



September 13, 2004

**ORIGINAL**

**By Hand Delivery**

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

**DOCUMENT  
FOLDER**

Re: Pennsylvania PUC v. PPL Electric Utilities Corporation  
Docket No. R-00049255

Dear Mr. McNulty:

On behalf of the PennFuture Parties, enclosed please find an original and nine copies of our Reply Brief in the above-captioned matter. Copies have been served upon all parties of record as indicated on the attached Certificate of Service.

If you have any questions, please contact me at (215) 569-9693 or [mcp hedran@pennfuture.org](mailto:mcp hedran@pennfuture.org).

Sincerely,

Charles McPhedran  
Senior Attorney

cc: Hon. Allison Turner  
Hon. Susan D. Colwell  
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Certificate of Service

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC  
UTILITY COMMISSION, et al.  
v.  
PPL ELECTRIC UTILITIES  
CORPORATION

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Docket No. R-00049255

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REPLY BRIEF OF THE PENNFUTURE PARTIES

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## **I. Introduction**

Citizens for Pennsylvania's Future (PennFuture) files this Reply Brief on behalf of PennFuture, Char Magaro, and Edward M. McGovern (collectively, the PennFuture Parties) in this proceeding, which involves a request for approval of an overall annual net increase in distribution revenues by PPL Electric Utilities Corporation (PPL). The PennFuture Parties filed a Petition to Intervene on May 18, 2004, which was granted on June 21, 2004 (Prehearing Order No. 3 at 8).

An evidentiary proceeding was held before Administrative Law Judge Allison K. Turner in Harrisburg from August 9 to 13, 2004. The PennFuture Parties' Main Brief, submitted on September 2, 2004, focused on issues regarding the Sustainable Energy Fund (SEF). The PennFuture Parties submit this Reply Brief in accordance with the schedule set forth in Prehearing Order No. 2 to respond to several SEF-related arguments offered by other parties in their main briefs.

## **II. Argument**

- A. Under the PPL Restructuring Settlement, SEF funding does not terminate on December 31, 2004, and this settlement creates no requirement that SEF be self-sustaining.

The PPL Restructuring Settlement contains the following provision regarding funding for SEF:

E.5. Sustainable Energy Fund. PPL will establish a sustainable energy fund which shall be funded from the 1.74 cents per KWH transmission and distribution rate at .01 cents per KWH (less applicable gross receipts tax) on all power sold for all customers beginning on January 1, 1999 and ending on December 31, 2004, or until the Commission establishes new distribution rates, whichever is longer. The .01 cent per KWH shall not automatically be considered a cost of service element upon expiration of the transmission and distribution rate cap on December 31, 2004...The purpose of the fund is to promote the development and use of renewable

energy and clean energy technologies, energy conservation and efficiency which promote clean energy.

Joint Petition for Full Settlement of PPL, Inc.'s Restructuring Plan and Related Court Proceedings, Docket No. R-00973954 (1998), Paragraph E.5. (see also PPLICA Cross-Exam. Ex. 3 in this proceeding)(hereinafter "PPL Restructuring Settlement"). As noted in PennFuture's Main Brief and testimony submitted in this proceeding, this provision contemplates funding for SEF continuing beyond December 31, 2004, because: (a) under its terms, SEF funding would end "on December 31, 2004, or until the Commission established new distribution rates, whichever is longer" (emphasis added); and (b) while the settlement states that SEF funding shall not automatically be considered a cost of service element after December 31, 2004, nothing prohibits the Commission from continuing SEF funding as a cost of service element after that date. See PennFuture Parties Main Brief at 4-6 and testimony cited therein. PPL has itself proposed continuing funding for SEF beyond December 31, 2004. PPL Initial Brief at 154-56, and testimony cited therein.

In its brief, PP&L Industrial Customer Alliance (PPLICA) claims that "the expectation was that the SEF would become self-sustaining after the conclusion of shareholder funding on December 31, 2004." PPLICA Main Brief at 11. First, as noted above, the PPL Restructuring Settlement does not rule out continued funding after December 31, 2004, so this date does not represent the "conclusion" of shareholder funding.

Second, although SEF may have the goal of being self-sustaining, neither the PPL Restructuring Settlement nor any subsequent Commission Order requires that SEF

be entirely self-funded. Joint Petition, Paragraph E.5. (above); see also PennFuture Parties Statement No. 1 at 7-8. PPLICA has offered no evidence that SEF is legally required to be self-sustaining. PennFuture Parties Statement No. 1-S at 3. Outside funding from PPL or ratepayers is not prohibited simply because the fund has a goal of becoming "sustainable", PennFuture Parties Statement No. 1 at 8, and requiring SEF to be completely self-supporting would hamper its performance of its mission. PennFuture Parties Statement No. 1 at 8-9.

B. SEF funding provides benefits to distribution ratepayers and is therefore a just and reasonable distribution expense.

The Office of Trial Staff (OTS) argues in its brief that SEF "provides no demonstrable benefits to the distribution system of PPL." See OTS Main Brief at 34. PPLICA offers argument in support of a similar conclusion about SEF. PPLICA Main Brief at 17-27.

However, testimony submitted by PPL, SEF and the PennFuture Parties demonstrates the benefits of SEF's work for distribution ratepayers. As summarized by PPL, "SEF projects in energy conservation, demand management and distributed generation all contribute to the reduction or shifting of customer load, which delays the need to upgrade distribution system plant and can defer future rate increases." PPL Initial Brief at 155, citing SEF Statement No. 1 at 13 and PPL Statement No. 7-R at 36. Distributed generation projects supported by SEF relieve the need to expand or improve distribution by reducing stress on the distribution system and producing "a reliability and distribution cost of service benefit to all customers." PennFuture Parties Statement No. 1-R at 2-3; see also SEF Statement No. 1 at 16-17. Further, renewable energy and energy efficiency help provide a hedge against fluctuations in prices of natural gas and

electricity. PennFuture Parties Statement No. 1 at 6. In sum, as demonstrated in testimony submitted by PPL, SEF, and the PennFuture Parties, funding for SEF provides benefits to distribution ratepayers and is therefore just and reasonable under 66 Pa.C.S. § 1301.

### III. Conclusion

For the reasons set forth in our Main Brief filed in this proceeding on September 2, 2004 and in this Reply Brief, the PennFuture Parties urge the Commission:

- to double funding for SEF to provide increased benefits to ratepayers;
- to set no sunset date for SEF funding at this time;
- not to place SEF under the management of PEDA; and
- to include the most qualified candidates on SEF's Board of Directors without regard to stakeholder representation.

Respectfully submitted,

FOR THE PENNFUTURE PARTIES



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PA PUC v. PPL Electric Utilities Co.

Docket No. R-00049255

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

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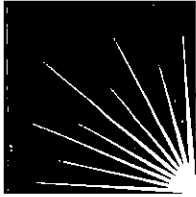
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**RE: Pennsylvania PUC v.  
PPL Electric Utilities Corporation  
Docket No.: R-00049255**

Dear Secretary McNulty:

Enclosed please find an original and nine copies (9) copies of Clean Air Council's Reply Brief in the above-captioned proceeding, commenced by PPL Electric Utilities Corporation on March 29, 2004.

Please time-stamp the extra copy for my files and return it to me in the postage-paid envelope provided.

Thank you for your effort in this regard.

Sincerely,

Michael Fiorentino, Esq.  
Attorney for Clean Air Council

Enclosures

cc: Parties of Record  
Honorable Allison K. Turner

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COMMONWEALTH OF PENNSYLVANIA  
BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility : Docket No. R-00049255;  
Commission : R-00049255C0001, *et al.*

Commission

v.

PPL Electric Utilities  
Corporation

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REPLY BRIEF OF CLEAN AIR COUNCIL

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## **I. Introduction**

Pursuant to 52 Pa. Code 5.501-502 and the Orders of the Presiding Administrative Law Judge, intervenor Clean Air Council hereby files this Reply Brief in the above-captioned matter. The Council addresses certain arguments briefed by PPLICA regarding the Sustainable Energy Fund, but specifically does not concede points not addressed herein.

## **II. Argument**

PPLICA objects to the inclusion of ongoing funding in rate base for the Sustainable Energy Fund. PPLICA argues that there are no “demonstrable benefits” to distribution ratepayers from the inclusion of SEF’s .01 cents/kWh in the distribution tariff, and that therefore the Commission must reject PPL’s proposal to include it. The Council maintains that PPLICA is incorrect, that the SEF funding does provide demonstrable benefit, and that the Commission has the authority to order its inclusion as a cost of service element.

Specifically, PPLICA claims that Conservation and Demand-Side Management projects cannot provide demonstrable benefits. Yet, the record in this proceeding contains sufficient evidence to conclude that conservation and demand-side management projects can yield demonstrable benefits. The testimony of witness Tuffey recognizes the distribution impacts of such projects. SEF St. 1 at 13-15. PPLICA’s focus on a lack of data concerning such impacts is not at all determinative. First, any distribution system has a limited capacity. This fact is acknowledged by PPL witness Douglas Krall. Tr. at 918-919. When customer demand begins to outstrip that capacity, distribution upgrades

are necessary, for which all customers are responsible through distribution rates. It is a truism that conservation reduces the amount of power used by a customer practicing it. A demand-side project reduces customer power requirements at peak times when the T&D system would be stressed. SEF St. 1 at 13. Therefore, conservation and demand-side projects provide an additional margin within a distribution system's limited capacity that, as a practical matter, serve to forestall or avoid the cost of distribution upgrades. SEF St. 1 at 13-14. *It is premature to suggest data regarding these projects must be available now.* The SEF has only been supporting projects for a few years, and it will take more time to reveal an impact on the distribution company's distribution upgrade timelines from these projects.

The Commission should soundly reject PPLICA's argument that general demonstrable benefits from distributed generation and demand-side SEF projects are irrelevant because SEF does not "support all distributed generation and demand-side management programs." PPLICA, M.Br. at 21. This is akin to suggesting that state funds provided for the addition of a bus line and a lane expansion along a busy corridor play no part in easing traffic congestion because some other entity financed the traffic signal synchronization in the same corridor. Attempting to discount SEF's contributions in this manner is fatally flawed.

PPLICA makes a curious argument dismissing the A.D. Little whitepaper as a source of support for the expert testimony of SEF witness Thomas Tuffey. PPLICA contends that the report has no value because it does not seek to promote or endorse distributed generation per se. PPLICA M. Br. at 23-24. To the contrary, as a more objective, neutral source of information, the Little report's persuasive value for SEF's

purposes is enhanced. The whitepaper provides a level, dispassionate discussion of the subject matter, and Mr. Tuffey sensibly references it in his testimony. The Commission should reject PPLICA's argument.

PPLICA also contends that *distributed generation* should be dismissed as generation-related, and that therefore the Competition Act mandates that any decision to fund distributed generation must flow from the competitive generation supply marketplace. While it may be true that distributed generation systems are generation-related, it is nonetheless also distribution-related, a fact which PPLICA chooses to ignore. If a significant percentage of homes or small businesses along a street operate distributed generation units, judicial notice can be taken that the amount of power that must flow down the distribution lines to serve customers on that street will be reduced by the amount of power generated by the distributed generation units. This is a matter of simple arithmetic.

PPLICA also argues that SEF funding "reintroduces regulatory restrictions and mandates related to generation supply and frustrates the legislative intent in introducing competition for the generation supply function." PPLICA, M.Br. at 24. But the Restructuring Act sought to achieve a balance among many important public policy objectives, such as the promotion of conservation and universal service. 66 Pa.C.S. §2803, §2804(8), §2804(9). The practice of competition in generation supply under the Act is not pure, at least not during the transition period. Witness the competitive transition charge (CTC), authorized by 66 Pa.C.S. §2808, representing, *inter alia*, an ongoing payment for "stranded costs" of allegedly uneconomical generation assets. By far the largest beneficiary of these payments are the nuclear power plants, such as

Susquehanna Steam Generating Station, whose continued operation are most certainly subsidized by the CTC.

It should be noted that the presence of the SEF rider in the distribution tariff over the last several years is itself Commission precedent for the practice of this inclusion. Economic development riders have also been included in distribution rates by the Commission. It is furthermore consistent with the manner in which systems benefits charges in other states are funded. SEF St. 1 at 18. These facts must be viewed against the backdrop of the Commission's broad discretion and flexibility in establishing just and reasonable rates. Popowsky v. Pa. PUC, 683 A.2d 958, 961 (Pa. Cmwlth.1996). In conclusion, the record clearly supports maintaining the SEF rider as proposed by PPL, and the Commission should so approve.

WHEREFORE, Clean Air Council requests that the Commission enter an Order making findings in accordance with the recommendations contained herein and in the Council's Main Brief, and grant the appropriate relief.

Respectfully submitted,



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**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission : R-00049255  
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v : :  
: :  
PPL Electric Utilities Corporation :

**Certificate of Service**

I hereby certify that on this day I have served a true and correct copy of the foregoing document, Clean Air Council's Reply Brief, upon the parties of record of this case in accordance with 52 Pa. Code §1.54, by electronic and first class mail.

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In re: Docket No. R-00049255, et al.  
Pa. P.U.C., et al. v. PPL Electric Utilities Corporation

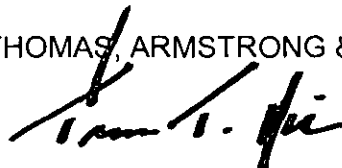
Dear Secretary McNulty:

Enclosed for filing on behalf of The Sustainable Energy Fund of Central Eastern Pennsylvania are an original and nine (9) copies of its Reply Brief in the above referenced matter. Copies of the Reply Brief are being served upon the persons and in the manner set forth on the certificate of service attached to it.

Very truly yours,

THOMAS, THOMAS, ARMSTRONG & NIESEN

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Thomas T. Niesen

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040913McNulty.wpd

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## I. INTRODUCTION

This proceeding concerns PPL Electric Utilities Corporation's ("PPL") Supplement No. 38 to Tariff Electric-Pa. P.U.C. No. 201 issued March 29, 2004 ("Supplement No. 38"). Supplement No. 38 proposes an increase in PPL's distribution rates of \$164 million.

On September 1, 2004, the Sustainable Energy Fund of Central Eastern Pennsylvania ("SEF") filed its Main Brief in support of continued funding of SEF as proposed at Third Revised Page No. 19K of Supplement No. 38.

Main Briefs addressing SEF funding were also filed by the Office of Trial Staff ("OTS"), the Office of Small Business Advocate ("OSBA"), the PPL Industrial Customer Alliance ("PPLICA") the United States Department of Defense/Federal Agency ("DOD"), the Commission on Economic Opportunity ("CEO"), Citizens for Pennsylvania's Future ("PennFuture"), the Clean Air Council ("CAC") and PPL.

This Reply Brief is supplemental to SEF's Main Brief and is limited to those matters raised by the other parties in their respective Main Briefs and not specifically addressed by SEF in its Main Brief and to those matters previously addressed by SEF, but which require additional discussion as a result of the Main Briefs filed by the other parties.

As set forth in SEF's Main Brief and this Reply Brief, Third Revised Page No. 19K of Supplement No. 38 should be allowed to go into effect as filed.

## II. ARGUMENT

### A. Reply to OSBA Main Brief

OSBA takes no position on whether SEF should be further funded beginning on January 1, 2005. OSBA argues, however, that, if further funding is allowed, it should be directed to the Pennsylvania Energy Development Authority ("PEDA").<sup>1</sup>

SEF certainly supports the effort of the Rendell Administration concerning renewable energy and is aware that the budget proposal for the Department of Environmental Protection ("DEP") contains seed funding for PEDA. SEF St. No. 1 at 8. No suggestion, however, has ever been made by anyone in the Rendell Administration that the efforts of the Administration are to result in the replacement of SEF. On the contrary, the efforts of the Administration are intended to complement SEF (and its companion funds) and the significant accomplishments SEF has made to date to establish a renewable energy footprint in Pennsylvania.

OSBA foresees a reauthorized PEDA that efficiently administers "diverse projects" with the ability to "successfully finance the larger projects that are beyond the means of any single sustainable energy fund" and an interest in "locally-focused" projects such as "biomass digesters." As a threshold matter, OSBA provides no statutory authority for PEDA to receive funding through a utility Rider.<sup>2</sup> PEDA is a state agency under the management of DEP, a several thousand person regulatory agency. There is no evidence of record and no reasonable expectation based on past experience that the type of PEDA envisioned by the OSBA will ever exist, assuming that PEDA comes to be funded as Governor Rendell has proposed.

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<sup>1</sup> The OSBA is not proposing any changes regarding SEF funding under the terms of the PPL restructuring settlement, through year end 2004. The OSBA states that it is a signatory to the restructuring settlement and will abide by its terms. OSBA St. No. 2 at 8.

<sup>2</sup> PEDA has statutory authority to issue bonds and notes not exceeding \$300,000,000 to "provide sufficient funds for any of its corporate purposes." 71 P.S. §720.7.

In the past, PEDDA principally funded projects that were large scale waste coal to power projects, characterized by secure revenue streams, associated with PURPA pricing requirements. PEDDA, most assuredly, did not fund locally-focused projects. SEF, on the other hand, has funded local projects and will continue to consider such projects with continued funding. SEF St. No. 1 at 9 and 17. A list of SEF commitments through June 2004 demonstrating SEF's overwhelming commitment to projects local to the PPL service territory is presented in OSBA Cross Examination 4.

Biomass digesters are a good example of SEF's local focus. In addition to the Oregon Dairy Farm biodigester methane-to-electric generation project discussed at page 24 of SEF's Main Brief,<sup>3</sup> SEF has also committed funding to Pine Hurst Acres to support a hog farm biodigester methane-to-electric generation project and to Zimmerman Farm to support a cattle farm biodigester methane-to-electric generation project. See OSBA Cross Examination Exhibit No. 4.<sup>4</sup>

Flowing rider monies through a large state agency as proposed by OSBA would surely lessen, if not eliminate, any local application of rider monies. There is, furthermore, no logic to the OSBA argument that PEDDA, as a government agency, can be more readily accountable for its spending priorities and management practices than can SEF. See OSBA Main Brief at 28. The record, in any event, demonstrates that SEF is accountable and transparent. A representative of the Commission monitors SEF Board and Committee meetings. SEF St. No. 1 at 26. The Pennsylvania Statewide

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<sup>3</sup> The Oregon Farm biomass digester and power generation project is also a good example of a smaller distributed generation project funded by SEF. It is projected to both save system demand and put excess power on the grid of 960,000 Kwhs per year. SEF St. No. 1 at 17.

<sup>4</sup> At page 29 and footnote 57 of its Main Brief, the OSBA suggests that SEF has given *relatively low priority to helping the agricultural community with manure disposal*. The suggestion is not supported by the record and simply not true, as is quite clearly shown by the Oregon, Pine Hurst and Zimmerman Farm projects.

Sustainable Energy Board ("PASEB") is actively meeting and has instituted quarterly data reporting of commitments made. N.T. 829-831; SEF St. No. 1 at 26.

Citing page 7 of OSBA Statement No. 2, the OSBA wrongly criticizes SEF for a lack of "definitive criteria" (OSBA Main Brief at 30) on how it awards funds. OSBA witness Schwarz was asked about the cited testimony on cross examination. He acknowledged that he "was not as clear" in his testimony as he should have been; that selection criteria, in fact, existed; and that his testimony "*wasn't correct.*"<sup>5</sup> The criticism of the OSBA which is based on the incorrect testimony of Mr. Schwarz should be given no weight.

In addition to being contrary to the *incorrect* testimony of its own witness, the argument of the OSBA that SEF has no definitive selection criteria and an internal process that is vague and unfocused is contrary to the substantial evidence provided by Dr. Tuffey concerning selection criteria and the metrics analysis through which SEF

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<sup>5</sup> Mr. Schwarz' response to cross examination was as follows (N.T. 883-884):

Q. Well, let me ask you this. We'll go to line 10 and 11 on page 7 of your testimony ... Now, there you testify that ... "The semi-annual reports provided to the Commission, as well as other reports, clearly identify the recipients of the grants and other forms of assistance provided to applicants. However, information is not available regarding the criteria used to select these recipients." Now, let me ask you to turn to page 10 of Appendix A to Dr. Tuffey's testimony.

A. Okay.

Q. In the first paragraph under section 2.1, it reads, I'll read it, "We received close to 200 inquiries and/or financing requests during the subject period. Each financing request was reviewed by staff against the Board-approved investment criteria. The investment criteria guidelines are presented in our Annual Plan and on the web site [www.SustainableEnergyFund.org](http://www.SustainableEnergyFund.org)." Now, are those the investment criteria that you're looking for and you said in your testimony are not available?

\* \* \*

THE WITNESS: Yes, but I guess I would just want to clarify that I was not as clear as I should have been in the written testimony, but referring primarily to criteria concerning the relationship, as I say in that sentence, to how the projects being funded support the long-term and short-term goals of the SEF. So to the degree that those criteria existed otherwise, *I wasn't correct.*

quantifies the benefits of projects to PPL ratepayers.<sup>6</sup> The metrics analysis with three examples and a summary of the substantial accomplishments of SEF is provided at pages 6 through 14 of SEF's Main Brief. The evidence of record demonstrates that SEF's project selection process is quite clear and anything but "vague and ambiguous" as argued by the OSBA.<sup>7</sup>

Although it presented no witness concerning SEF's "fiscal operations," OSBA presents several comments in its Main Brief, pages 30 and 31, concerning SEF's fiscal results. We reply to those comments below noting preliminarily that, contrary to the position of the OSBA, those parties that did testify about SEF's fiscal operations testified that SEF has a strong balance sheet. PPL St. No. 7 at 24. SEF completed its fiscal year 2002/2003 with net assets of \$12,203,454 and total liabilities of just \$103,397. SEF St. No. 1, Attachment A at 17-18.

First, OSBA claims that SEF is not using the money it receives.

SEF uses its metrics analysis to fund projects that benefit the PPL

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<sup>6</sup> As addressed at page 7 of SEF's Main Brief, SEF evaluates each funding proposal and quantifies the benefit to PPL ratepayers using the following mission metrics (SEF St. No. 1 at 10):

- KWHs renewable or clean energy generated;
- KWHs conventional energy saved;
- jobs created;
- money leveraged;
- environmental benefit, and
- people educated

<sup>7</sup> OSBA argues that a lack of "definitive criteria" can create a "myriad of problems." It then compares SEF's opposition to CEO's residential PV grant program with SEF's Nova Cruz investment. In contrast with the OSBA's argument, these projects actually demonstrate that selection criteria exist. *Selection criteria do not support a PV grant program. Every witness who testified in regard to the program, even Mr. Howatt who proposes it, acknowledged that there is no economic payback to PV grants. See SEF Main Brief at 30-31. Selection criteria also supported the Nova Cruz investment in the form of jobs in the Scranton area. The Nova Cruz electric motorbike did not achieve the market acceptance hoped for and the company discontinued operations, but SEF committed itself to make every effort to recruit a new electric vehicle company to the area, to preserve both jobs and the technology footprint. With participation from SEF, the Scranton Chamber of Commerce, DCED, and Ben Franklin Technology Partners, Oxygen SpA, a leading electric vehicle manufacturer in Italy, was recruited to Scranton and selected Scranton as its North American headquarters. SEF was also instrumental in the development of a new entity, Xootr LLC, that also purchased Nova Cruz assets and also indicated its intention to remain in Scranton. SEF St. No. 1 at Attachment A at 8.*

ratepayer. The reserves it maintains are appropriate for an organization with limited funding. See SEF Main Brief at 26-27. Funding commitments of approximately \$8,450,000 as of June 2004, with grants totaling an additional \$748,202, (See OSBA Cross Examination Exhibit No. 4) are representative of a careful and expert administration of funding consistent with SEF's Mission Statement and not a failure to use available funding.

Second, OSBA argues that SEF has made dubious investments in the stock market. Its argument is based on a line entry in the SEF Audit for 2002/2003. When asked about the entry, Dr. Tuffey explained that he was not an accountant and could not confirm for the OSBA if the number was solely investment gain/loss (N.T. 829) as the OSBA now represents it to be in its Main Brief. The investment vehicles include U.S. Government Obligations, Corporate Bonds and Equity Securities. SEF St. No. 1 at Attachment A, Audit Report at 9. These are not "dubious investments."<sup>8</sup>

Third, OSBA argues that SEF is a high overhead operation. It is not. The total expenses cited by OSBA in support of this argument of \$1,700,000 (since inception) includes *all* SEF expenses, not just "administrative overhead." N.T. 836. "Administrative overhead" is, in effect, Management & General Expenses as shown at page 4 of the SEF Audit Report for the 2002/2003 Fiscal Year (SEF St. No. 1, Attachment A, Audit Report at 4). Management & General Expenses for the

---

<sup>8</sup> As one would expect, the value of investments fluctuates with the market. OSBA relies on a one year entry -- a snapshot -- to argue that SEF has made dubious investments. Had investment results been raised in the testimony of the OSBA witness, those results could have been addressed fully on the record. The OSBA's argument based on a limited "snapshot" analysis should be given no weight.

2002/2003 Fiscal Year were just \$191,114. The conventional measure of overhead is the ratio of administrative expenses to total assets. With Management & General Expenses of \$191,114 and total assets of \$12,306,851 at 2002/2003 Fiscal Year end, SEF's overhead is extremely low at less than 1%.

OSBA claims, further, that there is uneven representation of interests on the SEF Board while acknowledging that "certain interests are represented." OSBA Main Brief at 31-32. The current SEF Board members and the interests they represent, if any, were addressed on the record at transcript pages 823 through 825. The Board represents many stakeholders.

There is, moreover, no record support for OSBA's statement that SEF Board members cannot be fired or removed from office. See OSBA Main Brief at 32. SEF, in addition, has a written conflicts of interest policy that was provided to OSBA in response to an on-the-record data request and admitted into the record as OSBA Cross Examination Exhibit No. 3.<sup>9</sup> There is no evidence of "logrolling" or anything of the kind occurring in respect to SEF consideration of funding applications.

In concluding its argument the OSBA states that SEF has failed to fulfill its potential. OSBA Main Brief at 34. The evidence of record belies this assertion. SEF funding has been expertly administered. Continued funding under the continued administration of SEF is just and reasonable and in the public interest.

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<sup>9</sup> A Board member could be part of an organization that applies for funding and might or might not be an actual participant in the underlying project. The conflicts policy requires recusal of the interested member in such a circumstance not just for the ultimate vote but the Board discussion and argument around the project as well. N.T. 831-832.

## **B. Reply to PPLICA Main Brief**

PPLICA argues that SEF funding is an illegal tax; that there has been no demonstration of “demonstrable benefits” from SEF funded projects; and that SEF funding is not a distribution-related cost. None of these arguments is supported by the record.<sup>10</sup>

Dr. Tuffey explained clearly, directly and specifically how SEF uses a metrics analysis to identify and quantify the “demonstrable benefits” of SEF funded projects. SEF St. No. 1 at 10-13. We addressed the metrics analysis, including the three examples highlighted by Dr. Tuffey, at length in the SEF Main Brief, Section B, pages 6 through 14.<sup>11</sup> PPLICA has no response to the clear, direct and specific testimony of Dr. Tuffey simply arguing, instead, throughout its Main Brief, that no “demonstrable benefits” were shown to exist.<sup>12</sup> Its unsupported argument should be rejected.

