



ORIGINAL

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June 12, 2007

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James J. McNulty
Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17105-3265

DOCUMENT
FOLDER

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 Main Brief, in the above-referenced proceeding.

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

Sincerely,

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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ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

Docket No. R-00061931

Philadelphia Gas Works

DOCUMENT
FOLDER

MAIN BRIEF OF THE
OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

A. Overview.

On December 22, 2006, Philadelphia Gas Works (PGW) filed Supplement No. 16 to Tariff Gas- Pa. P.U.C. No.2 to increase its distribution base rates by \$100 million. The Company also seeks to retain approximately \$10 million in Off-System Sales and capacity release revenue that is currently credited to customers to reduce the Gas Cost Rate (GCR). The impact of the Company's request is to increase overall rates by 9.6% and to increase the GCR charged to customers by \$10 million.

On July 1, 2000, pursuant to the Natural Gas Choice and Competition Act ("Act"), the Pennsylvania Public Utility Commission ("Commission") assumed jurisdiction over the public utility service offered by PGW within the City of Philadelphia. 66 Pa.C.S. § 2212. Prior to the passage of the Act, PGW's rates, terms and conditions of service were exempt from jurisdiction, regulation and control of the Commission. Instead, PGW was regulated by the Philadelphia Gas Commission (PGC), a local agency of the City provided for by the Philadelphia Home Rule Charter, 351 Pa. Code §§ 3.3-100, 5.5-902. The Philadelphia Gas Commission continues to approve PGW's Operating Budget each year, but rates and rate increases are subject to the jurisdiction of the Commission. Paramount in the consideration of any rate request under the Public Utility Code is the requirement that rates be just and reasonable.

Unlike PGW's prior rate increase 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. PGW's bond coverages currently meet all coverage requirements and its net funds from operation, which had been low and erratic for many years, have become more

robust. PGW's collection of revenue from its customers has also increased over the years so that it is now able to collect 96¢ of every dollar billed to customers. PGW also will be able to retire \$36.7 million of bonds in the test year in this case, and during the proceeding, PGW was able to issue \$200 million of additional revenue bonds.

The justification for PGW's request is primarily PGW's determination that it needs additional revenues to reduce its long-term debt balances. PGW's long term debt balance and its debt-to-equity ratio have developed over many years with many contributing factors. The Company's prior lack of adequate cost control, its aging system, the long delay in completing its LNG expander project, higher natural gas prices, and its payments (dividends) to its owner without obtaining capital contributions have all contributed to the problem. Since 1993, PGW's long term debt balance had grown by \$360 million and its debt-to-equity ratio increased from 75% to a high of 83%, before declining to about 82% in 2006. In a five year business plan and forecast that forms the basis of PGW's request, PGW now seeks to achieve \$205 million in debt reduction and establish a 50%/50% debt-to-equity ratio by 2012.

Thus, a critical area of dispute in this proceeding is how far forward the Commission should look when establishing rates and whether PGW's ratepayers should be asked to be the sole support for restoring PGW's financial health. By looking forward to 2012, and seeking to have ratepayers fund the debt reduction program and provide for capital expenditures through this period, PGW sees the need for a \$100 million rate increase and the need to further increase rates by retaining \$10 million in offsystem sales and capacity credits that are used to reduce the GCR paid by customers. In essence, over the test year and five year forecast period, PGW would recover \$660 million from ratepayers, but of this amount, only 3.4% would cover increased operating expense, while 54.2% goes to debt reduction and 36.8%

goes to capital expenditures. During this period, the City would provide \$72 million through the grant back of the City payment until 2010, but it plans to get \$45 million back through the repayment of the City loan.

When PGW's need is viewed in the context of traditional ratemaking which uses a future test year with owners/shareholders meeting the capital requirements of a utility, however, a very different picture emerges. Based on the future test year, PGW's revenues are sufficient to meet the bond-indenture coverages and provide sufficient cash for operations. At the end of the future test year, PGW has debt service coverage on its 1998 Ordinance bonds of 2.03x, even without pro forma adjustments, well in excess of the 1.5x coverage requirement. The Company will also have a year end cash balance of over \$50 million, a level that it has not seen since 1995.

The OCA has identified, however, a known and certain obligation to repay the \$45 million City Loan in two years. Based on this known obligation, the Office of Consumer Advocate (OCA) recommends a \$22.5 million increase to reflect a two-year repayment of the City loan. With this level of rate increase, PGW's financial measures remain above required levels, and PGW is provided sufficient revenue to meet its City loan obligations, continue to pay down its debt pursuant to its bond indentures, and continue to have sufficient cash at year end. The OCA submits that to the extent the Company seeks to achieve certain financial measures such as additional debt reduction, the City, as owner, should consider permanent equity contributions. Requirements to pay back the \$45 million City loan and the resumption of the \$18 million City payment will, in the end, be detrimental to PGW's own debt reduction initiative.

The OCA submits that PGW's long term debt problem is not one that can be realistically solved in five or six years and it cannot be solved solely through increased rates. The public input testimony was clear that PGW's ratepayers continue to struggle to pay their bills. Many customers spoke of the measures that they take to afford their bills, from turning the heat down to where the house is cold, to forgoing other necessities, to working other jobs. It is estimated that more than 30% of PGW's customers have incomes at or below 150% of the Federal Poverty Level. And, PGW's customers face the highest overall gas rates in Pennsylvania. Despite these circumstances, PGW's ratepayers are now paying 96¢ of every dollar that they are billed, a dramatically improved collection rate from the historic level of 92¢ on the dollar. As Representative Parker testified at the public input hearings regarding the increased collection tools afforded to PGW through Chapter 14, "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 cost cutting at PGW and enrolling more customers on PGW's customers assistance program, CRP." Tr. at 103-104. But, PGW has again turned to its ratepayers for more revenue, this time reaching out more than six years to justify its request.

The OCA submits that the Commission must ensure that PGW's rates are just and reasonable, and to do so, the Commission should adhere to traditional ratemaking principles that have guided the Commission's decision in prior PGW base rate cases and in all other utility rate cases. Based on the cash flow method and the test year concept, the OCA submits that PGW is entitled to a rate increase of \$22.5 million.

The OCA has attached to its Main Brief its Final Tables under the cash flow method of ratemaking as Appendix A, proposed ordering paragraphs as Appendix B, and any unpublished decisions referenced by the OCA as Appendix C.

The OCA hereby submits its Main Brief in support of its position.

B. History of the Proceeding.

On December 22, 2006, Philadelphia Gas Works (PGW) filed Supplement No. 16 to Tariff Gas- Pa. P.U.C. No.2 to increase its distribution base rates by \$100 million. The Company also seeks to retain approximately \$10 million in Off-System Sales and capacity release revenue that is currently credited to customers to reduce the Gas Cost Rate (GCR). The impact of the Company's request is to increase overall rates by 9.6% and to increase the GCR charged to customers by \$10 million.

PGW is a municipal utility owned by the City of Philadelphia and managed by Philadelphia Facilities Management Corporation (PFMC), a non-profit Pennsylvania Corporation. The natural gas service being furnished or rendered by PGW became subject to the regulation and control of the Pennsylvania Public Utility Commission (Commission or PUC) on July 1, 2000, pursuant to the Natural Gas Choice and Competition Act, 66 Pa. C.S. § 2212 and pursuant to Section IV of the Company's existing Tariff.

By order entered February 8, 2007, the Commission suspended the filing until September 20, 2007. The case was assigned to the Office of Administrative Law Judge and to Administrative Law Judges Cynthia Fordham and Angela Jones. On March 5, 2007, PGW supplemented its tariff filing to extend the suspension to September 28, 2007.

Approximately 71 formal complaints have been filed against PGW's rate request. On December 28, 2006, the Office of Trial Staff (OTS) entered its appearance. The

Office of Consumer Advocate (OCA) filed a Formal Complaint on January 5, 2007. On January 18, 2007, the Office of Small Business Advocate (OSBA) filed a Formal Complaint. The Action Alliance of Senior Citizens of Greater Philadelphia and Tenant Union Representative Network (Action Alliance) filed their Formal Complaint on January 27, 2007. The Philadelphia Industrial and Commercial Gas Users Group (PICGUG) filed a Formal Complaint on February 5, 2007. Petitions to intervene were filed by PECO Energy Company on February 7, 2007; Interstate Gas Supply, Inc. (IGS) on February 15, 2007; the Philadelphia Housing Authority (PHA) and School District of Philadelphia (School District) on February 16, 2007; the Hess Corporation (Hess) on February 22, 2007; and the Archdiocese of Philadelphia (Archdiocese) on March 9, 2007.

Two prehearing conferences were held on March 2, 2007 and April 6, 2007. ALJs Fordham and Jones presided over four public input hearings held on: March 26, 2007 at the Dorothy Emanuel Recreation Center; March 28, 2007 at the George Washington High School; and April 9, 2007 at the Community College of Philadelphia.

Direct Testimony was submitted by the active parties on April 6, 2007. The OCA submitted the Direct Testimony of Richard LeLash; Michael Bleiweis; Richard Galligan; and Roger Colton, the Rebuttal Testimony of Richard LeLash; Richard Galligan; and Roger Colton on May 4, 2007, and the Surrebuttal testimony of Richard LeLash; Michael Bleiweis; Richard Galligan; and Roger Colton on May 15, 2007. Evidentiary hearings were held during the week of May 21, 2007. In accordance with the procedural schedule established in this proceeding, the OCA hereby files this Main Brief in support of its position.

II. LEGAL STANDARD

A. Burden of Proof.

The burden of proof to establish the justness and reasonableness of every element of the Company's rate increase request is upon PGW. As set forth in Section 315(a) of the Public Utility Code:

Reasonableness of rates. -- In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceedings upon the complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa.C.S. § 315(a). This principle has been interpreted by the Commonwealth Court as follows:

Section 315(a) of the Public Utility Code, 66 Pa.C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial. [Citations omitted.]

Lower Frederick Twp. v. Pa. P.U.C., 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980) (emphasis added). See also, Brockway Glass v. Pa. P.U.C., 63 Pa. Commw. 238, 437 A.2d 1067 (1981). The Pennsylvania Supreme Court also has clearly stated that the party with the burden of proof has a formidable task before its position can be adopted by the Commission. Even where a party has established a prima facie case, the litigant must establish that "the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary." Burleson v. Pa. P.U.C., 501 Pa. 433, 436; 461 A.2d 1234, 1236 (1983).

With specific reference to base rate proceedings, it is well settled at the Commission and in the Courts that this burden does not shift to parties challenging a requested

rate increase. The utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one. In contrast, there is no similar burden placed on a party to justify a proposed adjustment to the company's filing. See, e.g., Berner v. Pa. P.U.C., 382 Pa. 622, 116 A.2d 738 (1955). In Berner, the Pennsylvania Supreme Court stated:

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

Berner, 383 Pa. at 631, 116 A.2d at 744.

This standard has been recognized by the Commission in its rate determinations as "[t]he Respondent, Equitable has the burden of persuasion in the issue of the reasonableness of an expense level. Respondent must affirmatively establish, on the record, that the test-year claim is a reasonable and appropriate amount." Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C. 423, 471 (1983). See also, University of Pennsylvania v. Pa. P.U.C., 86 Pa. Commw. 410, 485 A.2d 1217 (1984).

The OCA submits that it remains incumbent upon the Company to affirmatively demonstrate the reasonableness of every element of its claim and to demonstrate that its proposed rates are just and reasonable. As set forth below, the Company has failed to satisfy this burden.

B. The Commission Must Determine A Level of Rates For PGW That Is Just And Reasonable.

The Natural Gas Choice Act brought PGW under the jurisdiction of the Commission and provides that PGW is, with certain exceptions, "subject to regulation and control by the commission with the same force as if the service were rendered by a public utility." 66 Pa.C.S. § 2212(b). Under Section 2212(e) of the Act, the Commission is charged

with establishing the overall rates and charges for PGW. 66 Pa.C.S. § 2212(c). Section 2212(c), in pertinent part provides:

[I]n determining the city natural gas operation's revenue requirement and approving overall rates and charges, the commission shall follow the same ratemaking methodology and requirements that were applicable to the city natural gas distribution operation prior to the assumption of jurisdiction by the commission...

66 Pa.C.S. § 2212(c).

The task for the Commission is to harmonize and to reconcile the Public Utility Code with the ratemaking methodologies in place for PGW. It is critical to note that the fundamental principle of the Public Utility Code, which is also the fundamental principle applicable to PGW's ratemaking methodology, is that rates must be just and reasonable. 66 Pa.C.S. § 1301; Pa. PUC v. Philadelphia Gas Works, No. R-00006042 (Order entered Oct. 4, 2001), 2001 Pa PUC LEXIS 103 (Oct. 4, 2001)¹ (2001 PGW Base Rate Case); Public Advocate v. Philadelphia Gas Commission, 544 Pa. 129, 674 A.2d 1056 (1996). Indeed, the just and reasonable standard has been applied to PGW even at the time it was regulated by the Philadelphia Gas Commission. As the Supreme Court made clear in Public Advocate, the rates of PGW must be just and reasonable. Id. In Public Advocate, the Court stated that: [w]hen examining the 1991-92 rates for PGW, this Court is mindful that no applicable constitutional requirement is more exacting than the requirement of 'just and reasonable' rates." Id. at 1061. The Pennsylvania Supreme Court went on to hold as follows, "(w)e hold today that the United States Supreme Court guidelines for determining the constitutionality of a rate are also applicable to examining rate disputes involving municipal utilities." Id. at 1062; See also, Action Alliance v. Philadelphia Gas Commission, 406 A.2d 1155, 1158 (Pa. Commw. 1979)

¹ As of the writing of this Brief, the LEXIS Web Site is not capable of displaying this case. LEXIS has assured the OCA that it is aware of this situation, and is working diligently to resolve this issue.

and American Aniline Products, Inc. v. Lock Haven, 288 Pa. 420, 424, 135 A.2d 726, 727 (1927).

Based on these considerations, the OCA recommends rate relief in the form of a \$22.5 million increase in the revenue requirement for PGW. The OCA's recommendation adheres to the fundamentals of the ratemaking methodology employed by the Commission, properly recognizes the obligations and responsibilities of the owner of PGW, and balances the interests of the company and its ratepayers.

C. Statement Of The Question.

1. Is PGW's Request To Increase Its Distribution Base Rates By \$100 Million And Its Request To Increase Its Gas Cost Rate By \$10 Million Just, Reasonable And In Accord With The Public Utility Code?

2. Does PGW's Allocation Of The Revenue Requirement Result In Rates That Are Just, Reasonable And In Accord With The Public Utility Code?

III. SUMMARY OF ARGUMENT

PGW proposes to increase its distribution base rates by \$100 million, with approximately \$69 million of this increase being allocated to the Residential customers. PGW also proposes to keep all revenues from any off-system sales and/or capacity releases, an estimated \$10 million annually, to help fund construction costs and/or to reduce outstanding debt. PGW witness Mr. Howard Gorman presents an average embedded allocated class cost-of-service study (COSS) on behalf of PGW. Mr. Gorman allocated PGW's distribution mains plant investment seventy-five percent on the basis of customer class coincident peak demands, and twenty-five percent on the basis of number of customers. Mr. Gorman also presents a revenue allocation method in this proceeding that is meant to bring all classes closer to the system rate of return.

PGW's justification for the requested \$100 million revenue increase is based on its five-year financial projections, and achieving certain financial measures by the year 2012. The OCA submits that the test year concept applies to PGW and has been used by the Commission to establish PGW's rates in its prior base rate cases and should be used to establish PGW's revenue requirement in this case. The test year method, which uses only reasonably known and measurable events, should be used to establish rates in this proceeding. PGW's proposal to use its five-year forecast, and its planned debt-reduction initiative to achieve a 50/50 capital structure by the year 2012 is not a reasonable basis for the Commission to consider in this proceeding for ratemaking purposes, and results in rates that are unjust and unreasonable. The OCA submits that the basis for PGW's filing, as it is predicated on a five-year forecast, is fatally flawed and should be disregarded for the purpose of setting rates that the customers of PGW will be asked to start paying in 2007.

The OCA submits that the allocation of mains investment costs should be done on the basis of annual and peak demands, in accord with the principle of allocating costs on the basis of cost-causality. Accordingly, the OCA recommends that distribution mains costs in this proceeding should be set based on the Peak and Average methodology, as presented by OCA witness Richard Galligan, specifically recommending that eighty percent be allocated to average demands and the remaining twenty percent be allocated on the basis of peak demands.

The OCA agrees with PGW's proposed Residential revenue percentage increase, as included in PGW's proposed overall allocation of any revenue increase that may be granted in this proceeding. The OCA has presented testimony to show that when this percentage increase is measured against the allocation of costs using the Peak and Average methodology, the Residential Heating class will be essentially at cost-based rates.

Based on these considerations, the OCA recommends rate relief in the form of a \$22.5 million increase in the revenue requirement for PGW. The OCA's recommendation adheres to the fundamentals of the ratemaking methodology employed by the Commission, properly recognizes the obligations and responsibilities of the owner of PGW, and balances the interests of the company and its ratepayers.

The current use of the revenues from off-system sales and capacity releases provides a real benefit to PGW's ratepayers by helping to defray the GCR. PGW ratepayers already suffer under the burden of extremely high rates for natural gas service. The OCA submits that it would not be reasonable to trade off this immediate and substantial benefit for some undefined, possible benefit that may occur in the future. Accordingly, the OCA is opposed to any change in the way the revenues from off-system sales and/or capacity releases are currently being handled.

The OCA has also presented the testimony of Roger Colton regarding the universal service surcharge and how it is calculated; an analysis to show why the current method of collecting the universal service charges from all firm sales customers should remain intact; a proposal to implement an Electronic Fund Transfer (EFT) program; automatic Budget Billing program with an opt-out requirement for customers and expanded direct vendor program with the Philadelphia Housing Authority (PHA). The OCA submits that Mr. Colton's proposals are well-grounded and should be adopted.

IV. OVERALL REVENUE REQUIREMENT

A. Introduction.

The Company's request for an annual revenue increase of \$100 million in this matter is based on its financial forecasts for five to six years into the future. This attempt to set base rates on such far-reaching and speculative financial assumptions is directly at odds with the Commission's time-honored, and legally sustainable use of a future test year that incorporates only known and measurable events. As such, the OCA submits that the very foundation of PGW's revenue requirement is without legal support, and should not be considered by the Commission. As a matter of public policy, utility ratepayers should not be asked to pay current rate increases based on events that can only be characterized as speculative assumptions that reach well into the future.

The OCA and OTS present quantitative evidence in this proceeding that shows on a future test year basis – the Company's filing reveals no deficiencies in debt service coverage or cash flows at *present revenues*. PGW is seeking the current revenue increase primarily to fund a debt-reduction initiative so that it can achieve a 50%/50% debt to equity ratio by 2012. This point becomes abundantly clear when the Company's request is evaluated under the ratemaking framework used for PGW, that being the cash-flow method. The cash-flow method is succinctly described by OTS witness Plonski, as follows:

The revenue requirement for a cash flow utility is established based on the formula:

$$RR=E+DS+M$$

Where:

RR= Revenue Requirement

E= Operating Expense

DS= Debt Service

M= Margin

OTS St. 1 at 5-6. When posed the question as to PGW's current revenue requirement, based on the future test year data, debt service coverage, and considering the cash-flow method of ratemaking, OCA witness Mike Bleiweis responded in relevant part as follows:

There would be no coverage problem. For example, as shown on the Debt Service Coverage statement, Schedule MAB-11, column 3, line 22, debt service coverage on 1998 bonds, pro forma at present rates, utilizing PGW's Income Statement adjustments (and no rate increase), would be 2.03 times, well above the required 1.5 times coverage. Further, as shown on the Cash Flow Statement, Schedule MAB-10, column 3, line 31, the pro forma year-end cash balance would be over \$50 million.

OCA St. No. 2 at 13. And, when Mr. Bleiweis was further asked to incorporate his pro forma expense adjustments and then reconsider PGW's current revenue requirement, he responded:

As shown on the Debt Service Coverage statement, Schedule MAB-11, column 5, line 22, pro forma test year coverage at present rates on the 1998 bonds utilizing my pro forma adjustments would be 2.05 times. *This means that no rate increase is necessary to meet coverage requirements in FY2007.* As shown on the Cash Flow Statement, Schedule MAB-10, column 5, line 31, the pro forma year-end cash balance would still be over \$50 million.

OCA St. No. 2 at 13 (*emphasis added*). Simply stated, there is no basis for a revenue increase of based on the future test year data supplied and using the cash-flow method of setting the revenue requirement.

OCA witness Richard LeLash² explains the primary reason behind the Company's request for a \$100 million revenue increase in this proceeding, as follows:

² Mr. LeLash is an independent financial and regulatory consultant. Prior to becoming an independent consultant, he was a principal with the Georgetown Consulting Group for twenty years. He has testified on cost of service, rate of return, and regulatory policy issues in more than 200 regulatory proceedings before the Philadelphia Gas Commission, the Federal Energy Regulatory Commission, the Pennsylvania Public Utility Commission and the commissions in numerous other states. Mr. LeLash has also participated and provided testimony on behalf of the Philadelphia Public Advocate in all of PGW's Gas Cost Rate (GCR) proceedings and in other related matters since 1990. A complete description of Mr. LeLash's background and experience can be found on pages 1-2 of his Direct Testimony and the Appendix attached to OCA St. No. 1.

In justifying the need for this increase, the Company cites: increased operating expenses, inadequate earnings in 2009, and its on-going need for sufficient liquidity.

However, a review of the Company's Exhibit SPH-1 shows a different utilization for the requested rate increase over the next six years. Of the \$660 million request, only 3.4% goes for increases in expenses over the next six years, while 54.2% goes for debt reduction and presumably 36.8% is used for capital expenditures. In effect, this shows that the rate filing is not indicating a net income deficiency as much as it is an excess of financial leverage.

OCA St. No. 1 at 13. It is apparent that the current request for a revenue increase is not due to elevated operating expenses, debt service obligations or to maintain the appropriate coverage ratios, but rather the revenue increase is being sought by PGW in order to create a different capital structure for the utility. PGW witness Joe Bogdanavage clearly states the core reason for PGW's \$100 million revenue increase, as follows:

To reach these goals, it is essential that the Commission authorize a revenue level that, on a projected basis, will permit PGW to realize approximately a 50/50 capital structure in the next five to six years.

PGW St. No. 2 at 12.

While the OCA agrees that PGW should continue its efforts to reduce its long-term debt and improve its level of cash and liquidity (albeit not to the same level as PGW proposes), PGW's request here seeks to achieve all of this result at the expense of PGW's already strained ratepayers, at a time when PGW is being required to pay \$45 million to the City of Philadelphia. As was made abundantly clear in the testimony given by customers at the public input hearings, a significant increase in rates would present a financial hardship to many customers of PGW. Peter Lewis testified:

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. Mary Jane Hazell testified:

I'm sorry for people that can't afford it. But you know what, we can't afford it either. We cannot afford it. If I didn't have children I would not take medicine. If I didn't have children I would not have what to eat. So I am fortunate that I have them that will help me.

Tr. at 193. Selma Brockman testified:

My pension that I get every month goes almost to pay for the gas company bill and I just don't think it is right. There has to be something done so that senior citizens like us don't have to pay a bill this high. It's not right. I mean, it is to the point where I will not be able to eat one month in order to pay my gas bill.

Tr. at 219-220. Elizabeth Signil testified:

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.

Although the Company's future test year shows adequate debt service coverage and liquidity, the OCA has recognized that the \$45 million City loan that was provided to PGW in a time of prior financial crisis is due to be satisfied in 2008. This is a known and certain obligation that will impact PGW's liquidity when the loan is repaid. As such, the OCA has recommended that a revenue increase of \$22.5 million, reflecting a two-year payback of the City loan, be awarded to PGW so that it may satisfy this known and measurable cost. OCA St.

1 at 4-5. If PGW wishes to reduce its long-term debt beyond that provided through the normal ratemaking process or improve its liquidity to have greater levels of cash on hand, PGW should seek capital contributions from its owner, the City, and not ratepayers.

Any revenue increase that is granted in this proceeding must result in rates that are constitutionally just and reasonable. The OCA submits that a critical consideration in determining whether such rates are just and reasonable, involves an analysis as to the affordability of such enacted rates on the ratepayers who will bear the brunt of any increase. The OCA submits that the unique socio-economic factors relating to PGW's customer base provide further support for a revenue increase in line with OCA's and OTS's recommendations. As OCA witness LeLash testified, as many as 50% of PGW ratepayers have incomes below 250% of the federal poverty level, an income level found to be needed to meet the basic necessities of life. OCA St. 1 at 5. Coupled with the reality that PGW's number of customers and their usage are declining, it is quickly apparent that ratepayers have a limited ability to increase their level of payments to PGW. It is equally apparent that ratepayers cannot be the sole source of revenue to solve PGW's long-standing financial woes, problems resulting from years without seeking needed rate relief, management dysfunction, lack of adequate cost control, an aging system, and an owner that has historically taken dividends without making necessary capital contributions. OCA St. 1 at 8-9.

In addition to its \$100 million annual revenue increase, the Company is also requesting the ability to retain approximately \$10 million in additional annual revenues from any off-system sales or capacity releases. Currently, the proceeds from any off-system sales or capacity releases are used to defray the GCR. Accordingly, if the Company's request is granted, GCR rates will also increase. The OCA presents evidence in this proceeding that the already

hard-pressed PGW ratepayers are currently paying among the highest overall rates for natural gas service in Pennsylvania. The OCA submits that public policy should dictate that the current use of these revenues to help defray the already high PGW gas costs should remain in place.

B. The Fundamental Basis Of The Company's Request For Rate Relief Is Flawed.

I. Introduction.

It is now well-settled that pursuant to Section 2212(e), the Commission will utilize the cash flow method of ratemaking to establish PGW's rates. The Commission, in its 2001 PGW Base Rate Order in Docket No. R-00006042, explained:

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

2001 PGW Base Rate Order at 15. However, as also noted by the Commission's Order:

At the same time, the adoption of this ratemaking methodology to set rates for PGW allows the Commission's other statutory directives, such as minimum debt service coverage and just and reasonable rates, to be fulfilled in accordance with Sections 1301 of the Code and 2212(c) of the Act.

2001 PGW Base Rate Order at 15.

The OCA submits that the question to be answered in this proceeding is whether it is reasonable for the Commission to look well beyond the future test year, in effect to peer six years into the future, and in addition to agree that PGW's stated goals of reaching a 50/50 capital structure by the year 2012, having ratepayers fund capital expenditures, and having a stated level of cash at year end justify granting PGW a cumulative \$660 million revenue increase. The OCA submits that PGW's proposal to achieve its stated financial goals by 2012

through a massive rate increase at this time is not a reasonable or pragmatic approach to resolve the financial issues that this Company has continued to accumulate since 1993.

2. Utility Rates Are Not Set Based On A Five-Year Forecast.

The primary basis of the Company's rate request is shown in Exhibit JRB-1. Exhibit JRB-1 shows the future test year and the five year financial forecast for the period FY2008 through FY2012. OCA St. 2 at 7-8; PGW Exhibit JRB-1. As OCA witness Bleiweis explained:

PGW is relying on this forecast to support a \$100 million rate increase as a means of implementing a five-year forward business plan. Specifically, the company presents revenue, expense, cash flow, coverage and balance sheet data to bolster its major contention that a \$100 million revenue increase plus retention of \$10 million in capacity release/off-system sales revenue will ultimately result in a 47%/53% debt-to-equity ratio at the end of the five year period, i.e., the end of FY 2012.

OCA St. 2 at 8. The Company's claim is thus dependent upon a number of financial assumptions included in a five-year forecast and the major goals to be achieved at the end of the five-year period. OCA St. 2 at 7. The OCA submits that PGW's reliance on a five year financial forecast rather than a future test year analysis to support its requested \$100 million rate increase is fatally flawed.

As the Commission is well aware, traditional ratemaking, including traditional ratemaking for PGW, is based upon the utilization of future test year data that has been adjusted to reflect known and measurable changes. OCA St. 2 at 8. The Commonwealth Court of Pennsylvania provided this description of a test year, as follows:

In Pennsylvania, as in most other jurisdictions, rates for public utilities are set using what is known as a test year concept, which requires taking a snapshot of the utility's revenues, expenses and capital costs during a one year period.

Popowsky v. Pa. PUC, 869 A.2d 1144, 1152 (Pa. Commw. Ct. 2005), citing Green v. Pa. PUC, 81 Pa. Commw. 55, 473 A.2d 209, 231-215 (Pa. Commw. Ct. 1984); City of Pittsburgh v. Pa. PUC, 178 Pa. Super. 46, 112 A.2d 826, 832 (Pa. Super. Ct. 1955). In Popowsky, the Commonwealth Court also provided the following:

Under the test year concept, revenues, expenses, and capital costs are to be simultaneously reviewed for the same period of time so that a utility may prove that its new rates are just and reasonable.

Popowsky v. Pa. PUC, 869 A.2d 1144, 1152 (Pa. Commw. Ct. 2005), citing 66 Pa. C.S. § 315(a).

The use of a pro forma test year results in financial data that is representative of future periods. OCA St. 2 at 8. The speculative nature of PGW's use of five years of forecasts rather than a future test year is revealed when reviewing the five-year financial forecast of PGW. PGW's five year forecast is based on major assumptions regarding future revenue and expense items and PGW's major financial goals to be achieved in this five year time frame. These two sets of variables form the basis of the proposed rate increase, but any change in these assumptions can have a significant impact on the revenue requirement derived from the five year forecast.

A review of some of the key assumptions regarding major revenue and expense items, for example, reveals that the assumptions are far from known and measurable. For example, the five year forecast assumes that expenses will increase by a 2% inflation factor. As the Commission has often found, however, inflation factors, or attrition adjustments, should not be used to establish rates. See Pa. PUC v. Philadelphia Electric Co., 1990 Pa. PUC LEXIS 155 (May 16, 1990); Pa. PUC v. Philadelphia Electric Co., 58 Pa. PUC 7, 11 (1983). Another key variable in the forecast is that collections will decline from the current factor of 96% to a

93% rate. This assumption is lower than the 95% factor that is reflected in the future test year, and is not supported in the record. OCA St. 2 at 10. The OCA submits that such forward looking assumptions over a five year period are too speculative and unreliable for the setting of rates. The Commonwealth Court provided the following as to the setting of rates:

Necessity dictates that a rate proceeding must have some finality, and for this purpose a test year is used and accepted as it may be adjusted by the commission for unusual changes.

Dauphin Consolidated Water Supply Co. v. Pa. PUC, 55 Pa. Commw. 624, 639, 423 A.2d 1357, 1364, quoting Pittsburgh v. Pa. PUC, 187 Pa. Super. Ct. 341, 363, 144 A.2d 648, 660 (1955).

Additionally, the Company's rate request is grounded in its selected financial goals that are part of the five year forecast. Each of these financial goals can have an impact on any revenue requirement based on the five-year forecast. OCA witness Bleiweis identified the major financial variables included in the five year forecast as:

- 1) the \$45 million interest-free City Loan is to be paid back \$2 million in FY2007 and \$43 million in FY2008;
- 2) the "grant-back" by the City of Philadelphia of the \$18 million City Payments is to end in FY2010;
- 3) a year-end cash balance of approximately \$50 million is assumed for all years of the forecast;
- 4) a debt reduction program over the five-year period totaling \$205 million is reflected on the Cash Flow Statement;
- 5) an approximate 50/50 debt equity ratio is assumed at the end of the five-year period (FY2012).

OCA St. 2 at 10.

As Mr. Bleiweis explained, however, a change in any one of these financial goals can have a significant impact on PGW's financial position over time and its revenue

requirement in this proceeding. OCA St. 2 at 11. Mr. Bleiweis elaborated on this point in his Surrebuttal testimony as follows:

If any one or multiple major financial variables are changed, the financial results of the forecast period would be quite different. For example, OCA has included in its recommended future test year Cash Flow Statement (Schedule MAB-10) a two-year payback of the \$45 million City Loan, as compared to PGW's Scenario of a \$2 million payment in FY2007 and a \$43 million payment in FY2008 (Exhibit JRB-1, page 7). Obviously, any lengthening of the payback period beyond even the two years recommended by OCA would result in substantial additional cash to PGW and less reliance on the commercial paper program in the test year and forecast periods.

Another major effect on cash would result if PGW were to pare down what it has termed its Debt Reduction Funding program. This funding, which totals \$205 million for the period FY2007-FY2012, is part of PGW's program to attain an approximate 50/50 debt/equity ratio at the end of the five-year forecast period. For argument's sake, if the Debt Reduction program was reduced by \$100 million over the five-year period, then an additional \$100 million in cash would be available to PGW.

OCA St. 2-S at 2-3. As can be seen, any change in the major financial goals would have a considerable effect on PGW's proposed revenue requirement. The use of a five year forecast rather than the future test year to establish PGW's rates is speculative and unreasonable.

Similarly, PGW's stated target of having a year-end cash balance of \$50 million cannot be relied upon to set rates. Notably, PGW has not had a fiscal year-end cash balance of at least \$50 million since at least FY1995. OCA St. 2-S at 6. The year end cash balance can be affected by a number of variables, including the commercial paper balance and the uses of cash. Mr. Bleiweis explained the interaction of this assumption of \$50 million in year end cash on PGW's analysis:

It must be understood that this assumption has a major effect on the financial model, especially as it regards the outstanding Commercial Paper balance. For example, as shown on Exhibit

JRB-8 described above, if the financial goal had been to have a \$40 million year-end cash balance rather than a \$50 million balance, then all other things being equal, the FY 2007 commercial paper balance would have been \$10 million less, that is, \$85 million instead of \$95 million. Essentially, any reduction in uses of cash (for example to pay back the City Loan), would reduce reliance on the commercial paper program for everyday cash needs.

OCA St. 2-S at 6.

The OCA submits that the test year concept is a basic tenet of ratemaking that forms a sound and reasonable basis for establishing a representative level of prospective rates. See Dauphin Consolidated Water Supply Co. v. Pa. PUC, 55 Pa. Commw. 624, 639, 423 A.2d 1357, 1364, quoting Pittsburgh v. Pa. PUC, 187 Pa. Super. Ct. 341, 363, 144 A.2d 648, 660 (1955). The test year concept applies to PGW and has been used by the Commission to establish PGW's rates in its prior base rate cases and should be used to establish PGW's revenue requirement in this case. See Pa. PUC v. Philadelphia Gas Works, 2001 Pa PUC LEXIS 103 (Oct. 4, 2001). As OCA witness LeLash testified:

Requiring ratepayers to pay higher rates now for revenue requirements that might be justified in two or three years is not an accepted rate setting procedure, nor is it prudent. As stated previously, the Company has the ability to file another rate request anytime in the future when events and changes become known and measurable.

OCA St. 1-S at 14.

The OCA submits that PGW's claim of a \$100 million increase based on its five year forward forecast is fatally flawed and must be rejected.

3. PGW's Debt-Reduction Initiative Is Not A Reasonable Basis Upon Which To Set Rates In This Proceeding.

The major justification for PGW's rate request is that PGW has decided that now is the time to "fix" PGW and that this "fix" must be accomplished by 2012. PGW St. 1 at 3. When "fixed" in PGW's view, PGW will have a 50/50 debt to equity ratio and sufficient liquidity to have \$50 million in cash at year end. During this period, PGW also wants ratepayers to fund capital expenditures. While PGW shows that the City has agreed to grant back the \$18 million City payment through 2010, for a total amount of \$72 million for these efforts, PGW is asking ratepayers to pay \$660 million over the next six years in the hope that PGW's financial situation can be fixed.

In considering PGW's request in this proceeding, it is important to note two factors. OCA witness LeLash explained:

As shown on Schedule 2, PGW's net funds from operation, which had been low and erratic for many years, have during the last four years become far more robust. This turn around has occurred during a period when no incremental rate increases were obtained from ratepayers. And second, it is appropriate to note that Ms. Bisgaier and the rating agencies have all lauded the actions by the City to provide short-term financing and to grant back its \$18 million payment. However, over the past fifteen years, in total, the City has provided only about \$100 million, and it plans on getting \$45 million of this amount back in 2008. One should compare this with the additional \$110 million per year that is currently being sought from ratepayers when assessing what is just and reasonable.

OCA St. 1 at 28.

The OCA agrees that PGW should continue its efforts to address its tenuous financial condition and should continue its efforts to reduce its reliance on long-term debt and improve its liquidity. The OCA submits, however, that achieving PGW's specific targets over a five year period, at the expense of ratepayers, and having ratepayers be responsible for

providing the capital in excess of required earnings is not a reasonable basis upon which to set rates.

Through this case, PGW seeks to have its ratepayers fund a debt reduction program for the Company's long-term debt so that it can achieve a 50% debt ratio by 2012. PGW's long-term debt problem has developed over many years. In 1993, about 75% of PGW's total capital was provided by long-term debt. OCA St. 1 at 13. By 2003, this level had grown to nearly 84% and by the end of 2006, the long term debt level had declined to about 82%.³ Sec, OCA St. 1, Sch. 1. As OCA witness LeLash explained, the increase in long term debt was the result of several factors, including the fact that the City has historically received dividends without making any necessary capital contributions. OCA St. 1 at 8-9. Since 1993, for example, the Company's long-term debt had increased by \$360 million, and in the same period, the capital withdrawn by the City through its annual payments totaled \$198 million. On Schedule 1, Column 6 of OCA St. 1, Mr. LeLash shows that had the City reinvested the \$18 million City payment in PGW between 1993 and 2006, PGW's debt ratio would have declined to about 71% by the end of 2006.⁴

OCA witness LeLash provides the following sound rationale for why the Company's stated goal of a 50/50 capital structure should not be the basis for setting rates:

PGW's contention that a 50% debt ratio is needed and that it must be attained in the next 5-6 years is unreasonable in two regards. First, the 50% debt ratio target is overly aggressive and unwarranted given the City's own assumed industry best practice

³ Under the cash flow method, PGW reduces its debt by having rates reflect at least a debt service coverage rate of 1.5x and an adequate level of working capital. This provides the earnings to make annual payments to reduce the level of the bonds. As Mr. Bleiweis shows in OCA St. 2, Sch. MAB-10, in the future test year, PGW will retire \$36.7 million of its bonds. In addition to the revenue from rates, the City, as owner of PGW, can make capital contributions to PGW for debt reduction. OCA St. 1 at 10.

⁴ As PGW's own witness Mr. Krellenstein stated: "As a general rule . . . it is not uncommon for municipalities to reduce, defer, or grant back the payments if the utility is incurring financial distress." OCA St. 1 at 15. Indeed, PGW has been in financial distress over the last ten to fifteen year time period. OCA St. 1 at 15.

level of 70% debt and 30% equity (City of Philadelphia Five Year Financial Plan, February 22, 2007, Appendix I, Page 14). Likewise, for PGW, which has an 83% debt ratio in its test year, a 65% to 75% debt ratio target range would be far more realistic and it would still represent a dramatic improvement from the current level. Second, it is unrealistic to assume that ratepayers should, or could, provide revenue to achieve such a 50% debt level over 5-6 years.

OCA St. No. 1 at 14. Mr. LeLash further discussed this point in his surrebuttal testimony:

At this time, PGW wants to solve its accumulated financial deficiencies within five to six years with ratepayers being charged an incremental \$660 million through rates. The Company's premise that many years of financial and management deficiencies should be remedied in such a short time frame is unreasonable. A target of achieving a 50% debt ratio in this same time frame is equally unreasonable. As stated by the Commission in its Opinion and Order in Docket No. R-0006042,

... 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. (Opinion and Order, page 34)

OCA St. 1-S at 13.

PGW continues to argue that the City cannot help more than the grant back of the \$18 million that the City has committed to through 2010. As Mr. LeLash notes, however:

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. Ratepayers should not finance all of the capital requirements of PGW. OCA witness LeLash set forth this basic standard of regulation:

The City may seek to have ratepayers finance all of PGW's capital requirements, but the Commission has to consider the mandate to determine just and reasonable rates. For PGW and the City to believe that ratepayers can be required to pay for any capital deficiency regardless of the relative level of such rates and their adverse effect on customers goes against the just and reasonable standard and other regulatory practices. For example, in a case before the Washington Metropolitan Area Transit Commission, it was determined that a requested fare increase by the D.C. Transit system was unjust and unreasonable. As a result, the Transit Commission required new capital for debt repayment as a condition precedent to any increase in rates. The Transit Commission also stated on reconsideration "that additional funds, not increased fares alone, were required to remedy this situation." D.C. Transit System, Inc. v. Washington Metropolitan Transit Commission, 466 F.2d 394, 402-403 (D.C. Cir. 1972).

OCA St. 1-S at 4.

PGW's request for a \$100 million rate increase, plus retention of \$10 million in off-system sales and capacity release revenue, cannot be justified. As set forth below, the OCA submits that a \$22.5 million rate increase would establish a reasonable level of rates using the cash flow method of ratemaking and applying reasonable regulatory principles. PGW should continue to work with its owner to meet its prospective capital needs through such mechanisms as an extension of the grant back of the \$18 million City payment after 2010 and/or a further grant of some or all of the \$45 million loan. See, OCA St. 1 at 5.

4. Conclusion.

The test year method, which uses only reasonably known and measurable events, should be used to establish rates in this proceeding. PGW's proposal to use its five-year

forecast, and its planned debt-reduction initiative to achieve a 50/50 capital structure by the year 2012 is not a reasonable basis for the Commission to consider in this proceeding for ratemaking purposes, and may result in rates that are unjust and unreasonable. The OCA submits that the basis for PGW's filing, as it is predicated on a five-year forecast, is fatally flawed and should be disregarded for the purpose of setting rates that the customers of PGW will be asked to start paying in 2007.

C. A Rate Increase Of \$22.5 Million Adheres To Regulatory Principles And Establishes A Just And Reasonable Level Of Rates.

The OCA submits that to establish a reasonable level of rates for PGW in this case, the Commission must adhere to the regulatory principles that have been applied to PGW rate requests since the Commission assumed jurisdiction of PGW in 2000. PGW's revenue requirements in this case should be based on properly adjusted test year amounts and a reasonable balancing of the interests of customers and PGW. See, 2001 PGW Base Rate Order. When these principles are followed, it is clear that a rate increase of \$22.5 million provides a reasonable level of rate relief to PGW in this proceeding.

OCA witness LeLash explained the basis of the recommended rate relief of \$22.5 million:

As shown by the analysis in Mr. Bleiweis' testimony, under the cash flow method of rate setting and the Company's bond coverage requirements, the Company has no immediate need for a rate increase. Indeed, in the near future, the Company only requires additional revenues to fund payments to the City.

The Company's current revenues meet its obligations except for the additional revenues needed to repay the loan from the City. PGW has an obligation to repay this \$45 million short-term loan from the City in fiscal year 2008. Therefore, I recommend that rates include \$22.5 million to allow for the repayment over two years. Once the Company has received the full \$45.0 million through rates, the Company should be required to utilize the

continuing \$22.5 million of revenues solely for the retirement of its long-term debt.

OCA St. 1 at 17.

A \$22.5 million rate increase meets the basic financial measures that the Commission has previously utilized in setting just and reasonable rates for PGW. OCA witness LeLash explained:

[O]ne benchmark is the Company's required 1.5x debt coverage on its 1998 Ordinance Bonds. As acknowledged by Mr. Bogdonavage, PGW's pro forma results at present rates for 2006-2007 show \$8.9 million of net earnings, debt service coverage of 2.03x, fixed charge coverage of 1.34x and an ending cash balance of \$51.6 million. As shown on Mr. Bleiweis' Schedules MAB-9, 10 and 11, with the recommendations made in this testimony, along with Mr. Bleiweis' adjustments, the Company will have net earnings of \$31.7 million, debt service coverage of 2.45x, fixed charge coverage of 1.59x, and an ending cash balance of \$53.4 million. Therefore, with a \$22.5 million rate increase, PGW's financial measures are all above required levels. With grant backs from the City of the payments to be made by PGW, these levels could also be maintained.

OCA St. 1 at 27.

In an attempt to cast doubt on the OCA and OTS recommendations, PGW witness Bogdonavage presented Exhibit JRB-8. PGW St. 2-R, Exh. JRB-8. Rather than cast doubt on the OCA and OTS recommendations, Exhibit JRB-8 demonstrates the reasonableness of the rate increase recommendations of the OCA and OTS. OCA witness Bleiweis explained Exhibit JRB-8 and what it shows at a \$25 million rate increase level:

[T]he Exhibit JRB-8 scenario reflects PGW's pro forma test year expense position, a \$25 million test year rate increase and a test year payment of \$22.5 million for the City Loan. Utilizing this scenario, the Cash Flow Statement for the test year 2007 shows a year-end cash balance of approximately \$50 million and \$95 million of Outstanding Commercial Paper while the test year Debt Service Coverage Statement shows coverages on 1998 bonds of 2.47 times. Thus, even excluding any further expense

adjustments proposed by OCA and OTS, or any additional contributions by the City, the pro forma test year financial results provide PGW with the financial means to continue into the short-term future.

