 Mcf just to meet the annual demands. To meet peak demands, PGW's system capacity must be 3.75 times larger than 192,793 Mcf. Thus, some costs are related to the average deliveries each day on PGW's system, and some costs are related to the movement of gas when demands are above the average demand.
>
> ...
>
> Many of the costs associated with the distribution delivery system do not depend upon pipe sizes. These costs would include planning, surveying, excavation, hauling, pipe bed preparation, unloading and stringing of pipe, municipal inspection, backfill, and pavement and sidewalk replacement. Since a portion of total costs does not vary with pipe size, or are fixed costs, total costs do not increase at a one-to-one ratio with increases in maximum demands. The additional costs associated with meeting elevated demands are largely related to the cost of the pipe itself.
>
> Moreover, throughput capability increases not at a one-to-one ratio with the size of the pipe, but at a rate equal to the square of the pipe's diameter. Doubling the diameter of a pipe, for example, increases its capacity by four times the original capacity. Thus, the additional costs of providing additional capacity are lower than the average costs of providing capacity. This means that the costs associated with providing capacity for the movement of average demands are greater on a unit basis than are the costs associated with providing capacity for additional demands. PGW's distribution system exists to deliver annual system requirements. There are costs that are uniquely associated with meeting peak demands, and as such peak demands should bear some cost responsibility. But the additional costs incurred to meet peak demands tend to be small.

OCA St. 3 at 15-16. The OCA submits that the reasonable explanation for why distribution costs are incurred is to serve customers' demands as they occur on a daily basis, throughout the year, and for periods of peak demand.

In his Rebuttal testimony, PGW witness Gorman asserts that distribution demand costs are only related to peak demands, because the distribution system must be adequately sized to meet peak demands. PGW St. 8R at 16-17. OSBA witness Knecht raises a similar argument in his Rebuttal testimony. OSBA St. 2 at 22.

Mr. Galligan responds in his Surrebuttal, as follows:

> PGW allocates its demand related distribution mains costs on the theory that it would not have incurred any of those costs except for the fact that its customers insist on receiving gas deliveries on the coldest day in a 10- to 15-year period. If PGW faced a demand for delivered gas only once every 10- to 15- years, it would incur no costs, as its extensive, highly capital intensive, fixed cost delivery system would not exist. One can only believe that all of PGW's demand related distribution mains costs are caused by peak demands only, if one were to find, contrary to reality, that the PGW system would exist (and costs would be incurred) if there were no demand for gas deliveries but once every 10- to 15- years.

OCA St. 3S at 11. In the OCA's Main Brief, this issue was further discussed:

> The OCA submits that some percentage of the distribution mains investment should be allocated to peak demands, as the gas system must be adequately sized to meet those design day conditions that are expected to occur approximately one time in every 10-15 year period. However, it is simply not reasonable to allocate all the demand costs to this one extraordinary event, when in fact, the gas system is being used and costs are being incurred the overwhelming majority of the time to meet the average demands that are placed on the system by customers every day of the year, year in and year out.

OCA M.B. at 51. The OCA submits that Mr. Galligan's Peak and Average COSS should be used as a guide to set rates in this proceeding because it accurately portrays how PGW's system is used by its customers.

4. OSBA's "Unbundled" COSS Has No Material Impact On The Cost Allocations In This Proceeding.

In addition, although the OSBA generally accepts PGW's COSS, it believes that the unbundled COSS that OSBA requested to have run should be used to set rates in this proceeding. OSBA M.B. at 34-35. OCA witness Richard Galligan commented on the effect of using this unbundled COSS, as follows:

> The combined residential customers' return goes up slightly (from $45.3 million to $45.7 million) under the cost study which includes no GCR costs, while the residential rate base goes down slightly (from) $1.109 billion to $1.031 billion). The combined residential heating and non-heating index rate of return is virtually unchanged.

OCA St. 3R at 14. Additionally, Mr. Knecht made the following observation in his Rebuttal testimony:

> ...there is remarkably little difference in allocated costs for the major firm sales customers classes among the various cost allocation methodologies submitted in this proceeding.

OSBA St. 2 at 3. The OCA submits that the importance OSBA places on such an "unbundled" COSS is overstated in this proceeding. Under the Peak and Average COSS, the Residential heating class has an indexed rate of return of 92.9% at present rates, and at proposed rates the indexed return is 94.3%. OCA St. 3S at 13. As Mr. Galligan shows above, using the OSBA's unbundled COSS has little to no effect on these values.

5. Conclusion.

Mr. Galligan's Peak and Average COSS provides a reasonable guide for the setting of rates in this proceeding. The Company's allocation of distribution mains costs, based on the number of customers connected to the system, and based on what customers do or do not do on one

day that may occur every 10-15 years does not comport with the reality of how the PGW system is actually used by its customers, nor does it comport with how PGW incurs costs to serve its customers. Accordingly, the OCA submits that the Peak and Average COSS be used as a guide to set rates in this proceeding.

B. The Company's Proposed Revenue Increase Allocation Is Appropriate.

1. Introduction.

In its Main Brief, PGW explains the rationale behind its proposed revenue allocation, as follows:

> The Company ... has proposed to allocate this increase in a manner that moves each rate class toward unity between its relative rate of return and the system average rate of return.
>
> ...
>
> This proposal was designed to implement a multi-step, gradual process of moving all classes to a system rate of return.

PGW M.B. at 79, (footnotes omitted).

The OCA, through the filed testimony of Mr. Richard Galligan, and through its Main Brief has supported the Company's proposed allocation of the revenue increase to the different rate classes. The OCA supports the Company's proposed revenue allocation because, like PGW, the OCA submits that the Company's proposal will bring the different rate classes closer to unity (the system average rate of return). The OCA provides a thorough discussion of the revenue allocation issue in its Main Brief. OCA M.B. at 63-79.

In their respective Main Briefs, the OSBA, PICGUG and OTS all challenge the Company's proposed revenue allocation on the grounds that PGW's proposal will allegedly move the rate classes further away from unity. OSBA M.B. at 36-48; PICGUG M.B. at 19-22; and, OTS

M.B. at 58-61.[12] In its Main Brief, PICGUG essentially echoes the arguments proposed by OSBA witness Knecht in his filed testimony, and supports the OSBA's proposed alternative revenue allocations. PICGUG M.B. at 19-22. Accordingly, the OCA will devote its attention in this area of its Reply Brief to the OSBA's arguments as found in its Main Brief that are in opposition to PGW's proposed revenue allocation.

The OSBA's opposition to PGW's proposed revenue allocation is based on its assertions that the Company's proposed revenue allocation would not result in the different rate classes moving closer to the system average rate of return. OSBA M.B. at 37. The OSBA cites the Commonwealth Court's decision in Lloyd v. Pa. PUC[13] as standing "for the proposition that the cost of providing service is the polestar criterion for ratemaking and trumps other concerns such as gradualism or rate shock." OSBA M.B. at 42. The OSBA's assertions are incorrect, and also misplaced.

Initially, the OCA submits that the OSBA misstates the holding in Lloyd. In Lloyd, the Commonwealth Court provided:

> Because the flat percentage increase in transmission charges increases any previous discrimination in rates, and the Commission offers no explanation how discrimination in distribution and transmission rate structures are eventually going to be gradually alleviated, in effect, the Commission has determined that the principle of gradualism trumps all other ratemaking concerns - especially the polestar - cost of providing service.

Lloyd v. Pa. PUC, 904 A.2d 1010, 1020 (Pa. Commw. Ct. 2006). Lloyd clearly states that the Court found the Commission had allowed the principle of gradualism to trump cost of service. Lloyd did

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[12] OTS proposes a scaleback approach, in that if the Commission does not authorize the full amount of PGW's revenue request, then the alleged inequities between the classes can be rectified by allocating more of the increase to those classes that are currently underpaying their cost to serve and smaller increases, or no increase for those classes that are overpaying their cost to serve. OTS M.B. at 59-60. OTS apparently agrees with the Company's proposed revenue allocation if the Commission grants the Company's full revenue request, as it has offered only an alternative revenue allocation if less than the full revenue request is granted.

[13] Lloyd v. Pa. PUC, 904 A.2d 1010 (Pa. Commw. Ct. 2006)

NOT say that cost of service trumps all other considerations, as the OSBA asserts. In fact, the Court provided:

> While gradualism can be used to justify differences between rate classes ... .
>
> ...
>
> while permitted, gradualism is but one of many factors to be considered and weighed by the Commission in determining rate designs, and principles of gradualism cannot be allowed to trump all other valid ratemaking concerns and do not justify allowing one class of customers to subsidize the cost of service for another class of customers over an extended period of time.

Lloyd v. Pa. PUC, 904 A.2d 1010, at 1021, 1020. The OSBA's reliance on Lloyd is misplaced here because gradualism is **not** trumping cost of service. As all cost of service studies show and the indexed rate of return measures show, under PGW's proposed revenue allocation all classes are moving toward the cost of service "polestar." OCA M.B. at 69-72.

Under either PGW's COSS or the OCA's COSS, the different rate classes are moving toward unity as a result of the Company's proposed revenue allocation. OCA M.B. at 68. OSBA's contention that the rate classes are not moving closer to unity is based on its assertion that a rate class with a below system average rate of return cannot receive a lower than system average revenue increase, and still make progress toward unity. OSBA M.B. at 38. OTS also makes this argument. OTS M.B. at 58-60. The OCA discusses this issue in its Main Brief, and submits here that OSBA's position does not adequately consider the relation between revenue increases, the rate base, the underlying revenue requirement and the associated expenses assigned to a class. OCA M.B. at 72-75.

In the following sections the OCA will show that (1) the OSBA's and the other Parties' assertions that PGW's proposed revenue allocation is moving the rate classes further away

from unity are without merit, and (2) that OSBA's proposal to assign the Residential class a revenue increase that is 1.2 times the system average revenue increase is not supported.

2. The OSBA's Assertions That PGW's Proposed Revenue Allocation Will Move The Rate Classes Further Away From Unity Are Misplaced.

a. Introduction.

In its Main Brief, OSBA provides the basis for the current dispute between the Parties as to whether PGW's proposed revenue allocation is moving the different rate classes closer to unity. OSBA's Main Brief argues, in relevant part that "Simple logic leads to the conclusion that a class which is overpaying its cost of service at present rates can not be moving closer to the cost of service if it receives a larger than system average rate increase." OSBA M.B. at 39. The premise, or simple logic as OSBA calls it, is flawed. As the different COSSs show, under either the Company's or OCA's analysis, all classes are moving closer to the system average rate of return.

PGW's Main Brief provides the following:

> In terms of progress towards unity, the Residential Heating class would move 32% toward cost, Commercial Heating would progress 17%, and Industrial Heating would progress 33%.

PGW Main Brief at 79, (footnote omitted). In his Surrebuttal testimony, OCA witness Richard Galligan provides the following as to the Residential class's progress toward unity in this case:

> Under the Peak and Average cost study at present rates, residential heating customers pay rates which provide a 5.38 percent rate of return compared to a system average rate of return of 5.79 percent, or an index rate of return of 92.9 percent. At proposed rates residential customers provide a rate of return of 12.15 percent compared to a system average of 12.89, or an index rate of return of 94.3 percent. This represents a closure of 21 percent of the gap between the index rate of return at present rates and the system average index rate of return of 100 percent. Residential non-heating customers would pay increased rates that close 34 percent of the gap between their index rate of return at present rates and the 100 percent system index rate of return. Using PGW's cost study, in combination with its proposed

> residential rate increase, shows 32 percent progress to cost-based rates for heating customers and 34 percent progress for non-heating customers. The residential heating customer index, at 94.3 percent under the Peak and Average study, shows these customers are essentially at cost of service at PGW proposed rates. I believe these results are reasonable.

OCA St. 3-S at 13. PGW's and OCA's numbers provide that the Residential class is making between 32% and 34% progress toward unity as a result of the Company's proposed revenue allocation. Mr. Galligan's analysis, cited above, shows that under his Peak and Average COSS Residential customers have an index rate of return at present rates of 92.9%, and at proposed rates the index rate of return climbs to 94.3%. Id. The OCA submits that this level of return is essentially a cost-based rate, since COSSs are not an exact science.

b. The Indexed Rate Of Return Is A Simple And Reliable Method For Determining Whether PGW's Proposed Revenue Allocation In This Proceeding Is Reasonable.

The OSBA's assertion that the Residential class is moving further away from unity as a result of PGW's proposed revenue allocation cannot be squared with the results of PGW's and OCA's analysis as just discussed. The reason for this apparent paradox is not some mathematical error, but that the interplay between the class rate of return, the proposed revenue increase, the rate base and the underlying class cost allocations is not as simple as the OSBA paints it. The indexed rate of return measures this interplay and provides the Commission with the necessary information to assess the progress of rate classes toward unity under the proposed revenue allocations.[14] As

[14] The use of the Indexed rate of return method to gauge whether the different rate classes are making progress toward unity in relation to the proposed revenue allocation is not new. The Commission has a long history of using the indexed rate of return to evaluate the appropriateness of a particular revenue allocation proposal. See, Pa. P.U.C. v. UGI Utilities, Inc., 1994 Pa. PUC LEXIS 137, *159-*167 (July 27, 1994); Pa. P.U.C. v. West Penn Power Co., 1993 Pa. PUC LEXIS 62, *249-*299 (May 14, 1993); Pa. P.U.C. v. Philadelphia Suburban Water Co., 1991 Pa. PUC LEXIS 206, *184-*192 (Oct. 18, 1991); Pa. P.U.C. v. West Penn Power Co., 1990 Pa. PUC LEXIS 142, 73 Pa. PUC 454, *194-*212, 119 P.U.R.4th 110 (Dec. 13, 1990); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 1989 Pa. PUC LEXIS 225, *167-*182, 72 Pa. PUC 1 (Dec. 29, 1989). The Commission's use of the indexed rate of return is well-grounded and reasonable.

noted, under the Company's proposed revenue allocation the rate classes are moving closer to unity. PGW M.B. at 79.

The OSBA, in its testimony, tried to eschew this time-honored measure in an attempt to move its rate class more quickly to unity. OSBA St. 1 at 19-24. The OCA provided the reasoning and analysis to show why OSBA witness Knecht's attack on the indexed rate of return is misplaced, in relevant part as follows:

> OSBA witness Knecht takes issue with the use of the indexed rate of return to measure progress towards cost-based rates. In his Direct testimony, he attempts to show why the indexed rate of return produces results, in his opinion, that are at odds with common sense. OSBA St. 1 at 19-23. In part of his discussion of this matter, Mr. Knecht theorizes on what would happen if all classes received the system average increase, and therein he states:
>
> Again, by adding similar numbers to both the numerator and the denominator of the IRoR equation, the index moves closer to unity, from 74 percent to 87 percent, *even though the residential class faces the same increase as every other class.*
>
> The OCA would submit that this statement indicates the nature of the misunderstanding over the Indexed Rate of Return. While the *percentage increase* may be the same the *dollar amount* of the revenue increase is vastly different as it is applied to vastly different underlying revenues. In addition, the expense categories assigned to the classes does not increase at the same uniform level. Thus, the gains in return, which represent the amount remaining after subtracting expenses from revenues, will not be uniform.

OCA M.B. at 74-75, (citations omitted).

Mr. Knecht's attempts to discredit the indexed rate of return should be disregarded. The indexed rate of return is a simple and reliable method to determine whether different rate classes are moving closer to unity based on the revenue allocation proposed. The Commission should reject OSBA's attempt to modify PGW's proposed revenue allocation.

3. The OSBA's Proposal To Assign The Residential Class A 1.2 Times The System Average Increase Is Unsupported.

As the OCA provides in its Main Brief, the Residential class will essentially be at cost-based rates as a result of the Company's proposed revenue allocation in this case. OCA M.B. at 78. Mr. Galligan also provides the following commentary as to Residential rates in his Surrebuttal testimony:

> Whether PGW's proposed cost study is utilized or whether the Peak and Average cost study is utilized, substantial progress toward cost based rates results at PGW's proposed rates. This is shown on Exhibit HSG-7C, page 1, line 23, of PGW's exhibits, and Exhibit RAG-1, page 5, line 23. The Peak and Average study results show residential heating customers paying proposed rates that recover all of their allocated operating costs, depreciation and taxes, and providing a rate of return that is 94.3 percent of the system average rate of return. Given the fact that fully distributed cost allocation studies are not an exact science, free from controversy, the proposed residential rates are, in my opinion, essentially cost based.

OCA St. 3S at 15. The OCA submits that the foregoing, in addition to the substantial discussion in OCA's Main Brief, establishes that PGW's proposed revenue allocation is reasonable and should be adopted by the Commission. OCA M.B. at 63-80.

In its Main Brief, the OSBA concludes that if its "first dollar relief" is not adopted, it would be appropriate to assign the Residential class a revenue increase that would be 1.2 times whatever the system average increase turns out to be. OSBA M.B. at 47. The OCA submits that such an approach was neither quantified nor supported in the filed testimony. The impacts of this approach could vary greatly depending on the rate increase awarded to PGW. As the OCA has shown above, the OSBA's assertions about the Residential class not making any progress toward unity are unfounded. For the same reasons that OSBA's and OTS's other scale back proposals should not be adopted – so too should this one be rejected.

4. Conclusion.

Under either the Company's COSS or the OCA's COSS as presented by Mr. Galligan, the Residential class is making substantial progress towards unity in this case. Based on the Peak and Average method, and realizing the fact that cost of service studies in general are not an exact science, the OCA submits that as a result PGW's revenue allocation – the Residential class will essentially be at cost-based rates. The OCA submits that the Commission should approve the revenue allocation as proposed by PGW.

V. MISCELLANEOUS ISSUES

A. Universal Service Issues.

1. Universal Service Surcharge Cost Recovery.

As to PGW's Universal Surcharge Cost Recovery Mechanism, OCA witness Roger D. Colton recommended that PGW be required to: (1) collect additional information as part of its surcharge reconciliation proceeding to ensure that PGW recovers only incremental costs and to ensure accurate projected costs, and (2) to design a mechanism to avoid any double recovery of costs that are included in PGW's base rates. PGW objected to the OCA's proposal, arguing that Mr. Colton's proposal was simply designed to track bad debt which is not permitted by the Public Utility Code. PGW M.B. at 64-65. PGW also argued that since many things can affect the bad debt of a customer, and since PGW's bad debt level could increase over time, such a mechanism should not be allowed. PGW M.B. at 64-65. The OCA submits that PGW's attempt to characterize the OCA's proposal as related to tracking bad debt fails.

The OCA's proposal is to develop a mechanism to eliminate the double recovery of uncollectible expenses when the CRP participation increases over the level of participation at the time base rates were established. The OCA submits that PGW should be permitted to recover uncollectible expense only once. To the extent that the costs associated with customers who become CRP customers are already included in base rates through the uncollectible expense allowance, those costs should not be included again as a separate CRP expense. Allowing the inclusion of these expenses a second time as CRP expense constitutes double recovery.

As the OCA discussed in its Main Brief, the CRP shortfall is the difference between the CRP usage billed at the General Service (GS) Rate and the amount the CRP customer is asked to pay under the terms of the CRP. OCA M.B. at 81; OCA St. 4 at 4. The CRP shortfall is

recovered through the USEC from non-CRP customers. Before a customer enters CRP, however, the amount that the customer is unable to pay is reflected in the uncollectible expense. After entering CRP, the amount that the customer does not pay becomes the CRP shortfall. OCA witness Colton explained:

> As can be seen a PGW customer must be in one of two mutually exclusive groups of customers. Either a customer is a CRP participant, in which case the CRP credits are collected through the universal service charge as discussed above. Or, a customer is not a CRP participant, in which case unpaid bills are collected from ratepayers as an uncollectible expense.

OCA St. 4 at 6.

The key issue arises when a customer moves into CRP. OCA witness Colton describes the impact of when a customer becomes a CRP participant:

> When those low-income customers move into CRP, the CRP credits shortfall associated with their account will now be collected through the universal service program. Previously, this shortfall presented a portion of the account that was not collectible. As CRP increases, the Company continues to collect its entire uncollectible expense as though no net addition of CRP participants had occurred. Since the universal surcharge is reconcilable, however, as CRP participation increases, the Company collects the increased CRP shortfall associated with this increased participation as though that additional shortfall is a "new" expense. Even though, as I explain above, CRP participants and non-CRP participants are mutually exclusive groups of customers, in other words for ratemaking purposes, the costs of the new CRP participant are included both in base rates and in the universal service surcharge.

OCA M.B. at 82; OCA St. 4 at 7-8.

The Company's argument is based on the mistaken idea that the uncollectibles are tied to specific individuals. OCA St. 4-S at 3; PGW St. 2-R at 28. Mr. Colton explained why this assumption was incorrect:

> As with any ratemaking, the Company uses its past history as the basis for making reasonable projections of what the future will look

> like. My testimony is that to the extent there is a net increase of CRP participants, the bills of those participants will be collected through customer payments and CRP credits collected through the universal service rider. A *portion* of the bills for those net additional CRP participants will also still be embedded in base rates, however, unless an adjustment is made to prevent the double recovery.

OCA St. 4-S at 3 (emphasis in original).

Additionally, the CAP Policy Statement requires that such cost offsets be considered. The CAP Policy Statement provides:

> In evaluating utility CAPs for ratemaking purposes, the Commission will consider both revenue and expense impact. Revenue impact considerations include a comparison between the amount of revenue collected from CAP participants prior to and during their enrollment in CAP. CAP expense impacts include both the expenses associated with operating the CAPs as well as the potential decrease of customary utility operating expenses. Operating expenses include the return requirement on cash working capital for carrying arrearages, the cost of credit and collection activities for dealing with low income negative ability to pay customers and uncollectible accounts expense for writing off bad debt for these customers. When making CAP-related expense adjustments and projections, utilities should consider whether a customer's participation in a CAP produced an immediate reduction in customary utility expenses and a reduction in future customary expenses pertaining to that account.

52 Pa. Code § 69.266

The OCA submits that Mr. Colton's proposal to ensure that only incremental CRP shortfall costs are recovered through the surcharge is reasonable and should be adopted. The proposal is not a bad debt tracker as the Company tries to argue but a necessary adjustment to eliminate double recovery. The Company should be directed to collect information to establish the net increase in CRP participation over the level at the time of the base rate case and the average shortfall per participant to present with its quarterly reconciliation. The Company should also be directed to include a mechanism to eliminate any potential for double recovery of costs.

2. PGW's Historic Universal Service Cost Allocation To All Firm Service Customers Should Be Maintained.

a. Introduction.

Historically, PGW has allocated its universal service costs to all firm service customer classes and now collects these costs through the Universal Service and Energy Conservation Surcharge (USEC). In this case, PGW has recommended continuation of the historic allocation of the USEC to all firm service customers. PGW St. 1 at 15-20. The continuation of this allocation is fully in accord with the Commission's decision in PGW's restructuring proceeding to continue the traditional recovery of these universal service costs from all firm service customers. Pa. P.U.C. v. Philadelphia Gas Works, 2003 Pa. PUC Lexis 13, 223 P.U.R. 4th 412 (2003). The continuation of this allocation to all firm service customers is also in accord with the Commonwealth Court's determination in Lloyd. Lloyd v. Pennsylvania Public Utility Commission, 904 A.2d 1010 (Pa. Commw. 2006) (Lloyd).

In its Main Brief, OSBA argues that this historic practice should be changed and the entire cost of universal service programs should be assessed only to residential customers. The cumulative effect of this proposal would be to further increase residential customer rates by 3.9%, or by $.80 per Mcf, assuming that the USEC does not otherwise increase. OSBA St. 3 at 13. The OCA submits that OSBA's proposal to change PGW's historic allocation must be rejected. PGW's proposal to continue to collect its universal service costs from all firm service customers should be adopted.

b. OSBA's Proposal To Have Only Residential Customers Pay For Universal Service Costs Should Be Denied.

i. The Commission Decisions on CAP Cost Recovery Relied On By OSBA Do Not Support Its Position In This Case.

In support of its position, OSBA begins by citing to several Commission Orders and the Commission's recent CAP Policy Statement Order.[15] In the case-related Orders relied upon by OSBA, the Commission found that universal service costs should be allocated to residential customers.[16] Importantly, however, in those cases, the Commission was continuing the existing practice of each utility of allocating universal services costs to residential customers. The Commission found that it did not want to change the existing practice in the pending case. For example, the Recommended Decision, adopted by the Commission in the PPL Electric case states that there has not been shown:

> ***any basis to change established Commission policy*** to allocate costs of universal service programs to residential customers who may benefit directly from the programs, into allocating these costs across all customers.