PPLICA’s characterization of SEF funded projects as “generation” related is also not supported by the record. Again, Dr. Tuffey explained clearly, directly and specifically how SEF funded projects are related to distribution service and appropriately included in PPL’s distribution tariff. SEF St. No. 1 at 13-18. His testimony is based on his educational background and professional experience and the articles cited in his

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<sup>10</sup> At pages 10 through 13 of its Main Brief, PPLICA provides a Background of SEF funding. No reply to this section is necessary other than to emphasize that there is nothing in the documents cited by PPLICA that prohibits or precludes further funding of SEF. The proposal for further funding is just and reasonable, consistent with the interest of the public and supported by the evidence of record.

SEF’s reply to PPLICA, which follows, applies equally to the arguments of the OTS which, similar to PPLICA, argues that SEF funding provides no demonstrable benefits to the distribution system and is a hidden tax. OTS Main Brief at 33-37.

<sup>11</sup> We respectfully incorporate Section B of the SEF Main Brief herein by reference in reply to PPLICA.

<sup>12</sup> See PPLICA Main Brief, pages 20 and 21, where PPLICA cites several statements of testimony of various parties supporting SEF funding. Notably missing is any reference to the clear, direct and specific testimony of Dr. Tuffey at pages 10 through 13 of SEF Statement No. 1.

testimony. The conclusion that SEF funded projects are related to distribution service and appropriately included in PPL's distribution tariff is also based on common sense (1) that a reduction of customer load, or the shifting of that load to lower-peak periods, as a result of SEF funded projects, reduces the loading and stress on the distribution system, extending its life and ending or delaying the need for expensive distribution system upgrades (SEF St. No. 1 at 13) and (2) that distributed generation projects also reduce loading and stress on the distribution system, likewise extending its life and ending or delaying the need for expensive distribution system upgrades. SEF St. No. 1 at 16.

The cases cited by PPLICA do not support its position. Foremost in this regard is *U.S. Steel Corp. v. Pa. P.U.C.*, 37 Pa. Commonwealth Ct. 173, 185, 390 A. 2d 865 (1978), where the Court affirmed a Commission Order exempting the first 500 KWH of residential usage from a PECO rate increase. The Court concluded that the Commission's action was "a proper exercise of the Commission's flexible limit of judgment in fixing rates." This same flexibility in ratemaking supports continued SEF funding as addressed in SEF's Main Brief, pages 14 through 16. Indeed, paraphrasing the opinion of the Court, there is no reason, given the Rendell Administration's emphasis on renewable energy, why the Commission might not approve continued SEF funding in this rate proceeding. The Court in *U.S. Steel* explained as follows:

... Certainly there is nothing in Pennsylvania law which now empowers the Commission to require one customer simply to pay another's utility bill; and, as we have mentioned, the utility may not and could not for long be required to provide such subsidy out of its capital. This is not to say, however, that rate structures may not be rearranged from time to time in response to changes in economic conditions -- whether general changes or changes especially affecting particular classes of customers. The law presently permits reduced rates to large industrial and commercial consumers, either because such customers buy a lot of what the utility provides or because they may use another's product if the price factor warrants. *Pittsburgh v. Pennsylvania Public Utility Commission*, 182 Pa. Superior Ct. 376, 126 A.2d 777 (1956). **We see no reason why in times**

***of stringency the utility might not propose, and the Commission might not approve, rates for residential users less than the rates which an allocation of large increases in necessary revenues by a strict application of cost of service studies would suggest.***<sup>13</sup>

Pennsylvania, currently, is at a relative disadvantage in the development of a sustainable energy infrastructure as well as the associated job creation of an emerging technology sector. See SEF St. No. 1 at 9 and SEF Main Brief at 14 -16. If Pennsylvania were to deny continued funding, it would stand alone and in stark contrast to its neighbors. The benefits of SEF-type projects, in the form of clean air, less emissions, job creation and more, would flow away from Pennsylvania to neighboring states. Such a result would be inconsistent with the policies of the current administration in Pennsylvania and with the public interest as well. Once again, continued funding of SEF is an appropriate factor to reflect in the rates which will be set in this proceeding.

A few final comments concerning the PPLICA Main Brief are warranted. First, SEF funding is available to PPLICA members and any other industrial customer through the standard SEF application process. The availability of qualified project funding is a direct benefit to PPLICA members from SEF funding.

Second, SEF funding is not a "tax." Funding provides demonstrable benefits to PPL ratepayers and benefits the distribution system. Continued funding is just and reasonable and in the interest of the public. The inclusion of funding in the rates to be set in this proceeding is just and reasonable and in the interest of the public.

Third, in support of its argument concerning wind farms at pages 25 through 27 of its Main Brief, PPLICA cites extensively from a non-record study prepared by GE Power Systems Energy Consulting for NYSERDA. PPLICA's reference to this study is

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<sup>13</sup> PPLICA argues further that the law requires a cost/benefit analysis in support of SEF funding (PPLICA Main Brief at 19 and 22 and an analysis on a rate schedule by rate schedule basis (PPLICA Main Brief at 19). *U.S. Steel, supra*, would not support a conclusion that either of PPLICA's propositions are a required part of the Commission's flexible limit of judgment in setting rates.

certainly no less objectionable than was the material concerning the PJM bottleneck that PPLICA objected to in Dr. Tuffey's testimony. No weight should be given to this study.<sup>14</sup>

Finally, PPLICA insists throughout its Main Brief that funding proponents must demonstrate "demonstrable benefits" from SEF funding. At page 10 of SEF Statement No. 1, Dr. Tuffey was asked whether SEF provides demonstrable benefits to distribution service customers. He answered that it does and, over the next three pages of his direct testimony, explained SEF's metric analysis of demonstrable benefits. Not a single reference to the SEF metrics analysis appears anywhere in PPLICA's Main Brief. SEF submits that no response or rebuttal exists to the metrics analysis. SEF funding provides demonstrable benefits to distribution service customers. PPLICA's opposition to continued funding should be rejected.

### C. Reply to PennFuture Main Brief

PennFuture argues that, going forward, SEF Board members should be appointed from "the most qualified candidates without requirements of stakeholder representation." It states that this position is consistent with draft best practices soon to be considered by PASEB and the Commission. PennFuture Main Brief at 9-10. The settlement agreement in place for the current funds requires that nominations for the SEF Board of Directors come from the Joint Petitioners. The Board of the SEF is following the intent of that agreement. When reviewing nominations for Director

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<sup>14</sup> In further support of its criticism of wind technology, PPLICA cites *Conference on Supply Margin Assessment, et al.*, 108 FERC ¶61,026 (2004), and states that the FERC has recently acknowledged that wind power provides minimal benefits. PPLICA Main Brief at 26. SEF submits that PPLICA's characterization is inaccurate. The FERC's full comment appears below. Significant is the FERC's desire not to impede development of wind energy (108 FERC ¶61,026 at P.129).

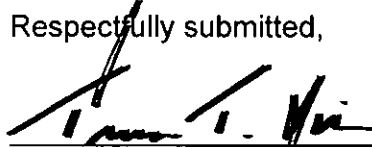
We agree with PacifiCorp that wind energy units, like hydroelectric units, are energy-limited and clarify that applicants may de-rate the available capacity of wind energy units using a five-year average of historical output. We will also allow applicants to submit estimated capacity factors for new units that do not yet have a history of actual output. ***We do not want to impede development of wind energy by overstating the market shares of wind energy producers and imposing regulatory burdens.***

positions, the Board seeks the most qualified candidate but also seeks diversity of skills and representation of various rate payer segments. The currently drafted best practices of PASEB regarding nomination, election, and approval of directors of sustainable energy funds have not been finalized or submitted to the Commission. The SEF does not believe it is appropriate for the Commission to consider the director nomination procedure or any of the other PASEB best practices until the entire document, still in draft form, has been fully vetted.

### III. CONCLUSION

Continued funding for SEF as proposed at Third Revised Page No. 19K of Supplement No. 38 is just and reasonable and consistent with the public interest. Third Revised Page No. 19K of Supplement No. 38 should be approved as filed.

Respectfully submitted,



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Attorneys for  
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DATED: September 13, 2004

Reply Brief.wpd

Before the  
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Administrative Law Judges Presiding  
**Allison K. Turner**  
**Susan D. Colwell**  
**Ember S. Jandebaur**

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**Pennsylvania Public Utility Commission** : **Docket No. R-00049255**  
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:  
**v.** :  
:  
**PPL Electric Utilities Corporation** :

**CERTIFICATE OF SERVICE**

I hereby certify that I have this 13th day of September, 2004, served a true and correct copy of the Reply Brief of the Sustainable Energy Fund of Central Eastern Pennsylvania, upon the persons and in the manner set forth below:

**VIA OVERNIGHT DELIVERY**

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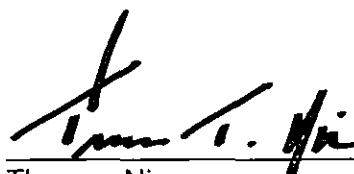
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September 13, 2004

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**Re: Pennsylvania Public Utility Commission v.  
PPL Electric Utilities Corporation  
Docket No. R-00049255**

Dear Secretary McNulty:

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

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

Sincerely,

Steven C. Gray  
Assistant Small Business Advocate

Enclosures

cc: Hon. Allison K. Turner  
Hon. Susan D. Colwell  
Hon. Ember Jandebaur

Parties of Record

Robert D. Knecht

107

**ORIGINAL**

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**ORIGINAL**

**PENNSYLVANIA PUBLIC UTILITY  
COMMISSION**

**v.**

**PPL ELECTRIC UTILITIES CORPORATION :**

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**Docket No. R-00049255**

**REPLY BRIEF  
ON BEHALF OF THE  
OFFICE OF SMALL BUSINESS ADVOCATE**

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**Dated: September 13, 2004**

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## **I. INTRODUCTION**

On March 29, 2004, the PPL Electric Utilities Corporation (“PPL” or the “Company”) filed with the Pennsylvania Public Utility Commission (“Commission”) a request for additional annual revenues of \$164.4 million. The PPL filing also included a notice that transmission service charges were expected to increase by \$57.2 million, a proposal for recovering transmission charges from ratepayers on a reconcilable basis, a request for the implementation of a distribution system improvement charge (“DSIC”), and a request for ratepayer funding for the Sustainable Energy Fund of Central Eastern Pennsylvania (“SEF”).

On May 7, 2004, the Commission suspended the proposed effective date of PPL’s filing and instituted an investigation into the justness and reasonableness of PPL’s proposals. On April 8, 2004, the Office of Small Business Advocate (“OSBA”) filed a complaint against the PPL filing.

On May 19, 2004, a prehearing conference was held before Administrative Law Judge (“ALJ”) Allison K. Turner, ALJ Susan D. Colwell, and Chief ALJ Robert A. Christianson.

Public input hearings were held throughout the PPL service territory during the week of June 28, 2004.

On June 29, 2004, the OSBA submitted the direct testimony of Robert D. Knecht and Mark D. Ewen and, in a separate document, the direct testimony of Andrew M. Schwarz. On July 27, 2004, the OSBA submitted the rebuttal testimony of Messrs. Knecht and Ewen. On August 5, 2004, the OSBA submitted the surrebuttal testimony of Messrs. Knecht and Ewen.

Evidentiary hearings were held in Harrisburg beginning August 9, 2004, and concluding August 12, 2004. An additional telephonic public input hearing was conducted on August 13, 2004.

*On September 2, 2004, the OSBA submitted a main brief in this proceeding.*

The OSBA submits this reply brief pursuant to the procedural schedule set forth in ALJ Turner's May 20, 2004, PreHearing Order No. 2.

## II. SUMMARY OF ARGUMENT

A. The Company's proposal to limit the maximum rate increase for each customer class to ten percent measured on a total-bill basis is not supported by substantial evidence, and yields an unjust and unreasonable revenue allocation among the customer classes. The Company's "10% total-bill" proposal should be rejected by the ALJ and the Commission.

B. The OCA cost of service study should be rejected by the ALJ and the Commission. The PPL cost of service study, with the acknowledged corrections to be made in the compliance filing, should be adopted by the ALJ and the Commission.

C. The revenue allocation proposed by the OSBA should be adopted by the ALJ and the Commission. All cost of service studies presented in this proceeding have demonstrated that residential customers are under-paying their distribution cost of service and that commercial customers are over-paying their distribution cost of service. To begin correcting this inequity, the OSBA revenue allocation proposal effectively employs the principles of gradualism while moving all rate classes closer to their respective cost of service.

D. The changes proposed by the OSBA to the Company's proposed transmission service charge ("TSC") should be adopted by the ALJ and the Commission. The OSBA proposal creates a TSC that passes through the transmission charges from Pennsylvania-New Jersey-Maryland, LLC. ("PJM"), but reduces the potential volatility of the transmission rates faced by PPL's customers through the use of a five year rolling average demand allocator.

E. The DSIC rate mechanism proposed by PPL should be rejected by the ALJ and the Commission. The proposed DSIC rate mechanism is illegal under Pennsylvania law, is not needed by the Company, and unfairly thwarts the ratemaking process.

F. If the ALJ and the Commission decide that ratepayers should fund sustainable energy, the ALJ and the Commission should adopt the OSBA proposal to direct the revenue to the Pennsylvania Energy Development Authority (“PEDA”).

G. The OCA proposal to require all customer classes to pay for the Company’s residential-only universal service programs should be rejected by the ALJ and the Commission.

### III. ARGUMENT

The single biggest issue in this proceeding, from the perspective of PPL's small business customers, is to reduce the subsidy that those customers have been paying since at least the mid-1990's. The Company's September 1995 bundled cost of service study documented that the commercial GS-1 and GS-3 customers were massively over-paying their cost of service. The Company's distribution cost of service study, presented in this case, showed that the GS-1 and GS-3 customers were, nine years later, massively over-paying their distribution cost of service. Logically, larger than system average rate increases must be allocated to all customer classes that are receiving a subsidy at present rates. Just as logically, if the Company's small business customers do not receive rate relief in this proceeding, every single additional dollar that those businesses are forced to pay for electricity will result in fewer jobs, lower wages, and less generous benefits.

#### A. The PPL "10% Total-Bill" Measure is Without Foundation

PPL set forth a series of "objectives" in this proceeding by which the Company intended to limit the maximum rate increase for each customer class to less than ten percent. As PPL witness Krall stated:

PPL Electric established the following objectives in allocating revenue requirements:

1. Keep the increase on a total-bill basis to all residential rate schedules below 10%. 'Total-bill' basis means that the allocation process included both the distribution increase proposed in this case and an estimate of the increase in transmission rates that will also occur on January 1, 2005.
2. Keep the increase on a total-bill basis to all rate schedules below 10%.
3. Move the relative rate of return for each customer class closer to the system average rate of return.

PPL Statement No. 4, at 27.

The first paragraph of the PPL main brief reiterated the Company's position on revenue allocation:

The distribution increase was allocated to customer classes based on the results of a class cost of service study with the condition that no rate schedule would receive an average increase of more than 10% in total rates.

PPL Main Brief, at 1 (footnote omitted). The Company's main brief accurately described the "10% total-bill" benchmark as a "goal" that PPL is striving to attain in this proceeding.<sup>1</sup> Unfortunately, it is this "goal" that prevents PPL from making any meaningful progress toward reducing the massive subsidies paid by the business classes to the residential classes. In fact, PPL's pursuit of this "goal" actually causes these subsidies to get worse.<sup>2</sup> For that reason alone, the ALJ and the Commission should reject PPL's proposed "goal." It is simply unreasonable to establish a goal that produces a result that is completely at odds with the Company's own cost of service study.<sup>3</sup>

The Company is free to advocate whatever version of the principle of gradualism that it prefers, just as other parties have done.<sup>4</sup> Nonetheless, PPL's assertion that the

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<sup>1</sup> PPL Main Brief, at 14.

<sup>2</sup> See OSBA Statement No. 1, 26-27.

<sup>3</sup> PPL claimed that it has been guided by the "fundamental principle that allocation of revenue requirements among electric utility customer classes should reflect the cost of providing service to those classes." PPL Main Brief, at 165. Evidently PPL must be judged by its numerical proposals and not its words. PPL ignored its cost of service results when it proposed to assign above average rate increases to those rate classes (particularly the GS-1 and GS-3 classes) that are already providing a subsidy.

<sup>4</sup> The OSBA advocates that the principle of gradualism should restrict a "total-bill" rate increase for any single customer class to twice the system average rate increase, measured on a percentage basis. In other words, the OSBA proposes that if the system average rate increase is four percent, no individual class would get a rate increase greater than eight percent. See OSBA Main Brief, at 13-14. In contrast, PPLICA advocates that gradualism should allow all customer classes to be moved to their respective cost of service in stages over three years. See PPLICA Main Brief, at 95-96.

Company's "10% total-bill" benchmark is the proper interpretation of what constitutes "gradualism" in correcting revenue allocation inequities is devoid of any substantive evidentiary foundation.

It is well established that PPL carries the burden of proof in this proceeding. Consequently, if PPL is to convince the ALJ and the Commission that the "10% total-bill" benchmark should be adopted as the proper measure of gradualism in this proceeding, the Company has the burden of proving the justness and reasonableness of that benchmark. Furthermore, the Company must demonstrate the justness and reasonableness of that benchmark by substantial evidence.<sup>5</sup>

In actuality, PPL made no attempt to support its "10% total-bill" benchmark. The Company simply referred to the "10% total-bill" benchmark as a "goal" or "constraint" or "objective" that the Company adopted in this proceeding.<sup>6</sup> However, the mere fact that PPL adopted this revenue allocation benchmark as a "goal" or "objective" does not create a scintilla of evidence in this proceeding. Specifically, the Company has not produced substantial evidence that its proffered "10% total-bill" benchmark is a valid measure of gradualism, or that the use of this benchmark produces a just and reasonable

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<sup>5</sup> 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 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). *See Lower Frederick Twp. v. Pa. PUC*, 409 A.2d 505 (Pa. Cmwlth. 1980) and *Brockway Glass v. Pa. PUC*, 437 A.2d 1067 (Pa. Cmwlth. 1981). *See also Burlison v. Pa. PUC*, 501 Pa. 433, 461 A.2d 1234 (1983) ("[t]he elements of that cause of action are proven with substantial evidence that enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary").

<sup>6</sup> *See* PPL Main Brief, at 1, 14, 102, 166, 170, 179.

allocation of the total revenue increase in this proceeding. Without the production of substantial evidence to support its “10% total-bill” benchmark, the Company has not carried its burden of proof on this issue.<sup>7</sup>

Furthermore, mere repetition by other parties of the Company’s proposed benchmark does not breathe new life into PPL’s failure to adduce substantial evidence and to meet its burden of proof on this issue.<sup>8</sup>

Therefore, the OSBA respectfully requests that the ALJ and the Commission reject PPL’s proposed “10% total-bill” benchmark as a proper measure of gradualism in the allocation of the total revenue increase. In addition, the OSBA respectfully submits that the gradualism proposals of OSBA witnesses Knecht and Ewen or PPLICA witness Stephen J. Baron (either of which provides for reasonable progress toward cost-based rates while recognizing gradualism concerns) are far superior to the Company’s arbitrary and unsubstantiated “10% total-bill” benchmark proposal.

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<sup>7</sup> Actually, the Company has produced *no* evidence in this proceeding that the “10% total-bill” benchmark is a fair measure of gradualism, or that it yields a just and reasonable revenue allocation. PPL simply kept repeating the benchmark throughout its main brief as if it were a magic incantation.

<sup>8</sup> See, e.g., OCA Main Brief, at 143 (“Under these alternative procedures, the Company’s allocation objective that no rate schedule should receive a total increase of over 10% is frequently violated.”). The OSBA is unable to identify any evidence cited by OCA or any other party that provides a justification for this arbitrary and inequitable constraint.

## **B. The PPL Cost of Service Study**

The Company and the OSBA submitted distribution class cost of service studies in this proceeding.<sup>9</sup> In spite of the fact that the PPL and OSBA cost of service studies used different analytical methodologies, both studies reached the same overall result. Specifically, both studies showed that the residential customers are paying less than their fair share of distribution costs, and that the small business customers are paying more than their fair share.<sup>10</sup>

The methodological difference between the PPL and OSBA cost of service studies revolves around the manner in which the studies calculated how much of the cost of the Company's secondary electric distribution plant to allocate on a per customer basis and how much to allocate on a peak demand basis. In spite of the differences, the "minimum system" methodology utilized by the Company and the "zero-intercept" methodology advocated by the OSBA demonstrate that the residential RS class is under-paying its cost of service, and that the commercial GS-1 and GS-3 customer classes are over-paying their cost of service.

Because the choice of cost of service methodologies would lead to the same conclusion, the OSBA recommended that the ALJ and the Commission simply adopt the PPL distribution cost of service study in this proceeding.<sup>11</sup> While the adjudication of

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<sup>9</sup> PPL cost of service study Exhibit JMK-1 sets forth the studies for the historic test year, which ended on December 31, 2003. PPL cost of service study Exhibit JMK-2 sets forth the studies for the future test year, which ends on December 31, 2004. The OSBA cost of service study is set forth in OSBA Statement No. 1, Exhibit IEC-3.

<sup>10</sup> See OSBA Statement No. 1, Table IEC-3, at 19.

<sup>11</sup> OSBA Main Brief, at 7. The OSBA was able to identify a number of programming errors in the PPL cost of service study. The OSBA understands that these errors, which have been communicated to and acknowledged by the Company, will be corrected in the compliance stage of this proceeding. See Tr. 967-968. See also OSBA Statement No. 1, at 13-14.

cost classification methodologies is important, the primary focus in this proceeding must be upon correcting the interclass inequities.

The OCA disagreed with the Company's cost of service analysis, specifically opposing PPL's use of the "minimum system" methodology.<sup>12</sup> As a result, the OCA proposed an alternative cost of service study to rectify the perceived flaws. The OCA's preferred alternative rejects the concept that secondary distribution plant costs have a customer-related component, and "incorporates the use of the Peak and Average methodology for allocating 'Common Distribution' and 'Primary Distribution' plant."<sup>13</sup>

If the ALJ and the Commission agree with the OCA and conclude that this proceeding is the best "opportunity to take a fresh look at distribution – in a more focused manner than perhaps ever before,"<sup>14</sup> that "fresh look" should be based upon the best industry practices as set forth in the *Electric Utility Cost Allocation Manual* published by the National Association of Regulatory Utility Commissioners ("NARUC").

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<sup>12</sup> The OCA summarized its opposition to the minimum system methodology:

First, the minimum system analysis used to determine the customer/demand split grossly overstates the customer component by including significant capacity, or demand related costs, in the customer-related cost component. Second, the Company's minimum system study is not consistent with its previous studies because it includes larger distribution system components than it contained in the past. Third, while the Company acknowledges that the minimum system it created for use in its study has load carrying capability it compounded its error by failing to account for that capability when allocating the demand portion of Common Distribution costs.

OCA Main Brief, at 104-105 (citations omitted). Thus, the OCA concerns boil down to the allegations that the minimum system has load-carrying capability, and that PPL has changed its definition of the "minimum system" since the last case. All of these concerns are resolved by using the zero-intercept approach advocated by the OSBA. Thus, there is no need to adopt the OCA methodology that will "throw the baby out with the bath water." See OSBA Statement No. 3, at 12.

<sup>13</sup> OCA Main Brief, at 113. The OCA cost of service study is set forth in OCA Statement No. 4, Exhibit RAG-1.

<sup>14</sup> OCA Main Brief, at 117, footnote 38.

The NARUC *Manual* reaches two conclusions that are relevant to this proceeding. First, the *Manual* “explicitly recognizes that a customer component for distribution should be recognized in a cost allocation study, and it explicitly excludes any energy-related component of distribution costs.”<sup>15</sup> Thus, the OCA’s “Peak and Average” methodology (which assumes that secondary distribution plant costs have *no* customer component) does not produce cost of service results that are consistent with normal industry practices, and should be rejected by the ALJ and the Commission.<sup>16</sup>

Second, the NARUC *Manual* describes in detail the zero-intercept methodology advocated by the OSBA.<sup>17</sup> The OSBA supports the zero-intercept methodology due to the limitations of the Company’s “minimum system” methodology, as well as due to certain criticisms of the “minimum system” methodology raised by the OCA.<sup>18</sup> However, instead of adopting the OCA’s proposed “peak and average methodology” (which is not favored by NARUC and creates illogical cost of service results for PPL’s

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<sup>15</sup> OSBA Statement No. 3, at 15.

<sup>16</sup> OCA witness Richard A. Galligan accepted the NARUC *Manual* as an authority for allocating electric utility distribution costs. In his rebuttal testimony, Mr. Galligan criticized OSBA witnesses Knecht and Ewen for not following the *Manual*’s dictates exactly for performing a zero-intercept analysis. See OCA Statement No. 4-R, at 8. It is curious that Mr. Galligan focused on the details in the *Manual* when rebutting the OSBA testimony, but completely ignored its overall methodological dictates in his own recommendations.

<sup>17</sup> See *Electric Utility Cost Allocation Manual*, National Association of Regulatory Utility Commissioners, January 1992, at 86-99.

<sup>18</sup> See OSBA Statement No. 1, at 14-18 for a detailed discussion of the methodologies. See also OSBA Statement No. 3, at 11-12 for an analysis of Mr. Galligan’s criticisms.

higher-use customers<sup>19</sup>), the ALJ and the Commission should simply order the Company to prepare a complete zero-intercept analysis for its next base rates filing. There is no reason to adopt the OCA's approach when the zero-intercept approach accurately and effectively addresses the limitations of the Company's minimum system methodology and yields substantially the same results as the Company's study.

### **C. The Class Allocation of the PPL Revenue Requirement**

Despite their differences in underlying methodology, the distribution cost of service studies presented in this proceeding reached common conclusions that should dictate the proper revenue allocation in this proceeding:<sup>20</sup>

- The PPL, OSBA, and OCA distribution cost of service studies show that the residential RS customer class is under-paying its cost of service at present rates;
- The PPL, OSBA, and OCA studies show that the commercial GS-1 customer class is over-paying its cost of service at present rates;
- The PPL and OSBA studies show that the commercial GS-3 customer is also over-paying its cost of service at present rates.<sup>21</sup>

Regardless of which cost of service study is selected, the analysis indicates that the residential RS class must be allocated a larger than average distribution rate increase, and the commercial GS-1 class must be allocated a smaller than average distribution rate

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<sup>19</sup> For example, the OCA methodology illogically implies that a 75 kW GS-3 customer actually costs more to serve than 30 residential customers whose total demand is 75 kW. See OSBA Statement No. 3, at 12.

<sup>20</sup> PPL cost of service results are set forth in PPL Statement No. 4, Exhibit JMK-2, at 76, lines 30-31. OSBA cost of service results are set forth in OSBA Statement No. 1, at 19, Table IEC-3. OCA cost of service results are set forth in Statement No. 4, Exhibit RAG-1, at 1, lines 30-31.