OCA St. 2-S at 5. On cross-examination, PGW witness Bogdonavage confirmed that with a \$25 million rate increase, the outstanding commercial paper at the end of the fiscal year would be \$95 million out of a maximum available of \$150 million and that year end cash balances would be \$50 million. Mr. Bogdonavage also confirmed that even looking out over the next few years of his five year forecast, the outstanding commercial paper would decline to \$75 million by FY2009 and the year end cash balance would remain at approximately \$50 million through 2009. Tr. at 597-598.

PGW witness Bisgaier also claims that the OCA has failed to analyze PGW's cash and liquidity needs in making its recommendation. PGW St. 3R at 5-6. The OCA's recommendation, however, shows that PGW has adequate cash and liquidity.⁵ Mr. LeLash explained this financial indicator as it relates to the OCA's recommendation:

I would first point out that Mr. Bleiweis developed an analysis of year-end cash under the OCA rate recommendation and determined that PGW would have \$50 million, a level that is higher than PGW has maintained in the past. Second, Ms. Bisgaier makes numerous references to the lack of internal generation of cash. On Schedule 2 of my direct testimony I show funds from operations that are determined by adding depreciation to PGW's income by year. As shown on this schedule, while the levels were low between 1998 and 2002, they have improved during the past four years. On average, the funds from operations have been about \$53 million per year.

OCA St. 1-S at 8.

The OCA submits that 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

⁵ On cross-examination of Mr. Bogdanavage, Mr. Bogdanavage agreed that "liquidity" means available commercial cash, commercial paper and year end cash. Tr. at 598-99.

measurable obligations. As OCA witness Bleiweis explained, PGW may need to file for further rate relief in a few years. In discussing the possibility of a future filing, Mr. Bleiweis stated:

[I]t is possible but such a filing would be dependent on many financial policies and variables such as the City's policy regarding the \$18 million payment, the success of the Company's collection and debt programs, as well as the success of the Company's efforts to reduce capital and operating expenditures.

OCA St. 2 at 14.

The OCA submits that PGW's ratepayers have seen overwhelming rate increases in the last several years, testing their ability to keep current with their payments. As Mr. LeLash testified, this burden has been identified by the City of Philadelphia. Mr. LeLash explained:

As noted in the City of Philadelphia's five Year Financial Plan (Appendix I), the annual bill for the average customer has increased by 100% between FY 2002 and FY 2007. As a result, the Financial Plan notes, "Such increases have placed an almost overwhelming burden on many of PGW's customers."

OCA St. 1 at 20.

The OCA submits that any additional burden on ratepayers above what is justified under the established rate setting process cannot be sustained. In particular, requiring ratepayers to pay higher rates now for revenue that might or might not be required four or five years in the future is not reasonable. Based on the future test year and known and measurable obligations, the OCA submits that the revenue requirement increase of \$22.5 million should be awarded to PGW. As future events change and become known and measurable, PGW can file another rate request, if required.

D. Off-System Sales And Capacity Release Revenues.

1. Introduction.

PGW, like many other NGDCs, engages in the practice of negotiating off-system sales and/or capacity releases when those opportunities are presented based on the Company's current demand predictions and supplies of natural gas. Currently, 100% of the revenue derived from these activities is flowed back directly to ratepayers as a credit to the GCR. PGW St. 1 at 5. PGW proposes to change the treatment of these revenues, in that instead of crediting the GCR, which directly lowers the ratepayers cost for natural gas, the Company proposes to keep 100% of these revenues for the stated purposes of funding its construction program and reducing its outstanding debt. PGW St. 1 at 5.

The OCA is opposed to any change in the existing way the revenues from off-system sales and/or capacity releases are treated by PGW. As OCA witness Richard LeLash discussed in his testimony, PGW already has the highest overall rates for natural gas service in Pennsylvania. OCA St. 1 at 22; St. 1S at 16. The OCA submits that it would be inequitable to further burden PGW's already economically-distressed ratepayers by essentially providing not only a possible base rate increase in this case, but at the same time increasing the commodity cost by allowing PGW to keep 100% of these revenues, that heretofore, had helped to defray the costs of their gas service.

2. PGW's Proposal To Keep 100% Of All Revenues Obtained From Off-System Sales Or Capacity Releases Is Not A Reasonable Request Because Ratepayers Would Immediately Face Higher Gas Costs.

PGW witness Stephen Hershey testifies as to why the Company believes it is a good idea for ratepayers to forego the immediate benefits they receive with the credit to the GCR, and instead to allow the Company to keep 100% of these revenues. PGW St. 1 at 5. Mr. Hershey states that it will be cheaper for the customers in the long-run to allow PGW to keep

these revenues and use them to fund construction projects or to pay off some of the Company's outstanding debt, because in essence, Mr. Hershey believes that PGW's costs to borrow money will create a greater burden for the ratepayers than the customer's obvious need to pay more for the commodity cost of the gas. PGW St. 1 at 5.

OCA witness Richard LeLash responds in his Direct testimony to Mr. Hershey's assumptions:

First, Mr. Hershey's implicit assumption is that the alternative to having ratepayer capacity margins and credits retained by the Company will be for the Company to issue additional debt. However, in lieu of PGW floating additional debt, the City could provide additional capital to PGW. In that case, there would be no associated cost that ratepayers would pay for such capital.

Second, based on the Company's Response to OSBA-2-42, the Company's financial analysis appears flawed. When asked whether the discount rate used on pages 1 and 4 of Exhibit JRB-4 was intended to be representative of the cost of capital of PGW's customers, the Company seems to say no. Specifically, the Company responded that, "the discounted rate used on pages 1 and 4 may or may not be the cost of capital of PGW's customers; instead, the rates on pages 1 and 4 reflect the cost of long-term debt borrowing for PGW, which is the cost reflected in rates." Based on this explanation, it does not appear that the Company's analysis supports its contention concerning the impact of the alternatives on ratepayers.

The central issue is whether ratepayers would be better off over time losing their margins and credits and not having to pay for alternative debt or not losing their margins and credit and having to pay for any debt. Central to this question is the opportunity cost of capital for ratepayers. In my opinion, the ratepayers' cost of capital is probably well above 15% and not the 5% or 6% apparently used by the Company. Consumers' opportunity cost of capital is best reflected by credit card interest rates, and the rates of pay day lenders referenced by Mr. Hershey. Even with all of the costs associated with incremental debt, a more realistic financial analysis should indicate that ratepayers would not be better off by foregoing their capacity margins and credits.

OCA St. 1 at 23-24. As Mr. LeLash indicates, the crux of PGW's position is that ratepayers' equity in PGW, by allowing the Company to keep these revenues, is cheaper than PGW can issue debt.

Mr. Hershey responds in his Surrebuttal testimony that according to the Company's calculations, even assuming an 18% cost of capital for ratepayers, it is still cheaper for ratepayers to immediately pay the higher cost for gas out of their pockets and allow PGW to keep the revenues at issue here. PGW St. 1R at 14-15. The OCA submits that as a general rule, debt is cheaper than equity. Mr. LeLash expounds on this point in his answer to Mr. Hershey:

In lieu of relying on Mr. Hershey's Exhibit SPH-3, which he never adequately describes or explains, my conclusions are based on empirical evidence. When faced with financing decisions, utilities and other privately owned companies seek to use debt financing because it is cheaper than equity. Indeed, the very rationale for financial leverage is predicated on this fact.

OCA St. 1S at 16.

Aside from the financial difficulties inherent in PGW's proposal, as outlined by Mr. LeLash, the OCA submits that a basic difficulty exists. The current credit saves ratepayers real dollars – right now. Money they can use to pay for food, medicine, bus tokens, etc. PGW's proposal does not and cannot deliver such immediate results.

3. Conclusion.

The current use of the revenues from off-system sales and capacity releases provides a real benefit to PGW's ratepayers by helping to defray the GCR. PGW ratepayers already suffer under the burden of extremely high rates for natural gas service. The OCA submits that it would not be reasonable to trade off this immediate and substantial benefit for some undefined, possible benefit that may occur in the future.

V. EXPENSES

A. Introduction.

In his Direct Testimony, OCA witness Michael Bleiweis proposed six adjustments to the Company's claimed level of expenses.⁶ The adjustments were for management incentive bonus program expense; lobbying expense; Authority legal expenses; regulatory penalties expense; utility merger expense; and bad debt expense. These adjustments are contained in Schedules MAB-1 through MAB-6 at OCA St. 2. PGW has agreed to withdraw two of its expenses: 1) Authority Legal expenses and 2) utility merger expense. PGW St. 2-R at 36; PGW St. 2-R at 35. The Company and OTS have reached a stipulation regarding bad debt expense submitted for the record as PGW Hearing Exhibit 5. After review of the Stipulation, the OCA accepts this resolution of the bad debt expense issue for this proceeding.

It is important to note that in this proceeding, the expense adjustments are not disallowances from the Company's claimed rate increase. Based on the OCA's analysis discussed in Section III, the Company is not in need of further rate relief to meet its expenses or satisfy its debt service coverage requirements. The expense adjustments offered here 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.

⁶ Michael A. Bleiweis is an independent financial and regulatory consultant. Mr. Bleiweis was formerly a consultant with The Woodside Group. In that capacity, he has provided assistance to the OCA in PGW's past rate proceedings before the Commission on the proper determination of revenue requirements and other related topics. OCA St. 2 at 1-2.

PGW has included \$500,000 in its pro forma test year expense for a management incentive bonus program. This Management Incentive Compensation expense for 55 to 57 employees:

consists of payments made under a one time or 'at risk' program developed by the Philadelphia Facilities Management Corporation to reward PGW's top management team, after years in crisis, and in lieu of an annual merit increase for those years.

OTS St. 2 at 3. The amounts included in the five-year financial forecast from FY2008 through FY2012 increase from \$510,000 in FY2008 to \$552,000 in FY2012. OCA St. 2 at 15; Tr. at 798-799. The OCA and OTS witnesses recommend that the claimed \$500,000 Incentive Bonus Program pro forma expense be excluded for ratemaking purposes because no formal guidelines have been submitted to define the program. OCA St. 2 at 15.

The OCA submits that PGW has not provided sufficient, detailed information regarding this program. As OCA witness Bleiweis testified:

When asked to supply details of the program, the reply to PA-OB-64 in PGW's FY2007 Operating Budget proceeding before the Philadelphia Gas Commission only stated:
"PGW's compensation program includes incentives for meeting departmental goals, the achievement of savings or elimination of costs. The PFMC Board will determine upon reviewing senior management's performance whether the incentive program, on an annual basis, is applicable for any given period."

OCA St. 2 at 16. PGW stated in the FY2007 Operating Budget proceeding before the Philadelphia Gas Commission that "Formal guidelines for an incentive bonus program **have not been adopted to date**, insofar as an incentive program for FY 2007 has not been approved."

(Emphasis added.) OCA St. 2 at 16.

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

Similar to my recommendation in the Operating Budget proceeding, I recommend that the claimed \$500,000 pro forma expense for the Incentive Bonus Program be excluded for ratemaking purposes. 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 St. 2 at 17.

OTS witness Markovich also recommended that this management incentive compensation expense be denied. After a review of the program, Ms. Markovich concluded “that it is not in the best interest of either the customers or the owners of PGW as it results in an expense that is excessive without direct correlation to implementation of improvements in the operational, service level and/or financial condition of PGW.” OTS St. 2 at 6; See also, OTS St. 2 at 4-6.⁷ Ms. Markovich detailed four additional reasons for her recommendation:

- the plan lacked documentation;
- the evaluations to determine the final payment are not based on “clearly defined and measurable Company or individual performance measures or objectives,” but instead on subjective core competencies;
- the incentive plan would result in excessive payments compared to the normal merit increases with no additional measurable objectives; and
- an employee with a higher pay-grade might be rated lower but still receive a higher incentive payment, based on PGW’s structure.

OTS St. 2 at 6-8.

PGW witness D’Attilio responds to Mr. Bleiweis’ recommendation that these costs be denied because there is insufficient documentation, by noting that while there is no single document, the combined answers provided to the interrogatories sufficiently set forth

⁷ Senator Michael Stack also testified at the public input hearings that the “Executive Bonuses” should be rejected if there is no benefit to consumers. Tr. at 178.

PGW's Incentive Compensation Program. Mr. D'Attilio further states that use of the formula and the ability to replicate the formula demonstrate the "formality of the program." PGW St. 12 at 9.

Mr. Bleiweis explained in Surrebuttal that a compilation of interrogatory responses and a formula do 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.

The Philadelphia Gas Commission, in its October 4, 2006 Order on PGW's operating budget reached this same conclusion. The Hearing Examiner found:

We grant the Public Advocate's exception to including the \$500,000 in the Budget for potential management incentive payments related to FY2007 performance because clearly articulated, well-defined, quantitative goals and criteria (as are used in private industry for such "pay-for-performance" programs) are absent. During the course of FY 2007, PGW is certainly free to re-submit a specific program and projected budget for Gas Commission review and approval.

In Re: Fiscal Year 2007 Budgets/Oversight Proceeding, Philadelphia Gas Commission at 3-4 (October 4, 2006) (footnote omitted)⁸; OCA St. 2 at 18. To date, PGW has not resubmitted a FY2007 management incentive bonus program. Tr. at 799.

The OCA submits that PGW's program does not meet the requirements for inclusion as an expense. The requirements for incentive compensation programs were highlighted by the Commission in the Pa. P.U.C. v. Roaring Creek Water Company case. In that case, the Commission found that an incentive compensation plan should be geared towards ratepayer benefits, including goals for better operational efficiency of the utility to be considered an allowable expense. 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 OCA submits that PGW has been unable to show that ratepayers benefit from this incentive bonus program and has been unable to provide sufficient documentation to support the program.

For the reasons stated above, the OCA submits that the \$500,000 incentive bonus program expense should be disallowed. See, OCA St. 2 at Schedule MAB-1, MAB-2.

2. Lobbying Expenses.

PGW has claimed recovery for \$100,000 in lobbying expenses. PGW's Statement of Income for Wolf Block identified \$450,000 in contract costs, with \$100,000 for lobbying expenses. PGW stated that the primary purpose of WolfBlock Government Relations, LP's contract with PGW is to "interact" with the Administration and the General Assembly on PGW's behalf. PGW affirmed that the "bulk of these activities" are lobbying. PGW St. 2-R at 32. OCA witness Bleiweis recommended that the lobbying expenses in the total amount of \$100,000 related to WolfBlock Government Relations be disallowed for ratemaking purposes. OCA St. 2 at 19.

⁸ A true and correct copy of the relevant pages of the Order are attached hereto as Appendix C.

Section 1316(a) of the Public Utility Code does not permit the inclusion of lobbying expenses in ratemaking:

(a) General rule. -- For purposes of rate determinations, no public utility may charge to its consumers as a permissible operating expense for ratemaking purposes any direct or indirect expenditure by the utility for political advertising...

(d) Definition. - - As used in this section the term "political advertising" means any advertising for the purpose of influencing public opinion with respect to any legislative, administrative action or candidate election or with respect to any controversial issue to be decided by public voting. The term includes money spent for lobbying but not money spent for appearances before regulatory or other governmental bodies in connection with a public utility's existing or proposed operations.

66 Pa. C.S. § 1316.

In PGW's last base rate proceeding, the Commission disallowed inclusion of lobbying expenses. 2001 PGW Base Rate Order, at 63-66. The 2001 PGW Base Rate Order stated:

We do not believe, however, that PGC's allowance of the recovery of a certain budget category, such as lobbying expenses, is an element of the cash flow method to which the Commission must adhere. Rather, the cash flow method previously utilized by the PGC is described in Section VII of the 1972 Management Agreement as requiring the approval of rates that will produce revenues that are sufficient to (1) pay reasonably incurred operation and maintenance (O&M) costs and expenses as they come due throughout the fiscal year; (2) make the \$18 million annual payment to the City; (3) satisfy debt service requirements; and (4) provide cash working capital. Although some expenditures, such as employees' retirement costs, are specifically identified for recovery, lobbying expenses are not so designated. Therefore, we do not view the recovery of lobbying expense as being required by Section 2212's mandate that the Commission adheres to the prior ratemaking method. Rather, we are free to examine the reasonableness of the amount and the category of O&M expense being claimed by PGW.

2001 PGW Base Rate Order at 65-66.

The Commission has ruled in other cases that lobbying expenses do not have a direct ratepayer benefit and as such cannot be included in rates. Several cases have examined this issue and reached this conclusion. Pa. P.U.C. v. Pennsylvania-American Water Co., 79 Pa. P.U.C. 25, 66 (1993) (portion of membership dues disallowed which related to legislative advocacy functions and lobbying); Pa. P.U.C. v. Duquesne Light Co., 59 Pa. P.U.C. 67, 118 (1985) (Edison Electric Institute (EEI) dues disallowed because the legislative advocacy activities were of no benefit to ratepayers.); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 84 Pa. P.U.C. 134, 196 (1995)(disallowed expenditures of the Governmental Affairs Department that related to lobbying); Pa. P.U.C. v. Metropolitan Edison Co., 60 Pa. P.U.C. 349, 382 (1985) (EEI dues eliminated for the percentage that went towards lobbying and legislative activities expenses).

In accord with prior Commission precedent, recovery of expenditures for lobbying expenses should not be allowed. OCA witness Bleiweis has recommended an adjustment of \$100,000 for the lobbying expense related to WolfBlock Government Relations. See, OCA St. 2 at Schedule MAB-1, MAB-3

3. Authority Expenses.

In its filing, PGW claimed an amount of \$190,000 for "Authority" in the FY2007, including expenses for two law firms, \$150,000 for Hangley Aronchick and \$40,000 for Blank Rome for services related to proposals and draft legislation to create a state "authority" that would include PGW. OCA witness Michael Bleiweis opposed the inclusion of this expense. OCA St. 2 at 22. In its Rebuttal Testimony, PGW witness Joseph Bogdonavage stated that "PGW agrees that these amounts should be removed from FY 2007 operating expenses." PGW St. 2R at 36. This adjustment has been incorporated into the final Tables.

4. Bad Debt Expense.

PGW was claiming test year Bad Debt Expense at proposed rates based on a collection ratio of 95% for the future test year. The OCA had recommended a collection ratio of 96% at proposed rates, a reduction of \$2,314,000 in the bad debt expense. OCA St. 2 at 27. OTS had also recommended an adjustment to bad debt expense.

Following the hearings in this case, the OTS and PGW entered into a Stipulation regarding the bad debt expense. PGW Hearing Exh. 5. The OCA accepts the bad debt expense level resulting from the OTS/PGW Stipulation for the purposes of this proceeding. The effect of this Stipulation is shown on the OCA's Final Tables.

5. Regulatory Penalties.

PGW included \$50,000 for regulatory penalties in its pro forma test year expenses. OCA St. 2 at 27; PGW St. 1 at JRB-2, Exhibit D, Other Income. The \$50,000 in regulatory penalties was mainly based on \$100,000 in fines which PGW paid as a result of two incidents where PGW had shut off service to customer premises and the occupants died as a result of hypothermia and heart disease. OCA St. 2 at 27. PGW has projected a \$50,000 amount on an annual basis through FY2012. OCA St. 2 at 27.

The OCA submits that the inclusion of an on-going expense for regulatory penalties to be recovered from ratepayers should not be allowed. As OCA witness Bleiweis explained:

What PGW is saying is that 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.

The OCA submits that inclusion of an annual expense for regulatory penalties is wholly improper. Inclusion of such an expense to ratepayers defeats the purpose of regulatory penalties and moves responsibility for Company actions to the customers who are the injured party by violations of the regulations. As such, the OCA submits that the \$50,000 in regulatory penalties expense should not be allowed. See, OCA St. 2 at Schedule MAB-1, MAB-5.

6. Utility Merger Expense.

In its filing, PGW claimed \$50,000 in on-going expense related to the Exelon/PSEG merger case. OCA witness Michael Bleiweis recommended disallowing this expenditure since the merger proceeding has ended. In Rebuttal Testimony, PGW witness Bogdonavage withdrew the expenditure for utility merger expense. PGW St. 2R at 35. This adjustment is reflected in the Final Tables. See also, OCA St. 2 at Schedule MAB-1, MAB-6.

VI. RATE STRUCTURE

A. Cost Of Service Study.

1. Introduction.

In support of the Company's case, Howard Gorman presents an average embedded allocated class cost-of-service study (COSS) on behalf of PGW. PGW Exhibits HSG-1 through HSG-8. Mr. Gorman allocated PGW's distribution mains plant investment seventy-five percent on the basis of customer class coincident peak demands, and twenty-five percent on the basis of the number of customers in each class that are attached to the system. The OCA submits that the allocation of mains investment costs should be done using both annual and peak demands, as this principle is most closely aligned to allocating costs on the basis of cost-causality. Accordingly, the OCA presented the testimony of Richard A. Galligan to explain why an allocation that recognizes both peak and average usage more accurately reflects how, and why, the PGW distribution system was built.⁹ The OCA recommends that distribution mains plant investment costs in this proceeding should be set based on the Peak and Average methodology, as recommended by OCA witness Galligan, specifically recommending that eighty percent be allocated to average demands and the remaining twenty percent be allocated on the basis of peak demands.

2. The Company's Cost-Of-Service Study Misallocates Costs, Producing Unreliable Results.

a. Introduction.

⁹ OCA witness Richard A. Galligan is a Principal with Exeter Associates, Inc., a firm of consulting economists specializing in utility economics. Prior to joining Exeter in 1987, Mr. Galligan served as Executive Director of the Texas Public Utility Commission and served in various positions at the Iowa, New Mexico, and Minnesota public utility commissions. Mr. Galligan has presented testimony on more than 90 occasions before the Federal Energy Regulatory Commission and various state commissions.

PGW witness, Mr. Howard Gorman, presented a COSS on behalf of PGW. PGW Exhibits HSG-1 through HSG-8. OCA witness Galligan comments on the use of a COSS, as follows:

Allocated costs of service are one component of information available for the Commission as it considers its affirmative responsibility to set just and reasonable rates. The controversial aspect of fixed cost allocations reinforces the general regulatory principle that cost of service results are often used as a guide to the setting of rates.

OCA St. 3 at 28.

OCA witness Galligan also explained the complex task that must be faced when producing a COSS, as follows:

The performance of such a study requires that every cost included in the total cost of service be ascribed, somehow, to the customers who allegedly, or to the best ability of the cost practitioner performing the study to determine, have "caused" the utility to incur such costs. Customers cause the utility to incur costs by demanding the services for which the Company incurs costs.

When performing an average, embedded, allocated class cost of service study, the cost practitioner's task is not done until each and every embedded cost, which comprises the total costs of providing service, is either directly assigned or allocated to the customer classes. In performing its cost of service study, PGW first functionalized its total costs of service into categories including production, storage, and distribution. Fixed costs are generally classified as being related to number of customers and to average and peak demands. Variable costs are generally classified as throughput related. Generally, customer related costs were allocated in a manner related to number of customers; throughput related costs were allocated on volumes; and distribution demand related costs were allocated on customer class maximum coincident demands. The allocation of fixed or capacity related costs is the most controversial aspect of performing an allocated cost of service study.

OCA St. 3 at 6 (footnote omitted).

The COSS serves as a guide used to set rates consistent with the principle of cost causation. It is critical that the COSS relied upon to guide the setting of rates be as accurate as possible. The OCA submits that there are significant flaws in the Company's study, making it an unreliable indicator of the cost to serve any particular class. As discussed below, the OCA has proposed an alternative to the Company's COSS that more accurately reflects the cost to serve the various classes. The OCA's COSS study should be used as the guide in this proceeding.

b. PGW's Allocation Of Distribution Mains Investment Costs.

Mr. Gorman classifies 25% of this investment as customer-related and allocates it on the basis of the number of customers in each customer class that are connected to the system. PGW St. 8 at 15. Mr. Gorman's defense of his customer component is based on the premise that one reason for installing distribution mains is to attach customers to the distribution system. PGW St. 8 at 14. Mr. Galligan explains how this particular allocation occurred, as follows:

Mr. Gorman explains that a zero-intercept study, which estimates the costs that would be incurred to install pipes of zero-inch diameter, would produce an estimated cost of mains that is classified as the customer component of mains. Further explaining that PGW did not have the data required to perform a zero-intercept study, and based on R. J. Rudden Associates' experience, an estimate of 25 percent was used. That is, 25 percent of PGW's actual distribution mains investment was determined by Mr. Gorman to be a customer cost.

OCA St. 3 at 7-8. The remaining 75% of distribution mains costs are allocated on the basis of customer class coincident peak demands. PGW St. 8 at 15.

The OCA submits that PGW's method of allocating the distribution mains costs in this proceeding is in error for at least two reasons. First, Mr. Gorman allocates 25% of the

distribution mains costs based on the number of customers connected to the system, using a zero-intercept study that hypothesizes the existence of zero-inch diameter pipes that are incapable of delivering any gas, even though PGW did not have the data to support such a study. Second, Mr. Gorman allocates the remaining 75% of the distribution mains costs on the basis of design day peak demands, or essentially what customers do or do not do in relation to their demand for gas service on one day, that may occur only once every 10-15 years.

c. The Company's Study Is Flawed Because It Allocates Twenty-Five Percent Of Its Distribution Mains Investment As Customer Costs.

As set forth by OCA witness Richard Galligan, mains are constructed to deliver gas, not merely to connect customers to the system. As Mr. Galligan states:

Clearly, it is its gas usage requirements, both annual and peak demands, which are the cause of PGW's distribution mains costs, not the imaginary costs of connecting customers who would use no gas.

OCA St. 3 at 11-12. Therefore, the entire investment in mains should be allocated on the basis of some measure of the gas they deliver or the loads they serve.

OCA witness Galligan provides a simple example to show the inherent flaw in allocating distribution mains costs based on the number of customers connected to the system, as follows:

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 cost of a distribution main is related, not to the number of customers served by the main, but to the annual gas consumption that drives the very existence of a gas utility's system. As OCA witness Galligan testified:

mains investment is undertaken when annual gas consumption is high enough to warrant the investment, and mains are sized to meet elevated demands, *independent of the number of customers.*

OCA St. 3 at 11 (*emphasis added*).

OTS witness Joe Kubas also agrees that distribution mains costs have no customer component. OTS St. 3 at 12. Mr. Kubas explains his reasoning as to why there is no customer component of distribution mains costs:

The Commission has previously determined in a 1994 Opinion and Order in the Pennsylvania-American Water Company Case at Docket No. R-00932670, Order entered July 26, 1994, at pages 111-115, that direct customer costs include "the depreciation, return and income taxes associated with meter and service investment, the operation and maintenance expense for meters and services, and the expense associated with meter reading and billing". Mains are not included in any of these categories and therefore should not be considered or classified as a customer cost. The basis for this determination is that the quantity and investment in mains does not change significantly if one customer joins or leaves the system. Mains 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.

OTS St. 3 at 12.

In addition to the arguments above, the Company's assignment of 25% of distribution mains costs as customer related is not supported by the Company's own witness, as Mr. Galligan explains:

After simply assuming a PGW customer cost component of mains at 25 percent of all the mains costs that PGW has incurred since its inception, Mr. Gorman, as indicated above, later determined that customer costs of mains is 21.2 percent when estimated on a zero-intercept basis, or 46.7 percent when estimated on a minimum system basis. Both the zero-intercept and minimum system methods attempt to measure the same thing -- the customer component of distribution mains. That customer costs could differ by so much, \$138.4 million, depending upon how they are determined by Mr. Gorman, raises significant concerns with the validity of these customer cost determinations.

OCA ST. 3 at 8-9 (footnote omitted).

The OCA submits that the Company's COSS improperly classifies 25% of the costs of distribution mains as customer related. As explained by both OCA and OTS testimony, the costs of distribution mains are related to usage. The 25% figure used by the Company is subject to significant variation and is not reliable, as further defined below. Moreover, the Commission has rejected zero-intercept and minimum system methods as being inconsistent with the principle of cost-causation. See, Pa. P.U.C. v. National Fuel Gas Distribution Corp., 83 Pa. PUC 262 (1994); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 73 Pa. PUC 552 (1990).

The OCA submits that Mr. Galligan's COSS more accurately depicts and describes the way that PGW actually incurs costs to serve its customers, and therefore should be used as a guide in this proceeding.

- d. The Company's Study Is Flawed Because It Allocates The Remaining Seventy-Five Percent Of Its Distribution Mains Investment On The Basis Of Design Day Peak Demands.

The Company's COSS is also flawed in the manner that it assigns distribution mains costs, that are classified as demand related, to the various customer classes. The Company has chosen to assign all demand-related costs to each class on the basis of its design day peak demands. 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. Mr. Galligan further explains the logic of allocating costs on the basis of both peak use, and average use, as follows:

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. PGW's failure to recognize the importance of annual demands as well as peak demands, and PGW's allocation of 100 percent of its demand related mains investment costs on peak demands only, violates the principle of cost-causality.

OCA St. 3 at 14.

There can be no dispute over the fact that PGW's gas delivery system is being used and ordinary demands are being placed on it by customers for delivery of gas each and every day of the year. There likewise can be no dispute that the design day peak demand calculations for the maximum throughput possible on PGW's system are designed with reference to one extraordinary weather event that is projected to occur once every 10-15 years.

OCA St. 3 at 12-13. Mr. Galligan's cost allocations more closely match the actual use of PGW's system, and therefore are more closely aligned with the principle of cost-causality than PGW's allocation of all demand costs based on only peak demand.

In addition, as Mr. Galligan explains, PGW's allocation method, if truly consistent with the principle of cost-causality, would not support the very existence of the PGW system. Mr. Galligan testified as follows:

Peak demands are not the major cause of PGW's demand related mains cost, and it is wrong therefore to allocate total demand related costs on the basis of peak demands, as PGW has done. Only the additional costs incurred to meet peak distribution demands above other demands are caused by, or directly related to, peak requirements. *The PGW gas distribution system simply would not be viable and simply would not exist if the only demand for gas was the demand associated with extreme weather conditions, or peak demands each year or each 10- to 15-years.* The PGW distribution system exists because the total annual demand for gas is sufficient to warrant its existence. It is an extreme and erroneous view that total demand costs associated with PGW's distribution network are caused by peak day demands. Because PGW's system exists to deliver annual gas requirements, but some additional costs are related to the delivery of gas during periods of elevated demand, it is appropriate to allocate distribution mains costs on both annual and peak demands.

OCA St. 3 at 16-17, (*emphasis added*).

OTS witness Joseph Kubas agrees with Mr. Galligan that the demand cost for mains should not be allocated on peak demands alone. Mr. Kubas testifies as to his use of the average and excess demand method for allocating some portion of demand to the average use and some portion to the difference between the average and the peak. OTS St. 3 at 13-14.

Mr. Galligan comments on Mr. Kubas' average and excess method in his Rebuttal Testimony:

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.

PGW's proposal to allocate 75% of the costs of distribution mains investment based on purely peak demands should be rejected. Mr. Galligan's Peak and Average COSS accurately allocates such costs based on the way PGW actually incurs costs to serve its customers, as the principle of cost-causality requires. The OCA submits that Mr. Galligan's COSS more accurately depicts and describes the way that PGW actually incurs costs to serve its customers, and therefore should be used as a guide in this proceeding.

3. Conclusion.

The OCA submits that the Company's COSS is not properly grounded in the principles of cost-causality. The PGW COSS improperly allocates a portion of distribution mains investment as customer costs. In addition, the Company's COSS fails to account for the average, year-round usage that drives the very existence of the entire system. In contrast, Mr. Galligan's COSS more accurately depicts the way the PGW system is actually used to deliver gas to customers, and therefore is more accurate than PGW's COSS that allocates distribution mains costs to customers that use no gas and allocates the remaining distribution mains costs based on periods of peak demand that may only occur one time in any 10-15 year period. The

OCA submits that based on the foregoing discussions and analysis, and as detailed below, Mr. Galligan's COSS should be used as a guide in this proceeding.

B. The Peak And Average Cost-Of-Service Study Presented By OCA Witness Galligan Better Reflects Cost Causation Of The Customer Classes And Should Be Adopted In This Proceeding As A Useful Guide In Setting Rates.

In order to provide the Commission with a COSS that reflected the costs of building the PGW distribution network, OCA witness Galligan had a COSS prepared that allocated eighty (80) percent of distribution mains and related costs to average demands, and the remaining twenty (20) percent to peak demands.¹⁰ See Exh. RAG-1. Mr. Galligan's COSS incorporates what is known as the "Peak and Average" method. This study correctly allocates PGW's total costs of service to those classes that caused the costs to be incurred. Mr. Galligan explains the basis for the 80/20 split, as follows:

PGW's design day peak demand is about four times its average demand. A pipe's cross-sectional area, and correspondingly its capacity, varies with the square of its radius. Therefore, doubling the size of a pipe's radius (or diameter), increases the capacity of the pipe four-fold. For example, doubling the diameter of a two-inch pipe to four inches, increases the capacity by four times the capacity of the two-inch pipe.

Considering the many costs which remain essentially fixed, and that pipe costs are a small portion of installed pipeline project costs, the result is a favorable relationship between the costs associated with increased capacity and increasing pipe size. Were a doubling of the pipe sizes (and hence, a quadrupling of capacity) to increase capacity related costs by as much as 40 percent, the result would be that increased demands above the average can be accommodated at increased distribution mains costs that are about 10 percent of the costs of meeting average demands. Thus 10 percent of distribution mains costs is

¹⁰ The Company's cost studies were produced using proprietary software. Due to the proprietary nature of the software, the Company offered to run alternative cost studies with different allocation factors at the request of the parties in this proceeding. The OCA had the Company run its proprietary cost of service software with allocators reflecting the Peak and Average methodology.

associated with meeting peak demand requirements and should be allocated on peak demands, and 90 percent of mains cost relates to customers' annual demands for natural gas and should be allocated on average demands.

OCA St. 3 at 17-18. And, Mr. Galligan concludes by showing that the 80/20 allocation method he advances is a conservative figure:

The additional costs of providing capacity in order to meet peak demands, as opposed to lesser demands, should be allocated on a peak demand basis. I earlier mentioned that about 10 percent of a gas utility's distribution mains cost is associated with meeting increased demands, and hence, 10 percent of mains costs should be allocated on the basis of peak demands. I conservatively recommend that fully 20 percent of PGW's distribution mains costs, instead of only 10 percent, be allocated on the basis of peak demands. The remainder of PGW's distribution mains cost, being related to, or caused by, PGW's annual gas requirements, should be allocated on annual, or average demands.

OCA St. 3 at 19.

The results from Mr. Galligan's COSS for the Residential classes at present rates are shown in the following Table:

Table 2							
Total Allocated Costs and Rate of Return at Present Rates (\$000's)							
		<u>Residential Heating</u>		<u>Residential Non-Heating</u>		<u>Total Company</u>	
		<u>Index Return</u>	<u>Rate of Return</u>	<u>Index Return</u>	<u>Rate of Return</u>	<u>Index Return</u>	<u>Rate of Retur n</u>
1.	Results per PGW's Study	78.6%	4.6%	(41%)	(2.4%)	100%	5.8%
2.	Results per OCA Study	93.0%	5.4%	(33%)	(1.9%)	100%	5.8%

OCA St. 3 at 21.

As is clearly shown, the correct allocation of PGW's cost of service by using the peak and average method reveals that at present rates, the Residential Heating class is providing an indexed rate of return of 93% compared to the Company's figure of 78.6%, which is based on its flawed COSS.

1. A Peak And Average Study More Accurately Reflects Cost Of Service Principles.

Mr. Galligan explains that to remain in accord with the principles of cost-causality, the investment in distribution mains should be allocated on the basis of the peak and average demand method. OCA St. 3 at 13. In the peak and average demand method, the demand allocation factors reflect both the class' average use of energy and its total usage on system peak days. Mr. Galligan explains that:

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.

To further illustrate the effect of correctly allocating the costs of service in this proceeding by using the peak and average method, Mr. Galligan prepared exhibits to accompany his Direct testimony that reflect the rate of return and the indexed rate of return at the Company's proposed rates. See Exhibit RAG-1. The following Table reflects the results of Exhibit RAG-1, at page 5.

Table							
Total Allocated Costs and Rate of Return For Future Test Year at Proposed Rates (\$000's)							
	<u>Residential Heating</u>		<u>Residential Non-Heating</u>		<u>Total Company</u>		<u>Rate of Return</u>
	<u>Index Return</u>	<u>Rate of Return</u>	<u>Index Return</u>	<u>Rate of Return</u>	<u>Index Return</u>	<u>Rate of Return</u>	
1. Results per PGW's Study	86.0%	11.07%	7.0%	.87%	100%	12.89	%
2. Results per OCA Study	94.0%	12.15%	12%	1.58%	100%	12.89	%

As can be seen from this chart, when the peak and average method is utilized to properly allocate costs, Residential Heating is considerably closer to PGW's overall rate of return than in the Company's study at the Company's proposed rates. Again, it is important that the costs of service study be as accurate as possible to serve as a useful guide when setting rates.

2. The Other Parties' Criticisms Of The Peak And Average Methodology Are Without Merit.

Several parties, in their Rebuttal testimony, have criticized the Peak and Average methodology. PGW Witness Howard Gorman takes issue with the examples used by Mr. Galligan, and his use of the Peak and Average method. PGW St. 8R at 6-17. As OCA witness Galligan explains in his Surrebuttal testimony, these criticisms of his examples and of the Peak and Average methodology are erroneous. OCA St. 3-S at 2-6. PGW witness Mr. Gorman further questions Mr. Galligan's use of Professor Bonbright's work. PGW St. 8R at 10-12.

Partially in response to Mr. Gorman's assertions, Mr. Galligan discusses the extent to which any cost allocation method is a precise instrument, as follows:

In addressing cost allocation issues in a recent PJM transmission rate design case, the Federal Energy Regulatory Commission ("FERC") put it this way:

As the Supreme Court has found, "allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science." The Commission recently articulated the same principles in Order No. 890:

Our decisions regarding transmission cost allocation reflect the premise that allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science. We therefore allow regional flexibility in cost allocation and, when considering a dispute over cost allocation, exercise our judgment by weighing several factors. First, we consider whether a cost allocation proposal fairly assigns costs among participants, including those who cause them to be incurred and those who otherwise benefit from them. Second, we consider whether a cost allocation proposal provides adequate incentives to construct new transmission. Third, we consider whether the proposal is generally supported by state authorities and participants across the regions. [Opinion No. 494, Opinion and Order on Initial Decision, Docket Nos. EL05-121-000 and EL05-121-002, April 19, 2007, footnotes omitted]

While these cost allocation standards are included in a transmission rate proceeding, these standards are not unique nor limited to transmission costs of service.

OCA St. 3-S at 5-6. Mr. Galligan goes on to explain how the Peak and Average method meets the three factors set out by the FERC above. OCA St. 3-S at 6-8.

OSBA witness Robert Knecht also takes issue with the peak and average method advocated by Mr. Galligan, as Mr. Knecht basically agrees with PGW's COSS. OSBA St. 2R at 9. Mr. Knecht further believes that Mr. Galligan's and OTS witness Joseph Kubas' use of COSS that include GCR costs is not reasonable in this proceeding. OSBA St. 2R at 9. Mr. Galligan responds to the inclusion of GCR related costs in his Surrebuttal Testimony:

I address the use of cost studies available in this record, both with and without GCR costs and revenues, at pages 13-15 of my rebuttal testimony. Here I would simply add Mr. Knecht's conclusion stated at page 3 of 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."

OCA St. 3S at 16. Mr. Galligan further responds to whether the inclusion of GCR costs has any substantial impact on this proceeding or his analysis, as follows:

No. 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. Utilization of the no-GCR study would not change my endorsement of PGW's proposed residential customer rate increase.

OCA St. 3R at 14. As to Mr. Knecht's basic agreement to use the PGW COSS in this proceeding as to the allocation of demand related distribution mains costs, Mr. Galligan responds:

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.

Clearly, for the reasons detailed above, PGW's system is built for year-round demand. The parties who ignore this reality fail to allocate costs for the reasons they are

incurred. The OCA submits that the Peak and Average methodology is a reasonable way to allocate costs and should be accepted.

Distribution facilities are built on the basis of year round demands as well as peak demands. The Commission has accepted this fact for gas distribution utilities in Pennsylvania. In National Fuel Gas Distribution's ("NFGD") 1994 base rate proceeding, the Commission accepted the Peak and Average methodology, stating, "The Peak and Average method that allocates mains equally is a sound and reasonable method of cost allocation and should remain intact." Pa. P.U.C. v. National Fuel Gas Distribution Co., 83 Pa. PUC 262 (1994). See also, Pa. P.U.C. v. National Fuel Gas Distribution Co., 73 Pa. PUC 552 (1990); Pa. P.U.C. v. Equitable Gas Co., 73 Pa. PUC 301 (1990); Pa. P.U.C. v. National Fuel Gas Distribution Corp., 72 Pa. PUC 1 (1989); Pa. P.U.C. v. Peoples Gas Co., 69 Pa. PUC 138 (1989). This is the precise method Mr. Galligan used for his study. OCA St. 3 at 4.

Other jurisdictions have accepted the Peak and Average methodology for the reasons proposed by OCA witness Galligan in this proceeding. The Indiana Utility Regulatory Commission (IURC) recently issued a decision, wherein the exact peak and average methodology advocated by Mr. Galligan in the present matter was accepted and strongly endorsed. See, In re Citizens Gas & Coke Utility, IURC Cause No. 42767, (Oct. 19, 2006).¹¹

The IURC found that the peak and average method, as advanced by Mr. Galligan,¹² was the "equitable and realistic" method for allocating distribution mains costs, and provided the following analysis:

In re Citizens Gas & Coke Utility, IURC Cause No. 39066, at

¹¹ A true and correct copy of this Order is attached in OCA Appendix C. Also available at: http://www.in.gov/iurc/portal/Modules/Ecms/Cases/Docketed_Cases/ViewDocument.aspx?DocID=0900b631800bcd10

¹² OCA witness Galligan was the expert witness in this Indiana proceeding.

31 (Nov. 1, 1991)

...
Based upon the record evidence, this Commission concludes that the OUCC's cost-of-service study is most reflective of cost causation and possesses a high degree of objectivity upon which the Commission may place reliance in establishing the rates and charges in this proceeding.

....
While we do not doubt that distribution mains must be constructed with peak demand in mind, distribution mains do not only serve customers on peak demand days. Therefore, a measure of the costs of distribution mains must be allocated to customers based on their usage that takes place on non-peak days. For example, a customer that does not take service at all on the peak demand day-and therefore contributes nothing to peak demand requirements of distribution mains-but receives service through distribution mains at other times should be responsible for some portion of distribution main costs

....
The OUCC's approach is much more equitable and realistic. Rather than allocating distribution main costs exclusively based on either peak demand day or average annual consumption, the OUCC used a compromise approach that allocated these costs based on both. Under the OUCC's cost of service study, 80% of distribution main costs are allocated based on average demand. (Public's Ex. No. 6 at 13.) In this way, the OUCC's approach allocates part of distribution main costs to customers who receive service through distribution mains throughout the year but who may not receive much or any service on the peak demand day

....
For the reasons set forth above, we find the OUCC's cost of service study most accurately reflects the manner in which distribution main costs are actually incurred. See, *In Re Citizens Gas & Coke Utility*, IURC Cause No. 39066, at 31 (Nov. 1, 1999). We therefore adopt the OUCC's cost of service study to implement the rates increase approved in this Cause.

In re Citizens Gas & Coke Utility, IURC Cause No. 42767, at 74-75 (Oct. 19, 2006).

The Illinois Commerce Commission ("ICC") recently affirmed their acceptance of the Peak and Average method for allocating transmission and distribution costs in the natural

gas industry. The ICC explained the reasoning behind utilizing a Peak and Average methodology in their decision as follows:

Generally, [Central Illinois Public Service Company or "CIPS"] and [Union Electric Company or "UE"] gas transmission and distribution facilities exist because there is a daily need for such facilities. Regardless of when CIPS and UE experience their respective peak and the level of the peak, customers depend on the continued operation of the Ameren gas transmission and distribution systems to meet their daily needs. On the day that the peak does occur, Ameren's own Mr. Carls testifies that CIPS' and UE's respective systems are built to accommodate the system peak without regard to each class' peak. In light of the nature in which the transmission and distribution systems are used and because of the relatively declining cost of increasing capacity, peak demand is not the appropriate emphasis in allocating demand costs...As the Commission concluded in Docket 94-0040, a utility can not justify its transmission and distribution investment on demands for a single day. The allocation method that properly weights peak demand is the [Average & Peak or "A&P"] method, the same method that the Commission adopted in CIPS' and UE's last gas rate cases. The A&P method properly emphasizes the average component to reflect the role of year-round demands in shaping transmission and distribution investments.