Pa. P.U.C. v. PPL Electric Utilities, Docket No. R-00049255, R.D. at 174-174 (emphasis added). It was existing allocations in the cases relied upon by OSBA that the Commission did not want to change. Here, the existing allocation is to all firm service customers.

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[15] Customer Assistance Programs: Funding Levels and Cost Recovery Mechanism Final Investigatory Order, Docket No. M-00051923 (Order December 18, 2006) (CAP Policy Statement Order).

[16] Pennsylvania Public Utility Commission v. Equitable Gas Company, Docket No. R-901595, 73 Pa. PUC 301 (Order entered November 21, 1990); Pennsylvania Public Utility Commission v. PPL Electric Utilities Corporation, Docket No. R-00049255 (Order Entered December 22, 2004) (PPL Electric); Pennsylvania Public Utility Commission v. Metropolitan Edison Company and Pennsylvania Electric Company, *et al.*, Docket Nos. R-00061366, *et al.* (Order Entered January 11, 2007) (Met-Ed and Penelec Consolidated Case.); Application of UGI Utilities, Inc., UGI Utilities Newco, Inc. and Southern Union Company for approval of the transfer by sale of all property used or useful in providing natural gas service to the public to UGI Corporation, *et al.*, Docket Nos. A-120011F2000, *et al.* (Order Entered August 18, 2006) (UGI/PGE Merger).

Moreover, OSBA's reliance on Equitable is misplaced. As noted in the OCA's Main Brief, some portion of Equitable's universal service costs are allocated to small business customers. The Commission specifically affirmed that the commercial class was funding the existing CAP as a result of the Equitable Gas Restructuring Settlement. OCA M.B. at 93, Appendix C, Application of Equitable Gas Company For Approval of Natural Gas Choice and Competition Act Restructuring Filing, Docket No. R-00994784, *slip op.* at 2-3 (September 12, 2002).[17]

The OCA submits that PGW is distinguished from these other cases because PGW has historically allocated these costs to all firm service sales customers. The continuation of this allocation is fully in accord with the Commission's decision in PGW's restructuring proceeding to continue the traditional recovery of these universal service costs from all firm service customers. Pa. P.U.C. v. Philadelphia Gas Works, 2003 Pa. PUC LEXIS 13, 223 P.U.R. 4th 412 (2003).

The Commission's recent CAP Policy Statement Order also does not support the OSBA's position. OSBA M.B. at 13-16. The Commission's CAP Policy Statement Order indicates that PGW's policy of allocating universal service costs was in place before the Commission assumed jurisdiction over PGW. Since the CAP Policy Statement Order intends to continue prior policies, PGW's policy of allocating its universal service costs to all firm service customers should be continued. CAP Policy Statement Order at 31.

ii. The Natural Gas Choice Act Supports PGW's Proposal Regarding Universal Service Cost Allocation.

OSBA in its Brief also argues that the Natural Gas Act does not support an allocation of cost responsibility to all customer classes as the OCA has argued. Specifically, OSBA argues that the term "non-bypassable" in Section 2203(6) is limited in meaning to customer switching to alternative suppliers and does not encompass a broad allocation of universal service

[17] A true and correct copy was attached to OCA M.B. at Appendix C.

costs. OSBA M.B. at 21. The rules of statutory construction provide, however, that the words in a statute are to have their common, understood meaning at the time of enactment. 1 Pa. C.S. § 1921. As OCA witness Colton testified, the common understanding of the term non-bypassable at the time of the Act was that some customers would leave the system and leave their share of system costs behind. OCA St. 4-R at 2. At the time of the Act , it was not residential customers that engaged in bypass of the natural gas system, rather it was commercial and industrial customers. OCA St. 4-R at 2. The words of Section 2203(6) incorporate the notion that all customers should pay the costs of these programs since no customer should be able to bypass or avoid the costs. See also, Lloyd, 904 A.2d at 1024-1027(the Competition Act specifically intends that conservation programs be funded and only provided that it funded by "non-bypassable rates" without any requirement that it be by a rate that is directly benefited by the program).

OSBA also relies on the legislative history of the Natural Gas Choice Act to support its position, arguing that the Act was just about retail choice. OSBA M.B. at 23-24. As OCA witness Colton explained, however, retail choice was but one element of the Natural Gas Act. Mr. Colton testified:

> The allocation of universal service costs to all customer classes was but one part of PGW's move to a retail choice natural gas industry in Philadelphia. Unlike the cases that Mr. Knecht cites, therefore, continuing the allocation of universal service costs to all customer classes would not represent inter-class cost-shifting. Since PGW has historically allocated these costs to all customer classes, maintaining this allocation would be consistent approach.
>
> Moreover, the PGW restructuring process involved making a decision on how to allocate the total costs of moving to a retail choice industry. PGW's natural gas restructuring costs have been allocated to all customer classes, including residential customers. As Schedule RDC-1R demonstrates, however, residential customers derive few, if any, direct benefits from the move to a retail choice industry. Schedule RDC-1R presents natural gas shopping statistics for eastern Pennsylvania. As can be seen, PGW and UGI Penn have

> had no residential customers engaged in switching to a natural gas retail provider. PECO has less than one-quarter of one percent (0.24% in January 2007 and 0.22% in April 2007) of its residential customer base that has switched.
>
> What has happened is that different customer classes derive different benefits from the restructuring statute. The non-residential customer classes derive the benefits of being able to tap the retail choice market. ***The residential customer class derives the benefit of being able to tap into universal service programs. In exchange for each class deriving its respective benefits from restructuring, all classes pay for the actions that enabled these benefits to arise.*** Having received the benefits of the move to retail choice, in other words, the commercial and industrial classes should not now be allowed to avoid their responsibilities under the package of benefits and responsibilities that was agreed to.

OCA St. 4-R at 20-21 (emphasis added).

The OCA submits that OSBA's statutory and case law arguments do not support a change in PGW's historic allocation of its universal service costs to all customer classes. As detailed in the OCA's Main Brief, continuation of PGW's practice is fully supported by the law and sound regulatory policy.

3. OSBA Understates The Impact On Residential Customers.

OSBA also argues in its Main Brief that the impact on residential customers of their proposal is small and thus "would not have any unduly detrimental impact on the residential class." OSBA M.B. at 16. The OCA submits that OSBA's argument seriously understates the impact on residential customers by focusing only on the first year of OSBA's proposed three year phase-in. The cumulative effect of the three year proposal is to increase gas costs for residential customers by $.80/Mcf - - even if universal service costs were to remain at the exact level as today. This

represents a 3.9% overall increase based on today's already high rates. This would be on top of any rate increase in this case.[18]

Action Alliance witness Geller testified that OSBA's assertion that the increase to the residential class was not an "insurmountable problem" was incorrect. Mr. Geller testified:

> Mr. Knecht's Table IEc-4 provides the incremental percentage increase for residential customers for the first year of a three year phase in, not the total incremental percentage increase on monthly bills above current levels that would occur in the second and third year due to his proposed reallocation of universal service costs. PGW residential customers already pay the highest rates in the state. PGW is requesting a substantial base rate increase which would increase residential monthly bills by almost 10%. Residential customers should not be made to assume in addition the exclusive burden of paying the public purpose costs of universal costs.

Action Alliance St. 1-R at 6. Mr. Geller also explained that under OSBA's proposal to shift these costs to residential customers, the cost of these programs would be assigned to a customer base of substantial low-income customers. Mr. Geller also testified:

> as the Commission's 2005 Report on Universal Service Programs & Performance indicates, the demographics of PGW's residential customer base are truly extraordinary, when compared to other Pennsylvania natural gas utilities.
> For instance, in 2005, PGW had 157,000 low-income residential customers (customers with household incomes at or below 150% FPL), constituting 33% of its customer base. By contrast, the natural gas utility with the second highest percentage of low-income customers is Dominion, with 24%, which in absolute numbers represents only half as many low income customers as PGW. Overall, PGW excluded, low-income natural gas customers represent 18% of the customer base for Pennsylvania natural gas utilities. On the electric side, Penelec has the highest percentage of low-income customers, who constitute 24% of the company's customer base; statewide, low-income customers constitute 19% of the total number of electric customers. These demographics would justify as in the public interest, a continuation of the present policy to promote universal services through contribution by all classes.

[18] OSBA has also proposed in this case to allocate substantially more of the distribution rate increase to residential customers than PGW.

Action Alliance St. 1-R at 5. OSBA's argument that shifting these costs onto residential customers is not problematic simply does not withstand scrutiny.

4. OSBA's Arguments On Cost Causation Do Not Recognize The Public Purpose Nature Of Universal Service Costs And The Direct Economic Benefits To Businesses From These Programs.

OSBA, in its Main Brief, argues that since residential customers derive the benefits of CAP programs, the costs of the programs should be borne by those customers. OSBA M.B. at 24-34. OSBA also argues that universal service costs are not a "public good" that would warrant a broader allocation of the costs. Both of these arguments ignore the statutory basis of the programs and the substantial benefits provided to all customers, as well as the City of Philadelphia, from these programs.

The OCA, through its testimony and Main Brief, detailed the many direct benefits to all customer classes from universal service programs. OCA M.B. at 88-93. OCA St. 4-R at 3-14. Some of these benefits to business and industry include:

- reduced employee absenteeism
- reduced employee health problems
- reduced employee turnover
- improved employee productivity.

OCA St. 4-R at 6-11. Moreover, universal service programs increase disposable income within the low-income population that helps to drive job creation, income generation and economic activity for local businesses. OCA St. 4-R at 11.

Additionally, universal service programs have a particular benefit to small business. As Mr. Colton explained:

> Low wage employers are often small businesses. As elsewhere, small business fills a unique role in the Philadelphia economy. Small business disproportionately offers employment opportunities to Philadelphia residents who have limited employment skills. Small firms disproportionately pay wages that do not allow a household to economically exist without public assistance. Indeed, workers in small firms earn, on average, 81.4% of the wages made by workers in comparable jobs in large firms.
>
> As can thus be seen, there is a reciprocal relationship between small businesses in Philadelphia and low-wage employees. On the one hand, without small business offering low-wage employment, many of the persons who are employed in such establishments would not find job opportunities. On the other hand, without the low wage employee, many of the small businesses that produce goods and services within Philadelphia would not be able to economically survive. These small business establishments providing low wage employment would not be able to survive if they were required to pay higher wages.

OCA St. 4-R at 16. The number of small businesses in Philadelphia that benefit is substantial. Mr. Colton provided the following information:

> The number of small businesses in Philadelphia paying low wages is substantial. Consider retail establishments as one example. As Schedule RDC-2R shows, nearly 5,700 Philadelphia workers in general merchandise stores earned only $19,108 in 2005; more than 11,000 workers in grocery stores earned only $20,333 in 2005. The 39,282 workers in food service and drinking establishments earned $17,351, in 2005, while the 2,498 workers in residential care services earned only $18,017. In contrast, 150% of the Federal Poverty Level for a 3-person household in 2005 was $24,135 while 150% of Poverty Level for a 4-person household was $29,025. Schedule RDC-2R presents data obtained from the U.S. Department of Labor's Bureau of Labor Statistics.

OCA St. 4-R at 17.

The relevance of these facts to PGW's situation cannot be overlooked. Mr. Colton explained the direct relationship to the issue:

> The observation is directly relevant. The reason small businesses can offer low wage employment to so many of their employees is because of the external programs that are available to help fill the

> wage gap. One analysis reports, for example, that businesses paying low wages:
>
> ...are effectively being subsidized by taxpayers through government assistance programs (e.g. food stamps, Earned Income Tax Credit) which help many low-income wage employees survive...[B]usinesses that pay poverty wages indirectly rely on government assistance programs to make up the difference between these wages and what it costs their employees to live.
>
> The same analysis applies to PGW. The small businesses that pay low wages indirectly rely on PGW's willingness to make up the difference between those wages and what it costs the employees to live. Requiring all customer classes to help pay for the PGW universal service programs which respond to the inability-to-pay resulting from the payment of low wages is simply one mechanism to have the customer classes which contribute to the need for the universal service program pay some part of the cost of the program.

OCA St. 4-R at 17-18.

As Mr. Colton further testified, basic societal conditions negatively affecting a customer's ability to pay are not "caused" by one particular customer class. The Commission's Bureau of Consumer Services also recognized this point. Mr. Colton stated:

> However, in originally proposing universal service programs such as CAP, the Bureau of Consumer Services observed that there is no "logic to the argument that because the larger societal economic conditions are negatively affecting the ability of some low income residential customers to pay their bills, that the problem is somehow caused by the residential class and should therefore be paid for by that class." I conclude that this BCS observation has a sound empirical basis in fact. No causal connection can be drawn from PGW's universal service costs to any particular customer class. Accordingly, the costs should be borne by all customer classes.

OCA St. 4-R at 18.

Finally, OSBA argues that universal services programs are not a "public good" since Section 2802(17) refers to the programs as "public purpose costs" not as "public goods." OSBA M.B. at 30-31. The OSBA tries to draw a distinction where one does not exist. As Mr. Colton

explained, a public good represents investments or expenses that are in the public interest and are mandated by regulation because of the intangible or immeasurable societal benefits which are not measured by the marketplace. OCA St. 4-R at 4-5. With respect to the universal service programs at issue here, Sections 2203(6), 2203(7) and 2203(8) mandate that the programs be continued and appropriately funded. 66 Pa.C.S. §§2203(6), (7), and (8). Whether referred to se as public purpose cost or a public good, the outcome is the same. See also, Lloyd v. Pennsylvania Public Utility Commission, 904 A.2d 1010 (Pa. Commw. 2006) (the General Assembly specifically authorized that public service programs...be funded.)

Action Alliance witness Geller succinctly summarized these key points:

> Universal service programs are public purpose programs, which are made necessary by the fact that our economic and social structure does not, in itself, assure that all citizens will always have the economic resources to pay for the basic necessities of life. It is not appropriate to think about allocating the costs of universal services programs as if the causes of these costs could be allocated to a particular class. Poverty (often aggravated by ill-health and disabilities) is a result of general economic and social forces in which all customer classes participate, and the cause of the inability of the participants in PGW's CAP programs to pay standard residential rates should not be attributed only to the residential class as opposed to the non-residential classes. For this reason, universal service costs should always be allocated to all firm service classes. This is especially true for a municipally owned utility like PGW. In a 2002 independent evaluation of the PGW universal service programs, the evaluators noted that the Philadelphia Gas Works' universal service programs are "a key component of the economic security of the City of Philadelphia." In proposing to continue to allocate universal service costs to all customer classes, the City of Philadelphia, as PGW's owner, fully recognizes the public purpose nature of these costs.

Action Alliance St. 1-R at 2 (footnotes omitted).

The OCA submits that the record fully demonstrates that the universal services programs at issue here benefit all customer classes and were intended by the General Assembly as

public goods, or public purpose programs, that are to be broadly funded. As such, PGW's proposed historic allocation to all firm service customers is fully supported, reasonable and should be approved.

5. Conclusion.

The OCA submits that there is no basis in this record to change PGW's historic method of recovering its universal service costs from all firm service customer classes. The proposal of the Company to maintain its historic allocation should continue.

B. Program Initiatives To Improve Collections.

1. An Electronic Fund Transfer (EFT) Payment Program For Customers In Arrears With Incomes Above 250% Of The Federal Poverty Level Should Be Developed.

The OCA continues to support a form of EFT program and does not believe that any further reply on this issue is needed.

2. Increased Budget Billing For Payment-Troubled Customers Should Be Adopted.

In its Main Brief, PGW opposes OCA's proposal to implement an enhanced budget billing program. PGW M.B. at 93-94. At hearings, PGW made an alternative proposal to "study the implications of such a program as part of its customer segmentation study that it plans to undertake this year with data available probably by the second quarter of 2008." PGW M.B. at 94. The OCA appreciates the Company's alternative proposal, however, the OCA continues to recommend that Mr. Colton's proposal be adopted in this proceeding.

PGW raises three primary arguments against the proposed enhanced budget billing program. First, PGW argues that the program does not guarantee that a payment-troubled customer will pay his/her bill more consistently. PGW M.B. at 93. Second, PGW argues that implementing

the program in November could have cash flow implications in the winter. PGW M.B. at 94. Third, PGW argue that implementing the program would require modifications to the billing system. PGW M.B. at 94. As discussed below, these arguments do not support opposition to a budget billing program.

As OCA witness Colton discussed, experience in Tennessee with a similar program shows improved payment by customers and a decrease in the collection activities as well as a decrease in the level of accounts and dollars in arrears. OCA witness Colton discussed the improvements to customer payments seen in Tennessee:

> (o)n the contrary, the Tennessee automatic budget billing program I discussed in my Direct Testimony yielded substantial bill payment improvement even during a time period when spiraling natural gas prices were resulting in increased arrears, disconnections, and uncollectibles in other natural gas utility service territories.
>
> Moreover as I discussed in detail in my Direct Testimony, PGW's own customer segmentation study (OCA-V-10) identifies budget billing as a way to reduce arrears. PGW's own customer segmentation study concludes that budget billing is an effective billing intervention to help reduce residential arrears.

OCA St. 4-S at 6. Further, Mr. Colton's analysis of billing and collections on behalf of the Coalition to Keep Indiana Warm demonstrates that budget billing improved payment patterns for low-income and residential customers generally. As can be seen, PGW's concern that budget billing may not improve payment is misplaced. OCA St. 4-S at 7.

As to PGW's cash flow concerns, the OCA submits that improving payment by customers on a year round basis should benefit PGW's overall financial condition. As the OCA has noted, it is willing to work with PGW in the design and implementation of the program to work through concerns or issues such as the short-term cash flow concerns raised by PGW. PGW's

concern with a short-term cash flow issue, however, does not offset the many benefits to be gained for customers and PGW from a budget billing program.

PGW also argues that such a program that automatically places someone on a mandatory payment arrangement because they miss one payment may result in "an overly draconian and inappropriate response to one missed payment and result in a potential violation of Chapter 14." PGW M.B. at 94. The OCA submits that automatic budget billing is neither draconian nor in violation of Chapter 14. First, the customer is not being placed on a payment arrangement, but on a budget billing plan. The customer also retains the right to opt out of the plan. Second, rather than being "draconian," budget billing has been demonstrated to help customers pay their bills on a more consistent basis; reduce their arrears; and lower terminations. The OCA would also note that budget billing concept has been broadly supported by the Commission as a means of managing bills for customers. In Re: Insuring Consistent Equal Monthly Billing, Docket No. M-00051925, 2006 Pa PUC LEXIS 21 (June 2, 2006). Again, the OCA is willing to work on any implementation issues with PGW to avoid any possible conflicts with Chapter 14.

Finally, PGW argues that implementing such a budget billing program would require modifications to PGW's billing systems which would have a financial impact on PGW. PGW M.B. at 94. The OCA submits that PGW already has a budget billing program with 48,000 customers enrolled. PGW has not quantified in the record of this proceeding what additional costs it might incur to implement a form of budget billing program recommended by OCA witness Colton. Nor has PGW considered that the benefits and resultant reductions in arrears and consistent payments benefit PGW financially.

The OCA recommends that Mr. Colton's proposal to have customers who become payment-troubled placed on budget billing be adopted. The OCA is willing to work with the Company to design a program that meets the Company's concerns and its needs.

C. The Philadelphia Housing Authority's Direct Vendor Program With PGW Should Be Expanded.

The Philadelphia Housing Authority's (PHA) Main Brief takes issues with Mr. Colton's proposal to expand PGW's existing direct vendor payment program with PGW for its Scattered Site Housing units. PHA argues that Mr. Colton's proposal lacks foundation, referencing portions of PHA's cross-examination of Mr. Colton. PHA's citations, however, are incomplete and fail to recognize the nature of the program that Mr. Colton recommended. Notably, as Mr. Colton testified on cross-examination, the points that PHA seeks to make are irrelevant to a consideration of the program proposed.

By way of example:

- PHA argues that Mr. Colton's analysis lacks foundation since Mr. Colton "does not know the specifics of how funds are transferred between the federal budget and PHA." PHA M.B. at 12. As Mr. Colton explained, though, the HUD utility allowance is similar to LIHEAP, and when discussing the application of LIHEAP payments against CAP shortfalls, the PUC does not consider the specifics of how funds are transferred between the federal budget and the state LIHEAP office. Tr. 847.

- PHA argues that Mr. Colton's analysis lacks foundation since he acknowledged that excess funds from utility allowances exceeding a customer's gas bill could also be used for other tenant-based PHA programs. PHA M.B. at 12. As Mr. Colton explained, though, the utility allowance is intended to pay the utility bill, and PGW ratepayers should not be

subsidizing the federal public housing authority even if those dollars are used for other tenant-based programs. Tr. 846.

- PHA argues that Mr. Colton's analysis lacks foundation because he did not consider how many tenants are on the CRP program or how much funding was involved. PHA M.B. at 12. Mr. Colton testified, however, that what was being discussed was a process, not a specific dollar adjustment. Tr. 847.

- PHA argues that Mr. Colton testified that his proposal would result in a PHA tenant paying a higher rent. PHA M.B. at 12-13. Mr. Colton testified, however, that the total amount that the tenant pays stays the same. It is only the portion that is directly paid to PHA as rent that increases while the amount directly paid to PGW as a utility bill decreases or is eliminated for the tenant since it is direct vendored to PGW. Tr. 852-853; 872-873.

As can be seen, PHA's attempt to criticize Mr. Colton's proposal are unfounded. As Mr. Colton testified, PHA tenants receive a federal utility allowance that is intended to pay the tenant's utility bill. Just as LIHEAP is direct vendored to PGW for payment of the utility bill, the natural gas portion of the HUD utility allowance should go to PGW for payment of the natural gas bill.

VI. CONCLUSION

For the reasons set forth above, the Office of Consumer Advocate requests that the Commission find that a $22.5 million increase in revenues is appropriate for PGW in the instant proceeding subject to the conditions set forth herein.

Respectfully Submitted,

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Dated: June 21, 2007

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CERTIFICATE OF SERVICE

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

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

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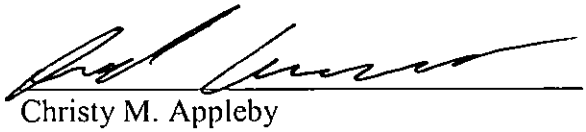

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Re: PA PUC v. PGW, Docket No. R-00061931

Dear Secretary McNulty:

On behalf of Philadelphia Gas Works, enclosed for filing please find an original and nine copies of its Reply Brief with regard to the above-referenced matter. We are also enclosing a CD with the Reply Brief in Word format. A copy has been served in accordance with the attached Certificate of Service.

Very truly yours,

Daniel Clearfield

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

DC/lww
Enclosure

cc: Hon. Cynthia Fordham w/enc.
Hon. Angela Jones w/enc.
Cert. of Service w/enc.

HAR:73923.1/PHI211-236005

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	Docket No. R-00061931
	:	
Philadelphia Gas Works	:	

REPLY BRIEF
of
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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES **Page(s)**

ADMINISTRATIVE CASES

ADMINISTRATIVE CASES (Continued) **Page(s)**

REGULATIONS

REGULATIONS (continued) **Page(s)**

I. INTRODUCTION & SUMMARY

Philadelphia Gas Works ("PGW" or "the Company") hereby submits this response to the Main Briefs of the Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), the Action Alliance of Senior Citizens of Greater Philadelphia and Tenant Union Representative Network ("AA"), Philadelphia Industrial and Commercial Gas Users Group ("PICGUG"), School District of Philadelphia ("SDP"), Philadelphia Housing Authority ("PHA"), Interstate Gas Supply, Inc., ("IGS"), and Hess Corporation ("Hess").

The position of the parties opposing PGW's requested $100 million base rate increase[1] can best be characterized as "denial" and "avoidance." Overwhelming evidence was presented showing that PGW desperately needs a rate increase to provide cash working capital and liquidity, as well as to reduce the Company's crushing debt burden, both of which were shown to be serious problems in the test year, as well as to recognize an impending debt service coverage crisis just a few years off. In response, the OTS and OCA , for the most part, simply deny that a problem exists, and/or insist that the issues need not be addressed now. PGW's present financial situation is just fine, these parties claim, since the Company can meet its minimum coverage levels in the test year and appears to have some cash at the end of that year.