<sup>21</sup> The OCA study shows that while the GS-3 customer class is under-paying its cost of service, it is paying more than the residential RS class. Under the OCA study, GS-3 would be over-paying its cost of service at the PPL proposed rates.

increase. If the ALJ and the Commission reject the “outlier” OCA cost of service study, which no other party supports, then relief in the form of a smaller than average rate increase must also be provided to the commercial GS-3 customer class.

The parties have a wide variety of opinions on how the overall distribution revenue increase should be allocated in this proceeding. However, *there is not one shred of evidence in the record that demonstrates why the commercial GS-1 customer class should be assigned the highest possible percentage rate increase instead of the lowest possible percentage rate increase.*

Despite the undisputed fact that the commercial GS-1 class is already subsidizing the residential RS class, PPL makes the problem worse by assigning a 9.9% increase in total rates to GS-1 while assigning only a 9.7% increase to RS.<sup>22</sup> The Company offers three explanations for this inequitable result. First, the customer class rate increases proposed by the Company follow the “10% total-bill” objective.<sup>23</sup> As discussed *supra*, the “10% total-bill” benchmark is an unsubstantiated “measure of gradualism” proffered by the Company without any evidentiary foundation to prove the justness and reasonableness of the resulting revenue allocation. On that basis alone, the “10% total-bill” goal should be disregarded by the ALJ and the Commission. Furthermore, it is unreasonable and unjustifiable to harm PPL’s small business customers financially merely because of an internal Company “goal” such as the “10% total-bill” benchmark.

Second, the Company argues that it is “in the middle of a transition” period, and therefore revenue allocation proposals by the OSBA and other parties should be rejected

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<sup>22</sup> See PPL Main Brief, Figure 1, at 166. This result is even more extreme when considered on a distribution-only basis. See OSBA Main Brief, at 9, footnote 16.

<sup>23</sup> See PPL Main Brief, at 166.

until the end of the transition period on January 1, 2010, in order to avoid “causing rate shock to customers.”<sup>24</sup> However, PPL is in no position to guarantee anyone – its customers, the parties in this proceeding, the ALJ, or the Commission – that once its generation rate cap expires on December 31, 2009, the Company’s capped customers will not experience massive “rate shock.” Furthermore, 66 Pa. C.S. § 2804(10) requires the Commission to establish just and reasonable rates for PPL’s distribution services, and that is precisely what the parties are working to attain in this proceeding.<sup>25</sup> PPL should not be permitted to thwart this legislative mandate with the clichéd argument that “let’s put off until tomorrow what we could do today.”

The OCA, in its support of the Company’s proposed revenue allocation, echoed this PPL argument that significant movement toward cost-based rates should wait for the expiration of the generation rate caps on December 31, 2009.<sup>26</sup> Specifically, the OCA observed:

[T]his is the first distribution-only rate case for a major electric utility that has been filed subsequent to the Customer Choice Act’s enactment. In past cases, cost of service studies reflected all elements of electric service, from production, to transmission, to distribution. The incumbent utility provided all aspects of service, and as a result, cost studies were designed to determine each class’ rate of return, factoring in all elements of service, relative to the Company’s overall rate of return. In prior cost of service studies, it was not separately distinguished as to

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<sup>24</sup> PPL Main Brief, at 167; PPL Statement No. 4, at 17.

<sup>25</sup> Section 2804(10) explicitly requires electric distribution rates to be set in accordance with Chapter 13 of the Public Utility Code. Chapter 13 includes 66 Pa. C.S. § 1301, which requires rates to be just and reasonable. Setting electric distribution rates for PPL in this proceeding is conceptually identical to setting distribution rates for natural gas distribution utilities in their base rate cases. While it may be reasonable to consider other potential implications, there is no reason to propose rate changes that are completely at odds with the results of a valid cost of service study.

<sup>26</sup> OCA Main Brief, at 124-125.

whether a residential class was paying a higher rate of return on one component of bundled service, such as generation, and a lower rate of return on another component of service, such as distribution. It was the overall class rate of return that was looked at in the cost of service study to serve as a guide when setting rates.

OCA Main Brief, at 122-123.

OCA's argument is a red herring that should not be permitted to confuse and delay the process of moving the customer classes to cost-based rates. Unfortunately, delay would continue the harm the commercial GS-1 and GS-3 customer classes are already experiencing. In actuality, the Company's 1995 compliance filing cost of service study (following its last base rate case) showed that the commercial GS-1 and GS-3 customer classes were substantially over-paying their "bundled" cost of service. In contrast, the residential RS class was significantly under-paying its "bundled" cost of service.<sup>27</sup> Thus, whatever complaint the OCA has with the transition from the "bundled" to the distribution cost of service studies, the OSBA has a much bigger one.

The Company's present distribution-only cost of service study carries forward the same result: the commercial GS-1 and GS-3 customer classes are over-paying their distribution cost of service.<sup>28</sup> Furthermore, PPL's transmission rates are now unbundled and subject to a pass-through rate mechanism, the design of which is at issue in this proceeding. Once the Company's generation cap expires on December 31, 2009, PPL will have to acquire its electricity "at prevailing market prices" and to design rates that

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<sup>27</sup> See OCA Statement No. 4, Schedule RAG-3. The GS-1 class rate of return was 15.68 percent, the GS-3 class rate of return was 11.44 percent, and the system average rate of return was 9.54 percent. In contrast, the RS class rate of return was 7.65 percent.

<sup>28</sup> In PPL's cost of service study, the GS-1 class rate of return is 9.28 percent and the GS-3 rate of return is 10.50 percent, both at present rates. The system average rate of return is 3.91 percent at present rates. The RS rate of return at present rates is only 1.60 percent. See Exhibit JMK-2, at 76.

reflect those market prices.<sup>29</sup> OCA offers no rational reason why waiting until 2010 to resolve a distribution rate inequity would in any way mitigate the transitional problems associated with the elimination of the generation rate cap. It is equally likely (if not more likely) that delay at this stage would simply make the problem in 2010 worse. Because of the current and potential financial harm to the Company's small business customers, the OCA's penchant for "waiting until the time is ripe" should be rejected by the ALJ and the Commission.<sup>30</sup>

Third, the Company argues that there is no precise "formula" for creating a revenue allocation among its customer classes.<sup>31</sup> The lack of a set formula, however, does not justify the Company's choice to harm its small business customers financially by heaping the largest possible rate increase upon them at a time when they are already paying well more than their fair share of the cost of distribution service. Furthermore, while it is true that developing a cost of service study is the practice of an inexact science, and that every revenue allocation requires a degree of professional judgment, it makes no sense to ignore the implication of *every single* cost of service study filed in the proceeding when developing a revenue allocation. Thus, the lack of a set "formula"

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<sup>29</sup> See 66 Pa. C.S. § 2807(e)(3).

<sup>30</sup> The PPL Public Lighting Users Group ("PLUG") made a similar argument, ultimately quoting Bonbright's "eight criteria of a sound rate structure." PLUG Main Brief, at 14. Ironically, PLUG supported the Company's proposed revenue allocation, an allocation that violates most of Bonbright's eight criteria. For example, looking at criteria 6, it is anything but "fair" to assign the highest possible percentage rate increase to the GS-1 class, as every single cost of service study shows GS-1 is over-paying its cost of service. If PPL and PLUG have their way, the only "mad dash" occurring in the Company's service territory will be the small businesses leaving. See PLUG Main Brief, at 14, line 1.

<sup>31</sup> See PPL Main Brief, at 167-168. The OCA echoed this argument as well. See OCA Main Brief, at 127-128. The OSBA agrees with the OCA that cost of service studies "are not an exact science." *Id.*, at 127. The OSBA observes, however, that the commercial GS-1 class is over-paying in the extreme under the OCA's own cost of service study.

should not be used to justify the infliction of substantial financial harm upon PPL's small business customers.

Therefore, the ALJ and the Commission must reject the Company's revenue allocation proposal. The OSBA revenue allocation proposal, in contrast, recognizes that most customer classes can be moved closer to their respective distribution cost of service in this proceeding while upholding the principle of gradualism and giving no class an increase which exceeds twice the system average. Therefore, the OSBA respectfully requests that the ALJ and the Commission adopt the OSBA revenue allocation proposal as set forth in OSBA Statement No. 1, Exhibit IEC-2.<sup>32</sup>

#### **D. The Transmission Service Charge**

A review of the main briefs submitted by the parties in this proceeding amply demonstrates what the OSBA stated in its main brief: while PJM's transmission charges contain both peak demand and energy components, the parties disagree about the best method for passing through those charges to PPL's customers. In general, because the parties accurately summarized the difficulties (and trade-offs) inherent in selecting a transmission charge pass-through mechanism, the OSBA will not repeat the summary set forth in its main brief of the advantages and disadvantages of the various proposals. The OSBA will, instead, respond only to three limited points.

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<sup>32</sup> See the summary of the OSBA revenue allocation proposals (at the Company's full revenue requirement and at the OCA revenue requirement) attached to the OSBA's main brief. See OSBA Statement No. 1, at 28-29 and OSBA Statement No.3, at 27-28 for a detailed discussion of the OSBA revenue allocation methodology. If the total revenue requirement is other than the OCA proposal, the ALJ and the Commission should perform a proportional adjustment using the revenue allocation set forth in OSBA Statement No. 3.

First, in trying to justify its proposed TSC, PPL stated:

PPL Electric is the only party which has given consideration to bases other than cost in allocating transmission service costs.

PPL Main Brief, at 102. This statement is not only incorrect, but it is also a factual misrepresentation. For example, the OSBA proposal addresses both the concern of cost allocation *and* the issue of the resulting transmission rate charge volatility.<sup>33</sup>

Second, PPL over-stated the advantages of the Company's second alternative proposal, which would "allocate transmission service charges among three broad groups." The Company claimed that this proposal "would reduce volatility in rates."<sup>34</sup> The Company's claim is incorrect, at least as it concerns PPL's commercial class customers. As OSBA witnesses Knecht and Ewen observed:

Mr. Krall's proposal to aggregate rate classes will not solve the rate volatility problem. As shown in his Exhibits DAK-3 and DAK-4, the aggregate 'commercial' transmission charge is 31 percent higher in a summer peak than in a winter peak.

OSBA Statement No. 4, at 9. In other words, the PPL alternative proposal results in a transmission charge that *varies by nearly one third* on a year to year basis. Making matters worse, this variation is random because it is entirely dependent upon whether the previous year exhibited a winter or summer peak.

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<sup>33</sup> See OSBA Statement No. 3, at 8-9.

<sup>34</sup> PPL Main Brief, at 108.

Third, PPL's brief ranked the various transmission rate proposals based upon two criteria: relative rate stability and consistency with cost causation.<sup>35</sup> While the OSBA does not take exception to PPL's ranking the proposals based upon rate stability, the *Company's proposed ranking based upon cost causation is baseless. PPL arbitrarily claimed that its alternative proposals are somehow more consistent with cost causation than the OSBA proposal. However, PPL provided no evidence or explanation as to why its proposals (which involve averaging rates across classes) are any more consistent with cost causation than OSBA's proposal (which involves averaging cost causation factors over five years).*

Consequently, the OSBA proposal to utilize the underlying PJM transmission rate design, but to smooth out the volatility by applying a rolling five year average on the peak demand component is the best solution to a difficult problem.<sup>36</sup> The OSBA respectfully requests that the ALJ and the Commission select the OSBA methodology for calculating the rates charged to PPL's customers for PJM transmission service.

**E. The Proposed DSIC Mechanism Would Violate Pennsylvania Law**

The PPL proposal to create a distribution system improvement charge ("DSIC") rate mechanism has been opposed by nearly every party in this proceeding, the OSBA included. The OSBA will not restate the effective and accurate arguments presented by the other parties in opposition to the DSIC. However, the OSBA will respond to one narrow issue raised the PPL.

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<sup>35</sup> See PPL Main Brief, at 108-109.

<sup>36</sup> Other parties have commented favorably on the OSBA proposal. See OCA Main Brief at 152-153; PLUG Main Brief at 18-19; DOD Main Brief at 27. Even PPL conceded that it is a methodology that provides a high degree of rate stability. See PPL Main Brief, at 108.

PPL made the claim that “OSBA did not respond to PPL Electric’s explanation that the DSIC will not cause double recovery of depreciation.”<sup>37</sup> Not only is that claim incorrect, but the response of OSBA witnesses Knecht and Ewen explained exactly why the DSIC could cause double recovery of depreciation:

Mr. Krall’s rebuttal misses the point. When base rates are set, PPL’s rates include depreciation for all assets that are not fully depreciated at the time of the rate case. Over time, if PPL makes no investments at all, its depreciation expense (and its overall rate base) decline, as assets become fully depreciated. Thus, suppose a particular \$10,000 asset had two years of depreciable life remaining (net book value of \$500) when base rates were set, and the depreciation charge was \$250 per year. Two years later, PPL incurs no depreciation charge for that asset on its books, because it is fully depreciated. However, unless PPL files a base rates case, its base rates continue to include that \$250. And if PPL then replaces that asset with a new \$10,000 DSIC-eligible asset, it will get to add another \$250 depreciation cost to its rates. In effect, ratepayers pay the \$250 depreciation charge for the identical asset twice, until the next base rates case.

OSBA Statement No. 4, at 10.

This testimony was not rebutted in rejoinder, in cross-examination or in PPL’s brief. As such, the record demonstrates that PPL’s proposed DSIC has the potential to double recover depreciation costs.<sup>38</sup>

Therefore, for the reasons set forth herein, as well as the reasons set forth in the OSBA’s main brief, PPL’s proposed DSIC is not a rate mechanism that is authorized

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<sup>37</sup> PPL Main Brief, at 129.

<sup>38</sup> It is possible that, in the implementation of the DSIC, PPL intended to provide a credit to the DSIC for the depreciation expense in existing base rates associated with assets that are replaced. If so, such an adjustment might potentially avoid the double counting problem. However, the OSBA can locate no clear assertion by PPL that this is its intention.

under Pennsylvania law and is not consistent with sound ratemaking policy. The ALJ and the Commission must reject the Company's DSIC proposal.

**F. Any New SEF Funding Should be Directed to PEDA**

In its main brief, the OSBA argued that if the ALJ and the Commission decide that sustainable energy should be funded by ratepayers, the surcharge revenue should be directed to the Pennsylvania Energy Development Authority ("PEDA"). In their main briefs, the parties raised only one issue that requires a response by the OSBA.

In its main brief, the SEF stated that "Mr. Schwarz acknowledges that PEDA *is* moribund." *SEF Main Brief, at 33 (emphasis added)*. The SEF is incorrect. Mr. Schwarz acknowledged that "at the time of PPL's restructuring settlement, PEDA *was* essentially moribund."<sup>39</sup> The verb tense transformation perpetrated by SEF significantly changes the meaning of Mr. Schwarz's testimony.

As stated in its main brief, the OSBA respectfully requests that if the ALJ and the Commission decide that sustainable energy should be funded by the proposed surcharge, the surcharge revenue should be directed to PEDA.

**G. The Allocation of Residential-Only Universal Service Programs**

In this proceeding, the OCA continued its advocacy for the allocation of universal service charges to all customer classes.<sup>40</sup> Specifically, the OCA argued that universal service is a "public good" for which all customers are mandated by statute to pay. The OCA also argued that since all classes "benefit" from residential-only customer assistance programs, all classes should pay for those programs.

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<sup>39</sup> OSBA Statement No. 2, at 6 (emphasis added).

<sup>40</sup> See OCA Main Brief, at 174, et seq.

The OCA made a simple, yet significant, error of statutory construction in its argument that universal service programs are recognized as a “public good.” The OCA began its analysis by quoting the language of 66 Pa. C.S. § 2802(17):

There are certain public purpose costs, including programs for low-income assistance, energy conservation and others, which have been implemented and supported by public utilities’ bundled rates. The public purpose is to be promoted by continuing universal service and energy conservation policies, protections and services, and full recovery of such costs is to be permitted through a nonbypassable rate mechanism.

66 Pa. C.S. § 2802(17).

The OCA then concluded:

As set forth above [in Section 2802(17)], the General Assembly declared universal service programs to be a ‘public good.’

OCA Main Brief, at 182. However, the General Assembly made no such declaration. The language of Section 2802(17) mentions the “public purpose” of certain policies and services, but nowhere in the statute is the phrase “public good” to be found. The plain language of the General Assembly should not be misconstrued in pursuit of some underlying “spirit.”<sup>41</sup>

As a practical matter, no cost allocation study filed in this proceeding incorporates the OCA recommendation. While the OCA did submit the results of its cost of service study, that study failed to quantify the OCA “all classes pay” recommendation. In fact, no expert witness even offered a specific proposal of exactly *how* such costs should be

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<sup>41</sup> 1 Pa. C.S. § 1921(b).

allocated to all rate classes.<sup>42</sup> Because no cost allocation study incorporates the OCA recommendation, and because no revenue allocation proposal relies upon that recommendation, the issue is moot and the OCA argument should be ignored. The current Commission precedent (which requires that all universal service costs shall be allocated to the classes that cause those costs) should be retained.

Furthermore, the OCA argument about the “public good” and theoretical (but immeasurable) public policy benefits associated with universal service programs is irrelevant for utility cost allocation.<sup>43</sup> Utility cost allocation should be based on cost causation – it should not be based on the hypothetical benefits that may accrue to other classes.<sup>44</sup> Universal service costs are caused by the residential rate classes, because those are the only classes whose customers are eligible for the benefits. All customers within the residential classes are *potentially* eligible to participate in those programs.<sup>45</sup> Essentially, the programs are an “insurance policy,” and the “insured customers” should pay the “premiums.”

In addition, using hypothetical benefits as a cost allocation criterion would be a step down a very slippery slope. For example, OCA witness Roger D. Colton cited job creation by small businesses as a significant benefit to low income residential customers.<sup>46</sup> Therefore, if “public good” benefits were to be reflected in electric utility

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<sup>42</sup> OCA witness Galligan did throw out suggestions, but he did not take a specific position or attempt to defend allocating universal service costs to all customer classes. See OCA Statement No. 4, at 21.

<sup>43</sup> See OCA Main Brief, at 177, et seq.

<sup>44</sup> See OSBA Statement No. 3, at 16, et seq.

<sup>45</sup> For example, any residential customer could benefit if that customer lost his job and his income were to drop.

<sup>46</sup> OCA Statement No. 5, at 30-31.

distribution rates, it would be logical to eliminate completely the subsidies paid by small businesses and to do so in this case.

Moreover, the OCA did not provide any evidence that allocating universal service costs to all the classes would reflect the relative benefit that each class or each customer allegedly would receive. Specifically, the OCA offered no quantitative proof that any such alleged benefits are proportional to (or even related to) the costs that small businesses would pay. The OCA also offered no proof that businesses that use more electricity (and would therefore need to pay more for universal service) somehow would benefit more from universal service programs than businesses that use less electricity.

Finally, the OCA argument that “all customer classes” should pay for residential-only customer assistance programs disregards the heavy burden that funding those programs would place upon PPL’s small business customers.

As OCA witness Colton stated:

As elsewhere, small business fills a unique role in the Pennsylvania economy. Small business disproportionately offers employment opportunities to Pennsylvania residents who have limited employment skills.

OCA Statement No. 5, at 30. Mr. Colton continued his reasoning:

[W]ithout small business offering low-wage employment, many of the persons who are employed in such establishments would not find job opportunities.

Id., at 30-31. Mr. Colton concluded:

The small business establishments providing low-wage employment would not be able to survive if they were required to pay higher wages.

Id.

Mr. Colton is correct. The OCA proposal to require Pennsylvania's small business customers to pay for the PPL universal service programs would place an additional financial burden upon those small businesses. Every dollar that PPL's small business customers would pay for residential-only universal service programs would be a dollar that would not go to hire a new employee. Every dollar taken away from that small business would be another dollar that would not go to expand the business, or to pay for employee health care.

Therefore, the OSBA respectfully requests that the ALJ and the Commission reject the OCA proposal to require all customer classes to pay for the Company's residential-only universal service programs.

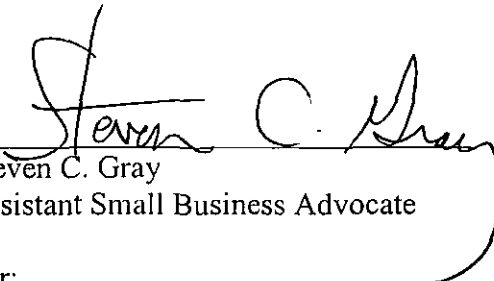
#### **IV. CONCLUSION**

Wherefore, the OSBA requests that the ALJ and the Commission:

1. Reject the PPL “10% total-bill” benchmark as a measure of gradualism for allocating revenue among the customer classes;
2. Adopt the PPL cost of service study, as corrected for the acknowledged programming errors;
3. Allocate the overall revenue requirement among the classes as set forth in OSBA Statement No. 1, Exhibit IEC-2 at the Company’s full revenue requirement, or OSBA Statement No. 3, Exhibit IEC-R1 at a reduced revenue requirement;
4. Adopt the OSBA proposal for allocating transmission costs to the customer classes which reflects the PJM transmission rate design but calculates the peak demand component using a five year rolling average;
5. Deny PPL’s request for a DSIC;
6. If sustainable energy is to be funded by ratepayers, direct the money to the Pennsylvania Energy Development Authority rather than the Sustainable Energy Fund of Central Eastern Pennsylvania; and

7. Reject the OCA proposal to allocate the Company's universal service costs to all customer classes.

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PENNSYLVANIA PUBLIC UTILITY :  
COMMISSION :

v. :

Docket No. R-00049255

PPL ELECTRIC UTILITIES CORPORATION :

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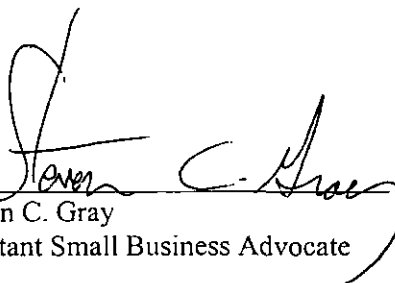
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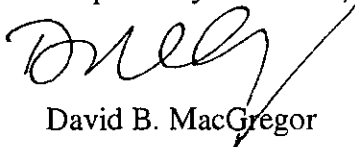
**Re: Pennsylvania Public Utility Commission  
v. PPL Electric Utilities Corporation  
Docket No. R-00049255**

Dear Secretary McNulty:

Enclosed, for filing, are the original and nine (9) copies of the Reply Brief of PPL Electric Utilities Corporation in the above-referenced proceeding. Please return a stamped copy of the Reply Brief to me in the enclosed, self-addressed, stamped envelope.

As indicated on the enclosed certificate of service, copies are being served on all parties.

Respectfully submitted,

  
David B. MacGregor

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PPL Electric Utilities Corporation

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## I. INTRODUCTION

On September 2, 2004, in accordance with the litigation schedule established at the Prehearing Conference and as set forth in Prehearing Order No. 2, numerous parties filed briefs in support of their various positions in this proceeding. The parties submitting briefs included PPL Electric Utilities Corporation (“PPL Electric” or the “Company”), the Office of Trial Staff (“OTS”), the Office of Consumer Advocate (“OCA”), the Office of Small Business Advocate (“OSBA”), the Department of Defense (“DOD”), the Mid-Atlantic Power Supply Association (“MAPSA”), PP&L Industrial Customers Alliance (“PPLICA”), Wal-Mart Stores East, LP, Pennsylvania Energy Consortium and the Pennsylvania Retailers Association (collectively, “PaEC”), PPL Public Lighting Users Group (“PLUG”), Sustainable Energy Fund (“SEF”), Commission on Economic Opportunity (“CEO”), Clean Air Council (“CAC”), Citizens for Pennsylvania’s Future (“PennFuture”) and Mr. Eric J. Epstein.

PPL Electric’s Initial Brief, in explaining that its proposed increase in rates should be approved, anticipated and responded to many of the arguments that have been raised by other parties. In several instances, PPL Electric’s position is fully set forth in its Initial Brief and further response is not necessary. Certain arguments, however, require further response. For ease of reference, PPL Electric’s Reply Brief follows the same sequence contained in its Initial Brief.

## II. SUMMARY OF ARGUMENT

In reviewing PPL Electric's proposed rate increase and the adjustments proposed by opposing parties, PPL Electric asks that Administrative Law Judge Allison K. Turner ("ALJ") and the Pennsylvania Public Utility Commission ("Commission" or "PUC") consider three overall points. First, the adjustments proposed by various parties are, to a surprising degree, inconsistent with Commission precedent and/or well-established practice in prior PPL Electric base rate proceedings. By simply following precedent and practice, most of the adjustments presented in this case should be summarily rejected. Second, on a number of other issues, the adjustments presented by the opposing parties are either factually wrong or unsupported by any credible record evidence. These adjustments also should be rejected. Third, this case presents a number of policy issues, where there is no "right" or "wrong" answer. On these issues, PPL Electric has tried to present a middle ground position which balances the legitimate competing interests of the various parties. PPL Electric's proposals should be accepted.

### A. **FAILURE TO FOLLOW PRECEDENT AND PRACTICE**

The most important issue in this case is the appropriate cost of common equity capital. PPL Electric's 11.5% claim is fully supported by the record, Commission precedent, decisions of other regulatory commissions and the expectations of the capital markets. The OCA (9.5%) and OTS (9%) recommendations are fundamentally flawed for the many reasons set forth in PPL Electric's Initial Brief. Most disturbing, however, is the failure of these parties to apply this Commission's most recent decisions concerning the cost of common equity capital. In the recent Pennsylvania American and Aqua Pa. proceedings, the Commission determined that the cost of common equity for these two water companies was 10.6%. These companies have A (Pennsylvania-

American) and A plus rates (Aqua-Pa.) and each has a S&P business ranking of 2 and a higher common equity ratio (and correspondingly lower financial risk) than PPL Electric. PPL Electric, by contrast, has a weak A minus bond rating, a business ranking of 4 and a lower common equity ratio than either of these companies. OTS and OCA do not and apparently cannot explain how, in light of these very recent decisions, they can recommend a cost of common equity of below 10% for PPL Electric. Equally disturbing, the Commission has clearly stated in these decisions that the cost of equity cannot be derived from the DCF method alone, and that an unadjusted DCF calculation understates the cost of equity when the market price of the utility's stock exceeds book value. Despite these clear pronouncements, the OTS (solely) and OCA (primarily) rely on unadjusted DCF presentations and thereby seriously understate PPL Electric's true cost of capital.

OTS and OCA seek to deflect these obvious flaws by attempting to compare the risks faced by PPL Electric today to the risks which it faced in 1995.<sup>1</sup> In its 1995 base rate proceeding, the Commission allowed PPL Electric an 11.5% cost of common equity. OTS and OCA contend that PPL Electric is significantly less risky today than it was in 1995, and that interest rates have fallen since that time. On this basis, they contend that PPL Electric's cost of capital must be lower today than it was in 1995, and that the Company's 11.5% claim in this proceeding is overstated.