Central Ill. Pub. Service Co. Proposed General Increase In Natural Gas Rates, et. al., 2003 Ill. PUC Lexis 824, 231-232 (2003).

The Arkansas Public Service Commission (APSC) also recently accepted the use of the Peak and Average method for gas transmission and distribution plant, stating, "The average and peak method is one of the methods accepted by regulators for allocating demand costs." In The Matter Of The Applications Of Ark. Western Gas Co. For Approval Of A General Rate Change In Rates And Tariffs, Docket No. 02-227-U; Order No. 17, 2003 Ark. PUC LEXIS 397, 69 (2003).

The OCA submits that the Pennsylvania Commission's decisions, the IURC, ICC and APSC decisions properly recognized that, while a gas distribution system may be sized

overall to accommodate peak demand, the entire system exists in order to meet year-round demands. The Commission should adopt the Peak and Average allocation methodology to accurately allocate costs in this case.

3. Conclusion.

OCA witness Galligan's COSS properly allocates costs in a more accurate manner than does the Company's study. The peak and average study captures the practical and realistic view of why PGW's distribution system was built, and why those costs were incurred. The OCA submits that Mr. Galligan's study is a useful guide for setting rates in this proceeding and should be adopted by the Commission.

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

1. Introduction.

The Company has proposed changes in rates for each rate schedule designed to move each rate schedule closer to the system average rate of return that was proposed by the Company, while observing the principles of gradualism. OCA witness Richard Galligan describes the Company's requested revenue increase, and its impact on the Residential class:

PGW's proposed rates would result in a total gas revenue delivery rate increase of \$100 million annually. This \$100 million increase is a 23 percent increase in non-gas tariff revenue, and a 9.6 percent overall increase. PGW proposes to achieve its approximate \$100 million revenue increase, in part, by increasing its residential customers' rates as follows:

Table 1		
Proposed Rate Increase Philadelphia Gas Works Total Company and Residential Service		
	<u>Revenue Increase</u> (\$)	<u>Percentage Increase</u>
Residential Heat	66,758,000	21.4
Residential Non-Heat	2,639,000	15.2
Total Company	100,000,000	23.0

PGW arrived at this proposed revenue spread among the classes by essentially adjusting each class' revenues so as to make progress toward basing rates on its average embedded class cost of service study results, while also considering the principle of gradualism.

OCA St. 3 at 2-3. The OCA supports the Company's proposed revenue allocation, finding that it essentially establishes cost-based rates for the Residential class.

The Commonwealth Court of Pennsylvania has recently provided that the "polestar" for determining the level of revenue for the different rate classes should be the cost of providing service to those different rate classes. Lloyd v. Pa. PUC, 904 A.2d 1010, 1020 (Commw. Ct. 2006). "Polestar" is a literary reference meaning "directing principle" or a "guide". The American Heritage Dictionary, Houghton Mifflin Co. (1985). As the Commission has found, a COSS is to serve as this guide in setting rates. Pa. PUC v. Pennsylvania Gas & Water Co., 1993 Pa. PUC LEXIS 61, *167 (June 23, 1993).

The Commission has also recognized that a COSS is not an exact science. Application of Metropolitan Edison Company for Approval of Restructuring Plan Under Section 2806 of the Public Utility Code, 1998 Pa. PUC LEXIS 160, *159 (June 30, 1998) (The Commission has always regarded **cost of service studies** as more of an art form and a **guide** rather than as a source of actual data.) The OCA submits that no matter who prepares the COSS

or how meticulous the practitioner has been in its creation, it is just that – a guide. It is also instructive to consider that cost of service studies are based on the cost allocation factors chosen by the creator of the study, which in and of themselves, are often controversial and the matter of great debate between the parties in a rate proceeding. As OCA witness Galligan points out:

The allocation of fixed costs is controversial, largely because in the short-run, these costs may not change with the provision of a little more or less service. Regarding the allocation of fixed customer costs, Bonbright puts it this way:

The really controversial aspect of customer-cost computation arises because of the cost analyst's frequent practice of including, not just the costs than can be definitely earmarked as incurred for the benefit of specific customers, but also a substantial fraction of the annual maintenance and capital costs of the secondary (low-voltage) distribution system - a fraction equal to the estimated annual costs of a hypothetical system of minimum capacity. [Bonbright, James C., et. al, Principles of Public Utility Rates, Public Utility Reports, Inc., Arlington, Virginia, Second Edition, 1988, p.491, emphasis added.]

OCA St. 3 at 26.

The allocation of capacity or demand-related costs is no less troublesome, or less fraught with controversy, as Mr. Galligan discusses further in his Direct testimony, as follows:

Also, regarding capacity related costs, the NARUC Manual, at page 23 states:

Dr. James Bonbright, whose Principles of Public Utility Rates is the classic examination of regulation and ratemaking, wrote:

Of all of the many problems of rate making that are bedeviled by unresolved disputes about issues of fairness, the one that deserves first rank for frustration is that concerned with the apportionment among different classes of consumers of the demand costs or capacity costs....Awareness of these unresolved conflicts about 'fair' cost apportionment has lead the British economist Professor W. Arthur Lewis to exclaim that, in rate determination, 'equity' is the mother of confusion,'

Dr. Bonbright also includes the following regarding the allocation of capacity, or demand related costs:

We come now to that category of costs, capacity, ready to serve, or demand costs, the treatment of which has made a nightmare of utility cost analysis (for two masterly theoretical treatments see Boiteux, 1960, and Crew and Kleindorfer, 1986). As the FERC *Handbook* (1983, p. 139) states: "For the problem which it presents is that of imputing joint costs to joint products or byproducts, and not merely that of distributing those common, but nonjoint, costs (See Chapter 2) which vary more or less continuously with number of consumers or with rates of output...."

Here, as with the other two categories of cost, there is no general agreement as to what items or portions of total costs should be included among the demand-related costs, perhaps because cost functions are far too complex to be reflected by the arbitrary, three-way classification of customer, energy, and demand....

Testifying before the ICC in Illinois (1953) in a rate case, Corey noted the existence of twenty-nine such formulae; in their textbook Garfield and Lovejoy (1964, p. 159) mention "20 or more allocation methods"; and Grainger (1972), 1976) discusses several methods of allocating the ready-to-serve costs. Most of them have no claim whatever to validity from the standpoint of cost determination and only a dubious claim to acceptance as compromise measures of reasonable rates. A harsher critic might use the metaphor of Bentham that these claims are "nonsense upon stilts". [Ibid., pp. 494-495]

OCA St. 3 at 27-28.

It should be clear that cost of service studies are as much art as they are science. The COSS should be viewed for what it is, a guide, albeit an important one, but only one component of the total information that is available to the Commission as it sets itself to the task of establishing just and reasonable rates.

Using the cost of service studies in this proceeding, the Company proposed an allocation of the rate increase to each customer class designed to bring those classes closer to the

system average rate of return. After a review of the Peak and Average study and the Company's proposed allocation of the rate increase, OCA witness Galligan accepted the Company's proposal finding that it achieves the goals of moving each class closer to the system average rate of return. Only the OSBA provided an alternative revenue allocation.

The following chart provides a summary of the different revenue allocations proposed by the parties in this proceeding based on the full revenue increase requested by the Company. The OCA has proposed overall reductions to the Company's revenue request, and provides this chart for comparison purposes only.

Proposed Revenue Allocations		
(\$000s)		
	PGW/OCA¹³	OSBA¹⁴
Res. Non-Heat	2,639	
Res. Heat	66,758	
Total Res.	69,397	95,641
Comm. Non-Heat	4,136	
Comm. Heat	20,617	
Total Comm.	24,753	3,682
Ind. Non-Heat	589	
Ind. Heat	1,254	
Total Ind.	1,843	217
Muni. Non-Heat	456	
Muni Heat	1,746	
Total Municipal	2,202	267
Housing Authority	1,744	134

The OCA generally agrees with the Company's proposal in this case to move each class closer to system average rate of return. The Company's proposed allocation of the rate increase accomplishes this goal under both the Company's and the OCA's cost of service studies. However, the OSBA's proposed allocation should be rejected because it is based entirely on the Company's flawed COSS, which significantly understates the residential class

¹³ Source: Exhibit HSG-7C, Revised (March 30).

¹⁴ Source: Exhibit IEC-4, Table 4-B.

rate of return, and it violates the principles of gradualism. When the OCA's COSS is used as a guide, the allocation proposed by the OSBA is clearly not supportable.

2. The OCA Supports The Company's Proposed Revenue Allocation.

While the OCA disagrees with the Company's assignment of costs in its cost of service study, the OCA agrees that principles of gradualism, avoidance of rate shock, and fundamental fairness requires a measured approach to bringing rates in line with costs. The OCA submits that the revenue allocation proposed by the Company meets all of these principles, and moves the various classes closer to their cost of service. OCA witness Richard Galligan explains how PGW created its proposed revenue allocation among the different rate classes:

For example, in step-one of its process, PGW determined that a twenty percent movement toward cost-based rates as measured by its indexed rate of return for its residential heating customers, using its proposed cost of service study results as the standard, would reasonably balance the concepts of costs and gradualism. PGW then combined the residential heating customers with residential non-heating customers and with Housing Authority customers to determine a common delivery rate. The resulting proposed increased revenues for residential heating customers in step-two would be such that residential heating customers would actually make thirty-two percent progress in reducing this difference between their rate of return compared to system average rate of return.

Table 3 below shows the residential heating customer rates of return, and system average rates of return at present and PGW-proposed rates, using PGW class cost of service study results.

Table 3
Residential Heating Customers
Financial Indicators Based On PGW Class Cost of Service
Study Results

	<u>Present Rates</u>		<u>Step-One Revenues</u>		<u>Step-Two Revenues</u>	
	<u>Rate of Return</u>	<u>Index</u>	<u>Rate of Return</u>	<u>Index</u>	<u>Rate of Return</u>	<u>Index</u>
Residential Heating	4.59%	79.2%	10.74%	83.3%	11.07%	85.6%
Residential Heating	Non- (2.4%)	(42.1%)	5.00%	38.8%	.87%	6.7%
Total PGW	5.79	100%	12.89	100%	12.89%	100%

The 10.74% residential heating, step-one rate of return represents a twenty percent movement of the class to the system average. The actual movement of residential heating customers at PGW proposed rates represents a 32% movement to the system average. The Step-1 and Step-2 results shown in Table 3 are based on PGW's proposed \$100 million rate increase, PGW's proposed spread of that requested amount, and PGW's proposed class cost of service study.

OCA St. 3 at 22-23. The Chart above clearly indicates that even when using PGW's COSS, that the OCA submits assigns too much cost responsibility to the Residential class, the Residential class is making substantial progress towards unity, or cost-based rates. If the revenue increase for the Residential class is viewed under the Peak and Average COSS, it is apparent that the Company's proposed rate increase allocation brings the Residential class substantially to cost-based rates. Mr. Galligan discusses class revenues and costs when his Peak and Average COSS is used:

When PGW's proposed residential heating rate increase is used and the cost results of the P&A cost of service study are substituted for PGW's cost study, residential heating customers are seen to be providing a 12.15 percent rate of return at proposed

rates. This 12.15 percent rate of return represents a 94.3 percent index return rather than the 86 percent index return based on the peak demand/customer study proposed by PGW. Thus, residential customers are seen to be paying rates that yield higher rates of return and higher index returns when PGW's proposed residential rates are compared to the more cost based P&A allocation of PGW's total costs of service.

OCA ST. 3 at 23-24. Mr. Galligan also prepared a chart to show the effects of the Company's proposed revenue increase and allocation, using the Peak and Average method for cost allocations:

Table 4					
Comparison of Class Financial Indicators When PGW-Proposed Rates Are Compared to PGW's Customer/Peak Cost Study Results and to OCA's Peak and Average Cost Study Results					
	<u>Total</u>	<u>PGW Customer/Peak Study</u>		<u>OCA Peak and Average Study</u>	
		<u>Heating</u>	<u>Non-Heating</u>	<u>Heating</u>	<u>Non-Heating</u>
Rate of Return	12.89%	11.07%	0.87%	12.15%	1.58%
Index Rate of Return	100%	85.9%	6.7%	94.3%	12.26%
Increase Required to Achieve PGW-Proposed Class Rate of Return	N/A	\$66,758,000	\$2,639,000	\$54,511,000	\$2,686,000

OCA St. 3 at 24. As the chart shows, at the Company's proposed revenue allocation and employing the OCA's Peak and Average methodology for assigning costs, the Residential Heating class is providing a 94.3% index rate of return, or as the OCA would submit – essentially is at cost-based rates.

PGW's proposed revenue allocation in this proceeding is fair and reasonable. The proposed revenue allocation moves the different rate classes closer to the system average rate of return, while still respecting the important principles of gradualism and avoidance of rate

shock. The OCA submits that the Commission should adopt the Company's proposed revenue allocation for use in this proceeding.

3. The OSBA's Assertion That The Residential Class Is Moving Further Away From Unity As A Result Of PGW's Proposed Revenue Allocation In This Case Is Not In Accord With The Facts.

In his Rebuttal Testimony OSBA witness Robert Knecht opines that under the COSS advocated by Mr. Galligan, the Residential class's rate of return at present rates is still less than the system average rate of return at present rates. OSBA St. 2 at 6-7. Mr. Knecht continues his analysis by stating that PGW's proposed revenue allocation in this case, which the OCA agrees with, provides that the Residential class will receive a base rate tariff percentage revenue increase that is less than the total system base rate tariff percentage revenue increase. OSBA St. 2 at 7. Mr. Knecht then concludes that assigning the Residential class an increase that is less than the system average increase will result in the Residential class moving further away from unity (or reaching equality with the system rate of return) as a result of this case. OSBA St. 2 at 7.

However, there is only one analysis that needs to be looked at to determine the matter at hand – based on the revenue allocation proposed by PGW, is the Residential class closer to unity after this proceeding than it was before this proceeding started? As the OCA has shown, and will continue to show, the Residential class is making progress toward unity in this case.

In his Rebuttal testimony Mr. Galligan presents the following chart:

Table 2-R below shows the resulting class rates of return and index rates of return at both PGW and OSBA proposed class rate increases, based on PGW's allocated cost results.

Table 2-R**Class Rates of Return under
PGW and OSBA Proposed Class Rate Increases
Totaling to \$100 Million**

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

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

OCA St. 3-R at 4. This chart uses PGW's COSS and revenue allocations. As the chart shows at present rates the Residential class is providing a rate of return of 4.4% in comparison to the system average rate of return at 6%, or in other words the Residential class is 73% of the way towards the system average rate of return before any revenue increase is allocated. Now, after the revenue allocation that PGW proposes the Residential class is providing a rate of return of 11.2% in comparison to the system average rate of return at 14.1%, or in other words the Residential class is 79% of the way towards the system average rate of return after the revenue increase is granted. Given that 79% is closer to unity than 73%, the OCA submits that the

Residential class has moved closer to unity as a result of the revenue allocation in this matter, even using the Company's flawed COSS.

In response to Mr. Knecht's characterizations that the Residential class is moving further away from cost-based rates as a result of the revenue allocation chosen by PGW in this proceeding and that the class "subsidiaries" are growing, Mr. Galligan responds in his Surrebuttal testimony:

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. Contrary to Mr. Knecht's assertions, this discussion of the numbers by Mr. Galligan clearly shows that the Residential class is moving closer to unity as a result of the revenue allocation in this proceeding.

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.*

OSBA St. 1 at 22, (*emphasis added*).

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.

Mr. Knecht's attempts to discredit the index rate of return should be disregarded. The Residential class is closer to the system average rate of return based on the Company's revenue allocation than it was before any revenue allocation was made, or for that matter, before this rate case began. The Commission should reject OSBA's attempt to discredit the index rate of return method.

4. The Alternative Revenue Allocation Proposed By OSBA Should Not Be Accepted In This Proceeding.

The Company has proposed a revenue allocation of its full request that fairly distributes any increase in rates while bringing the different classes closer to the system average rate of return. OSBA, however, has offered a different allocation that shifts substantially more of the burden of any increase onto residential customers. This alternate rate increase allocation should be rejected.

a. The OSBA Allocation Proposal.

Under the OSBA's recommended revenue allocation, the Residential class would pay \$95.6 million of the proposed \$100 million revenue increase. OSBA Exh. IEc-4. This is in contrast to the \$69.3 million increase proposed by the Company. OSBA Exh. IEc-4. The OSBA also proposes to increase the revenue for the Commercial Class by \$3.6 million. OSBA Exh. IEc-4. PGW had originally proposed a \$24.7 million increase for the Commercial class. The following Table from Mr. Galligan's Rebuttal testimony depicts the OSBA's recommendations:

Full Increase Request	<u>Residential</u>	<u>Commercial</u>	<u>Industrial</u>	<u>Municipal</u>	<u>Housing Authority</u>	<u>Total</u>
PGW Proposed	69,397	24,743	1,845	2,197	1,758	99,940
OSBA Proposed	95,641	3,682	217	267	134	99,940
<u>Scaleback</u>						
PGW Proposed	41,622	14,840	1,107	1,318	1,054	59,940
OSBA Proposed ¹	57,361	2,208	130	160	80	59,940
OSBA Proposed ²	57,028	2,359	176	209	168	59,940

¹ Full Revenue Requirement Method
² "First Dollar" Scaleback Method

Data Source: Exhibit IEc-4, Tables 4-A, 4-B, and 4-C

OCA St. 3-R at 3. Mr. Galligan comments on the appropriateness of such an allocation:

OSBA's proposed class rate increases are intended to make more progress toward "cost based" rates. Of course, to the extent that costs are misallocated, any progress toward basis in costs is misstated. Under OSBA's proposed base rate revenue spread, all classes would be awarded smaller rate increases than those

proposed by PGW except residential customers. Residential customers would receive \$95.6 million of the proposed \$100 million base rate increase, or a 41.3 percent increase, under OSBA proposals. This compare to a \$69.4 million increase, or 30.0 percent, for the residential class requested by PGW. Also, under OSBA's proposed rates and its acceptance of PGW's allocated costs, residential customers would yield a 13.7 percent rate of return, as shown on Table 2-R, which would close in one rate case, not 20 percent of the difference between the residential class' indexed rate of return and unity, but would close 90 percent of that current difference. All of the rates of return shown in Table 2-R are based on the results of PGW's customer/demand cost of service study.

OCA St. 3-R at 5.

The OCA submits that the OSBA's recommended allocation fails to take into account the principles of gradualism or rate shock, relies on the Company's flawed COSS, and also relies on the erroneous assumption that the Company's proposed revenue allocation does not make any progress towards unity. In addition, the OCA submits that such an allocation would place too great a burden on residential customers who are already paying one of the highest overall rates for natural gas service in Pennsylvania.

5. The Commission Should Adopt A Proportional Scaleback Of Any Reduction In PGW's Requested Rate Increase.

If the Commission grants PGW a revenue increase less than the full request, the OCA submits that a proportional scale back is a fair way to reduce the increase. OCA St. 3 at 28. OSBA witness Mr. Knecht advocates for either a First Dollar Relief (FDR) or a Full Revenue Requirements approach. Either approach is intended to benefit those classes that are currently providing a greater than average system rate of return, based on the OSBA's acceptance of the flawed COSS provided by PGW. OSBA 1 at 25-29. OTS witness Joseph Kubas recommends a scaleback intended to benefit those classes that are currently providing a

greater than average system rate of return, based on his Average and Excess COSS. OTS St. 3 at 24-25. As the OCA demonstrated above, Mr. Galligan's Peak and Average COSS should be adopted by the Commission in this matter.

Neither the OTS nor the OSBA scaleback proposals adhere to the principles that guided the Company's allocation that is supported by the OCA. The OCA submits that the Company's proposed allocation at its full request is fair, and there is no reason to change the proportionate increases to rates in a way that distorts that fair allocation should a scale back be necessary. As the OCA has shown in its filed testimony and throughout this Brief, the Residential class is making progress towards unity in this case even using the Company's flawed COSS that allocates far too much expense to the Residential class. Under Mr. Galligan's Peak and Average COSS, the OCA has shown that the revenue allocation proposed by PGW leads to the Residential class being at essentially cost-based rates as a result of this proceeding. The OCA would submit that once the Commission decides that the percentage of revenue allocation proposed by PGW is reasonable, there is simply no logic in then going back and altering that fundamental structure if indeed a scaleback of revenues is necessary because something less than the full revenue request by PGW is determined by the Commission to be fair and reasonable.

The OCA submits that the revenue allocation proposed by the Company is reasonable, especially when considering these revenue allocations in light of OCA witness Galligan's revised study. The OCA's adoption of PGW's revenue allocation is based on fundamental principles of gradualism and fairness as well. The Commission must not move too quickly to adjust perceived inequities between the different classes without first considering the principles of gradualism and any attendant rate shocks that may occur. Even if the Commission

does not accept the OCA's COSS, it should accept the Company's proposed revenue allocation for the reasons advocated by the Company and the OCA. The OCA's COSS simply demonstrates that the Company's revenue allocations are even more reasonable.

6. Conclusion.

The Company's revenue allocation, while guided in part by a flawed COSS, produces fair results. The OCA submits that the Company's proposed revenue allocation produces a reasonable result and the OCA supports its adoption in this proceeding.

D. Residential Rate Design Issues.

PGW has not proposed any changes to its current \$12 per month residential customer charge in this proceeding. PGW has also not proposed any changes to its current single-block residential volumetric delivery rate design. The OCA agrees that PGW's rate design proposals as to the residential class should be maintained, as the following chart indicates.

Residential Rate Design per PGW/OCA		
	Present Rate	Proposed Rate
Customer Charge	\$12.00	\$12.00
Delivery Charge per Mcf	\$4.2124	\$6.0799
Universal Service Charge per Mcf	\$2.5387	\$2.5387

E. Conclusion.

The OCA submits that its recommendations concerning cost of service, rate structure and rate design in this proceeding are reasonable. The OCA's recommendations have

applied appropriate cost of service and rate design principles. As such, the OCA submits that its recommendations set forth above should be adopted by the Commission.

VII. MISCELLANEOUS ISSUES

A. Universal Service Issues.

1. Universal Service Surcharge Cost Recovery.

a. Introduction.

OCA witness Roger D. Colton recommended several changes to the universal service surcharge (USEC) related to PGW's Customer Assistance Program (CAP), known as the Customer Responsibility Program (CRP), cost recovery.¹⁵ PGW collects its CRP costs through a reconcilable surcharge from all firm service customer classes. The CRP costs recovered include the CRP credits, referred to as the CRP shortfall, and the arrearage forgiveness credits. The actual CRP costs incurred are reconciled to the past collections and the surcharge is adjusted up or down for under- or over-collections respectively at the time of the 1307(f) proceedings. OCA St. 4 at 3.

From his review of PGW's universal service surcharge, OCA witness Colton was concerned that PGW may over-recover the CRP shortfall cost since some of those costs are already recovered through base rates. As Mr. Colton explains, the USEC should only recover the incremental costs of CRP participation that are not reflected in base rates. Mr. Colton was also concerned that the cost projections used to establish the USEC rate were not accurate, possibly resulting in an overstatement of the USEC and then wide swings when the USEC is

¹⁵ Roger Colton is a principal in the firm of Fisher Sheehan & Colton, Public Finance and General Economics. Mr. Colton provides technical assistance to a variety of public utilities, state agencies and consumer organizations on rate and customer service issues for telephone, water/sewer, natural gas and electric utilities. Mr. Colton's work focuses on low-income energy issues, and he has testified and published extensively in this area. OCA St. 4, Appendix A.

reconciled. As discussed below, Mr. Colton recommends that the Company be required to collect additional information as part of its surcharge reconciliation proceeding to ensure that PGW recovers only incremental costs and to ensure accurate projected costs. Mr. Colton also recommends that the Company design a mechanism to avoid any double recovery of costs that are included in base rates.

b. PGW Should Only Be Allowed To Collect Any CRP Shortfall From Ratepayers One Time.

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 St. 4 at 4. The CRP shortfall is recovered through the universal service surcharge from non-CRP firm service customers. Before a customer enters CRP, the amount that the customer is unable to pay is reflected in the uncollectible expense. After entering CRP, the amount that customer does not pay becomes the CRP shortfall. OCA witness Colton explained the situation as follows:

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 surcharge as described 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 OCA submits that a problem arises when a customer moves into CRP.

OCA witness Colton describes the impact when a customer becomes a CRP participant:

the dollars representing that new participant's CRP credits will be included in rates through a universal service surcharge as "new" CRP credits. Since the surcharge is reconcilable, a net increase in CRP participation will result in an increase in the universal service surcharge to reflect these "new" credits. In fact, however, not all of these CRP credits are "new" expenses. Some

portion of these dollars of billing that will not be collected from the customer have simply been moved from the non-CRP participant population to the CRP participant population. Those dollars are non-incremental CRP costs.

OCA St. 4 at 7. Mr. Colton further elaborated on the potential for double recovery when customers enter CRP:

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 represented 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 St. 4 at 7-8.

The OCA submits that PGW should be permitted to recover costs only once, *i.e.*, PGW should only be permitted to recover the incremental costs imposed on PGW as a result of a customer's participation in CRP. To the extent that the costs associated with customers that 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.

The issue of double-recovery of costs is only presented when there is a net increase in the CRP participation rate from that in effect when base rates were set. OCA St. 4 at 7-8. There is no issue with respect to the double-recovery when there is turnover in the Company's program, but no net increase in the CRP participation rate. To avoid this double recovery of the CRP shortfall associated with the net increase in CRP participants over the

enrollment figures at the time of the last base rate case, there needs to be a reduction in the CRP credits to account for the uncollectibles that are already in base rates. OCA St. 4 at 8.

The magnitude of this potential double-recovery can be significant. OCA witness Colton estimates:

given an average per-participant CRP credit of \$1,040, a net increase in CRP enrollment of 7,000 participants as reported by Ms. Coltro (Coltro Direct, at 4) will result in a net increase in the CRP shortfall of \$7,280,000 ($7,000 \times \$1,040 = \7.280 million). Given a gross write-off rate for the revenue of confirmed low-income customers of 55.42%, I calculate that there would be \$4,034,885 ($\$7,280,000 \times 0.5542 = \$4,034,885$) in CRP credits that would be included in the universal service surcharge by PGW that may already be included in the base rates claimed in this proceeding. This double recovery involves the extent to which the CRP credits are non-incremental expenses.

This dollar figure is not based on any assertion that these credits will not be granted. Instead, this figure is based on the observation that these dollars have already been included in rates and thus do not represent incremental expenses to the Company.

OCA St. 4 at 9. Mr. Colton also indicates that if there were fewer net additions to the CRP participant population, this double recovery would be smaller. He states that:

(f)or example, a net addition of 6,000 CRP participants, along with a per-participant CRP credit of \$1,040, would lead to a potential double-recovery of only \$3,458,473. Similarly, if the average CRP credit were smaller, the double recovery would be smaller as well.

OCA St. 4 at 9.

As Mr. Colton explained, two factors affect the magnitude of the double-recovery: (1) net increase to CRP participation and (2) average shortfall per participant. OCA St. 4 at 10. Given that these factors can vary from quarter to quarter, Mr. Colton recommended that PGW collect the necessary information to establish these figures and present information at each quarterly reconciliation. Mr. Colton then recommended that in the first quarterly

reconciliation of CRP costs following in this base rate case, PGW include a mechanism to identify and to adjust for those CRP credits. OCA St. 4 at 10.

PGW opposes Mr. Colton's recommendation, arguing that no portion of the discount for a customer enrolling in the CRP Program could be included in uncollectible expense because the discounts in the USEC are for billings which have just occurred or are yet to occur. PGW St. 2-R at 30. PGW misunderstands Mr. Colton's adjustment and improperly tries to tie the adjustment to the individual customer.

The OCA submits that the issue does not involve specific customers. The Company does not obtain rate recovery for actual uncollectibles of specific individuals after-the-fact as the Company tries to suggest. Mr. Colton explained:

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.

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 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. The OCA proposal regarding double recovery of these incremental CRP shortfall costs should be adopted.

c. PGW May Lack The Detailed Data Needed To Accurately Project Its CRP Surcharge.

OCA witness Colton also identified a concern with the reliability of projections used by PGW in order to establish the universal service charge. OCA St. 4 at 10. Mr. Colton described his concerns as follows:

The OCA requested certain information through discovery that I would have used as the basis to review the accuracy of PGW's CRP cost projections. The Company, however, repeatedly indicated that it lacked the monthly data that would be necessary to engage in such a review. Moreover, the Company could not provide data which, if such data were used in the reconciliation process for the universal service surcharge, would have been available. For example, PGW could not provide data on the monthly income of CRP participants by payment tier (OCA-X-3), even though this data is a direct input into its CRP cost projections. (See, Schedule RDC-1 and Schedule RDC-2). PGW could not provide monthly data on the number of new CRP enrollees by payment tier (OCA-X-4), even though the mix of CRP participants by payment tier is a direct input into the Company's CRP cost projections. PGW has not provided the basic information needed to develop accurate projections. This same basic information also seems to be needed to accurately reconcile actual experience to the CRP cost projections.

OCA St. 4 at 11; See also, OCA St. 4 at Sch. RDC-1, RDC-2.

While the OCA recognizes that any over-or under-projections should work out in the reconciliation process, it is necessary for accurate data to be available for this to occur. Additionally, it is particularly critical for PGW's universal service surcharge to be as accurate as possible on a projected basis. Mr. Colton explained:

Moreover, even if over- or under-projections could be completely "worked out" in the reconciliation process, having large swings in over- and under-collections is not the ideal way to operate the CRP. While CRP participants are exempt from paying the universal service surcharge, not all confirmed low-income customers are exempt. While PGW has roughly 75,000 CRP participants, it has more than 155,000 confirmed low-income customers (BCS Universal Service Report, at 7). The interest

paid on over-collections does not adequately compensate these confirmed low-income customers for the use of their money between the time the project cost is paid in rates and the time any over-collection is reconciled. In addition, given the frequent mobility of low-income customers, even if all under- or over-collections were exactly captured in the reconciliation process, it is likely that different customers will be paying the under-collection (or receiving the payment back of over-collections). Accepting wide swings in over- and under-collections institutionalizes a mismatch between those customers actually paying the universal service costs and those customers that should be paying those costs.

OCA St. 4 at 11-12. The OCA submits that these large swings in over-and under-collections can be detrimental to PGW's customers and should be avoided.

OCA witness Colton identified two primary concerns regarding the CRP cost projections. First, he is concerned that the mix of CRP participants by payment tier is erroneously stated in the CRP cost projections. OCA St. 4 at 13. Second, Mr. Colton identified a concern that the average participant income by payment tier is underestimated. OCA St. 4 at 14. Regarding the mix of CRP participants by payment tier, Mr. Colton testified:

I have a concern that the mix of CRP participants will have a substantive impact on the CRP shortfall that is charged to all ratepayers. To the extent that a higher proportion of CRP participants fall in the 10% payment tier, and a lower proportion fall into the 8% tier, the total CRP shortfall to be collected from remaining ratepayers will be less. This occurs because the 10% payment tier participants pay a higher proportion of their GS bill, leaving less to be passed through as a CRP shortfall.

OCA St. 4 at 13-14. Similarly, Mr. Colton found problems with PGW's average participant income by payment tier used in the calculation. OCA St. 4 at 14. As a result of Mr. Colton's findings, Mr. Colton recommends the following:

Based on the concerns about the reliability of the projections used to establish the universal service surcharge, I recommend that PGW be required to include the following reporting elements

along with each quarterly universal surcharge reconciliation it submits:

- The monthly number of CRP participants by payment tier; and
- The monthly average income of CRP participants by payment tier.

OCA St. 4 at 10. The OCA submits that these reporting requirements should be adopted to improve the surcharge calculations.

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 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. PUC v. Philadelphia Gas Works, 2003 Pa. PUC LEXIS 13, 223 P.U.R.4th 412.

OSBA witness Robert Knecht proposes that PGW change the way in which the Company has historically allocated its universal service costs and recover those costs solely from residential customers. Mr. Knecht proposes a three-year phase in of his proposal. OSBA St. 1 at 33. The cumulative effect of his proposal would be to further increase residential customer rates by 3.9% or \$0.80 per Mcf by the end of the three year period (assuming the universal service charge did not also increase). OSBA St. 3 at 13. The OCA submits that

PGW's proposal to continue to collect its universal service costs from all firm service customers must be adopted.

b. PGW's Proposal To Impose The USEC On All Firm Customers Is Reasonable and Should be Adopted.

Any analysis of the universal service cost allocation issue must begin with the Act. Section 2203(6) of the Act provides that an NGDC may establish

... an appropriate nonbypassable, competitively neutral cost-recovery mechanism which is designed to recover fully the natural gas distribution company's universal service and energy conservations costs over the life of these programs.

66 Pa.C.S. §2203(6). As OCA witness Colton testified:

The common understanding of the bypass problem is that some customers will either leave the distribution system entirely (and leave their share of system costs behind) or that those customers will negotiate a discount off their distribution charges by raising the threat that they will leave the system entirely. Use of the term "nonbypassable," therefore, incorporates the concept that all customers should help pay for universal service costs.

OCA St. 4-R at 2. It is important to note that it is not residential customers who engage in bypass of the natural gas system. OCA St. 4-R at 2.

In addition to Section 2203(6), the Natural Gas Choice Act established that universal service programs are to be maintained at least at levels in existence at the time of the Act, and they are to be appropriately funded and available in each natural gas distribution territory. 66 Pa.C.S. §§2203(7), (8). There is a second statutory section, 66 Pa.C.S. §2802(17) that has declared universal service programs to be a "public good" and that the public purpose is promoted through these programs.

OSBA witness Knecht challenged the continuation of the Company's historic allocation, arguing that there is no benefit to the small commercial class from these programs.

OSBA St. 1 at 30-31. The record in this proceeding simply does not support Mr. Knecht's position. Initially, it must be recognized that universal service programs are programs that promote the public good. OCA witness Colton explained the basic ratemaking associated with public goods as follows:

One well-accepted tenet of utility ratemaking is that certain expenses incurred by a public utility are for "public goods." Due to the nature of public goods, all customers receive benefits from public goods and, accordingly, the costs of such goods are spread over all customer classes. Each end user makes a financial contribution to the utility's delivery of public goods. The "public goods" doctrine is applied in a variety of settings as a justification to spread designated utility costs over all customer classes. Fire hydrants and streetlights, for example, have been found to be public goods. The basic telecommunications network has been found to be a "public good" as a justification for spreading network costs over all customer classes.

OCA St. 4-S at 3. The OCA submits that a product can represent a "public good" even though direct service is provided to an individual. Mr. Colton provided the following examples:

For example, businesses do not go to school, individuals do. Businesses do not go to doctors, individuals do. Businesses do not place their children in day care, individuals do. Despite this, in each of these instances, the direct benefits to business from affordable provision of these "public goods" have been documented. Affordable health care and child care are all akin to affordable home energy in their nature as public goods which provide direct and substantial benefits to businesses as well as individuals. Accordingly, businesses, as well as individuals, should be responsible for helping to pay for these public goods.

OCA St. 4-S at 4.

Moreover, the record contains substantial amounts of testimony about the benefits, both direct and indirect, that commercial and industrial customers receive from universal service programs. Mr. Colton first provided an analogy to explain the benefits derived from universal service programs:

Affordable home energy can be analogized to other public goods. For example, child care is an important analogy to affordable energy because of the direct benefits child care has been found to provide to business. The Committee on Economic Development has quantified the beneficial impacts to business from reducing the causes of employee absenteeism and employee turnover associated with unaffordable child care. According to the Committee:

Many businesses also find that helping parents meet their child care needs can potentially reduce absenteeism and employee turnover. The 1990 *National Child Care Survey* (NCCS) found that 15 percent of the mothers in its sample who worked outside the home reported losing some time from work (including arriving late, leaving early, or having to take a full day off) during the previous month because of a failure in their regular child care arrangement. Studies have found that employee turnover produces disruption and inefficiency in the work environment and that the cost of replacing employees is high. For example, Merck & Co., Inc. found that it costs . . . about 75 percent of salary to replace a clerical or technical employee. It also found that it may take considerable time to fill a vacant position and an average of 12.5 months for a new employee to become adjusted to the job.

OCA St. 4-R at 6-7 (footnotes omitted).

Mr. Colton also reviewed research that demonstrates that any increase in natural gas rates to businesses as a result of paying their share of universal service costs would be offset by increases in employee productivity. Mr. Colton described this benefit:

One professor at Johns Hopkins University considered the extent to which increased low-income status results in increased overall costs to business. She found a variety of offsets, reporting:

Poverty . . . produces ill-prepared workers whose lives are easily disrupted by small catastrophes. If the car breaks down, if the kid gets sick, it suddenly becomes impossible to be a reliable worker. Poverty also generates poor health among workers, making them less reliable still and raising the cost of employing them.

The nexus between unaffordable home energy and employee health problems can hardly be seriously questioned any more.

The unaffordability of natural gas service represents a distinct public health threat, particularly to low-income households with children. According to a Congressionally-funded 2005 survey by the National Energy Assistance Directors Association (NEADA), the loss (and threatened loss) of home heating service has significant health consequences to low-income households with children. . . .

A variety of reasons contribute to the overall rate of illness, as well as to the rate at which illnesses required medical treatment within the low-income energy assistance recipient population. The primary contributing factor to the adverse health outcomes involves the tendency of low-income households to keep their homes at unsafe or unhealthy temperatures with which to begin, given the unaffordability of home energy to the household. . . . Between roughly 30% and 40% of energy assistance recipients with incomes at or below 50% of the Federal Poverty Level reported to NEADA that they kept their homes at "unsafe or unhealthy temperatures" because they could not afford to pay their home heating bills.

These health consequences, which CED and Johns Hopkins University both found to impose substantial costs on business, are directly attributable to unaffordable home energy. Affordability programs such as CRP help remedy these problems and, as a result, deliver real dollars of benefit to the business community.

OCA St. 4-R at 7-9 (footnotes omitted)

OCA witness Colton then summarized how this information relates to affordable home energy provided through the universal service programs:

The conclusion from this multitude of research is that all PGW customer classes will benefit from the CRP. Commercial and industrial customers, as well as small businesses, will gain direct benefits from the CRP. Accordingly, this discussion has a direct relationship to the question of whether universal service costs should be allocated to all customer classes. There is a direct relationship between the offer of CRP and economic benefits to local commercial and industrial customers. For example:

- Turnover costs business money. We know that unaffordable home energy bills lead to the frequent mobility of households.

- Time missed due to family care provision costs business money. We know that unaffordable home energy leads to more frequent childhood illnesses.
- Time missed due to lack of employee productivity and employee illness costs business money. We know that the inability to stay warm due to unaffordable home energy bills leads to increased illnesses, including pneumonia, influenza, and other infectious diseases.

In sum, increasing employee productivity directly contributes to the increased profitability of firms. With low-wage employees, in particular, unaffordable home energy directly contributes to lowered productivity. Increased personal illness, increased employee turnover, and increased family care responsibilities are but three of the factors contributing to lower employee productivity. The provision of affordable energy through universal service programs such as CRP positively affects each of these productivity factors.

OCA St. 4-R at 10-11.

In addition to these benefits, Philadelphia businesses can further benefit since programs such as CRP support the economy of the City. As Mr. Colton testified, programs such as CRP provide an important economic benefit to businesses in that the program contributes to additional disposable income within the low-income population. This additional disposable income drives additional job creation, income generation, and economic activity for local businesses. OCA St. 4-R at 11.

Further, PGW's universal service programs provide additional benefits since PGW is a municipal gas company. As OCA witness Colton explained:

PGW's offer of universal service programs helps to control the need to provide local government services, the cost of which is largely borne by non-residential taxpayers. The connection between the loss of home energy service and housing abandonment has been documented in Pennsylvania. In addition, there is a documented connection between utility shutoffs and an increase in homelessness, with one of the primary studies being performed in Philadelphia. There is a direct connection between unaffordable home energy bills and the costs of providing public

health and nutrition services. There is a documented connection between unaffordable home energy bills and public safety costs. Particularly in a city such as Philadelphia, with a large low-income population, the costs of providing these city services can be tremendous. Conversely, the benefits of mitigating the need to provide these city services will redound to the benefit of all taxpayers, including commercial and industrial entities.

OCA St. 4-R at 13.

OSBA witness Knecht relies on several Commission Orders and the Commission's recent CAP Policy Statement for support of his position. OSBA St. 1 at 31-32. While each case must be taken on its own merits based on the facts and history of the particular utility, the OCA submits that OSBA's reliance on certain cases, and the CAP Policy Statement, is misplaced. For example, in Application of Equitable Gas Company For Approval of Natural Gas Choice and Competition Act Restructuring Filing proceeding at Docket No. R-00994784, the Commission specifically denied the OSBA's request that "the Commission's July 18th order should be corrected to remove statements asserting that universal service and arrearage forgiveness costs are being paid by business customers in the \$.17 portion of Equitable's transition cost surcharge." Application of Equitable Gas Company For Approval of Natural Gas Choice and Competition Act Restructuring Filing, No. R-00994784, at 2-3 (Order entered Sept. 12, 2002).¹⁶ The Commission specifically affirmed that the commercial class was funding the existing CAP. The Commission stated:

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 the certain language in the July 18th order regarding the purpose of Equitable's transition cost surcharge is not warranted.

¹⁶ A true and correct copy of this Order is attached at Appendix C.

Order at 3.

The Commission's recent CAP Policy Statement also does not support OSBA witness Knecht's position. Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms Final Investigatory Order, Docket No. M-00051923 (Order December 18, 2006) (CAP Order). The Commission's CAP Order indicates that PGW's policy of allocating universal service costs was in place before the Commission assumed jurisdiction over PGW. Since the CAP Order intends to continue prior policies, PGW's policy of allocating its universal service costs to all firm service customers should be continued. CAP Order at 31.

PGW witness Hershey provided important testimony on this issue with regard to PGW. Mr. Hershey testified:

The Commission and the parties must recognize that PGW is unique when it comes to universal service and that force-feeding a one-size-fits-all approach to CAP programs and their cost-recovery mechanisms simply will not work for PGW. These differences were discussed at length in PGW's restructuring proceeding, just under five years ago, and they were a part of the record on which the Commission's decision to retain the Company's traditional cost allocation across all firm customers was based. The obvious differences are the size of PGW's programs (and thus their costs) and the ability of the residential customers to absorb the significant costs that would be shifted to their shoulders if the OSBA position were adopted.

Philadelphia is home to the greatest concentration of Pennsylvania's poor. As stated, PGW's CRP program (not including the Senior Citizen Discount or other programs) presently has approximately 76,200 participants. Notably, as of the restructuring proceeding, 130,000 customers were at or below 150% of the federal poverty level and thus eligible for the CRP program. In terms of cost shifting, Mr. Knecht attempts to soft pedal the impact on PGW's residential customers who will be forced to pick up the tab, but his proposed phase-in of the increased cost cannot make its cumulative effect.

Ultimately, the Commission policy applied to other NGDCs that Mr. Knecht trumpets simply cannot and does not account for

these dramatic differences between run-of-the-mill CAP program and PGW's CRP program. The Commission should not impose a set of standards designed for very different circumstances on PGW's customers.

PGW St. 1-R at 19-20.

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 this historic allocation should continue.

B. Program Initiatives To Improve Collections.

The OCA recommends that PGW implement two program initiatives to assist in improving collections: Electronic Fund Transfer Program (EFT) for customers with incomes above 250% of the Federal Poverty Level that enter into deferred payment plans and increased budget billing for customers who become payment-troubled. In his Direct Testimony, OCA witness Colton discusses these specific credit and collection initiatives and recommends their implementation. OCA St. 4 at 15.

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

OCA witness Colton recommends that PGW require residential customers in arrears with income levels at or above 250% of the Federal Poverty Level to enter into Electronic Funds Transfer (EFT) agreements when they enter into deferred payment arrangements for the arrears. OCA St. 4 at 16. Through this program, PGW would automatically withdraw an agreed upon amount of funds from the customer bank account on a monthly basis. This is also referred to as an Automatic Clearinghouse (ACH) transfer. OCA St. 4 at 16. The purpose of Mr. Colton's proposal was described as follows:

The underlying objective is obviously to improve the use of deferred payment plans to successfully retire arrears. Accomplishing this would improve the Company's cash flow. It would benefit the Company, the Company's ratepayers who do not have arrears, and the Company's ratepayers that do have arrears.

OCA St. 4-S at 15. As Mr. Colton notes, PGW's August 2005 Final Analysis and Recommendations in its Customer Segmentation Analysis supports such an approach for chronic late payers who otherwise have good credit. OCA St. 4 at 18.