What the OTS/OCA briefs fail to confront – or even acknowledge – is that, currently, PGW is completely dependent upon the willingness of a handful of banks and bond underwriters to lend PGW the necessary funds it requires to operate. They apparently take the position that the Company is not in crisis as long as the Company can continue to borrow funds sufficient to meet

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[1] The OTS (OTS M.B. at 2) incorrectly states that the Company's request is $107 million. As noted in PGW's Main Brief (M.B. at 1, n. 1), PGW's supplement No. 16 would increase base rates by $100 million.

operating expenses in a timely manner. Implying that the Commission could simply reject PGW's request outright, OTS/OCA suggest more explicitly that the Company should only be awarded a $22.5 million to – $25 million rate increase to recognize the fact that a $45 million City Loan will come due and have to be paid back at the end of FY 2008. They seem to suggest that they are being generous in even recommending a rate increase to satisfy this obligation.

But the reverse is true. A fair and careful review of the record shows irrefutably that a correct application of PGW's mandated Cash Flow Method mandates the awarding of a rate increase that covers key elements: expenses, debt service and coverage to be sure but also a reasonable allowance for cash working capital and revenues to finance capital improvements and to pay down debt when, as here, it is absolutely essential. Only the Company's request even comes close to meeting these requirements. By engaging in speculation, denial and complete avoidance of the reality of the situation facing PGW and its customers, OCA and OTS seek to deny what is mandated by Code Section 2212. It is highly unlikely that such a position of denial would be seriously entertained if an investor owned utility made a comparable claim for a reasonable return on its rate base and the parties simply denied that it was entitled to such an allowance – but that is the equivalent of the opposing parties' position.

Nonetheless, both parties refuse outright, or refuse adequately to acknowledge the clear requirements of the Cash Flow Method that must (not may) be included in rates. In doing so, neither party provides a satisfactory explanation – or any explanation for that matter – that reconciles their position with these compelling facts:

- Neither party explains how it could be reasonable for a company with nearly $1 billion in operating expenses to have no – zero – cash working capital being produced from rates, and to rely completely on a relatively small line of credit, in order to be able to just barely meet its day-to-day obligations. Both parties pointed to PGW's projected cash balance at the end of the future test year, some $50 million, but neither bothered to acknowledge PGW's repeated

testimony that the $50 million cash balance is **completely borrowed** money that must be repaid. This means that its cash does not come from the rates – as required by the Management Agreement which sets out the requirements of the Cash Flow Method – but simply from utilization of PGW's only other source of borrowing – commercial paper – that PGW should be using to meet its peak cash flow needs during the year and for emergencies but instead is now being used to pay routine, day-to-day operating expenses. There is a real and continued risk, however, that PGW's commercial paper program could be reduced or pulled outright, plunging the Company into crisis.[2]

- Similarly, neither party dealt with the fact that PGW is not producing earnings from operations that permit it to fund any of its essential construction from internally generated cash, resulting in a construction program that is completely dependent upon PGW's continued ability to issue long term debt, with resulting debt costs that are spiraling higher and higher. While the OCA appeared to acknowledge that PGW's high percentage of debt in the capital structure is a concern, both OTS and the OCA refused to recognize that their inadequate rate increase recommendation **does nothing** to alleviate that problem. Without rate relief, PGW's percentage of debt to equity, which is now 83%, will grow to **89% by 2012. Even with a $25 million rate increase, PGW's debt percentage is projected to be 80% in 2012**. This result does not change, even if the remaining contested adjustments to PGW's *pro forma* test year are factored in. Why is this so concerning? With this much debt, PGW is at continued risk of not being able to access the bond markets.[3] Just as troubling, a $25 million rate increase will force PGW to issue two more bonds by 2012, raising total interest and coverage cost to ratepayers by **$52 million a year for the next 27 years, or over $1.4 billion**. To avoid at least the first of these two issuances, PGW needs at least $60 million in rate relief.[4]

- Neither party even bothered to mention PGW's evidence which showed that comparing its more or less undisputed test year *pro forma* revenues and expenses to the level that was permitted in PGW's last PUC rate cases, **the Company's expenses and interest costs had risen by $45 million** from the levels authorized in the 2001 case; and its **contribution margin had decreased by $38-$40 million** from the 2001 and 2002 cases. How could a $25 million rate increase be sufficient when PGW's expenses alone have risen by almost twice that amount? Where else could PGW have obtained the income necessary to maintain its cash working capital, internally generated cash to fund construction and debt service coverage cushion implicitly granted

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2 *See, e.g.*, PGW St. 1R at 3.

3 PGW St. 1R at 4.

4 PGW St. 2R, Exh. JRB10 ($50.0 MM plus $10 million scenario).

in those cases if its contribution margins have decreased by $40 million? Both parties simply ignore this evidence as somehow not relevant but the conclusion that must be made is that PGW needs at least a $70 million rate increase just to maintain the status quo from the Company's last two rate cases.

The bottom line of all this is that, absent adequate rate relief, PGW is a disaster waiting to happen. While PGW acknowledges that the OTS/OCA are sincere in their beliefs, the only way to describe their steadfast refusal to acknowledge the Company's financial deficiencies and its running on borrowed funds status is "head in the sand." It is crucially important for the Commission to recognize that this discussion is not some academic exercise. PGW's complete lack of cash working capital and inadequate liquidity is real. PGW's crushing debt burden is real. Absent adequate rate relief, PGW could easily experience a major financial emergency. PGW demonstrated that, even with a $25 million rate increase, all that has to occur is for natural gas prices to return to the levels that were experienced in early 2006 to plunge the Company into a crisis that would leave it significantly short of its ability to pay all of its bills – a bond covenant violation – absent undertaking "last ditch" steps to produce some cash flow relief. (Recall that PGW came within a few days of running out of liquidity in January of 2006.)

Either intentionally or otherwise, the parties appear to suggest that PGW should continue to be operated as close to the edge as possible with nothing but costly and risky "one time fixes," that are viewed by the investment community as desperate measures, as its only safety net. While admittedly, the Commission is charged with balancing the needs of the Company and its employees with those of its ratepayers, that balancing must recognize that if a failure to provide adequate financial support through rates generates a financial crisis all stakeholders – and particularly the Company's customers – will suffer the results of dramatically added costs and reductions in service. Again, it is hard to imagine that the parties or the Commission would ever let an investor owned utility get as close to the edge as PGW now finds itself.

To suggest that the solution to all these concerns is to have the City make additional contributions is not only unrealistic, but ineffective – the City clearly has insufficient funds to reverse the present situation without devastating other City services. Further, suggesting that no relief should be granted because PGW's present rates are high or that prior actions of the Company or the City might have mitigated the present situation is illogical and counter productive. These past events simply cannot change the fact that there exists a real need that must be addressed today. As the Commission concluded in the Company's 2002 Extraordinary Rate Order, "[w]hatever steps might have been taken in the past which could have avoided this situation, the Commission must deal with the Company and its problems as they exist today."[5]

Proof that this is not some academic exercise can be found merely by examining the history of PGW's last interactions with the Commission regarding a request for a base rate increase. In 2001, PGW filed a $65 million request for a base rate increase designed not only to permit it to meet its minimum debt service coverage requirements, but also to provide sufficient cash working capital and liquidity so that it could reduce its reliance on external borrowing.[6] Taking positions that are eerily similar to those taken in this case, the OCA/OTS insisted that all PGW needed was a rate increase to satisfy its debt service coverage requirements – a fraction of the amount requested.[7] Unfortunately, the Commission adopted those positions and granted the Company an increase of just $33.6 million or slightly more than half of the amount requested,

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5 *Petition of PGW for Extraordinary Rate Relief Pursuant to 66 Pa. C.S. § 1307(e)*, R-00017034F0002, April 12, 2002 (hereinafter "*PGW Extraordinary Rate Order*") at 14.

6 *Pa. PUC v. PGW*, (R-00006042, October 4, 2001 (hereinafter "*PGW 2001Base Rate Order*") at 36-37.

7 *See e.g.*, Brief of OCA, R-00006042 at 27.

commenting that the authorized rate level "would allow PGW to satisfy its debt service coverage requirements."[8]

Just six months later however, in March 2002, PGW was faced with a massive financial crisis because Standard & Poor's had determined that PGW did not have sufficient fixed coverage levels or liquidity to satisfy the requirements for an investment grade company and indicated that it would downgrade the Company if the situation was not changed.[9] PGW was forced to file for an emergency rate request in which it proved that, if it were downgraded to a non-investment grade, it would lose its access to commercial paper program and essentially not be able to function as a going concern. After a highly expedited proceeding , the Commission granted PGW a $36 million emergency rate request in order to stave off "PGW's current and immediate liquidity crisis."[10]

While the Commission's emergency rate order avoided the disaster in 2002, there is no assurance that a similar future crisis would be avoided if the Company's rates similarly are set here merely to meet debt service coverage requirements without adequate allowance for cash working capital and liquidity or to reduce debt levels. But that is what the OCA/OTS recommendation would lead to. The only way to assure that history is not repeated is to recognize that PGW has shown beyond a shadow of a doubt that it needs the rate increase that it has requested. The OCA/OTS's steadfast refusal to admit that PGW has virtually any revenue

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8 *PGW 2001 Base Rate Order* at 43. Upon reconsideration, the Commission affirmed its ruling. In response to PGW's argument that the rate award did not provide sufficient liquidity the Commission accepted the arguments of the OCA and the OTS and concluded that the $33.8 million rate increase also produced sufficient working capital. *See* Order on Reconsideration at 31.

9 *PGW Extraordinary Rate Order* at 6-9.

10 *Id.* at 14.

requirement need if it can meet its debt service coverages has been proven wrong in the past. The PUC has an obligation to see beyond these positions and to take action which is in the best interest of customers and the Company and in the long term best interest of the Commonwealth. That evidence compels acceptance of PGW's position.

In addition to addressing these crucial revenue requirement issues, PGW will explain why the remaining expense adjustments offered by OTS and OCA should be rejected and why the OCA's call for a mechanism to adjust downward PGW's bad debt expense to account for incremental increases in Customer Responsibility Program ("CRP") participation must be rejected.

PGW will also respond to OCA/OTS opposition to the Company's proposal to benefit customers by retaining proceeds from off-system sales and capacity release credits to fund construction programs rather than simply reducing the Gas Cost Recovery ("GCR") – a proposal that would save ratepayers $1.50 for every $1 that PGW does not have to borrow.

The Reply Brief will also show that AA's call to deny PGW's rate increase because it is dissatisfied with PGW's universal service programs and certain customer service policies is not in accordance with law and unsupported by the evidence. This Reply Brief will also explain that the Commission should accept the agreement that has been reached between OCA and the Company regarding a mandatory EFT program but should reject OCA's demand to institute a mandatory budget billing program for delinquent customers.

With respect to cost of service, PGW will show that the Commission should accept PGW's cost of service study results and also allocate the authorized rate increase in accordance with its proposal. The OSBA and PICGUG's claim that a recent Commonwealth Court case requires a different allocation, or transportation rates set at cost, is without merit. The School

District's claims regarding PGW's application of its line extension policy and PHA's suggestion that its customers have been billed at the wrong rate in the past are also shown to be invalid. Finally, PGW shows that Hess's call for significant modifications to the supplier rules are unreasonable or inappropriate, as is IGS's call for a residential customer aggregation program.

Because PGW has conclusively proven that its proposed rate increase is necessary and justified, the Commission must approve it and finally put PGW on the page of becoming a fiscally secure and viable company for the benefit of its customers.

II. REVENUES

No revenue issues remain contested.

III. EXPENSES

A. Introduction

Only a small handful of adjustments to PGW's *pro forma* expenses remain contested.[11] Specifically, OCA and OTS object only to: (1) the management incentive plan; (2) lobbying expenses; and (3) regulatory fines and penalties. OTS also objects to: (1) the application of the bad debt expense; (2) marketing promotion expenses; (3) advertising expenses; and (4) injuries and damages reserve.[12] Because the record supports PGW's position on each of these expenses, the objections must be rejected.

1. Application of Stipulated Bad Debt Expense

PGW and OTS have agreed to utilize a 4.5% level for PGW's Bad Debt Expense[13] and OCA has accepted this figure.[14] Nonetheless, OTS discusses in some detail its testimonial

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11 PGW M.B. at 24.

12 OTS M.B. at 16-26.

13 PGW Hearing Exh. 5.

14 OCA M.B. at 43.

position regarding how bad debt expense should be calculated.[15] The Stipulation makes that entire discussion irrelevant.

The only remaining issue is the application of the agreed-to Bad Debt Expense: OTS argues that it should be applied only to "jurisdictional revenues,"[16] *i.e.*, PGW's total gas revenues rather than its total operating revenues. OTS's position is that "non-jurisdictional revenues are not subject to review by the Commission" and, therefore, "[i]t would be improper to make an allowance in jurisdictional rates for non-jurisdictional activities."[17] This reasoning, however, overlooks that PGW includes its non-jurisdictional and non-gas revenues in its total operating revenues (and does likewise for any associated expenses).[18] Thus, ratepayers benefit from these activities in the form of higher *pro forma* net income.[19] However, just as with all other forms of revenue shown on the income statement, the amounts listed are "billed" – not collected – amounts. Of course, PGW will not collect 100% of the total appliance repair revenues billed or all the finance charges it assesses. Therefore, applying a bad debt expense to the entire operating revenue base is necessary and appropriate to account for this under-collection. It makes no sense, and is decidedly inequitable, to include revenues that PGW will not receive in the *pro forma* net income figure. That is precisely what will happen, however, if the 4.5% Bad Debt Expense, as OTS argues, is not applied to PGW's total operating revenues

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15 OTS M.B. at 19-20.

16 OTS M.B. at 20-21.

17 OTS M.B. at 21.

18 *See*, PGW M.B. at 64-64; App. A, p. 1. As noted, these "non-jurisdictional revenues" are revenues from its appliance repair program and "Other Operating Revenues," chiefly finance charges. Finance charges are in fact "jurisdictional."

19 PGW M.B. at 64.

OTS relies on the Commission's previous rate order to support its position.[20] In that complex proceeding, which involved many different issues, the Commission focused on how bad debt expense should be calculated (which is not at issue here). It did not focus on the base to which the expense should be applied (which is the pending issue). Now, the Commission has the issue squarely before it. Basic ratemaking principles require that the bad debt expense be applied to total operating revenues since those revenues are included in PGW's *pro forma* income. Therefore, OTS's position on this issue must be rejected and the 4.5% Bad Debt Expense should be applied to PGW's total operating revenues.

2. Bad Debt Expense Tracker

An issue related to bad debt expense is OCA's recommendation that the Commission direct PGW to include in its quarterly reconciliation of CRP costs a "mechanism" to identify and adjust CRP credits to reflect any reduction that may occur in bad debt expense as a result of incremental increases in the number of CRP customers.[21] As more fully detailed in PGW's Main Brief, this proposal is neither necessary, reasonable, or practical and, in fact, is contrary to law.[22] Furthermore, OCA's recommendation contemplates adjustments only when CRP enrollment increases, not when the enrollment decreases.[23] Nor does it propose that PGW should receive

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20 OTS M.B. at 21. *See Pa. P.U.C. v. Philadelphia Gas Works*, Docket No. R-00006042 (Order on Reconsideration entered December 6, 2001) (hereinafter "*PGW 2001 Base Rate Order on Reconsideration*").

21 OCA M.B. at 84. The language of Section 1408 exempts "clauses associated with universal service," but obviously that is designed to assure that a universal service surcharge, such as PGW now has, would not be prohibited. OCA's proposal is to build a separate mechanism, either within existing USC or independently, to track changes in PGW's bad debt expense caused by a single item, the number of CRP customers; this is clearly prohibited.

22 PGW M.B. at 64-65.

23 OCA M.B. at 82-83.

more bad debt expense when PGW's natural gas revenues exceed the *pro forma* amount assumed in the test year. Clearly, if OCA's proposal has any merit, it must be balanced and, at a minimum, this one-sided recommendation must be rejected. In any event, § 1408 of the Public Utility Code prohibits any "automatic surcharge mechanism for uncollectible expenses."[24] That is exactly what OCA is proposing.[25] Thus, beyond being unreasonable, unnecessary and impractical, OCA's proposal is illegal.

3. Management Incentive Plan

PGW included $500,000 in its *pro forma* test year expenses to reflect the costs of an "at risk" incentive compensation program to provide performance-based annual increases to PGW's 55 top managers.[26] OTS properly recognizes that "[i]f retaining this management group will improve the operational capabilities of the utility, recognition of the expense may be warranted."[27] Yet, neither OCA nor OTS supports including these expenses, claiming that the plan was insufficiently documented.[28] As explained in PGW's Main Brief, the record showed that the program is an important part of PGW's efforts to retain its most valuable senior managers. Consumers will receive a direct benefit in the form of qualified, appropriately compensated managers who will be motivated to work to ensure that the company best serves its

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24 66 Pa. C.S. § 1408.

25 OCA M.B. at 84.

26 PGW M.B. at 59-60.

27 OTS at 19.

28 OCA M.B. at 37; OTS M.B. at 18.

"owner" and customers – who are one and the same.[29] Thus, OTS and OCA's objections on this point must be rejected. PGW must be permitted to recover the costs of the plan in its rates.

OCA further argues that the management plan should be rejected because the Philadelphia Gas Commission ("PGC") did not approve the expense for PGW's operating budget.[30] But PGC's approval is not necessary, as the OTS recognizes for inclusion in rates.[31] In terms of employee compensation expenses, the Commission can only reject the expenses if it finds that the program is not necessary to attract or retain qualified employees or is otherwise imprudent.[32] Since PGW has met the Commission's standards for allowing employee compensation plans for ratemaking purposes, OTS and OCA's objections must be rejected and PGW should be permitted to include its incentive compensation program in the *pro forma* test year expenses.

4. Advertising Expenses and Marketing Promotion Expenses

OTS continues to recommend that the total amount PGW submitted as *pro forma* expenses for advertising be reduced by $35,000. (Similarly, OTS also supports only $25,000 of the total $500,000 PGW included in *pro forma* expenses for its ongoing program to provide incentives to customers in order to assist them in converting to natural gas.[33]) OTS bases its

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29 PGW M.B. at 60-63.

30 OCA M.B. at 37-40.

31 OTS M.B. at 40.)"[T]he Commission is not required to accept the level expense approved by the Philadelphia Gas Commission because PGW has the burden of proving that all rates are just and reasonable before the Commission.")

32 PGW M.B. at 61.

33 PGW M.B. at 71; PGW St. 2R at 37-38; OTS M.B. at 22.

position on the assumption that PGW customers do not benefit from marketing activities.[34] OTS's assumption is wrong.

OTS ignores the overall benefits these incentive programs provide to PGW's customer base. As detailed in PGW's Main Brief, both expenses increase the base of customers over which fixed costs can be recovered.[35] Each program enables fuller utilization of PGW's facilities and distributes PGW's operating costs among more customers. Fuller utilization of PGW's facilities maximizes their operational potential and creates fuller realization of the investment in these facilities. This leads to a decrease in each customer's pro rata share of costs. Since both the advertising expenses and the marketing promotion expenses seek to increase utilization of PGW's systems and increased utilization benefits PGW's entire rate base, these two expenses must be permitted.

OTS also challenges the $500,000 for marketing incentives on the basis that the costs will not occur in the test year.[36] OTS is wrong. As the record clearly shows, PGW expects that it will incur expenses in the test year related to this expense, even though it may not provide incentives to the specifically identified customers.[37] Accordingly, OTS's challenge to the marketing incentive expenses should be rejected.

5. Injuries and Damages Reserve

PGW's *pro forma* expenses included an amount to cover anticipated payments resulting from certain class action lawsuits. This estimate included $725,000 for a particular pending class

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34 OTS M.B. at 25.

35 PGW M.B. at 68-69; 71-72.

36 OTS M.B. at 22.

37 OTS Exhibit No. 2SR, Schedule 1, p. 2 ("For customers A and C, the projects will take place in 2007").

action lawsuit.[38] Due to developments in that lawsuit, PGW revised its estimate to $3.8 million.[39]

OTS objects to the inclusion of these costs on the premise that they are speculative and, when they become definite, they should be amortized.[40] The pending lawsuit is a known and definite expense. Legal fees have already been spent and settlement amounts have been proposed. Therefore, OTS's claim that these are not known expenses should be rejected. However, PGW does agree that class action suit payouts do not necessarily occur annually so amortization of the $3.8 million over the five year planning period is appropriate.[41] The result of this amortization is $760,000 annually, which is very close to the $725,000 originally proposed. PGW is willing to accept the lower figure. Accordingly, no adjustment to this expense should be made by the Commission.

6. Lobbying Expenses

PGW's *pro forma* expenses include $100,000 for WolfBlock Government Relations, $130,000 for Mardi Enterprises, and $15,200 for dues and subscriptions.[42] Both OCA and OTS object to the inclusion of the $100,000 for WolfBlock Government Relations. OTS objects to the other two items as well.[43] The basis for these objections is that they constitute lobbying and cannot be included.

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38 PGW St. 2R at 36.

39 PGW M.B. at 70-71.

40 OTS M.B. at 24.

41 PGW M.B. at 71.

42 PGW M.B. at 66.

43 OCA M.B. at 40-42; OTS M.B. at 22-24.

Regarding the Mardi Enterprises contract, PGW presented unchallenged testimony that only 25% of this contract, or approximately $30,000, could be characterized as "lobbying."[44] Since the rest of the contract, or approximately $100,000, does not constitute lobbying, this portion cannot be eliminated based on the "lobbying expenses" objections raised by OTS and OCA. Aside from this, no further adjustment is necessary regarding the Mardi Enterprises contract.

Regarding the two other expense items, PGW recognizes the Commission's traditional view that lobbying expenses such as these should not be included in *pro forma* expenses. However, as explained in PGW's Main Brief, the Commission should exercise its discretion pursuant to § 2212(c) of the Code and grant PGW a waiver of this prohibition.[45] OTS's opinion that it is "imprudent for the Company to continue with these activities"[46] and OCA's characterization that "lobbying expenses do not have a direct ratepayer benefit"[47] ignore the fact that PGW is "owned" by the citizens of Philadelphia, who are also the ratepayers. Any benefit to PGW necessarily flows to the ratepayers.[48]

The record readily supports this assertion. As explained by Cristina Coltro, one example is PGW's diligent efforts to obtain monies to supplement LIHEAP grants in an effort to assist eligible customers in paying any balances beyond the grant the customer receives. During this past heating season, PGW worked with the City of Philadelphia and the Commonwealth to

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44 PGW M.B. at 66-67.

45 PGW M.B. at 67-68.

46 OTS M.B. at 24.

47 OCA M.B. at 42.

48 PGW M.B. at 67.

establish additional grants for low income customers. As a direct result of PGW's activities, an additional $345,000 in supplemental assistance was made available for low-income customers.[49] Efforts such as these, which clearly benefit PGW's ratepayers, are possible in part because of PGW's lobbying activities. To suggest that these activities are "imprudent" is inappropriately dismissive of the significant benefits PGW has been able to obtain for its customers. The Commission has clear statutory authority to exercise discretion and to recognize that customers directly benefit from these lobbying activities and expenses. It should exercise that discretion here to allow PGW to include all lobbying activities in its *pro forma* expenses.

7. Regulatory Fines and Penalties

PGW budgeted a small amount ($50,000) for fines and penalties that may be assessed against it in the test year.[50] Both OTS and OCA oppose inclusion of this expense.[51] While PGW recognizes that the Commission's general policy is to exclude such costs, similar to its request regarding lobbying expenses, PGW respectfully submits that its status as a municipal utility justifies an exception pursuant to § 2212(c) of the Code.[52]

As explained more thoroughly in PGW's Main Brief, denial of an expense that PGW is required to pay will reduce PGW's available cash working capital and debt service coverage levels. As a consequence, PGW will either need to request a future rate increase or borrow additional long-term debt.[53] OTS's bold statement that PGW's inclusion of these expenses

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49 PGW St. 7R at 11; Tr. at 955.

50 PGW M.B. at 69.

51 OTS M.B. at 26; OCA M.B. at 43-44.

52 PGW M.B. at 69-70.

53 PGW M.B. at 70.

expresses "an intention to violate accepted standards and practices" is inaccurate and unwarranted.[54] PGW has no intent to incur fines and has every incentive not to do so, but circumstances do arise in which errors may be made and fines ultimately imposed. To assert otherwise is to ignore reality in a complex system. It is similar to claiming that a homeowner should not be permitted to purchase fire insurance because that person should have the incentive to be diligent in avoiding a fire. The reality in both situations is that there are circumstances beyond the control of either PGW or the homeowner. Moreover, in certain cases, PGW may choose to financially settle claims, instead of expending financial resources to challenge allegations of statutory or regulatory violations. Because applying the normal policy applicable to public utilities for this item does not benefit the rate payers of PGW, PGW requests that the Commission exercise its authority pursuant to § 2212(c) to allow PGW to include regulatory fines and penalties in its *pro forma* expenses.