There are several flaws in this argument. First, the issue in this case is what PPL Electric's risk is today as perceived by today's capital markets; not what risks it may have faced in 1995. Many things have changed since 1995, and it is clearly fruitless, and

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<sup>1</sup> In 1995, the name of PPL Electric Utilities Corporation was Pennsylvania Power & Light Company.

indeed counterproductive, to speculate about risk differences today versus 1995 or any other time frame. OCA, in particular, points to several changes since 1995 which, on their face, would appear to show that PPL Electric is less risky today than in 1995. But, there are other changes, *e.g.*, the 9/11 tragedy, the California energy crisis and the Enron debacle, which have clearly increased the risks faced by all energy companies, including PPL Electric. The “bottom line” of this analysis, however, is that in 1995, PPL Electric’s predecessor was a vertically integrated, fully regulated electric utility with a full “A” debt rating. Today, PPL Electric is no longer vertically integrated, and must obtain its generation supplies under a strict generation rate cap and has a weak A minus debt rating. Thus, despite the OCA’s unsupported speculations, the capital markets have spoken and their message is clear: PPL Electric is a riskier investment today than it was in 1995, and if anything, has a **higher** cost of capital.

Similarly, on other issues the parties have simply refused to follow clear precedent and practice. The OCA’s prepaid postage adjustment is inconsistent with PPL Electric’s uniform practice in all of its prior rate proceedings; DOD’s mid-year rate base adjustment is completely unprecedented in Pennsylvania rate regulation; DOD’s unbilled revenue adjustment is at odds with PPL Electric’s prior practice and Commission precedent; the OTS’ pension adjustment is inconsistent with the Commission’s order in PPL Electric’s 1995 rate proceeding, which specifically considered and rejected the OTS approach; and OTS’ and OCA’s opposition to a capital stock tax “gross up” is inconsistent with PPL Electric’s prior practice which has been uniformly accepted by this Commission.

The Company's storm damage amortization claim also is consistent with a long line of Commission cases, and its claimed AMR amortization is identical, in concept, to a claim specifically approved in PPL Electric's 1995 rate case. On these issues, the OCA contends that PPL Electric's claims violate the rate caps in the Competition Act. But, OCA does not address and presumably cannot address the fact that the rate caps apply to rates, not to costs, and that nothing in the Competition Act purports to change traditional ratemaking principles which clearly permit the amortization of prior period costs in establishing prospective rates.

Many parties argue that PPL Electric's proposed DSIC is illegal, despite the fact that this Commission has twice held to the contrary. These parties also present a laundry list of factual and policy arguments against the DSIC, but all of these contentions have been previously considered and rejected by the Commission in approving similar charges for water and sewer companies.

Finally, with respect to the cost of service study, OCA extensively criticizes the minimum system study presented by the Company, yet this same study has been accepted in every prior PPL Electric rate case. Moreover, the bulk of the OCA's criticism relates to the classification of transformers which represent only 7% of secondary distribution costs. However, rather than propose a correction on this narrow issue, the OCA asks that the Commission take the unprecedented step of completely ignoring the Company's minimum system study and allocating secondary distribution costs on the basis of demand and energy, a result which is totally unprecedented for any Pennsylvania electric utility.

## **B. ADJUSTMENTS BASED ON FACTUAL ERRORS**

Even where there is no precedent directly on point, a number of the adjustments proposed by other parties are simply factually wrong. For example, the OTS proposes a substantial revenue adjustment that is riddled with a variety of serious errors (improper comparison of calendar and revenue month data, incorrect assumption that all October load is non-weather sensitive, and improper exclusion of cooling degree days and seasonal changes in lighting load), which results in a sales forecast that bears no relation to actual experience thus far in the future test year. Similarly, DOD's injuries and damages and health care adjustments are based on a misunderstanding of how PPL Electric developed its claims for these costs and ignore the pattern of these costs in recent years. Mr. Epstein's proposal for a shareholder proposal on executive compensation ignores the undisputed fact that PPL Electric has already implemented such an approach.

Similarly, PLUG contends that the Commission should not approve any increase in street lighting rates because street lighting is a public service and because PPL Electric has not provided reliable service to street lighting customers. The facts are that street lighting rates are **already** among the most heavily subsidized rates on PPL Electric's system and even under the Company's proposed rates will provide only about 25% of the system average return. Similarly, PLUG's allegations as to quality of service are unsupported by the record. PLUG consists of six PPL Electric street lighting customers. Only one of the six had any complaints about outages and those outages have been addressed.

Finally, CAC alleges, for the first time on brief, that PPL Electric failed to adhere to the terms of its restructuring settlement. As explained below, this allegation is simply

false, as PPL Electric would have explained had CAC raised this issue in a timely fashion.

### **C. POLICY ISSUES**

Finally, on some issues in this case, *e.g.*, class revenue allocations, SEF funding, and universal service, there is no “right” or “wrong” answer. On these issues, PPL Electric attempted to develop a middle ground that balanced the interests of all parties. In allocating the distribution rate increase, PPL Electric generally followed the results of its class cost of service study with the constraint that no rate class, as a whole, receive an increase, on a total bill basis, in excess of 10%. In allocating the transmission charge increase, PPL employed a uniform kWh approach designed for simplicity and to avoid volatility. Several parties have extensively criticized PPL Electric’s proposals, but these criticisms should be recognized for what they are: One-sided arguments designed to shift costs from their clients to other ratepayers.

On universal service, PPL Electric proposed substantial increases in its already successful programs, but constrained those increases in recognition that all of the increased costs must be paid by other residential customers. On SEF, PPL Electric proposed continued funding through 2009 at existing levels. On each of these issues, PPL Electric faced spirited “attacks” from both sides, and many of the parties presented arguments supporting an end result that benefits their own narrow interests. PPL Electric attempted, to the extent possible, to take these wide ranging positions into account and appropriately balance competing interests. Obviously, it is not possible to satisfy all parties, but PPL Electric believes that its proposals on these issues are reasonable and should be approved.

### III. ARGUMENT

#### A. RATE BASE

##### 1. OCA's Proposed Adjustment For Prepaid Postage Is Erroneous And Should Be Rejected.

OCA contends that the prepaid postage component of PPL Electric's rate base should be disallowed. OCA Main Brief, pp. 19-20. There are two components of postage costs in rate base. Both components relate to postage used to mail bills to customers. One component consists of an average of thirteen months of prepayment balances, and the other is included in the lead-lag study of PPL Electric's cash working capital requirement. OCA would include the cash working capital component, but would exclude the average prepaid balance, arguing that PPL Electric has double counted its investment in postage. As explained in PPL Electric's Initial Brief, pp. 18-20, there is no double counting, and the OCA' adjustment should be rejected.

The postage component of the lead-lag study tracks the period of time between the actual use of postage to mail bills to customers and the reimbursement by customers of that expense. In contrast, the average prepaid postage balance component reflects the average investment in postage obtained from the United States Postal Service from the time that such postage is purchased until the postage is used to mail a bill. There is no double count because the average prepayment balance is the investment in postage required prior to the mailing of the bill, while the component in the lead-lag study measures the investment required from the mailing of the bill to the payment of the bill by the customer. Tr. 416-18.

OCA counters that the prepaid balance "is simply the balance at the end of the month, and does not attempt to measure any time interval." OCA St. 1-S, p. 12; OCA

Main Brief, p. 20. OCA is correct, but its conclusion does not support its adjustment.<sup>2</sup> Instead, the average balance measures PPL Electric's average investment in postage prior to using the postage to mail bills to customers. This is the method of measuring investment used by PPL Electric in developing its rate base claims for materials and operating supplies, and stores expense. Neither of these claims has been challenged by the OCA or any other party. PPL Electric Ex. Future 1, Sch. C-5, pp. 2-3. Similarly, *PPL Electric has reflected insurance and the Commission's regulatory assessments on the same basis without controversy.* PPL Electric Ex. Future 1, Sch. C-4, p. 3. Average prepaid balances are routinely included in rate base, and there is no reason for prepaid postage to be treated any differently in this proceeding. OCA's proposed adjustment to eliminate PPL Electric's average balance of postage prepayments from rate base should be rejected.

## **B. REVENUES**

### **1. OTS' Proposed Weather Normalization Adjustment Should Be Rejected.**

OTS reiterates its contention that its proposed "weather normalization" adjustment to PPL Electric's sales to residential heating customers should be adopted. OTS Main Brief, pp. 17-19. In support of its contention, OTS emphasizes that it has used data from the National Oceanic and Atmospheric Administration ("NOAA"). In making these contentions, OTS ignores the many shortcomings of its weather normalization adjustment.

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<sup>2</sup> Indeed, the cash working capital requirement is calculated using time intervals determined in the lead-lag study because the cash working capital requirement cannot be measured directly by using average balances. Use of average balances to measure investment is preferable where it is available because it measures investment directly, whereas time intervals are used as a substitute when average balances are not available.

Initially, OTS ignores the fact that PPL Electric also obtains its weather data from NOAA. Such data originate with NOAA and are obtained on an hourly basis from weather stations operated by either NOAA or the Federal Aviation Administration through a service known as Meteorlogix. PPL Electric receives these data and uses them to project customer usage. Thus, the data sources are the same except that PPL Electric obtains NOAA data more promptly, by using an intermediary, Meteorlogix. PPL Electric St. 3-R, pp. 6-7.

OTS also continues to ignore the fact that its procedures mismatch revenue month sales data with calendar month weather data. PPL Electric St. 3-R, pp. 3-4. OTS further continues to ignore the fact that its use of October data to determine “base load” is improper because there is substantial heating load in October. OTS continues to ignore the fact that its “weather normalization” procedures ignore many factors including air conditioning load, additional lighting load at holidays, variation in lighting load due to variations in the length of nights when electric lighting is needed and many other factors. PPL Electric St. 3-R, p. 5.

In support of its contention, OTS claims that its procedures are consistent with “accepted Commission practices,” citing *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, Docket No. R-00942991 (December 6, 1994). Significantly, the case cited by OTS involved a gas distribution company, not an electric distribution company. There are substantial differences in residential gas usage and residential electric usage, and these differences clearly require a more detailed and sophisticated approach to forecast residential electric sales.

For example, domestic use of natural gas by residential customers is limited, in most instances, to cooking, clothes drying, water heating and space heating. Unlike electric usage, it generally does not include lighting or air conditioning. All of these uses of gas, other than space heating, remain relatively constant throughout the year. Thus, it clearly is reasonable for a natural gas distribution company's sales to residential customers to be adjusted based solely on heating degree days. This approach, however, makes no sense for electric utilities, who have substantial lighting and air conditioning load that varies throughout the year for reasons other than heating degree days.

The OTS' weather normalization adjustment contains numerous errors, and substantially overstates PPL Electric's sales. Accordingly, OTS' proposed adjustment should be rejected.

**2. The OTS And OCA Adjustments To Late Payment Fees Improperly Ignore Offsetting Factors And Should Be Disregarded.**

Both OTS and OCA propose to increase PPL Electric's revenues at proposed rates to reflect additional late payment fees. OTS Main Brief, pp. 20-21, OCA Main Brief, pp. 21-22.

Before addressing the specific adjustments proposed by OTS and OCA, it should be noted that PPL Electric did accept a refinement to its proposed level of late payment fees that was proposed by OTS. OTS pointed out that PPL Electric, in its filing, calculated late payment fees of \$6.336 million, but simply rounded that amount to \$6 million. PPL Electric accepted OTS' comments that late payment fees should not be rounded and adjusted late payment fees to \$6.336 million. PPL Electric St. 2-R, pp. 15-16. Thus, the initial adjustment to eliminate the effect of rounding by PPL Electric is no longer at issue.

Both OTS and OCA, however, proposed an additional adjustments to late payment fees to reflect the effect of the rate increase in this proceeding. Both adjustments use a ratio based on the relationship of late payment fees to revenues over a three-year period instead of over a five-year period as proposed by the Company. OTS Main Brief, pp. 20-21; OCA Main Brief, pp. 21-22.

These adjustments should be rejected. First, it is more appropriate to use five years of data to develop a ratio of late payment fees to revenues in order to smooth out short-term variations in experience. Second, and more importantly, as explained by PPL Electric witness Schadt, although there is logic to applying the late payment fee ratio to the increase in revenues allowed in this proceeding, that same logic applies with equal validity to uncollectible accounts expense. PPL Electric St. 2-R, pp. 15-16.

In its filing, PPL Electric did not gross up either late payment penalties or uncollectible accounts for the increase in operating revenues in this proceeding. The two elements of revenue requirement should be treated the same – either both should be grossed up or neither should be grossed up. Thus, if the Commission were to adopt the OTS' and OCA's adjustments, then the Commission should also increase uncollectible accounts expense by \$1.044 million.

## **C. EXPENSES**

### **1. PPL Electric's Claim To Recover Storm Damage Expense Through An Amortization Allowance In Prospective Rates Will Not Violate The Rate Cap.**

OCA, PPLICA and Mr. Epstein contend that allowing PPL Electric to recover costs incurred in responding to Hurricane Isabel would violate the rate cap because Hurricane Isabel occurred within the rate cap period. OCA Main Brief pp. 25-30; PPLICA Main Brief, pp. 31-36; Epstein Main Brief, pp. 12-13. In making these

arguments, the parties rely heavily on the Commonwealth Court's decision in *ARIPPA v. Pa. P.U.C.*, 792 A.2d 636 (Pa. Cmwith. 2002) ("*ARIPPA*"). As PPL Electric explained in its Initial Brief, Commonwealth Court in *ARIPPA* did not address the issue raised here. Instead, Commonwealth Court held that: (1) the electric distribution companies ("EDCs") involved, Metropolitan Edison Co. and Pennsylvania Electric Co., did not qualify for an exception to the rate cap because their expenses of purchasing power to provide Provider of Last Resort ("POLR") service were within their control, and (2) the EDCs could not recover increased costs of purchasing power to provide POLR service as additional stranded costs because these costs were to be determined with finality in those companies' earlier restructuring proceedings. See PPL Electric Initial Brief, pp. 35-37. The Commonwealth Court never addressed the issue of whether post-rate cap recovery of extraordinary costs incurred near the end of the rate cap period pursuant normal ratemaking practices was unlawful.

In an attempt to portray *ARIPPA* as supporting their position, certain parties cite the case inaccurately. They quote a passage from *ARIPPA* which describes contentions of certain parties in that proceeding and imply that the quotation reflects a holding of the Commonwealth Court. See, e.g., OCA Main Brief, p. 28. Such citation is erroneous because the Commonwealth Court, as explained above, never reached the issue of whether the Commission's approval for the EDCs' deferred tracking mechanism would violate the rate cap. *ARIPPA* contains no such holding.

The second prong of OCA's argument is that:

"During the rate cap period, PPL [Electric] explicitly assumed all risk of all operating costs, but for the exceptions enumerated in the statute."

OCA Main Brief, pp. 28-29. OCA's contention is unsupported and without merit.

First, and most importantly, it ignores the plain language of the statute, which, on its face, applies to **rates**, not costs. There is no reference in the Competition Act to a cap on cost recovery; let alone any finding that EDCs were to bear all operating cost risk during the rate cap period. The Commission is a creature of statute and must apply the plain language of the Competition Act. The plain language of the Competition Act establishes rate caps for certain defined periods of time. It does not deal with the setting of rates after the rate caps expire and says nothing about whether PPL Electric's claim to recover extraordinary storm damage costs in prospective post-rate cap rates should be approved. The OCA, itself, seems to concede this point by referring to the Company's claim as a "de facto" rate cap exception. OCA Main Brief, p. 25.

*Further, the notion that PPL Electric is precluded from recovering revenue* requirement associated with events that occurred during the rate cap period is clearly erroneous. For example, PPL Electric added substantial plant during the rate cap period and, although the Company was not allowed to recover depreciation, return and income taxes related to such plant during the rate cap period, it is uncontested that PPL Electric can recover such fixed costs of plant added during the rate cap period once the rate cap has expired. Similarly, PPL Electric's employees received increases in salaries and wages during the rate cap period. No party has contended that PPL Electric is precluded from recovering increased levels in wages and salaries that were granted during the rate cap period upon the expiration of the rate cap.

Further, the statute clearly contemplated that it would apply to the ratemaking effect of events, not to the timing of the events themselves. Under Section 2804(4) of the Competition Act, 66 Pa.C.S. § 2804(4), the rate cap was initiated for EDCs on the

effective date of the Competition Act – January 1, 1997. If Hurricane Isabel had struck PPL Electric’s service territory, for example, on June 1, 1996, PPL Electric would have been effectively precluded from recovering expenses of responding to that hurricane because there was not sufficient time between the event and the initiation of the rate cap period for PPL Electric and the Commission to process a general increase in base rates to become effective prior to the initiation of the rate cap. In contrast, Hurricane Isabel actually struck PPL Electric’s service territory in late 2003. PPL Electric prepared a rate promptly thereafter to become effective upon the expiration of the rate cap. Thus, under normal ratemaking, Hurricane Isabel occurred within a time frame that made recovery of the associated costs appropriate and timely after the expiration of the rate cap. To adopt the OCA’s argument would unfairly and improperly extend the effectiveness of the rate cap to conclude, as OCA proposes, that utilities are automatically and completely barred from recovering increases in revenue requirements associated with events occurring during the rate cap period.<sup>3</sup> This is simply not the law.

Other parties’ objections to recovery by PPL Electric of Hurricane Isabel expenses should be rejected.

**2. OCA’s Proposal To Eliminate AMR Displacement Costs Should Be Denied.**

PPL Electric proposes to recover certain increases in pension benefits for employees whose positions are being eliminated as a result of the Automated Meter Reading (“AMR”) project by amortizing the cost of such increases over five years. The

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<sup>3</sup> Even if the Commission were to determine that the deferral of the Hurricane Isabel expenses affects the recovery of such expenses, that determination should only affect the date of the commencement of the amortization reflecting the expenses for ratemaking purposes. It should not affect whether the expenses can be recovered through a continuation of the amortization after the rate cap expires.

AMR project will create substantial benefits for customers and, accordingly customers should bear the costs of increased pension benefits for former employees whose positions are being eliminated. PPL Electric Initial Brief, pp. 40-47. Not the least of these benefits is a reduction in payroll expense of \$5,950,000 directly resulting from the AMR system. PPL Electric St. 2-R, pp. 7-8. OCA is inconsistent. Although OCA accepts the payroll reductions resulting from the AMR system, it would disallow the cost of achieving those savings.

OCA, however, contends that PPL Electric should not be allowed to recover the increased pension expense for employees whose positions are being eliminated because, when the cost of the pension benefit increase is included, the total cost of the AMR project very slightly exceeds the amount of the specifically quantifiable benefits. OCA Main Brief, p. 32.

OCA can make this contention only by assigning a \$0 value to the substantial reliability and quality of service enhancements that are resulting from the AMR system. These improvements include elimination of estimated bills and elimination of the need for customers to arrange for manual meter readings for final bills. Service reliability will be enhanced because the AMR system will allow PPL Electric to diagnose distribution system problems and determine whether problems in a particular distribution system area have been resolved. In addition, the AMR system will provide a platform to support programs that will benefit customers in the future, including programs that will enable customers to save money by using electricity during low cost periods. PPL Electric Initial Brief, pp. 42-43.

It is completely unrealistic to assign a \$0 value for these substantial benefits, yet that is precisely what OCA has done in order to support its proposed adjustment.

OCA also contends that allowing PPL Electric to recover the costs of increased pension benefits would violate the rate cap. OCA Main Brief, p. 33. Such contentions are erroneous for the reasons explained above in conjunction with the amortization of PPL Electric's expenses incurred to respond to Hurricane Isabel.

### **3. OTS' Proposed Adjustment To Pension Expense Should Be Rejected.**

OTS contends that PPL Electric's pension expense should be denied in its entirety. OTS Main Brief, pp. 22-24. OTS contends that pension expense for ratemaking purposes should be based upon cash payments into the pension fund, and not upon accrual accounting as mandated by Generally Accepted Accounting Principles and the Financial Accounting Standards Board Statement of Financial Accounting Standards 87.

In support of its contention, OTS cites *Pa. P.U.C. v. Aqua Pa.*, Docket No. R-00038805 (August 5, 2004) ("*Aqua Pa.*") and *Pa. P.U.C. v. Pennsylvania-American Water Co.*, 231 PUR 4th 277 (2004) ("*Pa.-American 2004*"). OTS' reliance upon these Commission orders is misplaced. In those cases, each company based its pension expense claim for ratemaking purposes on cash payments. There was no controversy with regard to the matter. In fact, the issue was not litigated or even mentioned in the *Pennsylvania-American 2004* Order. Nothing in those orders, however, indicates that cash payments are the only basis that can be used to establish pension expense for ratemaking purposes.

In fact, in PPL Electric's last base rate case, *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 309, 329 (1995), the Commission concluded that PPL Electric's use of accrual accounting to establish pension expense for ratemaking purposes was

appropriate and that **consistent** use of accrual accounting over time would be fair to both ratepayers and shareholders. Thus, OTS' proposal is inappropriate because it proposes to shift from accrual to cash accounting rather than continue the consistent use of accrual accounting. OTS' proposal is improper for the additional reason that it is inconsistent with general ratemaking practices. PPL Electric uses accrual accounting for almost all other expenses. OTS' proposed adjustment to pension expense therefore should be rejected.

**4. OTS' Proposed Adjustment To Rate Case Communications Expense Should Be Rejected.**

In its Main Brief, OTS contends, for the first time, that:

"In essence, the Company's Rebuttal explanation indicates that the expense has been entered under two separate categories. Therefore, the Company's claim of \$130,000 must be removed."

OTS Main Brief, p. 29. OTS' new argument is diametrically opposed to its initial position in this proceeding. In its case-in-chief, OTS stated:

"Q. Is this rate case communications charge duplicative of the Company's rate case expense claim show on PPL Ex. Future 1, D-6?"

A. No."

OTS St. 2, p. 25. Thus, OTS definitively testified that the rate case communications expense was not a duplication. Indeed, the sole basis in the evidence for OTS' recommendation to disallow the rate case communications expense was, that in OTS' opinion, it "is a non-recurring expense." OTS St. 2, p. 25.

In rebuttal, PPL Electric explained that OTS' proposed disallowance of rate case communications expense was inappropriate and stated the following:

"Q. Do you agree that the expense is non-recurring?"

“A. Yes, I agree the expense is non-recurring. However, even through it is a non-recurring cost, the Company should be allowed to collect the amount as a normal rate case expense. It appears that the confusion over this expense may result from the mechanics of the Company’s request to recover the rate case expense.

“In preparation of the rate case filing, PPL Electric anticipated \$2,000,000 in rate case expenses associated with the case. The \$2,000,000 of anticipated expenses include \$1,000,000 of budgeted expenses by PPL Services (including \$130,000 budgeted by External Affairs) and \$1,000,000 of expenses for legal fees, witnesses and other costs which were unbudgeted. The Company proposed amortizing the total anticipated rate case expense of \$2,000,000 over a two-year period, resulting in an annual amortization of \$1,000,000. Because this annual amortization of \$1,000,000 equals the budgeted rate case expenses of \$1,000,000 for PPL Services, no additional adjustment is appropriate to rate case expenses or PPL Services expenses.”

PPL Electric St. 2-R, pp. 9-10.

Despite the fact that OTS filed surrebuttal testimony on many subjects, OTS did not address this issue. On this basis, PPL Electric concluded that OTS had accepted PPL Electric’s above-quoted explanation of the appropriateness of recovery of rate case communications expense.

OTS’ proposed adjustment to rate case communications expense should be rejected for two different reasons. First, it is incorrect for the reasons stated above. Second, it is improper for OTS to completely revise the factual basis for its proposed adjustment for the first time in its Main Brief. In the evidentiary record, OTS contended that the rate case expense should be disallowed as non-recurring; in its Main Brief, it apparently abandoned that rationale and now relies on its incorrect contention that the rate case communications expense is duplicative – a contention that is directly contrary to

its own evidence. OTS' proposed disallowance of rate case communications expense should be rejected.

**5. OTS' Proposed Adjustments To OnTrack and WRAP Should Be Rejected.**

PPL Electric has proposed to "ramp-up" its spending on its customer assistance program, OnTrack, and its low-income Winter Relief Assistance Program ("WRAP") to take into account the challenges associated with expanding low-income customer enrollment in OnTrack by thousands of people and increasing deployment of WRAP services by community-based organizations. PPL Electric Initial Brief, pp. 136, 145. Under PPL Electric's proposal, funds collected during the "ramp-up" period of 2004-07 would be escrowed to permit higher expenditures in 2008-2010. *See id.* OTS opposes PPL Electric's full increase, contending that the increase for both programs should be limited to the average of PPL Electric's planned spending over the next two years and that PPL Electric should file a new base rate case if additional funds are necessary. OTS Main Brief, pp. 29-32.<sup>4</sup>

OTS' proposed adjustment is premised on a belief that there is no need for additional OnTrack and WRAP monies beyond what is administratively appropriate in the first two years following this rate case. *See* OTS Main Brief, p. 30 (suggesting that PPL Electric file a new base rate case "[i]f expenses for OnTrack increase"). However, testimony in this proceeding has established that the full funding proposed by PPL Electric is necessary to obtain an OnTrack enrollment level recommended by the Commission and to implement the successful solar water heating pilot program created

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<sup>4</sup> OCA had previously proposed a similar adjustment for OnTrack, but did not raise this issue in its Initial Brief.

after PPL Electric's restructuring proceeding. *See* PPL Electric Initial Brief, pp. 137, 144. In effect, OTS' proposal would freeze funding below justified levels, and if PPL Electric did not return within two years with a new base rate case, many PPL Electric low-income customers would not receive benefits that the Commission and other parties to agree should be provided. *See* PPL Electric St. 7-R, p. 26 (explaining that OTS proposal may result in denial of OnTrack benefits to 1,500 families). OTS' proposed adjustments should be rejected by the Commission.

#### **D. TAXES**

##### **1. OTS' And OCA's Proposed Adjustments To Capital Stock Tax Should Be Rejected.**

Both OTS and OCA proposed similar adjustments to Capital Stock Tax ("CST"). OTS Main Brief, pp. 39-42; OCA Main Brief, pp. 40-42. In its Initial Brief (pp. 56-59), PPL Electric explained that such adjustments are not correct. In support of its proposed adjustment, the OCA states that "the cost of generation operations must not be included in distribution rates of a company." OCA Main Brief, p. 42. OCA's statement reflects a misunderstanding of Pennsylvania Capital Stock Tax law.

Under Pennsylvania law, the CST is calculated based on, in part, the average of five years of net income, regardless of the source of that income. Thus, PPL Electric's Capital Stock Tax liability for 2004 is based, in part, on its average income for the 2000-04 period. In a portion of 2000, PPL Electric owned and operated generating stations, and those operations influenced the Company's total net income for that year, and will correspondingly affect its CST liability for 2004, the future test year in this proceeding. This is true even though PPL Electric's generation resources have been divested.

The CST at issue here is imposed on PPL Electric, not on the entities that now own and operate former PPL generation facilities. Under the OTS/OCA approach, a portion of PPL Electric's actual 2004 CST would be excluded from rates and the Company would not have any other means of recovering this tax expense. The Commonwealth of Pennsylvania has determined the manner in which the CST is imposed on taxpayers. The Commission should calculate the CST for ratemaking purposes in the same manner as it is imposed on PPL Electric so that the Company has a reasonable opportunity to recover the tax which it is required to pay to the Commonwealth. OTS' and OCA's proposed adjustments to Capital Stock Tax should be rejected.