The OCA would also note that as discussed in Mr. Colton's testimony, the utility industry has supported such programs:

The Institute of Management and Administration (IOMA) identified promoting EFT payments as a "best practice" in its 2006 catalogue of "best practices" for credit, receivables and collection in 2006. According to IOMA, a company would be well-served to recruit customers for EFT "after collection calls (especially if the customer claims it is going to pay immediately)"; including an EFT payment process "when negotiating contracts"; and "offering electronic payment option to accounts that you are getting ready to put on credit hold."

OCA St. 4 at 21.

In response to the Company's concerns raised by the Company about a mandatory program, Mr. Colton in Surrebuttal Testimony suggested a middle ground:

PGW imposes substantial cash security deposits on delinquent customers. In response to Mr. Gyory's observation, it may be beneficial, short of implementing a mandatory EFT program, for PGW to offer to waive customer deposits (including a refund of existing deposits) for customers who enter into EFT agreements through which to pay their monthly PGW bills. If a customer closes his or her account after entering into an EFT plan, and after having his or her deposit returned, or if the customer routinely has insufficient funds at the time of the EFT payment, the Company could again impose a cash security deposit.

OCA St. 4-S at 14-15. Mr. Colton noted that while this eliminates the mandatory feature for the higher income customers, it still provides a substantial financial incentive for customers in arrears to agree to EFT for their payment plans through the offer to waive the security deposit. OCA St. 4-S at 15.

During Mr. Gyory's Rejoinder Testimony. Mr. Gyory testified that the Company was proposing to implement a program similar to that recommended by Mr. Colton. Mr. Gyory testified that the Company was in the process of developing a program for customers who pay late. The program would target appropriate customers and have those customers enter an EFT program rather than pay the deposit for being late in their payments. Mr. Gyory explained the program:

[I]t's targeting customers who let's say have the means to go onto an EFT, but it's targeting those customers who are late payers are prescribed by Chapter 56 which allows us to charge a deposit for late payers. And part of that proposal is that we will waive the deposit to those customers if they agree to go onto an EFT program.

Tr. 948-949. The OCA submits that this program is very similar to that recommended by Mr. Colton in his Surrebuttal Testimony.¹⁷ The OCA would support the Company moving forward with this initiative as soon as possible. Mr. Gyory also proposed to further study and report to the Commission and interested parties on a broader application of the program. Tr. at 975-977.

The OCA submits that the Commission should accept an EFT program for customers with incomes at or above 250% of the federal poverty level. Given PGW's current initiative, and its commitment to study the issue, the Commission should direct PGW to work with the interested parties to design a program that will assist PGW in its collection efforts. The OCA would look forward to working with the Company on this initiative.

¹⁷ The Company seemed to think that Mr. Colton's program was for applicants but as his Surrebuttal makes clear, the program is for delinquent *customers*, not *applicants*. OCA St. 4-S at 14; Tr. 974-975.

2. Increased Budget Billing For Payment-Troubled Customers.

Another program that can serve to stabilize payment by customers is the use of budget billing arrangements. Through budget billings, customers' bills are spread over a 12-month time period, thus reducing the bill amount in any one month. The concept of budget billing has been broadly supported by the Commission. In re: Insuring Consistent Equal Monthly Billing, No. M-00051925 (Order entered June 2, 2006), 2006 Pa PUC LEXIS 21 (June 2, 2006).

OCA witness Colton found that PGW's residential enrollment in the budget billing plans is at a three-year low. The January 2007 enrollment was 44,855 customers, approximately 15% lower than January 2006. OCA St. 4 at 22. For the four months between October 2006 through January 2007, enrollment in budget billing was lower in each month than for the same month of the last two years. This low level of enrollment through September through November 2006 has not been experienced in any month since October 2004. OCA St. 4 at 22. The OCA submits that both PGW and its customers would benefit from greater participation in budget billing.

OCA witness Colton recommended a program to enroll customers in automatic budget billing. Mr. Colton described the program as follows:

For customers in good standing as of November 1 of each winter heating season who fall behind in the winter months, the billing methodology should be adjusted to a levelized monthly budget billing plan. That plan should include both the arrears and the bill for current usage. The budget billing methodology will continue until October 1 of the next heating season. A customer may opt out of the billing methodology by bringing his or her account current. To the extent that the customer defaults on any payments, normal collection processes will apply.

OCA St. 4 at 27. The program recommended by Mr. Colton is based on the program implemented by three natural gas utilities in Tennessee. See OCA St. 4 at 24-25 for a description of the Tennessee program.

In Tennessee, after adoption of the program, enrollment in budget billing increased almost 35% amongst all three Tennessee natural gas utilities. OCA St. 4 at 25. The number of nonpayment disconnections also decreased for two of the three gas utilities. OCA St. 4 at 25. Further, the decreases occurred despite a substantial increase in natural gas prices between 2004/2005 to the 2005/2006 winter heating season in Tennessee. OCA St. 4 at 26. Based on the experiences in Tennessee, the OCA submits that PGW could expect to experience a decrease in both its collection activities and in its level of accounts and dollars in arrears.

The Company objected to Mr. Colton's proposal arguing that there is no guarantee that budget billing will result in more consistent payment by payment-troubled customers. PGW St. 6-R at 14-15. OCA witness Colton points out, however, that there is evidence that budget billing improves payment. Mr. Colton testified:

(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.

Mr. Colton also performs an annual study of billing and collections for the Coalition to Keep Indiana Warm.¹⁸ In Mr. Colton's most recent report for Indiana, he documented that budget billing improved payment patterns for low-income and residential customers generally. Mr. Colton found the benefits of budget billing could be demonstrated by reference to the "bills behind" statistic. OCA St. 4-S at 7. Mr. Colton explained what his data showed:

(s)o, while the *dollars* of arrears certainly increase during the winter months, the number of payments missed varies in a reasonably narrow band around 1.25 "bills behind." There is a slight uptick in January (to 1.33).

What the data shows is that roughly the same number of bills are unpaid in any given month throughout the year. Higher dollar levels of arrears occur in the winter months, however, simply because each unpaid bill in the winter months is worth more dollars. As can be seen, therefore, if some portion of those winter bills could be moved forward to a month with a lower "bills behind" statistic, even if the "bills behind" statistic could not be lowered, the overall revenue in arrears would be less since each "bill behind" would relate to a *smaller* bill.

The same phenomenon is true for low-income accounts. There is a moderate increase in the number of "bills behind" during the winter months (from 1.41 in January to 1.79 in March). As with residential accounts, even if Budget Billing could not reduce the number of "bills behind," each bill would be smaller and the total revenue in arrears should decrease. In fact, it would reasonable to expect that Budget Billing would reduce the total number of "bills behind" as well. Accordingly, two favorable results would arise: (1) fewer bills would be outstanding; and (2) each outstanding bill would be smaller, with total revenue in arrears declining as a result.

OCA St. 4-S at 7 (footnote omitted). The OCA submits that Mr. Colton's analysis for the Coalition to Keep Indiana Warm demonstrates the benefits of budget billing.

¹⁸ The Coalition is a statewide consortium of community-based organizations, the state's six major utilities, and state agencies (including the Indiana Utility Regulatory Commission (IURC). The format of the study was negotiated between the IURC staff, the state association of Community Action Agencies (CAA) and the six utilities. OCA St. 4-S at 7.

In the Rejoinder testimony of Mr. Gyory, the Company offered to further analyze a program and provide a report to the Commission and the OCA. Tr. 946. While the OCA appreciates PGW's willingness to review the proposal, the OCA submits that Mr. Colton's recommended budget billing proposal already has a sound empirical basis in both PGW data and data from other jurisdictions. 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 has suggested in this proceeding that all of its clients residing in Scattered Site PHA Housing be placed on the CRP rate, since they are low-income. PHA St. 1 at 9. The OCA submits that the Philadelphia Housing Authority's proposal should not be adopted. All CAP programs have as their purpose serving low-income customers who are payment-troubled. 52 Pa. Code §69.264. A payment troubled customer is a customer that has failed to maintain one or more payment arrangements. 52 Pa. Code §69.262. PGW's CRP program is supported by other ratepayers both low-income non-CRP customers, and all other firm service customers. Through the PHA program, low-income customers in Scattered Site housing are provided a utility allowance intended to pay their PGW natural gas bill. PHA's proposal to move all these customers into the CRP program would, in effect, allow PHA to shift the responsibility for utility allowances from federal taxpayers to PGW's ratepayers. OCA St. 4-R at 28. The OCA submits that such a proposal is not consistent with the purpose of the CRP program, would unduly burden other PGW customers, and should not be adopted.

The OCA submits, however, that PGW should be directed to expand its existing direct vendor program with PHA to ensure that it captures the full utility allowance properly owed and payable to PGW. PHA tenants are paid a monthly allowance for their utility costs, according to the federal Department of Housing and Urban Development (HUD) guidelines for residents of low-income public housing. PHA Direct at 7. This allowance provides residents with the funds to make the monthly PGW utility payment. OCA witness Colton explained the basics of the utility allowance:

Tenants of public and assisted housing- "assisted housing" generally involves private rental housing subsidized through the federal Section 8 program, while "public housing" represents housing owned by local housing authorities- receive, as part of their housing subsidy through the U.S. Department of Housing and Urban Development (HUD), a "utility allowance." That utility allowance is by law designed to pay for the household's home utility service (energy along with water/sewer).

OCA St. 4-R at 24. Mr. Colton further explained the utility allowance:

Housing authorities are directed by law to provide utility allowances sufficient to pay for the consumption of energy conservative households of modest means. HUD regulations articulate a series of nine "mandatory factors" that the local housing authority is to take into account in setting a utility allowance. These mandatory factors include: (1) the equipment and functions intended to be covered by the allowances for which the utility will be used; (2) the climatic location of the housing projects; (3) the size of the dwelling units and the number of occupants per dwelling unit; (4) the type of construction and design of the housing project; (5) the energy-efficiency of PHA-supplied appliances and equipment; (6) the utility consumption requirements of appliances and equipment whose reasonable consumption is intended to be covered by the total resident payment; (7) the physical condition, including insulation and weatherization of the housing project; (8) the temperature levels intended to be maintained in the unit during the day and at night, and in cold and warm weather; and (9) the temperature of domestic hot water.

OCA St. 4-R at 25. According to PHA witness Mondre, PHA pays the utility allowances to the "Scattered Site" residents with the understanding that tenants will use the funds to pay PGW bills.¹⁹

PGW should take particular interest in the HUD utility allowance related to the natural gas bill. Just like LIHEAP, the utility allowance is to pay the utility bill, but unlike LIHEAP, the HUD utility allowance is provided year-round. Mr. Colton explained the importance of the allowance:

Unlike LIHEAP payments, however, HUD utility allowances are not seasonal benefits; they are paid year-round. Moreover, utility allowances are not designed to pay merely a portion of a customer's bill; they are designed to pay the customer's entire bill (as contrasted to LIHEAP's programmatic objective of paying home heating/cooling costs). HUD utility allowances are paid for both electric and natural gas service. While the number of customers who are tenants of public or assisted housing is probably lower than the number of LIHEAP recipients, the dollars of benefit at stake could be far greater for HUD utility allowances than for LIHEAP.

OCA St. 4-R at 25-26.

Since the HUD utility allowance is intended to pay the customer's utility bill, Mr. Colton recommends that PGW's existing direct vendor program be expanded so that the utility allowance amount for natural gas service is directly vendored to PGW by PHA. For PHA tenants that are already in CRP, this same procedure would apply. Similar to LIHEAP, any utility allowance in excess of the customer's CRP amount would be used to reduce the CRP shortfall. Mr. Colton explained:

If all utility allowances were distributed in this fashion to public/assisted housing tenants who were also CRP participants, the utility would first apply the utility allowance against the customer's CRP payment obligation. Any excess over the

¹⁹ There are separate utility allowances for each utility – electric, natural gas, water, and sewer. At issue here is only the natural gas portion of the allowance.

customer's CRP payment obligation should then be used as a revenue source to reduce the CRP shortfall just as LIHEAP payments are now used. PGW, of course, should not retain any utility allowance paid in excess of the customer's full residential bill.

OCA St. 4-R at 27.

It is important to note that the CRP customer bill consists of two components – the amount the customer is asked to pay and the CRP shortfall that all other customers must pay.

OCA St. 4-R at 24; Tr. 839-840. As Mr. Colton discussed in cross-examination:

the CRP participant receives a bill from PGW. That bill consists of two different components. The first component is - - the component is what I refer to as the customer payment.

The second component is the...CRP shortfall. That CRP shortfall, which is what we're talking about, can be paid from any - - any of a number of sources.

The first source could be the LIHEAP payment. That LIHEAP payment goes to pay the CRP participant's bill.

The second component could be other PGW rate payers, through their pass through of CRP credits.

A third source could be the HUD utility allowance, unlike the LIHEAP payment, historically has not been captured as a payment toward that component of the CRP's bill.

What I'm proposing is that that component of the CRP bill be, to the extent that there is a source of dollars to pay for it, other than the remaining rate payers, can and should be used to pay for that bill that's rendered to a CRP customer.

Tr. at 839-840.

As Mr. Colton explained, the utility allowance that is intended to pay the customer's full natural gas bill should be put to this use whether the customer is in CRP or not.

Mr. Colton explained the impact:

For tenants of public or assisted housing that also participate in CRP, to the extent that the tenant's utility allowance exceeds the CRP participant's percentage of income-based bill, the excess benefit should be captured as a revenue source to pay the costs of the CRP. The issue arises because the percentage of income-based payment of a CRP participant will always be less than the

customer's bill at full residential rates. To the extent this is not true, the tenant/customer would choose not to participate in CRP.

OCA St. 4-R at 28.

The OCA submits that further development of the direct vendor program would benefit all four stakeholders affected by the utility allowances paid to PHA tenants: (1) PHA tenants themselves; (2) PGW; (3) PHA and (4) PGW ratepayers. Mr. Colton identified the following benefits:

It would benefit PHA tenants, since their utility bills would be automatically paid with PHA utility allowances, as intended by the HUD utility allowance program.

It would benefit PGW, since PGW would directly receive payment for bills rendered to PHA tenants. PGW should not only reduce, but completely eliminate, any collection problems associated with PHA tenants that also are CRP participants. It should also receive cash flow benefits by the pre-scheduled, automatic, electronic monthly payment of bills by PHA.

It would benefit PHA, since PHA would pay up to, but not to exceed, the full residential bill rendered to CRP participants. No utility allowance would be paid in excess of the annual full residential bills rendered to PHA tenants.

It would benefit PGW ratepayers, since the utility allowance amount which exceeds a PHA tenant's CRP payment would be captured as a revenue source to offset the costs of CRP (and, accordingly, reduce overall universal service costs to be paid by remaining ratepayers).

OCA St. 4-R at 30.

The OCA submits that the HUD utility allowance is intended to pay the household's utility bill. If not put to that use, the only other source of funds to pay the bills of PHA tenants is PGW's ratepayers. Mr. Colton described his position in cross-examination:

I mean that there is a stream of Federal dollars that are intended to pay for the utility bills of tenants of public housing, and those – that stream of Federal dollars should, in fact, be used to pay for utility bills of tenants of public housing, pay for utility bills of

tenants of public housing, and those - - the obligation to pay those utility bills, given the existence of that stream of money, should not be transferred to other PGW rate payers.

To the extent that the obligation to pay those utility bills is transferred to other PGW rate payers, that's a windfall to the Housing Authority.

Tr. at 849.

The OCA submits the Commission should adopt the following recommendations of OCA witness Colton as follows:

- articulate a policy that like LIHEAP, the difference between a CRP participant's percentage of income-based payment and the utility allowance based on full residential rates is to be used as a revenue source to offset the CRP shortfall;
- direct the Company to develop a mechanism to expand its direct vendor payment program for utility allowances from the Philadelphia Housing Authority;
- direct the Company to track and review the utility allowances paid by local housing authorities.

OCA St. 4-R at 30. The OCA submits that these initiatives will assist PGW in ensuring that it receives full payment for service provided to PHA scattered site housing units so that other customers are not asked to bear these costs.

D. Marketer Issues.

1. Introduction.

Interstate Gas Supply, Inc. (IGS) witness Mr. Vincent Parisi testifies as to his concerns over the lack of any competition for residential customers on PGW's system. IGS St. 1 at 1-2. Mr. Parisi also discusses his thoughts as to why there is no residential competition on the PGW system, including the inability of PGW's current billing system to accommodate Natural Gas Suppliers (NGS), the lack of education as to Choice within PGW's marketplace, and the resistance from PGW to invest capital in its billing system to accommodate NGS billings. IGS St. 1 at 2-6. Mr. Parisi also comments on the proposal by PGW to retain any off-

system sales or capacity release revenues as he believes this levels the playing field for customers who may choose to shop for natural gas. IGS St. at 6-7. Mr. Parisi also recommends that the Commission force competition by setting some threshold level of customers to be assigned to suppliers, in return for some type of time-definite price guarantee that would be below PGW's GCR. IGS St. at 7-8.

Hess Corporation's (Hess) witness Mr. Randy Magnani also testifies as to the lack of retail competition on the PGW system. Hess St. 1 at 2. Mr. Magnani believes that there are significant barriers to entry on PGW's system that are currently stifling the ability of a competitive market to fully develop. Hess St. 1 at 2-3. Mr. Magnani goes on to identify and discuss these market inadequacies, such as issues with nominations and balancing, and communications issues relating to how NGS can effectively interact with PGW in an efficient manner. Hess St. 1 at 3-9.

The OCA supports competition for natural gas supply within an NGDC's service territory, as envisioned by the Natural Gas Choice and Competition Act. The OCA's concerns with Mr. Parisi's and Mr. Magnani's testimony as to the lack of current competition on PGW's system are not directed at initiatives to reduce barriers to competition, but more to the possible economic consequences to PGW's current ratepayers due to any outlays of capital that may be required to fund initiatives recommended by these witnesses. In addition, as the OCA has addressed elsewhere in this Brief, the OCA is opposed to PGW keeping the revenues generated from off-system sales or capacity releases as endorsed by Mr. Parisi.

2. The Actions And Initiatives Sought By Hess And IGS In This Matter To Enable Competition On PGW's System Should Not Result In Economic Harm To PGW's Ratepayers.

As Mr. Parisi testifies, "PGW must be required to spend the money to make its billing system workable for choice and it must be allowed to recover that money." IGS St. 1 at 7. Mr. Magnani also discusses numerous initiatives that he believes PGW should act on to reduce some of the barriers to competition that allegedly exist on PGW's system. Hess St. 1 at 3-8. The OCA is concerned that some of the initiatives that Mr. Magnani seeks may require the significant expenditure of funds by PGW, and the subsequent receipt of such funds from PGW's ratepayers. OCA witness Richard LeLash responds to both Mr. Parisi and Mr. Magnani in his Rebuttal testimony, and after individually discussing different elements of each witness's proposals, provides the following summary:

In the testimonies that I have addressed here, both direct and indirect subsidies have been requested by suppliers. However, there have been no commitments concerning service to residential customers despite the fact that they will end up paying for such subsidies. It is doubtful that suppliers will serve CRP, Senior Citizen, or customers with poor payment histories. However, it is certain that such customers will be impacted by the loss of margin credits and the costs associated with imbalances, systems changes, reductions in transportation rates, and billing for suppliers.

Commission rules and PGW's practices appear to allow suppliers to provide gas supply in PGW's territory since they have already entered the market. At this point, their successful operation should be predicated on their operating efficiency and skill and not on artificial subsidies extracted from customers who already are burdened with current gas costs.

OCS St. 1R at 10.

Mr. Magnani filed Surrebuttal testimony, in part, as a response to the testimony of Mr. LeLash. Hess St. SR-1. Therein, Mr. Magnani made the following statements:

On the contrary, as I have explained, these proposals will result in no impact to incumbent ratepayers but will reduce costs for transportation customers.

...

I agree that additional costs should not be incurred due to NGS entry, and none of the changes I have proposed would add costs to ratepayers, whether incumbent or transportation.

Hess St. SR-1 at 11, 12. The OCA agrees with Mr. Magnani that further NGS entry on the PGW system at this time, if such entry can be accomplished, should occur only if the ratepayers are held harmless from this activity. The proposals of Mr. Magnani and Mr. Parisi do not achieve this goal, as detailed in Mr. LeLash's Rebuttal testimony. OCA St. 1R at 10-11.

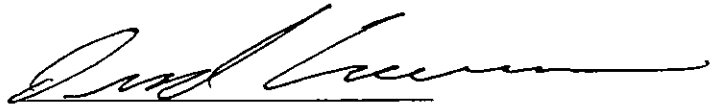
3. Conclusion.

The OCA supports the creation of competition on PGW's system, as it would support such competition within all NGDC service territories. The OCA would submit, however, that the furtherance of competition at this time on the PGW system should not be accomplished at the expense of ratepayers who are already struggling to manage their ever-increasing energy bills.

VIII. 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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APPENDIX A

Appendix A – Tables

Philadelphia Gas Works Base Rate Case – Docket No. R-00061931

The Company's ratemaking methodology and the OCA's recommended position establish the revenue requirement for the Company using the cash flow method of ratemaking. The attached schedules show the equivalent data to that typically filed in Table I Income Summary, and in Table II Summary of Adjustments under the cash flow method. The OCA's Schedules attached to this Brief begin with PGW's Rebuttal Exhibit JRB-13A, which incorporated changes proposed by the OCA and OTS that were adopted by the Company and other changes proposed by PGW. From JRB-13A, the OCA's schedules show the following adjustments:

- 1) \$650,000 in additional Operating Budget Adjustments reflecting the expense adjustments proposed by the OCA that have not been accepted by PGW (Rev. Sch. 1);
- 2) a \$22.5 million rate increase proposed by the OCA;
- 3) a \$22.5 million payment of the City Loan by PGW during the future test year; and
- 4) Bad Debt Expense calculated at the rate provided for in the PGW/OTS Stipulation.

The impact of the OCA's position is presented on three schedules containing the Statement of Income, the Cash Flow Statement, and the Debt Service Coverage.

Since the PGW/OTS Stipulation did not specify whether the bad debt rate was to be applied to total revenues or only gas revenues, the OCA has provided schedules for both applications. Schedules marked as Rev. Schedules MAB-9 (Statement of Income), MAB-10 (Cash Flow Statement) and MAB-11 (Debt Service Coverage)

calculate Bad Debt Expense at OCA proposed rates at 4.5% of Total Revenues.

Schedules marked as Rev. Schedules MAB-12 (Statement of Income), MAB-13 (Cash Flow Statement), and MAB-14 (Debt Service Coverage) calculate Bad Debt Expense at the OCA proposed rates at 4.5% of Gas Revenues only.

PHILADELPHIA GAS WORKS
STATEMENT OF INCOME
(Dollars in Thousands)

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
OPERATING REVENUES							
Non-Heating	\$ 114,834		\$ 114,834		\$ 114,834		\$ 114,834
Gas Transport Service	7,256		7,256		7,256		7,256
Heating	820,732	\$ 6,497	827,229		827,229		827,229
Restructuring Charge	-	(3,396)	(3,396)		(3,396)		(3,396)
Proposed Base Rate						\$ 22,500	
Weather Normalization Adjustment	-						
Unbilled Adjustment	(732)		(732)		(732)		(732)
Total Gas Revenues	942,090	3,101	945,191		945,191	22,500	967,691
Appliance Repair & Other Revenues	10,532		10,532		10,532		10,532
Other Operating Revenues	18,032		18,032		18,032		18,032
Total Other Operating Revenues	28,564	-	28,564		28,564		28,564
Total Operating Revenues	970,654	3,101	973,755		973,755	22,500	996,255
OPERATING EXPENSES							
Natural Gas	630,836	4,546	635,382		635,382		635,382
Other Raw Material	5		5		5		5
Sub-Total Fuel	630,841	4,546	635,387		635,387		635,387
CONTRIBUTION MARGINS	339,813	(1,445)	338,368		338,368		338,368
Gas Processing	15,715		15,715		15,715		15,715
Field Services	34,698		34,698		34,698		34,698
Distribution	16,536		16,536		16,536		16,536
Collection	7,944		7,944		7,944		7,944
Customer Service	14,125		14,125		14,125		14,125
Account Management	7,625		7,625		7,625		7,625
Bad Debt Expense (Total Revenues)	52,258	(8,579)	43,679		43,679	1,152	44,831
Marketing	2,992		2,992		2,992		2,992
Administrative & General	43,963	(240)	43,723		43,723		43,723
Health Insurance	37,784	(460)	37,324		37,324		37,324
Capitalized Fringe Benefits	(11,261)		(11,261)		(11,261)		(11,261)
Capitalized Administrative Charges	(7,950)		(7,950)		(7,950)		(7,950)
Amortization of Restructuring Costs	-		-		-		-
Pensions	15,075		15,075		15,075		15,075
Taxes	6,485		6,485		6,485		6,485
Environmental Expenses	-		-		-		-
Pro Forma Adjustments (PGW)	217		217		217		217
Pro Forma Adjustments (OCA)				\$ (650)	(650)	0	(650)
Cost / Labor Savings	(6,274)		(6,274)		(6,274)		(6,274)
Sub-Total Other Oper. & Maintenance	229,932	(9,279)	220,653	(650)	220,003	1,152	221,155
Depreciation	38,213		38,213		38,213		38,213
Cost of Removal	3,200		3,200		3,200		3,200
To Clearing Accounts	(3,217)		(3,217)		(3,217)		(3,217)
	38,196		38,196		38,196		38,196
Sub Total Other Oper. & Maint. & Depreciation	268,128	(9,279)	258,849	(650)	258,199	1,152	259,351
TOTAL OPERATING EXPENSES	898,969	(4,733)	894,236	(650)	893,586	1,152	894,738
OPERATING INCOME	71,685	7,834	79,519	650	80,169	21,348	101,517
Other Income	11,212		11,212		11,212		11,212
INCOME BEFORE INTEREST	82,897	7,834	90,731	650	91,381	21,348	112,729
INTEREST							
Long-Term Debt	56,437	2,708	59,145		59,145		59,145
Other	13,186		13,186		13,186		13,186
AFUDC	(1,202)		(1,202)		(1,202)		(1,202)
Loss From Extinguishment of Debt	5,557		5,557		5,557		5,557
Total Interest	73,978	2,708	76,686		76,686		76,686
NET INCOME	8,919	5,126	14,045	650	14,695	21,348	36,043
City Payment							
Net Earnings	\$ 8,919	\$ 5,126	\$ 14,045	\$ 650	\$ 14,695	\$ 21,348	\$ 36,043

**PHILADELPHIA GAS WORKS
CASHFLOW STATEMENT
(Dollars in Thousands)**

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
SOURCES							
Net Income	\$ 8,919	\$ 5,126	\$ 14,045	\$ 650	\$ 14,695	\$ 21,348	\$ 36,043
Depreciation & Amortization	46,007		46,007		46,007		46,007
Earnings on Restricted Funds	38		38		38		38
Elimination of Accrued Interest on Refunded Debt							
Increased/(Decreased) Other Assets/Liabilities Available From Operations	911		911		911		911
	<u>55,875</u>	<u>5,126</u>	<u>61,001</u>	<u>650</u>	<u>61,651</u>	<u>21,348</u>	<u>82,999</u>
Funds Required for Capital	72,000		72,000		72,000		72,000
Grant Income	18,000		18,000		18,000		18,000
Capital Leasing Funds Debt Service	-		-		-		-
Capitalized Interest Debt Service	-		-		-		-
Release of Sinking Fund Asset	-		-		-		-
Temporary Financing	20,000		20,000		20,000		20,000
TOTAL SOURCES	<u>\$ 165,875</u>	<u>\$ 5,126</u>	<u>\$ 171,001</u>	<u>\$ 650</u>	<u>\$ 171,651</u>	<u>\$ 21,348</u>	<u>\$ 192,999</u>
USES							
Net Construction Expenditures LNG & BCCS	\$ 75,152		\$ 75,152		\$ 75,152		\$ 75,152
Funded Debt Reduction:							
Revenue Bonds	36,675	5,145 H	41,820		41,820		41,820
PMA Lease/Subordinate Debt	1,370		1,370		1,370		1,370
Capital Lease	-		-		-		-
Debt Reduction Funding	-		-		-		-
Temporary Financing Repayment							
City Loan Repayment/Status	2,000		2,000		2,000	20,500	22,500
Distribution of Earnings	18,000		18,000		18,000		18,000
Additions To (Reductions of) Non-Cash Working Capital	(8,118)		(8,118)		(8,118)		(8,118)
Cash Needs	125,079	5,145	130,224	-	130,224	20,500	150,724
Cash Surplus (Shortfall)	40,796	(19)	40,777	650	41,427	848	42,275
TOTAL USES	<u>\$ 165,875</u>	<u>\$ 5,126</u>	<u>\$ 171,001</u>	<u>\$ 650</u>	<u>\$ 171,651</u>	<u>\$ 21,348</u>	<u>\$ 192,999</u>
Cash - Beginning of Period	\$ 10,820		\$ 10,820		\$ 10,820		\$ 10,820
Cash - Surplus (Shortfall)	40,796	(19)	40,777	650	41,427	848	42,275
ENDING CASH	<u>\$ 51,616</u>	<u>\$ (19)</u>	<u>\$ 51,597</u>	<u>\$ 650</u>	<u>\$ 52,247</u>	<u>\$ 848</u>	<u>\$ 53,095</u>
Outstanding Commercial Paper	\$ 90,000		\$ 90,000		\$ 90,000		\$ 90,000
City Loan Outstanding	\$ 43,000		\$ 43,000		\$ 43,000		\$ 22,500

**PHILADELPHIA GAS WORKS
DEBT SERVICE COVERAGE**
(Dollars in Thousands)

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
FUNDS PROVIDED							
Total Gas Revenues	\$ 942,090	\$ 3,101	\$ 945,191	\$ -	\$ 945,191	\$ 22,500	\$ 967,691
Other Operating Revenues	28,564		28,564		28,564		28,564
Total Operating Revenues	970,654	3,101	973,755	-	973,755	22,500	996,255
Other Income Incr. / (Decr.) Restricted Funds	11,250		11,250		11,250		11,250
City Grant	18,000		18,000		18,000		18,000
AFUDC (Interest)	1,202		1,202		1,202		1,202
TOTAL FUNDS PROVIDED	\$ 1,001,106	\$ 3,101	\$ 1,004,207	\$ -	\$ 1,004,207	\$ 22,500	\$ 1,026,707
FUNDS APPLIED							
Fuel Costs	\$ 630,841	\$ 4,546	\$ 635,387	\$ -	\$ 635,387	\$ -	\$ 635,387
Other Operating Costs	268,128	(9,279)	258,849	(650)	258,199	1,152	259,351
Total Operating Expenses	898,969	(4,733)	894,236	(650)	893,586	1,152	894,738
Less: Non-Cash Expenses	41,887	-	41,887	-	41,887	-	41,887
TOTAL FUNDS APPLIED	\$ 857,082	\$ (4,733)	\$ 852,349	\$ (650)	\$ 851,699	\$ 1,152	\$ 852,851
Funds Available to Cover Debt Service	\$ 144,024	\$ 7,834	\$ 151,858	\$ 650	\$ 152,508	\$ 21,348	\$ 173,856
1975 Ordinance Bonds Debt Service	\$ 35,748		\$ 35,748		\$ 35,748		\$ 35,748
Debt Service Coverage 1975 Bonds	4.03	0.22	4.25	0.02	4.27	0.60	4.86
Net Available after Prior Debt Service	\$ 108,276	\$ 7,834	\$ 116,110	\$ 650	\$ 116,760	\$ 21,348	\$ 138,108
Other Capital Leases	-		-		-		-
Net Available after Prior Capital Leases	108,276	7,834	116,110	650	116,760	21,348	138,108
1998 Ordinance Bonds Debt Service	\$ 53,313	\$ 5,145	\$ 58,458		\$ 58,458		\$ 58,458
New Proposed Bond Debt Service	-		-		-		-
Total New Debt Service	\$ 53,313	\$ 5,145	\$ 58,458	-	\$ 58,458	-	\$ 58,458
Debt Service Coverage 1998 Bonds	2.03	(0.04)	1.99	0.01	2.00	0.37	2.36
Net Available after 1998 Debt Service	\$ 54,963	\$ 2,689	\$ 57,652	\$ 650	\$ 58,302	\$ 21,348	\$ 79,650
1998 Ordinance Subordinate Bond Debt Ser	\$ 1,987		\$ 1,987		\$ 1,987		\$ 1,987
Debt Service Coverage Subordinate Bonds	27.66	1.35	29.01	0.33	29.34	10.74	40.09
Net Available To Service Aggregate Debt Serv	\$ 122,295	\$ 7,834	\$ 130,129	\$ 650	\$ 130,779	\$ 21,348	\$ 152,127
Aggregate Debt Service	\$ 91,048	\$ 5,145	\$ 96,193	\$ -	\$ 96,193	\$ -	\$ 96,193
Fixed Coverage Charge	1.34	0.01	1.35	0.01	1.36	0.22	1.58

PHILADELPHIA GAS WORKS
STATEMENT OF INCOME
(Dollars in Thousands)

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
OPERATING REVENUES							
Non-Heating	\$ 114,834		\$ 114,834		\$ 114,834		\$ 114,834
Gas Transport Service	7,256		7,256		7,256		7,256
Heating	820,732	6,497	827,229		827,229		827,229
Restructuring Charge	-	(3,396)	(3,396)		(3,396)		(3,396)
Proposed Base Rate						\$ 22,500	
Weather Normalization Adjustment	-						
Unbilled Adjustment	(732)		(732)		(732)		(732)
Total Gas Revenues	942,090	3,101	945,191		945,191	22,500	967,691
Appliance Repair & Other Revenues	10,532		10,532		10,532		10,532
Other Operating Revenues	18,032		18,032		18,032		18,032
Total Other Operating Revenues	28,564	-	28,564		28,564		28,564
Total Operating Revenues	970,654	3,101	973,755		973,755	22,500	996,255
OPERATING EXPENSES							
Natural Gas	630,836	4,546	635,382		635,382		635,382
Other Raw Material	5		5		5		5
Sub-Total Fuel	630,841	4,546	635,387		635,387		635,387
CONTRIBUTION MARGINS							
Gas Processing	15,715		15,715		15,715		15,715
Field Services	34,698		34,698		34,698		34,698
Distribution	16,536		16,536		16,536		16,536
Collection	7,944		7,944		7,944		7,944
Customer Service	14,125		14,125		14,125		14,125
Account Management	7,625		7,625		7,625		7,625
Bad Debt Expense (Gas Revenues)	52,258	(9,864)	42,394		42,394	1,152	43,546
Marketing	2,992		2,992		2,992		2,992
Administrative & General	43,963	(240)	43,723		43,723		43,723
Health Insurance	37,784	(460)	37,324		37,324		37,324
Capitalized Fringe Benefits	(11,261)		(11,261)		(11,261)		(11,261)
Capitalized Administrative Charges	(7,950)		(7,950)		(7,950)		(7,950)
Amortization of Restructuring Costs	-		-		-		-
Pensions	15,075		15,075		15,075		15,075
Taxes	6,485		6,485		6,485		6,485
Environmental Expenses	-		-		-		-
Pro Forma Adjustments (PGW)	217		217		217		217
Pro Forma Adjustments (OCA)				\$ (650)	(650)	0	(650)
Cost / Labor Savings	(6,274)		(6,274)		(6,274)		(6,274)
Sub-Total Other Oper. & Maintenance	229,932	(10,564)	219,368	(650)	218,718	1,152	219,870
Depreciation	38,213		38,213		38,213		38,213
Cost of Removal	3,200		3,200		3,200		3,200
To Clearing Accounts	(3,217)		(3,217)		(3,217)		(3,217)
	38,196		38,196		38,196		38,196
Sub Total Other Oper. & Maint. & Depreciation	268,128	(10,564)	257,564	(650)	256,914	1,152	258,066
TOTAL OPERATING EXPENSES							
	898,969	(6,018)	892,951	(650)	892,301	1,152	893,453
OPERATING INCOME							
Other Income	71,685	9,119	80,804	650	81,454	21,348	102,802
	11,212		11,212		11,212		11,212
INCOME BEFORE INTEREST							
	82,897	9,119	92,016	650	92,666	21,348	114,014
INTEREST							
Long-Term Debt	56,437	2,708	59,145		59,145		59,145
Other	13,186		13,186		13,186		13,186
AFUDC	(1,202)		(1,202)		(1,202)		(1,202)
Loss From Extinguishment of Debt	5,557		5,557		5,557		5,557
Total Interest	73,978	2,708	76,686		76,686		76,686
NET INCOME							
City Payment	8,919	6,411	15,330	650	15,980	21,348	37,328
Net Earnings	\$ 8,919	\$ 6,411	\$ 15,330	\$ 650	\$ 15,980	\$ 21,348	\$ 37,328

PHILADELPHIA GAS WORKS
CASHFLOW STATEMENT
(Dollars in Thousands)

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
SOURCES							
Net Income	\$ 8,919	\$ 6,411	\$ 15,330	\$ 650	\$ 15,980	\$ 21,348	\$ 37,328
Depreciation & Amortization	46,007		46,007		46,007		46,007
Earnings on Restricted Funds	38		38		38		38
Elimination of Accrued Interest on Refunded Debt							
Increased/(Decreased) Other Assets/Liabilities Available From Operations	911		911		911		911
	<u>55,875</u>	<u>6,411</u>	<u>62,286</u>	<u>650</u>	<u>62,936</u>	<u>21,348</u>	<u>84,284</u>
Funds Required for Capital	72,000		72,000		72,000		72,000
Grant Income	18,000		18,000		18,000		18,000
Capital Leasing Funds Debt Service	-		-		-		-
Capitalized Interest Debt Service	-		-		-		-
Release of Sinking Fund Asset	-		-		-		-
Temporary Financing	20,000		20,000		20,000		20,000
TOTAL SOURCES	<u>\$ 165,875</u>	<u>\$ 6,411</u>	<u>\$ 172,286</u>	<u>\$ 650</u>	<u>\$ 172,936</u>	<u>\$ 21,348</u>	<u>\$ 194,284</u>
USES							
Net Construction Expenditures LNG & BCCS	\$ 75,152		\$ 75,152		\$ 75,152		\$ 75,152
Funded Debt Reduction:							
Revenue Bonds	36,675	5,145 H	41,820		41,820		41,820
PMA Lease/Subordinate Debt	1,370		1,370		1,370		1,370
Capital Lease	-		-		-		-
Debt Reduction Funding	-		-		-		-
Temporary Financing Repayment							
City Loan Repayment/Status	2,000		2,000		2,000	20,500	22,500
Distribution of Earnings	18,000		18,000		18,000		18,000
Additions To (Reductions of) Non-Cash Working Capital	(8,118)		(8,118)		(8,118)		(8,118)
Cash Needs	125,079	5,145	130,224	-	130,224	20,500	150,724
Cash Surplus (Shortfall)	40,796	1,266	42,062	650	42,712	848	43,560
TOTAL USES	<u>\$ 165,875</u>	<u>\$ 6,411</u>	<u>\$ 172,286</u>	<u>\$ 650</u>	<u>\$ 172,936</u>	<u>\$ 21,348</u>	<u>\$ 194,284</u>
Cash - Beginning of Period	\$ 10,820		\$ 10,820		\$ 10,820		\$ 10,820
Cash - Surplus (Shortfall)	40,796	1,266	42,062	650	42,712	848	43,560
ENDING CASH	<u>\$ 51,616</u>	<u>\$ 1,266</u>	<u>\$ 52,882</u>	<u>\$ 650</u>	<u>\$ 53,532</u>	<u>\$ 848</u>	<u>\$ 54,380</u>
Outstanding Commercial Paper	\$ 90,000		\$ 90,000		\$ 90,000		\$ 90,000
City Loan Outstanding	\$ 43,000		\$ 43,000		\$ 43,000		\$ 22,500

PHILADELPHIA GAS WORKS
DEBT SERVICE COVERAGE
(Dollars in Thousands)

	PGW BUDGET 2006-07	Present Rate PGW Adjustments	PGW Revised BUDGET 2006-07	Present Rate OCA Adjustments	OCA Revised BUDGET 2006-07	Proposed Rate OCA Adjustments	OCA Revised BUDGET 2006-07
FUNDS PROVIDED							
Total Gas Revenues	\$ 942,090	\$ 3,101	\$ 945,191	\$ -	\$ 945,191	\$ 22,500	\$ 967,691
Other Operating Revenues	28,564		28,564		28,564		28,564
Total Operating Revenues	970,654	3,101	973,755	-	973,755	22,500	996,255
Other Income Incr. / (Decr.) Restricted Funds	11,250		11,250		11,250		11,250
City Grant	18,000		18,000		18,000		18,000
AFUDC (Interest)	1,202		1,202		1,202		1,202
TOTAL FUNDS PROVIDED	\$ 1,001,106	\$ 3,101	\$ 1,004,207	\$ -	\$ 1,004,207	\$ 22,500	\$ 1,026,707
FUNDS APPLIED							
Fuel Costs	\$ 630,841	\$ 4,546	\$ 635,387	\$ -	\$ 635,387	\$ -	\$ 635,387
Other Operating Costs	268,128	(10,564)	257,564	(650)	256,914	1,152	258,066
Total Operating Expenses	898,969	(6,018)	892,951	(650)	892,301	1,152	893,453
Less: Non-Cash Expenses	41,887	-	41,887	-	41,887	-	41,887
TOTAL FUNDS APPLIED	\$ 857,082	\$ (6,018)	\$ 851,064	\$ (650)	\$ 850,414	\$ 1,152	\$ 851,566
<i>Funds Available to Cover Debt Service</i>	\$ 144,024	\$ 9,119	\$ 153,143	\$ 650	\$ 153,793	\$ 21,348	\$ 175,141
1975 Ordinance Bonds Debt Service	\$ 35,748		\$ 35,748		\$ 35,748		\$ 35,748
Debt Service Coverage 1975 Bonds	4.03	0.26	4.28	0.02	4.30	0.60	4.90
Net Available after Prior Debt Service	\$ 108,276	\$ 9,119	\$ 117,395	\$ 650	\$ 118,045	\$ 21,348	\$ 139,393
Other Capital Leases	-		-		-		-
Net Available after Prior Capital Leases	108,276	9,119	117,395	650	118,045	21,348	139,393
1998 Ordinance Bonds Debt Service	\$ 53,313	\$ 5,145	\$ 58,458		\$ 58,458		\$ 58,458
New Proposed Bond Debt Service	-		-		-		-
Total New Debt Service	\$ 53,313	\$ 5,145	\$ 58,458	-	\$ 58,458	-	\$ 58,458
Debt Service Coverage 1998 Bonds	2.03	(0.02)	2.01	0.01	2.02	0.37	2.38
Net Available after 1998 Debt Service	\$ 54,963	\$ 3,974	\$ 58,937	\$ 650	\$ 59,587	\$ 21,348	\$ 80,935
1998 Ordinance Subordinate Bond Debt Ser	\$ 1,987		\$ 1,987		\$ 1,987		\$ 1,987
Debt Service Coverage Subordinate Bonds	27.66	2.00	29.66	0.33	29.99	10.74	40.73
Net Available To Service Aggregate Debt Serv	\$ 122,295	\$ 9,119	\$ 131,414	\$ 650	\$ 132,064	\$ 21,348	\$ 153,412
Aggregate Debt Service	\$ 91,048	\$ 5,145	\$ 96,193	\$ -	\$ 96,193	\$ -	\$ 96,193
Fixed Coverage Charge	1.34	0.02	1.37	0.01	1.37	0.22	1.59

PHILADELPHIA GAS WORKS
Summary Adjustments to Pro Forma Net Earnings
Test Year Ended August 31, 2007
(\$000)

Line No.		<u>O.C.A.</u>	<u>Schedule MAB</u>
<u>Present Rates</u>			
1	Incentive Bonus Program	(\$500)	2
2	Lobbying Expense	(100)	3
3	Regulatory Penalties	<u>(50)</u>	5
4	Adjustment to O&M Expense	<u>(\$650)</u>	
5	Adjustment to Net Earnings	<u>\$650</u>	
<u>Proposed Rates</u>			
6	Bad Debt Expense	<u>\$1,152</u>	Rev. 9

APPENDIX B

OCA PROPOSED ORDERING PARAGRAPHS

1. PGW shall be allowed to implement rates enabling the Company to collect \$22.5 million in additional revenues.
2. The rate increase shall be allocated to the customer classes as proposed by the Company with a proportional scaleback to reflect the appropriate rate increase amount.
3. All revenues derived from off-system sales and capacity release transactions shall continue to be credited back to the GCR consistent with the Company's current practice.
4. PGW shall maintain its historic practice of allocating universal service costs to all firm service customers.
5. PGW shall commit to implementing an Electronic Funds Transfer program, with the input and assistance of the interested Parties, for PGW's customers that are at or above 250% of the Federal Poverty Level.
6. PGW shall commit to implementing a program, with the input and assistance of the interested Parties, designed to enroll more of PGW's payment-troubled customers in Budget Billing.
7. PGW shall commit to working with the Philadelphia Housing Authority, and the interested Parties, to expand the scope of the direct vendor program between PGW and PHA.