8. OTS's Summary Schedules Use Outdated Data And Are not Usable.

A final issue that must be raised is the summary schedules submitted by OTS. Without any explanation, OTS's summary schedules do not use as their starting PGW's revised *pro forma* test year claim that were submitted in PGW Exh. 13A and 13B and instead use the data submitted in an outdated interrogatory as the starting point.[55] By doing so, OTS has arbitrarily denied PGW recovery of various expense and revenue adjustments that were fully explained and detailed in the testimony including the substantial additional costs that PGW will incur as a result

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[54] OTS M.B. at 26.

[55] OTS M.B. App. D.

of its new bond issuance.[56] OTS's inexplicable refusal to accept PGW's adjusted test year *pro forma* financial schedules should be rejected.

IV. DEBT SERVICE COVERAGE, CASH WORKING CAPITAL/LIQUIDITY, AND CAPITAL STRUCTURE

A. The OTS Misapplies the Applicable Ratemaking Standard By Focusing Too Narrowly on PGW's Debt Service Coverages.

As anticipated by the Company in its Main Brief, the OTS and the OCA misapplies the Cash Flow Method by focusing too narrowly on merely satisfying PGW's minimum debt service coverages.[57] As fully explained in PGW's Main Brief and below, this approach is flawed and wholly at odds with both the express language of the Management Agreement Ordinance and the Philadelphia Gas Commission's application of that Ordinance as the Company's prior ratemaking methodology.[58]

OTS appears to acknowledge the fact and legal requirement (under both the Management Agreement Ordinance and Section 2212(e) of the Code) that PGW's "revenues must be sufficient to cover all cash needs, including debt obligations and a reasonable level of working capital, that become due in the test period."[59] However, the OTS's analysis of the evidence in this matter. the Company's revenue needs supporting its proposed rate increase, and the OTS/OCA recommendation of a mere $22.5-$25 million in rate relief completely betray the acknowledgement and focus exclusively on satisfying PGW's minimum debt service coverages. To wit, in declaring its opposition to the Company's request, the OTS explains: "The OTS

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56 PGW St. 2R at 39-41.

57 OTS M.B. at 28-34; OCA M.B. at 15.

58 PGW M.B. at 19-20.

59 OTS M.B. at 28.

position is based on the undisputed fact that the Company is able to meet its debt service coverage during the future test year. Under the cash flow methodology, PGW must satisfy its debt service coverages . . . ."[60]

This overly restrictive position has absolutely no legal support. To be sure, both the Cash Flow Method and Section 2212(e), separate and apart from its mandated use of that method, demand that the Commission set rates for PGW at levels sufficient to ensure that PGW has the revenues necessary to satisfy (all of) its bond covenants, including its debt service coverages. However, the mandate that the Commission ensure revenues to produce reasonable amounts of cash and to enable the Company to pay down its debt is equally grounded in Section 2212(e) and its adoption of the Cash Flow Method.

The plain language of the Management Agreement states that PGW's regulator "**shall** fix and regulate rates and charges for supplying gas to customers . . . which . . . will, in each fiscal year produce revenues, at a minimum" sufficient to cover various costs, including debt service requirements, and "**sufficient also**":

> (ii) To provide appropriations, to the extent not otherwise provided for prepayment of debt and for capital additions . . .; and
>
> (iii) *To provide cash, or equivalent, for working capital* in such reasonable amounts *as may be determined by the Company to be necessary* and as shall be approved by the Gas Commission.[61]

Bolstering these plain requirements of the Cash Flow Method that far exceed merely setting rates to allow for debt service coverages, are the decisions of the Gas Commission itself which, as

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60 OTS M.B. at 30. The OTS also proclaimed that PGW's unreasonable level of debt also was an issue that could not be addressed under the Cash Flow Method. *Id.*, at 37.

61 PGW M.B. at Appendix D (Management Agreement at § VII(1)) (emphasis added).

detailed in PGW's Main Brief, rejected similar attempts to set the Company's rates by focusing solely on debt service requirements.[62]

Again, PGW is not contesting that its rates must be set at just and reasonable levels. Ultimately, though, in accordance with both *Public Advocate* and the Company's prior ratemaking method, this requirement simply means that the level of the individual revenue and expense claims making up PGW's rate proposal must be determined to be just and reasonable within a "broad zone of reasonableness."[63]

B. The OTS and the OCA Are Incorrect in Their Claim that PGW's Revenue Requirement is Based on Evidence Outside the Test Year.

The OCA and OTS continue to insist that PGW is perfectly healthy according to the test year financial results[64] and that its demand for rate relief is based on the position that the

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62 *See* PGW M.B. at 19-20 and Appendix E thereto. The OCA also notes that, as part of PGW's prior ratemaking method, its rates were required to be just and reasonable, and then proceeds to invoke the "exacting" "constitutional requirements" recognized by the Pennsylvania Supreme Court in *Pub. Advocate v. Philadelphia Gas Comm'n*, 674 A.2d 1056 (Pa. 1996). (OCA M.B. at 9-10.) This discussion takes place in conjunction with the OCA's framing of the Company's burden of proof in this matter. (*Id.* at 7-10.)

While PGW acknowledged in its Main Brief that its rates must be just and reasonable, (PGW M.B. at 18) the OCA's invocation of *Public Advocate* and its discussion of an exacting constitutional just and reasonable requirements is overbroad and imprecise. The Supreme Court in *Public Advocate* was discussing the well-known constitutional review standard that "the total effect" of a rate order cannot be "unjust and unreasonable in its consequences." (674 A.2d at 1061-62 (citing *Fed. Power Comm'n Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944)). It is that appellate review standard that is exacting and that "he who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is . . . unjust and unreasonable." (*Id.*)

63 *Id.* at 1062 ("Any rate selected which falls within the broad zone of reasonableness cannot properly be attacked as unconstitutional . . ."); PGW M.B. at Appendix E (*Philadelphia Gas Com'n*, Opinion and Order (September 3, 1982) at 8).

64 For example, both suggest that the Company's ability recently to issue some $200 million in long term debt is an indication of PGW's financial health (See, e.g. OTS M.B. at 35). Yet, PGW's financial expert documented that PGW was only able to issue these bonds because it paid a premium amount to obtain bond insurance, in effect, to improve its

Commission must "look well beyond" or to "abandon" the test year concept in favor of setting rates based on a five year forecast and that this is the only basis on which PGW can show a revenue requirement need.[65] This is patently untrue. In fact, PGW is suggesting that the Commission use the five year forecast to supplement, not to replace the test year.[66] Moreover, these parties seem not to understand, that as a Cash Flow Method regulated company, PGW's year-to-year revenue requirement is interrelated;[67] therefore, it is important both from the standpoint of the Company and its customers to understand the financial effects of a particular level of a rate increase on the Company over a period of time – rather than just one year. PGW's five year forecasts are a dependable and reasonable way of doing that.[68] Additionally, some

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rating to AAA. Moreover, the expert report that accompanied the bonds and which evaluated the risks of purchasing them for potential bondholders specifically assumed that PGW would be successful in this rate proceeding. Tr. 740-42. Similarly, while one rating agency recently upgraded PGW by one-half (from BBB- to BBB), PGW's chief financial officer explained that this was a technical correction on PGW's less important 1975 bond. Tr. 575.

The OCA also suggests that another indication of positive financial health for PGW is that it was able to retire some $36.7 million in long term debt in the test year (OCA M.B, at 26, n.3). Unfortunately, OCA neglected to mention that the Company is required to pay off the remaining principal on these bonds or default on those obligations. PGW M.B. at 21. Using this fact as an indication of financial health is like suggesting that a patient with coronary artery disease is just fine because his heart continues to pump – for the moment.

65 OCA M.B. at 19; OTS M.B. at 29.

66 Tr. at 576; Tr. at 609-11.

67 PGW M.B. at 27.

68 The OCA has incorrectly reported in their testimony and main brief (OCA M.B. at 21-22) that PGW used a 93% collection factor for its five year projection (i.e. FY 2008 to FY 2012). The only time PGW provided five year projection data to the parties that used a 93% collection factor was in its initial filing which provided the related Philadelphia Gas Commission filing. All other five year projections provided during this proceeding, including the five year projections provided in Appendix A of PGW's main brief, use a 95% collection factor. This is easily confirmed by performing a simple calculation using

problems can only be evaluated over a series of years. For example, the over reliance on debt in the Company's capital structure can only be changed by it achieving a necessary level of earnings over a series of years. Clearly, it is reasonable to evaluate progress towards achieving this goal by examining the Company's financial results over that same period.

Even if one were to characterize the Company's position as looking beyond the test year, at least to measure the effects of its proposal (but not to actually set the revenue requirement) there is no legal prohibition against that. None of the parties cited a legal requirement that rates must be based solely on a test year or a future test year. In fact, as PGW has indicated, it is well established that the Commission may make adjustments to a future test year in order to take account of "known and definite changes."[69] Importantly, there is no legal prescription or other hard and fast rule that requires that the known and definite change occur within a certain period of time after the end of the test year.[70] The future test year itself is filled with projections , that are then carried through into the five-year forecast. Moreover, both the OCA and the OTS have acknowledged the payback of the City loan as a "known and definite" change even though it is going to occur a full year after the end of the test year cover at the end of FY 2008.[71] Why is the projection of a revenue requirement for September 2007, or for the end of FY 2008 acceptable but the projection of a revenue requirement to reduce the debt percentage in FY 2008 or FY 2009 unacceptable? Recognizing the level of revenue requirements that is necessary to bring PGW's

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the income statement data provided in Appendix A of PGW's main brief. Of course, PGW is not proposing to set its revenue requirement using its five year forecast – only to project the results of any authorized increase.

69 PGW M.B. at 25-26.

70 *Id.*

71 *See, e.g.*, OCA M.B. at 17.

level of debt in its capital structure down to more reasonable levels is just as "known and definite." PGW's forecasting process is well-established and reviewed.[72] Indeed, this portion of the Company's projection does not have any of the concerns that were raised by OCA with respect to projections such as the use of inflation factors and the like. PGW's annual construction budget is fairly stable and well known. For years, the Company has had to fund all of its construction through external funds.[73] Thus, PGW's projections of its future funding sources should be reliable. Moreover, PGW proposed to have rates reviewed if and when it met what it considered to be the appropriate level. That target level could be changed, if the Commission saw fit, in order to provide more oversight and greater control over the forecasts.

Importantly, as PGW witness Hershey aptly stated, unless the Commission is willing to consider the effect over time that rate increases will have on certain issues, such as the level of debt in its capital structure, PGW's crushing debt burden may never be effectively addressed.[74] Mr. Hershey explained:

> [t]raditionally courts and regulatory agencies will interpret existing precedent in a manner that permits resolution in a problem that might otherwise escape review and resolution. However, if certain regulatory practices and principles that were designed for investor-owned utilities don't fit the case for cash flow companies, that fact must be acknowledged and an appropriate solution found to solve the problem.[75]

C. PGW's Revenue Requirement Claim is Not Based Upon a "Goal" of Achieving a Balanced Capital Structure.

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72 *Id.* at 26.

73 *See*, PGW M.B. at 12, 26.

74 PGW St. 1R at 9.

75 *Id.*

Both the OCA and the OTS insist that PGW's base rate request is solely based on a goal or a "plan" or a "desire" to reduce the amount of debt in its capital structure to achieve a 50/50 debt-to-equity ratio by 2012.[76] This is simply not true.

First, the claim that the Company's base rate request is entirely focused on producing the amount of debt in its capital structure is demonstrably incorrect. PGW showed in its Main Brief that it needs at least a $100 million rate increase in order to produce sufficient cash working capital and liquidity in the test year to meet reasonable standards, and to reduce the level of debt in its test year capital structure, as fully supported in the record.[77] Moreover, PGW also showed that while the Company's minimum debt service coverage requirements are projected to be met in the test year, the Company will very quickly fail to meet them – as soon as FY 2008 – if it receives no rate increase in this proceeding.[78] A $25 million rate increase (as proposed by both parties) would result in PGW being in danger of not meeting its minimum debt service requirements by FY 2009-2010.[79] Thus, PGW's projections clearly show that debt service coverage will become a problem virtually as soon as this case is completed, certainly justifying immediate action by the Commission now in order to avoid the serious consequences that will inure if this most minimal of standards is not met.[80] To be sure, an increase designed to provide adequate working capital or to assure adequate coverages in the planning period will adequately address PGW's debt-to-equity ratio imbalance – and vice versa. But, the opposing parties'

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76 OCA M.B. at 19; OTS M.B. at 34.

77 PGW M.B. at 25, 39-43.

78 *Id.* at 38.

79 PGW M.B. at 48-49, App. C, p. 1.

80 *Id.*

attempts to suggest that PGW's entire revenue requirement was solely to address PGW's unbalanced capital structure just does not hold up under careful scrutiny.

D. OTS and OCA Are Incorrect in Their Claims that PGW's Cash Working Capital and Liquidity Would Be Sufficient If PGW Received a $25 Million Rate Increase.

The OCA and the OTS continue to insist that PGW will have sufficient cash working capital and liquidity in the test year with a $25 million rate increase, but both parties completely ignore the evidence demonstrating irrefutably that just the opposite is true.

The OCA actually insists that PGW's analyses of the cash working capital and liquidity effect of a $25 million rate increase (which is actually $2.5 million more than the OCA is even willing to recommend) shows that PGW has sufficient cash working capital because it will "only" be utilizing $95 million out of its $150 million available commercial paper balance at year end and will have cash balance of $50 million.[81] Then after previously excoriating PGW for considering data in its five-year planning period, it suggests that the Company's claims should be rejected because with a $25 million rate increase, its projected liquidity will get better in FY 2008 and 2009.[82]

Astoundingly, OCA never mentions that the available cash shown in the test year is actually completely borrowed and that if PGW paid off its borrowers (the owners of its commercial paper as well as the City Loan) it would have a huge negative balance of $57.7 million, *i.e.*, negative cash from rates.[83] This is crucially important for at least two reasons.

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81 OCA M.B. at 30-31.

82 *Id.* OCA fails to mention that after improving slightly for a few years ($120.3 million in FY 2009-10) projected liquidity plunges to less than $76 million in FY 2012, compared to the test year projected level of $137.5 million. As discussed below, all of these levels are inadequate. *See*, PGW M.B. App. C, p. 2.

83 PGW M.B. at 49-50.

First, because PGW was only able to achieve any year end cash by using its only other legitimate source of liquidity – its commercial paper program – its overall liquidity is dangerously low. Obviously, when one source of liquidity goes up (cash) the other – available short-term borrowing ability – goes down. PGW has no other source of funds. The question, therefore, is not whether PGW has any cash working capital or liquidity but whether it has sufficient and reasonable levels. Incredibly, OCA never indicates what level would be sufficient or reasonable[84] Its position is akin to insisting that an investor owned utility's return on shareholder equity is sufficient merely because it is earning 1% or 2%, even when the utility's cost of equity is shown to be 10%. Second, because its ability to handle day-to-day operations is completely dependent on borrowed funds it is constantly at risk if the banks that support the commercial paper program elected to end the relationship.[85] The obvious conclusion is that PGW is in desperate need of non-borrowed cash from rates in addition to the liquidity from its commercial paper program.

However, the only measures of reasonableness or adequacy presented on the record demonstrated that PGW's projected test year levels of cash working capital and liquidity (which OCA appeared to agree is comprised of cash and its available commercial paper)[86] are woefully inadequate, even with a $25 million rate increase. PGW presented evidence that the minimum liquidity standard for municipal utilities is at least 200 days of cash operating expenses (and, for

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84 The OCA does comment that PGW hasn't achieved a $50 million cash balance since 1993. OCA M.B. at 23. But that only shows that PGW's liquidity deficiency has existed for several years. Unfortunately, the risk of serious crisis as a result of this deficiency is much greater today because of the significant increase in natural gas prices. *See*, PGW St. 2 at 7.

85 PGW St. 1R at 3.

86 *See*, OCA M.B. at 31.

the municipal utilities for which data was available, the amount was far greater);[87] yet a $25 million rate increase would give the Company just a fraction of that level of liquidity. Using the updated Exhibit JRB-8 (Appendix C to PGW's Main Brief) which reflects a $25 million rate increase and the level of bad debt expense agreed to by the OCA/OTS and PGW,[88] PGW's available liquidity at the end of the test year is projected to be just **58.5 days**.[89] While the levels get slightly better in FY 2008 and 2009, PGW is projected to finish the planning period (FY 2012) with just 34.8 days of liquidity or less than one-fifth of the minimally acceptable amount.[90]

But both OCA and OTS suggest that the 200 days of cash operating expense standard is not applicable and that a more standard method of calculating cash working capital is the "1/8th (or 45 days) method."[91] However, even using these parties' own referenced method, the OCA/OTS recommendation is just as inadequate. The 1/8th method provides for a cash allowance equating to 45 days (or 12.5%) of total operating expenses – not cash plus other sources of borrowing.[92] Employing the method correctly, PGW would need a rate increase of

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87 *See*, PGW M.B. at 44.

88 *See*, OCA M.B. at 49.

89 *See*, App. C, p. 2. Available liquidity: $50.3 million cash + $85 million of available commercial paper and $2 million City Loan (which must be paid off at the end of FY 2008) = $137.3 million, divided by $2,349 per day total cash operating expenses (cash operating expenses of $852.3 million [total operating expenses less depreciation expense] divided by 365) = 58.5 days.

90 Total liquidity: $76 million ($50 million cash + $26 million short term borrowing capability) divided by $2,187 per day cash O&M expenses.

91 OCA St. 1R at 10; OTS M.B. at 43. OTS raised this comparison but then, without explanation, stated that it was "inappropriate for a cash flow company." *Id.* Since PGW is not a typical cash flow company and since the OTS never gave a reason for rejecting this comparative, the Commission can feel comfortable considering the results for PGW.

92 *See, e.g.*, PGW M.B. at 45. Importantly, the 1/8th or 45 day method establishes an appropriate level of cash – not cash and other borrowing capability – that a utility needs.

over $230 million to end up with $110 of non-borrowed cash at year end (12.5% of test year operating expenses).[93] Even if one were to include PGW's projected $50.3 million year-end cash balance, which is all borrowed, this amount represents just 20.5 days of total operating expenses rather than the required 45 days. As noted in PGW's Main Brief, even counting PGW's $50 million of borrowed year-end cash, the Company would need a rate increase of **$85 million** to have 45 days of year end cash from any source.[94]

The OTS attempted to show that its recommended rate level is adequate first by suggesting that PGW cash and liquidity problems are "outside the test year," and that the Company's five year projections have changed during the case and are thus unreliable.[95] But the Company's acute cash working capital and liquidity needs are clearly reflected in the test year, while they are projected to become much worse if the OTS's recommendation is adopted. Moreover, in all instances, the changes in PGW's projections were accompanied by explanations that clearly set out the basis for the changes, and in all projections, the results were not materially different.[96]

The OTS's primary defense to the claims that its recommendation is inadequate is that PGW's definition of liquidity is "inappropriately narrow" and points out that PGW itself recognized four sources of cash flow it has used in the past: its commercial paper program; its

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PGW could not find a single case in which a cash working capital allowance computed using the 1/8th method was reduced to reflect the availability of other short term borrowing that could take the place of cash to meet the utility's working capital needs.

93 PGW M.B. at 45; App. A, p. 1.

94 PGW M.B. at 52.

95 OTS M.B. at 38-40.

96 PGW St. 2R at 39-41.

$45 million City Loan; borrowing from bond-funded capital accounts and gas-deferral contracts.[97] First OTS's attempted defense actually impliedly recognizes one of the crucial defects in PGW's current financial status – none of those four sources of liquidity includes cash, and each represents borrowed funds. Moreover, PGW has shown that each of these sources of liquidity other than its commercial paper program and the City Loan (which will no longer be available) are insufficient, risky, costly or all three.[98] Moreover, the Management Agreement which mandates the elements that must be included in rates under the Cash Flow Method, plainly requires an allowance for "cash, or equivalent . . . ."[99] As noted, PGW has none in rates currently.

Incredibly, OTS refuses to accept this, claiming that the term "cash or equivalents" not only includes cash but also things like "gas inventories" and the Company's commercial paper program,[100] even though, under cross-examination, OTS's own witness agreed that the term "cash or equivalent" referenced cash or things that were the equivalent of cash, such as money market holdings or some other company's commercial paper.[101] The OTS witness admitted that this phrase does not include gas inventories or a bond fund and certainly does not include the Company's commercial paper program (which is a liability – not an asset).[102]

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97 OTS M.B. at 40-41.

98 PGW M.B. at 51.

99 PGW M.B. at 19; App. D, § VII(1)(b)(iii).

100 OTS M.B. at 41.

101 PGW Cross Exam Exh. 5; Tr. 918-920.

102 *Id.*, (Plonski's definition of cash equivalent is "items on the balance sheet that report the value of asset that can be covered into cash immediately") *i.e.*, "money market holdings, short-term government bond, commercial paper." Mr. Plonski admitted that his reference to commercial paper was to commercial paper issued by some other entity and purchased

Thus, whether or not PGW has other acceptable sources of liquidity (which, as will be explained, it does not), it nonetheless has a legal right to have included in rates an amount for "cash or equivalent" to provide for working capital. Using the OTS's own definition of "cash or equivalent" in the record, the OTS's recommendation clearly does not satisfy this basic requirement.

The OTS tried to rehabilitate its witness' failure to make adequate provision for cash working capital in his recommendation, or even to conduct any type of cash flow study to determine the necessary and reasonable level for PGW by suggesting that, even though its witness had not measured it, the OTS was still sure that PGW had sufficient "working capital." PGW, OTS insisted, could obtain additional capital by taking such steps as selling gas inventories or accounts receivables, engaging in gas deferral arrangements or "using unspent proceeds of bonds or capital projects," and claimed that the rating agencies recognized some of these as legitimate "liquidity tools."[103] It also claimed that if all "liquid assets" on its balance sheet were counted, PGW would "likely" produce more than 200 days of liquidity.[104] But this is simply not consistent with the record evidence. In fact, the unrebutted testimony was that:

- The Company had already accounted for all valid sources of cash flow and most of the "liquid assets" referenced by OTS such as short term investments

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by PGW as an investment, not the issuance of commercial paper by PGW. Tr. 920. Mr. Plonski's definition of working capital excludes PGW's commercial paper because every dollar of cash produced (short term asset) is offset by a dollar of liability – resulting in no additional working capital. Tr. 919.

103 OTS M.B. at 41. The OTS proclaims that PGW's witness, Mr. Bogdonavage, agreed that these items were sources of working capital (OTS M.B. at 41) but did not mention that Mr. Bogdonavage also testified that relying on such assets to provide liquidity would not necessarily be prudent (Tr. at 585).

104 OTS M.B. at 43.

in its cash flow analysis – which showed that PGW was woefully short of necessary cash flow compared to any reasonable indices.[105]

- As stated above, its own commercial paper program is not a source of "working capital" even under Mr. Plonski's methodology since this "liquid asset" is offset by a corresponding liability.[106]

- PGW could only directly "sell" the portion of its accounts receivables that were deemed not collectible (because the collectable portion is already pledged for its bonds) and the last time it sold the uncollectible accounts it received less than one cent on the dollar.[107]

- The notion that PGW would obtain working capital in an emergency by selling off gas supplies that it had purchased to serve customers is impractical at best (the Company would only have to turn around a repurchase the gas) and imprudent at worst, as it would threaten PGW's ability to provide safe adequate and reasonable service.[108] Moreover, under Mr. Plonski's "balance sheet" approach, only the difference between the value of its gas assets and its bill for the gas (a current liability) would be a net asset and would produce any working capital (since the Company obviously would have to pay its suppliers for the gas) even under the OTS definition. Mr. Plonski never even showed that there was such a balance for gas inventories or for anything else.[109]

- Gas deferral transactions where the Company arranges with a gas supplier to defer payment on needed gas supplies until the spring or summer is enormously expensive (equating to a "taxable loan"), available no more than once each season and requires in any event a counter party willing to take the risk that PGW will be able to pay the gas supply cost deferred back.[110] Moreover, when the Company has had no choice but to engage in such a transaction in the past, it produced relatively little cash working capital, and, as the name implies, merely deferred the obligation to a later period.[111]

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105 Tr. at 532.