**E. RATE OF RETURN**

**1. Introduction**

One of the critical issues in this proceeding is the cost of equity. As explained in PPL Electric's Initial Brief, the Commission's determination not only is important to PPL Electric and its customers but also is important to all electric distribution companies and their customers in Pennsylvania. This is the first electric distribution base rate case following restructuring and expiration of the transmission and distribution rate caps. The Commission, the industry and its customers are at a fork in the road of regulation. One fork would continue regulation that is viewed by capital markets as balancing the interests of utilities, their customers and infrastructure development of the Commonwealth. The other fork favors lower rates and short-term, short-lived benefits to customers in exchange for higher capital costs in the future. OTS, OCA and certain other parties who support their positions in briefs invite the Commission to take the latter path. The Commission should not do so, as the evidence in this proceeding clearly demonstrates.

OTS and OCA recite in their briefs the long established standards for determining a fair rate of return set forth in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) (“*Bluefield*”) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)(“*Hope*”), noting that *Hope* provides that a fair rate of return, “should be commensurate with returns on investments in other enterprises having corresponding risks.” *Hope, supra*, p. 603. Yet, in the face of this clear standard, OTS and OCA propose 9.0% and 9.5% return on equity (“ROE”) allowances when the Commission recently has determined the ROE to be 10.6% for two water companies having clearly less risk than PPL Electric. *Pa.-American 2004, Aqua Pa*. The risk differentials are demonstrated by a comparison of the S&P Business Profiles (1 to 10 with 1 being the least risky) and S&P Bond Ratings.

	S&P Business Profile	S&P Bond Rating
Pa. American	2	A
Aqua Pa.	2	A+
PPL Electric	4	A-

PPL Electric St. 9-R, p. 24; PPL Electric Ex. PRM 2.

PPL Electric presented this comparison in rebuttal testimony, and neither OTS nor OCA has attempted to explain in surrebuttal testimony or in its Main Brief how its ROE recommendation could possibly meet the comparable return standard of *Hope*, given the Commission’s recent decisions in *Pa.-American 2004* and *Aqua Pa*. PPL Electric submits that the capital markets will see this inconsistency and react negatively if either the OTS’ or OCA’s recommendation is adopted.

Although they have failed to justify their recommendations under the fundamental standard of *Hope*, OCA and OTS offer numerous reasons why the analysis of PPL Electric witness Moul is allegedly in error. Curiously, they have offered no testimony and little argument in opposition to the recommendation of DOD witness Kincel that the ROE be set at 10.75%.

Distilled to their essence, the numerous arguments offered by OTS and OCA fall into two categories. The first is that the DCF analysis, as performed by these witnesses, is the only analysis that provides reliable information on the cost of equity. The second is that PPL Electric's cost of equity must be lower than it was in 1995, when the Commission last determined its ROE, because an electric distribution utility must be less risky than an integrated electric utility.

As to the contention that the Commission should rely solely on the DCF analysis as performed by OTS witness Deardorff and OCA witness Kahal because it is the only reliable evidence of cost of equity, the Commission has rejected such contention, holding that the unadjusted DCF understates the cost of equity and, as a result, must be adjusted and/or the results of other cost of equity models must be given weight. *Pa.-American 2004*, 231 PUR 4th, *supra*, pp. 314-15, *Aqua Pa.*, pp. 61-66. Accordingly, the arguments of OTS and OCA that there must be sole reliance on their unadjusted DCF analyses have been rejected by the Commission and are contrary to Commission precedent that the unadjusted DCF analysis understates the cost of equity.

The argument that PPL Electric as an electric distribution company today clearly must be less risky than an integrated electric utility in 1995 also has no merit. These are theoretical arguments comparing a utility in 1995 to a utility in 2005. Theoretical

arguments by rate of return witnesses do not determine risks; capital markets do. The S&P business profile and bond ratings demonstrate that PPL Electric is at least as risky as the water companies and as least as risky as it was in 1995 when it had a slightly higher bond rating (Tr. 563). The comparable return standard requires that the Commission allow an ROE equal to that allowed to similar risk companies in today's market conditions, not those of 10 years ago. There have been extraordinary changes in the electric industry and the world since 1995, including electric restructuring, the Enron collapse and the tragic events of September 11, 2001, to name just a few. Attempts to qualitatively compare risks across a decade and use such comparisons to justify an ROE allowance are inappropriate. OCA's and OTS's arguments of allegedly reduced risk, therefore, provide no basis for the Commission to conclude that PPL Electric should be allowed an ROE less than that recently determined for water companies.

It also is to be noted that the rate of return discussed in testimony and briefs of OTS and OCA fail to address, in any manner, the superior service provided by PPL Electric to its customers, including service provided during the rate cap period when PPL Electric was earning about 2% on equity. PPL Electric St. 1, p. 3.

Indeed, the explanation of rate of return standards in these parties' briefs makes no mention of quality of service even though the Commission has consistently concluded that quality of service is an important and relevant consideration in arriving at the allowed ROE. *Aqua Pa.*, pp. 63-65. As explained in the PPL Electric Initial Brief, pp. 67-69, PPL Electric has presented undisputed evidence that it has provided extraordinary service, as recognized by its customers, without a net increase in total rates for nearly 18 years. It is important that the Commission recognize this high level of service by

adopting an ROE at the high end of the cost of equity range, both to encourage and enable PPL Electric to continue such service and encourage other utilities to meet such standards.

Finally, OTS and OCA argue that PPL Electric's proposed ROE of 11.5% is not supported by substantial evidence. To the contrary, only PPL Electric witness Moul and DOD witness Kinzel have used multiple cost of equity models to define the cost of equity range. As explained in PPL Electric's Initial Brief, giving weight to both of these witnesses' presentations, the Commission's recent decisions that the cost of equity was 10.6% in *Aqua Pa.* and *Pa.-American 2004*, PPL Electric's evidence demonstrating the Company's greater risk under S&P bond ratings and business profiles and evidence indicating an investor expected ROE of 10-12%, an equity cost rate range of 10.75% to 11.75% is clearly supported by the record. Mr. Moul's recommendation of 11.50% is within this range and is particularly justified given PPL Electric's extraordinary service to its customers.

## **2. Capital Structure**

The only rate of return issue in this proceeding, other than cost of equity, is the Company's capital structure at December 31, 2004. No party disputes the proposition that the capital structure should reflect the types and amounts of capital at December 31, 2004, the end of the future test year in this proceeding. OCA contends, however, that the Company's modest projected growth in retained earnings of \$15 million in 2004 should not be reflected in the equity balance at December 31, 2004. OCA's witness, Mr. Kahal, gives two reasons for not reflecting this increase. First, Mr. Kahal suggests that such projection is unsupported because PPL Electric earned \$25 million in 2003, but paid dividends of \$29 million and earned \$39 million in 2002, and paid dividends of \$63

million (OCA, St. 1, p. 13). One problem with this “analysis” is that it is overly simplistic. On cross, Mr. Kahal admitted that he made no analysis of what caused PPL Electric to earn these low returns in 2002 and 2003, or whether PPL Electric had any unusual expenses in these years (Tr. 604-05). The record demonstrates that PPL Electric had \$8.8 million in employee severance costs in 2003, related to installation of the AMR system. PPL Electric St. 4, pp. 12-17; PPL Electric 4-R, pp. 40-42. But for these costs, PPL Electric would have had positive retained earnings.

In rebuttal, PPL Electric explained that it had earned \$36 million in the first half of 2004, more than it earned for all of 2003 and essentially the same amount it earned for all of 2002. It had positive retained earnings in the **first half** of 2004, after payment of \$2 million in dividends, resulting in a net increase of \$34 million in its equity balance. PPL Electric also explained that it was retaining earnings to cover its construction expenditures. PPL Electric St. 9-R, pp. 7-8. The evidence clearly supports PPL Electric’s modest projection that its equity balance will grow by \$15 million due to retained earnings in 2004.

OCA witness Kahal also stated in his testimony that it would be inappropriate to reflect the earnings retained by PPL Electric in 2004 in the capital structure, because the effect on doing so would increase the ultimate rate allowance. OCA St. 3-R, pp. 12-13. OCA repeats this argument in its brief stating as follows:

“While small, Mr. Moul’s increase served no purpose other than to artificially inflate the Company’s capital structure.”  
OCA Main Brief, p. 48.

There is no basis for this statement, and it is simply incorrect. The purpose of retaining earnings is to finance plant additions to serve customers, not to increase the rate allowance. If the Commission were to adopt the OCA’s approach, there would be a

disincentive to retain earnings because an equity return would not be provided on retained earnings during the future test year, thereby encouraging the utility to simply pay out all earnings in dividends and raising all capital to finance plant in the capital markets. The Commission should not create a disincentive to retaining earnings to finance construction of facilities needed to serve customers.<sup>5</sup>

OCA's arguments are both contrary to the record and, if adopted, would represent poor Commission policy. The modest projection of increased equity created by growth in retained earnings in 2004 is fully supported and properly reflected in the capital structure.

### **3. Cost of Equity**

As explained in the Introduction to the Rate of Return section of this Reply Brief, the ROE recommendations offered by OTS and OCA (9.0% and 9.5% respectively) are simply not credible given the Commission's recent determinations in *Pa.-American 2004* and *Aqua Pa.* that the cost of equity is 10.6% and PPL Electric's greater risk profile as specified by S&P. In this section of the Reply Brief, PPL Electric will respond, briefly, to the arguments presented by OTS and OCA, which attempt to convince the ALJ and the Commission that the Commission has erred in rejecting sole reliance on an unadjusted DCF analysis. The responses outlined below are fully set forth in PPL Electric's Statement Nos. 9 and 9-R, presented by Mr. Moul. Furthermore, it is to be noted that *each of the arguments raised by OTS and OCA in support of sole reliance on an unadjusted DCF analysis to set the cost of equity has been presented to, and rejected by,*

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<sup>5</sup> Under OCA's argument, it would be appropriate to deny employee wage increases in the future test year, or at least deny the utility recovery of the wage increases, because the increases would increase the rate allowance.

the Commission as recently as its decision on August 5, 2004, in *Aqua Pa.*, p. 63, where the Commission stated as follows:

“The ALJ recommended a 10.0% cost of equity, relying too heavily on the DCF methodology. However, the ALJ failed to sufficiently consider the other standard financial models, including Comparable Earnings, the risk Premium Model, and the CAPM, as checks upon the reasonableness of the DCF results. *See generally, PA P.U.C. v. Pennsylvania Suburban Water Company*, 219 PUR 4th 272 (2002).

\* \* \* \*

We are also persuaded by AP’s reasoning that a financial risk adjustment is necessary to compensate it for the application of a market based cost of common equity to a book value common equity ratio. We note that preliminary the [sic] DCF calculation, which is computed using the market price of AP’s common stock, should be adjusted to reconcile the divergence between market and book values. Additionally, when investors value a company’s common stock, they employ actual market capitalization data, and not book data, although book capitalization is employed for ratemaking purposes.”

The conclusion is clear, even if OTS and OCA refuse to accept it. The unadjusted DCF analysis understates the cost of equity when market prices exceed book value. Therefore, the results of the DCF analysis must be adjusted if it is the primary method to be employed and/or other cost of equity models must be considered.

As explained in subsequent sections of this brief, OTS’s and OCA’s criticisms of the CAPM and Risk Premium methods employed by Mr. Moul are inaccurate and incorrect. Furthermore, their arguments concerning PPL Electric’s allegedly reduced risk are just that, nothing more than arguments, unsupported by, and contrary to, the market’s evaluation of PPL Electric’s risk relative to other utilities.

**a. OTS's and OCA's DCF Analyses Understate the Cost of Equity.**

**(1) PPL Electric Witness Moul and DOD Witness Kincel Have Properly Determined the DCF Growth Rate.**

PPL Electric witness Moul and DOD witness Kincel each concluded that the growth rate employed in the DCF should be 5.5%, and both concluded that the unadjusted DCF analysis would yield 10.25% based upon a barometer group of electric distribution companies. They arrived at their recommended growth rates using two different methods, which provide confirmation of their reasonableness. Mr. Moul arrived at his growth rate by reviewing analysts' forecasts of earnings and selecting a growth rate near the high end of such range given that analysts' forecasts are likely conservative given the uncertainty following restructuring. PPL Electric St. 9, pp. 27-28. DOD witness Kincel based his recommendation on analysts' forecasts of growth rates in dividends. DOD characterized Mr. Kincel's analysis in its Main Brief, as follows:

“Mr. Kincel chose the 10.26% (rounded to 10.25%) dividend growth-based ROE as the most realistic estimate because: (1) the DCF analysis tends to produce low estimates of ROE when the price-to-book ratio is greater than 1.0, as it is for this Comparable Group (1.49); (2) the original DCF computation is based on dividend growth *before simplification into the single stage growth model*; and (3) in Mr. Kincel's judgment “there is nothing better than hard cash dividends to provide a realistic estimate of the growth rate, and the associated ROE, for a group of utilities. DOD supports the reasoning of Mr. Kincel, and recommends that the Commission consider as the most realistic estimate of ROE stemming solely from DCF analysis to be 10.25%.” DOD Main Brief, pp. 11-12.

In rebuttal, Mr. Moul confirmed that a DCF analysis based upon growth rates in dividends as projected by Value Line produces a growth rate of 5.5% and an unadjusted DCF of 10.29%. PPL Electric St. 9-R, p. 17. These analyses reflect reasonable

expectations of an investor expected return on market price, which, as explained subsequently, must be adjusted to produce an ROE to be applied to book equity.

OTS and OCA assert, in their testimony and briefs, that Mr. Moul overstates the growth rate. They do not address Mr. Kinzel's growth rate. They offer two criticisms of Mr. Moul's growth rate. First, that he did not average the analysts' projections of earnings growth rates in his initial analysis. However, Mr. Moul explained that earnings growth rates are cyclically depressed at this time because of the economy and that, with growth in the economy accelerating, investors likely expect growth rates at the higher end of projections. PPL Electric St. 9, pp. 29-31; PPL Electric St. 9-R, p. 16. Furthermore, analysts' projections of growth rates in dividends support 5.5%. PPL Electric St. 9-R, p. 17.

OCA cites testimony of Mr. Kahal in its Brief, p. 58 as follows, in support of his earnings growth rate of 4.5%:

“Page 4 of Schedule MIK-4 shows growth projections for dividends, book value and retained earnings growth published by Value Line (June 4, 2004). The dividends and book value reflect the next five years, while retained earnings growth is for the time period 2007 to 2009. These measures for the eight proxy companies average 3.0 to 3.7%, and absent the very low UIL figures, that group average ranges from 3.4 to 4.1%. Again, this confirms the reasonableness of adopting a growth range of 3.5 to 4.5%.”  
OCA St. 3 p. 30.

However, as was demonstrated on cross, Mr. Kahal did not use the same Value Line method to calculate his earnings and book value growth rates. Tr. 612-620. He used Value Line's reported earnings growth rates, which are based on 3-year base periods and calculated book value and dividend growth rates using Value Line data for a single base year period. PPL Electric demonstrated on cross that using a consistent approach to

calculate a projected earnings growth rate produces a growth rate of 5.67% for Mr. Kahal's preferred barometer group (excluding the Vermont Companies), and 5.36% for Mr. Moul's 10 company barometer group, confirming Mr. Moul's 5.5% growth rate. PPL Electric Cross Exam Ex. 2.

In OCA's Main Brief, p. 59, without basis in evidence, OCA attempts to rehabilitate Mr. Kahal's inconsistency. OCA averages 5.36%, the growth rate shown on PPL Electric Cross Exam Ex. 2 for Mr. Moul's 10 companies, with other reported earnings growth rates for the 10 companies, including the Vermont Companies, to produce 3.9%. However, Mr. Kahal rejected use of the 10 companies in his testimony that is quoted on page 56 of OCA's Main Brief. More importantly, PPL Electric Cross Exam Ex. 2 demonstrates that, whether one uses the 10 companies (5.36%) or the eight companies (5.67%), Mr. Kahal would have reported earnings growth rates that supported Mr. Moul's 5.5% conclusion if Mr. Kahal had used consistent methodologies in his presentation.

OTS and OCA criticize the analysts' projections of dividend growth claiming that 16% for PEPCO must be erroneous. Several points are to be made. First, it is the analyst's projection, and there is no reason why investors would ignore it. Second, OTS and OCA do not complain about the inclusion of a negative 4.0% growth rate for Duquesne Light in the average. Third, both witnesses testified that the purpose of the barometer group is to smooth out such unusual circumstances. OCA St. 3., p. 25; OTS St. 1, p. 10. It is clear that investors could conclude that a dividend growth rate of 5.5% is appropriate for use in the DCF analysis.

However, OCA's and OTS arguments about the selection of a growth rate in the DCF analysis prove a more important point. There is so much room for difference of opinion among experts as to the investor expected growth rate that sole reliance on the DCF is inappropriate. The Commission has recognized this even if OCA and OTS refuse to accept it.

**(2) The Leverage Adjustment is Necessary to Determine the Investor Required Return on Book Value.**

In their main briefs, OCA, in particular, and OTS argue that Mr. Moul's leverage adjustment to the DCF and CAPM analyses is unnecessary and inappropriate. PPL Electric has explained in its testimony the reasons that the adjustment is necessary (PPL Electric St. 9, pp. 34-37; PPL Electric St. 9-R, pp. 17-19) and will briefly respond to such arguments in this Reply Brief. It is to be noted that each argument presented by OTS and OCA has been rejected by the Commission in *Aqua Pa.* and *Pa. American 2004* and in prior cases, and the parties have provided no basis to reverse those decisions in this case.<sup>6</sup>

**(3) The Leverage Adjustment Is Both Necessary and Appropriate.**

OTS and OCA offer a series of arguments in their attempt to convince the ALJ that the Commission has erred in concluding that the DCF methodology understates the cost of equity when market prices exceed book values. These arguments are incorrect and the Commission has properly rejected them.

OTS and OCA argue that the adjustment is unnecessary because the DCF determines the market required return. Investors determine their required returns and

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<sup>6</sup> The one exception to this is OCA's contention that the leverage adjustment is improperly calculated. This argument is, as explained *infra*, erroneous.

judge their achieved returns based upon the market price of the stock, not its book value. *Aqua Pa.*, p. 63. Hence, the DCF determines the investor required return on the market price. When the market price is higher than the book value, the investor required return on book value is greater than the investor required return, as a percentage, on the higher market price. Since the DCF is determining the required percentage return on market price, the required return will not be produced if the percentage return on market price is applied to lower book value. PPL Electric St. 9, pp. 3-4. As noted by Mr. Moul, there is another way to express, and adjust for, this problem, which relates to the fact that the percentage of debt in the capital structure based upon book value of equity is greater than the percentage of debt in the capital structure when viewed based upon market prices of equity (market capitalization).

“As noted previously, the divergence of stock prices from book values creates a conflict within the DCF model when the results of a market-derived cost of equity are applied to the common equity account measured at book value in the ratesetting context. This is the situation today where the market price of stock exceeds its book value for most companies. This divergence of price and book value also creates a financial risk difference, whereby the capitalization of a utility measured at its market value contains relatively less debt and more equity than the capitalization measured at its book value. It is a well-accepted fact of financial theory that a relatively higher proportion of equity in the capitalization has less financial risk than another capital structure more heavily weighted with debt. This is the situation for the Electric and Gas Groups where the market value of their capitalization contains more equity than is shown by the book capitalization.” PPL Electric St. 9, pp. 12-13.

OTS and OCA also contend that the DCF provides the full cost of equity because it is a market based method. While the DCF is a market based method, their argument fails to account for the fact that the investors are identifying the expected return rate upon

the market price they are paying. If that return rate is applied to lower book value, they cannot achieve the required return.<sup>7</sup>

OTS and OCA also argue that there is no need to adjust the DCF result when market prices exceed book values because this means that companies are earning more than their cost of capital. This argument, as explained by Mr. Moul, is not credible because it would mean that the market as a whole is earning more than its cost of capital:

“ . . . it is a misperception that market prices in excess of book value are symptomatic of earnings that exceed a firm’s cost of capital. Mr. Deardorff fails to realize that stock prices above book value are common for utility stocks, and indeed for all of the major market indexes. According to the Barron’s issue of May 24, 2004 (the one relied upon by Mr. Deardorff), utility stocks were trading at a multiple of 1.87 times book value, the S&P 500 index was trading at 3.37 times book value, the S&P Industrial index was at 3.99 times book value, and the Dow Jones Industrial index was trading at 4.36 times book value. It is difficult to accept that the vast majority of all firms with publicly traded stocks are generating returns far in excess of their cost of capital. Certainly, in our free-market economy, competition should constrain such “excesses” if they indeed existed.” PPL Electric St. 9-R, pp. 29-30.

OCA and OTS also argue that the leverage adjustment is intended to maintain market prices and that it will increase market prices leading to a greater adjustment to the DCF in the future. These arguments proceed from the same incorrect conclusion that a market price in excess of book value means that a company is earning more than the cost of capital. Market prices are affected by many factors, including a company’s earnings.

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<sup>7</sup> In cases cited by OCA from West Va. (OCA Main Brief, p. 92) it is suggested that this adjustment is the same as an inflation of rate base. This is not the case for two reasons. First, PPL Electric is using an original cost rate base in this case. Second, the adjustment is to reflect the fact that the DCF does not determine the investor required return on an original cost rate base.

Earning the investor required return will not cause the market price to increase. PPL Electric St. 9-R, p. 30.

A fourth argument offered by OCA is that Mr. Moul's leverage adjustment is improper because it is calculated using the difference in leverage at book and market values for the barometer group and not PPL Electric. This argument is also fallacious. The witnesses are using the DCF applied to the barometer group to determine the cost of equity and that determination understates the cost of equity to the extent that the percentage of leverage to total capital at book value exceeds the percentage of leverage to total capital at market capitalization **for the barometer group**.

OCA also argues that there is no change in the dollar amount of debt financing at book and market capitalization. This entirely misses the point. The **percentage** of debt at book value is greater than at market value, and it is this greater percentage which is used to quantify the additional risk at book value to the equity investor.

OCA also contends that the DCF result should not be adjusted because “. . . the unadjusted DCF model is **representative** of a market-based cost of common equity.” Citing *Pa.-American 2004*, at pp. 314-15, emphasis in OCA Main Brief at page 84. However, the Commission states as follows in *Pa.-American 2004*, 231 PUR 4th 277, 314-15 (2004).

“We determine that the DCF method is the preferred method of analysis to determine a market based common equity cost rate. Although we agree with the ALJ's adoption of the 10.00% market based common equity cost rate as a starting point, we find merit in the financial risk adjustment proposed by PAWC. We note that, in *Lower Paxton Township v. Pennsylvania Public Utility Commission*, 317 A.2d 917 (Pa. Cmwlth. 1974)(*Lower Paxton Township*), the Commonwealth Court recognized that this Commission may consider such factors that affect

the cost of capital such as the utility's financial structure, credit standing, dividends, risks, regulatory lag, wasting assets and any peculiar features of the utility involved.

"We are persuaded by PAWC's reasoning that a financial risk adjustment is necessary to compensate PAWC for the application of a market based cost of common equity to a book value common equity ratio. However, we find that the PAWC's recommended 78 basis point adjustment is excessive. As we determined in PAWC's prior base rate case, at Docket No. R-00016339 (Order entered January 25, 2002), a 50 basis point adjustment to the market based common equity cost rate will compensate PAWC for the aforementioned application of a market based common equity cost rate to a book value common equity ratio."

The suggestion in OCA's Main Brief that *Pa.-American 2004* supports the proposed rejection of the leverage adjustment is simply erroneous.

Finally, OCA argues that the adjustment is inappropriate in this case due to the recovery of stranded costs. OCA Main Brief, p. 88. OCA argues that the recovery of stranded costs of generation represents recovery of costs of generating facilities below book value. This argument is irrelevant for three reasons.

First, and most importantly, PPL Electric does not own generating assets and ownership by unregulated affiliates has no relevance to this distribution rate case. Second, the stranded costs referenced by OCA are the result of electric restructuring and the creation of a competitive market. But for those efforts, there would have been no stranded costs, and PPL Electric would have retained its generating assets and recovered the full cost of the book value of such assets as well as a fair return on such assets over their useful lives. And, third, as a result of the generation rate cap under the Competition Act, PPL Electric's customers will pay no more than under regulation, including both POLR rates and stranded costs. If customers shop and find lower rates, they will pay

less. If regulation of generation had continued, customers could have paid more for generation. As a result, customers are clearly not harmed by stranded cost recovery. OCA's arguments are meritless and provide no basis to deny PPL Electric the full cost of capital on its distribution rate base, which is precisely what OCA seeks to accomplish.

**(4) OCA's Contention that the Leverage Adjustment is Improperly Calculated is Erroneous.**

Failing to provide any argument not previously advanced to and rejected by the Commission in support of its challenge to the leverage adjustment, OCA contends that the adjustment is improperly calculated. OCA Main Brief, pp. 89-90. OCA offers two criticisms: (1) that the leverage adjustment is calculated based upon the difference between book and market capitalization of the barometer groups instead of PPL Electric; and (2) Mr. Moul has not used included short term debt in his analysis. Both arguments are erroneous. Mr. Moul responded to the first contention as follows in rebuttal:

"Q. Mr. Kahal criticized the leverage adjustment that you propose to account for the divergence of market capitalization and book value capitalizations. Please comment.

"A. It must be recognized that, in order to make the DCF results relevant in the ratesetting context, the market-derived cost rate cannot be used without modification. The importance of the leverage modification to the DCF results was fully supported in my direct testimony, wherein it was shown that the market value of the equity in the Electric's Group's and Gas Group's capitalization was much higher than its book value. To make the market-derived DCF results applicable in the ratesetting context, it is necessary to account for the higher financial risk that arises from the lower common equity ratio measured by book value capitalization as compared to the higher common equity ratio measured by market capitalization. Because book value capital structures are used instead, my

adjustment procedure is required.” PPL Electric St. 9-R, pp: 7-10.

The capitalization differences for the barometer group must be used because the DCF cost rate is determined from the barometer group. OCA’s first criticism therefore is obviously without merit. As to Mr. Kahal’s contention that Mr. Moul failed to consider short term debt, Mr. Moul explained that short term debt had no effect on his adjustment.

“Q. Mr. Kahal claims that regardless of whether your leverage adjustment is necessary, it has been incorrectly calculated. Please respond.

“A. My adjustment is accurately calculated. It employs the FAS 107 data that each company must report in the financial statements filed with the SEC. Generally, these data exclude short-term debt, and Mr. Kahal offers absolutely no proof the market versus book value differences is “perhaps to 2 percentage points.” Even if short-term debt were to be included in the calculation, it would affect both the market capitalization and the book value capitalization. Hence, Mr. Kahal has not proven his point. Recall, the adjustment must be made with the same set of companies, i.e., the market capitalization for the Electric Group. Although the book value of PPLEU’s capital structure ratios are between the market capitalization and book value capitalization of the Electric Group, the Company’s relatively high business risk for an electric delivery utility (as shown by its ‘4’ business profile) mandates a relatively stronger equity ratio to offset its higher business risk.” PPL Electric St. 9-R, p. 18.