APPENDIX C

UNPUBLISHED OPINIONS

**BEFORE
THE
CITY OF PHILADELPHIA - GAS COMMISSION**

PUBLIC MEETING HELD: October 4, 2006

In Re: Fiscal Year 2007 Budgets/Oversight Proceeding

- **Proposed Philadelphia Gas Works Fiscal Year 2007 Operating Budget**
 - **Related Oversight Issues**
-

ORDER

(with Appendix)

INTRODUCTION

After legal and public notice, the Gas Commission held a special meeting on October 4, 2006 at which a quorum was present. At that meeting, the proposed Fiscal Year ("FY") 2007 Operating Budget for the Philadelphia Gas Works ("PGW") and related oversight issues were before the Gas Commission for deliberation and decision. Commissioner Royal E. Brown presented a recommendation and motion to the Gas Commission for its consideration. Having considered these matters as well as the recommendation and motion presented by Commissioner Brown, good cause has been shown for the Gas Commission to take action as stated in this Order.

APPLICABLE LAW

Section IV.2.a. of the Agreement Between The City Of Philadelphia And The Philadelphia Facilities Management Corporation For The Management And Operation Of The Philadelphia

disagreement with the recommendations offered by the Hearing Examiner.³ PGW's proposed FY 2007 Operating Budget has projected Revenues of \$981 million, projected Natural Gas expense of \$631 million, and projected Non-Fuel Operating expenses of \$243 million before Depreciation expense. After careful review, we reduce Non-Fuel Operating expenses in this Budget by approximately \$4.2 million (or 1.7% percent). A table summarizing the various adjustments is attached to this Order as **Appendix "A"**.

1. CONTRIBUTION MARGINS

PGW took exception to the Hearing Examiner's recommended adjustments to Gas Revenues and Natural Gas expense flowing from PGW's more current Marketing Forecast. While these adjustments bring a slightly finer degree of accuracy to the Budget, their net effect is so minor that it does not warrant the effort necessary to revise the underlying sales and revenues schedules. Consequently, neither these adjustments nor the associated \$50,000 reduction to Bad Debt expense recommended by the Hearing Examiner are made.

2. LABOR & FRINGE BENEFITS EXPENSE

Labor - PGW excepted to the Hearing Examiner's recommended \$691,000 reduction to the budgeted \$147.305 million Labor & Fringe Benefits expense, which would reflect a reduction of ten in the average personnel count (i.e., from 1,740 to 1,730). In recent years, PGW has failed repeatedly to meet its budgeted goals for trimming the workforce, despite various touted initiatives to improve productivity and to outsource certain functions. During the hearings, PGW conceded that the budgeted average personnel was overstated by at least two positions. Since PGW's overall financial condition has not changed significantly, we again set a slightly more aggressive target which challenges PGW to manage this situation more tightly. Indeed, if PGW is to pay management "incentive bonuses" for achievement of goals, this should be one of the goals for which designated personnel are directly accountable. We therefore deny PGW's exception.

Fringe Benefits - We also correct the ancillary reduction to Fringe Benefits expense as recommended by Staff, so that it is based on the gross payroll reduction (rather than the net used by the Public Advocate) consistent with the methodology used in last year's proceeding. This increases the dollar amount of the Hearing Examiner's recommended adjustment by \$59,000 to \$274,518.⁴

Incentive Bonuses - We grant the Public Advocate's exception to including \$500,000 in the Budget for potential management incentive payments related to FY 2007 performance because clearly articulated, well-defined, quantitative goals and criteria (as are used in private industry for such "pay-for-performance" programs) are absent. During the course of FY 2007, PGW is certainly free to re-submit a specific program and projected budget for Gas Commission review

³ We thank the Gas Commission staff and the parties for their work in defining the issues and offering recommendations.

⁴ The \$274,518 Fringe Benefits reduction is calculated as 45.3% of the \$606,000 gross payroll reduction. See Ordering Paragraph 4.A.2.

and approval. Consistent therewith, we also grant the Public Advocate's request that we indicate to PGW management and the PFMC Board that no such incentive bonuses should be paid for FY 2006 performance. Not only did PGW fail to submit for the record the specific advance goals and metrics for an incentive bonus program, such expense was not included in its proposed FY 2006 Operating Budget. Accordingly, it was not included in the Gas Commission-approved FY 2006 Budget.⁵

3. PURCHASED SERVICES EXPENSES

TechInsight Product Purchase - We reject PGW's exception as well as its "compromise" offer regarding the proposed purchase of 3-Point Technologies' TechInsight product by the Field Services Department ("FSD"). PGW has failed to explain why these capabilities were not incorporated in its new computerized field work systems using capital funding for the Field Optimization Initiative ("FOI") as had originally been represented to us. Nor has PGW met its burden of establishing a positive cost-benefit for this reporting service, with the associated savings immediately reflected in its proposed Budget. Moreover, PGW does not dispute that it would cost significantly less to develop these capabilities in-house (even as an add-on to FOI) rather than be locked into purchasing this service indefinitely.

Corporate Communications Advertising - PGW has failed to demonstrate that it is reasonable or necessary to fund its proposed Corporate Awareness Advertising campaigns at the level or for the purposes requested. PGW has not shown any direct benefit that can be attributed solely or primarily to last year's expensive "Prepare and Conserve" campaign. The proposed Customer Responsibility Program ("CRP") advertising campaign is also at odds with the rest of the Budget, which assumes no change in CRP during the course of the fiscal year. With deferred submission to the Pennsylvania Public Utility Commission ("PUC") of PGW's Universal Services Plan, the need for such advertising becomes even more remote. The requested Rate Case advertising expense is out of line with past expenditures and has not been justified by PGW. We leave intact over \$1.25 million in Advertising purchased services expense - including \$100,000 for conservation awareness, \$350,000 for collections efforts, \$300,000 for Low Income Home Energy Assistance Program ("LIHEAP") outreach, \$377,000 for Parts & Labor Plan and Automatic Meter Reading ("AMR") replacement advertising, and \$25,000 for gas safety issues. When taken together with other budgeted Advertising expenses (including \$25,000 for normal PUC required notifications), PGW's approved Advertising budget is \$1.477 million. Compared to actual FY 2005 expenses of \$1.4 million and the FY 2006 approved budget of \$1.2 million, this is eminently reasonable.

⁵ On September 20, 2006 a newspaper article referenced statements by PGW executive management regarding the Gas Commission and the incentive bonus awards. These statements attempted to justify PGW's failure to contemporaneously inform the Gas Commission of incentive bonus awards to certain managers circa August /September 2005 for FY 2005 performance. See "Secret PGW Bonuses: Fanning the Flames", Philadelphia Daily News (September 20, 2006), at 4. See also Recommended Decision, at 15 - 16. Then, on September 21, 2006 PGW came to City Council's caucus and, in the presence of Chairwoman Tasco, incorrectly indicated to Council members that the Gas Commission had in fact been made aware of this situation at the time. By letter dated September 21, 2006 to the PFMC Board Chairman David L. Hyman, Chairwoman Tasco communicated her concerns about PGW management's disingenuous and disrespectful conduct (while at the same time expressly avoiding any discussion on the merits of the proposed Budget). By letter dated September 22, 2006 (and filed September 26, 2006), PFMC Board Chairman Hyman replied to these concerns and also discussed the merits of the Board's decision to award bonuses for FY 2005.

ORIGINAL

STATE OF INDIANA
INDIANA UTILITY REGULATORY COMMISSION

PETITION OF THE BOARD OF DIRECTORS)
FOR UTILITIES OF THE DEPARTMENT OF)
PUBLIC UTILITIES OF THE CITY OF)
INDIANAPOLIS, AS SUCCESSOR TRUSTEE)
OF A PUBLIC CHARITABLE TRUST, D/B/A)
CITIZENS GAS & COKE UTILITY FOR)
AUTHORITY TO INCREASE ITS RATES AND)
CHARGES FOR GAS UTILITY SERVICE AND)
FOR APPROVAL OF A NEW SCHEDULE OF)
RATES AND CHARGES APPLICABLE)
THERE TO, APPROVAL UNDER IC 8-1-2.5 OF AN)
ALTERNATIVE REGULATORY PLAN)
IMPLEMENTING AN UNCOLLECTIBLE EXPENSE)
ADJUSTMENT MECHANISM, A DEMAND SIDE)
MANAGEMENT AND RATE DECOUPLING)
MECHANISM AND APPROVAL OF OTHER)
CHANGES TO ITS GENERAL TERMS AND)
CONDITIONS FOR GAS SERVICE)

CAUSE NO. 42767

APPROVED: OCT 19 2006

BY THE COMMISSION:

David W. Hadley, Commissioner
Aaron Schmoll, Administrative Law Judge

**INDIANA UTILITY REGULATORY COMMISSION
CAUSE NO. 42767**

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We find that Petitioner's current rates and charges, which produce annual operating revenue of \$414,225,930, are insufficient to provide for Petitioner's aggregate annual cash revenue requirement and, therefore, are unjust and unreasonable. Petitioner's rates and charges for gas service need to be increased by \$14,370,300, plus additional revenues of \$366,142 associated with increased Bad Debt Expense at the approved 1.10% and Indiana Utility Receipts Tax at a tax rate of 1.4%, producing total annual operating revenues of \$428,962,372, in order to meet its aggregate annual cash revenue requirement.

We note that much of the difference between Petitioner's proposed revenue increase and that actually approved by this Commission stemmed from the difference between Petitioner's calculation of its revenue at current rates using its computer model and the Commission's use of actual test year data. Citizen's approach is inconsistent with an approach based upon factors that are fixed, known, and measurable. Although we recognize that Citizens has utilized this computer model with success in GCA proceedings, a forecasting approach appropriate in the GCA process is inconsistent with Commission precedent in rate cases. Unlike GCA proceedings, there is no reconciliation to bring forecasting variations in line with what has come to pass. We strongly encourage Indiana utilities to present rate cases in a manner consistent with our precedent.

8. Method of Implementing Rate Increase.

a. Evidence.

Petitioner's witness Jones sponsored Petitioner's cost-of-service study by which Petitioner proposed to allocate the authorized total annual revenue requirement among customer classes. Mr. Jones employed essentially the same cost-of-service study methodology used by Citizens Gas in connection with its last rate case, Cause No. 39066, and its "unbundling" proceeding, Cause No. 41605. (Pet. Ex. CAJ at 9.) Mr. Jones testified Petitioner's latest cost-of-service study (i.e., Petitioner's Exhibit CAJ-1), showed that the difference in rates of return by class have shifted significantly from the 1990 cost-of-service study. (Pet. Ex. CAJ at 7.) Mr. Jones indicated, despite the limited modifications he made to the methodology employed in Petitioner's cost-of-service study, the derived allocation factors were significantly different from those found in Cause No. 39066 due to changes in customer numbers, individual class usage totals, peak day information, cost data and other factors. (Pet. Ex. CAJ at 18.) Mr. Jones stated that with the exception of minor adjustments, the cost-of-service study was based on the same assumptions as the studies used in Cause Nos. 39066 and 41605. (Pet. Ex. CAJ at 15.) The minor adjustments included: (i) updating the balancing study used in Cause No. 41605; (ii) eliminating the Interruptible Delivery Service class; (iii) allocating a portion of the bad debt expense to the Large Volume class. (Pet. Ex. CAJ at 15-16.)

Petitioner's witness Richcreek testified Citizens Gas proposed to eliminate the Interruptible Delivery Service rate class, which consists of just 3 customers.

Mr. Jones described Citizens Gas' proposed rate design, which included: (i) elimination of the Interruptible Service Rate Class; (ii) establishment of a per-meter monthly Facility Charge for Large Volume Gas Rate No. D5, based on the number of meters at a customer's location; and (iii) elimination of a customer-owned delivery charge for Compressed Natural Gas Customers, Gas Rate No. D7. (Pet. Ex. CAJ at 40.) Mr. Jones further indicated Citizens Gas was proposing to increase monthly Facility Charges. (Pet. Ex. CAJ at 48-53.)

Mr. Jones also sponsored Petitioner's proposed changes to its Incremental Banking Charge, Gas Rate No. A9. Citizens Gas proposed to post the available quantity of Incremental Banking on its website each April 10. All interested parties utilizing Petitioner's system, 3rd Party Suppliers and End-Use Customers, will be able to submit bids for both the quantity and price of Incremental Banking they would like to purchase. Mr. Jones explained Petitioner's proposal is designed to recover part of the cost associated with allowing certain customers to opt-out of banking services. (Pet. Ex. CAJ at 61.)

OUCG witness Galligan offered testimony presenting the OUCG's findings, conclusions and recommendations with respect to Citizens Gas' cost-of-service study. (Pub. Ex. 6 at 3.) Mr. Galligan summarized his opinions, as follows: (i) Citizens Gas' cost-of-service study misallocates its distribution mains; (ii) the proposed rate spread, therefore, is not reasonably allocated among customer classes; and (iii) Petitioner's proposal to increase its Residential Domestic and Residential Heating Facility Charges should be rejected, along with its proposal to increase the declining nature of the Residential Heating delivery service rates. (Pub. Ex. 6 at 4.)

Mr. Galligan described Citizens Gas' cost-of-service study as "an average embedded allocated class cost-of-service study," sometimes referred to as a distributed cost study. (Pub. Ex. 6 at 5.) Mr. Galligan stated the allocation of fixed or capacity related costs is "the most controversial aspect of performing an allocated cost-of-service study." (*Id.*) According to Mr. Galligan, Petitioner's allocation of its distribution mains plant investment on the basis of customer class coincident peak demand is "controversial." (Pub. Ex. 6 at 6.)

Mr. Galligan believes only about 10% of the distribution mains cost should be allocated on peak demands. (*Id.*) According to Mr. Galligan, "it is obviously wrong to profess that all distribution mains cost is caused by what customers do on one day in a 10- to 15-year period." (Pub. Ex. 6 at 7.)

Mr. Galligan testified the basic reason why local distribution companies invest monies in their distribution system is to meet the annual demands for gas by end-use customers. (*Id.*) Citizens Gas' distribution system exists because the total annual demand for gas is sufficient to warrant its existence. (Pub. Ex. 6 at 10.) "Because distribution mains exist and are related to both annual demands and peak demands, both

annual and peak demands must be recognized in the allocation of distribution mains costs. . . ." (Pub. Ex. 6 at 7.)

Mr. Galligan indicated "if there were no variance in the daily demands on Citizens Gas' system, the capacity of that system would have to be designed to accommodate the daily movement of 138,197 dekatherms just to meet the annual demands." (Pub. Ex. 6 at 8.) Citizens Gas' system capacity, however, must be four times larger to meet peak demands. Mr. Galligan concluded that "some costs are related to the average deliveries each day on the Citizens [Gas] system, and some costs are related to the movement of gas when demands are above the average demand." (Pub. Ex. 6 at 9.)

Mr. Galligan noted, in particular, that costs associated with planning, surveying, excavation, and municipal inspection, among others, are not dependent on peak demand. (*Id.*) "There are costs that are uniquely associated with meeting peak demands . . . [b]ut the additional costs incurred to meet peak demands tend to be small." (Pub. Ex. 6 at 10.)

For purposes of preparing his proposed revised cost-of-service study, Mr. Galligan stated he "conservatively" allocated 80% of distribution mains cost on the basis of average demand, and 20% on the basis of peak demand. (Pub. Ex. 6 at 13.) Mr. Galligan's proposed allocation of distribution mains resulted in a \$2.6 million decrease in the revenue requirement for Residential Heat customers and a nearly \$3 million increase in the revenue requirement for Large Volume customers. (Pub. Ex. 6 at 14.) Under Citizens Gas' proposed cost-of-service study, the rates of Residential Heat and Large Volume customers would be increased by approximately 10% and 28.6%, respectively. (Pub. Ex. 6 at 16.) The OUCC's proposed cost-of-service study would cause the rates of Residential Heat and Large Volume customers to increase by approximately 9% and 44.1%, respectively. (*Id.*)

Mr. Galligan further disagreed with Citizens Gas' use of fully distributed cost in the development of its proposed increases to Residential Heating and Residential Domestic Facility Charges. (Pub. Ex. 6 at 18.) Mr. Galligan contended "[i]t is widely acknowledged that rates based on *marginal costs* are proper price signals consistent with economically efficient rates." (Pub. Ex. 6 at 19 (emphasis in text).) "Setting the Residential monthly Facility charge on fully distributed costs, as Mr. Jones recommends, is inconsistent with the economic efficiency standard of utility ratemaking." (Pub. Ex. 6 at 20.) Mr. Galligan asserted "avoided costs," which are less than Petitioner's current monthly Facility Charges, were the proper basis for developing customer charges. Therefore, Mr. Galligan recommended that Petitioner's current monthly Facilities Charges of \$6.65 and \$10.00 be retained.

Mr. Galligan further testified that Citizens Gas is proposing to increase its current tailblock discount of 6.36¢ per therm to 9.62¢ per therm. (*Id.*) Mr. Galligan stated Citizens Gas' cost-of-service study does "not reveal the costs associated with zero to 46 therms and above 46 therms consumption blocks." (Pub. Ex. 6 at 21.) Mr. Galligan recommended that the Commission reject Citizens Gas proposal to increase the declining nature of its Residential Heat rate by increasing the tailblock rate by only 5.23¢ per therm, while increasing the initial block rate by 8.49¢ per therm. (*Id.*) Instead, Mr.

Galligan recommended that both rates be increased by the same absolute amount. According to Mr. Galligan, tailblock usage is likely to occur later in a month, rather than earlier. "There is no cost study support for the notion that it is any less costly" to deliver gas later in the month according to Mr. Galligan.

CIG witness Phillips testified the non-gas portion of the rates proposed by Citizens Gas would increase the current Large Volume rates, which already are significantly higher than those charged by NIPSCO, SIGECO and Indiana Gas, by approximately 100%. (CIG Ex. NP at 4.) In Mr. Phillips' opinion, "all other things being equal, Citizens [Gas] should be able to provide its customers lower rates than the investor owned utilities. . . ." (CIG Ex. NP at 5.) Mr. Phillips believes the fundamental reason Citizens Gas' Large Volume rates are "out of line" is that its "cost-of-service contains erroneous allocations to the Large Volume class, and particularly to the transportation customers served from the transmission system." (CIG Ex. NP at 6.)

Mr. Phillips stated "if a transmission system and a customer component to distribution mains were recognized and implemented properly, the cost to serve Citizens [Gas]' Large Volume transportation customers served from [Petitioner's] transmission system would be more in line with the cost and rates approved by this Commission for similar customers served by NIPSCO and Vectren." (Id.) Fourteen customers are served from Citizens Gas' transmission system, including all of the CIG members. (CIG Ex. NP at 13.) In Mr. Phillips' opinion, customers served from the transmission system should only be allocated a proportionate share of transmission mains cost and not be allocated any distribution mains cost. (Id.) Mr. Phillips indicated this process has been followed by NIPSCO and by Vectren South, and was approved by the Commission in past proceedings. (Id.)

According to Mr. Phillips, transportation customers, particularly those that have "opted-out" of banking under Petitioner's terms and conditions for service should not be allocated costs associated with Citizens Gas' underground storage and LNG facilities. (CIG Ex. NP at 14.) Transportation customers incur expenses associated with transporting gas to Citizens Gas for daily balancing in order to not use underground storage and LNG facilities, and therefore, allocating storage costs to such customers "is not fair or reasonable and should not be allowed." (CIG Ex. NP at 15.) Mr. Phillips indicated that in Cause No. 39066, Petitioner explicitly stated that it constructed its LNG facilities to meet peak demand, but in this proceeding indicated a significant portion of the facilities were used for daily balancing. (Id.)

Mr. Phillips contended another problem with Citizens' cost-of-service study was that "for unexplained reasons, Citizens [Gas] forecasts a decline in the Large Volume load factor from the past proceeding to this proceeding." (CIG Ex. NP at 18.) Citizens Gas showed a Large Volume class load factor of 41.9% in this case, which Mr. Phillips states is extremely low for a class that is not largely heat sensitive and contains very large manufacturing type customers. (Id.) Mr. Phillips stated that Citizens Gas did not have data with respect to actual peak day volumes by class, which he described "unusual." (Id.) Mr. Phillips also indicated that, according to Petitioner's witness Jones, the Large Volume class has 77 customers, but Citizens Gas used 112 customers in its load factor forecast and regression analysis. (CIG Ex. NP at 19.)

Mr. Phillips reviewed monthly sales factors and peak month sales on an average day basis, which he stated indicate that the Large Volume load factor remains at the 66% level and has not dropped to 41%. (CIG Ex. NP at 20.) Mr. Phillips noted that Mr. Jones even testified in his deposition that the 41% load factor appeared low and that a load factor of 70% or higher for processed gas users was more typical. (Id.) Accordingly, Mr. Phillips recommended using the 66% load factor from Petitioner's last rate proceeding. Mr. Phillips stated that the load factor from the last rate case "is a conservative measure of load factor for the larger users in the Large Volume class." (Id.)

Mr. Phillips sponsored a revised cost-of-service study (CIG Exhibit NP-1) based on Petitioner's requested revenue requirement in this proceeding. Mr. Phillips indicated that he:

performed the cost-of-service study based on a large volume class of customers served from Citizens [Gas]' transmission system, transporting gas . . . to the Citizens [Gas] system at the customer's own expense and risk and operating at a reasonable load factor. Portions of storage and LNG identified by Citizens [Gas] as supply-related have not been allocated to this class. Storage and LNG identified by Citizens [Gas] as utilized for balancing have been allocated to this class based on peak day demand. . . .

(CIG Ex. NP at 21.)

The results of Mr. Phillips' cost-of-service study indicated the Large Volume class would require a rate reduction of \$1.189 million under the full revenue requirement increase sought in this proceeding. (Id.) Mr. Phillips indicated that, if his proposed rate reduction for Large Volume customers were implemented, the per unit cost would be 35¢ per Dth, which he contends is "in a much more reasonable range compared to the other Indiana utilities." (CIG Ex. NP at 23.) Mr. Phillips' proposed cost-of-service study would increase delivery rates for Residential Heat and Residential Domestic customers by 11.81% and 36.18%, respectively. The rates of Petitioner's Large Volume customer class then would be decreased by 6.21%. (CIG Ex. NP-1 at 1).

Mr. Phillips supported reducing all elements of the current D5 rate by 23.87% in order to implement the results of his cost-of-service study. (CIG Ex. NP at 24.) Mr. Phillips stated that if his proposal of "utilizing only transmission pipes to serve transmission level customers is not implemented, a minimum system technique to determine customer component must be used." (Id.)

Other major Indiana gas utilities do not have a Demand Charge and Petitioner's Demand Charge is simply intended to provide a mechanism to receive revenues from customers, even if their usage declined. (Id.) According to Mr. Phillips, "a customer served by the transmission system should not pay a demand charge based on the fixed cost of distribution mains not required or used to serve that customer." (CIG Ex. NP at 25.)

In his rebuttal testimony, Petitioner's witness Jones responded to the testimony of OUCC witness Galligan and CIG witness Phillips. Mr. Jones testified Citizens Gas' cost-of-service study did not misallocate its distribution main plant investment. (Pet. Ex. CAJ-R at 2.) Rather, Mr. Jones contended Petitioner's cost-of-service study provided a much more neutral and equitable allocation of class cost responsibilities than proposed by either Mr. Galligan or Mr. Phillips. (Id.)

Mr. Jones, however, agreed with Mr. Galligan that all distribution main costs should not be passed along to customers based on a single peak day of the year. (Pet. Ex. CAJ-R at 5.) In Mr. Jones' opinion, combining a cost-of-service analysis with rate design eliminates that concern. (Id.)

Mr. Jones then responded to the criticisms raised by CIG witness Phillips. Mr. Jones indicated that Petitioner's proposed cost-of-service study was not "fraught with problems" and is "suitable for ratemaking." (Pet. Ex. CAJ-R at 12.) According to Mr. Jones, CIG witness Phillips failed to recognize that the Large Volume class has increased disproportionately to the rest of Citizens' system, which is one cause of the cost allocation change since Petitioner's last rate case. (Id.)

Mr. Jones indicated the most significant problem with CIG's proposed cost-of-service study was that it inappropriately removed distribution main related costs from allocations to the Large Volume class. (Pet. Ex. CAJ-R at 13.) During the test year, there were 77 customers in the Large Volume class—only four of which were directly served from the transmission mains. (Id.) Moreover, only one of the four CIG members was served solely from the transmission mains and not connected to the distribution system. Therefore, it would not be appropriate to remove distribution main related costs from allocation to the Large Volume class. (Id.)

Mr. Jones further disagreed with Mr. Phillips' contention that certain Large Volume customers should not be allocated costs associated with Citizens Gas' underground storage and LNG facilities related to banking service. (Pet. Ex. CAJ-R at 16.) Mr. Jones noted that just nine of the 77 Large Volume customers were using Basic Delivery Service, and six of those customers have the ability to "opt-out" of banking service. (Id.) Mr. Jones indicated customers that "opt-out" of banking already are compensated for doing so through an "8-cent credit on each Dekatherm of throughput during the year." (Pet. Ex. CAJ-R at 16.) The 8-cent credit amounted to over \$350,000 of cost during the test year, which Citizens Gas did not recover through rates. (Id.) Mr. Jones said Mr. Phillips was not proposing to eliminate the 8-cent credit, but simply recommended Petitioner exclude banking costs from the rates charged to customers that have "opted-out" of banking. (Pet. Ex. CAJ-R at 17.)

Mr. Jones concluded that Mr. Phillips strayed from sound cost-of-service theory by proposing to not allocate any distribution main costs to the Large Volume class, even though Large Volume customers use distribution main. (Pet. Ex. CAJ-R at 31-32.) "Additionally, [Mr. Phillips'] choice to ignore the way 'transportation' customers use storage resources is inappropriate." (Id.) Large Volume customers use distribution main and storage resources. (Id.) Accordingly, Mr. Jones stated Large Volume customers should be responsible for their allocated portion of those costs. (Id.)

Mr. Jones further indicated he was surprised by Mr. Phillips' objection to the Demand charge. (Pet. Ex. CAJ-R at 33.) The Demand charge has been in place since the Large Volume rate was put in place nearly 15 years ago. (Id.)

OUCG witness Galligan offered cross-answering testimony responding to CIG witness Phillips' proposed cost-of-service study and rate design. Mr. Galligan criticized Mr. Phillips' decision to allocate just transmission costs to the entire Large Volume class. (Pub. Ex. 6-C at 2.)

Mr. Galligan stated that anyone advocating excluding certain customer classes from an allocation of distribution lines, but not from transmission lines, should perform a functional analysis of the pipeline facilities. (Pub. Ex. 6-C at 3.) Mr. Phillips did not perform a functional analysis of Citizens Gas facilities; instead he simply accepted Citizens Gas' plant booked as transmission and distribution plant in accordance with Department of Transportation ("DOT") classification. (Pub. Ex. 6-C at 4.) This classification is not based on a functional analysis of Petitioner's pipeline facilities. (Pub. Ex. 6-C at 3.) Mr. Galligan testified "[f]or purposes of cost allocation leading to setting rates, it is not reasonable to rely on accounting cost categorizations without first determining the functional use of the facilities." (Pub. Ex. 8 at 5.)

CIG witness Phillips offered cross-answering testimony criticizing OUCG witness Galligan's proposed cost-of-service study. Mr. Phillips asserted, in general, the OUCG's cost-of-service study has all of the same "problems" as Petitioner's cost-of-service study and, in addition, "contains a completely erroneous proposal with respect to the allocation of 80% of distribution main costs on a volumetric basis." (CIG Ex. NP-C at 4.)

b. Discussion and Findings.

i. Cost Allocation. The parties have presented this Commission with three interclass cost-of-service studies for possible use in determining the appropriate proportion of Petitioner's total authorized revenue requirement to be assigned to each of its customer classes. Of necessity, each of the parties' proposed cost-of-service studies allocated Petitioner's original request for a rate increase among the respective customer classes. If the Commission were to accept Citizens' initial request for a \$39 million rate increase, the differing results of each cost-of-service study on Petitioner's customer classes would have been the following percentage increases:

	<u>Res. Heat</u>	<u>Res. Dom.</u>	<u>Gen. Heat</u>	<u>Gen. Non-Heat</u>	<u>LV</u>	<u>CNG</u>	<u>NMGL</u>
Petitioner	9.99%	18.96% ²	6.55%	4.45%	28.57%	80.04%	33.94%

² Petitioner's proposed rate increase to the Residential Domestic Class is reduced from that which its cost-of-service study indicated to be appropriate, which was approximately 35%. See, Section 8.b.ii, *infra*.

OUC	9.0%	20%	5.9%	9.7%	44.1%	86.5%	33.9%
CIG	11.81%	36.18%	8.08%	4.37%	-6.21%	112.25%	33.11%

After weighing the evidence of record, it remains for this Commission to determine in an objective and reasonable manner which cost-of-service study best reflects the actual incurrence of costs, or cost causation, on Petitioner's system. As this Commission stated in Petitioner's last rate case:

Although this Commission is not statutorily mandated to base rate design solely upon cost-of-service studies, we have been consistently espousing the position that utility rates should be designed to the maximum extent practicable to reflect the cost of providing service, while avoiding abrupt changes in rate structures and undue hardship.

In re Citizens Gas & Coke Utility, IURC Cause No. 39066, at 31 (Nov. 1, 1991) (citations omitted). We have steadfastly adhered to the principle that utility rates should be designed "to the maximum extent practicable to reflect the cost of providing service." *Id.* (citations omitted).

Based upon the record evidence, this Commission concludes that the OUC's cost-of-service study is most reflective of cost causation and possesses a high degree of objectivity upon which the Commission may place reliance in establishing the rates and charges in this proceeding.

As the OUC's witness Galligan testified, "the lion's share of Citizens' plant, accounting for two-thirds of its plant, is comprised of Distribution Mains and Services investment." (Public's Ex. No. 6 at 3.) He also testified that "[t]he allocation of fixed or capacity related costs is the most controversial aspect of performing an allocated cost of service study." (Public's Ex. No. 6 at 5.) Not surprisingly, therefore, the primary disagreement among the parties' cost of service studies is the proper allocation of distribution main costs.

Citizens conducted a cost-of-service study at proposed rates that allocated 100% of distribution main costs based on "peak day" consumption and 0% of these costs based on average annual consumption. CIG submitted an alternative cost-of-service study designed to correct what it believed to be an overstatement of costs assigned to the Large Volume customer class as a result of Petitioner's allocating costs associated with distribution main and certain storage facilities to that class. The OUC presented a cost-of-service study taking a middle-of-the-road approach by allocating some distribution main costs on a peak day basis (20%) and the remaining distribution main costs on a volumetric basis (80%).

Citizens' witness Jones attempted to justify allocating 100% of distribution main costs based on peak day usage by stating that peak day demand is "the driver of how much Distribution Main is installed." (Pet. Ex. CAJ-R at 5.) However, we are not

persuaded that all of these costs should be allocated solely based on customers' consumption on a single day in a 10 or 15 year period. (Public's Ex. No. 6 at 6.)

While we do not doubt that distribution mains must be constructed with peak demand in mind, distribution mains do not only serve customers on peak demand days. Therefore, a measure of the costs of distribution mains must be allocated to customers based on their usage that takes place on non-peak days. For example, a customer that does not take service at all on the peak demand day—and therefore contributes nothing to peak demand requirements of distribution mains—but receives service through distribution mains at other times should be responsible for some portion of distribution main costs.

An example of the inequity of Citizens' cost allocation can be found, ironically, in Mr. Jones' Rebuttal Testimony intended to support Citizens' allocation of distribution main costs. He cited a hypothetical example of a class of customers who use gas to heat their swimming pools in the summer but have no other connected load. (Pet. Ex. CAJ-R at 3.) Typically, the peak demand day on which Citizens proposes allocating 100% of distribution main costs would be a winter day. (Tr. at Q-55.) Consequently, a class of customer that only takes service during the summer would have zero contribution to peak day demand. Under Citizens' proposal, these customers would be allocated 0% of the distribution main costs, even if these customers receive service through distribution mains for six months of the year.

This result is inequitable and clearly inconsistent with how Citizens' costs are actually caused. The OUCC's approach is much more equitable and realistic. Rather than allocating distribution main costs exclusively based on either peak demand day or average annual consumption, the OUCC used a compromise approach that allocated these costs based on both. Under the OUCC's cost of service study, 80% of distribution main costs are allocated based on average demand. (Public's Ex. No. 6 at 13.) In this way, the OUCC's approach allocates part of distribution main costs to customers who receive service through distribution mains throughout the year but who may not receive much or any service on the peak demand day.

We reject Mr. Phillips' cost of service study for the same reason. Allocation of distribution mains based solely on peak day demand may be advantageous to some industrial customers, but is still an undue burden on other rate classes.

For the reasons set forth above, we find the OUCC's cost of service study most accurately reflects the manner in which distribution main costs are actually incurred. *See, In Re Citizens Gas & Coke Utility*, IURC Cause No. 39066, at 31 (Nov. 1, 1999). We therefore adopt the OUCC's cost of service study to implement the rates increase approved in this Cause.

ii. Revenue Distribution. As we noted above, by necessity, all three cost of service studies submitted in this case generated percentage rate increases based on Citizens' initial requested revenue increase of \$39 million. As OUCC's witness Galligan testified, "This is not an endorsement of Citizens requested revenue increase; rather, it is a convenience which allows an apples-on-apples revenue spread comparison for the trier of fact." (Public's Ex. No. 6 at 16-17.) Therefore, as Mr. Galligan explained, "If the

Commission authorizes less revenue than Citizens has requested, each class' responsibility for the additional revenues should be scaled back in proportion to the OUCC's proposed rate spread[.]” (Id. at 17.)

In other words, the OUCC did not endorse, for example, a 20.0% increase for Residential Non-Heat customers and a 44.1% increase for Large Volume customers. Rather, the OUCC proposed that whatever increase *is* approved should be applied in a manner consistent with the cost distribution in Mr. Galligan's study.

As stated above, in this order we are adopting the OUCC's cost of service study for implementation of the rate increase approved herein. However, we are not approving the full amount (\$39 million) that Citizens originally requested in this case. Consequently, we are not adopting the actual percentage rate increases in the table in the preceding section in the row labeled "OUCC." Rather, we find that the rate increase approved in this order should be implemented by class consistent with the relative "rate spread" proposed by the OUCC. (See, Public's Ex. No. 6 at 16-17.)

iii. Rate Design. Having established the total annual revenue requirement Petitioner should be authorized to recover in its rates and charges for service and the appropriate revenue requirements by customer class, the remaining issue to be resolved by the Commission is the structure and design of the rates by which the Petitioner is to recover the authorized class revenue responsibility.

A. Residential Heating and Residential Domestic Facility Charges. Citizens proposed increasing its Facilities Charges, which are the flat monthly fees Citizens charges its customers just for being a Citizens customer. Citizens' witness Jones recommended increasing the Facility Charge for Residential Heating customers from \$10.00 to \$13.50 and for Residential Domestic Customers from \$6.65 to \$10.00. OUCC witness Galligan recommended that Citizens' current monthly Facility Charges remain the same. Mr. Galligan testified that Citizens' facility charges already exceeded "avoided costs," i.e., those costs Citizens would shed if a given customer left Citizens' system. (Public's Ex. No. 6 at 18.) There was no dispute among the parties that Citizens current facilities charges already exceed Citizens' avoided costs for the customers to which they apply.

The obvious logic of the OUCC's argument is undeniable: the charges a customer pays for *simply being a customer* should reflect the costs Citizens bears for that person *simply being a customer*. We therefore agree with the OUCC that Citizens' current facilities charges—which already exceed Citizens' avoided costs—should remain unchanged.

B. Increased Residential Heating Tailblock Discount. Currently, Citizens offers a volume or "tailblock" discount for Residential Heating customers that consume over 46 therms per month. Citizens Gas proposed to increase the size of this discount for the Residential Heating class from 6.36¢ per therm to 9.62¢ per therm, thereby placing a larger share of any rate increase on lower-volume customers. Citizens Gas' current and proposed Delivery Charges are:

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg PA 17105-3265

Public Meeting held September 12, 2002

Commissioners Present:

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

RECEIVED

SEP 12 2002

OFFICE OF
CONSUMER ADVOCATE

Application Of Equitable Gas Company For
Approval Of Natural Gas Choice And
Competition Act Restructuring Filing

Docket No. R-00994784

ORDER

BY THE COMMISSION:

Before the Commission is the Petition for Clarification of the Office of Small Business Advocate (OSBA) filed on August 1, 2002. A timely Answer was filed by the Equitable Gas Company, a division of Equitable Resources, Inc. (Equitable).

Background

By order entered on July 18, 2002 at Docket No. R-00994784, the Commission granted, in part, the Petition of Equitable Gas Company For Amendment Of That Part Of The Restructuring Order Of The Pennsylvania Public Utility Commission Concerning Universal Service, Arrearage Forgiveness, and Cost Recovery.¹ In pertinent part, we

¹ The Commission's Office of Trial Staff, the Office of Consumer Advocate, and the Office of Small Business Advocate all participated in the proceeding, filing responses to Equitable's petition.

directed Equitable to implement its Delinquency Reduction Opportunity Plan (DROP)² for Energy Assistance Program (EAP) participants and other low-income residential customers.

However, in this same order, we declined to include small business customers within the DROP.³ Accordingly, we directed that small business customers shall not pay the \$.0579 portion of the transition cost surcharge that will be used to fund the DROP. With respect to the \$.17 component of the transition cost surcharge previously allocated to small business customers as per the Restructuring Settlement Agreement, which was to fund, *inter alia*, Equitable's universal service and energy conservation costs, we directed that the issue be addressed in Equitable's next general rate case.

On August 2, 2002, OSBA filed a Petition for Clarification, pursuant to 52 Pa. Code §5.572 (Petitions for relief following a final decision). OSBA seeks clarification of language in the Commission's July 18th order, which OSBA alleges does not accurately state the purpose of Equitable's transition cost surcharge. According to OSBA, universal service costs were not listed as a category for recovery of the transition cost surcharge. OSBA submits that the sentences in the footnote of page 2 and on page 15 of the Commission's July 18th order should be corrected to remove statements asserting that universal service and arrearage forgiveness costs are currently being paid by business

² The DROP seeks to reduce delinquencies, i.e. balances 90 days in arrears, for EAP participants and other low-income residential customers as the program would retire the average customer's delinquency in under four years. The program will allow EAP and other low-income customers to make payments exceeding their current bill amount and receive matching credits from Equitable in return. Equitable sought to create a \$24 million program, which included \$5 million previously approved by the Commission in the Restructuring Settlement.

³ Equitable's petition included approximately \$1.3 million in delinquencies for small business tariff customers.

customers in the \$.17 portion of Equitable's transition cost surcharge. OSBA also requests that ordering paragraph No. 5 be deleted if these corrections are made.

In its Answer filed to the petition, Equitable asserts that clarification is not warranted. First, Equitable emphasizes that the Commission's July 18th order expressly removes commercial and industrial customers both from participation in the DROP program and the responsibility for its costs. Thus, OSBA opposition to the program has been satisfied. Equitable adds that the request for clarification is not warranted because the request is based upon assertions, which are inconsistent with the settlement in Equitable's restructuring proceeding and the Commission's order approving the same.

Discussion

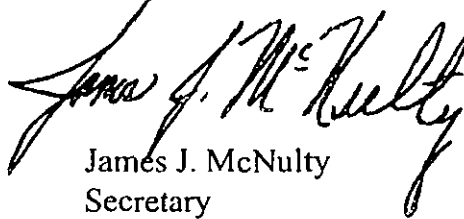
We hereby deny the Petition for Clarification of the Office of Small Business Advocate. Because it appears that at least some portion of the transition cost surcharge was allotted to fund Equitable's universal service and energy conservation programs, we believe that OSBA's requests to correct certain 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 portion of the transition cost surcharge that will be used to fund DROP program costs; **THEREFORE,**

IT IS ORDERED THAT:

1. The Petition for Clarification of the Office of Small Business Advocate is denied.

BY THE COMMISSION

A handwritten signature in black ink, appearing to read "James J. McNulty". The signature is written in a cursive style with a large, sweeping initial "J".

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: September 12, 2002

ORDER ENTERED: **SEP 12 2002**

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

Dated this 12th day of June 2007.

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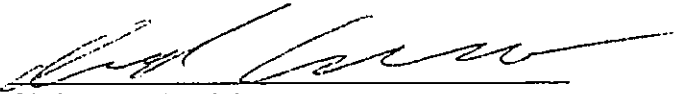
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June 12, 2007

VIA HAND DELIVERY

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

DOCUMENT
FOLDER

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

Dear Secretary McNulty:

Enclosed please find the original and nine (9) copies of the Main Brief on behalf of the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") in the above-referenced proceeding.

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

Very truly yours,

McNEES WALLACE & NURICK LLC

By 

Charis Mincavage
Barry A. Naum

Counsel to the Philadelphia Industrial and
Commercial Gas Users Group

BAN/cas
Enclosures

c: Administrative Law Judge Cynthia Fordham (via e-mail and Federal Express)
Administrative Law Judge Angela Jones (via e-mail and Federal Express)
Certificate of Service

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SECRETARY'S BUREAU

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY
COMMISSION

v.

PHILADELPHIA GAS WORKS

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DOCKET NO. R-00061931

DOCUMENT
FOLDER

MAIN BRIEF OF
THE PHILADELPHIA INDUSTRIAL AND COMMERCIAL
GAS USERS GROUP

Building Owners' and Managers'
Association of Philadelphia
Philadelphia College of Osteopathic Medicine
Temple University
Thomas Jefferson University/Jefferson Health System

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Dated: June 12, 2007

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Appendix A:

Pennsylvania Public Utility Commission v. PGW, Docket No. M-00021612, Opinion and Order (March 31, 2003)

I. INTRODUCTION

On December 22, 2006, Philadelphia Gas Works ("PGW" or "Company") filed with the Pennsylvania Public Utility Commission ("PUC" or "Commission") Supplement No. 16 to Tariff Gas – Pa. P.U.C. No. 2, requesting approval of proposed changes in rates designed to produce approximately \$110 million in additional annual revenues, to be effective on February 20, 2007.

On February 5, 2007, the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") filed a Complaint in this proceeding. PICGUG is an ad hoc association of energy-intensive industrial and commercial customers receiving service from PGW under various rate schedules. PICGUG members use substantial volumes of natural gas in their businesses, and natural gas costs comprise a significant element of their respective costs of operation. Because any modification to PGW's rates and services would impact PICGUG member businesses, PICGUG is an active party to this proceeding. The membership of PICGUG is listed on the cover page of this Main Brief.

On March 15, 2007, Administrative Law Judges ("ALJs") Cynthia Williams Fordham and Angela T. Jones convened a Prehearing Conference, in which the procedural schedule for this proceeding was developed. Pursuant to the procedural schedule, PICGUG submitted Direct Testimony in this proceeding on April 6, 2007, and received Direct Testimony from the Office of Consumer Advocate ("OCA"); Office of Trial Staff ("OTS"); Office of Small Business Advocate ("OSBA"); Action Alliance of Senior Citizens of Greater Philadelphia and Tenant Union Representative Network (collectively, "AA"); the Archdiocese of Philadelphia ("Archdiocese"); School District of Philadelphia ("SDP"); Interstate Gas Supply, Inc. ("IGS"); Hess Corporation ("Hess"); and Philadelphia Housing Authority ("PHA").

On May 4, 2007, PICGUG received the Rebuttal Testimony of PGW, OCA, and OSBA. On May 15, 2007, PICGUG submitted Surrebuttal Testimony and received Surrebuttal Testimony from the OCA, OTS, OSBA, Hess, and PHA. Evidentiary hearings were held on May 21-24, 2007, in Philadelphia, for the purpose of cross-examining witnesses and submitting testimony into the record.

Pursuant to 52 Pa. Code Sections 5.501 and 5.502 and the established procedural schedule, PICGUG files this Main Brief in order to address certain issues raised in this proceeding. As discussed more fully herein: (1) PGW's Interruptible Transportation ("IT") rates must be modified to provide cost-based transportation rates for interruptible customers; (2) any modification to the firm sales rates must ensure that all customer classes are moving closer to their cost to serve; and (3) PGW's application of the Universal Service and Energy Conservation ("USC") surcharge to non-residential customers must be phased-out, as only residential customers benefit from these programs.

II. SUMMARY OF ARGUMENT

During PGW's Restructuring Proceeding, pursuant to the Natural Gas Choice and Competition Act ("Competition Act"), the PUC indicated that several issues raised in that proceeding should be revisited as part of PGW's next base rate proceeding. See Pennsylvania Public Utility Commission v. PGW, Docket No. M-00021612, Opinion and Order (March 31, 2003) (hereinafter, "Restructuring Order").¹ The current proceeding is the first base rate filing by the Company since the Restructuring Proceeding. Accordingly, this proceeding provides the Commission with appropriate and ample opportunity to revisit PGW's current rate allocation methodology and to determine whether the proposed allocation is fair, just, and reasonable.