106 Tr. at 918-20.

107 Tr. at 534-36.

108 Tr. at 534-40.

109 *See, Pa. Pub. Util. Comm'n v. Bell Tel. Co. of Pa.*, 1983 Pa. PUC LEXIS 1 (1983); *Pa. Pub. Util. Comm'n v. Philadelphia Elec. Co.*, 1981 Pa. PUC LEXIS 73 (1981).

110 Tr. 748-50; Tr. at 608-09.

111 *Id.*

– Permanently appropriating the unspent proceeds from long term debt for other purposes violates PGW's bond ordinances.[112] Such proceeds may only ultimately be used only to pay for construction. While the proceeds may be used on a short-term basis during the year, to pay for other activities such proceeds must either be used for construction or paid back by year's end, or PGW will suffer severe penalties.[113] In any event, the ability to borrow from the bond fund requires that there be bond proceeds, which requires the continual issuance of long-term debt – which most seem to understand is the path to disaster for PGW.

Probably just as important, these sources of working capital are not only extremely costly, risky and impractical, they are also precisely the types of last-resort, "one-time fixes" and bailouts that are symbolic of a company on the brink of disaster. Ms. Bisgaier explained:

> Q. Is there any cumulative effect of the use of all these factors that the investing community or the rating agencies realize?
>
> A. The cumulative of all of these is a presentation to the financial market that says, PGW does a whole series of moves, if you will, transactions, the deferral, the borrowing from capital, to get through the year.
>
> If you look at PGW's bonds, it's a highly leverage company. If you add to that the fact that it's borrowing for operating expenses all year long, it has no internally generated funds. I would analogize the bonds to a home mortgage that you're paying, and, then you're borrowing to pay for food and transportation, and not producing enough revenue to simply cover your costs.
>
> Q. What's the effect of all that on the view of PGW in the financial community?
>
> A. Well, the financial community feels that PGW lurches from crisis to crisis and they're always at risk that the lack of real cash working capital generated from rates is going to put them in a position where a crisis might hit and they would have no more opportunity to use one of these techniques, and really it could put PGW in a position of not being a viable financial [entity].
>
> Q. Does the increased risk cause costs today?

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112 Tr. at 539-40, Tr. at 750-51.

113 *Id.*

A. Yes, it does. I mean, PGW pays top dollar for all of these borrowings that it does. Even when it sells its bonds, the fact that the bonds are Triple A should insure investors that they're going to get paid.

Because of PGW's underlying credit rating, many investors can't even buy it with bond insurance, and that translates into higher interest rates on PGW's bonds.[114]

The OTS never submitted any testimony to refute Ms. Bisgaier's expert assessment. It merely pointed to a Standard & Poor's Report ("S&P") that referenced the Company's past use of these "techniques," claiming that this reference was an indication that S&P endorsed this approach and concluded that PGW had adequate liquidity.[115] In fact, their reference was in the context of describing PGW's liquidity as marginal and referenced the use of these techniques as an indication of this marginal status. For example, the S&P Report maintained PGW's BBB- rating (the lowest investment grade level) and a negative outlook. The discussion of liquidity concluded that:

> PGW exhibits nominal financial flexibility despite the City's recent decision to rebate the utility's $18 million annual transfer payments. As noted, the $100 million CP program has been fully tapped and PGW as exhausted all sources of liquidity other than unspent bond proceeds for capital projects.[116]

The conclusion by S&P's at that time was:

> The negative outlook on Standard & Poor's underlying rating (SPUR) on PGW reflects the presence of several challenges that have the potential to erode the utility's credit quality. Despite the benefits of stronger collection enforcement tools, the utility needs to demonstrate an ability to sustain recent improvements in collection rates in the face of higher commodity costs and the system's customers' weak demographic profile. Furthermore, additional debt needed to support a sizable capital program will

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114 Tr. 751-752.

115 OTS M.B. at 41.

116 PGW Exh. BB-2 (emphasis added).

> likely pressure rates and possibly also collections and financial margins. Higher ratings are not likely in the absence of improved and sustained collection rates and financial margins.[117]

If PGW's gas deferrals, the potential sale of accounts receivable, or the temporary use of bond proceeds provide the trove of acceptable working capital that OTS suggests, why has S&P's not upgraded the Company and taken it off negative outlook? These facts clearly support Ms. Bisgaier's testimony and conclusions. Thus, there is no credible evidence that PGW can or should be forced to rely on sources other than cash from rates and its commercial paper program to satisfy its short term liquidity needs. As PGW showed, at present rates, its liquidity levels are alarmingly low – less than 40 days[118] – and would be wholly inadequate (less than 60 days) even with a $25 million rate hike.[119] All of its other sources are simply additional, more marginal and more risky forms of borrowing which may or may not be available.

As noted, evidence presented by PGW showed that a minimally acceptable level of needed liquidity (cash and short term borrowing) is 200 days. In addition to the expert opinion of PGW's financial advisor, a compilation of "days of liquidity" for water and mixed service municipalities was presented showing that most companies have far more liquidity than 200 days, and certainly far more than PGW.[120] The OTS set about trying to discredit PGW's 200 days of liquidity standard by suggesting that the data submitted by Ms. Bisgaier was not reliable and did not contain enough gas companies.[121] But the OTS never explained why the data from

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117 *Id.*

118 PGW M.B. at 42.

119 *See*, PGW M.B., App. C, pp. 1-2.

120 PGW Exh. BB-3, 4; PGW Hearing Exh. 5.

121 OTS M.B. at 42.

these companies, and particularly from mixed services companies, were somehow not a useful basis for comparison. It simply used this distinction as an excuse to reject the findings.[122] Moreover, the fact that liquidity was not precisely defined in the analysis is not a valid criticism because PGW's level of liquidity is so small compared to the levels reported in these studies that there is no danger that some modification in the definition would show that PGW has more than the average listed there. Indeed, PGW's witness did testify that the results were in fact comparable as supporting data[123] but that her conclusion was not based on this compilation but on her extensive experience as a financial advisor to municipal utilities.[124] Attacking Ms. Bisgaier's supportive study does not discredit her unrebutted testimony that the minimum reasonable level of liquidity necessary for a municipal utility such as PGW is 200 days.

While the Company has the ultimate burden of proof in the proceeding – which does not change – the burden of going forward with evidence can shift, and in this instance it did shift to OTS and OCA to show that Ms. Bisgaier's expert testimony was incorrect once PGW established its *prima facie* case.[125] Merely claiming that the evidence "is not credible" is not a valid response.[126] PGW's entire rate increase is needed to provide it with a reasonable level of

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122 As noted, the average days of liquidity for the companies with an energy component was 691 days (PGW Exh. BB-4) and 653 days for mixed service companies that also provide natural gas service. PGW Exh. BB-4A.

123 Tr. at 771.

124 *Id.*

125 *See, e.g., Kupstas v. Pa Gas & Water*, F-9136863, 1992 Pa. PUC LEXIS 108 (1992).

126 Again, the only substantive response offered by either party was to claim that the accepted regulatory standard was "45 days;" but, both the OTS and the OCA – whether intentionally or inadvertently – failed to note that the 45 day standard is always a cash standard and does not include items like available short term borrowing, "gas inventories" or accounts receivables. As described above, PGW would need a rate increase of $85 million in order to meet this 45 cash working capital day standard.

cash working capital from rates. Even counting its existing, borrowed, level of cash, the Company would need an $85 million rate increase to satisfy a typical "45 day or 1/8 method cash working capital calculation.

E. The OCA/OTS Recommendation Is Inadequate Because It Would Do Nothing to Reduce the Level of Debt in PGW's Capital Structure.

The OCA and the OTS take different approaches but come to the same conclusion regarding PGW's overwhelming debt burden: nothing should be done to address the issue. While OCA seemed to agree that PGW's 83% debt level is too high and should be reduced, the OTS refused to see the problem, claiming that the Cash Flow Method does not consider a utility's capital structure.[127] Since the Company can pay its debt service and make its coverages in the test year, therefore, in its view, PGW's level of debt is not an issue! Both claim that PGW's proposed increase which would have the effect of giving PGW internal funds to finance construction and pay off existing debt, is also an out-of-test-year issue which cannot be accurately projected and, thus, should not be considered. Finally, they both insist, that even if it would be appropriate to consider, the OTS/OCA recommendation for a $22.5-$25 million rate increase should make sufficient progress in reducing PGW's level of debt. These parties have gotten it all exactly backwards.

First, as has been shown, the consistent claim that the Company's unreasonably high debt burden is not a problem "in the test year" is inexplicable. It is undisputed that PGW's level of debt in the test year is 83%.[128] That level has serious negative consequences for rate payers right now: it is imposing enormous costs to fund both the debt service as well as the additional 50% to cover PGW's bond debt service coverage requirement. PGW's test year debt service and

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127 OTS M.B. at 37.

128 PGW M.B. at 42.

coverage requirement (50% of the debt service) on its 1998 bonds is $87.7 million a year,[129] which is slightly less than twice as much as the comparable amount in PGW's 2001 base rate proceeding.[130] Accordingly, failure to reduce PGW's long term debt is and will continue to impose enormous costs on ratepayers; This burden will grow by some $52 million by 2012. Moreover, PGW showed that failure to reduce its reliance on external financing could result in the Company being denied access to the capital markets which could stop or cripple PGW's capital improvement program.[131]

PGW witness Krellenstein discussed these consequences in stark terms.

> Q. WHAT DO YOU BELIEVE WILL BE THE IMPACT ON PGW IF PGW IS UNABLE TO REDUCE ITS RELIANCE ON EXTERNAL FINANCING AND PRODUCE A MORE BALANCED CAPITAL STRUCTURE OVER THE NEXT SEVERAL YEARS?
>
> A. The continued reliance on external financing for all of its capital requirements will put pressure on PGW's financial operations and ratios and will probably result in the loss of additional bond insurance capacity, the reduction or loss of its current bank facilities and the probable downgrade of its ratings.
>
> The loss of additional bond insurance capacity and bank facilities will make it difficult for PGW to access the capital markets in a timely and efficient manner. To successfully access the capital markets without high quality enhancement, the utility would have to pay significantly higher interest rates and fees to compensate investors and counterparties for their greater risk exposure. This will result in higher financing costs, which will lead to higher costs for PGW's customers.
>
> Worse, should the utility's ratings drop below investment grade, its ability to access the capital markets would be severely compromised and it could be forced to pay excessive fees to obtain any sizeable amount of funding. Should this downgrade coincide with increased volatility in the gas

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129 PGW M.B. App. 1, pg. 3 (Debt Service).

130 *PGW 2001 Base Rate Order*, Appendix "Debt Service Coverage" (line 23, 1998 Ordinance Debt Service Coverage ($29.5 million) plus 50% ($14.6 million)).

131 PGW M.B. at 42-43.

> markets (such as a dramatic increase in natural gas prices), PGW could lose its access to the capital markets for a period of time, resulting in dire consequences to its operations and ability to serve its customers.[132]

Thus, this is both a current and a future problem.

In the face of this, OTS's denial that this is a problem on the ground that PGW is capable of meeting its debt service and coverage requirements in the test year betrays a serious misunderstanding of these fundamental financial facts.[133] The fact that PGW can pay these amounts is not the relevant concern, it is the level of cost and risk imposed as a result.

OTS's further suggestion that PGW's present capital structure is perfectly acceptable because there was no evidence presented to show that a 50%/50% level was more typical for a municipal utility[134] simply ignores PGW's extensive evidence presented by a municipal finance expert showing just the opposite. That evidence shows that a 50%/50% level is not typical – the average level of debt for municipal utilities is far lower. The average level of debt in the capital structure of hundreds of municipal utilities that Ms. Bisgaier surveyed was 27.89% and 31.49% for municipal utilities that provide energy service as well as other utility services.[135]

Moreover, OTS's claim that PGW's capital structure is not even to be considered when setting rates for PGW[136] is also perplexing in light of the fact that during cross-examination the OTS witness admitted that provisions of the Management Agreement, which dictates what can

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132 PGW St. 4 at 5-6.

133 As noted previously, the fact that PGW was able to issue additional long term debt during the proceeding reflected its purchase of insurance which effectively converted the rating of its bonds to "AAA" as well as the fact that the expert report assessing the financial soundness of the Company accompanying the bond prospectus assumed a satisfactory outcome of his proceeding. PGW Rejoinder Exh. 5 (Bisgaier); Tr. 740-42.

134 OTS M.B. at 37.

135 PGW Exh. BB-3, BB-4.

136 OTS M.B. at 37.

be included in the Cash Flow ratemaking method, indeed authorizes an inclusion in rates of just and reasonable amounts to finance construction and debt reduction.[137]

Finally, the claims by both OTS and the OCA that their recommendations for a $22.5-$25 million increase would result in sufficient reductions in PGW's level of debt is also perplexing because the only record evidence directly contradicts this claim. The evidence in the record shows that a $25 million rate increase will do virtually nothing to reduce PGW's reliance on long term debt. Appendix C to PGW's Main Brief showed that with a $25 million rate increase and including all agreed to adjustments to PGW's *pro forma* test year income (including the stipulated bad debt expense level),[138] PGW's level of capital structure of debt in 2012 would be **81%**, as opposed to 82% in the future test year.[139]

OTS simply ignores this evidence. It claims, without explanation, that the Company's testimony is "unsupported,"[140] or that the projections are "outside the test year" and allegedly "unreliable,"[141] or that PGW's problems would be solved if the City were to waive the repayment of the $45 million City Loan. But, OTS again ignores the undisputed evidence showing that only PGW's proposed $100 million rate increase makes any material change in PGW's debt level even if one only considers the test year:

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137 Tr. at 914-15.

138 For this reason, OTS's suggestion that PGW would have an additional $11.3 million of "operating efficiencies" by which to fund capital construction (OTS M.B. at 38) is substantially incorrect. PGW's Appendix C incorporates all but $3 million of these agreed upon adjustments.

139 PGW M.B., App. C, p. 5. If one wishes to look at the future TY only, a $25 million rate increase makes no change in the level of debt compared to 2006. *Id.*

140 OTS M.B. at 33. Inexplicably, OTS actually cites to an earlier interrogatory answer modeling the results of a $25 million rate increase to claim that its recommendations would produce adequate reductions in the Company's level of debt. *See*, OTS St. 1, Exh. Sch. 8. However, that exhibit does not contain any capital structure analysis. Moreover,

2007 TY debt level at present rates:	83%[a]
2007 TY debt level at $25 million increase:	82%[b]
2007 TY debt level at $25 million and waiver of City loan repayment:	80%[c]
2007 TY level of debt at $100 million (plus off-system sales)	77%[d]

Table Footnotes:

a. PGW M.B. App. A, p. 5

b. PGW M.B. App. C, p. 5.

c. PGW Rejoinder Exh. 4, p. 5. This despite OTS's completely unsupported claim that this analysis must – for some unarticulated reason – be "fundamentally incorrect." (OTS M.B. at 38.)

d. App. A, p. 10.

Thus, the record evidence requires a rejection of OCA/OTS recommendation as inadequate to deal with PGW's over reliance on long term debt to finance its construction. Interestingly, the OCA never mentions the fact that its own witness, Mr. Lelash agreed that PGW's debt-to-equity ratio was too high and that, in his opinion, a level of 70% would be a more reasonable goal.[142] Also unmentioned was that, as the record evidence shows, the Company

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the interrogatory answer was updated in PGW's rebuttal testimony (Exh. JRB-8) to include the results of PGW's most recent $200 million bond issuance as well as other adjustment detailed in Mr. Bogdonavage's testimony. *See*, PGW St. 2R at 39-41.

[141] OTS M.B. at 36.

[142] PGW Cross Exam Exh. 1, Answer to PGW Interrogatories 20-23

would need at least a $60 million - $70 million rate increase to achieve a capital structure in that range by FY 2012.[143]

F. The OCA and OTS are Incorrect By Suggesting that Forgiving the City Loan Would Make Their Recommendation Adequate.

Both the OCA and the OTS have, once again, insisted that their recommendation should be supplemented by additional contributions by the City; more precisely, that the City should "forgive" the $45 million City Loan which is due to be paid back at the end of FY 2008 or further grant back the $18 million transfer payment that PGW is scheduled to start repaying in FY 2011.[144] PGW has addressed this issue at length in its Main Brief but it is important to reiterate that both parties have assumed that waiving the City Loan or a similar amount of City Payment grant back – along with a $25 million rate increase – would somehow eliminate the need for any further rate increase and would alleviate all of PGW's problems. Both have also proclaimed that the PUC has in the past indicated that it expected the City to take such steps in lieu of granting a needed rate increase.[145] Both assumptions are incorrect.

First, rather than directing the City to contribute to PGW in lieu of a rate increase, the PUC in its earlier orders specifically rejected these very claims (made by the same parties, no less). For example, in PGW's 2001 rate proceeding the Commission reacted to claims by the OCA that PGW's rate increase could be reduced by directing the City to grant back its $18 million transfer payment:

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143 PGW Exh. JRB-10 ($50.0M + $10M). A rate increase of $70 million is needed for PGW's debt level to drop below 70% by 2011 and possibly avoid the projected 2012 bond issue.

144 OCA M.B. at 28; OTS M.B. at 38.

145 *Id.*

* * * 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) 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 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.

* * *

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.[146]

In the *Extraordinary Rate Order*, the Commission reiterated its position that PGW's revenue requirement needs could not be ignored by assuming or directing that the City would be able to supplement an otherwise inadequate award:

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146 *PGW 2001 Base Rate Order* at 34-25.

> The Record establishes that PGW has met the criteria for extraordinary rate relief and that the appropriate amount to be granted is $36 million. With respect to any other conditions that may be imposed on PGW, it is noted that the ALJ posed the question as to whether any relief should be conditioned on the City of Philadelphia (City) granting back the $18 million and whether the City should defer or waive repayment of the $45 million loan. As this Commission has held in the past, we do not have the statutory authority to direct the City to do either. However, we advise the City and PGW, in the strongest of terms, to explore those possibilities.[147]

To be sure, the PUC urged the City to consider making – or continuing to make – contributions to supplement the rate increases that were necessary. And the City has done so – to the tune of approximately $200 million in loans, and foregone payments and interest.[148] The City has also committed to continue to forego its legally required transfer payment – the only compensation it receives for its ownership of PGW – through FY 2010.[149] In the face of these facts, these parties' constant calls to force the City of Philadelphia to make further contributions should be seen for what they are: a transparent attempt to make completely inadequate rate increase recommendations look less unreasonable.

But, even if the Commission were inclined to consider "encouraging" some City contribution in lieu of granting the level of rate hike necessary to address PGW's critical problems, the fact is that the Company's financial condition would be barely affected if the City were to grant back the $45 million loan. PGW's evidence showed that a $25 million rate increase and a grant back of the City Loan would do the following:

- PGW would have $32.8 million of net income in the test year, dropping to $15.4 million in FY 2008; PGW would need an additional $55.5 million in additional rate

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147 *PGW Extraordinary Rate Order* at 4.

148 PGW M.B. at 55.

149 *Id.*

increase just to replicate the level of income it was permitted to earn in the last two cases;[150]

– PGW would still have only 63.8 days of liquidity in the test year and only 59 days in FY 2008 – still far short of the 200 day minimum;[151]

– PGW's debt percentage in the Test Year would drop only to 80% and would end up at 80% in FY 2012; and[152]

– PGW would still fall below mandatory debt service coverage requirements by FY 2009-10 and barely scrape by in FY 2009-09.[153]

Moreover, such a one-time fix would do nothing to create confidence in the investment community that PGW could function on its own without continued bail out. The evidence therefore shows that any assumption that an inadequate rate award can be repaired by simply forcing the City to forgo repayment of a loan it provided with the good faith expectation of repayment is misplaced. The only way this result would be different is if the City were to provide several hundred million dollars to PGW – a proposal no one has made because, frankly, it is clearly unrealistic on its face. Based upon the record evidence, contributions by the City of such magnitude would devastate equally important programs such as the public schools and the police and fire departments.[154] Trying to argue that the Company's rate increase can be avoided by holding out the possibility of even greater contributions from the City is thus unrealistic, unfair and illegal.

G. The OTS and the OCA Are Wrong that PGW's Rate Increase Can or Should Be Denied Do to A Perceived Inability of PGW Customers to Pay Higher Rates.

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150 PGW Rejoinder Exh. 4 (Bogdonavage), p. 1.

151 *Id.*, p. 2 (cash flow) and p. 1 (cash operating expenses).

152 *Id.*, p. 5.

153 *Id.*, p. 3

154 *See*, PGW St. 9 (Wilkerson); St. 10 (Dubow).

Finally, both the OCA and the OTS have raised the extraordinary suggestion that the Commission should take into account the ability of PGW's customers to afford a base rate increase and deny the Company's claim, in whole or in part, on account of this perceived lack of ability to make such payments.[155] From a legal, policy and factual standpoint this argument is meritless.

First, while PGW understands and sympathizes with the burden that will be created on the average customer by the proposed increase in base rates, PGW has shown that it is in desperate need of the full request and that, absent sufficient additional revenues to bolster its cash working capital and liquidity and to assist it in paying for new construction without long term borrowing, its continued ability to continue to maintain its service and reliability at the highest levels will be seriously threatened. No customer likes to pay more but if the alternative is diminished service, then PGW believes customers will understand and recognize the need.

Rather than use perceived ability to pay by PGW's customers as an excuse to deny the rate increase, the PUC and the other parties should work with PGW to do everything reasonable to find additional assistance and to otherwise help low-income customers to deal with the increases. The record is clear that PGW has done as much, if not more, than any other utility in Pennsylvania to protect its vulnerable customers and it will continue to improve on those initiatives. For example, PGW maintains open enrollment in its CRP and aggressively promotes it, encouraging every eligible customer to participate.[156] Customers in CRP will remain

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155 OCA M.B. at 16-17, 32; OTS M.B. at 50-52.

156 PGW St. 7 at 3-5.

unaffected by the rate increase.[157] In addition, approximately 45,500 customers receive a senior citizen discount which is 20% off the normal general service rate.[158]

Further, PGW is the most successful utility in Pennsylvania in its efforts to obtain LIHEAP Cash and Crisis grants for its customers.[159] In addition to these LIHEAP grants, PGW persuaded the City of Philadelphia to create a special fund for low income customers (those below 125% of the federal poverty standard) to provide grants to help them avoid shut-off or to restore service. PGW also partnered with ACORN to persuade Commonwealth leaders to create a special grant program to help PGW customers with incomes up to 250% of poverty restore service during the winter.[160]

PGW has leveraged external funds to provide an emergency chimney repair program for low income customers to mitigate carbon monoxide problems associated with poor ventilation of the house heater and water heater.[161] The program is expected to begin by mid-summer. Once in place, a PGW serviceman who has identified the problem will be able to simply give the customer a card with an emergency hotline number to obtain free, prompt repair in order to ensure heat during the winter.

PGW has an extensive low-income weatherization program and, in addition, annually sponsors free neighborhood weatherization workshops to teach people the benefits of weatherization, how to use caulk, window covering and other materials, and to distribute those

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157 PGW St. 1R at 6-7.

158 *Id.*; PGW St. 7R at 4-6.

159 PGW St. 7 at 6-7; PGW St. 7R at 9-10.

160 PGW St. 1R at 6; PGW St. 7R at 11.

161 PGW St. 1R at 6-7.

materials without charge.[162] PGW has promoted budget billing[163] and has "CARES" program, LIHEAP Outreach programs and a Hardship fund designed to assist customers or to refer customers to helpful sources.[164] PGW's efforts are extensive and sincere; the Company is committed to continuing to develop all possible avenues to help its less fortunate customers. But to simply use the existence of low-income customers in PGW's service territory as an excuse to deny the Company's rate request is unfair and inappropriate.

Second, the assumption that customers will simply not be able to pay this relatively modest (9.6%) overall increase in base rates is not consistent with the evidence. Several witnesses, including OCA's Mr. Bleiweis noted that PGW has been able to achieve high collection rates during a time when commodity costs were higher than they have been for the test year and increases to PGW's GCR were regularly occurring.[165] PGW's overall success in maintaining its collection rate in the face of these large increases supports the conclusion that the Company's efforts – as well as those of the PUC and municipal state and federal governments – should be focused on the low income customers who are at risk, not on seeking to insulate all customers from necessary increases in base rates, rates that have not increased since 2002.

Finally, and perhaps most important, from a legal standpoint, of course, the Commission has, to PGW's knowledge, never suggested that affordability could be the basis for rejecting a

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162 *Id.*

163 PGW St 6 at 11-12.

164 PGW St. 7 at 6-9.

165 OCA St. 2 at 26; PGW St. 1R at 7.

rate increase.[166] While affordability can and should play a role in the allocation of a rate increase, or in rate structure, an otherwise justified rate increase cannot legally be denied because of the perceived difficulty of customers to absorb the new rates. Neither the customers nor the public interest is served if PGW does not have funds sufficient to provide safe and reliable service. Artificially low rates to insulate customers cannot possibly be just and reasonable.