As explained by Mr. Moul, his exclusion of short term debt is irrelevant since it would be reflected on both sides of the analysis. OCA searches in vain for an excuse to reject the leverage adjustment accepted by the Commission. Its criticisms have no merit.

**(5) Decisions of other Regulatory Commissions Do not Support Rejection of the Leverage Adjustment.**

OCA contends that other regulatory commissions have “soundly rejected Mr. Moul’s reasoning” with regard to the leverage adjustment. OCA Main Brief, p. 90. Even if this were true, the decisions of other regulatory bodies would not be binding on the Commission. More importantly, the OCA has seriously mischaracterized these decisions.

OCA purports to find support in decisions issued by the District of Columbia, West Virginia, Missouri and Michigan commissions. OCA Main Brief, pp. 91-94. In the first case, involving the Washington Gas Light Co., the utility’s witness contended that a market-based return of 11.0% translated into a required return on book value of 17.5% (*i.e.*, the equivalent of a 650 basis point market/book leverage adjustment). *In the Matter of the Application of Washington Gas Light Co.*, 229 PUR 4th 177 (D.C.P.S.C. 2003)(“WGL”). This, of course, is a far cry from the modest .44 basis point adjustment proposed in this proceeding. Moreover, it bears noting that in its *WGL* Order, which was issued in November 2003, the District of Columbia Commission awarded an equity allowance of 10.6%, the same as approved by the Commission in *Pa. American* and *Aqua Pa.*

The second case cited by OCA is *Re West Virginia-American Water Co.*, 231 PUR 4th 423 (W.Va.P.S.C. 2004). In evaluating the persuasiveness of this decision, it should be noted that the allowed rate of return on equity was only 7%, which is financially unrealistic and out of step with the decisions of this Commission and those of other states. In 2003, there were only 5 out of 43 rate cases across the nation in which the allowed return on equity less than 10%. In contrast, in 19 cases the return on equity

ranged from 11% up to 12% and the allowed return was greater than 12% in 6 cases.

PPL Electric St. 9-R, p. 6.<sup>8</sup>

The third case cited by the OCA involved the St. Louis County Water Co. and was litigated sixteen years ago. *In the Matter of St. Louis County Water Co.*, 94 PUR 4th 96 (Mo. P.S.C. 1998). In that proceeding, the Staff's witness argued that "it is appropriate to apply the DCF analysis unadjusted for market-to-book differences because in doing so share price will be driven to book value . . . ." 94 PUR 4th, *supra*, p. 104. PPL Electric respectfully submits that the public would be poorly served by a regulatory policy designed to intentionally confiscate shareholder value. To be sure, were the Commission to embrace a goal of driving market/book ratios closer to 1.0, no reasonable investor, facing the prospect of a significant loss of capital, would commit funds to a Pennsylvania utility. The resulting inability to attract new capital on terms comparable to similar risk enterprises would, in turn, raise serious constitutional issues. *See Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).<sup>9</sup>

The fourth decision discussed by the OCA was issued by the Michigan Public Service Commission in a proceeding involving the Wisconsin Electric Power Co. *In the Matter of the Application of Wisconsin Electric Power Co.*, 221 PUR 4th 136 (Mich.

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<sup>8</sup> It also is to be noted that in the rankings of state utility commissions by Lehman Brothers in the article referenced by Ms. Cannell (PPL Electric St. 10, pp. 17-18), West Virginia has the lowest ranking of 5 and is only one of six state commissions with such a ranking. Lehman Brothers, *They're Back! Twenty-Six Rate Cases This Year Give Rise to the Regulations*, p. 8 (March 5, 2004).

<sup>9</sup> Furthermore, if the OCA's proposals were implemented, and stock prices were driven down to something approximating book value, utility dividend yields - - a key component of the DCF calculation - - would be much higher. For example, assume a firm that has a book value of \$10.00 and pays out \$1.00 in dividends. If the firm trades at 3x book value, its dividend yield, as noted previously, is 3.33%. Conversely, if its market price drops to book value, its dividend yield becomes 10.0% ( $\$1.00 \div \$10.00$ ).

P.S.C. 2002). There, the Michigan Commission stressed the importance of reviewing and considering the results of several standard financial models and **not** relying wholly on the DCF method. Accordingly, there was no need to make a separate and specific adjustment to the DCF result because the Michigan Commission was relying on other cost of equity models.

The cases cited by OCA are overstated and do not support the conclusion offered by OCA that no adjustment to the DCF cost rate is necessary or appropriate.

If the Commission considers opinions of other regulatory agencies, however, it must be noted that several have expressed concern that the DCF may not accurately determine the ROE. For example, in a case involving one of PAWC's affiliates, the Indiana Utility Regulatory Commission discussed this problem at length:

In determining a common equity cost rate, we must again recognize the tendency of the traditional DCF model, relied on heavily by Mr. Bolinger, to understate the cost of common equity. As the Commission stated in *Indiana Mich. Power Co.* (IURC 8/24/90), Cause No. 38728, 116 PUR 4th 1, 17-18, "the unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore requires an upward adjustment based largely on the expert witness's judgment."

\* \* \*

It is recognized that "there are difficulties in making a good DCF calculation whenever a utility's stock sells, for whatever reason, above book value." *Niagara Mohawk Power Corp.* (NY PSC 2/2/93), 140 PUR 4th 481, 491. This phenomenon was also discussed in Whittaker, "The Discounted Cash Flow Methodology: Its Use In Estimating A Utility's Cost of Equity," 12 Energy L.J. 265, 281-282 (1991), where it is stated:

The DCF methodology presumes to produce the “market required” return on equity, that is, the “cost of equity” on the market value -- not the book value -- of a company's stock. **Unless the market price of a utility's stock equals its book value, the unmodified application of the market-oriented DCF results to a net original cost (book value) rate base understates the earnings necessary to satisfy the investor-required (expected) return.**

Thus, if the traditional DCF model is strictly applied to an original cost rate base, the investor could earn the cost of capital only if the investor paid no more than book value for the stock.

*Re Indiana-American Water Company*, 150 PUR 4th, 167-68 (1994) (emphasis added).

The Iowa Utilities Board reached the same conclusion in *Re Interstate Power Company*, 152 PUR 4th 377, 382-83 (1994):

The Board generally relies on the DCF model for the initial analysis to determine the cost of equity and uses a risk premium analysis as a check on the validity of the DCF analysis. In *Iowa Electric Light and Power Company*, Docket No. RPU-89-9, “Final Decision and Order” (October 25, 1990), the Board stated: “[T]he DCF model may understate the return on equity in some circumstances. This is particularly true when the market is volatile and the company in question has a market-to-book ratio in excess of one.” Those conditions exist in this case (Ex. 17, Sch. 2, p. 3). The DCF results do not overlap with the risk premium analysis because the DCF model yields extremely low results.

\* \* \*

In this case, the DCF approach underestimates the cost of equity needed to assure capital attraction during this time of market uncertainty and volatility . . . The Board will, therefore, give preference to the risk premium approach . . .

*See also Re Maui Electric Company, Ltd.*, 153 PUR 4th 437, 473 (1994) (“We agree with MECO that there is currently a downward bias in the DCF model.”); *Re*

*Commonwealth Edison Company*, 158 PUR 4th 458, 520 (1995) (“[T]he presentations made by Messrs. Gorman, LeLash and Kahal lead to determinations which understate Edison's cost of equity; e.g., use by all three Intervenor witnesses of an annual DCF model, which has been explicitly rejected by this Commission.”).

Commissions in other states do not agree with OTS and OCA concerning reliance solely on the DCF method to determine the cost rate of common equity.

**b. OCA’s and OTS’s Criticism of PPL Electric’s CAPM and Risk Premium Calculations Are Meritless.**

In a further attempt to support their unadjusted and discredited DCF analyses, OCA and OTS criticize Mr. Moul’s CAPM and Risk Premium analyses. As explained below, these criticisms are without merit.

OCA and OTS criticize Mr. Moul’s use of investor expected interest rates during 2005, as the risk free rate in the CAPM analysis and as the bond yield in the risk premium analysis. OCA and OTS argue that this is speculative. However, Mr. Moul explained that the consensus forecast is that interest rates are rising:

“The Blue Chip Financial Forecasts (“Blue Chip”) is published monthly and contains consensus forecasts of a variety of interest rates compiled from a panel of banking, brokerage, and investment advisory services. I have provided below the Blue Chip yields on Aaa rated and Baa rated corporate bonds and the yield on 10-year and 20-year Treasury obligations. These forecasts from the July 1, 2004 Blue Chip are:

<u>Quarter</u>	<u>Aaa-rated Corporate</u>	<u>Baa-rated Corporate</u>	<u>10-Year Treasury</u>	<u>20-Year Treasury</u>
3rd Qtr. 2004	6.2%	7.0%	4.9%	5.6%
4th Qtr. 2004	6.4	7.2	5.1	5.8
1st Qtr. 2005	6.6	7.4	5.3	6.0
2nd Qtr. 2005	6.8	7.5	5.5	6.1
3rd Qtr. 2005	6.9	7.7	5.6	6.2
4th Qtr. 2005	7	6.8	5.8	6.3

“Q. Are there forecasts of interest rates that extend beyond those shown above?

“A. Yes. Twice yearly, Blue Chip provides a long-term forecast of interest rates. In its June 1, 2004 publication, the consensus forecasts of interest rates were forecast to be:

<u>Year</u>	<u>Aaa-rated Corporate</u>	<u>Baa-rated Corporate</u>	<u>10-Year Treasury</u>	<u>Long-term Treasury</u>
2005	6.9%	7.7%	5.6%	6.1%
2006	7.3	8.0	5.9	6.5
2007	7.5	8.2	6.1	6.6
2008	7.6	8.3	6.2	6.7
2009	7.6	8.3	6.2	6.7
2005-09 (avg)	7.4	8.1	6.0	6.5
2010-14 (avg)	7.5	8.2	6.1	6.6"

PPL Electric St. 9-R, pp. 4-5.

The criticisms of use of projected higher interest rates in the CAPM and Risk Premium analyses are unjustified. Mr. Kahal’s refusal to reflect the consensus of higher rates in his own CAPM analysis understates the cost of equity. Equally important, however, the refusal of OCA and OTS to accept the fact that investors believe that interest rates and capital costs are rising pervades OTS’s and OCA’s presentations and undermines their credibility in this proceeding.

## (1) CAPM Analysis

OCA quotes Mr. Kahal's summary of his criticisms of Mr. Moul's CAPM analysis on page 96 of its Main Brief:

"I have three main concerns. First, his risk free rate (Treasury bond yield) is based on forecasts rather than actual market data. Second, his analysis includes a leverage adjustment similar to the one I just discussed in connection with his DCF study. This adjustment is both conceptually and empirically wrong in the CAPM for precisely the same reasons that I discuss above. Third, he includes a "size" adjustment of (0.82), apparently based on the notion that small capitalization stocks are riskier than large capitalization stocks. This adjustment is erroneous."  
OCA St. 3, p. 44

Mr. Kahal's listing of criticisms is not only meritless but also provides a clear listing of the deficiencies of his own CAPM analysis.

First, he criticizes Mr. Moul's use of a prospective Treasury Bond yield as the risk free rate instead of a current yield in determining the risk free rate. Mr. Moul explained that use of a current Treasury Bond yield is necessary because investors expect increases in interest rates in 2005:

"By using a current interest rate of 5.0% to 5.5% as compared to a prospective interest rate of 6.0% during the rate effective period, Mr. Kahal has understated the CAPM cost rate. Mr. Kahal claims that he prefers to rely on current known interest rates. However, it is critical to reflect investors' expectations of higher interest rates in the future under current circumstances." PPL Electric St. 9-R, p. 20.

Second, as explained previously, a leverage adjustment is appropriate where the return rate is derived from investor expected returns on market prices. The adjustment is equally applicable to the CAPM analysis because the betas used in the CAPM are based on market prices. PPL Electric St. 9-R, p. 21.

Third, Mr. Moul explained that a size adjustment is appropriate because PPL Electric is clearly a smaller company than the average company used to determine the market return in the CAPM:<sup>10</sup>

“Mr. Kahal compounded this omission by also rejecting the size adjustment through his focus on the parent company, PPL Corporation. We are setting the cost of common equity allowance for PPLEU not PPL Corporation. PPLEU is clearly smaller than companies used in the CAPM market return and as recognized by Mr. Kahal would be no better than a mid cap company on a stand alone basis.”  
PPL Electric St. 9-R, p. 20.

OCA’s listing of its criticisms of Mr. Moul’s CAPM simply demonstrates the deficiencies of Mr. Kahal’s CAPM. As explained in the PPL Electric Initial Brief, p. 87, when properly adjusted for these errors Mr. Kahal’s CAPM analysis indicates a CAPM cost rate of 11.13%. This result is consistent with DOD witness Kincel’s CAPM result of 11.0% DOD St. 2, p. 15 and Mr. Moul’s CAPM analysis for the electric group of 10.71% and for the gas group of 11.22%.<sup>11</sup>

Finally, OTS and OCA criticize Mr. Moul’s CAPM analysis claiming that it relies on historic premiums over the risk free rate. This criticism is inaccurate. Mr. Moul did not rely solely on historic premiums. In fact, the historic and prospective risk premiums based on expected total market returns were averaged and then adjusted by the beta for utility stocks as compared to the total market. PPL Electric St. 9, pp. 46-47.

The criticisms of Mr. Moul’s CAPM analysis are without merit.

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<sup>10</sup> OTS contends that Fama and French conclude that the CAPM does not accurately predict actual returns. OTS Main Brief, p. 59. Mr. Moul explained that Fama and French concluded that a size adjustment was necessary in the CAPM. PPL Electric St. 9-R, p. 33.

<sup>11</sup> It is to be noted that Mr. Kincel also used a size adjustment in his CAPM analysis. While Mr. Moul’s CAPM analysis for the electric group of 10.71% is somewhat lower than the 11.13% recalculated CAPM to reflect Mr. Kahal’s errors, Mr. Moul used a conservative risk free rate of 5.75% instead of 6.0% in his direct testimony. Higher projected interest rates justify use of higher risk free rate of 6.0%.

## (2) Risk Premium Analysis

OTS' and OCA's criticisms of the Risk Premium are essentially the same. They challenge use of a prospective bond yield and claim Mr. Moul relied only on inappropriate historic risk premiums.

As noted above, it is essential to reflect the consensus of a higher interest rates in 2005. Mr. Moul used a projected 7.25% A-rated bond yield given the projections of bond yields in 2005.<sup>12</sup>

OTS and OCA also criticize the use of historic risk premiums in the risk premium analysis, noting cases where the Commission concluded in the 1980's that there was no reason to depart from the DCF and that use of very long periods (1926-1984) to develop risk premiums were not relevant to today's investor. Two things have changed. First, as noted previously, the Commission has concluded in *Aqua Pa.* that there is reason for concern about sole reliance on the DCF. Second, Mr. Moul did not rely solely on long period returns but averaged the risk premiums achieved 1928-2003 and 1974-2003, thereby giving extra weight to more recent period during which current Federal Reserve policies have been in effect. PPL Electric St. 9, pp. 41-42. For these reasons, OTS's and OCA's criticisms are properly rejected.

### c. **OCA's Contention That PPL Electric Has Reduced Risk Is Both Unsupported and Erroneous.**

OCA attempts to justify its low ROE recommendation of 9.5% with arguments that PPL Electric has reduced risk as a result of its conversion to an electric T&D company. OCA Main Brief, p. 63.

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<sup>12</sup> Blue Chip forecasts only Aaa rated and Baa rated yields as shown supra. The A-rated yield would be approximately at the midpoint.

The principal problem with OCA's argument is that it is contrary to empirical evidence. As explained in the Introduction to the Rate of Return section of this Reply Brief, PPL Electric has a *lower* bond rating today than it did at the time of its last rate case in 1995 (A minus from S&P and Baa-2 from Moodys as compared to A minus and A-2 in 1995; Tr. 563). The lower bond rating from Moody's indicates greater risk, while the S&P rating indicates that the risk today is about the same. Furthermore, its business profile of 4 is at the high end of the range of 1 to 4 for delivery utilities in the water, natural gas and electric businesses. PPL Electric St. 9-R, p. 10. The empirical data, therefore, do not support OCA's conclusion that PPL Electric is a low-risk utility.

OCA's attempt to characterize PPL Electric as a "low-risk utility" is based upon a theoretical qualitative comparison of PPL Electric today and PPL Electric's predecessor as an integrated, fully-regulated public utility. PPL Electric does not believe this type of comparative qualitative analysis of PPL Electric and its predecessor sheds any light on the capital market's perception of PPL Electric's risk today, which is the real issue in this proceeding. As noted above, the market has defined PPL Electric's risk today relative to other utilities, and it is not a low-risk utility. The market simply does not care whether PPL Electric is more or less risky than its predecessor. It cares about PPL Electric's relative risk to other investments in today's market.

For these reasons, PPL Electric believes that OCA's attempts to compare PPL Electric to its predecessor are not a relevant or productive inquiry in this proceeding. Nevertheless, PPL Electric has attempted to demonstrate in this proceeding that it continues to face risks as a T&D company, albeit somewhat different risks than its predecessor.

In its Main Brief, OCA states that the primary issue is whether PPL Electric faces greater risk than the electric barometer group. PPL Electric agrees that this is the primary issue. The answer is clear: PPL Electric is more risky than the barometer group as evidenced by its business profile of 4 and the fact that only three of the nine barometer group companies have a business position of 4 with six companies having less risky business positions. PPL Electric Ex. PRM 2, PPL Electric St. 9-R, p. 10. Therefore, there is simply no basis to conclude that PPL Electric is less risky than the barometer group.

OCA states that a second “but less important question” is whether PPL Electric is less risky than the former fully integrated operations. PPL Electric submits this comparison is not only less important, it is also irrelevant and impossible to perform. It is irrelevant because the barometer group defines the cost of equity. It is impossible to perform because the risks of a fully regulated utility with full cost recovery in 1995 simply cannot be compared quantitatively to a distribution utility today.

Nevertheless, PPL Electric will provide summary responses to the comparisons presented in OCA’s Main Brief.

OCA contends that PPL Electric does not face risk of concentration of assets or risks of an economic downturn. Although these arguments are presented separately by OCA, they are interrelated.

OCA contends that concentration risk occurs when there is one large asset, such as *the Susquehanna Generating Facility*. While this is true, there are other types of concentration risks. The predecessor company was engaged in generation, transmission and distribution of electricity. PPL Electric now is engaged only in transmission and

distribution of electricity. This is a type of concentration risk as well because PPL Electric is now engaged in solely the delivery of electricity. PPL Electric St. 10-R, pp. 7-9.

Related to concentration risk is the fact that, if there is an economic downturn, PPL Electric will likely lose load. It is unlikely that PPL Electric can replace that load during an economic downturn because its facilities can only serve customers in its service territory. In contrast, its predecessor could offset lost generating sales by selling its generation off system. While it might not have been able to replace all generating revenues, it could compete to sell generation and offset losses. OCA responds that such revenues would have been flowed through to customers under regulation. OCA also argues that the effect of lost customers on PPL Electric is smaller because PPL Electric no longer has generation revenues. OCA cannot have it both ways. PPL Electric's distribution revenues are as equally affected today by loss of customers as they were 10 years ago.

OCA also argues that PPL Electric seeks an equity allowance today for lost customers in the future. This is totally untrue. PPL Electric faces business risks, evaluated by the market at the high end of distribution utilities, that investors would reflect in its cost of equity. OCA's contentions are, therefore, without merit.

OCA also argues alternatively that PPL Electric faces no risk related to Provider of Last Resort ("POLR") service, that any such risk should be reflected in POLR rates and that it is improper for PPL Electric to claim such risk. All of such contentions are erroneous.

PPL Electric faces risk of POLR service because it must purchase power to serve customers and sell it at a capped price until the end of 2009. OCA's suggestion that the potential underrecovery of costs is not viewed as a risk by capital markets is demonstrated to be fallacious by comparison to a gas company that recovers all prudent gas costs. OCA's argument is simply not credible. Furthermore, it is less than clear that full recovery of costs after 2009 will be allowed, and this uncertainty affects the risk of earnings for PPL Electric. OCA's assertion that this risk should be reflected on POLR rates is equally erroneous. PPL Electric bears the risk of underrecovery of costs and underrecovery will reduce its earnings. It is an equity risk of PPL Electric. PPL Electric St. 10-R, pp. 9-12.

PPL Electric has acted to reduce its POLR risk through the end of 2009 by entering a contract with its affiliate under which its affiliate provides power to PPL Electric at the generation rate cap in exchange for a \$90 million payment to the affiliate. While this quantifies and reduces the risk to PPL Electric, it does not eliminate it, and it does nothing with regard to post 2009 uncertainty. OCA contends that it is improper to consider this risk in this proceeding because PPL Electric agreed not to seek recovery of the \$90 million payment. The payment does not create the risk; risk was created by the generation rate cap and the obligation to provide POLR service at that rate cap. Such risk is an equity risk of PPL Electric under the generation rate cap and is reflected as such by the capital markets.

OCA's arguments do not provide a basis to conclude that PPL Electric is any less risky than the barometer group companies. To the contrary, the empirical data indicate that it is at the high end of the risk range for these companies. OCA's attempts to

compare a fully regulated integrated utility with an electric distribution company are not relevant.

## **F. TRANSMISSION SERVICE CHARGE**

### **1. OTS' Opposition To PPL Electric's Proposed Transmission Service Charge Should Be Rejected.**

In this proceeding, OTS contends that PPL Electric should recover transmission charges as a component of base rates. OTS' main concern is that the Transmission Service Charge ("TSC") should not be subject to reconciliation. OTS Main Brief, pp. 64-67.<sup>13</sup> The principal criticism raised by OTS to reconciliation of the TSC is that PPL Electric's proposal does not contemplate an annual investigation of the prudence of the transmission service charges incurred by PPL Electric. Such criticism is misplaced because, among other flaws, it has nothing to do with reconciliation. PPL Electric's TSC could be reconciled with or without a prudence investigation.

More importantly, however, there is no basis for a prudence review of transmission service charges incurred by the Company. PPL Electric, like all other load serving entities in the PJM Interconnection, LLC ("PJM"), obtains transmission services from PJM. Such services are provided under PJM's Open Access Transmission Tariff ("OATT"). PPL Electric cannot obtain transmission services from any entity other than PJM. Nor does the Company "select" the level of charges that it incurs. To the contrary, such charges are determined by PJM under the OATT which has been approved by the FERC. PPL Electric does not control the PJM; PPL Electric does not control the FERC; and PPL Electric does not control the peak or annual loads of its POLR customers.

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<sup>13</sup> Pa.EC, for the first time on brief, also opposes the TSC. However, it offered no evidence on this issue, and its opposition is entirely derivative.

Literally, there is nothing for a prudence review to investigate. PPL Electric St. 4-R, pp. 21-22.

In support of its argument that a prudence review would be appropriate, OTS analogizes to the annual prudence reviews under Section 1307(f) of the Public Utility Code, 66 Pa.C.S. § 1307(f), applicable to natural gas distribution companies. OTS states that a prudence review for gas companies is held despite the fact that “this commodity is based on FERC approved rates.” OTS Main Brief, p. 66. OTS is incorrect. Although transmission rates charged by interstate pipeline companies are subject to FERC rate regulation, the commodity cost of gas is market-determined. Indeed, the principal point of FERC Order 636 and its progeny was to create a national market for natural gas. Further, even though interstate pipelines’ transportation rates are FERC-approved, a natural gas distribution company must determine the volume of capacity to obtain and from which alternative providers of capacity to obtain it. Natural gas distribution companies must select from among many suppliers of natural gas, negotiate market prices, determine contract terms, and make many other decisions which affect the cost of natural gas to their customers. PPL Electric St. 4-R, pp. 22-23. As explained above, PPL Electric simply cannot make any similar decisions that will affect the level of the TSC. OTS’ concerns about a prudence review for the TSC are not valid.

OTS also contends that PPL Electric’s proposed TSC should not be subject to reconciliation because transmission costs are “no different, from a regulatory point of view, from distribution related costs.” OTS Main Brief, p. 66. OTS’ contention again is erroneous. In fact, transmission service charges incurred by PPL Electric are substantially different from regular distribution-related costs. Unlike most distribution-

related costs, for the reasons explained above, transmission service charges incurred by PPL Electric are completely beyond the Company's control. PPL Electric St. 4-R, p. 21.

Further, PPL Electric's transmission service charges are substantial. The Company projects that it will incur approximately \$200 million of transmission service charges in 2005, which represents 29% of its distribution revenues at proposed rates of \$688 million. PPL Electric Ex. Future 1, Sch. D-1; PPL Electric St. 4-R, p. 20. Although distribution revenues in total exceed transmission service charges incurred by PPL Electric, transmission service charges are far greater than any single category of distribution expenses.

Finally, PPL Electric's transmission service charges are subject to substantial variation. Those charges have been as low as \$139.95 million in 2000, but in 2005, they are expected to be \$200 million. Such substantial variations in costs are much more suited to recovery under a Section 1307(a) automatic adjustment clause than through base rates. Base rate proceedings are expensive and protracted. Under Section 1308(d), of the Public Utility Code, 66 Pa. C.S. §1308(d), a proposed increase in base rates is initially subject to a 60-day notice period followed by a 7-month suspension period. Thus, from the time of filing a proposed increase in rates, almost 9 months elapse before new rates can become effective. This nine-month delay does not include the time required by the utility to prepare a filing, which is obviously a substantial undertaking. Such a protracted, cumbersome procedure is not well-suited to rapidly-changing costs.

OTS' objections to reconciliation of PPL Electric's TSC should be rejected.

**2. PPLICA's Concerns About The Effects Of PPL Electric's Proposed TSC On Competition Are Exaggerated.**

PPLICA argues that PPL Electric's proposed TSC would impact negatively the competitive generation supply market. PPLICA Main Brief, pp. 78-80. PPL Electric explained that such concerns are not meritorious. PPL Electric Initial Brief, pp. 102-104. This position was confirmed by MAPSA, an association of EGSs and generators of electricity. MAPSA explained at pages 1-3 of its Main Brief that PPL Electric's proposed TSC under which the Company will recover a uniform amount of 0.546¢ per kWh **will promote competition**. MAPSA further explained that PPL Electric's proposal will provide a simple "price to compare, that shopping customers may use to evaluate offers from competitive suppliers." Thus, MAPSA, whose members include EGSs, does not share PPLICA's competitive concerns. MAPSA's Main Brief reinforces PPL Electric's explanations that PPLICA's competitive concerns are greatly exaggerated.

**G. DISTRIBUTION SYSTEM IMPROVEMENT CHARGE**

**1. The Cases Cited By Other Parties Present No Barrier To Approval Of The Distribution System Improvement Charge.**

Various parties rely primarily upon two Commonwealth Court opinions in opposing PPL Electric's proposed Distribution System Improvement Charge ("DSIC"). These principal cases are *Pennsylvania Industrial Energy Coalition v. Pa. P.U.C.*, 653 A.2d 1336 (Pa. Cmwlth. 1995), *aff'd. per curiam*, 543 Pa. 307, 670 A.2d 1152 (1996) ("*PIEC*") and *Barasch v. Pa. P.U.C.*, 127 Pa. Cmwlth. 544, 562 A.2d 414 (1989), *allocatur denied*, 526 Pa. 654, 586 A.2d 923 (1991) ("*Factoryville*"). As explained below, neither of these cases present any barrier to the Commission's approval of PPL Electric's DSIC.