Specifically, PGW proposes to retain its current margin-based IT rate structure, contrary to established rules, regulations, and precedent of both the PUC and Commonwealth Court.² See Sections IV.A.1. and IV.A.2., infra. The Company's margin-based IT rates are also unduly discriminatory to the extent that they result in the subsidization of other customer classes, deprive IT customers of meaningful competitive rates, and move the IT rate class further from the Company's cost to serve. See Section IV.A.2., infra. While the Company asserts that the problems inherent in this margin-based rate design can be overcome via PGW's ability to negotiate a customer's rate below the maximum level, PGW's course of dealing with potential IT customers clearly indicates that such "negotiations" are insufficient to remedy the unjust, unreasonable, and inappropriately discriminatory nature of these transportation rates. See

¹ For ease and convenience, PICGUG has attached a copy of the Restructuring Order to this Main Brief as "Appendix A."

² PGW maintains a Rate Schedule – Interruptible Transportation (i.e., Rate IT). Within that schedule, however, are eight separate levels of service, with each level maintaining a distinct maximum, margin-based rate for the distribution charge. The Company determines the level of a customer's service at PGW's sole discretion. See PGW Gas Tariff – Pa. PUC No. 2, Original Page Nos. 111-17.

Section IV.A.3., infra. Regardless of the justifications offered by the Company for its proposed base rate increase and continuance of these margin-based rates, the record demonstrates that PGW must immediately move to a cost of service ratemaking approach for IT rates. See Section IV.A.4., infra.

Similarly, as part of its requested rate increase, PGW proposes a rate allocation for firm sales customers that would be unjust, unreasonable, and inappropriately discriminatory with respect to large commercial and industrial customers receiving service under these rate schedules. Currently, PGW's non-residential firm sales customers are providing rates of return that are significantly above the system average; however, as part of PGW's proposed rate increase, the Company suggests assigning these customers an increase above the system average, thereby moving these classes further away from their cost to serve. Because this proposal does not reflect the principle of rate gradualism, much less make any progress towards cost-of-service rates, PGW's request must be rejected. See Section IV.B., infra.

Finally, PGW remains one of the few Natural Gas Distribution Companies ("NGDCs") allocating the costs of low-income programs to non-residential customers. Although the Commission has recently cemented a firm policy indicating that USC costs should be allocated to only residential customers, as only these customers benefit from such programs, PGW's filing in this proceeding makes no movement towards implementing such policy. In order to address this problem, the Commission should adopt the OSBA's proposal to phase-out the application of PGW's USC costs to non-residential firm sales customers over the next three years beginning with PGW's 2008 Gas Cost Rate ("GCR") proceeding.³ See Section IV.C., infra.

³ Appropriately, PGW does not assign USC costs to non-residential interruptible customers. See Direct Testimony of Robert Knecht, OSBA Statement No. 1 (hereinafter, "OSBA St. 1"), p. 28.

III. STATEMENT OF THE QUESTIONS PRESENTED

Q. Should PGW be required to implement cost-based interruptible transportation rates, as required by the Commission's rules and regulations, as well as Commonwealth Court precedent?

Suggested Answer: Yes

Q. Should PGW be required to apply any resulting rate increase in a manner that ensures all firm sales customers are moved closer to their cost to serve?

Suggested Answer: Yes

Q. Should PGW be required to phase-out the application of USC costs to non-residential firm sales customers over the next three years, because, as indicated by PUC policy, these customers do not benefit from these programs?

Suggested Answer: Yes

IV. RATE STRUCTURE

A. **COST OF SERVICE: PGW's Margin-Based Rates Must Be Rejected as Unjust, Unreasonable, and Unduly Discriminatory.**

In 2002, pursuant to the requirements of the Competition Act, PGW submitted its Restructuring Filing with the PUC. As part of this proceeding, the Company proposed to implement IT rates based upon the unbundling of the gas cost and the margin elements from the Interruptible Sales Service ("ISS") customer classes. See Restructuring Order, pp. 28-29. A simple margin was calculated using the realized margin for each of the ISS classes over the last three years. According to PGW, the resulting transportation rate assured the Company that, if all ISS customers switched to transportation service, PGW would realize the same level of margin that it had previously received from the ISS class. Id.

As a party to that proceeding, PICGUG argued that PGW's proposed unbundled IT rates were not cost-based, contrary to previous Commission precedent. Id. at 29. Upon review, the assigned ALJ agreed with PICGUG, finding that the proposed margin-based IT rates were flawed, in contravention of Commission policy, and resulted in discrimination among the rate classes. Id. at 30. As a result, the ALJ recommended that the Company's proposed IT rates be rejected. Upon review of the record, however, the PUC concluded that this issue should be addressed in PGW's next base rate proceeding rather than as a part of the Company's Restructuring Proceeding. Id. at 31. To that end, the PUC directed PGW to develop cost-based IT rates for the PUC's consideration as part of PGW's next base rate proceeding. Id.

As part of the next base rate proceeding (i.e., the instant proceeding), PGW submitted a Cost of Service Study ("COSS") but declined to submit cost-based IT rates. In fact, PGW did not propose any changes to the IT maximum, margin-based rates, suggesting that any change in this rate structure would be inappropriate in light of PGW's significant rate increase request. See

Direct Testimony of Craig White, PGW Statement No. 5 (hereinafter, "PGW St. 5"), pp. 7-8. According to PGW, these rates "provide an economic advantage to the IT customer to use natural gas (as opposed to oil or other alternative fuels), while maximizing the margin produced from this service, and thus, the contribution to the benefit of the firm customers." Rebuttal Testimony of Craig White, PGW Statement No. 5-R (hereinafter, "PGW St. 5-R"), p. 3. Moreover, PGW suggests that, because the Company has the ability to negotiate a customer's IT rate below the maximum cap, any concerns regarding these margin-based rates should be dismissed. PGW St. 5, p. 8.

In other words, PGW seeks to maintain margin-based IT rates in order to ensure that the Company is able to obtain as much revenue as possible from transportation customers regardless of whether these rates provide a just basis under which customers can obtain reasonable transportation service. Unfortunately, PGW fails to recognize that both PUC regulations and Commonwealth Court precedent have held that the Company's desire for increased revenue should not be the basis upon which transportation rates are established. Rather, the Commission and the Commonwealth Court have indicated a need for NGDCs to unbundle their rates and move customers towards the appropriate cost of service.

Because PGW's proposal in this proceeding fails to indicate any movement whatsoever in terms of moving IT customers toward their cost to serve, the Company's request to maintain the current margin-based IT rates must be rejected. Instead, this Commission must undertake immediate action that would develop and implement cost-based IT rates in order to provide just and reasonable rates for these customers.

1. PGW's Margin-Based Interruptible Transportation Rates Must Be Rejected as Contrary to the Commonwealth Court's Recent Precedent Indicating that Cost-Based Rates Are the Polestar to Be Achieved When Setting Rates.

The Commonwealth Court of Pennsylvania ("Commonwealth Court") has previously held that for unbundled rates in a competitive supply market, the cost to serve is the polestar that must be achieved. See Lloyd v. Pennsylvania Public Utility Commission, 904 A.2d 1010, 1020 (2006). As part of this proceeding, however, PGW has made no advancement whatsoever with respect to this achievement, instead seeking to maintain customers at current margin-based rates, regardless of the effects upon these customers' rates. Because PGW's margin-based IT rates fail to meet the cost-to-serve standard required by the Commonwealth Court, the PUC must require PGW to revise these rates to move them to the cost to serve.

The PUC indicated that the issue of PGW's IT rates should be addressed in PGW's next base rate proceeding and directed PGW to "develop cost based IT rates for our consideration in its next base rate filing." Restructuring Order, p. 31. Rather than complying with this mandate, however, PGW's filing in the instant proceeding indicates that the Company believes the current maximum margin-based rates are appropriate, and, therefore, PGW does not propose any modifications. PGW St. 5, pp. 7-8.

When pressed further on this issue, PGW provided the following justification for its decision to refuse to consider moving towards, much less fully implementing, cost-based rates.

The result [of implementing cost-based IT rates], just as it was during the restructuring proceeding when a move to cost-based rates was rejected, would be a significant negative impact on the rates of PGW's remaining firm customers. As is evident from the Cost of Service Study ("COSS"), PGW's maximum IT rates result in a positive margin. The margin makes a contribution to the Company's cost of service that benefits the firm customers. Without the revenue realized from PGW's IT customers, the Company would be forced to recover those revenues from its

remaining firm customers. Eliminating that margin in one fell swoop in this proceeding would clearly violate the approved theory of gradualism.

PGW St. 5-R, p. 9. PGW considers the benefit to the Company resulting from the margin provided by IT customers to be much more significant than any concern that IT rates are not even incrementally based upon the customers' cost to serve.⁴ While these positions provide PGW's justifications for its unwillingness to move towards cost-based IT rates, these reasons do not withstand Commonwealth Court scrutiny.⁵

Recently, the Commonwealth Court examined a request by an Electric Distribution Company ("EDC"), in which the EDC sought an increase in its distribution and transmission rates. Lloyd, 904 A.2d at 1010. In establishing the parameters for this increase, however, the EDC set a goal of limiting the rate increase for all classes of customers to below 10% of the total bill. Id. at 1015. Due to the limitations of this proposal, there were substantial differentials in the rate structure between rate classes for both distribution and transmission service; however, the PUC approved these differentials as reasonable and justified based on the principles of gradualism and mitigation of rate shock. Id. at 1018.

In reviewing this decision, the Commonwealth Court found that rates and rate structures, especially after an unbundling due to implementation of competition, must be set for each service primarily on a COSS. Id. at 1020. According to the Commonwealth Court, 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

⁴ Currently, PGW's revenue margin for IT rates exceeds costs by nearly \$2.1 million. PGW St. 5, p. 7.

⁵ Interestingly, PGW notes that eliminating the margin "in one fell swoop" would be problematic under terms of gradualism; however, the Company never provided any proposal in this proceeding that would begin the process of gradualism in terms of the moving IT rates towards a cost-to-serve basis. PGW St. 5-R, p. 9.

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." Id. As a result, the cost of providing service to customers is to be the "polestar" in examining and setting rates. Id.; see also OSBA St. 1, p. 15 (citing Lloyd as holding that cost-of-service is the "polestar" consideration for ratemaking in Pennsylvania).

PGW's unwillingness to set IT rates on a cost-basis, mainly to ensure the Company continues to receive the resulting marginal revenues, directly contravenes the requirements of the Commonwealth Court. By maintaining margin-based IT rates, without any movement whatsoever towards the cost-to-serve, PGW is effectively allowing IT customers to subsidize all other classes for an unlimited period of time.

In order to ensure that the mandates of the Commonwealth Court are followed, the PUC must require PGW to implement cost-based rates for IT customers. Only by undertaking such action can the PUC ensure that the "polestar" of ratemaking (i.e., cost to serve) is adequately and accurately accounted for with respect to this class of customers. Without such action by the PUC, this customer class will be forced to continue an unjust, unreasonable, and discriminatory subsidization of the other customer classes contrary to the mandates of the Commonwealth Court. For these reasons, PGW's margin-based IT rates must be rejected by the PUC, and PGW must be required to implement cost-based IT rates.

2. *PGW's Margin-Based Rates Must Be Rejected as Unjust, Unreasonable, and Inappropriately Discriminatory Under the Commission's Rules, Regulations, and Previous Precedent.*

In addition to violating the requirements of the Commonwealth Court by failing to adhere to the polestar of cost of service ratemaking, PGW's unwillingness to modify its margin-based IT rates also violates the requirements of the Commission's rules and regulations. In order to ensure

that PGW implements just, reasonable, and non-discriminatory rates for interruptible transportation customers, the PUC must modify PGW's IT rates to account for the cost to serve.

Initially, the Public Utility Code provides specific parameters in terms of setting rates for customers by indicating that "[e]very rate made, demanded, or received by any public utility...shall be just and reasonable, and in conformity with regulations or orders of the commission." 66 Pa. C.S. § 1301. In addition, Section 1304 provides the following:

No public utility shall, as to rates, make or grant any unreasonable preference or advantage to any person, corporation, or municipal corporation, or subject any person, corporation, or municipal corporation to any unreasonable prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates, either as between localities or as between class of service.

Id. at § 1304. Accordingly, any rate set by the PUC for an NGDC's transportation service must be just, reasonable, and non-discriminatory.

With respect to the justness and reasonableness of "margin-based" versus "cost-based" rates, the PUC has reviewed this issue as a result of unbundling on other NGDCs' systems in the mid-1980s. Specifically, the simple margin rate method is what was utilized by NGDCs when commercial and industrial customers began transporting almost two decades ago. Since that time, the PUC has moved the majority of NGDCs to cost-based rates to ensure customers an adequate opportunity to access the competitive natural gas market.

For example, in 1988, the Commission addressed transportation rates of The Peoples Natural Gas Company ("Peoples"). See Pennsylvania Public Utility Commission v. Peoples Natural Gas Company, 66 Pa. P.U.C. 281 (Feb. 16, 1988). According to the Commission, that proceeding revealed the "difficult natural of establishing just and reasonable transportation rates that will satisfy the utility, producer and the end-user," considering that the PUC's transportation

regulations were promulgated "to establish transportation as a viable alternative to natural gas sales service provided by the utility." Id. at 283. Moreover, "transportation service was intended to be a tool employed by the utility in competing in a highly competitive energy marketplace. Consequently, the transportation regulations were designed with the concern that transportation rates meet competition." Id.

With this goal in mind, the PUC reviewed proposed modifications to Peoples' transportation rates, which sought to have Peoples' cost of service rates established as the maximum transportation rates, as opposed to the previously utilized simple margin maximum rates. Id. at 287. The Commission determined that this proposal was acceptable since Peoples' simple margin rates were too high, while "the use of cost of service maximum rates in this case will promote transportation" Id. In other words, the PUC found that in order to provide customers with an opportunity to access the competitive natural gas marketplace, simple margin rates had to be rejected for cost-based rates, as these rates ensured just, reasonable, and non-discriminatory transportation service for customers.

The previous Commission analysis of Peoples' transportation rates is indicative of further revelation by the PUC regarding the necessity of cost-based transportation rates. In 1996, the Commission modified existing natural gas transportation regulations. See Re Gas Transportation Tariffs, 171 PUR 4th 496 (Aug. 28, 1996). These modifications stemmed, in part, from the changing dynamics of the natural gas marketplace and the fact that "[t]ransportation service has grown to become an important part of the overall natural gas industry." Id. at 503. Specifically, the Commission determined the following regarding transportation service.

Transportation service has certainly caused major changes in [Local Distribution Company ("LDC")] operations, but it has also yielded major benefits to both utilities and customers by reducing gas costs and spurring economic development within the

Commonwealth. Without the availability of transportation service, it is certainly possible that LDCs would be in a worse position than they are, having lost a substantial portion of their customer base to alternate fuel or bypass. We similarly believe today that providing customers with economically rational choices provides net benefits to the Commonwealth's economy.

Id. at 517. In other words, any changes that NGDCs had to undergo as a result of transportation service were offset by the resulting significant benefits to the NGDCs, the customers, and the Commonwealth.

With respect to such regulations, the PUC implemented rules, which are still in effect today, addressing the setting of transportation rates as follows:

A...natural gas utility shall maintain a gas transportation program that adheres to the following terms and promotes the following objectives when providing natural gas transportation service:

(6) Transportation service shall be provided under a contract between the jurisdictional natural gas utility and the customer...The rates set shall recover, to the maximum extent possible, the fixed costs associated with the service.

52 Pa. Code. § 60.2(6). Thus, the PUC's goal in setting any transportation rate is to recover only the fixed costs associated with the service, as compared to also providing the NGDC with an accompanying margin.

In this instance, PGW's margin-based IT rates are unjust, unreasonable, and inappropriately discriminatory. Rather than moving towards cost-based rates that will ensure the ability of customers to compete on the Company's system, as intended by the Competition Act, PGW's margin-based rates extensively limit the options of customers who are unable to obtain a reasonable transportation rate. Direct Testimony of Lewis C. Cohen, PICGUG Statement No. 1 (hereinafter, "PICGUG St. 1"), pp. 6-7.

For example, the most favorable margin-based IT rate that the Philadelphia College of Osteopathic Medicine ("PCOM") could recently secure from PGW was approximately 350% higher than the equivalent rate available in the PECO Energy Company ("PECO") service territory, which is located across the street from PCOM's facility. See Surrebuttal Testimony of Lewis C. Cohen, PICGUG Statement No. 1-S (hereinafter, "PICGUG St. 1-S"), p. 4. Not surprisingly, PECO maintains cost-based transportation rates, which are more directly in line with the intent of the Commission in terms of developing a competitive natural gas market.

The obvious intent of the PUC, through its rules, regulations, and the terms of the Competition Act, is to provide a competitive natural gas market for customers. In order to access this market, however, the Commission has recognized the imperative need for cost-based transportation rates. Unfortunately, PGW has been unwilling to adhere to the requirements previously established by the Commission, instead seeking to maintain margin-based rates that benefit only the Company. Because PGW's margin-based rates are unjust, unreasonable, and contrary to PUC precedent, the Commission must reject the current IT rates and implement cost-based transportation service on PGW's system.

3. *Contrary to PGW's Assertions, the Company's Ability to "Negotiate" Interruptible Transportation Rates Does Not Render These Rates Just and Reasonable.*

In an effort to mitigate the significant and substantive problems underlying PGW's IT Rates, the Company claims that its ability to negotiate rates for customers below the maximum rate cap obviates any concerns. Considering that PGW maintains full and complete discretion with respect to any such negotiation, has no incentive to negotiate below the maximum rate, and has been unwilling in some instances to do so, PGW's proposed "solution" fails to resolve the underlying problems with this margin-based rate structure.

Currently, PGW maintains the ability to negotiate IT rates below the maximum rate, however, under the terms of the Company's Tariff, any adjustment to the maximum cap is "at the sole discretion of the Company." PGW Gas Tariff – Pa. PUC No. 2, Original Page No. 115; see also Evidentiary Hearing Transcript (hereinafter, "Tr.") at 639. To that end, various customers have been able to negotiate rates with PGW in order to transport on the Company's system; however, this ability is based upon PGW's willingness to offer a reasonable transportation rate. PICGUG St. 1-S, p. 3. In addition, PGW does not have a specific process in place with respect to such negotiations, thereby suggesting that the ability to obtain a negotiated rate may be based more in chance than in substance. Tr. at 636.

For example, for over a year, PCOM had been in discussions with PGW regarding the possibility of installing alternative fuel capability in order to be able to transport using PGW's IT rates. See Tr. at 635. Because the undertaking of such an installation would be expensive, PCOM sought to enter into negotiations with PGW prior to actually installing the system. PICGUG St. 1-S, p. 4. Due to the monopoly that PGW maintains over its customers, PGW's "negotiation" with PCOM resulted in PCOM being offered the maximum, margin-based transportation rate. Id. at 5. This rate is 350% higher than the cost-based rate that PCOM would receive if it were transporting natural gas on PECO's system. Id. Not surprisingly, PCOM views this rate as cost-prohibitive in terms of transporting on PGW's system. Id.

Interestingly, when first confronted with this issue, PGW witness White claimed that PGW never had negotiations with PCOM. See PGW St. 5-R, pp. 7-8. Only after reviewing PICGUG's response that such negotiations had occurred, including PGW being provided with a proposed installation date of the alternative fuel system, was PGW willing to admit that a

"preliminary" discussion had taken place.⁶ See PICGUG St. 1-S, p. 4; Tr. at 621-22. During cross-examination, however, Mr. White admitted that he could not confirm that a face-to-face discussion had taken place between PGW and PCOM; that there were several telephone conversations between PGW and PCOM; and that various e-mails were exchanged on this issue. Tr. at 634-36.

In fact, Mr. White was unable to provide any type of documented protocol followed by PGW with respect to a point person dealing with such issues; whether notes are kept on any negotiations; and whether the appropriate information is requested by PGW and/or received from the customer. Tr. at 636-69. Rather, PGW's negotiations seem to occur on a random basis, with each account representative utilizing their own set of parameters to determine whether a negotiated rate should be offered.⁷ Id. This haphazard process, however, does not seem to correspond with the intent of the General Assembly in seeking to provide customers the opportunity to obtain viable natural gas supply through implementation of the Competition Act.

The purpose of the Competition Act was to allow retail gas customers an opportunity to choose from a variety of products and prices to ensure a robust natural gas market. 66 Pa. C.S. § 2203(2). In addition, the Competition Act ensures that the PUC "continue to regulate rates for natural gas distribution services for new and existing retail gas customers in accordance with Chapter 13," including the requirements that NGDCs offer "just and reasonable" rates that do not

⁶ For example, Mr. White claimed that PCOM did not have dual fuel capability, thereby rendering any discussions improbable. PGW St. 5-R, pp. 7-8. In addition to notifying PGW that PCOM was seeking to negotiate an IT rate in order to determine the viability of installing an alternative fuel system, PCOM had already notified PGW of the proposed installation date of an alternative fuel system prior to Mr. White making this claim. PICGUG St. 1-S, p. 4.

⁷ Mr. White suggests that part of the reason for his confusion regarding the PGW/PCOM negotiations stems from the fact that the individual negotiating with PCOM had moved from the marketing department to operations. Tr. at 622. Under this premise, if an employee within PGW changes positions, no protocol exists to ensure that other employees are able to continue to address outstanding issues regarding rate negotiation.

"grant any unreasonable preference or advantage" to any customers. Id. at §§ 2203(11), 1301, and 1304. Under Section 2212, the aforementioned goals of the Competition Act transfer to PGW. See generally id. at § 2212.

Although PGW touts its willingness to negotiate as the panacea to the Company's implementation of unjust and unreasonable margin-based transportation rates, the haphazard way in which these negotiations occur confirm that customers do not have any firm assurances with respect to receiving a reasonable rate. Moreover, customers currently transporting on PGW's system are only able to continue to do so as long as PGW is willing to agree to such a rate. Should PGW decide, during renegotiation, that the Company would prefer a larger margin from such customers, PGW has the sole discretion to offer a higher "negotiated" rate. PICGUG St. 1-S, p. 3; see also Tr. at 639.

Pursuant to the Competition Act, the General Assembly intended to provide all customers, including those on PGW's system, with a viable opportunity to choose competitive natural gas supply. Unfortunately, even though competitive access may exist on PGW's system, customers are not able to choose to transport natural gas supply if PGW's rates are not just and reasonable. In this instance, PGW's "willingness" to "negotiate" below the margin-based maximum rate cap does not ensure just and reasonable rates for all customers seeking to transport on the Company's system.

Accordingly, PGW's cost-based transportation rates are unjust, unreasonable, and inappropriately discriminatory. The only way to ensure that all customers receive rates that permit viable competition is to remove the discretion PGW currently maintains and require the Company to implement cost-based transportation rates.

4. *PGW's Unsubstantiated Claims for a Rate Increase Should Not Prohibit the Implementation of Cost-Based Transportation Rates.*

In proposing to maintain margin-based rates for transportation customers, PGW suggests that these rates must be maintained mainly to address the Company's need for additional revenue. According to PGW, the "maximum IT rates result in a positive margin. That margin makes a contribution to the Company's cost of service that benefits the firm customers. Without the revenue realized from PGW's IT customers, the Company would be forced to recover those revenues from its remaining firm customers." PGW St. 5-R, p. 9. Thus, PGW's desire for a rate increase shadows the need for any change in rate allocation, even if such a change is mandated by the Commonwealth Court, PUC regulations, and the Competition Act. See Section IV.A.1-3, supra.

To that end, PGW maintains that the primary justification for its proposed rate increase is the fact that the Company has consistently "limped from one crisis to the next, never having the resources to address its structural financial problems." Direct Testimony of Steve Hershey, PGW Statement No. 1 (hereinafter "PGW St. 1"), p. 2. According to the Company, over the last few years it "has found itself with only the slimmest of cash balances ... and all of them from borrowed funds." Id.

Upon further review, however, the record evidence in this proceeding suggests that PGW's financial crisis is not as dire as that claimed by the Company. As appropriately noted by the OCA, "[p]rospective revenue requirements based on the future test year show that no increase is needed." Direct Testimony of Richard LeLash, OCA Statement No. 1 (hereinafter, "OCA St. 1"), p. 4. In fact, based upon the OCA analysis, while the Company's rate request would provide PGW with \$660 million of incremental revenues over the next six years, of this amount, only 3.4% would cover increased operating expenses. Id. As a result of its full and

complete review, the OCA appropriately recommends that PGW receive only a \$22.5 million rate increase.⁸ Id. at 4-5.

The OTS also reviewed the information underlying the Company's request to increase its rates and appropriately determined that PGW, as a cash flow company, does not need a base rate increase at the present time. Direct Testimony of Robert Plonski, OTS Statement No. 1 (hereinafter, "OTS St. 1"), p. 16. Similarly, the OTS recommends that PGW be granted a \$25 million rate increase solely to extinguish the loan due to the City in 2007-2009. Id. at 16-17.

In other words, although the Company claims that fiscal crisis is driving PGW to obtain as much revenue as possible from all customer classes, in actuality, the Company has not even met the requirements for a rate increase. In light of these circumstances, PGW should not be permitted to continue to extract as much margin as possible from the IT rates merely because the Company seeks to obtain as much revenue as possible from this class of customers. Rather, PGW must be required to adhere to the same rules and regulations as those applicable to other NGDCs and implement cost-based IT rates so that larger customers can reap the benefits provided to their counterparts on other NGDCs' systems.

B. REVENUE ALLOCATION: PGW's Proposed Rate Allocation for Firm Sales Customers Must Be Rejected as Unjust, Unreasonable, and Unduly Discriminatory.

As part of the Company's request to increase rates by \$110 million, PGW proposes an allocation of this increase based upon its accompanying COSS. See Direct Testimony of Howard Gorman, PGW Statement No. 8 (hereinafter, "PGW St. 8"), pp. 1-5. Although PGW's COSS indicates that larger customers are providing a rate of return above the system average,

⁸ OCA recommends a \$22.5 million rate increase only because PGW must repay a \$45 million loan to the City of Philadelphia ("City"), and this repayment obligation, which becomes due in 2008, will impact PGW's ability to meet its coverages. OCA St. 1, p. 4.

PGW proposes to assign these customers a rate increase that is above the system average increase, resulting in moving these customers' rates further from the cost to serve. Direct Testimony of Robert Knecht, OSBA Statement No. 1 (hereinafter, "OSBA St. 1"), pp. 2-3. Because this proposal does not reflect the mandate of the Commonwealth Court that ratemaking utilize cost-to-serve as the polestar, PGW's proposed rate allocation must be rejected in favor of the OSBA's alternative proposal.

According to PGW's data, without implementing any rate increase, PGW's current system average rate of return for sales customers is 6.0%. Id. at 3, 16. On a customer class basis, the residential sales customers are the only class with a rate of return below that amount, at 4.4%, while commercial sales customers are providing a rate of return of 13.5%, and industrial sales customers are providing a rate of return of 16%. Id.

In designing the proposed rates for this filing, PGW claims that certain goals were advanced, including: (1) gradually moving the rate classes closer to their full cost of service; (2) minimizing the impact on low load factor customers; and, (3) avoiding purported "rate shock" that would occur if all customers were immediately moved to their full cost of service.⁹ PGW St. 5, p. 9. In implementing these goals, PGW claims to have observed the principles of gradualism and avoidance of rate shock by "allocating the rate increase in such a way that 'carefully' moves" the residential customer class to their cost to serve, while allocating the remaining rate increase to other firm sales customers. Id. at 9-10.

Pursuant to this methodology, and assuming arguendo that PGW receives its full request for a \$110 million rate increase, the Company's system average rate of return would be 33.9%.

⁹ Interestingly, PGW recognizes the need to move firm sales customers closer to their cost to serve but fails to apply this same principle to interruptible transportation customers. See Section IV.A., supra.

OSBA St. 1, p. 16. With respect to the customer classes, the residential sales customers would still be providing a class rate of return below the average at 30.0%, while the commercial sales customers and industrial sales customers would remain significantly above average at 49.5% and 35.3%, respectively. Id. Through this process, PGW's proposal moves the rates of certain customers further away from allocated costs resulting in an increase in cross-subsidies among rate classes. Id.

As noted previously, the Commonwealth Court has found that rates and rate structures, especially after an unbundling due to implementation of competition, must be set for each service primarily on a COSS. Lloyd 904 A.2d at 1020. Specifically, "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." Id.

While the Commonwealth Court has decreed that cost-to-serve is the polestar in terms of setting rates, PGW's proposed allocation focuses on "gradualism" with respect to only the residential customer class, thereby ignoring the unjust, unreasonable, and inappropriately disproportionate impact on PGW's customers. Accordingly, the PUC must reject the Company's proposed rate allocation and implement a methodology that adheres to the requirements of Commonwealth Court precedent by moving all customer classes closer to their cost to serve.

To that end, the OSBA offers alternative proposals that appropriately consider cost to serve requirements for firm sales customers, while also accounting for gradualism and rate shock issues. OSBA St. 1, pp. 23-28. In addition, the OSBA's proposals account for the fact that the Company may not receive the full \$110 million rate increase. Id. Specifically, one proposal is

based on gradual progress toward cost-based rates at PGW's full revenue requirement, while the second proposal is based upon the concept of first dollar relief for the non-residential rate class. Id. at 2-3. Under both of these proposals, the OSBA appropriately accounts for the cost to serve for all of PGW's customer classes, while also ensuring that the resulting rates are just, reasonable, and appropriate.

PGW's proposed rate allocation for firm sales customers considers the impact of any rate increase on the residential customer class but inappropriately ignores the detrimental effects on the non-residential customers. PGW chooses to ignore the need for customers to move closer to their cost to serve, instead allowing the principle of gradualism to trump any other considerations. Because this methodology completely disregards the precedent set by the Commonwealth Court and results in unjust and unreasonable rates for non-residential firm sales customers, PGW's proposed allocation must be rejected. Rather, the PUC should adopt the proposals of the OSBA, which appropriately account for cost of service principles while still ensuring just and reasonable rates for all customer classes.

C. TARIFF STRUCTURE: Because Non-Residential Customers Do Not Benefit from USC Programs, PUC Precedent Mandates that the OSBA's Proposal to Phase-Out USC Costs to these Customers Over a Three-Year Period Be Adopted.

Prior to implementation of the Competition Act, PGW was not under the jurisdiction of the Commission. Under Section 2212(b) of the Act, however, on July 1, 2000, PGW became subject to regulation and control by the PUC, similar to any other NGDC in the Commonwealth. 66 Pa. C.S. § 2212(b). At the time of this transfer, PGW was allocating its USC costs to all firm sales customers based on volumetric usage. See OSBA St. 1, p. 28. As part of its Restructuring Proceeding, PGW proposed to continue this allocation; however, PICGUG and the OSBA argued that USC costs should only be allocated to residential customers, as only residential customers

benefit from these programs. Restructuring Order, pp. 62-63. In reviewing this issue, the PUC determined that PGW's Restructuring Proceeding was not the appropriate forum to address these issues, as the record did not contain a cost study that would support a shift in rate design. *Id.* at 64. While PGW's Restructuring Proceeding did not allow for such review, the current proceeding meets the PUC's concerns, as it is a base rate case and includes a COSS. Accordingly, this proceeding provides an excellent opportunity to modify the current USC cost allocation to ensure that such allocation comports with PUC mandates.

As correctly noted by the OSBA, the Commission has consistently upheld a long-standing policy of declining to allocate USC costs to non-residential rate classes in various natural gas proceedings. *See* OSBA St. 1, p. 30. Moreover, the Commission adopted the same policy in a recent electric proceeding, in which the PUC indicated that "[u]niversal service programs, by their nature, are narrowly tailored to the residential customers and therefore, should be funded only by the residential class." *Id.* This finding was also echoed in a very recent policy decision implemented by the PUC last year.

Specifically, the Commission instituted an investigation to develop general standards for determining various issues related to Customer Assistance Programs ("CAP"), including whether the costs of these programs should be allocated to all customer classes. *See Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051923, Order (Dec. 18, 2006) (hereinafter "CAP Order"). As part of this investigation, the PUC resoundingly declared the following.

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.

Id. at 31.

While the PUC noted, as part of this investigation, that PGW's cost allocation was determined prior to the PUC's oversight of the Company, the CAP Order does not seem to provide any prohibition against modifying PGW's inappropriate USC allocation on a going-forward basis. Id. In fact, when examining the question of how any CAP costs should be allocated among different rate classes, the PUC references PGW's recommendation that costs be allocated to all firm customers; however, the PUC notes that, in light of the disposition of the aforementioned issues (i.e., that CAP costs should not be allocated to non-residential customers), this question is moot. Id. at 34-35. Thus, the PUC's Order implies that PGW's inappropriate USC allocation should be modified in order to align any such collection of costs with PUC policy.

To that end, the OSBA proposes a process that would revise this inappropriate allocation while still addressing the concern of gradualism. OSBA St. 1, p. 31. According to the OSBA, PGW's annual reconciliation of the USC affords the Commission with an opportunity to phase-out USC charges to non-residential customers on a regular and gradual basis over a number of years. Under this approach, during PGW's 2008 GCR proceeding, the responsibility of non-residential customers for the USC could be reduced by one-third. A second one-third reduction would take place in PGW's 2009 GCR proceeding, with the final phase-out occurring in PGW's 2010 proceeding. Id. This phase-out process would have minimal impact on residential customer rates, while still ensuring appropriate cost-causation by allocating these costs only to those customers who benefit from these programs (i.e., residential customers). Id. at 32-33.

In light of recent developments at the Commission firmly establishing a residential-only allocation of CAP costs, the OSBA provides a just and reasonable proposal that would address any rate shock concerns while still accounting for cost-causation principles. Accordingly, the PUC should implement a phase-out of PGW's USC costs to any non-residential customer rates in order to ensure that only the customers who benefit from CAP programs (i.e., residential customers) are required to remit the costs for these programs.

D. SUMMARY AND ALTERNATIVES: PGW's Rate Structure Must Be Modified to Account for Cost-Based Rates, to Move Classes Closer to the Cost to Serve, and to Adhere to Appropriate Cost Causation Principles.

This proceeding is ripe to address the numerous flaws contained in PGW's rate structure. In order to provide PGW's customers an opportunity to achieve success in the competitive natural gas marketplace, the PUC must require PGW to implement cost-based rates for its IT customers based upon the COSS presented in this proceeding. Similarly, to ensure that all customers are moving closer to their cost to serve, the Commission must endorse the rate allocation proposals for firm sales customers presented by the OSBA. Finally, considering the Commission's recent decision regarding the appropriate allocation of CAP costs, the PUC must implement a phase-out of the USC from non-residential sales customers in order to ensure that only the customers benefiting from such programs (i.e., residential customers) are remitting the costs of implementing such programs. By employing such modifications, PGW's rates will move from a process that benefits only the Company to a structure that benefits the customers.

V. CONCLUSION

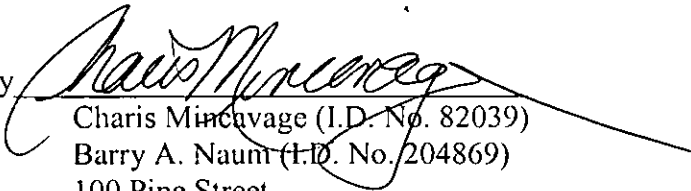
WHEREFORE, the Philadelphia Industrial and Commercial Gas Users Group respectfully submits that the Pennsylvania Public Utility Commission require Philadelphia Gas

Works to:

- (1) Implement cost-based rates for the Interruptible Transportation Rate Schedule;
- (2) Adopt the OSBA's proposal to allocate any resulting rate increase among the firm sales customers; and,
- (3) Apply a three-year phase out of any Universal Service and Energy Conservation Costs so that these costs are no longer allocated to non-residential sales customers.

Respectfully submitted,

McNEES WALLACE & NURICK LLC

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Dated: June 12, 2007

APPENDIX A

**PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265**

Public Meeting held March 21, 2003

Commissioners Present:

Glen R. Thomas, Chairman, Statement attached
Robert K. Bloom, Vice Chairman
Aaron Wilson, Jr., Dissenting Statement attached
Terrance J. Fitzpatrick, Statement Concurring in part and Dissenting in part attached
Kim Pizzingrilli

Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

M-00021612

M-00021612C0001

M-00021612C0002

M-00021612C0003

OPINION AND ORDER

BY THE COMMISSION:

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I. Introduction

On June 22, 1999, the Natural Gas Choice and Competition Act (the Act) was enacted to provide a competitive and non-discriminatory market for natural gas supply services within the Commonwealth. 66 Pa. C.S. §§2201-2212. Pursuant to the Act, the Commission assumed jurisdiction over the natural gas services provided by the Philadelphia Gas Works (PGW) within the City of Philadelphia. *Id.* §2212. On July 1, 2002, consistent with the filing schedule established by the Commission, PGW filed its Restructuring Petition¹ in which it proposed, *inter alia*, to unbundle its rates and to initiate customer choice pursuant to the Act.

The matter was assigned to Administrative Law Judge (ALJ) Allison K. Turner who issued her Recommended Decision relative thereto on February 18, 2003. That Decision, including the various Exceptions and Reply Exceptions of the parties, is now before us for disposition.

We shall adopt and incorporate herein by reference the ALJ's Recommended Decision to the extent that it is not expressly or by necessary implication overruled or modified by this Opinion and Order. Initially, we are reminded that we are not required to consider expressly or at great length each and every contention raised by a party to our proceedings. *University of Pennsylvania, et al. v. Pa. PUC*, 485 A.2d 1217, 1222 (Pa. Cmwlth. 1984). Any Exception or argument that is not specifically addressed herein shall be deemed to have been duly considered and denied without further discussion.

¹ Along with the Restructuring Petition, PGW filed Direct Testimony, Filing Requirements, and Exhibits including its proposed tariffs. PGW Annex A (Revised) Tariffs, Section 1 – Philadelphia Gas Works Gas Service Tariff, Pa. P.U.C. No. 2 (hereinafter: Annex A, Section 1) and Section 2 – Philadelphia Gas Works Gas Supplier Tariff, Pa. P.U.C. No. 1 (hereinafter: Annex A, Section 2)

II. Preliminary Matters

A. Overview

Subsequent to the filing of PGW's Restructuring Plan, the following eight parties filed Petitions to Intervene or Complaints with the Commission: Philadelphia Industrial and Commercial Gas Users Group (PICGUG); The Consumers Education and Protective Association, the Association of Community Organizations for Reform Now, the Tenants' Action Group, and the Action Alliance of Senior Citizens of Greater Philadelphia (collectively CEPA); the Office of Trial Staff (OTS); the Office of Consumer Advocate (OCA); the Office of Small Business Advocate (OSBA); Service Employees International Union, Local 686 (SEIU); Texas Eastern Transmission LP (TETCO), and PECO Energy Company (PECO).²

ALJ Turner conducted a Prehearing Conference on August 7, 2002, which generated a transcript of 37 pages. By Prehearing Order No. 2, issued on August 27, 2002, the ALJ established a litigation schedule and procedural rules for the proceeding. Public Input hearings were held at the Community College of Philadelphia on October 7-9, 2002. The Public Input hearings produced 194 pages of transcript.

Evidentiary hearings were held on November 13-15, 2002 in Philadelphia. The Evidentiary hearings generated 502 pages of transcript. PGW, the OTS, the OCA, PICGUG, the OSBA, SEIU, and CEPA filed Main and Reply Briefs according to the procedural schedule. TETCO filed only a Main Brief. As noted, the Recommended Decision containing proposed resolutions of the various issues, was issued February 18, 2003.

² The ALJ dismissed the Petition to Intervene filed by PECO Energy Company.

Exceptions and Reply Exceptions to the Recommended Decision were filed by CEPA on February 24, 2003. The following Parties filed Exceptions on February 25, 2003: PGW; the OCA; PICGUG; the OSBA; the OTS; and SEIU. The following Parties filed timely Reply Exceptions: PGW, CEPA, the OTS, the OSBA, SEIU, the OCA, and PICGUG.

B. The Company

Operating since 1836, PGW is the largest municipally-owned gas utility in the nation, maintaining a distribution system of 6,000 miles of gas mains and services and providing service to nearly half a million customers. PGW's service territory is defined as the City of Philadelphia in the *Agreement between the City of Philadelphia and the Philadelphia Facilities Management Corporation for the Management and Operation of The Philadelphia Gas Works*. (PGW Annex A (Revised) Tariffs, Section 1 – Philadelphia Gas Works Gas Service Tariff, Pa. PUC No. 2 (Annex A, Section 1), p. 5).

PGW furnishes natural gas service to approximately 500,000 residential customers and 19,000 industrial and commercial users and has a customer assistance program for low-income customers, the Customer Responsibility Program (CRP), which currently has 65,500 customers. (PGW St. 8, p. 3). PGW also provides a 20 percent discount on gas bills for all senior citizens, 65 years of age and older, that apply for its Senior Citizen Discount (SCD) program. (PGW St. 8, p. 11). There are currently approximately 83,000 participants in the SCD program. (*Id.*)

PGW is a cash flow utility which does not rely on equity financing. Its rates are based on its operating ratio, not the traditional rate base/rate of return methodology. *Pa. PUC v. Philadelphia Gas Works*, R-00006042, et al., C-00014826, et al., 2001 Pa. PUC LEXIS 103, *24 (Order entered October 4, 2001).

PGW's peak day requirements are approximately 768,100 Mcf. PGW uses its firm transportation capacity on interstate pipelines (Pipeline FT Capacity) to transport gas it purchases to meet customer requirements. Two interstate pipeline suppliers, TETCO and Transcontinental Pipeline (TRANSCO), deliver approximately 40% of PGW's peak day supplies to the city gate. When capacity is not needed to meet customer demand, PGW also uses Pipeline FT Capacity to fill storage, fill its LNG tank, and, make interruptible sales. When customer demand exceeds the Pipeline FT Capacity, PGW withdraws gas from storage. As of June 2002, PGW has ten interstate pipeline storage contracts, totaling approximately 20 Bcf. In extremely cold weather, PGW turns to its LNG peaking facility to meet demand as well as to help ensure system integrity in the event of an emergency. (PGW St. No. 5, pp. 10-11).

C. The Act

As a municipal natural gas distribution company (NGDC), PGW was previously regulated by the Philadelphia Gas Commission (PGC), a local agency of the City of Philadelphia (City). This Commission assumed jurisdiction over the public utility services being furnished by PGW, on July 1, 2000. 66 Pa. C.S. §2212(b). As noted above, the Act was signed into law in 1999, to provide a competitive and non-discriminatory market for natural gas supply services within the Commonwealth. The Act provides the framework for restructuring NGDC services in order to allow Pennsylvania's natural gas customers a choice in their natural gas providers. Section 2212 of the Act, 66 Pa. C.S. §2212, specifically addresses city natural gas distribution operations such as that of PGW.

The Act addresses the various duties of the NGDCs as they transition to retail choice, including, *inter alia*,: (1) integrity of distribution systems; (2) installation and improvement of facilities; (3) enhanced metering; (4) customer protection; (5) supplier of last resort obligations; (6) licensing requirements; (7) supplier access and

market power remediation; (8) the unbundling of natural gas supply services, including commodity, capacity, storage, balancing and aggregator services; (9) recovery of costs associated with restructuring; (10) universal service programs, funding and cost recovery; and, (11) employee obligations.

In addition to meeting the requirements of the Act to transition to retail choice, PGW must also, through this proceeding, bring its existing information technology, accounting, billing, collection, gas purchasing and other operating systems and procedures into compliance with the rules, regulations, and orders of the Commission. 66 Pa. C.S. §2212(h)(1).

D. Motions and Petitions

1. Motion in Limine

On October 10, 2002, PGW filed a *Motion in Limine* to strike portions of SEIU's testimony and exhibits from the record. SEIU filed an Answer on October 17, 2002. On October 24, 2002, ALJ Turner issued Prehearing Order No.3, granting, in part, and denying, in part, PGW's *Motion in Limine*. On November 1, 2002, SEIU filed a Petition for Interlocutory Review and Stay regarding the stricken portion of its direct testimony. By Opinion and Order entered December 24, 2002, the Commission denied SEIU's Petition.

Specifically, the ALJ excluded the testimony and exhibits of SEIU witness Shawn Plunkett (SEIU Statement 3 and SEIU Exhibits 17, 18, and 19). The testimony and exhibits that were stricken suggest wording changes in three sections of PGW's proposed tariff. The relevant sections deal with the obligations of PGW customers to provide access to their premises to PGW employees or agents. The ALJ ruled that SEIU

would not be permitted to propose changes in the wording of any of these tariff provisions. She held that SEIU was attempting to make the tariff consistent with the collective bargaining agreement. She also held that the design of tariffs is primarily a management function, and it would not be beneficial to allow the union to control this aspect of management functions through input into the tariff in this proceeding. (Prehearing Order No. 3, p. 4).