V. MISCELLANEOUS ISSUES

A. The Arguments Opposing PGW's Capacity Release and Off-System Sales Proposal Should Be Rejected.

The OTS and the OCA unfortunately place PGW's proposal to retain capacity release credits and off-system sales margin within a context that flatly ignores how this proposal financially benefits PGW's customers. OTS and OCA clearly would prefer that PGW charge its customers not only for the principal to borrow $10 million annually, but the fees and insurance related to the issuance of debt, the interest, and, most significantly, the debt service coverage at 1.5 times the borrowed amount. Somehow, in their calculus, it is better to borrow $10 million that results in a base rate increase that well exceeds $15 million. Additionally, there is a fundamental failure to realize that PGW's customers are better off if they forego an annual $10 million reduction in gas costs now in order to fund capital costs in this manner until PGW's debt-to-equity ratio is in better shape.

One context in which OTS places this proposal is least cost fuel procurement. By narrowly asserting that fuel costs will rise if PGW retains these credits and margins for capital costs, the OTS ignores that there is more than a 50% savings in base rates. OTS's failure to be

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166 *See, e.g., Pa. PUC v. Pa. Gas & Water Co.*, 1993 PUC LEXIS 61 (OCA proposed $1 million adjustment to PGW's revenue requirement on the grounds of "unaffordability" rejected).

discerning about a proposal that will result in a decrease in base rates that is exponentially larger than the related increase in fuel costs demonstrates the short-sightedness of its evaluation.

OTS also complains that PGW's testimony is vague when discussing how the credits and margins will be spent. It is uncertain exactly what this brief comment means because PGW has been incredibly clear that the funds will be spent on capital programs such as the Phase 2 LNG plant and the planned billing system upgrades. Additionally, if permitted, PGW has agreed to deposit any such proceeds in a construction fund and use them only to pay for construction items included in its approved capital budget.[167]

OTS further complains that the capital projects do not solely benefit Purchased Gas Cost ("PGC") customers but transportation and interruptible customers as well. Again, a lack of discernment is demonstrated by OTS's argument. All of PGW's capital projects primarily benefit PGC customers and some projects also benefit transportation and interruptible customers. But, the gas assets that create these credits also are used by both sales and transportation customers.[168] This alone causes the OTS argument to fail. Nonetheless, when coupled with the exponential decrease in base rates, the simultaneous benefit received by transportation and interruptible customers is absolutely irrelevant.

OTS also claims that PGW does not have an incentive to maximize capacity release and off system sales because it is not an investor-owned utility and it is not proposing an incentivizing sharing mechanism. This really does not make sense. A look at data presented by OCA demonstrates that even though PGW is not an investor-owned utility and does not currently share in capacity release credits and off-system sales margins, PGW has recently tripled total

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167 PGW St. 2 at 16.

168 PGW M.B. at 75-76.

credits and margins when compared to prior years.[169] PGW's incentive to increase these credits will be even bigger when its ability to fund its capital program is at stake. Moreover, how could it be reasonable to permit an investor-owned utility to take some portion of the proceeds completely away from ratepayers (and give them to shareholders) but unreasonable to give 100% of the proceeds to customers, merely in a different manner?

In sum, regardless of any analysis of the opportunity costs of borrowing money, whether it be PGW's or OCA's, retention of the $10 million annually in order to fund capital projects is cheaper for ratepayers if the $10 million is utilized for capital budget projects and not credited to Purchased Gas Costs. Even if PGW were permitted to retain 50% of credits and margins, this would provide some assistance without requiring a respective base rate increase. Essentially, PGW's proposal is not about raising rates, it simply removes a PGC reduction which is more than offset by avoiding a larger base rate increase, thereby producing a win-win situation.

B. The Commission Must Reject Both AA's Primary And Alternate Positions Opposing the Rate Increase Because PGW's Customer Service Is Just And Reasonable.

AA's primary position in this case is that, because of perceived service inadequacies, PGW's request for a rate increase must be rejected. In the alternative, AA supports OCA's and OTS's position that if a rate increase is granted it should be no more than $22.5 - $25 million and, if granted, the rate increase should be conditioned on the numerous, and costly, recommendations set forth in AA's testimony.[170] But, the only way the Commission can reject, in whole or part, PGW's request for a rate increase is by finding that PGW's service is so inadequate that PGW should be denied its right to rates that meet its other legal and

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169 OCA St. 1, Schedule 5.

170 AA M.B. at 2; 50-52.

constitutional standards.[171] Inadequate service has been used to justify denying a rate increase only where the service is so poor that customers are not able to reasonably utilize the utility's facilities.[172]

Despite the voluminous testimony presented by AA, it has not shown one instance in which PGW has violated any laws or regulatory obligations regarding service. Furthermore, neither the Commission nor its Bureau of Consumer Services has found PGW to be in violation of the law. While AA may not agree with PGW's policies and operating procedures in many instances, it has not shown that these policies lead to inadequate service sufficient to justify denying PGW's requested rate increase. AA's unsupportable reliance on the amount of customers without service during the time of the 2006 Cold Weather Survey does not provide an appropriate basis upon which to assess PGW's service in the context of a rate case.[173]

Moreover, AA's sole focus in this case is on one customer class, i.e. low income customers who fail to pay their bills, even though AA correctly recognizes that PGW has to balance the interests of the utility and its owner against the interests of the customers.[174] AA's singular focus ignores the entire customer base served by PGW and the duty PGW has to provide safe, adequate and reasonable service to its entire customer base. In short, PGW has shown that

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171 66 Pa.C.S. § 526(a). *Nat'l Util. v. Pa PUC*, 709 A.2d 972 (Pa.Commw. 1998).

172 *See e.g. Nat'l Util. v. Pa PUC*, 709 A.2d 972 (Pa.Commw. 1998)(In denying a rate increase for a water company, the Commission based its decision on the fact that 17 out of the company's 23 water systems produced water unsuitable for drinking, cleaning or bathing. Customers also frequently experienced low-water pressure and, almost daily, water outages without warning, explanation or information regarding when service would be restored. The water company also failed to provide timely customer notification when water quality was poor and needed to boiled.)

173 PGW M.B. at 97.

174 AA M.B. at 8.

its policies regarding all its customers are adequate and reasonable and in compliance with the law.

AA also cites to the Gas Choice Act and argues that PGW has failed in its duty to adopt universal service policies.[175] As outlined in more detail below, there is no record support for this assertion. On the contrary, PGW's universal service policies are among the best in the Commonwealth. AA is really arguing that PGW has not adopted the universal service policies that AA thinks are appropriate. Since the record does not support a finding that PGW has provided inadequate service to justify a denial of its rate increase under §§ 526 or 1501 of the Public Utility Code, AA's recommendations must be rejected.[176]

While the Commission need not move beyond this legal analysis of AA's positions to conclude that they must be rejected, the reality is that the foundations upon which AA relies to arrive at its final positions are flawed. As will be discussed further below, AA's accusations that PGW has not done enough for low-income customers is not based in fact; AA chooses to ignore all the numerous, proactive ways PGW has worked to assist low-income customers. Also, AA's attempts to convince the Commission that PGW has violated the law or somehow applied its policies to violate the law in individual instances are disingenuous and incorrect. Further, implementation of AA's recommendations would be costly and place an unreasonable burden on PGW's entire customer base. Because the foundations upon which AA relies to reach its

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175 AA M.B. at 7; 66 Pa.C.S. § 2202.

176 66 Pa. C.S. § 526; 1501. Moreover, AA's alternate position that a $22.5 - $25 million rate increase be conditioned upon implementation of the costly suggestions of AA is not practical. As already shown, a rate increase of this amount does nothing to aid the financial situation currently faced by PGW and, if ordered, would not create any of the revenues necessary to implement AA's recommendations. As the Commonwealth Court has aptly stated, "a starved utility is in no better position to render proper service than a starved horse or a motor car without fuel." *Nat'l Util. Inc.* at 975.

ultimate recommendation in this matter are flawed and inaccurate, the Commission must reject AA's position that PGW should be denied the requested rate increase or, in the alternative, should have a minimal rate increase conditioned upon the implementation of AA's suggestions.

1. AA's Assertions That PGW Has Done Nothing And Plans To Do Nothing To Assist Low Income Customers Is Inaccurate.

Throughout its Main Brief, AA claims that PGW has not done enough for low income customers and that, even with a rate increase, PGW would do no more for low income customers.[177] This argument is simply illogical and not based on the facts in the record. Not only does PGW have an incentive to insure that its customers pay their bills, but it has repeatedly indicated on this record that it plans to continue to improve its operations for the benefit of all customers.[178] Therefore, the Commission must reject AA's position to the extent it is arguing that PGW's requested rate increase should be rejected because PGW will not continue to assist customers with the influx of more revenue.

Further, by choosing to singularly focus on all the areas where AA opines PGW needs improvement, AA fails to acknowledge even just one of the many ways in which PGW works to assist low-income customers in paying their bills. As highlighted in PGW's Main Brief[179] and detailed throughout the testimony in this proceeding, below is a sampling of the ways PGW works to assist low-income customers with paying their bills:

1. The Customer Responsibility Program ("CRP"), low-income participants pay a monthly percentage of their household income, based upon the Federal Poverty Level

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177 AA M.B. at 12.

178 PGW St. 7 at 5 ("We are carefully considering proposed modifications suggested in the CRP Evaluation Report conducted by Applied Public Policy Research Institute for Study and Evaluation . . ."); PGW St. 7R at 16 ("As I indicated earlier, during this upgrade, PGW will take into consideration Mr. Geller's suggestions. . .")

179 PGW M.B. at 94-96.

of the relevant customer and is one of the best in the Commonwealth.[180] Despite PGW's resource disadvantage, PGW allocates considerable resources to encourage high participation levels (16% of the total customer base)."[181]

2. PGW has implemented an extensive outreach program to encourage each eligible customer to apply for and assign the federally-funded grants available through Low Income Home Energy Assistance Program (LIHEAP) to PGW to provide low-income customers with financial assistance; in the 2006-2007 season, PGW received 15,781 requests and approved 95% of these requests (14,949).[182]

3. PGW has worked with the City and the Commonwealth to establish additional grants resulting in an additional $345,000 in supplemental assistance for low-income customers this past heating season.[183]

4. PGW provides hardship funds through the non-profit Utility Emergency Service Fund ("UESF") which directs company and customer contribution to provide financial assistance for PGW's customers and solicits contributions to UESF at least two times per year via bill inserts.[184]

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180 *See* PGW St. 7 at 3-5; Tr. 956.

181 PGW St. 7 at 3; PGW St. 7R at 4.

182 PGW St. 7 at 7; PGW St. 7R at 10. In the context of this testimony, PGW explains that AA's accusations that PGW has "refused to accept" LIHEAP grants and promptly reconnect service are simply not accurate and AA's recommendations on this point must be rejected. *See* AA M.B. at 37-38.

183 PGW St. 7R at 11.

184 PGW St. 7 at 8; PGW St. 7R at 15-16.

5. PGW offers a Customer Assistance Referral and Evaluation Program ("CARES") to customers in need of referrals to assistance and social services to assist customers in securing energy assistance funds and other needed services.[185]
6. Through PGW's Senior Citizen Discount program, approximately 46,000 eligible participants as of August 31, 2003 receive a 20% bill discount on their bills.[186]
7. PGW accepts medical certifications from eligible customers, which delay termination so long as the customer pays his/her bills.[187]
8. PGW has a Conservation Works Program ("CWP") which focuses on low-income customers to educate them about how to reduce gas usage in a cost-effective manner to lower gas bills and make payments more affordable. Approximately 2,700 customers each year receive this benefit.[188]
9. PGW offers various electronic payment options including "Pay Your Bill" (approximately 280,000 payments received), "Express Bill"(approximately 8,300 customers enrolled), and "Auto-Pay" (approximately 4,600 customers enrolled) to facilitate the process of bill payment for customers.[189]

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185 PGW St. 7 at 8.

186 PGW St. 7 at 9; PGW St. 7R at 5.

187 PGW St. 7R at 16-17.

188 PGW St. 7 at 6.

189 PGW St. 6 at 9.

10. PGW offers budget billing with approximately 48,000 enrolled in the program, and implemented a multi-faceted program in 2006 to educate customers about its availability and benefits.[190]

11. PGW performs outbound calling campaigns, on average over 130,000 calls a month, in an attempt to reach customers who have missed a payment to enter into a payment arrangement or remove their delinquency so that these customers do not have to have their service terminated.[191]

12. PGW complies with all applicable regulations necessary before terminating customers' service, this includes written notices, phone calls and field visits.[192]

13. In the past year, PGW partnered with various community based organizations, neighborhood services and expended significant resources to establish a state grant program in order to have the service of terminated customers restored.[193]

As the record in this proceeding clearly demonstrates, PGW has undertaken significant efforts to assist its entire customer base with paying their bills. While PGW is always seeking out ways that it can enhance and improve its efforts, AA's allegations that PGW's universal service programs are "inadequate" are obviously unfounded. For example, AA alleges that PGW's CRP enrollment processes are inadequate.[194] PGW's current CRP enrollment of 75,093 is

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190 PGW M.B. at 93-94; PGW St. 6 at 11-12.

191 Tr. at 935; 957.

192 Tr. at 935.

193 Tr. at 936-937.

194 AA M.B. at 14.

its highest level ever[195] and in the last two years PGW has engaged in significant efforts to increase enrollment.[196] Beyond CRP, customers may be eligible to enroll in other programs such as PGW's Senior Citizen Discount Program and the Philadelphia Housing Authority gas allowance program that are more beneficial for their individual circumstances.[197] The full extent and benefits provided by PGW's universal service programs and offerings to assist low income customers with bill payment have been detailed at great length in the record. PGW believes that its efforts compare favorably to other utilities throughout the Commonwealth. AA's premise that they are "inadequate" must be rejected as it lacks any evidentiary basis.

2. AA's Attempts To Convince The Commission That PGW Has Violated The Law Or Somehow Misapplied Its Policies In Individual Instances Are Not Based On Fact Or Law.

In numerous areas, AA attempts to convince the Commission that PGW is violating the law either outright or through its policies. However, as explained further below, assessing these claims in their entirety and with full information conclusively proves that AA's claims are incorrect, inaccurate and must be rejected.

a. Budget Billing

AA tries to create the impression that PGW is in violation of Commission directives because it does not have a standard policy of allowing customers to pay true-up amounts over a period of installments when that customer utilizes budget billing.[198] In support of its argument,

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195 PGW St. 6 at 4.

196 PGW St. 6R at 6. In its discussion about increasing awareness of PGW's CRP program, AA's Main Brief is devoid of any recognition of PGW's substantial educational outreach efforts. *See* AA M.B. at 16.

197 PGW St. 6R at 5.

198 AA M.B. at 28.

AA cites to a Commission order which did initially direct utilities to give consumers a certain period of months over which to pay their delinquent amounts.[199] However, AA does not reference, or even mention, the Commission's subsequent order reconsidering this very issue and deleting its initial requirements on this point.[200] The fact is that PGW is compliant with PUC directives on this issue and PGW provided testimony that, on a case-by-case basis, it will permit customers the ability to pay-off their delinquencies in installments.[201] Furthermore, PGW's quarterly reviews and adjusts a consumer's budget bill as necessary to avoid a large true-up at the end of the year.[202] AA's recommendation that a rate increase be conditioned upon implementation of this suggestion must be rejected.[203]

AA's other criticism, that PGW imposes unreasonable barriers to enrollment in budget billing because it requires customers with outstanding bills to either pay off the arrearage or enter into a payment agreement as a pre-condition for enrolling in budget billing again fails because it does not even allege that PGW is violating any law or regulation with this requirement. Moreover, as explained by PGW's Consumer Affairs Chief Randall Gyory, the purpose of budget billing is to assist customers in managing ongoing utility bills by eliminating seasonal fluctuations in utility bills. It is not a payment arrangement and is not intended to allow customers who default on payments to obtain extended periods of time to repay their debt. In

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199 *In re: Insuring Consistent Application of 52 Pa. Code § 56.12(7) Equal Monthly Billing*, Docket No. M-0005925 (Final Interpretive Order entered June 2, 2006.)

200 *In re: Insuring Consistent Application of 52 Pa. Code § 56.12(7) Equal Monthly Billing*, Docket No. M-0005925 (Order entered November 14, 2006). PGW did not file the Petition for Reconsideration that lead to entry of this order.

201 PGW St. 6R at 13.

202 PGW St. 6R at 13.

203 AA M.B. at 52.

fact, if AA's proposal were adopted, customers with incomes of less than 250% would have less time to pay-off their arrearages under the one-year term of the budget bill than they would have pursuant to Section 1405(b).[204] AA's recommendation that a rate increase be conditioned upon implementation of this suggestion must be rejected.[205]

b. CARES Program

AA makes the argument that PGW has a legal duty to provide a CARES program and then concludes that PGW is not meeting that duty because of the way its program is currently structured.[206] AA advocates this in its Main Brief even though its witness, Harry Geller, accurately admitted in discovery that "[t]he standard for judging the adequacy of PGW's CARES program are not contained in Chapter 14 or Chapter 56 or other PUC Order imposing a specific duty or obligation on PGW."[207] The fact of the matter is that AA cannot use the structure of PGW's CARES program to conclude that PGW has violated the law and the Commission must reject this argument.

c. Payment Arrangements

AA alleges that PGW has failed to comply with 52 Pa. Code § 56.97 in negotiations regarding payment agreements.[208] AA also alleges that PGW refuses to exercise the discretion it has been provided by 66 Pa.C.S. § 1405(b) in a way that is advantageous to the customer.[209] The

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204 PGW St. 6R at 14; 66 Pa. C.S. §1405(b).

205 AA M.B. at 52.

206 AA M.B. at 16-18.

207 PGW Exh. No. CC-4.

208 AA M.B. at 10; 22-26.

209 AA M.B. 26-27.

foundation of AA's arguments on this issue is PGW's Payment Arrangement Guidelines.[210] Despite an accurate recognition of PGW's testimony that "the Payment Arrangement Guidelines are only part of a bigger collection of the training materials provided to CSRs [Customer Service Representatives]," in many places throughout its Main Brief AA asserts that the Payment Arrangement Guidelines are strict mandates and, and such, fail to instruct the CSRs on each and every nuance related to dealing with consumers requesting payment arrangements.[211] As PGW witness Randall Gyory testified, the Payment Arrangement Guidelines are "only one component of the material" that PGW provides its representatives, "[t]hey are not scripted rules that [PGW's] representative must follow," and are "a reference to basically bridge the gap on what [the CSRs have] been trained and maybe what they remember so they can complete the call as necessary."[212] Therefore, AA's reliance on the Payment Arrangement Guidelines to argue that PGW is not appropriately handling payment arrangements for its customers is misplaced.

However, even if the Commission were to accept AA's faulty premise and rely on the Payment Arrangement Guidelines to determine the appropriateness of PGW's policies, AA's

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210 AA Exh. No. HSG-5.

211 AA M.B. at 15 ("References to CRP in other parts of the Guidelines apply only to those customers who steadfastly insist on their inability to make whatever non-CRP payment terms may be offered."); 18 ("Nowhere in these Guidelines are CSRs instructed to refer customers to CARES. . ."); 23 ("Payment Arrangement Guidelines do not prompt CSRs to seek to assure payment arrangement is one that . . . customer can afford to make."); 24 ("Guidelines do not incorporate any consideration of the customer's payment history. . . "); 24("Payment Arrangement Guidelines also indicate that the payment agreements that PGW offers to customers whose service is on are much more severe than the agreements which BCS is authorized to offer, under Chapter 14 Section 1405(b)."); ("As the Payment Arrangement Guidelines indicate, PGW also requires that customers whose service is on who are seeking a payment arrangement must make a substantial upfront payment on the arrears."); 27 ("[T]he so-called Guidelines instruct the customer service representative to require that a customer who has had one or more payment agreements or been broken from CRP must pay the 'catch-up/cure amount'.")

212 Tr. at 940-41; 959-961; PGW St. 7R at 11-12.

attempts to show that PGW is not in compliance with the law would still need to be rejected because these allegations are simply wrong. For example, AA takes the position that the Payment Arrangement Guidelines indicate PGW's payment arrangements are either inconsistent with Chapter 14 or unreasonable because they are "more severe" than those BCS is authorized to offer under Chapter 14 Section 1405(b).[213] Irrespective of its opinion, the inescapable fact is that Section 1405(b) applies to the Commission, not PGW and – more importantly – "PGW's policies are properly based on the needs of PGW to be adequately paid for the services rendered and consideration of the ability of customers to pay for these services."[214] Moreover, neither the Commission nor BCS has ever found PGW's policies violative of Section 1405 or any other PUC policy. While AA may disagree with the general principles that guide PGW in structuring payment arrangements, the reality is that these principles are not in violation of the law and must be determined based on the needs of PGW's entire customer base – including those low-income customers who timely pay their bills.

Another example of where AA attempts to use the Payment Arrangement Guidelines to try to prove that PGW has not complied with the law relates to Section 1405(d).[215] First, AA seems to assert that because nothing in Chapter 14 authorizes PGW to require upfront payments from delinquent customers as a pre-condition for establishing payment agreements, PGW is somehow in violation of the law.[216] Nothing in Chapter 14 prohibits requesting upfront payments. Second, AA seems to claim that PGW is somehow violating Section 1405(d) by not

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213 AA M.B. at 24.

214 PGW St. 6R at 12.

215 66 Pa.C.S. §1405(d).

216 AA M.B. at 25-26.

exercising its discretion to enter into a second or subsequent payment arrangement with customers.[217] From a legal perspective, both of these arguments are without merit. First, PGW does not need specific statutory authorization to implement policies that do not otherwise violate the law. Second, "discretion" means that PGW has the option of taking the action but is not required to do so. PGW presented evidence that illustrates why both of these policies are justified[218] and within the confines of the law and, therefore, AA's position must be rejected.

A final example where AA relies on the Payment Arrangement Guidelines to improperly accuse PGW of violating the law is AA's assertion that because the Guidelines do not instruct CSRs to consider customer's payment history or the period of time over which the bill accumulated, PGW is in violation of Chapter 56.97(b). First, the Guidelines do show that PGW's CSRs obtain income and occupancy information so that the most affordable payment arrangement can be offered, which still allows PGW to ensure that it has the revenue necessary to keep operating and to maintain safe utility supply.[219] Second, PGW witness Gyory specifically explained that during telephone calls, CSRs "look at the account to establish if [the customer] had been previously on CRP and what type of agreements they had."[220] Also, Mr. Gyory testified that PGW's CSRs "are trained extensively regarding what to do with these particular customers."[221] Chapter 56.97(b) requires that the utility "exercise good faith and fair judgment in attempting to enter a reasonable. . . payment agreement" and the record in this

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217 AA M.B. at 27.

218 PGW St 6R at 9, 11.

219 PGW 6R at 10.

220 Tr. at 961.

221 Tr. at 965.

proceeding clearly demonstrates that PGW is in compliance with these requirements.[222] Therefore, AA's attempts to claim PGW has violated Chapter 56.97 must be rejected.

d. Medical Certification Policies

AA claims that PGW "does not recognize" its obligations pursuant to the medical certification policies of 52 Pa. Code § 56.111-114.[223] This assertion cannot be based on noncompliance with Sections 56.111-114 (because PGW is in compliance)[224] but are instead based on AA's position that PGW is not in "scrupulous compliance" with 52 Pa. Code § 56.116.[225] Section 56.116 is titled "Duty of Ratepayer to Pay Bills" and requires the ratepayer to "equitably arrange to make payment on all bills."[226] From this Section, AA argues that PGW is required to indefinitely allow customers to maintain service so long as they make payments on current bills.[227] Such a requirement is not required by this Section and, therefore, must be rejected. Moreover, from a practical standpoint PGW witness Cristina Coltro explained that such a policy would create a subset of non-CRP customers from whom PGW could not collect arrearages incurred prior to the date of the first medical certification. The burden of this uncollectible expense would be borne by all of PGW's customers and, therefore, must not be adopted.[228]

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222 52 Pa. Code § 56.96(b).

223 AA M.B. at 20.

224 PGW St. 7R at 16.

225 AA M.B. at 21.

226 52 Pa. Code 56.116.