OCA and OSBA contend that *PIEC* stands for the proposition that a utility can meet its burden of proving that plant is used and useful only in the context of a Section 1308 rate proceeding. OCA Main Brief, pp. 193-95; OSBA Main Brief, pp. 22-26. Such contentions are erroneous.

Initially, it must be noted that the Commission rejected these exact same arguments in *Pa. P.U.C. v. Pennsylvania-American Water Co.*, Docket No. R-00027982, pp. 13-14 (November 7, 2003) (“CSIC Order”). The Commission stated:

“In *PIEC*, the appellant, the Industrial Energy Coalition, challenged the Commission’s approval of a Section 1307 adjustment for recovery of electric utilities’ costs to design and implement demand side management (DSM) programs. Significantly, the Court affirmed the Commission’s resolution of that issue, finding that Section 1307 authorizes the use of adjustment clauses to recover a wide variety of costs, including the costs of “financing” DSM programs. (653 A.2d at 1349). Thus, for that reason, *PIEC* cannot be construed as *per se* prohibition against the use of a Section 1307 clause to recover the fixed costs of utility plant. (Company R B at 4).

“The OCA’s contention that the Company’s proposed CSIC should be denied because it would recover capital costs is misplaced. The OCA draws this conclusion, apparently, from language found on page 1347 of *PIEC*. In this context, it is important to remember that the *PIEC* decision deals with a proposal for the recovery of costs for a DSM program by electric utilities. The language relied on by the OCA occurs in the context of the Court’s consideration of the requirements of Section 1315 of the Code, 66 Pa.C.S. § 1315, which imposes limitations on the recovery of certain costs for electric utilities. We agree with the ALJ’s conclusion in that regard that we are not required to read into the language relied on by the OCA any limitation on the types of costs to be considered recoverable under the language of Section 1307(a) of the Code. (R.D. at 7).

“Additionally, we note that this argument was considered and rejected by the Commission when it approved the Company’s request to implement a DSIC in 1996. *Petition*

*of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, 1996 Pa. PUC Lexis 182 (1996) (DSIC Order). (Company I.B. at 12-13; Company R.B. at 4). As noted in detail in the DSIC Order, Section 1307(a) conferred the necessary authority on the Commission to adopt the DSIC and, for the same reasons, that Section confers ample authority on the Commission to approve a CSIC.”

OCA and OSBA have not attempted to distinguish the Commission’s rejection in the *CSIC Order* of the arguments they raise in this proceeding. *PIEC* provides no basis for rejecting PPL Electric’s proposed DSIC.

In *PIEC*, a group of industrial customers challenged the Commission’s approval of a Section 1307(a) adjustment clause for recovery of electric utilities’ costs of demand-side management (“DSM”) programs. The Commonwealth Court affirmed the Commission’s resolution of that issue finding that Section 1307 of the Public Utility Code, 66 Pa.C.S. § 1307, is sufficiently broad to encompass DSM costs, and the Commonwealth Court rejected the contention that adjustment clauses could only be used to recover those categories of operating expenses for which such clauses had been approved in the past:

“Although we agreed that Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process, the General Assembly did not limit the allowance of automatic adjustment clauses to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the PUC or the utility to initiate the automatic adjustment of costs within specific procedures.” *PIEC*, 653 A.2d, *supra.*, at 1349.

*PIEC*’s challenge did not distinguish between DSM expenditures accounted for as operating expenses and those for DSM-related capital costs. *Id.* Instead, *PIEC* argued

that, because DSM was a novel and untested concept, it would be impossible to determine whether projected expenditures to be recovered through the Demand Side Recovery Clause (“DSRC”) were “prudent and reasonable” or “used and useful” until specific DSM programs had been in operation sufficiently long to produce discernable results. *Id.* On these bases, PIEC argued that no “substantial evidence” to support “prudent and reasonable” or “used and useful” findings could exist before DSRC charges would become effective or for several years thereafter.

The Commonwealth Court rejected PIEC’s argument because the “PUC had established a method whereby the proposed programs will be proposed for a determination of whether they were prudent and cost-effective.” 653 A.2d, *supra*, at 1347. The Commonwealth Court further held that, “because there was little or no experience in establishing the [DSM] programs,” the Commission’s “determination of cost necessarily must be based on forecasts and projections,” and “it was not unreasonable for the Commission to rely on well-supported forecasts.” 653 A.2d, *supra*, at 1347. After rejecting PIEC’s main argument, Commonwealth Court discussed how, if at all, the “used and useful” requirement of Section 1315 of the Public Utility Code, 66 Pa. C.s. §1315, might apply to the DSRC. From this portion of *PIEC*, the OCA and OSBA have extracted one sentence as the foundation of their arguments:

“As to the Industrial Coalition’s argument that the costs are not related to used and useful expenses, Section 1315 expressly applies only to determine when the cost of construction or expansion of facilities may be included in the rate base. Section 1315 is only applicable to the extent that DSM program costs relate to physical facilities and is not relevant to determine whether the cost recovery methods approved by the PUC are violative of the Code. *Because new physical facilities are appropriate costs only within the rate base under Section 1315, in the unlikely*

*event that DSM programs require new physical facilities, those costs should be raised in a base rate case only, subject to the restrictions of Section 1315, and not through the surcharge mechanism.” 653 A.2d, supra, at 1347. (Emphasis added; citations omitted.)*

This single sentence from PIEC does not provide any basis for invalidating PPL Electric’s proposed DSIC. As explained previously, PIEC’s criticisms of the DSRC did not focus on the issue of whether fixed costs of plant could be recovered under Section 1307. Instead, it raised only the narrow question of whether the Commission could determine if DSM expenditures are “prudent and reasonable” and “used and useful” before the associated DSM programs were in operation long enough to “quantify” the results. Indeed, the issue presented here – whether there is a *per se* prohibition against recovery of fixed costs of utility plant through a properly designed Section 1307(a) clause – was not presented in PIEC. Therefore, the sentence relied upon by OCA and OSBA was not necessary to the Commonwealth Court’s decision and is clearly *dicta*.<sup>14</sup>

*Pennsylvania Association of Home Health Agencies v. Pennsylvania Insurance Department*, 119 Pa. Cmwlth. 495, 547 A.2d 824 (1988).

In *PIEC*, Section 1315 is offered as the source of authority for the proposition that “new physical facilities are appropriate costs only within the rate base.” Section 1315, however, only addresses **when** plant costs may be recovered, *i.e.*, when the facility is

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<sup>14</sup> The OCA contends that the Pennsylvania Supreme Court “affirmed” this aspect of the Commonwealth Court’s decision (OCA Main Brief, p. 193). Such contention is erroneous. The Supreme Court issued an affirmance *per curiam* at 543 Pa. 307, 670 A.2d 1152, which was limited to the specific issues presented in the Petition for Allowance of Appeal. *Commonwealth v. Tilghman*, 543 Pa. 578, 588, 673 A.2d 898, 903 (1996). The Commission’s Petition for Allowance of Appeal raised only two issues related to Commonwealth Court’s reversal and remand respectively of the portions of the Commission’s Order granting financial “incentives” for DSM and allowing electric utilities to recover “lost revenues.” The issue of whether the fixed cost of physical facilities could be recovered through a Section 1307(f) clause was not presented to the Pennsylvania Supreme Court and, therefore, the Supreme Court did not give an opinion on that issue either expressly or by implication.

used and useful in service to the public, and not how they may be recovered, *i.e.*, under Section 1308 or Section 1307. In fact, Section 1315 clearly contemplates that plant costs may be recovered other than as a part of a utility's "rate base" in a base rate proceeding under Section 1308. Section 1315 expressly provides that:

"[T]he cost of construction or expansion of a facility . . . shall not be made part of the rate base *or otherwise included in the rates* charged by the electric utility until such time as the facility is used and useful in service to the public." (Emphasis added.)

In addition, the DSIC is different from the DSRC in ways which distinguish this case from *PIEC*. The DSRC was designed to recover all DSM expenditures, both expense and capital, that an electric utility expected to make over a projected computation year. *Re. Investigation into Demand-Side Management by Electric Utilities: Uniform Cost Recovery Mechanism*, 127 PUR 4th 516, 525 (1991) ("*DSM Order I*"); *Re Demand-Side Management by Electric Utilities – Uniform Cost Recovery Mechanism*, 80 Pa. PUC 608, 662 (1993) ("*DSM Order II*"). Consequently, the cost of physical facilities expected to be incurred during the projected computation year would be recovered without regard to whether facilities giving rise to those costs would be in service at any point during that year. Clearly the traditional "used and useful" standard would have been ignored, not due to anything inherent in Section 1307, but instead due to the manner in which the DSRC was designed to operate.

In contrast, PPL Electric's DSIC has been designed to reflect only eligible property additions that actually have been placed in service prior to being included in the DSIC. Accordingly, the issue that precipitated Commonwealth Court's discussion of Section 1315 in *PIEC* cannot arise under PPL Electric's DSIC.

The second case relied upon heavily by OCA is *Factoryville*. OCA contends that the Commonwealth Court determined, in *Factoryville*, that capital cost recovery was improper under Section 1307(a). OCA Main Brief, p. 193. OCA's contentions are based upon a misinterpretation of *Factoryville*.

In *Factoryville*, Commonwealth Court held that the Commission should not have approved a rate increase to provide for prepayment of principal and interest associated with a loan used to finance waterworks facilities that were not yet in service. Nowhere in *Factoryville*, however, did Commonwealth Court indicate that fixed costs of utility plant that was used and useful in the public service could not be recovered under Section 1307. Such issue was not addressed, raised or decided in *Factoryville*.

The absence of any conflict between Commonwealth Court's holding in *Factoryville* and PPL Electric's proposed DSIC is clear from the language of the DSIC itself which limits costs to be recovered to "fixed costs (depreciation and pre-tax return) of non-revenue producing distribution system improvement projects *completed and placed in service.*" Supplement No. 38 to PPL Electric Tariff – Electric Pa. P.U.C. No. 1, p. 19z.2, PPL Electric Ex. OGK 1. (Emphasis added). PPL Electric has not requested recognition in the DSIC of fixed costs of any item of plant before it is placed in service. OCA's reliance upon *Factoryville* is misplaced.

**2. PPL Electric's Proposed DSIC Is Necessary Because PPL Electric Is Making, And Will Continue To Make, Substantial Additions To Net Plant In Service.**

OCA has criticized PPL Electric's proposed DSIC as unnecessary. As a basis for this contention, OCA has indicated that, since PPL Electric's restructuring proceeding, PPL Electric's net plant in service has actually declined. OCA Main Brief, p. 190; OCA St. 2, p. 6.

In making this contention, OCA relies upon a temporary period of time when PPL Electric was subject to a statutory rate cap under Section 2808(4) of the Public Utility Code, which was extended through December 31, 2004, in the settlement of PPL Electric's restructuring proceeding. During this period of time, PPL Electric's return on equity deteriorated to approximately 1% for 2004. PPL Electric St. 1, p. 3. Obviously, during this period of constrained rates and resulting financial stress, PPL Electric, to the extent practical, limited its capital expenditures to avoid exacerbating its already deteriorated financial condition.

Commencing in 2004, however, PPL Electric's construction program is no longer constrained. For the five years ending December 31, 2008, PPL Electric's capital budget calls for expenditures of \$986,762,000, or almost \$200 million per year. In contrast, PPL Electric's annual depreciation accrual is much less – only about half of these projected expenditures. The Company's annual depreciation accrual for the future test year is \$106,735,746. PPL Electric Ex. JJS-1, p. III-5. Thus, PPL Electric's construction expenditures and resulting plant additions will far outstrip depreciation accruals, and its net plant will increase substantially in the future.

OCA's concern that PPL Electric's rate base will shrink is not warranted and this concern does not support the rejection of PPL Electric's proposed DSIC.

**3. OTS' Criticisms Of PPL Electric's Proposed DSIC Are Without Merit And Should Be Rejected.**

OTS contends that the Commission should not approve PPL Electric's proposed DSIC. OTS Main Brief, pp. 62-64. PPL Electric has explained that its proposed DSIC is reasonable, proper and fully consistent with Section 1307(a) of the Public Utility Code. PPL Electric Initial Brief, pp. 122-133.

OTS, however, now relies upon testimony of a few state legislators to the effect that it was not the intent of the legislature in 1996 when it enacted Section 1307(g) of the Public Utility Code to create broad authority for the Commission to establish system improvement charges for categories for utilities other than water companies. OTS Main Brief, pp. 63-64.

Such contentions are meritless for several reasons. First, such informal presentations by a few legislators do not rise to the level of formal legislative history and therefore are not a reliable indicator of the intent of the entire General Assembly in 1996.

Further, PPL Electric has never contended that its proposed DSIC is authorized by Section 1307(g) of the Public Utility Code. Instead, authority for the DSIC arises under Section 1307(a) of the Public Utility Code which was enacted in its original form as part of the Public Service Company Law, Act of July 26, 1913, P.L. 1374, No. 854, art. III, § 1, effective January 1, 1914 (repealed).

Moreover, OTS' contention cannot be reconciled with the Commission's *CSIC Order* in which it authorized Pennsylvania-American Water Co. to establish a system improvement charge for its sewer divisions. OTS' reliance upon the testimony of several legislators presents no barrier to the Commission's approval of PPL Electric's DSIC.

#### **H. UNIVERSAL SERVICE AND CUSTOMER/COMMUNITY PROGRAMS**

In this proceeding, PPL Electric seeks to continue and expand its universal service programs, which have helped tens of thousands of low-income customers throughout PPL Electric's service territory maintain electric service. The Company's proposals reflect its commitment to ensuring that its universal service programs provide real assistance to as many eligible customers as possible, within the funding limits and guidelines of the Commission and the Public Utility Code. PPL Electric's dedication to providing this

assistance has established its leadership among Pennsylvania electric utilities in low termination rates for residential and low-income customers. *See* PPL Electric Initial Brief, pp. 134-35. PPL Electric intends to maintain that leadership.

Notably, parties to this proceeding who have offered additional proposals for customer assistance or criticisms of PPL Electric's existing programs also include approval or praise for the Company. For example, OCA evaluated PPL Electric's programs and found that the programs "are reasonably designed and operated, and with the proposed increase in funding level, . . . adequately funded over the near term." OCA Main Brief, p. 154. And CEO's executive director testified that PPL Electric should be "commended for its commitment to Universal Service Programs, since most of these programs pre-dated the restructuring of the Company." CEO St. 1, p. 3.

The positions of parties to this proceeding with respect to PPL Electric's programs may be divided into three categories: (1) recommendations for additional funding and program changes for PPL Electric's OnTrack and WRAP programs (CEO) and Operation HELP (CEO and OCA); (2) adoption of a mandatory "opt out" budget billing program for low-income customers with arrears (OCA); (3) recommendations to eliminate funding for PPL Electric's proposed Community Betterment Initiative ("CBI") (OTS); (4) recommendations to expand funding for PPL Electric's universal service programs to all rate classes (proposed by OCA, and opposed by PPLICA and PPL Electric).<sup>15</sup>

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<sup>15</sup> PPL Electric has already agreed to adopt certain other proposals of the parties. *See* PPL Electric Initial Brief, p. 141 & OCA Main Brief, p. 168 (agreement on PPL Electric earned income tax credit); OCA Main Brief, p. 158 (agreement on modification of OnTrack program fact sheet); PPL Electric Initial Brief, p. 148 (documenting existing PPL Electric commitment to match ratepayer funds for CBI, as requested by Mr. Epstein).

In the following sections, the Company sets forth the nature of the remaining disputes and the reasons why the Company's current proposals should be adopted by the Commission. PPL Electric strongly believes that its programs are effective in maintaining universal service, and that the proposed funding levels are consistent with the Company's overall rate increase in this proceeding and its responsibility to use ratepayer funds wisely in implementing universal service programs. The Public Utility Code is clear that funding for these programs is fully recoverable from ratepayers, *see* 66 Pa. C.S. § 2804(8), and is traditionally recovered from PPL Electric residential customers who may benefit directly from such programs. PPL Electric Initial Brief, pp. 152-53. If the Commission nevertheless concludes that ratepayer funding for universal service programs should be increased above PPL Electric's proposals to further expand enrollment, program features, or benefits for low-income customers, PPL Electric is prepared to take the necessary administrative actions to implement any such directives.

**1. OnTrack**

**a. The Commission Should Approve PPL Electric's Proposed 25.6% Increase To Enroll 17,000 Customers In OnTrack By 2007 And Reject CEO's Proposal To Enroll 30,000 Customers**

PPL Electric has proposed a 25.6% increase in On-Track funding (\$11.7 million to \$14.7 million) to permit a total enrollment of 17,000 customers by 2007. PPL Electric Initial Brief, pp. 136-37. OTS has opposed a portion of PPL Electric's requested funding. OTS Main Brief, pp. 29-31. CEO, on the other hand, has recommended that OnTrack funding be increased immediately by an unspecified amount to serve 30,000 low-income customers, without any reduction in average benefit levels for OnTrack participants. CEO Main Brief, p. 20. For the reasons set forth below, CEO's proposal should be rejected.

In its testimony, CEO proposed an unspecified increase in OnTrack funding to enroll between 39,000 customers and 100,125 customers, which PPL Electric calculated would require between nearly \$40 million and \$100 million in annual OnTrack funding. PPL Electric Initial Brief, pp. 138-39. On brief, CEO proposes an enrollment level of 30,000 customers, but again fails to quantify the cost of its proposal. However, multiplying CEO's proposed enrollment level of 30,000 by the current average OnTrack customer benefit level of \$998 (PPL Electric St. 7-R, pp. 12-13) yields an annual cost of approximately \$29.9 million, or a 150% increase from the current level of OnTrack funding. CEO makes no recommendation for how an additional \$15.2 million of expenses above PPL Electric's current proposal should be allocated among ratepayers. If these expenses are to be recovered in the same manner as current OnTrack funding, the increase would fall directly on other residential customers. PPL Electric Initial Brief, pp. 152-53.

In support of its proposal, CEO relies on the Commission's order in *Re: PPL's Universal Service and Energy Conservation Plan Submission in Compliance with 52 Pa. Code § 54.74*, Docket No. M-00031698 (June 12, 2003) ("*June 12 Order*"). Contrary to CEO's argument, however, the Commission did not "recommend" an enrollment of 30,000 customers in the June 12 Order. Instead, the Commission concluded that PPL Electric should have an enrollment level no lower than 17,000, "and possibly as high as 30,000," which the Commission identified as the recommendation of a third-party report commissioned by PPL Electric. *June 12 Order*, at 15; *see also* PPL Electric Initial Brief, p. 137 (explaining PPL Electric experience in enrolling 1 out of 2 referrals and therefore proposing funding for OnTrack enrollment between 15,000 and 17,000 customers).

Notably, the Commission did not “immediately direct” PPL Electric to enroll 17,000 customers in its *June 12 Order* or declare that PPL Electric was in violation of the Public Utility Code, as CEO suggests. In fact, the Commission’s *June 12 Order* did not address the costs of enrolling customers, or the specific amount of assistance that could actually be provided within current budgetary constraints. After noting that pending changes to reduce program costs precluded any determination of an appropriate funding level, *id.* at 7, the Commission directed the Company to report on its progress in reducing costs and increasing enrollment based upon program design changes and process improvements to the Bureau of Consumer Services by March 31, 2005. See *June 12 Order*, at 17. As a result of PPL Electric’s efforts to reduce costs and improve enrollment, administrative costs for 2003 are more than 25% lower than 2002 costs and enrollment is 33% higher (18,471 enrollments in 2003, with a participation of 12,420 customers at the end of 2003, a 25% increase over 2002). PPL Electric St. 7-R, pp. 12-14.

PPL Electric’s proposal in this proceeding is intended to achieve the enrollment levels required by the Commission in a “ramp-up” period appropriate for organizations involved in OnTrack and with the goal of keeping administrative costs reasonable for an enrollment increase of over 30%. PPL Electric Initial Brief, pp. 136 & 138. In contrast, CEO’s proposal advocates an enrollment level that the Commission did not “recommend,” without any analysis of the costs or effects on other ratepayers to reach that enrollment level. While CEO’s final proposal is smaller than the massive enrollment levels CEO proposed in testimony, PPL Electric Initial Brief, pp. 138-39, its final

proposal is no more specific and no more justified, and should be rejected by the Commission.

CEO's related request that OnTrack funding be sufficient to ensure that average benefit levels do not decrease, CEO Main Brief, p. 20, similarly contains no suggestion of what this request would cost if approved and is not discussed at all in its brief. If the Commission approves PPL Electric's proposed funding increase, PPL Electric expects that future OnTrack customers will receive a similar benefit level to that received by OnTrack customers today in light of PPL Electric's on-going efforts to improve the OnTrack program and reduce costs. However, if the Commission were to determine that OnTrack should be increased by an amount equal to the current average benefit for each projected enrollee, the Commission should increase OnTrack funding to \$16.9 million (17,000 x \$998), a funding increase of 40% that must be recovered from residential customers. *See* 66 Pa. C.S. § 2804(8) (explaining that costs of universal service programs shall be fully recoverable).

**b. The Commission Should Reject CEO's Request To Assume Primary Outreach Responsibility For On-Track And To Participate In Submitting PPL Electric's Universal Service Plan To the Commission**

As explained previously, PPL Electric has very low termination rates, reflecting its success in helping customers maintain electric service in accordance with the Public Utility Code. PPL Electric Initial Brief, p. 134. The settlement of PPL Electric's 1998 restructuring proceeding established an annual funding level of \$11.7 million for PPL Electric to spend on its customer assistance program, OnTrack, consistent with the provisions of the Public Utility Code providing that costs of such programs are fully recoverable. PPL Electric St. 7-R, p. 11.

In examining enrollment levels in the June 2003 Order, the Commission did not undertake to determine the appropriate level of fully recoverable costs to make OnTrack available to 17,000 customers, or 30,000 customers, or any specific number of customers. Nevertheless, CEO relies upon the Commission's conclusion that the low number of low-income customers in PPL Electric's territory participating in OnTrack "indicate[s]" that OnTrack is not "appropriately available," *June 12 Order*, p. 4, and requests that the Commission: (i) direct resources to CEO and other community-based organizations ("CBOs") so that these organizations can assume primary responsibility for OnTrack program outreach to PPL Electric customers, and (ii) formally order PPL Electric to involve CBOs in the design and implementation of program outreach and permit CBOs to participate in developing PPL Electric's Universal Service Plan submitted to the Commission. CEO Main Brief, p. 22. The Commission should deny CEO's requests for several reasons.

First, as Mr. Dahl, PPL Electric's manager responsible for PPL Electric's universal service programs testified, PPL Electric has a sufficient pool of low-income customers to refer to OnTrack and a number of means of increasing referrals. PPL Electric St. 7-R, p. 17 (explaining sources of referrals); Tr. 731-33. PPL Electric has managed the OnTrack program to stay within the level of ratepayer funding agreed to by all parties to the 1998 Settlement Agreement. *See id.*, p. 12. Now that the distribution rate cap is ending PPL Electric recognizes that OnTrack enrollment may be expanded and has therefore proposed a substantial 25.6% increase in funding. *See id.*, p. 12.

Second, CBOs are *already* directly involved in implementing OnTrack program outreach, contrary to the implicit assumptions of CEO's proposal for more involvement.

See CEO St. 1, p. 4 (explaining CEO's role in implementing PPL Electric programs in Luzerne County, including outreach to low-income customers). But CBOs generate only 5% of the OnTrack referrals, see PPL Electric St. 7-R, p. 14, and CEO never explains why CBOs generate so few referrals.

Third, CEO and other CBOs are not within the jurisdiction of the Commission. Tr. 770. Turning over essential components of PPL Electric's universal service program to non-jurisdictional entities outside of Commission oversight may create significant administrative and customer relationship problems, and it is PPL Electric that remains accountable for ratepayer funds. PPL Electric St. 7-R, p. 33. Notably, CEO does not appear to be able to even decide what level of responsibility it really wants. While CEO's executive director proposed PPL Electric's universal service responsibilities be limited to "administration, monitoring and inspection" in written testimony before the Commission and now seeks "primary responsibility" for outreach, he testified on cross-examination that he only wanted to "provide advice and suggestions." Tr. 774.

Finally, there is no basis for the Commission to direct PPL Electric to involve CBOs in design and implementation of program outreach or to involve CBOs in developing its universal service plan prior to submission of the plan to the Commission. CEO Main Brief, p. 21. PPL Electric has worked with CBOs for many years to implement *and improve* its low-income programs, and will continue to do so in accordance with its statutory obligations. PPL Electric St. 7-R, p. 33 (emphasis added); 66 Pa. C.S. § 2804(9). If the Commission determines that CBOs should have a more formal role in the preparation, evaluation or operation of the universal service programs and plans of electric distribution companies than presently required under the Public

Utility Code or Commission regulations, the Commission should undertake a separate proceeding to determine the scope of any such changes for all electric utilities and not impose new requirements or procedures upon PPL Electric in this proceeding.

As Mr. Dahl testified, the partnership between PPL Electric and CBOs is critical to the on-going delivery of PPL Electric's low-income programs. PPL Electric St. 7, p. 6. But PPL Electric strongly opposes any transfer of its critical universal service program outreach functions to CEO or other CBOs, and CEO's requests to assume such responsibilities or formally participate in designing and developing PPL Electric's universal service programs should be denied in their entirety.

**c. The Commission Should Permit PPL Electric To Retain Its \$150 Arrearage Requirement Pending Review By The Bureau Of Consumer Services**

As explained in testimony before the Commission and in PPL Electric's Initial Brief, PPL Electric has retained a \$150.00 arrearage requirement for participation in the OnTrack program. PPL Electric Initial Brief, pp. 139-140. This requirement has served as a key indicator of the vulnerability of low-income customers to termination, as it corresponds to the Company's collection efforts procedures and also serves as a means to ensure that OnTrack resources are directly targeted to such at-risk customers. *See id.*

OCA has not recommended elimination of this requirement, *see* OCA St. 5-R, p. 8, but CEO has proposed that the Commission direct PPL Electric to abolish this requirement based upon the *June 12 Order*. PPL Electric opposes CEO's proposal, and requests that the Commission affirm PPL Electric's retention of the \$150 arrearage eligibility requirement or, in the alternative, permit PPL Electric to resolve this issue with the Bureau of Consumer Services in accordance with the *June 12 Order*.

PPL Electric imposed the \$150 arrearage requirement for OnTrack enrollment pursuant to the Commission's Policy Statement on Customer Assistance Programs ("CAPs"), which permitted electric distribution companies to establish such requirements in determining customer eligibility for low-income programs. *See* 52 Pa. Code §§ 69.262 & 69.265(4)(i). In the *June 12 Order*, the Commission concluded that the provision of the policy statement expressly providing for arrearage criteria had been superseded by the Commission's universal service regulations, which do not include such a provision, and that PPL Electric's \$150 eligibility requirement should be removed so that eligibility requirements for customer assistance programs would be consistent across Pennsylvania. *See June 12 Order*, p. 11. However, the Commission ordered PPL Electric to retain the arrearage requirement pending resolution of OnTrack funding issues, since PPL Electric's ability expand enrollment in OnTrack was constrained by funding and expected reductions in program costs. The Commission directed PPL Electric to report to the Bureau of Consumer Services on its progress on enrollment and cost reduction by March 31, 2005. *See id.*, p. 17.