SEIU excepts to the ALJ's recommendation on this issue averring that it is attempting, via its suggested wording changes to PGW's proposed tariff, to remove ambiguity from the proposed tariff concerning the customer's obligations to provide access to PGW's facilities on the customers' premises. Furthermore, SEIU asserts that its proposed modifications to PGW's tariff are required to make the tariff provisions internally consistent, to ensure the safety and security of PGW's facilities, and to protect customers from unauthorized persons who may attempt to gain access to their property or PGW's facilities. Accordingly, SEIU argues that the Commission should reverse the ALJ's Prehearing Order No. 3 and reopen the record to admit the testimony and exhibits of Mr. Plunkett. (SEIU Exc., pp. 2-4). PGW responds to SEIU's Exception on this issue, arguing that the Commission should affirm the ALJ's ruling on this issue. (PGW R. Exc., pp. 17-21).

The ALJ's ruling should be affirmed. The Commission denied SEIU's request for interlocutory review. See *Pa PUC v PGW*, Docket No. M-00021612, entered December 24, 2002. In that Order, we affirmed the ALJ's ruling that SEIU had improperly attempted to enlarge the scope of the hearing. The purpose of this restructuring proceeding is to initiate customer choice of natural gas supply in PGW's service territory and finally transition PGW into compliance with all the requirements of the Commission's Regulations and the Public Utility Code. This is not a proceeding to litigate what may be legitimate collective bargaining issues.

Therefore, the Exceptions of the SEIU are denied.

2. Motion to Strike CEPA's Brief in Part

On January 3, 2003, PGW moved to strike portions of CEPA's Main Brief on the grounds that it challenges the wording and effect of PGW's proposed tariff, and also that it supports its arguments with facts not included in the record. PGW moved to strike all or portions of pages 8-22 and 24-31. PGW furthermore contended that it had no prior notice that CEPA would challenge its tariff in this way, and thus, it was not afforded the opportunity to prepare a response. On January 13, 2003, both CEPA and the OCA separately filed Responses in Opposition.

CEPA and the OCA contend that PGW's proposed tariff is in the record as a PGW exhibit. Accordingly, references to specific tariff sections are sufficient. Likewise, references to specific sections of Chapter 56 of the Commission's regulations are sufficient. CEPA and the OCA contend that PGW's Motion to Strike should be denied.

The ALJ found that not one of CEPA's assertions or contentions on these pages is supported by a record citation. The ALJ opined that the Parties, the ALJ and the Commission should not be put in the position of searching the record to validate factual references in a brief. Also, no party should be allowed to argue on "inferred" facts without record support. The ALJ recommended that PGW's Motion to Strike be granted only with regard to factual references not based on the record, but not as to issues regarding differences between its proposed tariff and the Commission's regulations. (R.D., p. 14).

CEPA excepts to the ALJ's recommendation on this issue. CEPA contends that the ALJ stated that a party should not be "allowed to argue from 'inferred facts'

while at the same time recognizing that the Proposed Tariff was part of the record.” (I.D., p. 13). CEPA further contends that the only “evidence” that is necessary for such analysis is the Proposed Tariff itself, and Chapter 56. That evidence does not constitute “extra-record facts.” (CEPA Exc., pp. 13-15).

With regard to factual references not based on the record, we will affirm the ALJ’s Recommended Decision consistent with our regulations at 52 Pa. Code §§5.501 and 5.502. We find that CEPA’s assertions/contentions are not supported by record citation. Neither the Commission nor the ALJ should be placed in the position of having to search the record in order to validate factual references in a party’s brief. No party can be permitted to argue “inferred” facts without record support.

With respect to the differences between PGW’s proposed tariff revisions and Chapter 56, the ALJ correctly ruled that a reference to specific sections of Chapter 56 was sufficient. No Exceptions were filed to this finding.

We affirm the ALJ’s ruling and the Exception of CEPA relative to this issue is denied.

3. PGW’s Motion for Leave to File Late-Filed Exception.

On February 28, 2003, PGW filed a Motion for Leave to File Late-Filed Exceptions (Motion) together with its Exceptions which address its capacity assignment methodology. The OSBA filed an Answer opposing the Motion on March 5, 2003. By correspondence filed March 7, 2003, the OCA stated that it does not take any position on PGW’s Motion. The rationale for the lateness is that, should the Commission adopt the ALJ’s recommendation, PGW will suffer “system problems”. (Motion, p. 1).

Given our statutorily imposed deadline for entry of an order in this Restructuring Proceeding, no later than April 1, 2003, and the fact that Reply Exceptions would be warranted, there simply is no time to permit late-filed Exceptions. The finite amount of time the Commission has to consider the instant matter should be utilized to analyze those Exceptions properly before us. As such, PGW's Motion for Leave to File Late-Filed Exceptions is denied.

4. Petition to Intervene: City Council of Philadelphia

On March 13, 2003, the City Council of Philadelphia (City Council) filed a Petition to Intervene requesting that it be granted full status as an intervenor and that the proceeding be remanded to the ALJ. The Parties to the proceeding were granted until 12:00 noon on March 20, 2003, to file responses to the City Council's Petition.³

This Petition was not only filed several months after this case began, but it was also filed just days before the Commission reached its final decision. The City fails to demonstrate extraordinary circumstances adequate to warrant accepting its intervention at this late date and to justify a delay in these proceedings as requested in the Petition. Moreover, this Commission is under a statutory obligation to render a decision in this matter no later than April 1, 2003. In any event, the issues raised by the Petition highlight a dispute between the City and PGW regarding whether PGW had the authority to make its senior citizen proposal. However, that is an internal governance dispute that is not within the Commission's jurisdiction to adjudicate. The Commission will not insert itself between PGW and its owner, the City.

This Commission directed PGW to undergo a Management Audit and subsequently issued a Secretarial Letter on April 5, 2001, instructing PGW to prepare

³ CEPA and the OTS filed Responses to the Petition on March 17, 2003 and March 26, 2003, respectively.

alternatives to submit to the City. This was done in response to PGW's claim that it did not have the "legal authority to implement" an audit recommendation to eliminate the senior citizen discount. If the allegations in the Petition are true, PGW may have failed to comply with a lawful Commission directive in violation of 66 Pa. C.S. Section 3301. As a result, we will refer this matter to the Law Bureau for investigation and such further action as may be warranted.

Based on the foregoing, the City's Petition to Intervene is denied.

E. The Stipulations

1. RRA/IRC Partial Stipulation

PGW proposes to include in its unbundled rates a Revenue Reconciliation Adjustment (RRA) and an Interruptible Revenue Credit (IRC). The RRA and IRC are the subject of a proposed Partial Stipulation signed by PGW, the OCA and the OTS. The OSBA opposed the Stipulation on the grounds that it was anti-competitive. The remaining Parties did not endorse the Stipulation, but have authorized the Signatories to represent that they do not oppose it. (PGW M.B., Appendix 4). The proposed Stipulation provides two tariff mechanisms: a non-reconcilable RRA to be added to base rates, and a reconcilable IRC to be credited to the Gas Cost Rate (GCR). The signatories to the Stipulation agreed to set the RRA at \$5.3 million. (PGW M.B., p. 20).

PGW offers interruptible gas sales service to large industrial customers who have alternative fuel capability. PGW prices its gas sales to interruptible customers at 10% above its commodity cost of gas or the market price for alternative fuels. (Tariff Pa. PUC No. 2, p. 100). The commodity costs associated with providing this service are excluded from the determination of PGW's GCR and the margin realized (revenue in excess of the commodity cost of gas) is credited to PGW's base rates. Included in this

margin is a return for both the upstream pipeline capacity used to deliver the gas to the city gate and the distribution costs associated with delivering the gas from the city gate to the burner tip. PGW uses the margin earned from its interruptible sales to support the base rates of its firm customers and to provide additional funds to cover its costs. (PGW M.B., p. 20).

The ALJ recommended approving the Partial Stipulation, finding that OSBA's position was set forth, and specifically rejected in the *Pa. PUC v. UGI Utilities, Inc. - Gas Division*, Docket No. R-00994786 (June 29, 2000); that the proposal is not anti-competitive; and, that the OSBA's position is based on a misreading of the Act. (R.D., p. 7).

The OSBA excepts to the ALJ's recommended adoption of PGW's proposal regarding the RRA/IRC stating that it will result in a tariff that provides an unfair competitive advantage for PGW gas supply and will discourage competition in gas supply for both retail and transportation customers. (OSBA Exc., p. 3). The OSBA argues that PGW must be ordered to establish cost-based transportation rates that would apply to both interruptible sales and interruptible transportation service customers, and that the costs associated with providing transportation service to interruptible sales customers should be excluded from the computation of the interruptible sales commodity margin and, therefore, from the RRA and IRC. (*Id.*, p. 4).

PGW rejoins that its proposed Stipulation is consistent with Section 2211(g) of the Public Utility Code (Code), 66 Pa. C.S. §2211(g), and the Commission's decision in the *UGI* restructuring case. (PGW R.Exc., p. 3).

We note that the OSBA is advocating the same position on the identical issue that the OCA advocated in the *UGI* restructuring proceeding. In that proceeding, we stated as follows:

We shall deny the OCA's Exception on this issue because its proposals are inconsistent with the express language of Section 2211(g) and would not meet the obvious legislative objective embodied in this section of the Act. We find that UGI's proposed adjustment removes the incentive for the NGDC to retain PGC load and associated PGC capacity used to make interruptible sales and is entirely consistent with the requirements of Section 2211(g).

(*UGI*, pp. 10-11).

We find that PGW's proposal and the Stipulation are consistent with Section 2211(g) of the Act and our decision in the *UGI* restructuring proceeding. Adopting the OSBA in this proceeding would create a completely inconsistent interpretation of the Act and impose disparate treatment on two identically situated Natural Gas Distribution Companies (NGDCs). The OSBA has presented no persuasive or compelling evidence for us to adopt its proposal. Our rationale used in the *UGI* proceeding is applicable in this proceeding. Therefore, we deny the OSBA's Exceptions and adopt the ALJ's recommendation.

2. Supplier Tariff Stipulations

PGW, the OTS, the OCA, and the OSBA entered into a Stipulation wherein they agreed that PGW shall include a section in its General Tariff setting forth an exit fee, and its calculation procedures. The Parties to the stipulation agreed that the fee and its calculation procedures shall be in place for five years, subject to possible annual readjustment.

The Parties to the Stipulation also agreed as to the interest rate on outstanding Supplier/PGW balances. Specifically, PGW agreed to modify its Supplier Tariff Sections 12.2 and 12.3 so that unpaid supplier balances shall accrue interest at the

rate of 0.83% per month, or 10% per annum. The other active Parties did not join in these Stipulations, but do not oppose them.

As noted by the ALJ, there was no opposition to the Stipulation by the Parties. The ALJ recommended the adoption of the Stipulation. (R.D., p. 8).

Our review of the terms of the Stipulation leads us to conclude that the terms are reasonable and in the public interest. Accordingly, we shall adopt the Stipulation without further comment.

PGW, the OTS, and the OCA reached agreement as to the assignment of capacity. Specifically, PGW agreed to modify its tariff so that FT capacity assignment revisions shall be conducted quarterly in accordance with standards set forth in the tariff provision. The OSBA opposes this provision of this Stipulation. The other Parties are not opposed to the Stipulation.

The OSBA recommended that PGW allocate its interstate pipeline capacity in two stages. The first would be a quantity equal to the average daily load of the customer or customer class to which the FT capacity is allocated. The second would allocate PGW's actual pipeline capacity in excess of its average daily firm loads on the basis of customer class excess demands.

The OCA agreed with the OSBA's proposal with two minor qualifications. The first is that this method must also be used as the basis for determining the assignment of PGW's interstate pipeline FT capacity to the Natural Gas Suppliers (NGSs) in the customer choice program. The second is that the OSBA's proposal for storage cost recovery should apply to storage costs and not storage capacity. The OCA noted that the

OSBA witness agreed with the OCA on these points in his surrebuttal testimony. (OCA M.B., pp. 23-24).

The ALJ recommended that the Commission modify this Stipulation to incorporate the capacity methodology jointly agreed to by the OCA and the OSBA. (R.D., p. 8). No Exceptions were filed to the ALJ's recommendation. Having reviewed the capacity methodology recommended by the ALJ, we find it reasonable, appropriate and in the public interest. Accordingly, we adopt the recommendation and modify the Stipulation.

3. CRP/Customer Assistance Program (CAP) Design Stipulation

PGW, the OTS, the OCA, the OSBA and CEPA reached an agreement that, as of the effective date of PGW's Restructuring Plan, PGW's CRP/CAP program will have a program design which is consistent with a series of standards or guidelines.

The guidelines cover such actions as removal of a participant from the CRP program for non-payment of CRP charges prior to service termination, and grounds for reinstatement; not requiring a 5% down payment for entry or reinstatement into the CRP program; inclusion of customers between 135% and 150% of the poverty level in the CRP on a percent of income basis as specified for various levels; all CRP participants being required to make a co-payment of \$3 per month towards the participant's pre-program arrears; forgiveness of 1/36th of each CRP participant's frozen arrears for each timely (before the issuance of the next bill) CRP payment in full; no assessment of finance charges on CRP participants; and, no requirement of security deposits from CRP participants or applicants who are eligible for CRP and wish to obtain service as CRP participants.

The other active Parties do not oppose the Stipulation. The ALJ recommended adoption of the Stipulation. (R.D., p. 9). Our review of the terms of the Stipulation leads us to conclude that they are reasonable and in the public interest. Accordingly, the Stipulation is adopted without further comment.

The only CRP/CAP Program design issues that remain in dispute are whether the proposed tariff should provide for collection of an Excess Usage Charge and/or LIHEAP make-up charges. These issues will be discussed in the Universal Service Issues section below.

4. Restructuring and Consumer Education Surcharge Cost Recovery Stipulation

PGW, the OTS, the OCA, the OSBA and CEPA reached an agreement as to this cost recovery mechanism which states that:

- The initial (and subsequent) surcharges shall be calculated to include actual costs already incurred; projected costs where PGW has concrete (as defined in the agreement) plans to incur those costs during the year. Only costs attributable to compliance with Chapter 59/56 Obligations (as that term is defined in the "Settlement Agreement of Certain Restructuring Issues [related to the FOI],") and other restructuring-related costs (as defined in the agreement) may be recovered through the restructuring surcharge.
- The establishment of the surcharge for the next period and the reconciliation of the existing restructuring surcharge shall occur in a proceeding filed concurrently with PGW's 1307(f)/GCR filing and which follows the same procedural schedule. During this proceeding, it will be PGW's burden to demonstrate that all costs it seeks to recover through the restructuring surcharge are restructuring-related, incremental, prudent and reasonably incurred.

- PGW shall file reconciliation statements quarterly and shall submit a claim for over/under recovery on an annual basis, at the same time it submits its projected Restructuring costs and Restructuring Surcharge claim for the next year. If a project whose costs were included in the restructuring surcharge is cancelled or delayed beyond the year in which the cost was originally scheduled to be incurred, the Company will withdraw the projected costs of that project from the Restructuring Surcharge in its next quarterly update.
- PGW shall be permitted to recover in its Restructuring Surcharge costs approved by the PUC as restructuring related in accordance with the amortization schedule set forth in the agreement.
- PGW shall remove all expenses and the depreciation or other costs of capital items that are included in the Surcharge from any future base rate request.
- The surcharge shall be terminated as follows: The recovery of ongoing expenses shall be transferred to base rates in PGW's next base rate case. No later than 5 years after the surcharge is initiated, one-time restructuring expenses, any ongoing expenses not otherwise rolled into base rates, and capital costs shall be rolled into base rates for recovery on an amortization basis in a single issue proceeding in which the only issue shall be the transfer of the surcharge amounts into base rates and the termination of the surcharge.
- The parties agree that PGW may defer on its books, costs related to restructuring. No absolute right to cost recovery is created by PGW's decision to book the cost into a deferral account. The deferred costs shall be amortized consistent with the PUC ratemaking decision.

None of the Parties excepted to the Stipulation and the ALJ recommended its adoption. (R.D., p. 9). Our review of the Stipulation leads us to conclude that it is reasonable. Accordingly, we shall adopt the Stipulation without further comment.

III. Unbundled Rates and Services

The Act requires that PGW begin offering to its customers, by September 1, 2003,⁴ the opportunity to purchase natural gas supply services from a natural gas supplier. After that date, the choice of natural gas suppliers shall rest with the retail gas customer. 66 Pa. C.S. §2212(j). To comply with this requirement, PGW submitted a proposed tariff that unbundled both the firm and interruptible rates for each rate schedule offered by PGW pursuant to which customers purchase natural gas supply services. (PGW M.B., p. 4; R.D., pp. 14-15).

PGW asserted that the resulting unbundled rates are fair and reasonable, and will permit customers on any rate schedule to purchase natural gas supply service from a licensed NGS and avoid the “GCR” or commodity related portion of the rates. PGW stated that in preparing its unbundling proposal it was “guided by two key principles that, in PGW’s view, are mandated either by law or PUC precedent, or both. First, PGW unbundled its rates so that the unbundling process was “revenue neutral.” That is, the existing rates were revised so that PGW would realize the same level of revenue after the unbundling as it had before the unbundling occurred. Second, PGW attempted to design its rates so that not only would PGW collect the same level of revenues after unbundling as before, but that *each rate class* would produce the same level of revenues both before and after unbundling.” (PGW M.B., pp. 5-6 (emphasis in original)).

⁴ The actual language is “beginning with the commencement of the first fiscal year of a city natural gas distribution operation after the order approving the restructuring plan of a city natural gas distribution operation becomes effective” Since PGW was required to file its restructuring plan on July 1, 2002, and the PUC had nine months to make a determination, or until April 1, 2003, the first fiscal year beginning after the Commission will issue its order on PGW’s restructuring filing will be the 2003-2004 fiscal year, which begins on September 1, 2003.

A. Interclass and Intraclass Cost Shifting

As stated above, PGW's rate proposal attempts to follow two principles from two separate sections of the Act. First, PGW unbundled its rates so that the unbundling process was "revenue neutral" and, second, it attempted to design its rates so that not only would it collect the same level of revenues after unbundling as before, but each rate class would produce the same level of revenues after unbundling that was produced before unbundling. PGW asserted that although "the legal support for interclass revenue neutrality is slightly less clear ... it is there nonetheless." The Act contains a general provision, applicable to all natural gas distribution companies in Section 2211 of the Act:

Except as provided in section 2212, for the period from the effective date of this Chapter until January 1, 2001, interclass or intraclass cost shifts are prohibited. This prohibition against cost shifting may be accomplished by maintaining the cost allocation methodology accepted by the commission for each natural gas distribution company in the company's most recent base rate proceeding.⁵

PGW stated that the date certain for the expiration of this prohibition against interclass and intraclass cost shifts "clearly was not intended to preclude the applicability to PGW of this section, as the reference to Section 2212 presumably is intended to make clear." (PGW M.B., p. 7; R.D., p. 16).

The ALJ found that the exception in Section 2211(e) of the Act related to the expiration of the prohibition; that is, the expiration of the cost shifting prohibition was not intended to preclude application of the prohibition to PGW. (R.D., p. 16).

⁵ 66 Pa. C.S. §2211(e).

In its Exceptions, the OSBA argues that the ALJ's finding that there exists a prohibition on interclass and intraclass cost shifting in this proceeding is wrong as a matter of law. The OSBA bases its arguments on Section 2212(e), a section of the Act relating to the ability of the Commission to engage in intraclass and interclass cost shifting in a base rate case where the funding of PGW's securities obligations are at issue. (OSBA Exc., pp. 7-12).

In its Exceptions, PICGUG argues that the ALJ erred in rejecting its proposed rates as contrary to the Act's prohibition against cost-shifting. PICGUG maintains that the ALJ inappropriately rejected its arguments concerning the implementation of cost-based transportation rates based upon a reference by the OCA, concerning a cost of service study filed in PGW's most recent base rate proceeding. PICGUG submits that any references to a cost of service study filed in PGW's most recent base rate case are irrelevant because the Commission has yet to review or approve PGW's current cost allocation methodology. (PICGUG Exc., pp. 7-8).

We note that the OSBA bases its arguments on Section 2212(e) of the Act. Section 2212(e) has nothing to do with the interplay between Section 2211(e), the general prohibition against intra and interclass cost shifting for all NGDC's, and Section 2212(g) and (h), which specifically relate to PGW's Restructuring Proceeding. The ALJ correctly found that the exception in Section 2211(e) related to the expiration of the prohibition; that is, the expiration of the cost shifting prohibition was not intended to preclude application of the prohibition to PGW. As we have previously concluded, interclass and intraclass cost shifting is inappropriate in the context of natural gas restructuring cases. Such issues are more appropriately resolved in a base rate case.

Similarly, we reject the argument of PICGUG relative to utilizing the allocation methodology accepted in PGW's most recent base rate case as a justification

for cost shifting. We reject the argument not wholly upon the basis that doing so would be violative of the Act, but chiefly in recognition of the fact that a completely acceptable alternative has not been presented in this proceeding. Indeed, as stated above, an in-depth analysis is more appropriately suited to a base rate proceeding. Given the complexity of methodology design and PGW's relative inexperience in establishing such a methodology, these issues will be deferred to PGW's next base rate case.

Accordingly, we adopt the ALJ's recommendation and deny the Exceptions of the OSBA and PICGUG relative to this issue.

B. Firm and Interruptible Rate Unbundling

PGW has three principal firm rate schedules that it asserts are appropriate to unbundle: General Service, Municipal Service, and Philadelphia Housing Authority Service (PHA).

PGW provided the following description of its methodology for unbundling its firm rates:

The overall approach was to identify specific components of the unbundled rates related to providing the commodity itself (to be included in the GCR Portion of the rate), or which are proposed to be recovered in a separate mechanism (*i.e.*, the USC), and then adding the proposed new rate element, the RRA; the remaining amount constitutes the distribution charge. [PGW witness] Gorman identified the individual components of the existing bundled rates that could be separated out by the use of a cost and revenue allocation study. This Cost of Service/Revenue Allocation Study uses the same cost allocation principles and methodologies as were utilized by PGW in its last two base rate proceedings. The Cost of Service/Revenue Allocation

Study enabled Mr. Gorman to identify the portions of the present bundled firm rate that is gas or commodity related.

The first step was to calculate existing firm commodity-related rates for each rate class (the customer charge was left alone). Existing firm commodity rates were calculated starting with the *pro forma* revenues for each class as presented in PGW's last base rate case, and were adjusted for the settlement of that case at the \$36 million rate increase level.⁶ Added to that amount was the revenue associated with Revenue Reconciliation Adjustment (RRA). (discussed in more detail below). To calculate the RRA for the *pro forma* unbundled rates, Mr. Gorman used a placeholder: the average annual margin for the 36 months through January 2002.⁷

The second step was to identify and place into the GCR charge the costs associated with providing gas sales service. Those costs include supply costs, storage and peaking costs, and capacity costs.⁸ Those costs were characterized as the "Sales Service Charge" which makes up one portion of the GCR charge.⁹ In addition, Gorman then subtracted the *pro forma* IRC, the companion to the Rate Reconciliation Adjustment (RRA).¹⁰ (discussed in more detail below).

[The RRA and the IRC are the subject of a stipulation among several parties, to which OSBA objects, and the remaining parties do not object. Earlier in this RD, the ALJ recommended that the Commission adopt this stipulation]

The third step was to identify universal service related costs to be recovered in the USC and remove them from the distribution charge. These costs, with but one exception, are all included in existing rates either in the base rate or in the

⁶ PGW St. 4, pp. 5-6.

⁷ PGW St. 4, p. 6. In the compliance filing, PGW will adjust that amount to reflect the stipulated level of the RRA – \$5.3 million – assuming that the Stipulation is approved by the PUC.

⁸ PGW St. 4, p. 3.

⁹ *Id.*

¹⁰ PGW St. 4, p. 8.

GCR portion of PGW's current rates.¹¹ The costs removed are the Senior Citizen Discount, CRP discounts, the cost of the CWP program, universal service administrative costs and a portion of uncollectibles accounts expense.¹²

The unbundled distribution charge for each rate schedule was then calculated by backing out of the GCR charge and the Universal Service Charge. The remaining amount constitutes the distribution rate for each class. By including all costs identified as directly related to providing gas commodity service in the GCR, PGW has assured that a firm sales customers [sic] who wishes to switch to transportation will pay only the cost associated with providing the distribution related portion of the service and not costs directly associated with providing natural gas service. The rate applicable to a firm customer who elects to utilize an NGS for his/her commodity service is spelled out in PGW's tariff for each of the firm service rates.¹³ The GCR rate listed on each rate schedule contains a notation that it is "not applicable to GS customers who transport gas through a qualified NGS."

The above unbundling method was applied to each of PGW's principal firm rate schedules: General Service,¹⁴ Municipal Service¹⁵ and Philadelphia Housing Authority Service (PHA).¹⁶ These constitute all the firm rates that are appropriate to unbundle.¹⁷

Accordingly, a PGW firm service customer taking service under PGW's GS tariff rate would now remit a

¹¹ PGW St. 4, p. 3.

¹² *Id.*, pp. 3, 10.

¹³ *See, e.g.*, Philadelphia Gas Works Gas Tariff – Pa. P.U.C. No. 2, (Annex A)(Revised) (hereinafter, "Gas Tariff No. 2") Original Page No. 84. The specific components of the GCR are spelled out in PGW St. 4, p. 8.

¹⁴ *Id.*, pp. 84-86.

¹⁵ *Id.*, pp. 88-90.

¹⁶ *Id.*, pp. 92-94.

¹⁷ NGV-S firm and NGV-S interruptible were not unbundled because there are no customers on those rates. Two riders – the Air Conditioning Rider and the CNG Rider – were not unbundled because they are only available to PGW firm sales customers of PGW. PGW St. 2, p. 4.

customer charge, a GCR charge, and a distribution charge. The distribution charge contains a delivery charge as well as two surcharges, the Universal Service and Energy Conservation Surcharge and the Restructuring and Consumer Education Surcharge.¹⁸ In addition, several riders may apply to the rate including the migration rider, a reverse migration rider, an exit fee provision and two specialized rate riders.¹⁹ Mr. Gorman demonstrated that the rate elements proposed for each part of the new unbundled rates produced the same amount of revenues by class, and overall as PGW was collecting on a *pro forma* basis prior to the unbundling.²⁰

(PGW M.B., pp. 8-11; R.D., pp. 19-22).

PGW submits that its approach to the unbundling of each element of both the Firm Rate schedules and the Interruptible Rate schedules are comparable. The Parties' arguments concerning what cost elements are to be included in the as GCR are addressed, *infra*, as part of the overall discussion of unbundling. The Parties did not specifically except to PGW's customer or distribution charge as applied to Firm Rate services.

PGW unbundled all of its interruptible service rate schedules using close to the same basic approach that it used to unbundle the firm rate schedules. PGW provides Interruptible Sales Service to about 400 large industrial customers with alternative fuel capability in three general categories: Boiler and Power Plant Service (Rate BPS), Load Balancing Service (Rate LBS) and Cogeneration Service (Rate CG, which is also referred to hereinafter as Interruptible Sales Service or ISS).²¹ All three of these rates are established based upon the alternative price of fuel, with floors established so that the

¹⁸ See, Gas Tariff No. 2, Original Page No. 84.

¹⁹ *Id.*, p. 85.

²⁰ See, PGW St. 4, p. 11; Exh. HSG – 3C. (This proof of revenue neutrality does not include the Restructuring Surcharge or the new cost recovery claims in the Universal Service Charge (USC). (*Id.*)

²¹ PGW St. 2, p. 5.

price never falls below the cost of gas sold to the customers plus a profit margin. (PGW M.B., p. 16; R.D., pp. 22-23).

PGW contended that if it will not be harmed financially should a customer avail itself of transportation service, "it will have every incentive to structure its rules and operational requirements to permit transportation, thereby assuring that customers will be able to obtain the most economic deal possible." PGW also argued that "the resulting simple margin 'maximum' transportation rates are the same as those that will be used in the current Transportation Pilot" and will provide some continuity to customers participating in the Pilot. Finally, PGW asserted that "Customers will still have the ability to negotiate different rate arrangements if competitive conditions make such alternatives in the best interest of the Company and its firm customers." (PGW M.B., p. 17; R.D., p. 24).

Addressing the unbundling of the various rate schedules, the ALJ recommended the following: (1) that the Commission allow PGW's proposed rates to be implemented temporarily; (2) that these rate issues be included in the proposed collaborative, as appropriate; and (3) that PGW propose a new set of cost-based rates and tariffs to the Commission by July 1, 2004. (R.D., pp. 31-32).

As a result, we shall adopt the ALJ's recommendation as modified by our findings concerning the GCR costs in the following Section.

C. GCR

The following is a comparison of the costs included in the GCR and the calculated GCR rate of the various parties:

	Total/Net (\$000)	Total/Net (\$000)
Costs:	PGW - \$335,810/\$290,415	Rate: PGW \$5.7088/\$4.9371
	OCA - \$306,306/\$284,548	OCA \$5.203/\$4.8374
	OSBA - \$375,780/\$315,431	OSBA \$6.3883/\$5.3624

(Attachment 2 to OSBA MB; R.D., p. 28).

The OTS noted that PGW has unbundled its current retail rate to a customer charge, a delivery rate, a single gas cost rate and various other surcharges. The OTS contended that PGW should continue the unbundling process by separating its GCR into two component parts (gas commodity and gas demand) and that there should be separate E-factors for each part.²² The ALJ recommended rejection of this proposal, concluding that these elements should be the subject of discussion among the Parties and be made part of the next GCR filed by PGW. (R.D., pp. 24-25).

The ALJ recommended including the LNG related gas costs in the GCR, as proposed by PGW and challenged by the OCA. Accordingly, the ALJ recommended the inclusion and exclusion of certain specific costs in PGW's GCR. In particular, the ALJ recommended that PGW's GCR include production expenses, LNG and LNG operations expenses, non-operating income and unbilled income. Conversely, the ALJ recommended that PGW's GCR exclude uncollectible costs, A&G billing expense, depreciation expense, taxes and financing costs net of charges.

In Exceptions, PGW argues that the ALJ erred in her rejection of the non-gas costs. (PGW Exc., 13-15; R.Exc., pp. 1-2).

²² OTS St. No. 2, p. 4.

The OCA argues that the ALJ erred by including operating costs associated with PGW's LNG plant. The OCA maintains that the LNG related operating expenses should remain in base rates and not be subject to annual review and reconciliation. The OSBA and the OCA argue that the ALJ erred in not including Supply Security Costs, Balancing Demand/Capacity Charges and Injection/Withdrawal Balancing charges in the calculation of GCR gas costs. (OCA Exc., pp. 3-6; R.Exc., pp. 1-2; OSBA Exc., pp. 13-15; R.Exc., pp. 7-9). The OCA contends that the \$41 million of proposed GCR costs included by PGW, are currently being recovered in base rates and, therefore, should be removed from the restructured GCR.

Finally, the OSBA argues that the ALJ erred in concluding that costs incurred by PGW to provide gas supply service are not gas costs. (OSBA Exc., pp. 13-15). However, the OCA and CEPA submit that Uncollectible Expenses and Working Capital expense should be excluded from the GCR and that the ALJ is correct in her conclusion. (OCA R.Exc., pp. 21-22; CEPA R.Exc., p. 16).

We note that, in this proceeding, PGW proposed to move LNG operating expenses out of base rates and recover them through the GCR. We find that the LNG costs are normal operating expenses associated with the operation of the LNG facilities and should not be subject to the annual review and reconciliation process of the GCR. This is consistent with how we have permitted similar LNG expenses to be recovered by other Pennsylvania NGDCs that own and operate LNG facilities. There is no justification for according reconciliation treatment to LNG operating expenses, except for the related fuel costs. Expenses related to operating the NGDC's facilities are traditionally recovered in base rates and should continue to be recovered in this manner post restructuring. Only the fuel related LNG costs, which equate to \$1,151,000,²³ are properly included within the purchased gas costs as defined by Section 1307 of the Code.

²³ See, OSBA Exhibit RDK-R2.

Therefore, we shall reverse the ALJ and exclude LNG operating costs from PGW's GCR rate. The Exceptions of the OCA are granted, in part, consistent with the foregoing and the Exceptions of PGW and the OSBA are denied.

In addition to the foregoing, we find convincing the OTS' argument that PGW should continue the unbundling process by separating its GCR into two component parts (gas commodity and gas demand), with a separate E-factor for each part. The ALJ recommended rejection of this proposal at this point in time, concluding that PGW could not accommodate the proposal at this time in its computer system and that these elements should be the subject of discussion among the Parties in the form of a collaborative. Finally, the ALJ recommended that the OTS' proposal be made part of the next GCR filed by PGW. No Party filed Exceptions to the ALJ recommendation.

The ALJ's recommendation to refine PGW's GCR as proposed by the OTS is consistent with the policy of 1307(f) of the Code to accurately track natural gas costs and consistent with the practices of other NGDCs. However, implementation will require substantial modification to PGW's computer systems. As a result, we shall adopt that portion of the ALJ's recommendation which requires PGW to refine its GCR filing to include a breakdown of its GCR gas cost into commodity and demand charges and including separate E-factors. However, we reject the ALJ's recommendation for a collaborative and direct that the foregoing be implemented in PGW's next GCR filing.

D. Interruptible Transportation Rate Unbundling

PGW's unbundled Interruptible Transportation (IT) rates were developed based on the unbundling of gas cost and the margin elements from the Interruptible Sales Service (ISS) customer classes. A simple margin was calculated using the realized margin for each of the ISS classes over the last three years. The resulting transportation

rates assured PGW that, if all ISS customers switched to transportation service, PGW would realize the same level of margin it now receives from the ISS class.

PICGUG argued that PGW's proposed unbundled IT rates are not cost-based and the Commission has moved, through policy and precedent, from setting margin-based transportation rates to a clear statement that transportation rates should be cost based. *See Pennsylvania Public Utility Commission v. Peoples Natural Gas Company*, 90 PUR 4th 504 (Feb. 16, 1988); *Re Gas Transportation Tariffs*, 171 PUR 4th 496 (Aug. 28, 1996). (PICGUG M.B., pp. 9-13)(R.D., p. 33).

The OCA argued that in PGW's recently concluded rate case in *Pennsylvania Public Utility Commission v. PGW*, Docket No. R-00017034 (Order entered August 8, 2002), the cost of service study indicated that the aggregate rates of the interruptible and transportation classes did reflect PGW's costs and, therefore, the OCA maintained that PGW's proposed IT rates also reflect the cost of serving interruptible customers. (OCA M.B., p. 21).

The ALJ concluded that PGW's proposed IT rates were flawed in that the rates are not cost based, but are margin based in contravention of Commission policy. The ALJ noted that, taken with PGW's existing GTS rates, the IT rates discriminate between rate classes. The ALJ found that PICGUG's IT rate proposal was also flawed, and recommended that the Commission reject it. (R.D., p. 39). The ALJ recommended the following: (1) that the Commission allow PGW's proposed rates to be implemented temporarily; (2) that these rate issues be included in the proposed collaborative, as appropriate; and (3) that PGW propose a new set of cost-based rates and tariffs to the Commission by July 1, 2004. (*Id.*).

PGW excepts to the ALJ's recommendation that its proposed rates be implemented temporarily and included in the proposed collaborative. PGW argues that

the marginal rates proposed by it be adopted and a trigger be set, as an alternative to the inclusion in the collaborative, such as 40% of all throughput for the beginning of the transition from margin to cost based rates. (PGW Exc., pp. 6-7).

The OCA contends that the issue of IT rates should be addressed in PGW's next base rate case and not in this Restructuring Proceeding or in a collaborative. The OCA contends that lowering PGW's IT rates will result in an impermissible shift in costs from interruptible to firm customers. (OCA Exc., pp. 6-7).

The OSBA argues that the Commission should reject the ALJ's proposal to delegate the interruptible transportation rate design to a collaborative process. While a collaborative may have merit for addressing the specific details of the transportation rates for large interruptible customers, the OSBA recommends that the Commission establish guidelines based on the OSBA proposal for interruptible transportation rates before turning the matter over to PGW and a collaborative process. (OSBA Exc., pp. 15-16; R.Exc., pp. 2-5).

PICGUG maintains that the ALJ's recommendation should be implemented on an expedited basis to allow for revised cost based rates to be presented to the Commission by July 1, 2003, and implemented no later than November 1, 2003, not a proposal of new rates by July 1, 2004, as recommended by the ALJ. (PICGUG Exc., pp. 4-7; PICGUG R.Exc., pp. 10; 15-17). PICGUG contends that the ALJ erred in rejecting PECO's IT Rates as a basis for comparing PGW's proposed rate schedule IT.

Upon review of the record on this issue, we conclude that the issue of IT rates should be addressed in PGW's next base rate proceeding and not within the current restructuring case. We find that lowering PGW's IT rates in this proceeding may result in an impermissible shift in costs from interruptible customers to firm customers. As a

result, we will direct PGW to develop cost based IT rates for our consideration in its next base rate filing. However, we decline to direct that a cost-based rate case be filed in July 2004 as recommended by the ALJ. The decision as to when to file a rate proceeding is a management decision for PGW to make and not one for us to impose. Accordingly, the Exceptions of the OCA and PGW are granted and the Exceptions of the OSBA and PICGUG are denied relative to this issue.

IV. Customer Choice Program Design

A. Supplier Tariff, Rules, Regulations and Procedures

1. Switching Fee

PGW proposed a \$10.00 switching fee to be imposed on NGSs for each customer that switches suppliers after the initial enrollment (Supplier Tariff Rule 6.1.E.). Pursuant to the PGW proposal, the switching fee would not be charged to a customer returning to Supplier of Last Resort (SOLR) service. No party opposed the amount of the proposed fee.

The OSBA opposed the recommendation as being anti-competitive. (OSBA M.B., p. 32). The OSBA proposed that any applicable switching fee be charged to the customer and not the NGS. The OSBA's proposal would result in a customer being assessed a fee for return to SOLR service, except in the case of a supplier default.

The OCA did not oppose PGW's proposal and, in fact, opposed the OSBA's proposal. (OCA St. 1R, p. 5). The OCA argued that the OSBA's proposal would result in an unnecessary and unreasonable charge to customers seeking to return to regulated service. (OCA M.B., pp. 3-4).

The ALJ agrees with the OCA that customers should not be hindered in any way in returning from SOLR service and recommended that the OSBA's proposal be rejected and that PGW's proposal be adopted. (R.D., p. 45).

In its Exceptions, the OSBA concedes that the fee is a minor issue, but charged that it was part of a concerted effort by PGW to discourage retail competition.

The OSBA maintains that any switching fee apply on a non-discriminatory basis that does not further discourage competition in retail gas supply. (OSBA Exc., pp. 18-19).

The OCA rejoins that the OSBA's proposed fees were in contravention of the Act because they would hinder a customer's desired return to SOLR service. The OCA argued further that PGW would be in the absurd position of having to charge itself \$10.00 for every customer returning to SOLR service. (OCA R.Exc., p. 26).

The ALJ's recommendation is adopted. We note that no Party in the proceeding objected to the amount of the fee and that the fee is consistent with a similar charge that was authorized in the *UGI* restructuring proceeding. However, while we recognize that there is a cost to the NGDC to process customer switching among NGSs, this fee should be reevaluated as customer choice evolves on PGW's system.

We deny the OSBA's Exception.

2. Supplier Imbalances and Penalties

To reliably serve its customers, an NGDC must impose certain requirements on the delivery of natural gas by NGSs to its city gate. Since PGW proposes to retain control of the load balancing function, it proposes that the NGSs be required to deliver gas either to the city gate or to PGW's storage facilities. PGW further requires that deliveries must reasonably be in balance with the demands of the customers served by the NGS, and with the expectations of the NGDC.

NGDCs will typically allow a range for natural gas deliveries, within which an NGS does not incur substantial penalties for noncompliance. It is the industry practice that, for deliveries beyond the allowable range, a substantial penalty be imposed to prevent the NGDCs customers from bearing the costs of NGS noncompliance. For

deliveries to customers in Rate Schedule DB and GTS, PGW is proposing a daily tolerance range of plus or minus 5% and a monthly imbalance tolerance of 2.5%. The OTS supports the PGW proposal. (OTS M.B., pp 12-14).

PICGUG opposed the recommendation and proposed a daily tolerance rate of plus or minus 10% and a monthly imbalance tolerance of 5%. (PICGUG M.B., pp. 29-34). The OSBA opposed the recommendation, as being anti-competitive. (OSBA M.B., pp. 30-32). The OTS opposed the PICGUG/OSBA proposal. (OTS M.B., pp. 12-15).

The ALJ recommended that PGW's proposed daily tolerance level of plus or minus 5%, and a monthly imbalance tolerance of 2.5% for the Daily Balance (DB) and Gas Transportation Service (GTS) Rate Schedules be adopted. (R.D., p. 55).

In its Exceptions, the OSBA argues that PGW's proposed charges for retail suppliers are much more stringent than those imposed on suppliers for large industrial customers. The OSBA asserts that proposed penalties make retail competition relatively less attractive for alternative suppliers than it would be if penalties were consistent between the two types of services. (OSBA Exc., pp. 17-18).

PICGUG, in its Exceptions, contends that, under PGW's Rate Schedule GTS, PGW provides a monthly balancing tolerance of +/-5% and a daily balancing requirement of +/-10%. PICGUG argues that PGW has provided no justification for the sharp decrease in the balancing tolerances. PICGUG argues further that PGW's proposed stringent banking and balancing requirements may result in NGSs passing through these charges to customers, resulting in higher bids for natural gas supply. (PICGUG Exc., pp. 12-15).

PGW rejoins that the ALJ properly found that its firm and interruptible transportation rules, including its proposed imbalance tolerances, surcharges and cash-out formulas, were just and reasonable and nondiscriminatory. PGW continues that the tolerances, penalties and cash-out for interruptible transportation "are reasonable, foster transportation, and minimize the financial exposure of the sales customers." According to PGW, the ALJ correctly observed that the ranges proposed by PGW were "in line" with those employed by other Pennsylvania NGDCs. (PGW R.Exc., pp. 6-8).

We agree with the ALJ's recommendation on these issues noting, as does the OTS, that the tolerance ranges proposed by PGW will foster transportation and minimize the financial exposure of sales customers. In addition, the proposed ranges and penalties are consistent with those utilized by other NGDCs. However, the ALJ's *recommendation for a collaborative is rejected. This process is not necessary as the penalty issue will be reevaluated as customer choice evolves on PGW's system.* Therefore, the Exceptions of the OSBA and PICGUG are denied.

V. Tariff Issues Pertaining to Chapter 56 and Customer Protections

A. Standards and Billing Practices

The Act requires PGW to convert its accounting, billing, collection, and other systems and procedures to comply with the requirements applicable to jurisdictional gas companies and the applicable rules, regulations, and orders of the Commission. 66 Pa. C.S. 2212(h)(1). PGW must meet the Commission's residential utility service requirements of Chapter 56 and must maintain existing consumer protections and policies at the same level of quality. (R.D., p. 55).

PGW argued that it has made improvements to its new computer system which improved its billing and collection capabilities and that it has also improved the access to its call center and has increased employee training. In addition, it is PGW's position that it has improved its ability to track payment arrangements and to accept credit card and check payments. PGW argued that these changes not only maintain but improve the level of consumer protections as required by the Act. (R.D., pp. 55-56). PGW also argued that its proposed tariff is fully compliant with Chapter 56 and that the new tariff does not need to include all of the provisions of the old tariff that purportedly provide more consumer protections than Chapter 56. (R.D., p. 57) (PGW M.B., pp. 62-63).

The OCA and CEPA asserted that PGW's tariff neither complies with Chapter 56 nor meets the requirements of the Act. It is the OCA position that the Commission should direct PGW to file a revised tariff that restores the consumer protections and clearly complies with Chapter 56. (R.D., pp. 57-60) (OCA M.B., p. 25; CEPA M.B., pp. 4-5).

The ALJ concluded that PGW's proposed tariff does not have to contain the exact provisions of the prior tariff in order to maintain the same level of consumer protections, nor does the tariff have to repeat Chapter 56 provisions word for word. The ALJ recommended the establishment of a collaborative group chaired by appropriate Commission personnel, including personnel from the Bureau of Consumer Services (BCS), as well as PGW, the OCA and the OTS, to ensure that an appropriate and compliant set of tariffs is produced. (R.D., pp. 61-62).