227 AA M.B. at 22.

228 PGW St. 7R at 17.

c. Reconnection Policies

AA alleges that PGW's reconnection policies "may not comply with limitations on utility actions imposed by Chapter 14, and as such they are per se unreasonable. However, even if they are not in violation of Chapter 14, they constitute a misuse of discretion provided to utilities by the legislature."[229] AA accuses PGW of making payment arrangements difficult to uphold and then utilizing Section 1407(c)(2)(i) to require upfront payment from the customer who has broken a previous payment arrangement before reconnecting service.[230] This allegation is not accurate. PGW's reconnection policies are consistent with Chapter 14 restoration terms and the Commission's regulations and are therefore reasonable.[231] As Mr. Gyory explained, PGW incurs employee expense and time in crafting these payment agreements. PGW has an incentive to ensure that its customers pay their bills.[232] Customers are given a one month grace period before the non-payment is treated as a breach but the failure to make any agreed-upon payment is a breach of a payment agreement and PGW properly treats it as such.[233]

AA's recommendations that the Commission direct PGW to ignore defaults on either CRP payments or non-CRP payment arrangements is not in compliance with the law.[234] Furthermore, such a requirement ignores the fact, with which AA agrees, that customers have an obligation "to satisfy any applicable payment obligations including any payment arrangements

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229 AA M.B. at 30

230 66 Pa.C.S. § 1407(c)(2)(i).

231 PGW Main Brief at 96-97.

232 PGW St. 6R at 11.

233 PGW St. 6R at 11.

234 AA's attempts to argue that CRP is not a "payment agreement" under Section 1407(c)(2)(i) must be rejected.

entered into with the utility."[235] Therefore, the Commission must reject AA's recommendations on this issue.

3. Implementation of AA's Recommendations Would Be Costly And Place A Burden On PGW's Entire Customer Base, Including Low Income Customers Who Timely Pay Their Bills

In this proceeding, PGW has addressed each and every one of AA's allegations regarding customer service and has shown that PGW's policies are a reasonable balance of the needs of its customer base and the needs of the company.[236] As explained more fully above and in PGW's Main Brief, AA cannot credibly show that PGW has violated any law regarding its customer service and, therefore, these allegations should not properly be considered in the context of PGW's base rate request.[237] Despite this, AA argues that if a rate increase is granted, then it should be conditioned on various recommendations.[238] As the record in this proceeding shows, however, these recommendations would be costly to implement, may not address the problem specified, and would create a substantial burden for all of PGW's customers. Consider the following:

1. AA recommends that PGW implement a contribution check-off on bills to allow customers to contribute to UESF.[239] Implementing such a change in PGW's bills would require a substantial investment in both administrative and system costs.[240]

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235 PGW Hearing Exh. No. 1.

236 PGW St. 6R; 7R; Tr. 933-43; 952-966. Each CRP arrangement includes an arrearage forgiveness plan for prior arrearages – in effect a payment plan for those amounts. PGW St. 7 at 3.

237 PGW M.B. at 97.

238 AA M.B. at 51-52.

239 AA M.B. at 19.

2. AA makes recommendations regarding training related to PGW's CARES program.[241] As explained by PGW witness Cristina Coltro, AA's suggestions are unnecessary, potentially costly and not in the interest of PGW or its customers.[242]

3. AA recommends that PGW reduce its $123.23 reconnection fee to $50.[243] AA recognizes that this fee is based on PGW's actual costs.[244] As explained by PGW witness Randall Gyory, a reduction in this fee would result in PGW's inability to recover approximately $73/customer of the cost incurred to perform the reconnection and such cost would be subsidized by PGW's entire customer base.[245]

4. AA recommends that PGW waive its $372 "dig-up" (excavation) charge for certain customers.[246] As Mr. Gyory explained, numerous attempts are made by PGW to avoid excavation. Only those customers with the highest arrearages (on average in excess of $3,000) are targeted for excavation, the costs to restore service after excavation is close to $2,500 and waiving the excavation charge would require all of PGW's customers to further subsidize the costs.[247]

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240 PGW 7R at 15.

241 AA M.B. at 18.

242 PGW St. 6R at 13-14.

243 AA M.B. at 33-35; 51.

244 Despite the recognition, AA argues that cost is irrelevant. AA M.B. at 34.

245 PGW St. 6R at 7-8.

246 AA M.B. at 35-36; 51.

247 Tr. at 939-40; 956-58; 971; PGW St. 6R at 8-9.

5. AA advocates that PGW should be directed to remove deposit requirements for Level 1 customers who are income eligible for CRP but who would not benefit from CRP.[248] While PGW may elect to implement a similar policy in the future, it would only be done after careful review of the ramifications on PGW's entire customer base.[249]

As discussed in PGW's Main Brief, AA never made an estimate of either the costs to PGW to implement the proposals or the effectiveness of the proposals.[250] Even after PGW explained its concerns regarding AA's proposals and the funding of those proposals, AA failed to offer any fiscally practical steps for implementation. AA's position in this case is narrowly focused on one class of customers - those low-income customers who do not pay their bills. PGW, however, owes a duty to its entire customer base, including those who timely pay their bills. Implementing AA's recommendations would ultimately result in requiring those who pay their bills to also pay the bills of the other customers who do not pay their bills. This outcome would be patently unfair and is not necessitated by the record in this proceeding. Therefore, the Commission must reject AA's recommendation that PGW be required to implement its suggestions.

C. The Commission Should Accept The Agreement Between PGW And OCA Regarding EFT And Must Reject OCA's Proposal To Direct Implementation Of A Mandatory Budget Billing Program

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248 AA M.B. at 36.

249 PGW St. 6R at 9.

250 PGW M.B. at 97.

In this proceeding, OCA recommended two initiatives to improve collections - an Electronic Fund Transfer (EFT) Payment Program and Mandatory Budget Billing Program.[251] Throughout development of the record, OCA's original EFT recommendation was revised and OCA now supports PGW moving forward with its late payer deposit program as detailed in the testimony of PGW witness Randall Gyory.[252] Therefore, the Commission should adopt PGW's recommendation on this issue.

The parties were unable to similarly agree regarding OCA's proposal that PGW automatically enroll customers in budget billing when they become delinquent. As explained in its Main Brief, PGW does not support automatic enrollment in budget billing because it does not guarantee that payment troubled customers will pay more consistently, automatic placement on the program for missing one payment may be an overly draconian response, implementing the program in November of each year would have an impact on PGW's cash flow, and implementation of this program would require a modification of PGW's billing systems.[253] In response to these concerns, OCA points to data that its expert witness has available from other jurisdictions.[254] While instructive, data from other jurisdictions fails to take into account that no evidence was produced to show whether these companies were regulated on the basis of the Cash Flow Method,[255] and thus, PGW's specific circumstances and requirements may well be quite different. Before implementation of such a program, PGW would need further information and,

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251 OCA M.B. at 95.

252 OCA M.B. at 97; Tr. at 950-951.

253 PGW M.B. at 93-94.

254 OCA M.B. at 99-101.

255 Tr. 830.

consequently, indicated that it would be willing to analyze this program in the context of its upcoming customer segmentation study.[256] The Commission should not direct implementation of an automatic program until the costs and benefits are known. Because PGW is already committed to assessing this program's viability and working with OCA on these issues as this process moves forward, the Commission should reject OCA's suggestion to direct mandatory implementation.

D. Hess's Proposed Revisions To Supplier Tariff/Rules.

Hess Corporation ("Hess") argues that the Company has not met its burden of proof that *Hess's proposed revisions* to the Company's supplier tariff and rules *should not be adopted.* PGW respectfully asserts that Hess is mistaken because Hess bears the burden of proving that its proposals should be adopted.[257] As the Commission has previously approved as just and reasonable the existing tariff provisions and rules Hess seeks to change, Hess bears a heavy

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256 PGW M.B. at 94.

257 66 Pa. C.S § 332(a) (Except as otherwise provided in Section 315 of the Code or other relevant statutory provisions, "the proponent of a rule or order has the burden of proof."). The Company acknowledges that it has the overall burden of proof of its claims in this case, including the justness and reasonableness of its existing and proposed tariff provisions. The Company meets its burden of proof if it produces substantial evidence to support its claims. *Burleson v. Pa. P.U.C.*, 461 A.2d 1234, 1236 (Pa. 1983). The Company's Main Brief (at 100-03) identifies the substantial evidence which demonstrates that its existing supplier tariff provisions and operational rules related to Hess's nomination, daily delivery and imbalance proposals are just and reasonable because the Company's existing provisions and rules are necessary to enable the Company to maintain the safety and reliability of its distribution system, which the Company is required to do by Section 2205(a) of the Gas Choice Act: An NGDC must implement procedures to require all NGSs to supply natural gas to the NGDC "at locations, volumes, quantities and pressures that are adequate to meet the natural gas supplier's supply and reliability obligations to its retail gas customers and the natural gas distribution company's supply and reliability obligations to its retail gas customers." 66 Pa. C.S. § 2205(a)(2). The Company's existing nomination, daily delivery and balancing requirements comply with the statutory requirements, and have been previously approved by the PUC; Hess does not argue otherwise.

burden to show that the justification for the Commission's prior determination no longer exits.[258] Hess has not met its burden.[259]

Hess attempts to meet its heavy burden by arguing that "PGW takes the stance that the rules governing suppliers in 2003 should be maintained indefinitely, despite the experience that has been accumulated by PGW and the two suppliers operating on its system."[260] This argument misstates PGW's position, and also fails to acknowledge that PGW's experience forms the basis for its position that its existing nomination, daily delivery and balancing requirements are required by its unique system characteristics and use of upstream supply assets to enable the Company to maintain the safety and reliability of its system.[261]

While Hess's experience may include the inability to comply with these requirements without avoiding penalties, that does not mean that PGW's existing tariff requirements and operational rules are unjust, unreasonable or anticompetitive – or a reason that more suppliers are not operating on the Company's system. A more likely reason is the inability of suppliers to compete on commodity price in light of the existing practices for natural gas pricing and cost

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258 *Brockway Glass v. Pa. P.U.C.*, 437 A.2d 1067, 1071 (Pa.Cmwlth. 1981) (burdened party must demonstrate that rate schedule previously determined at least twice to be just and reasonable is no longer reasonable).

259 Moreover, the Company's filing did not propose any revisions to its existing supplier tariff provisions related to the Section 2205(a) requirements or Hess's proposals; consequently, there are no *proposed* revisions to nomination, daily delivery and balancing requirements for which the Company bears the burden of proof under Section 315 of the Code. However, to further demonstrate its commitment to gas choice, the Company stated its willingness to implement proposals responsive to Hess's concerns (PGW MB at 101-02), and assumes that Hess does not object to these concessions as not supported by substantial evidence.

260 Hess M.B. at 8.

261 These unique characteristics, which limit the Company's operational flexibility and which have remained the same since 2003, are explained by PGW witness Muntzer in PGW St. 11 at 5-6.

recovery place in the Commonwealth, as the Commission found in its Gas Competition investigation.[262] Hess's reliance on generic findings in the Commission's Gas Competition Order and Report does not constitute evidence that *PGW's* existing nomination, daily delivery and balancing requirements are impeding competition on the Company's system.[263]

Hess's "shoot first and ask questions later" approach – change the Company's existing requirements, and then "remedy" any operational problems later through additional tariff filings – is not a prudent or acceptable course of action, or consistent with the requirements imposed on the Company by Section 2205(a) of the Gas Choice Act. Also, it is clear that Hess's proposals to *require* the Company to take actions (in the areas of late nominations, retroactive nominations and correction of nomination errors) which the Company now takes on a "best efforts" basis when system safety and reliability will not be adversely affected,[264] would effectively cede control of the Company's system to interstate pipelines and suppliers. Hess's argument that the Company has presented "no" evidence that Hess's proposals "will definitely create operational problems"[265] misstates the Company's evidence and reverses the legal requirement; it is Hess –

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262 The Commission identified these practices as: (1) a "price leader" oligopoly situation where the utility establishes the benchmark against which NGSs must compete; (2) the omission of some gas supply acquisition costs from the benchmark price; and (3) the quarterly adjustment of the benchmark price, and the resulting lag in recognizing increased gas costs. *Investigation into the Natural Gas Supply Market: Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market*, Docket No. I-00040103 (October 6, 2005), *Report on Competition* at 60-61.

263 Hess relies upon the Commission's findings that "according to suppliers" *differing* penalties that *vary among suppliers* act as substantial barriers to NGS entry and market participation. Hess M.B. at 2.

264 Hess fails to acknowledge that the Company has taken these actions for Hess. PGW St. 11 at 4; PGW St. 11-RJ at 1-3.

265 Hess M.B. at 8.

not PGW – that must submit sufficient evidence to show, in the first instance, that its proposal is operationally reasonable. PGW has submitted substantial evidence that they are not.[266]

Finally, the Company's burden of proof does not require the Company to quantify expense savings that Hess alleges would accrue to PGW from implementing Hess's proposals.[267] Nonetheless, contrary to Hess's argument, the Company has demonstrated that the costs to implement Hess's proposals are material and significant.[268] Accordingly, the Commission should reject Hess's proposals because Hess has failed to meet its burden of proof.[269]

E. IGS Residential Customer Aggregation Proposal Should Be Rejected.

As explained above for Hess, IGS also bears the burden of proving why its proposals should be adopted but, same as with Hess, IGS has not met its burden, as shown in the Company's Main Brief.[270] Nonetheless, in its Main Brief, IGS asserts that its testimony showed that its proposed Market Share Threshold ("MST") program could be implemented "without

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266 PGW St. 11 at 5-7 (eliminate daily balancing); PGW St. 11 at 7-8; PGW St. 11-RJ at 3 (change daily balancing tolerance level/penalty); PGW St. 11 at 10; PGW St. 11-RJ at 5 (imbalance netting/trading); PGW St. 11 at 14:6-8 (changes to customer enrollment processes and provision of customer information).

267 *Id.* at 5.

268 PGW St. 11-RJ at 2 (require PGW to accept retroactive nominations); PGW St. 11 at 7; PGW St. 11-RJ at 3 (change daily balancing tolerance level/penalty); PGW St. 11 at 10-11; PGW St. 11-RJ at 4 (imbalance netting/trading); PGW St. 11 at 13-14; PGW St. 11-RJ at 5-7 (changes to customer enrollment processes and provision of customer information).

269 Hess attached to its Main Brief PGW witness Muntzer's discovery response explaining the Company's imbalance rules. This concise explanation does not support Hess's request (Hess M.B. at 21), made the first time in brief and not supported by testimony, that PGW be required to redraft its annual firm transportation imbalance rules in its compliance filing. However, the Company is happy to meet with Hess to discuss these rules further to clear up any remaining confusion

270 PGW M.B. at 103.

increase in costs to PGW."[271] However, the cited testimony states IGS's program proposals could be implemented without producing additional costs to the Company *that would be unrecoverable or nonproductive*, but that is not the same thing, and IGS does not explain how these costs would be recovered. Similarly, in its Main Brief, IGS asserts that its testimony showed that a 30% migration under its MST proposal "would provide significant benefits in the form of a sharing of the discount [below the PGC rate] to fund system improvements to PGW's billing system without the need to spend additional PGW dollars."[272] However, the cited testimony does not explain how this would occur or quantify the alleged savings, and refers only to potential savings *to customers*. As with Hess's proposals, the Company's burden of proof does not require the Company to either quantify the costs to implement IGS's proposals or explain how they would be covered by alleged savings or recovered. IGS's residential customer aggregation should be rejected.

VI. RATE STRUCTURE

A. Cost of Service.

1. The Company's Cost of Service Study Is A Reasonable Guide For Allocating The Proposed Base Rate Increase.

Both the OCA and OTS criticize the Company's cost of service study ("COSS") for (1) allocating a portion of its distribution mains investment as a customer cost and (2) allocating the demand component of the distribution mains cost on a peak demand, as opposed to a peak and

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271 IGS M.B. at 8 (citing IGS St. No. 1, pp. 7-8).

272 *Id.* at 10 (citing IGS St. No. 1, pp. 7-9).

annual demand, basis.[273] The Company's Main Brief fully sets forth the expert testimony that refutes these critiques.[274]

At the outset, it is important to remember the inherently subjective nature of cost of service studies. As the Commission has explained:

> [A] cost of service study is one of the most subjective elements in any rate case. The methods used for classifying items of plant and expense between demand, customer, and energy components are far from being an exact science. Cost of service studies are more accurately characterized as engineering art. . . . This commission has historically recognized the cost of service study for what it is; a useful tool for testing the reasonableness of a proposed allocation of the revenue requirement.[275]

Based upon the expert testimony of record by Mr. Gorman, the Company's COSS plainly satisfies this purpose.[276] In terms of the 25% customer component of the distribution mains cost, Mr. Gorman explained that the number and geographic location of customers being served by the distribution system has a casual relationship with the size, and thus cost, of that system.[277] As such, a customer component is appropriate and, contrary to the continued assertions of the OCA, Mr. Gorman's 25% allocation was not simply assumed but rather was based on his expert analysis of pertinent data.[278]

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273 OCA M.B. at 48-53; OTS M.B. at 54-56. The OTS also objected to PGW's COSS based upon its allocation of industrial measuring and regulating station equipment costs. However, this issue is not in dispute as PGW accepted OTS's suggested change. PGW St. 8R at 20; OTS M.B. at 57.

274 PGW M.B. at 77-79.

275 *Pa. P.U.C. v. Duquesne Light Co.*, 51 PUR 4th 198, 252 (1983).

276 PGW Sts. 8 and 8R.

277 PGW St. 8R at 8-10.

278 OCA M.B. at 50; PGW St. 8R at 8. Furthermore, Mr. Gorman fully explained that, contrary to the OCA's claims, there is no "significant variation" in the Company's

While the Commission has certainly accepted different cost of service studies and allocation methodologies, it has also previously accepted a customer component to distribution mains costs (as well as allocating the demand component on a 100% peak demand basis). In *Pa. P.U.C. v. National Fuel Gas Distribution Corporation*, 1982 Pa. PUC LEXIS 132, the Commission rejected arguments by the OCA that track virtually the same positions advanced by the OCA and OTS here: that there should be no customer component to distribution mains costs and that the commodity based costs should be allocated 50%-50% on peak and annual or average demand.[279]

In rejecting the OCA's position, the Commission recognized the customer cost basis "for the reasons that the footage of distribution mains installed is influenced by the number of customers in each class . . ." and noted that "It is of course true that the footage of distribution mains is influenced by the number of customers being served."[280] Likewise, the Commission reached a similar conclusion as to the OCA's 50-50 split proposal, which is akin to its and the OTS's peak demand criticism of PGW's COSS in this matter. While recognizing that certain costs "may" be appropriately allocated on an annual demand basis, the Commission adopted the ALJ's reasoning that "if [the utility] sized its mains on a commodity-related basis, *peak demand deliverability would not be adequate* . . . it is also true that distribution mains are normally sized and installed in order to meet the maximum peaking requirement on a system."[281] Much like the

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classification of the customer component of the distribution mains cost. *Id.* This assertion is based on the OCA's incorrect notion that the minimum system study and the zero intercept study "measure the same thing." *Id.*

279 1982 Pa. PUC LEXIS 132, **61-62. While the OTS recommends a 50-50 split, OCA has recommended an 80% average demand and 20% peak demand allocation.

280 *Id* at *62 (emphasis added).

281 *Id.* (emphasis added).

OTS here, the Commission found that the OCA did not support its 50-50 methodology "other than to cite examples of use by other utilities," which it deemed insufficient.[282]

The Commission's decision in accepting a 100% peak demand allocation and rejecting an annual-peak demand split is also consistent with the principle of cost causation. As Mr. Gorman explained in his expert testimony, the cost of distribution mains are causally related only to the system's peak demand.[283] Obviously, as OCA and OTS trumpet, PGW's distribution system is used to deliver gas on a daily basis. But, this annual demand was not a factor in designing the Company's distribution system and thus could not be causally related to the system's cost. Rather, as the Commission noted in *Pa. P.U.C. v. National Fuel Gas Distribution Corporation* and as Mr. Gorman testified, the cost of a distribution system depends on the length and diameter of its pipe, and those determinants are designed based on (and the cost of the system is thus causally related to) the length and diameter necessary to meet the system's peak demand requirements.[284] For all of these reasons, the Commission should find that the Company's COSS is reasonable and accept it for purposes of allocating the requested rate increase.

B. Revenue Allocation

1. The Company's Revenue Allocation Is Reasonable And Makes Progress Toward Unity With Each Customer Class's Cost Of Service.

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282 *Id.*

283 PGW St. 8R at 15-20.

284 PGW St. 8R at 17, 19. Additionally, specific to OTS, Mr. Gorman explained how the A&E method it advocates, when properly applied in accordance with the *Gas Rate Fundamentals* guidebook, does not use a 50/50 weighting, but rather produces a result that is equal to the peak demand method used in PGW's COSS. PGW St. 8R at 20.

The OSBA, OTS and PICGUG all oppose the Company's proposed revenue allocation alleging that it strays too far from the principle of cost based rates.[285] The parties' arguments should be rejected as they both rely on an overly broad reading of the Commonwealth Court's decision in *Lloyd v. Pa. Public Utility Comm'n*[286] and are contrary to the record evidence that progress is indeed being made toward unity with cost.

While the court in *Lloyd* clearly considered cost of service as a major concern in ratemaking, the court also cited – and neither backed away from nor overturned – its long-held guidance that "[w]hile cost to serve is important, other relevant factors may also be considered" and that "overall, . . . rate differentials must advance efficient and satisfactory service to the greatest number at the lowest overall charge."[287] As PGW's testimony demonstrated, and as the OCA agreed, PGW's revenue allocation is consistent with this guidance.[288]

The real error recognized in *Lloyd* is not adherence to gradualism, but the court's perception that the Commission had allowed it to "trump" all other ratemaking concerns.[289] This occurred because the approved revenue allocation showed no progress toward closing the gap between the subsidizing classes' rate of return and their cost of service. As the court explained:

> [The PUC] also never explains how the acknowledged discriminatory rate class structures are going to be lessened . . . Because . . . the Commission offers no explanation how discrimination in distribution and transmission rate structures are eventually going to be gradually alleviated, in effect, the

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285 OSBA M.B. at 37-48; OTS M.B. at 58-63; PICGUG M.B. at 19-22.

286 904 A.2d 1010 (Pa. Commw. 2006).

287 *Id.*, at 1016.

288 PGW Sts. 8 and 8R; OCA M.B. at 63-79.

289 904 A.2d at 1020.

> Commission has determined that the principle of gradualism trumps all other ratemaking concerns . . . .[290]

The same simply cannot be said in this case, and, as a result, the parties' reliance on *Lloyd* stretches its holding much too far. The fact of the matter is that the record evidence demonstrates that the relative rate of return for all customer classes will move closer to unity with the system average rate of return under the Company's proposed rates as compared to its present rates.[291] The residential class's relative rate of return increases toward cost by 6% and the rates of return for all other classes decrease toward cost by the substantial range of 26-62%.[292]

While OSBA's Mr. Knecht objects to the use of the system average rate of return as a benchmark for measuring progress toward unity,[293] the court in *Lloyd* actually referenced the same benchmark and expressed no inherent dissatisfaction with them.[294] Further, OSBA's citation to the fact that the total dollars of cross-subsidy will increase post-rate increase offers no support whatsoever for its claim that the revenue allocation moves the classes farther away from unity.[295] Obviously, if PGW's base rates are increased by $100 million, the total dollar amounts of subsidy will increase as compared to present rates. The material fact is whether the non-residential classes percentage of subsidy is decreasing and moving toward cost – as it undeniably is under the Company's proposed revenue allocation.

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290 *Id.*

291 PGW St. 8R at 5; PGW Exh. HSG-7C Revised (Mar. 30); OCA M.B. at 72-73 (citing Exh. 1Ec-4, Table 4-B).

292 *Id.*

293 OSBA St. 1 at 18-19.

294 *Id.* at 1016-17.

295 OSBA M.B. at 37; OSBA St. 1 at 19.

For all of these reasons, and those set forth in the Company and OCA's Main Brief, the Commission should accept PGW's revenue allocation. Further, the Commission should apply a proportional scale-back of that allocation in the event it authorizes less than the Company's full requested rate increase.

2. The Commission should maintain the universal service cost allocation approved during PGW's restructuring and reject the OSBA and PICGUG's request to shift all such costs onto the residential class.