PGW argues that the ALJ erred in recommending a collaborative and in failing to conclude that the tariff is consistent with Chapter 56. PGW reiterates that the provisions of the proposed tariff are fully consistent with Chapter 56. Further, PGW claims that referring this matter to a collaborative will unavoidably interfere with a PGW management function by opening up the design of PGW's restructuring tariff to anyone who is interested in participating. In addition, PGW acknowledges that any provision of the tariff found to be inconsistent with Chapter 56 would be superceded by the Chapter. *For these reasons, PGW argues that the tariff should be permitted to become effective without the formation of a collaborative.* In the event a collaborative is necessary, PGW requests that the tariff be allowed to become effective pending the outcome of the collaborative. (PGW Exc., pp. 25-28; PGW R.Exc., pp. 11-16).

The OCA agrees with the ALJ's conclusion that PGW's proposed tariff is not in compliance with Chapter 56. The OCA is concerned that the ALJ's recommendation for a collaborative does not provide enough guidance to resolve the numerous compliance issues. The OCA believes that for a collaborative to work efficiently the Commission must provide clear policy guidelines that provide a mechanism for resolving key issues. The OCA contends that many of the changes PGW proposes to make to its tariff will decrease the level of quality of consumer services and protections in violation of the Act. The OCA argues that the Commission should specify that PGW's tariff must include enough detail to ensure that it complies with Chapter 56 and that other interested

parties should also be allowed to participate in the collaborative process as well. (OCA Exc., pp. 8-15).

CEPA excepts to the Recommended Decision on the basis that the ALJ erred in not ruling on the specific tariff proposals cited by CEPA that purportedly provide a lower level of consumer protection. CEPA also excepts to the Recommended Decision on the basis that the ALJ erred in recommending a collaborative working group to produce a tariff that is in compliance with Commission rules and regulations. CEPA believes that PGW's proposed tariff clearly does not preserve the required levels of consumer protections, and that the Commission should specifically identify the provisions that are not in compliance and should order PGW to file a compliance tariff.

CEPA also opposes the makeup of the collaborative group recommended by the ALJ. CEPA questions whether a collaborative is legal and argues that if it is legal it is inappropriate to omit CEPA and other litigants from the group. Finally, CEPA excepts to the ALJ's ruling that granted PGW's Motion to Strike significant portions of CEPA's Main Brief due to "factual references not based on the record." (CEPA Exc., pp. 6-15).

Upon review of the record on this issue, the ALJ's recommendation for a collaborative is denied. The BCS and PGW have been meeting since July 1, 2000, to bring PGW's practices into compliance with Chapter 56. On July 20, 2000, PGW and the Commission signed a Memorandum of Understanding with the purpose to "establish a common basis of understanding between the Commission and PGW concerning the manner in which PGW will administer its customer service and customer complaint handling procedures for residential customers as of July 1, 2000, through the effective date of a restructuring order by the PUC... ." There is no need to hold a further collaborative on this issue. On the effective date of this Opinion and Order, Chapter 56 will be in effect and any PGW tariff provision that does not meet the standards of

Chapter 56 is void. The compliance filing resulting from this Opinion and Order is the appropriate time for PGW to revise its tariffs to conform with Chapter 56.

As a result, we will deny the Exceptions of PGW and the OCA and grant, in part, the Exceptions of CEPA.

B. Customer Service Centers

In January 2002, PGW began cutting the number of days that its Customer Service Centers (CSCs) were open to the public. In June 2002, PGW closed two CSCs and continued to open the other offices three or four days a week. The net effect was that in June 2002, the CSCs were open for 656 hours. This represents a 50% reduction in availability of the CSCs when compared to July 2000. The issue in dispute is whether this reduction violates the Customer Choice Act by reducing customer service and consumer protections. (R.D., p. 63).

SEIU argued that the closures and reduction in hours are prohibited by the Act. This position is based on two of the Act's provisions that require that customer service and protections be maintained at the same level of quality under retail competition as in existence on the effective date of the Act. In addition, the Act requires the Commission to continue the level and nature of consumer protections, policies and services that are in existence as of the effective date of the Act to assist low-income retail gas customers afford service. (R.D., p. 63). SEIU contended that, under Section 1505 of the Code, 66 Pa C.S. §1505, the Commission has the authority to order PGW to reopen the CSCs it has closed and to keep all its CSCs open for a full day, five days a week. (SEIU M.B., pp. 11-12) (R.D., p. 64).

PGW asserted that, if SEIU is to obtain the relief sought regarding the CSCs, it should be through the complaint process. It is PGW's position that the closure

of the CSCs as well as the reduction in the hours of operation was a management decision made in response to a Management Audit conducted at the behest of the Commission. PGW characterized the closure and reductions as a cost cutting measure. (SEIU M.B., p. 10) (R.D., pp. 64-65).

The ALJ concluded that PGW need not keep its CSCs open in order to comply with the Act. However, should the closure or limited availability of the CSCs result in a reduction in the ability of customers to access services, PGW would be required to find alternative ways to provide those services to its customers. The ALJ, due to insufficient evidence, was unable to reach a conclusion as to whether or not such services were available. (R.D., p. 66).

SEIU excepts to the ALJ's failure to order any remedy for PGW's decision to close some, and reduce the operating hours of other, CSCs. SEIU notes that PGW requires low-income customers to visit a CSC to apply for CRP and, in some cases, to restore service after a disconnect. It is the view of SEIU that the ALJ has found that PGW has failed to maintain the level of service to low-income customers that existed on the effective date of the Act. Based on that view, SEIU argues that the Commission must order PGW to restore the operation of the CSCs to the level that existed on the effective date of the Act. Additionally, SEIU takes the position that PGW should be required to seek Commission approval prior to any cutbacks in the operations of the CSCs. (SEIU EXC, pp. 5-6).

PGW counters that the ALJ erred by not summarily dismissing SEIU's challenge to the utility's decision to close two CSCs and reduce the hours of operation of others. PGW argues that the decision, relative to the CSCs, was made in response to the Commission's Management Audit of PGW that found that the district offices may no longer be cost effective and directed PGW to conduct a study to determine whether district offices should be closed. Therefore, it is PGW's view that the decision to close

CSCs had nothing to do with restructuring. As a result, PGW states that the ALJ should have dismissed SEIU's claim as being outside the scope of this proceeding.

In addition, PGW argues that Section 2203(7) of the Act requires the maintenance of low-income protections and policies and services "which assist low-income gas customers to afford natural gas service." PGW claims that, because district offices in no way reduce the rates or required payments of customers, they do not assist low-income customers to afford natural gas service. Finally, PGW puts forth the position that even if the district office issue is within the scope of this proceeding, the relief sought by SEIU is beyond the Commission's enabling authority.

It is PGW's position that the ALJ properly refrained from interfering with PGW's decision to close two offices and reduce the hours of operation of other district offices. PGW notes that it is the only major utility which still operates district offices and characterizes SEIU's position as an attempt to force PGW to hire additional union employees. PGW maintains that it has dramatically improved its overall level of customer service since the effective date of the Act. Based on the above, PGW urges the Commission to reject SEIU's arguments. (PGW R.Exc., pp. 15-17).

We adopt the recommendation of the ALJ. Operations of its CSCs should be left to PGW's management. This management decision does not relate to the issues in this Restructuring Proceeding. The ALJ properly recognized that fact when she stated: "I acknowledge PGW's assertion that SEIU's true interest in this case is protection and promotion of union interests, and not representation of customer interests, I agree." (R.D., p. 66). The ALJ comments that if PGW's level of service was affected by the centers being closed, PGW would be required to find effective ways to provide those services to its customers. The record reflects that PGW has dramatically improved (not just maintained) access to its call centers as a means of interacting with PGW, which is also a function provided by the CSCs. (PGW M.B., pp. 60-62). The record reflects that

PGW will, as it is required under the Act, maintain all of its customer service functions at the same levels of quality as it has in the past. It should also be noted that PGW is the only major gas utility in the Commonwealth that continues to operate six CSCs within its service territory.

Therefore, the Exception of SEIU is denied and the Exception of PGW is granted, consistent with this Opinion and Order.

C. Senior Citizen's Discount

Since 1973, PGW has operated a Senior Citizen Discount (SCD) program. This program offers senior citizens, defined as those who are age 65 or older, with a 20% discount on their PGW bills. In enacting the Gas Choice Act, the General Assembly addressed PGW's SCD by stating that "[t]he Commission may approve a program designed to provide discounted rates for natural gas distribution and supply services to senior citizens residing in the service territory of a city natural gas distribution operation provided that such rates and the terms of such program are just and reasonable." 66 Pa. C.S. §2212(r)(1). Additionally, the Act acknowledged the authority of Philadelphia's City Council over the program and required that grandfathered participants in the SCD continue to receive the pre-Act SCD. 66 Pa. C.S. §2212(r)(2). (R.D., pp. 67-68).

PGW's plan is to admit no new participants after September 1, 2003, and to allow the present participants to remain in the program. The OTS, CEPA, and SEIU all oppose this proposal. (R.D., p. 68). PGW proposes to maintain the SCD for grandfathered participants, but to close the program to any additional entrants. PGW maintains that the phase-out of the SCD was initiated by the Commission through its management audit of PGW. (R.D., p. 69).

The OTS argued that the SCD is an unjust and unreasonable rate because there is no means test. As a result, it is possible that wealthy customers are receiving the benefit of the program. In the opinion of the OTS, it is not reasonable to offer a non-income related discount to one class and shift the burden of these costs to other classes. (OTS M.B., pp. 9-12).

CEPA argued that the SCD is outside the Commission's jurisdiction based on the Act. CEPA opposed PGW's plan to terminate the program and also opposes any action by the Commission to direct PGW to request that City Council abolish the program. (CEPA M.B., p.47; CEPA R.B., pp. 17-18; R.D., p. 72).

In SEIU's view, PGW's SCD is a just and reasonable rate based on a number of factors. SEIU notes that PGW's rates under the Philadelphia Gas Commission were required to be just and reasonable and that both PGW and the City's Water Department have SCD programs that have been accepted by the Pennsylvania courts. Finally, SEIU points out that public utilities in other states have received approval for SCD-type programs. (SEIU M.B., pp. 15-21; R.D., pp. 72-76).

The ALJ recommended that the Commission allow PGW to implement its SCD proposal not because she agrees with it but because, in her opinion, it comports with Commission policy. (R.D., p. 76).

In its Exceptions, the OTS takes the position that the ALJ's decision that PGW be allowed to gradually abolish the SCD program is misguided. According to the OTS such a phase-out is unduly burdensome. In the OTS' view it is feasible that the program, as recommended, will not be entirely eliminated for over twenty years. The OTS favors a gradual five year phase-out of the program and states that the advantages of such an approach include the establishment of a definite ending date with a clearly defined reduction in program benefits allowing customers to adjust over a period of

five years. The OTS agrees that the SCD program was founded by Philadelphia City Council and that the elimination of the program would require action by the Council.

CEPA takes exception to the ALJ's recommendation because the recommendation may possibly not be limited to a simple approval of the proposed SCD tariff provisions. It is CEPA's view that, to the extent that the ALJ recommendation that the Commission prejudice its response to any modification of the program that might be proposed by the City of Philadelphia "by ordinance," it should not be followed. It is CEPA's position that doing otherwise would result in the Commission exceeding its enabling authority. (CEPA Exc., pp. 23-24).

It is the position of SEIU that the ALJ erred in failing to order PGW to retain its existing SCD program. SEIU argues that the ALJ decision gives PGW a tremendous amount of unauthorized discretion over the SCD. SEIU states that PGW has not asked City Council to approve any change in the SCD and that the Commission should not change it, particularly when the record indicates a need for the discount. SEIU acknowledges that the Act gives the Commission the authority to either grandfather the rate or retain the rate for all senior citizens. (SEIU Exc., p. 7).

Upon review of the record on this issue, we will adopt the recommendation of the ALJ as being consistent with Section 2212(r) of the Act. The Commission has jurisdiction over programs to provide discounted natural gas service to senior citizens residing in PGW's service territory. Section 2212(r)(1) authorizes the Commission to "approve a program...provided that such rates and terms of such program are just and reasonable." There is only one statutory limitation placed on the Commission's oversight of such a program. Section 2212(r)(2) states that those senior citizens receiving discounted service at the time the post-restructuring tariff takes effect under Section 2212(d) "shall be entitled to continue to receive such discount under the terms of the prior tariff unless and until the program is modified by ordinance of the governing

body of the city.” However, the Commission is not required to approve a program that allows new participants to enroll after the Commission approved restructuring tariff takes effect. Section 2212(r)(3) expressly addresses this point: “Nothing in this title shall require the commission to approve the continuation of the program identified in paragraph (2) in whole or in part for any person other than an individual identified in paragraph (2).”

Based on the foregoing, the Exceptions of the OTS, CEPA and SEIU are denied.

VI. Consumer Education

The Act provides that a consumer education program be established by PGW to inform customers of the changes in the natural gas utility industry and that the program provide retail gas customers with information necessary to help them make appropriate choices as to their natural gas service. 66 Pa. C.S. §2206(d).

The OCA submitted that PGW's proposed consumer education plan does not provide adequate information to enable customers to make informed choices about choosing a natural gas supplier, and that it also fails to educate the customers on the changes in operations caused by Commission regulation. (OCA M.B., p. 36). The OCA requested that the Commission direct PGW to file a more complete consumer education plan which addresses the changes caused by Commission jurisdiction and retail choice. The OCA is particularly concerned with changes in the development of an educational bill insert on customer choice, as well as PGW's low-income and senior citizen discount programs, dispute resolution, credit and collection procedures, and termination policies. (*Id.*, pp. 37-39).

The OCA recommended that PGW provide consumer education to its customers regarding Chapter 56 regulations and other issues related to the transfer of jurisdiction from the City of Philadelphia to the Commission. PGW should seek input from community-based organizations to help reach customers most effectively, particularly low-income customers and senior citizens. The OCA believes the Commission should require PGW to establish an advisory committee to assist in revising its consumer education plan. The advisory committee should include the OCA, community-based organizations, and other interested stakeholders. The plan should provide customers with information related to the Commission's customer service regulations as well as changes in PGW's practices and procedures. (OCA M.B., pp. 35-42)(R.D., pp. 77-78).

Because the costs of the consumer education program will be recovered through the Restructuring and Consumer Education Surcharge, PGW does not oppose the OCA's proposals. (R.D., p. 78). The ALJ recommended that the Commission adopt the OCA's proposal for consumer education. (R.D., p. 78). No Parties filed Exceptions to the ALJ's recommendation.

We believe that the OCA's proposals regarding consumer education are reasonable and in the public interest. This working group will revise PGW's consumer education plan and draft the bill inserts needed to provide customers with essential information about the Commission's consumer protection policies, the changes in PGW's practices and procedures, as well as the changes in the low-income and senior discount programs. In adopting the ALJ's recommendation, we note that PGW's participation in the statewide consumer education program was mandated in *Creation and Implementation of a Statewide Consumer Education Program for Natural Gas Competition*, Docket No. M-00001326, entered on November 8, 2002. As a result, PGW shall work in conjunction with the Council on Utility Choice and the Commission Staff to establish the advisory committee as proposed by the OCA.

VII. Consumer Protections and Other Aspects of Gas Choice Implementation

The OCA addressed PGW's proposal on bill format, security requirements, complaint handling procedures, door-to-door marketing issues, appliance repair issues, and other customer choice issues. The OCA recommended that PGW make the following revisions to its proposed procedures.

- First, PGW should be directed to revise its current bill to include separate charges for gas distribution and gas supply to help educate customers regarding the "price to compare." The revised bill format should be submitted with PGW's compliance filing.
- Second, given the unique conditions of PGW's service territory and the recent experiences with suppliers abruptly exiting the market, PGW's Supplier Tariff should require suppliers who seek to market customers in PGW's service territory to post financial security for consumer protection purposes payable upon order of the Commission.
- Third, PGW should submit revised tariffs and procedures with its compliance filing that fully accommodate retail choice, particularly in areas such as consumer complaint handling, application for service, deposits, credit and collection, termination, allocation of partial payments, and its appliance service.

(OCA M.B., pp. 49-50).

The ALJ recommended that the OCA's proposed revisions be adopted. (R.D., pp. 78-79). No Party filed Exceptions to the ALJ's recommended resolution. We find the proposed revisions to be reasonable and in the public interest. Accordingly, we shall adopt the ALJ's recommendation without further comment.

VIII. Universal Service Issues

PGW's CRP "is a percent-of-income customer assistance program designed to offer affordable and discounted payment plans to low-income customers with gross household income at or below 150% of the federal poverty level. Adjustments must be made to the CRP so that it complies with the Commission's Policy Statement at 52 Pa. Code §69.265, *et seq.* Two program design issues remain in dispute: (1) excess usage charges; and (2) Low Income Home Energy Assistance Program (LIHEAP) make-up charges. (R.D., p. 80).

A. Excess Usage Charges

PGW currently assesses an excess usage charge on customers where monthly usage exceeds a class average usage in any given month. PGW proposes to suspend the charge for the first year of restructuring and then evaluate whether the charge should be reinstated. PGW pointed out that continuing excess usage charges for the first year of restructuring would cause PGW to exceed the percentage of income standards in the Commission's Policy Statement at 52 Pa. Code §69.625, *et seq.* (PGW M.B., pp. 37-38)(R.D., pp. 80-82).

The OCA proposed that the excess usage charge be eliminated, and PGW must make a proper demonstration in support of reinstatement of the charge if the Commission allows the reinstatement. (OCA M.B., pp. 58-61)(R.D., p. 81).

The OTS proposed that the charge should not be suspended in that it serves *a useful purpose in limiting consumption.* (OTS M.B., pp. 3-6)(R.D., p. 82).

The ALJ recommended that the Commission allow PGW to suspend and evaluate its excess usage charge as proposed. (R.D., p. 82).

In its Exceptions, the OTS argues that PGW's interpretation of the Commission's regulations is erroneous and the ALJ's reliance on this position compounds the error. The OTS argues that, to determine that the control provisions in the Commission's Policy Statement and Guidelines on Customer Assistance Programs are included in the maximum percentage of income payments is contrary to the intent of the regulation. (OTS Exc., pp. 5-7).

The OCA also excepts, arguing that if PGW seeks to reinstate this charge in the future, that PGW be required to make certain specific showings in support of its proposal. Specifically, the OCA has proposed that the filing must be supported by evidence to find: "(1) that the removal of the charge directly resulted in a systematic increase in consumption by CRP participants who otherwise would have paid the excess usage charge; and (2) that the increase in consumption was within the ability of the CRP participant to control." (OCA Exc., pp. 15-18).

CEPA argues that PGW's excess usage charge is not compliant with the Policy Statement. CEPA also argues that a decision to reinstate the charge cannot be done without a reevaluation of the redesigned CRP three years after implementation. (CEPA Exc., pp. 15-19).

In its Reply Exceptions, PGW rejoins that the OCA's position to establish strict standards governing reinstatement of the excess usage charge restricts its evaluation of the effects of eliminating the charge and should be rejected. PGW excepts to the OTS' position to prohibit suspension of the charge arguing that the OTS position ignores evaluation of whether PGW's CRP program is applicable to CRP participants with excess usage. (PGW R.Exc., pp. 21-22).

In its Reply Exceptions, the OTS counters that the positions of the OCA and CEPA, that there is no authorization for the continuation of the excess usage charge, lacks merit and should be denied. (OTS R.Exc., pp. 14-16).

The OCA argues that the OTS misinterprets the Policy Statement. The OCA submits, as discussed by PGW evaluator, Dr. H. Gil Peach and the OCA witness Roger Colton, that an excess usage charge represents a penalty to customers who do not have the ability to control their usage, including the impacts of space heaters and water heaters. The OCA further submits that the excess usage charge should be eliminated and the OTS' Exception denied. (OCA R.Exc., pp. 26-27).

CEPA argues that the OTS misinterprets the Policy Statement. CEPA submits that the provision at 52 Pa. Code §69.265)(iii) "recommends" consumption limits and that 52 Pa. Code §69.265(3)(iv) envisions special treatments for consumption through usage reduction provisions such as energy education, weatherization, and set back thermostats. CEPA requests the Commission to deny the OTS's Exceptions. (CEPA R.Exc., pp. 10-11).

Based on our review of the record on this issue, the ALJ's recommendation will be adopted with modifications. Our Regulations at 52 Pa Code §69.265 *et seq.* set forth the design elements for customer assistance programs. PGW's proposal does not meet the requirements of Section 69.265 (3)(iii) which states that "[l]imits on consumption should be set at a percentage of a participant's historical average usage." This is intended to discourage a household from enrolling in a customer assistance program and then increasing their usage beyond the household's historical average usage. In contrast, PGW's excess usage charge is directed at every household whose average exceeds a class average. The purpose of the charge is to encourage the CRP participant to reduce usage in order to avoid the charge.

When PGW refiles this charge after its suspension and evaluation that it has agreed to, PGW is directed to revise its excess usage charge in compliance with Section 69.265(3)(iii) so that the intended purpose is achieved. Accordingly, the Exceptions of the OTS, the OCA and CEPA are granted.

B. LIHEAP Make-up Charges

The second design issue for the CRP Program is the Low Income Home Energy Assistance Program (LIHEAP). PGW proposes to suspend the CRP LIHEAP make-up charge for the years 2002 and 2003. After that, PGW proposes to evaluate the impact of suspending the LIHEAP make-up charge and determine whether the charge should be reinstated. (R.D., p. 83).

The OCA supported PGW's proposal to eliminate the penalty and opposes any reinstatement. The OCA argued that the penalty violates the federal LIHEAP statute at 42 USCA §8624(f)(1) and should be eliminated permanently. (OCA M.B., pp. 61-62) (R.D., pp. 83-85). *The OTS recommended that the charge be automatically reinstated.* (OTS M.B., pp. 6-8) (R.D., p. 83).

The ALJ recommended that the Commission adopt PGW's proposed LIHEAP make-up charge, reasoning that such a charge comports with the Commission's Policy Statement at 52 Pa. Code §69.265(9)(iv). Furthermore, the ALJ reasons that the LIHEAP make-up charge does not run afoul of Federal LIHEAP statutes because, in essence, the LIHEAP grant is an entitlement of money that belongs to PGW, not the customer. (R.D., pp. 84-85).

The OTS excepts to the ALJ's recommendation to continue waiving the LIHEAP make-up charge. The OTS argues that waiving the charge is contrary to Commission Policy and should be rejected. (OTS Exc., pp. 7-8).

The OCA submits that the LIHEAP make-up charge is illegal and must be eliminated on a permanent basis. The OCA argues that the ALJ incorrectly finds that the LIHEAP grant belongs to the Company and not the customer. (OCA Exc., p. 18).

CEPA argues that the ALJ's recommendation is contrary to PGW's expert's recommendation in his evaluation that this change not be assessed for at least three years until it could be evaluated based on actual results and compared with previous years. CEPA also argues that there is a substantial question set forth in OCA's Main Brief and Reply Brief whether a LIHEAP make-up charge is consistent with federal law. (CEPA Exc., pp. 18-22).

PGW rejoins that the Parties' Exceptions should be denied and the ALJ's recommendation adopted. PGW argues that it considers the LIHEAP grant to be an important source of funding for CRP, contrary to the OCA's Exceptions that PGW treats a LIHEAP grant as income. PGW submits that the OTS approach denies PGW the ability to conduct an evaluation of the suspension of the penalty to determine if reinstatement is warranted. (PGW R.Exc., pp. 21-23).

The OTS counters that the ALJ's recommendation to continue waiving the LIHEAP make-up charge is contrary to Commission policy and should be rejected. The OTS submits the advocates have misinterpreted the federal LIHEAP statute and Commission regulations permit the application of the charge. (OTS R. Exc., pp. 16-17).

The OCA submits that the OTS' Exceptions should be denied because the application of a LIHEAP make-up charge is illegal and adversely affects affordability. (OCA R.Exc., pp. 27-28).

CEPA argues that the OTS Exceptions should be denied because the OTS misinterprets Section 69.265(9)(iv) of the Commission's Policy Statement and misinterprets the Settlement Agreement in PGW's last base rate case. Furthermore, CEPA argues that the OTS Exceptions ignores unrebutted and overwhelmingly credible evidence in the record that a LIHEAP make-up charge would subvert the affordability of the CRP program for participants subjected to such charges. (CEPA R.Exc., pp. 12-14).

We agree with the ALJ. Conceptually, this charge does not run afoul of the Commission's Policy Statement. It must be stressed that the same Policy Statement admonishes utilities to "use this option carefully" In a similar vein, one must question how the imposition of an additional charge upon payment troubled customers can be in the public interest. At best, it will place an additional burden upon a targeted low-income group of customers who are already struggling to pay their bills.

The LIHEAP make-up charge does not violate 42 USCA §8624(f)(1) since a customer's household that does not apply for LIHEAP assistance does not receive, directly or indirectly, any LIHEAP funds. PGW's plan is accepted to the extent that it suspends the LIHEAP make-up charge for the 2002 and 2003 LIHEAP program years and we direct PGW to undertake an evaluation of whether LIHEAP revenues are affected by the suspension. However, PGW's proposal is hereby modified so as to require it to seek specific authority from this Commission following any such evaluation and prior to reinstating a LIHEAP make-up charge.

Therefore, the Exceptions of the OTS, the OCA and CEPA, relative to this issue, are denied.

IX. Universal Service Costs and Allocation

A. CRP Preprogram Arrears

PGW proposed to include \$7 million per year in the Universal Service Charge (USC) to recover a balance of \$35 million of CRP preprogram arrearages (arrears accumulated before the individuals entered the program)²⁴ amortized over a five year period. The \$35 million amount is the amount PGW projects to be on its books by September 1, 2003, and is comprised of accounts receivables from a prior period that PGW has been unable to collect up to this point. These amounts previously had been determined to be collectible, so they were never included in the calculation of PGW's bad debt expense during that period. PGW asserted that the amounts have never been included in its claims for increased rates before the Commission.

The OTS and the OCA argued, on the other hand, that it is not appropriate to include these costs in the USC. The record in this proceeding demonstrates that the primary reason that this amount was never collected was the failure of PGW's Billing Credit and Collection System (BCCS) and the poor performance of PGW's call center and credit and collection functions in recent years. As a result of these shortcomings, PGW experienced a revenue shortfall when it was unable to collect these arrearages that it had previously deemed collectible. The shortfall in revenues was made up by PGW borrowing against its short-term debt until that line of credit was fully extended. PGW's short-term debt problem has now been addressed in its recent base rate proceeding at Docket No. R-00017034, *supra*. In that proceeding, the Commission granted a rate

²⁴ PGW's CRP arrearages are the accounts receivables balance for the customers at the time that a customer enters CRP. Since 1994, PGW has built up a balance of pre-program arrearages from its CRP customers. Those customers were never required to pay any portion of their pre-program arrearages. Arrearages forgiveness is the write-off of the pre-program arrearages balances over time to the reserve account for uncollectibles. (OTS M.B., pp. 26-27; OTS St. No. 1, p. 15).

increase sufficient to allow PGW to pay down its short-term debt by \$20 million per year. (OCA St. 2S, p. 4).

The ALJ recommended that PGW's attempt to include the \$35 million in claimed pre-program arrearages in its USC be disallowed. As a rationale, the ALJ adopted the OTS' argument that this PGW claim is contrary to its cash flow rate making methodology. (R.D., pp. 86-89).

PGW excepts to the ALJ's recommendation on this issue, arguing that the ALJ erred by concluding that PGW should be prohibited from recovering the pre-restructuring frozen arrearages through the USC. PGW avers that, under either scenario, pre or post restructuring, those frozen arrearages are a direct result of PGW's continued provision of service to low-income customers who are unable or otherwise fail to pay their bills. PGW asserts that there is no rational basis for distinguishing between the pre- and post-restructuring frozen arrearages.

The OSBA also excepts to the ALJ's recommendation on this issue. The OSBA contends that, whether or not the pre-program arrearage costs are already reflected in rates, those costs are directly related to the universal service program and therefore should be included in the USC. The OSBA submits that the pre-program arrearage costs should be treated in the same manner as the bad debt costs associated with the universal service programs. (OSBA Exc., pp. 19-20).

We note that the pre-program arrearages of \$35 million represent an accounts receivable balance, which is the sum of all bills not paid by customers. Since these pre-program arrearages occurred during the time period from 1994 to date, there should have been a cash-flow problem with the non-payment of \$35 million. In the absence of a base rate case, as a cash-flow utility, PGW had to rely on short-term loans to compensate for any deficiency in revenues at the end of any particular fiscal year. While

the \$35 million may not have been included in rates, the failure of those customers responsible for the arrearages in not paying their bills was borne by the other ratepayers, and PGW was made whole either by short-term borrowing or uncollectible accounts.

Additionally, on August 8, 2002, the Commission approved a base rate increase that included revenues to pay down PGW's commercial paper program (debt). Since PGW utilized its short-term borrowings to compensate for any revenue deficiency, including the non-payment of \$35 million since 1994, any recovery in the USC would represent double recovery of the pre-program arrearages.

Accordingly, the recommendation of the ALJ is adopted in its entirety and the Exceptions of PGW and the OSBA are denied.

B. Administrative Expense and Bad Debt Expense

PGW claimed that \$5,788,401 of administrative costs should be removed from its base rates and collected through the USC. According to PGW, the basis for this proposed shift of administrative costs to the USC is to ensure the immediate pass-through of any savings or efficiencies in administration as the program size changes. Also, PGW proposed to recover 50% of its bad debt expense associated with low-income customers in the USC. PGW argued that the definition of universal service is not relevant to its claim to recover bad debts in its USC, but rather, that the claim is derived from Section 2212(h)(2) of the Act. (PGW M.B., pp. 45-46).

The ALJ recommended that administrative expenses and bad debt expenses not be allowed in PGW's USC. The ALJ observed that PGW had the burden of proof on this issue and that it did not present persuasive evidence to support its claim. (R.D., p. 92).

PGW excepts to the ALJ's recommendation because, in its opinion, the ALJ is thereby ignoring the plain language of Section 2212(h)(2) of the Act, which states that PGW can recover all "costs of providing programs for low-income ratepayers and other assisted ratepayers" through a separate surcharge.

As to administrative expenses, PGW contends that one cannot argue that administrative costs for operating low-income programs do not qualify for USC treatment under Section 2212(h) of the Act. Without administration of the programs for low income and assisted ratepayers, there are no programs. As to the bad debt expense, PGW posits that, obviously, some portion of bad debt expense is related to the service of low-income customers. PGW has estimated that one-half of its existing annual bad debt expense is associated with CRP and other low-income customers. (PGW Exc., pp. 22-24).

The OSBA also excepts to the ALJ's recommendation on this issue, contending that administrative, operating, and bad debt costs that are specifically related to the provision of universal service programs are in fact universal service program costs. Specifically, with respect to the bad debt expense, the OSBA argues that the essence of the universal service program is that PGW will forgive arrearages and incur bad debt costs. Finally, the OSBA posits that the ALJ erroneously recommended that a significant amount of the costs associated with providing universal service should be inaccurately hidden in a gas delivery charge. (OSBA Exc., pp. 20-22).

The OCA and CEPA respond to PGW's and the OSBA's Exception on this issue, arguing that the ALJ was correct in her recommendation. The OCA and CEPA point out that the types of expenses at issue herein are currently typically recovered through base rates, and that neither PGW nor the OSBA have provided any justification for moving those particular costs into the USC. Therefore, the OCA and CEPA submit

that the PGW and the OSBA Exception on this issue should be denied. (OCA R.Exc., p. 11; CEPA R.Exc., pp. 16-17).

As to administrative expenses, the problem with PGW's proposal is that administrative costs are not within the definition of "universal service" as defined in the Act. PGW's administrative costs, for example, include expense items such as the call center and district offices, which are not volatile, and are not incremental. Additionally, normalized allowances have already been provided in base rates for administrative expenses. There is, therefore, no rational basis or need to have administrative expenses reallocated to a reconcilable surcharge.

As to bad debt expense, it is based on the write-off of uncollectible accounts. PGW admits that bad debt expense is not specifically a program designed for the benefit of low-income customers. That admission alone is enough to justify denying PGW's proposal to include 50% of its bad debt expense in the USC. Additionally, we note that bad debt expense is traditionally recovered in base rates, the same as any other O & M (operations and maintenance) expense. Bad debt is determined by applying a historic ratio of net write-offs to billed revenue and applying that ratio to proposed revenues. The Commission has affirmed this methodology in its recent Opinion and Order in PGW's base rate proceeding.²⁵ PGW has not presented any evidence so as to justify a change in that methodology.

Therefore, the recommendation of the ALJ is adopted and the Exceptions of PGW and the OSBA are denied.

²⁵ Pa. P.U.C. v. Philadelphia Gas Works, R-00006042, Order entered October 4, 2001, pp. 56-59.

C. Cost Offsets

The OCA argued that PGW failed to calculate any cost offsets as a means of funding its Universal Service Program (USP). The OCA argues that PGW's proposal is in violation of the Commission's Policy Statement regarding CAPs at 52 Pa. Code §69.266.

The OCA submits that it has identified the following cost offsets and savings:

Credit and collection cost savings: Dollar savings that are based on savings generated by CAP programs.

Working capital savings (arrearage forgiveness): Dollar savings that will arise from writing off the arrearage forgiveness rather than continuing to carry these debts and paying carrying costs.

Bad debt offsets: Cost that is already included in rates that must be netted out to avoid a double collection.

Working capital savings (going forward bills): Dollar savings that will arise from increasing the collection of bills for current usage.

Bad debt offsets (going forward): An offset to account for the bad debt already in rates since billed amounts are now collected through customer payments and the CRP shortfall amount.

(OCA St. 5-Revised, pp. 36-37).

PGW countered that the Commission's Policy Statement provides that offsets are encouraged, but not required. 52 Pa. Code §69.233. PGW argued further that in view of its unique ratemaking methodology and circumstances, the likelihood of any

reduction in costs, compared to what it is charging its ratepayers, is speculative and unwarranted. (PGW M.B., pp. 54-57).

The ALJ recommended that the OCA's proposed adjustment be rejected. (R.D., p. 93).

In its Exceptions, the OCA maintains that PGW's failure to offset costs is in violation of 52 Pa. Code §69.233. The OCA continues that any reduction in arrears will generate an offsetting working capital savings which it maintains should be considered as an important source of funding for its CAP programs. (OCA Exc., pp. 21-22).

PGW rejoins that the cost savings projected by the OCA are speculative. PGW asserts that the projected offsets are based upon incorrect assumptions about PGW's ratemaking allowance for the items, or its recent accounting treatment of them. PGW adds that despite years of experience with a customer assistance plan that has continued to grow, it never saw any drops in the expenses claimed as offsets by the OCA.

The ALJ's recommendation will be adopted with modifications. The OCA's basic premise is that, before PGW is permitted to recover any claimed increased costs associated with its CRP and allocate the cost among ratepayers, it must first calculate and apply any cost savings or cost offsets attributable to the program consistent with 52 Pa Code Section 69.266. That Section states that the Commission will consider both revenue and expense impacts when evaluating customer assistance programs for ratemaking purposes. The cost savings and cost offsets, on a per participant basis, should be applied to determine the net incremental costs of the new CRP participants that are recovered from ratepayers. Nonetheless, this issue should not be decided without first having the opportunity to consider PGW's own calculations. As such, it is appropriate

that PGW track these offsets until the next base rate proceeding. At that time, PGW shall submit cost offsets and savings, if any, that it has realized based on the new data.

Therefore, the Exceptions of the OCA are granted, in part.

D. Allocation

PGW proposed to collect universal service costs from all customer classes. The OTS and the OCA support the PGW proposal. PGW reasoned that all customers and not just residential customers receive benefits from universal service programs. (PGW M.B., p. 58).

The OCA made a similar argument regarding the benefits received from all customer classes. The OCA argued further that these costs have traditionally been included in the GCR, *i.e.*, collected from all sales customers, that an important criteria of the Act is that this charge be non-bypassable, and that such a cost allocation would involve massive cost shifting between classes prohibited by Sections 2211(e) and 2212(h) of the Act. (OCA M.B., pp. 71-80; R.B., pp. 33-36).

The ALJ recommended that PGW's proposed allocation be adopted. The ALJ reasoned that all customer classes benefit, at least indirectly, by the USP. (R.D., p. 95).

In its Exceptions, the OSBA claims that the argument that the Universal Service Costs should be non-bypassable is highly selective and discriminatory argument. The OSBA alleges that evidently it is perfectly acceptable for the universal service charge to be non-bypassable charges for the sales customers of PGW, but somehow the interruptible customers are excused from this requirement. (OSBA Exc., p. 26).

In its Exceptions, PICGUG states that the Act allows all retail gas customers the opportunity to purchase natural gas supplies, effectively providing all customers the opportunity to bypass these low-income costs. PICGUG continues that the purpose of this provision is to ensure that customers responsible for the costs of these programs do not avoid paying for these programs merely by accessing the competitive natural gas supply market. Thus, according to PICGUG, the appropriate application of “non-bypassable” ensures that those customers to whom the costs are appropriately allocated cannot “bypass” this allocation. (PICGUG Exc., p. 21).

PGW rejoins that Philadelphia is home to perhaps the greatest concentration of Pennsylvania's impoverished citizens, as one third of PGW's customers are at 150% below the federal poverty level, but only a portion of those customers are taking advantage of the universal service program. PGW opines that adopting the OSBA/PICGUG proposal could make the program so expensive to the customers who can least afford it that the entire program could be threatened. (PGW R.Exc.. pp. 4-5).

The OCA counters that the costs for this program have always been recovered through the GCR and have always been paid by all firm customers. The OCA states that no one in this proceeding has advocated allocating universal service costs to interruptible customers. According to the OCA, the OSBA is correct that interruptible customers currently do not contribute toward universal service costs. (OCA R.Exc., p. 16).

According to the OCA, PGW's proposal is to assess the USC to all firm sales and transportation customers. The OCA continues that since there was little or no transportation on PGW's system prior to the Act and restructuring, all firm customers on PGW's system were firm sales customers. Therefore, argues the OCA, all of these firm sales customers contributed to the costs of universal service through payment of the GCR. The OCA argues that assessing the USC to all firm sales and transportation

customers will retain the same allocation of universal service costs that was in place prior to the Act and restructuring. (OCA R.Exc., p. 16).

The OCA submits that to reallocate these costs solely to residential customers would result in a massive shift in costs from the commercial and industrial classes to the residential class in contravention of the Act's prohibition on cost-shifting in Restructuring Proceedings. The OCA opines that such a cost-shift would result in a significant increase in rates paid by residential customers. (OCA R.Exc., p. 16).

The ALJ's recommendation should be adopted. These costs have traditionally been included in PGW's GCR and that such a cost allocation would involve massive cost shifting between classes prohibited by Sections 2211 (e) and (h) of the Act. This is a restructuring proceeding and not a base rate case. Therefore, the record does not contain a cost study that would support a shift in rate design.

Accordingly, the Exceptions of the OCA are granted, in part, and the Exceptions of PICGUG and the OSBA are denied.

X. Conclusion and Order

Based on our review of the record as developed in this proceeding, we conclude that the ALJ's Recommended Decision, as modified by this Opinion and Order, is amply supported by substantial evidence in the record; **THEREFORE**,

IT IS ORDERED:

1. That the Exceptions filed by the Parties hereto are granted or denied consistent with this Opinion and Order.
2. That the Recommended Decision of Administrative Law Judge Allison K. Turner is adopted, as modified by this Opinion and Order.
3. That the Natural Gas Choice and Competition Act Restructuring Filing that was submitted by the Philadelphia Gas Works shall be approved as modified by this Opinion and Order.
4. That the interventions of the Office of Trial Staff, the Office of Small Business Advocate, Service Employees International Union, Local 686 (SEIU), and Texas Eastern Transmission Company are granted, in part, and dismissed, in part. The intervention of PECO Energy Company is dismissed. The Petition to Intervene filed by the City Council of Philadelphia is denied.
5. That the Complaints of the Philadelphia Industrial and Commercial Gas Users Group (PICGUG) (C0001), Consumer groups including Consumers Education and Protective Association (CEPA, et al.) (C0002), and Office of Consumer Advocate (OCA) (C0003) are granted, in part, and denied, in part.

6. That PGW shall implement the settlement regarding its Field Operations Initiative (FOI) as approved and ordered by the Commission.

7. That PGW's stipulated capacity assignment and allocation proposal shall be modified consistent with this Opinion and Order.

8. That the Stipulations among the Parties regarding the restructuring and consumer education surcharge; CRP/CAP program design; supplier tariffs (as modified); and RRA/IRC shall be approved to the extent that they are consistent with this Opinion and Order.

9. That PGW shall recalculate its unbundled GCR rate consistent with this Opinion and Order.

10. That PGW shall recalculate its proposed unbundled sales and transportation rates consistent with this Opinion and Order.

11. That PGW's transportation rates be approved consistent with this Opinion and Order and that PGW file cost based rates as part of its next base rate proceeding.

12. That PGW's nominations and balancing proposals are approved.

13. That PGW's proposed switching fee is approved.

14. That PGW's proposed penalty for marketers who fail to deliver their daily delivery requirement (DDR) is approved.

15. That PGW's proposed penalty for marketers who fail to comply with an operational flow order (OFO) or a (DFD) is approved.

16. That PGW's proposed supplier tariff, supplier contract and nomination procedures are approved, with the inclusion of complaint procedures.

17. That PGW shall require suppliers who are participants in the RFP process to demonstrate that they have firm capacity rights adequate to meet and match the firm requirements of the customers they serve throughout the calendar year.

18. That the PGW shall require participants in its RFP procedure to demonstrate that they have firm capacity available at receipt (including on indirect pipelines) and delivery points for replacement capacity in the RFP process.

19. That PGW include its affected pipelines in the group to be notified and included in the RFP.

20. That PGW adhere to the Commission's code of conduct set forth in the Binding Interim Standards of Conduct Pursuant to 66 Pa. C.S. §2209(a), Docket No. M-00991249F0004 (Order entered November 22, 1999).

21. That PGW shall include the Standards of Conduct in its tariff.

22. That PGW revise its consumer education program to comply with the OCA's proposals and shall ensure compliance with the Commission's Orders such as Creation and Implementation of a Statewide Consumer Education Program for Natural Gas Competition, Docket No. M-00001326 (Order entered November 8, 2002).

23. That PGW shall, in conjunction with the Council on Utility Choice, Commission Staff, the Office of Consumer Advocate, Community-based organizations and other interested stakeholders, establish an Advisory Council to provide customers with information related to the Commission's customer service regulations as well as changes to PGW's practices and procedures.

24. That PGW ensure that its bill format is in compliance with the Bill Format Order and the Consumer Education Order.

25. That PGW comply with the Commission regulations in Chapter 56 and the generic orders issued by the Commission concerning the Gas Choice Act.

26. That PGW shall, if it is to continue the changes it has implemented to the operations of its Customer Service Centers (CSCs), ensure that its low-income customers have adequate access to make application for its customer assistance programs.

27. That PGW is hereby directed to suspend the LIHEAP make-up charge for the 2002 and 2003 LIHEAP program years and PGW is further directed to undertake an evaluation of whether LIHEAP revenues are affected by the suspension. Furthermore, PGW shall seek specific authority from this Commission following any such evaluation and prior to reinstating a LIHEAP make-up charge.

28. That the Commission's Law Bureau is hereby directed to initiate an investigation into the allegations contained in the Petition to Intervene filed by the City of Philadelphia on March 13, 2003, in order to ascertain whether PGW failed to comply with the direction of the Commission's Secretarial Letter issued April 5, 2001, and what action, if any, is deemed appropriate.

29. That the Philadelphia Gas Works file a tariff, consistent with the discussion contained herein and the foregoing Ordering Paragraphs, within forty-five (45) days of the date of entry of this Opinion and Order.

30. That it shall be incumbent upon PGW to timely comply with all the requirements of this Opinion and Order even though not expressly set forth in the foregoing *Ordering Paragraphs*.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

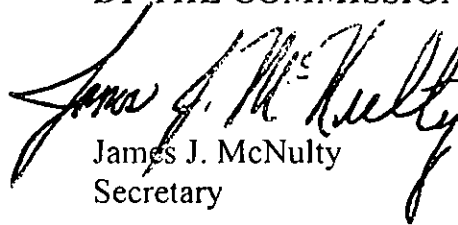
ORDER ADOPTED: March 21, 2003

ORDER ENTERED: March 31, 2003

29. That the Philadelphia Gas Works file a tariff, consistent with the discussion contained herein and the foregoing Ordering Paragraphs, within forty-five (45) days of the date of entry of this Opinion and Order.

30. That it shall be incumbent upon PGW to timely comply with all the requirements of this Opinion and Order even though not expressly set forth in the foregoing Ordering Paragraphs.

BY THE COMMISSION,



James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: March 21, 2003

ORDER ENTERED: March 31, 2003

CERTIFICATE OF SERVICE

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

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Charis Mincavage

Dated this 12th day of June, 2007, in Harrisburg, Pennsylvania.