Both the OSBA and PICGUG have suggested that their constituencies should be freed from the responsibility to support PGW's universal service measures, and that all of those costs should rest squarely on the shoulders of the residential customers of Philadelphia.[296] As in so many other instances since PGW has come under the jurisdiction of the Commission, this proposal stems from a refusal to recognize that PGW, in a multitude of ways including its ratemaking methodology, its customers demographics, its municipal status, etc., is in fact different from other, traditional utilities. With their universal service proposal, the OSBA and PICGUG attempt to place the round PGW peg into the square utility whole, and the result is contrary to the terms of the Gas Choice Act, an overstatement of Commission precedent, and bad policy.

Stepping back a moment, the Commission has repeatedly recognized its duty under the Gas Choice Act to "ensure that 'universal service and energy conservation policies are appropriately funded and available' in each natural gas distribution service territory."[297]

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296 OSBA M.B. at 8-33; PICGUG M.B. at 22-25.

297 *Application of Equitable Gas Company for Approval of Natural Gas Choice and Competition Act Restructuring Filing* ("Equitable Drop"), Docket No. R-00994784, Order (July 18, 2002) at 13; *see Petition of National Fuel Gas Distribution Corporation Requesting: 1) Permission to Expand Participation in LIRA Rate, 2) Permission to Revise Rates Charged Under the Existing LIRA Rate, and 3) Permission to Implement a Funding*

However, beyond this statutory duty, the Commission has declared repeatedly that universal service programs are a good thing. For example, the PUC has stated:

> Distribution's LIRA program plays an important role in the pursuit of universal service by making gas service affordable to low-income Pennsylvanians. Obviously, expanding the program by increasing the number of participants will only aid in promoting affordable gas service to low-income customers.[298]
>
> Equitable's DROP will play a key part in the pursuit of universal service by helping ensure that some of Pennsylvania's most vulnerable citizens, those in poverty, continue to have access to affordable natural gas service.[299]

Clearly, these passages demonstrate that universal service is something the Commission has long believed should be pursued, and that providing access to affordable natural gas for our Commonwealth's poor and lower-income citizens is an important policy achievement. These sentiments were reiterated in the Commission's recent Order in *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms Final Investigatory Order*, Docket No. M-00051923 (Order entered December 18, 2006), and have only grown since the enactment of Chapter 14 of the Public Utility Code.

Accordingly, the Commission should find that the Company's programs, which ensure affordable gas for a large number of impoverished citizens, are a considerable success in the worthy pursuit of universal service. Certainly, as the record reflects, Philadelphia is home to perhaps the greatest concentration of some of Pennsylvania's most vulnerable citizens, as one

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Mechanism to Provide Recovery of Costs of Variable Discount for the Expanded LIRA Program ("NFG LIRA"), Docket No. P-00021945, Order (March 28, 2002) at 13.

298 *NFG LIRA* at 13 (emphasis added).

299 *Equitable Drop* at 13 (emphasis added).

third of PGW's customers are at 150% below the federal poverty level.[300] The fact that, as the Commission has noted, universal service programs "do not come without a cost,"[301] does not alter the success that PGW has realized through its CRP. Moreover, the Commission's recognition of the value of universal service programs in the face of that cost strongly suggests that it would not favor the dismantling of a successful program, like PGW's CRP, in order to save commercial and industrial customers a buck, as proposed by OSBA and PICGUG.

Against this backdrop, the fallacy of the OSBA and PICGUG's universal service program cost shift becomes clear. As Section 2203(8) of the Gas Choice Act requires, the Commission must "ensure that universal service and energy conservation policies, activities and services are appropriately funded and available in each natural gas distribution service territory."[302] Obviously, the universal service programs that are to be "funded and available" in each NGDC's service territory must be suitable to address the needs of the population in each service territory. For instance, it would do little good for the Commission to ensure that NFG's universal service program, which assisted 5,000-8,500 customers in 2002, is available in PGW's territory where some 76,000 customers are CRP participants and a substantial additional amount of customers are eligible.[303]

While OSBA and PICGUG reference the Commission's policy of collecting universal service costs from only residential customers, that policy was not applied to PGW in its Restructuring Proceeding and is based on cases and utilities that differ materially from PGW.

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300 PGW M.B. at 94.

301 *Equitable Drop* at 14.

302 66 Pa. C.S. § 2203(8).

303 PGW M.B. at 95.

For instance, consider the following distinguishing facts from two such cases *Equitable Drop* and *NFG LIRA*:

- *Participants* – In the February 2002 filing, NFG was seeking permission to expand its LIRA program from 5,300 customers to 8,500.[304] Similarly, Equitable planned to reach maximum universal service participation of 10,000 customers by 2004.[305] PGW, on the other hand, presently has some 76,000 CRP customers, which represents only 50% of those who could be eligible.[306]

- *Costs shifted to residentials* – NFG's expansion of the program, as applied only to residential customers, would increase rates somewhere between $0.06-$0.08/Mcf.[307] With Equitable's universal service changes, the Commission asked residential customers to absorb an additional five cents per Mcf.[308] Notably, the Commission actually refused to shift $0.17/Mcf from the small business to the residential class.[309] Finally, we have the OSBA and PICGUG who would shift over $0.80/Mcf to the residential class.

The stark differences between the cases forming the basis for the Commission's standard policy on this issue and the Company's experience, customer demographics, and universal service programs plainly eliminates them as any form of guidance or prototype for the Commission in this proceeding. The parties would extend the Commission's precedent well beyond its reasonable factual boundaries. Requiring residential customers in an NGDC service territory where a mere 5,000-10,000 persons are at 150% below the poverty level to absorb an additional five to eight cents per Mcf in order to fund and make available universal service may well be reasonable. However, when some 150,000 residential customers are at 150% of the poverty level, and the residential customers (including those eligible but non-CRP participants)

304 *NFG LIRA* at 3.

305 *Equitable Drop* at 2.

306 PGW M.B. at 94-95.

307 *NFG LIRA* at 6.

308 *Equitable Drop* at 15.

309 *Id.*

would be asked to pay an additional $0.80/Mcf – or around $71 - $80 annually – in order to excuse the commercial and industrial customers from supporting what the PUC has recognized as the important pursuit of universal service and access to affordable gas, the conclusion is radically different. Accordingly, the OSBA and PICGUG's proposal should be rejected on these grounds alone.

Nor can the parties find any support for their cost shift in the Commission's recent Order in *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms Final Investigatory Order*. Indeed, not only is PGW's CRP cost recovery allocation not inconsistent with the Commission's Order, but the Commission's discussion actually supports not adopting OSBA's proposal. As the Commission explained in its Order:

> After careful consideration of the comments and the arguments presented, the Commission will continue its current policy of allocating CAP costs to the only customer class whose members are eligible for the program – residential customers. The Commission believes that we should not initiate a policy change that could have a detrimental impact on economic development and the climate for business and jobs within the Commonwealth.
>
> Since the Commission first encouraged utilities to initiate CAP programs on a voluntary basis, it has allocated CAP costs to the residential class, with a few exceptions. . . .[310]

In looking to this text for support, the OSBA and PICGUG apparently overlook the fact that *PGW is one of those "few exceptions"* referenced by the Commission.[311] Moreover, a residential-only CRP allocation is not the PUC's "current policy" as to PGW and, if the

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310 *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms Final Investigatory Order,* Docket No. M-00051923 (Order entered December 18, 2006) at 31 (emphasis added).

311 *Id.* at 31 and n. 25. Indeed, the Commission expressly references PGW, along with Dominion Peoples and PG Energy, as examples of its "few exceptions" in footnote 25 to its Order.

Commission were to "continue its current policy" as applied to the Company, it would continue to allocate the CRP costs to all firm customers.

Further, in the quoted text, the Commission rejects the idea of initiating "a policy change that could have a detrimental impact on economic development and the climate for business and jobs." Yet, that is exactly what the parties' proposal requires the Commission to do. Businesses in PGW's service territory are already paying a portion of the costs of the CRP program. By maintaining the status quo, the Commission would not be imposing some new or increased cost on them. To the contrary, by deciding to change the CRP cost recovery allocation for PGW, the Commission would in fact be initiating a policy change and, as Messrs. Hershey, Colton and Geller testified, that change could very well have a detrimental impact on businesses and jobs in Philadelphia.[312]

Ultimately, OSBA and PICGUG's position falls of its own weight. There can be no question that the non-residential classes receive indirect benefits from PGW's CRP.[313] The parties do not appear to dispute this fact. Instead, OSBA bases its proposal on the erroneous contention that the ineligible and non-enrolled residential customers somehow receive a direct benefit from CRP in the form of an "insurance policy."[314] However, as PGW demonstrated on the record, this is flat wrong – this alleged insurance policy is just as indirect and distant a benefit, and in some ways more so, than the benefits realized by the non-residential classes.[315]

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312 PGW St. 1R at 16-17; OCA St. 4-R at 3-14; Action Alliance St. 1-R at 1-4.

313 PGW St. 1R at 16-17; OCA St. 4-R at 3-14; Action Alliance St. 1-R at 1-4.

314 OSBA St. 1 at 29-30.

315 PGW St. 1R at 18; OCA St. 4-R at 3-14.

Accordingly, the indisputable fact is that *the only* direct beneficiary of the CRP program are the participants themselves – who do not contribute to its cost recovery.[316] Thus, OSBA's proposal does not further cost causation principles, and instead devolves into an arbitrary picking and choosing between indirect beneficiaries of the CRP program. Given the numerous flaws in its proposal, and the Commission's reiteration just a few months ago that PGW is an appropriate exception to its residential-only allocation policy, the Commission should reject OSBA's universal service cost allocation proposal.

C. Tariff Structure.

1. PICGUG Failed To Make The Case For Cost-Based IT Rates

In terms of both the evidentiary record and its legal arguments, PICGUG has failed to make the case for its dramatic cuts in PGW's IT rates by moving from the Company's individually negotiated, alternative fuel-based margin rates to cost-based rates. The Company anticipated and addressed the majority of PICGUG's claims in its Main Brief, and will not repeat those arguments here. Instead, PGW focuses on two assertions by PICGUG that merit additional comment.

First, PICGUG's attempt to rely on the *Lloyd* cases is meritless. Beyond the fact that *Lloyd* specifically dealt with revenue allocation, the court in *Lloyd* did not hold that every rate must be cost-based and that no other ratemaking concerns or principles may be considered by the Commission. Rather, the court expressly repeated its past precedent that "while cost to serve is important, other relevant factors may also be considered."[317]

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316 PGW St. 1R at 18-19.

317 *Lloyd v. Pa. Public Utility Comm'n*, 904 A.2d 1010 (Pa.Cmwlth. 2006).

Second, as further explained in the Company's Main Brief, the record evidence shows that: (1) the Company's has successfully negotiated reasonable IT rates with its IT customers; (2) the Company has ample incentives to do so and has committed to negotiating fairly, responsibly and in good faith with any potential customer that has alternative fuel capabilities; (3) using the customer's "opportunity cost" vis a vis the cost of alternative fuel sources is a reasonable and market-driven basis on which to negotiate such rates; and (4) the amount of throughput being delivered via IT has increased tenfold since 2002 – again endorsing PGW's existing rates.[318] In response, PICGUG offers only speculative conjecture and unfounded fears that its members will either not be able to negotiate such agreements with PGW or that those customers admittedly already receiving reasonable IT rates will somehow not be able to renew them.

The lone example PICGUG offers as an alleged instance of the Company's unwillingness to negotiate is its interactions with the Philadelphia College of Osteopathic Medicine ("PCOM"). PICGUG trumpets the fact that the Company's initial offer to PCOM was the tariff's maximum rate. However, the testimony of PGW's Craig White, Executive Vice President and Acting Chief Operating Officer, established that this offer was in the context of preliminary discussions, at which time PCOM did not even have dual fuel capabilities and still had issues pending with the Philadelphia Fire Department concerning its proposed use of propane, and that the Company had not been provided with any data as to volumes of gas that PCOM may use, the term that it would use those volumes and the potential revenues that would result therefrom. Based on this scenario, PGW responsibly pointed to the max rate and waited to receive additional information and counter-offers from PCOM – which it never received. Nonetheless, PGW made clear its

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318 PGW M.B. at 82-84.

willingness to negotiate and add PCOM as an IT customer.[319] With this interaction as the sole "evidence" for its claims, PICGUG falls woefully short of substantiating the need for its radical change to the Company's IT rates and its proposal should be rejected.

2. The School District's Arguments Regarding Rule 10 Must Be Rejected.

PGW requires up front payments for all capital costs related to connecting School District of Philadelphia ("SDP") buildings to PGW's distribution system (i.e. the cost of mains and services).[320] When SDP meets its obligations related to these contracts, the up front payments will eventually be credited to SDP in whole or in part.[321] To date, SDP has not met its obligations under any of these contracts, therefore, SDP has not yet received any credits.[322] PGW requires these up-front payments because SDP not only failed to meet its contractual usage obligations in the past, it also failed to reimburse PGW for the related capital costs when SDP failed to meet these usage obligations.[323] The bottom line result of SDP's failure is that other PGW ratepayers are now paying for the costs for which SDP should have paid.[324]

SDP claims that PGW does not have discretion granted by its tariff to require up front payments by SDP.[325] Such a claim is ridiculous because the plain reading of Section 10.B.1. of the Gas Service Tariff clearly states that this tariff section is applied to gas service applications "where the Company in its sole judgment anticipates long-term, continuous usage at projected

319 Tr. at 622-624.

320 Tr. at 687-688.

321 *Id.*

322 PGW St. 5R at 23.

323 *Id.* at 22-23.

324 Tr. at 686-687.

325 SDP M.B. at 4-10.

volumes of Gas." As discussed in more detail in PGW's Main Brief,[326] SDP has clearly demonstrated that its commitment to fulfilling it contractual obligations is dubious, therefore, PGW cannot anticipate "long-term, continuous usage at projected volumes of Gas" from SDP. Additionally, SDP's current track record has yet to demonstrate its commitment to fulfill its obligations because SDP has not yet met its current contractual obligations.

SDP further asserts that PGW has not provided any supporting documentation or accounting for its current contracts which required up front capital payments. By so asserting, SDP seems to imply that it has indeed met its contractual obligations – but SDP does not come out and say so. Regardless, SDP has all of these contracts in its possession and receives all of the invoices billed pursuant to these contracts. If it indeed has met its obligations under these contracts, it should have presented such on the record , but it did not. Furthermore, if SDP actually reviewed these contracts, actually determined that it has met its contractual obligations and actually informed PGW that it was due a credit for certain contracts, it certainly would have stated all of this in its testimony, but it did not. Beyond SDP's attempt to imply that it has met its current contractual obligations, SDP, in fact, has not met these very same contractual obligations.[327]

SDP makes another claim that in its witness, Judith Mondre's experience with PGW customers, PGW is treating SDP differently[328] from other customers by requiring up front capital payments and also seems to find confirmation of this because PGW has failed to deny this claim

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326 PGW M.B. at 87-89.

327 PGW St. 5R at 22-23.

328 The School District states: "I have observed through my experience on behalf of other clients who are PGW customers that this is inconsistent with PGW's practices with regard to its other customers..." SDP St. No. 3 at 13 (Direct Testimony of Judith Mondre).

originally set forth in SDP's direct testimony. PGW did not deny this claim because Ms. Mondre's experience is so limited with PGW customers, therefore, she cannot provide a credible basis for such an opinion. In fact, her testimony does not even mention the number of PGW customers with which she is involved nor the extent of her involvement with any other PGW customers. Additionally, Ms. Mondre has never identified any customers, or claimed to know of any customers, who, like SDP, have failed to meet its contractual obligations and was treated differently by PGW with regard to up front payments for capital costs. As a result of the foregoing, her opinion has no value.

Given many opportunities to set forth its position on the record, SDP has failed to present credible evidence to supports its claim, therefore, its request for an accounting and its claim that PGW applies its tariff in a discriminatory manner fail due to the lack of factual bases as well as the lack of legally sufficient arguments.

3. PHA's Demand That its Service Should Be Billed at the Residential Rate Should Be Rejected.

The Philadelphia Housing Authority ("PHA"), in its main brief, is fundamentally confused about the basis for the PHA Rate and alleges variously that PGW is over-charging PHA, PHA Rate 8 should be billed at either the GS - Residential Rate or the MS - Municipal Rate and PGW has not provided support for PHA Rate 8.[329] With respect to the claims regarding the MS rate, the best way for PGW to frame its reply, is exactly what Craig White, PGW's Acting Chief Operating Officer, stated in PGW's rebuttal testimony:

> If the PUC approved it and the other parties to this proceeding did not object, PGW would not object to reclassifying PHA's conventional sites, currently served under the PHA 8 rate class, as MS rate customers. Given the complete lack of even similarities between the individual residential customers at PHA's scattered

[329] PHA M.B. at 5-10.

> sites and those entities eligible for the MS rate, the Company does not support extending the MS rate to customers at those locations. Additionally, any lost revenue from the reclassification would need to be recovered from PGW's remaining customers.[330]

Nonetheless, PHA incorrectly continues to maintain that its Rate 8 accounts (i.e. PHA's conventional sites) have been eligible for the MS Rate all along and that PGW, as a result, has over-billed PHA up to $2.8 million. While this allegation, if true, could possibly constitute violation of Section 1303 of the Public Utility Code, by the current text of the tariff clearly shows, PHA is not in fact eligible for the MS rate. Likewise, even the text of the tariff quoted by PHA in relation to the GS-Residential rate – that it includes "residential and public housing authority customers"[331] – plainly does not cover PHA's conventional sites. As to those sites, PHA, not its customers, is the customer of record. The reference in the tariff is for PHA's scattered site customers, who reside in individually metered residences.[332]

PHA also claims that PGW did not provide an explanation, in discovery, to PHA's request for information regarding the reasons for the proposed PHA Rate increase.[333] This claim is baseless because PGW provided both extensive explanation and underlying data in the Cost of Service Study and the testimonies of Howard Gorman and Craig White. Furthermore, PHA's attorney made this same claim during the hearings in this proceeding and there was a finding that if PHA believed that an inadequate explanation was provided to this discovery request, then PHA lacked due diligence in pursuing an adequate response.[334]

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330 PGW St. 5R at 27.

331 PHA (Mondre-Surr.) at 2.

332 Tr. at 624-626.

333 PHA M.B. at 6.

334 Tr. at 666.

Finally, PHA confuses the history of the PHA Rate and the current basis for the PHA Rate. PHA seems to be asserting that the proposed PHA Rate is somehow based on the historical rate. As is demonstrated by the Cost of Service Study and the testimony of Howard Gorman, the PHA Rate is based on test year data (i.e. PGW's fiscal year 2007) regardless of the Rate's history – PHA even acknowledged this in its stipulation with PGW.[335]

The issues raised by PHA regarding PGW's past dealings with the Housing Authority notwithstanding, PGW would not object if the Commission or the parties found in support of PHA's position for the application of the MS rate to the PHA conventional sites.

4. AA Makes No Sustainable Argument Against The Tariff Revisions Proposed By PGW To Conform Its Tariff To Current Law And To The Tariffs Of Most Other Public Utilities.

As detailed in PGW's Main Brief, tariff revisions have been proposed in this proceeding to clarify the applicable standards, conform to existing law, and to create a tariff more in line with the format used by most other regulated utilities.[336] AA recommends that the Commission deny PGW's revisions in six specific sections.[337] Because AA's justifications for these recommendations are not adequately supported by the record or the law, they must be rejected.

a. Applicable Law

AA does not support PGW's proposed inclusion of "Company Policy" in its definition of Applicable Law.[338] PGW's response clarified that the intent of adding this language into its tariff

335 Tr. at 815-16.

336 PGW M.B. at 98-100.

337 AA M.B. at 38-50.

338 AA M.B. at 38-41.

is to provide notice to customers that such policies exist.[339] PGW recognizes that all of its policies must be consistent with the law and anytime PGW considers implementing a policy or revising an existing one, it extensively reviews the proposal to ensure consistency with the law.[340] All such policies are constantly reviewed by the PUC's Bureau of Consumer Services. AA's suggestion to the contrary is an unwarranted supposition that should be summarily rejected. While PGW's position is that AA's recommendation on this point be rejected, PGW is willing to modify the company policy references in its tariff to clearly state that "the policies follow the applicable law and . . . follow the rules and regulations of the Commission."[341]

b. Adequate Assurances (Section 8.3.B)

AA dislikes the terminology "sole discretion" in Section 8.3.B of PGW's proposed tariff claiming that it is a misrepresentation of the law.[342] But, as AA well knows, such "sole discretion" language is always subject to PUC review. Under current regulations PGW has an obligation to protect the public from danger[343] and with this obligation comes the right to make an initial determination as to whether or not the customer will continue to present a safety risk.[344] Applicants who have been denied service are notified of their right to appeal PGW's decision and PGW has not required satisfactory assurance from any residential customer in the recent past.[345]

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339 Tr. at 942-43; PGW St. 6R at 16.

340 Tr. at 943.

341 Tr. at 943-44.

342 AA M.B. at 42.

343 52 Pa. Code §§ 56.191, 59.26, and 59.33.

344 PGW St. 6R at 17.

345 PGW St. 6R at 17.

AA's opinion of the terminology notwithstanding, PGW's proposed language is accurate, in accordance with the law and should be adopted.

c. "Unauthorized Use" v. "User Without a Contract"

AA is concerned that PGW's proposed tariff could mislead "users without contract" into believing that they could be terminated without prior written notice and have no basis for claiming other consumer protections available to customers and occupants.[346] However, as explained by PGW witness Gyory, regardless of how it occurs a user who lacks permission is an "unauthorized" user and PGW's tariff revisions accurately reflect this.[347] Therefore, AA's position on this issue must be rejected.

d. Notice of Rejection (Section 2.4.C)

AA recommends that PGW's tariff retain the provision that PGW is required to provide a full and complete itemized statement of the reasons PGW has rejected an applicant's request for service.[348] As stated in the record, though PGW proposes to remove this section, it does not intend to change its present practices which utilize the existing Residential Credit Statement as the written denial.[349] PGW proposes to remove the language setting forth the specific information to be included in the notice so that PGW has the same legal rights enjoyed by other utilities in the Commonwealth to not include in its tariff voluntary policies that it follows as a

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346 AA M.B. at 44.

347 PGW St. 6R at 17.

348 AA M.B. at 44-46.

349 PGW St. 6R at 18.

public service; as well as to provide PGW with the same level of flexibility needed to modify those policies to benefit customers.[350] AA's recommendation must be rejected.

e. Persons Not Responsible for Unauthorized Use (Section 8)

AA is concerned that PGW's proposal to eliminate Section 8.3.D of its current tariff will empower PGW to hold innocent persons responsible for tampering or theft.[351] Assuming that PGW would act in this manner even though to do so would be a violation of current law and Commission regulations, is inappropriate.[352] The Commission should reject AA's position on this issue.

f. Home Visits (Section 2)

AA opposes PGW's proposed removal of Section 2.1.D regarding home visits for persons with disabilities even though AA has conceded that no other utilities have a similar tariff provision.[353] Although PGW does provide home visits as part of its current policies, requiring it to maintain tariff provisions setting forth obligations that are not legally required is not reasonable and must be rejected.[354]

D. Summary and Alternatives

Philadelphia Gas works has shown that its requested $100 million base rate increase is just and reasonable and that its proposal to retain the proceeds from off-system sales and capacity release credits to be used to fund a construction projects is in the public interest. PGW has also shown that the minimum increase that could be awarded to maintain the status quo and

350 PGW St. 6R at 18.

351 AA M.B. at 47-48.

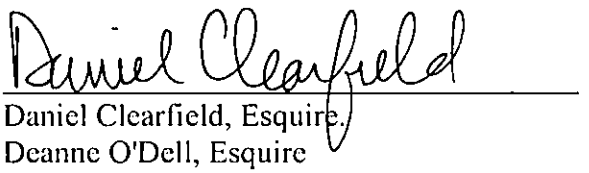
352 PGW St. 6R at 18.

353 AA M.B. at 49; PGW Exh. No. RG-5.

354 PGW St. 6R at 19.

be consistent with the PUC's prior two base rate decisions is $70.2-$71.5 million. PGW also has demonstrated that its proposal to allocate the rate increase as it has proposed is reasonable, and that its proposed modifications to its Tariff Gas No. 2 rules and regulations should be accepted. Its stipulation with the Office of Trial Staff regarding class 2 gas leak monitoring should be approved as well as the PGW/OCA agreement proposal to move forward with a late payer deposit program. PGW does not oppose PHA's proposal for its conventional sites to be henceforth included in the MS rate. The Commission should take further action consistent with PGW's Main and Reply Briefs.

Respectfully submitted,



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CERTIFICATE OF SERVICE

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

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