The Commission's approval of PPL Electric's requested increase for the OnTrack program in this proceeding will substantially improve the funding for OnTrack. However, PPL Electric requests that the Commission expressly permit PPL Electric to retain the \$150 eligibility requirement. As Mr. Dahl explained in his testimony, elimination of the \$150 arrearage requirement may create serious concerns regarding the administration and funding of OnTrack. PPL Electric St. 7-R, p. 17. While CEO asserts that the \$150 arrearage requirement theoretically discriminates against an unspecified number of low-income customers (particularly elderly customers) who pay their bills on

time, the indisputable effect of eliminating this requirement is that there will be less OnTrack resources to enroll and assist individuals with high arrearages who are more at risk for termination of service.<sup>16</sup>

Because elimination of the \$150 requirement will reduce OnTrack resources for individuals with higher arrearages, the Commission should approve PPL Electric's retention of this requirement and reject CEO's proposal. However, in the alternative, the Commission should direct PPL Electric to resolve this issue as part of its comprehensive report on OnTrack program changes which must be filed with the Bureau of Consumer Services in March 2005. At that time, if PPL Electric is experiencing an OnTrack enrollment level inconsistent with enrollment of 17,000 low-income customers by 2007, PPL Electric will work directly with BCS to determine if the \$150 arrearage requirement can be eliminated without adverse effect on OnTrack.

## 2. WRAP

PPL Electric has proposed a \$1 million increase (\$5.7 million to \$6.7 million) in funding for its Winter Relief Assistance Program ("WRAP"), which provides free weatherization measures and energy conservation services to low-income customers. As part of this increase, PPL Electric would implement solar water heating as a standard measure. Spending of the \$1 million increase and expansion of PPL Electric's solar water heating pilot program would be undertaken over a three-year "ramp-up" period. PPL Electric Initial Brief, pp. 143-144. The only party to propose a larger increase in

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<sup>16</sup> PPL Electric notes that the procedure which culminated in the *June 12 Order*, was not a fully litigated proceeding, but one in which the Commission reviews a universal service plan submitted by PPL Electric and subsequently approves or disapproves the plan. See 52 Pa. Code § 54.72. Moreover, given the wide diversity of universal service programs implemented by electric utilities, PPL Electric does not believe that the eligibility requirements for such programs must necessarily be equivalent.

WRAP is CEO, which advocates a \$1.3 million increase with an immediate \$1 million devoted to solar water heating and elimination of the “ramp-up period” proposed by the Company.<sup>17</sup>

CEO’s principal justification for its proposal for an additional \$300,000 in funding and elimination of the “ramp-up” period is Mr. Howat’s general concern about “the effects of rising and volatile prices that appear likely in the new era of electric utility industry restructuring.” CEO Main Brief, p. 18. However, Mr. Howat’s concerns appear to be associated with the end of generation rate caps, which will not occur until 2010, well after WRAP funding is at full levels. *Compare* CEO St. 2, pp. 4 & 14. CEO does not address – or even mention – the complexities PPL Electric experienced in its solar water heating program, which make a “ramp-up” period for this program appropriate. PPL Electric Initial Brief, p. 145.

CEO’s additional assertion that PPL Electric must “develop a meaningful and substantial investment in renewable and sustainable energy” ignores the substantial investment accomplished through PPL Electric’s recommendation to continue funding the Sustainable Energy Fund. And CEO’s citation to PPL Electric’s expenditure of \$2,415 in 2003 on solar water heating installations neglects to mention that this value represented the end of PPL Electric’s successful pilot program, which PPL Electric is now proposing to fund as a standard option at an annual level of \$600,000. Tr. 734. Because CEO has thus failed to justify either an additional increase in WRAP funding or

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<sup>17</sup> Mr. Epstein has proposed that PPL Electric “match” ratepayer funding of WRAP, which is discussed in Section III.H.6. His allegations regarding a decline in WRAP funding and administrative costs are incorrect. *See* PPL Electric Initial Brief, p. 152 n.43.

an alteration of PPL Electric's proposed "ramp-up" period, the Commission should reject CEO's requests to modify PPL Electric's WRAP program.

### **3. Operation HELP**

Operation HELP is PPL Electric's hardship program, which provides short-term financial assistance to PPL Electric customers who are experiencing difficulties paying their electric bills using funds provided by PPL Corporation shareholders and donations from PPL Electric employees, customers, and retirees. PPL Electric Initial Brief, p. 145. PPL Electric has proposed a modest increase in Operation HELP funding, with a goal of \$900,000 in total contributions. PPL Electric St. 7, p. 6.

Only three parties to this proceeding have raised any issues concerning Operation HELP. Mr. Epstein proposes that PPL Electric should match ratepayer contributions to Operation HELP, *see Epstein Main Brief, p. 17, but he fails to note that the Commission is without power to do so. See PPL Electric Initial Brief, p. 146.* He also fails to note that PPL Corporation already donates \$440,000 annually, which approximately matches the contributions from customers as well as PPL Electric employees and retirees. PPL Electric St. 7-R, p. 28.

CEO contends that "it would make perfect sense" for the Commission to impose a strict allocation mechanism for Operation HELP funds, requiring that funds be distributed according to the distribution of low-income customers in each county within PPL Electric's service territory. CEO Main Brief, p. 16. Unsurprisingly, this recommendation would result in an increase in funds for the county in which CEO operates (Luzerne), with a corresponding reduction in funds available to other customers. CEO contends that PPL Electric has offered little justification for not distributing funds by county population of low-income customers, but in fact PPL Electric has explained

that it considers several factors, including the ability of local agencies to administer funds and overall customer needs throughout its territory. PPL Electric Initial Brief, pp. 147-48. Given that Operation HELP is funded entirely by donations from shareholders, customers, employees and retirees from throughout PPL Electric's service territory (and beyond). PPL Electric believes that it should continue to exercise this discretion in directing funds to where these funds are most needed and likely to be spent effectively.

The OCA contends that there has been a substantial decline in Operation HELP contributions and that PPL Electric should be required to submit a plan to the Commission detailing how it will increase contributions from ratepayers, employees, retirees and shareholders. As explained in PPL Electric's Initial Brief and in testimony, OCA's analysis of Operation HELP contributions is incorrect.<sup>18</sup> PPL Electric Initial Brief, pp. 146-47. OCA recognizes that the Commission has no authority to direct shareholder contributions, OCA Main Brief, p. 171, and obviously has no control over voluntary donations by others, and OCA makes no proposal whatsoever as to what the Commission is supposed to do with any such plan filed by PPL Electric. In effect, OCA's proposal is an effort to persuade the Commission to attempt to assert jurisdiction over these voluntary contributions, and should be rejected in its entirety.

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<sup>18</sup> PPL Electric notes that OCA's witness, Roger Colton, appears to have referenced the incorrect section of the Commission's 2003 Bureau of Consumer Services Report in assessing shareholder contributions to Operation HELP. The amounts Mr. Colton cites as shareholder contributions in 2001 and 2002 -- \$655,643 and \$438,138 -- are in fact the amount of benefits disbursed from Operation HELP in those years. Compare *Pennsylvania Public Utility Commission 2002 Utility Consumer Activities Report and Evaluation*, at 51 & OCA St. 5, p. 41. PPL Electric's 2002 shareholder contribution of \$448,000, an amount consistent with Mr. Dahl's testimony, is shown on the preceding page of the BCS report. *Id.* at 50; PPL Electric St. 7-R, p. 30.

#### 4. Community Betterment Initiative (“CBI”)

PPL Electric has also proposed the creation of a “Community Betterment Initiative,” a program designed to leverage matching funds from the Commonwealth of Pennsylvania for targeted programs in economic development and affordable housing. PPL has proposed initial funding of this program for three years, with an annual contribution of \$1 million from PPL Corporation shareholders and \$1 million from ratepayers, with an evaluation of the program in 2007. PPL Electric Initial Brief, p. 148.

OCA has expressly endorsed the CBI, noting in particular the program’s potential for substantial ratepayer benefits in the form of energy efficiency. OCA Main Brief, p. 171-72. OTS is the only party to this proceeding who now raises objections to the CBI. OTS Main Brief, pp. 27-28. OTS’ objections are based upon its view that CBI is a social program, lacking in direct benefit to ratepayers, and designed to enhance PPL Electric’s own community image. OTS also emphasizes the Commission’s decision in PPL Electric’s 1995 rate case, in which the Commission disallowed funding for programs it perceived as “socio-economic” and without direct benefit to ratepayers. *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 306, 339-340 (1995).

The Commission should reject OTS’ objections. PPL Electric fully intends to ensure that CBI generates direct benefits to ratepayers, consistent with the Commission’s previous rulings. As PPL Electric explained in its Initial Brief, CBI is not intended to be a social or charitable program, but a tool for leveraging funding for economic growth, which will increase electric usage and promote a more efficient use of PPL Electric’s facilities. PPL Electric Initial Brief, p. 149. OTS’ concern that PPL Electric’s intent is directed to its own community image is illogical; if PPL Electric wished to simply spend funds on community image, there would be no reason to devote shareholder monies to

undertake the added complexity inherent in a program involving ratepayer funds and designed to assist public-private partnerships to obtain state grants.

PPL Electric believes this program will return substantial benefits to ratepayers, and has also included a three-year funding limit with a review scheduled in 2007. *See id.*, p. 148. In light of the potential benefits of this initiative, the Commission should approve the CBI.

#### **5. OCA Has Failed To Justify Its Mandatory Budget Billing Program**

As described in PPL Electric's Initial Brief, OCA has proposed a "mandatory budget billing" option in which PPL Electric would automatically and without customer consent enroll all identifiable low-income customers with arrearages in May of each year on a budget bill payment program. PPL Electric Initial Brief, p. 141; OCA Main Brief, p. 161. OCA asserts that its program will help better identify low-income customers for participation in OnTrack, encourage payments of arrearages, and reduce the cost of OnTrack by lowering the arrearages of customers who enroll in the program. OCA Main Brief, pp. 162-163. As explained below, OCA's mandatory budget billing proposal, even when combined with its proposed earned income tax credit program (which PPL Electric has agreed to implement as a pilot program), is unlikely to reduce arrearages, and is highly likely to increase costs and cause customer dissatisfaction. The OCA's proposal therefore, should be rejected.

The primary flaw in OCA's mandatory budget billing program is that there is simply no reason to believe that low-income customers, who already have substantial arrearages, will be more likely to pay their electric bill after being placed on budget billing in May and receiving a higher than normal bill. *See* PPL Electric Initial Brief, pp. 141-42. As Mr. Dahl explained in testimony, PPL Electric remains convinced that

simply sending a low-income customer a higher budget bill will not lead to increased payments of arrears. *Id.* OCA contends that its program is better than no contact between PPL Electric and its customers with substantial arrears, *see* OCA St. 5-R, p. 7, but this argument ignores the fact that PPL Electric is already attempting to contact these customers to specifically address their arrearages, and that the OCA’s proposal to place a customer on budget billing without consent is likely to create significant customer confusion and dissatisfaction. Tr. 716-17; PPL Electric Initial Brief, p. 142.

Furthermore, despite OCA’s reference to its proposal as an “opt-out” program, there is effectively no “opt-out” option. The only means by which a customer can be removed from budget billing is by negotiating a payment plan with PPL Electric, Tr. 851, and any violation of that payment plan may result in termination of service. Thus, OCA’s program may actually expose low-income customers to more risk of termination, not less.

Despite presenting extensive testimony on this proposal, OCA has noticeably failed to identify any other Pennsylvania public utility (or any public utility anywhere) that has implemented this program and achieved any success. Given the substantial risks and unlikelihood of success, PPL Electric strongly opposes any effort to subject its low-income customers to OCA’s experiment. The Commission should reject OCA’s mandatory budget billing program.

**6. The Commission Should Reject Proposals To Allocate Universal Service Costs To PPL Electric Shareholders And Non-residential Customers**

In its Initial Brief, PPL Electric explained that Mr. Epstein’s proposal that PPL Corporation shareholders “match” ratepayer funding of PPL Electric’s universal service programs was inconsistent with Commission precedent and the Public Utility Code,

which specifies that the costs of universal service programs are to be fully recovered from ratepayers. PPL Electric Initial Brief, p. 152.

PPL Electric also addressed OCA's proposal that the costs of universal service programs be allocated to all PPL Electric customers instead of residential customers on the ground that universal service was a "public good." *See id.*, pp. 152-53. As PPL Electric noted, the Commission had previously rejected proposals to allocate universal service costs to rate classes other than residential customers to avoid cost shifting. *See id.* at 153; *Re: Pennsylvania Power & Light Company*, 89 Pa. PUC 587, 658 (1998). OCA makes no argument here that anything has occurred since PPL Electric's restructuring proceeding to now justify reallocation of these costs or re-examination of the Commission's earlier decision. The Commission should affirm its previous ruling and reject OCA's proposal.

#### **I. SUSTAINABLE ENERGY FUND**

As PPL Electric observed in its Initial Brief, PPL Electric Initial Brief, p. 154, the 1998 consensus among the parties to the settlement of PPL Electric's restructuring proceeding with respect to the Sustainable Energy Fund ("SEF") no longer exists. The varied opinions now held by stakeholders and their representatives are thoroughly reflected in the initial briefs of other parties in this proceeding. Nevertheless, PPL Electric remains convinced that the proper proposal at this time remains continued funding of SEF from distribution rates at its current level of 0.01 cents per kWh from all customers, for a period to end no later than December 31, 2009.

As initial matter, assertions by several parties that PPL Electric ratepayers have been paying for SEF are, at best, irrelevant. SEF funding was established and assigned to distribution costs as part of a "black-box" settlement of PPL Electric's 1998 restructuring

proceeding. There is therefore no specific basis for concluding whether SEF has been funded by ratepayers or shareholders. However, there is no dispute that the SEF charge is part of PPL Electric's current distribution rates.

Moreover, in analyzing whether this funding should continue, the extended argument between several parties as to whether specific SEF projects return sufficient distribution benefits misconstrues both the nature of the Competition Act as well as PPL Electric's own role as an electric distribution company. The Competition Act is not solely about creating a competitive market in generation. *See, e.g.*, 66 Pa. C.S. § 2802(12) ("Electric industry restructuring should ensure the reliability of the interconnected electric system by maintaining the efficiency of the transmission and distribution system."). And PPL Electric, as a distribution company in the midst of Pennsylvania's restructuring of the electric industry, retains its POLR obligations to provide generation to all customers who do not choose an alternative supplier.

In this context, the Commission has recognized that reductions in demand and energy efficiency can have positive benefits for ratepayers, and has encouraged electric distribution companies to pursue programs that reduce demand. *SEF funding should be continued to realize these benefits in efficiency and reduced demand from its existing projects and from projects that can be identified in the remaining years of PPL Electric's transition period.* To the extent the Commission has concerns regarding issues of program management and evaluation, project selection, or governance, the Commission can initiate a separate proceeding to address those concerns instead of eliminating SEF funding in this proceeding.

Second, PPL Electric does not believe that the Commission should undertake substantial restructuring of SEF in this proceeding, such as the transfer of SEF to the Pennsylvania Energy Development Authority, as recommended by OSBA. OSBA Main Brief, p. 27. Such proposals are contrary to the original consensus that created the SEF, and PPL Electric believes that standards for SEF operations and other activities are more appropriately managed under the jurisdiction of the Commission.

Third, the Commission should reject the concerns of PPLICA and OTS regarding future funding past 2009. Both parties express their concern that PPL Electric's proposed compromise is improper because ratepayers may be obligated to contribute to SEF in the future, and PPL Electric will not foreclose any future request for additional funding for SEF. PPLICA Main Brief, p. 30; OTS Main Brief, p. 33. The concerns of PPLICA and OTS regarding the future funding of SEF are appropriately addressed in the future. PPL Electric's compromise proposal simply extends the agreement reached by many parties at the beginning of the Company's transition period. PPL Electric sees no reason why the substance of this prior agreement should not be extended for the remainder of PPL Electric's transition period to permit SEF to realize the potential benefits anticipated at its creation.

#### **J. RETAIL COMPETITION ISSUES**

The issues addressed in briefs filed by the Mid-Atlantic Supply Association and Wal-Mart pertaining to testimony presented by Strategic Energy have been fully discussed by PPL Electric Initial Brief, pp. 157-60.

#### **K. DEMAND SIDE MANAGEMENT**

In testimony in this proceeding, PPL Electric detailed its extensive history of demand side response ("DSR") programs and its current DSR offerings to residential,

commercial, and industrial customers, which PPL Electric has proposed to continue. PPL Electric St. 4, pp. 19-25. For residential customers, PPL Electric also introduced an experimental DSR Rider in 2002 to permit up to 200 eligible AMR-equipped residential customers to shift load from on-peak periods to off-peak periods during the four summer months, and PPL Electric has proposed increasing participation in this program up to 300 customers. *See id.*, p. 25.

CAC has generally objected to PPL Electric's DSR programs, and asserts that PPL Electric should offer a residential DSR program for 10,000 customers, "or preferably" no limit at all. In addition, CAC proposes that the Company offer incentives to customers to purchase appliance timers. CAC Main Brief, pp. 13-15.

The Commission should reject CAC's proposals in their entirety. CAC offers no testimony or evidence whatsoever regarding the costs of its proposals to vastly expand enrollment in PPL Electric's experimental program and offer equipment rebates to customers. Worse, CAC does not address in any way the actual results of PPL Electric's residential DSR program detailed by Mr. Krall, in which he explains that the benefits customers received under PPL Electric's tariff were significantly greater than the value of their actions in the energy market. PPL Electric St. 4, pp. 22-24.

PPL Electric has been and continues to be a strong supporter of market approaches to electricity supply issues, of which DSR is an important element. *See id.*, p. 19. While the recent results indicate that this program may not be an appropriate offering during the period generation rate caps are in place, PPL Electric believes it is appropriate to continue this program to better understand customer behavior and test alternative program designs that can be offered on a larger scale when the generation rate cap ends.

*See id.*, p. 25. But in light of the actual results and the substantial costs of this program, PPL Electric's proposed customer limit on customer participation should be retained, and the Commission should reject CAC's vague proposals.

#### **L. PHOTOVOLTAIC SYSTEMS**

CAC contends that PPL Electric failed to comply with provisions of the 1998 restructuring proceeding settlement agreement that provided for a photovoltaic ("PV") installation program of 35 installations in 1999 and 75 installations in 2000 and a total budget of \$550,000. CAC Main Brief, pp. 15-19. This argument was raised for the first time in CAC's brief, and as a result, PPL Electric had no opportunity to respond on the record. The Commission should reject CAC's argument for this reason alone. *See Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 57 Pa. P.U.C. 559, 596-97 (1983) ("[I]t is highly inappropriate for a party to propose a new adjustment for the first time in its brief."); *see also Allegheny Center Associates v. Pa. P.U.C.*, 131 Pa. Cmwlth. 352, 570 A.2d 149, 153 (1990) (A utility "cannot be called upon to account for every action absent prior notice that such action is to be challenged.").

If CAC had presented this argument in a timely fashion, PPL Electric would have demonstrated that it fully met the requirements of the 1998 restructuring settlement and expended in excess of \$550,000 on photovoltaic systems. PPL Electric would also have demonstrated that it had procured appropriate photovoltaic systems at reasonable cost, and that those costs were far in excess of initial estimates, leading to a reduction in the number of units actually installed. CAC's contention that PPL Electric should have built 100 systems, regardless of cost is inconsistent with the plain language of the settlement agreement and makes no sense. CAC cites no authority for its assertion that "traditional

norms of statutory construction,” CAC Main Brief, p. 17, require such an interpretation of PPL Electric’s 1998 restructuring settlement agreement.

Furthermore, CAC also asserts – again for the first time on brief – that PPL Electric should be able to realize certain economies of scale in purchasing photovoltaic systems. *See id.*, p. 18. Yet CAC offers no evidence whatsoever supporting its contentions that prices for photovoltaic systems are now “significantly lower,” or that unspecified websites offer suitable, cheaper photovoltaic systems. In light of CAC’s failure to properly present its allegations and proposal in this proceeding, as well as the lack of justification for any of its claims, the Commission should reject CAC’s proposal in its entirety.

## **M. RATE STRUCTURE**

### **1. Cost of Service**

In this proceeding, PPL Electric’s cost of service study is based upon the same methodology it has used in its prior rate proceedings, which the Commission has repeatedly approved. PPL Electric St. 5-R, p. 3; *see, e.g., Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 306, 393 (1995); *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th 185, 243-44 & 249-50 (1993). Several parties to this proceeding – PPLICA, the Department of Defense, and Wal-Mart – have expressly endorsed PPL Electric’s cost of service study. *See, e.g., PPLICA Main Brief*, p. 88 (explaining that PPL Electric’s study is reasonable and consistent with prior proceedings); *DOD Main Brief*, p. 19 (same); *PaEC Main Brief*, p. 7 (agreeing with cost of service presentation by PPL Electric). Other parties, including the OTS, have not objected to the cost of service study in any way. OSBA, which had raised certain conceptual issues with the Company’s

study in testimony, now requests the Commission to approve PPL Electric's study. *See* OSBA Main Brief, p. 3.<sup>19</sup>

The only party still objecting to PPL Electric's cost of service study is the OCA, which contends that: (1) PPL Electric's "minimum system" used to allocate secondary distribution plant costs has load carrying capability that is allocated improperly to customers on a customer count basis; (2) the minimum system uses larger components than necessary; and (3) PPL Electric erred by not adjusting its allocation of secondary distribution plant costs based upon demand to reflect the load carrying capability already allocated by the minimum system, thus "double-counting" demand costs. OCA Main Brief, pp. 104-05. On the basis of these objections, OCA proposes an alternative study which allocates costs based upon an average and peak demand basis. *Id.* at 113-14.

As a threshold matter, the Commission need not resolve these issues in this proceeding for two reasons. First, the two studies produce essentially the same bottom line result – residential ratepayers are being heavily subsidized by commercial and industrial customers. Second, and relatedly, because of these results, the OCA does not object to the class revenue allocations proposed by PPL Electric. OCA Main Brief, pp. 121-25. However, if the Commission does consider OCA's objections, it should reject those objections and OCA's alternative cost of service study as without merit for several reasons.

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<sup>19</sup> PLUG asserts that PPL Electric's cost of service study does not properly reflect PLUG's view of the "interruptible" nature of streetlighting service and that SL/AL rates are "almost certainly" overrecovering more than should be allocated to an "interruptible" service. PLUG Main Brief, p. 13. PLUG did not submit its own cost of service study, and PPL Electric addresses the errors in PLUG's assertion that it receives "interruptible" service in Section III.N.2.

First, as PPL Electric explained in testimony and in its Main Brief, a minimum size system, by definition, must have some load carrying capability. PPL Electric Initial Brief, at 164; PPL Electric St. 5-R, p. 8. OCA objects to PPL Electric's minimum system because it includes some demand-related costs, but this conceptual issue with minimum system studies does not detract from the usefulness of minimum system studies. PPL Electric St. 5-R, p. 10.<sup>20</sup> In PPL Electric's last rate proceeding, OCA also objected that PPL Electric's minimum system overstated the amount of distribution costs that are customer related. *See Pa. PUC v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 306, 390 (1995). The Commission rejected OCA's objection then, and it should do so again.

Second, OCA's objection that PPL Electric has used larger components than necessary in its minimum size study is based only upon PPL Electric's current use of 30kVa transformers in calculating the minimum system, instead of the 10kVa transformers PPL Electric used in its last base rate case in 1995. OCA Main Brief, p. 108. But OCA does not dispute that the NARUC guidelines for conducting minimum system studies specifically provide that a utility shall use the smallest size equipment *currently* being installed by a utility. PPL Electric Initial Brief, p. 165.

Third, as explained in PPL Electric's Initial Brief, the proportion of transformer costs to the total customer component of PPL electric's minimum size system is quite small. *See* PPL Electric Initial Brief, p. 165 (documenting transformer costs of \$157.5 million out of \$2.249 billion in total customer component, or 7%. Even if the Commission were to accept OCA's view – contrary to the NARUC guidelines – “that the

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<sup>20</sup> “In actual practice, the vast majority of utilities utilize some form of minimum system to classify costs, which is in line with FERC accounts.” BONBRIGHT, DANIELSEN, & KAMERSCHEN, *PRINCIPLES OF PUBLIC UTILITY REPORTS* (1988), p.492.

Company's choice of equipment should have no bearing on the hypothetical customer-related only costs of its distribution system," OCA Main Brief, p. 109, this does not mean, as OCA contends, that the Company's entire cost of service study "produces unreliable results." OCA Main Brief, p. 109. Instead, the study should be adjusted to reflect the 10kVa transformers which PPL Electric is no longer currently installing, and then applied accordingly.

Fourth, OCA's assertion that PPL Electric has overstated customer costs for the Company's secondary distribution system ignores PPL Electric's overall cost allocation, which includes an understatement of customer costs associated with PPL Electric's primary distribution system. PPL Electric allocates all costs of its primary distribution system on a demand basis, not on a customer count basis. Any minor overstatement of the customer cost component in PPL Electric's secondary distribution component is at least partially offset by PPL Electric's allocation of all primary distribution system costs on a demand basis. PPL Electric Initial Brief, p. 164; PPL Electric St. 5-R, p. 9. There is simply no evidence in this proceeding that PPL Electric's cost of service study, taken as a whole, produces unreasonable or unreliable results.

Finally, and most importantly, even if the Commission were to accept OCA's objections, OCA's proposed alternative approach – to allocate distribution costs based solely upon the peak and average demand of customers with no customer component at all – is fundamentally flawed. While reasonable parties can debate the exact level of the customer component of distribution costs, there is no rational basis to contend that at least some portion of distribution costs are incurred simply to connect customers to the distribution system and should be allocated on a customer basis.

Similarly, OCA's proposed allocation of a portion of secondary distribution costs on an energy basis (average demand) is totally inconsistent with industry standards. Distribution system costs do not vary with energy usage; they vary based on number of customers and peak demand. PPL Electric St. 5-R, p. 5. The Commission has repeatedly rejected OCA's attempts to require PPL Electric to use a cost of service study based upon these flawed principles. *See, e.g., Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 306, 393 (1995); *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th 185, 243-44 & 249-50 (1993).<sup>21</sup>

The Commission has emphasized that cost of service studies serve only as a guide in setting rates, and that cost of service analysis is not an exact science. PPL Electric Initial Brief, p. 161. PPL Electric's cost of service study is fair and reasonable, as nearly all parties to this proceeding agree. The Commission should therefore adopt PPL Electric's cost of service study, and reject OCA's objections and alternative "peak and average" methodology.

## 2. Class Revenue Allocation

PPL Electric, and Pennsylvania in general, are in a time of transition in electric service. While nearly every party to this proceeding has acknowledged this fundamental fact, and also agreed that gradualism in rate design remains important, the critiques of PPL Electric's revenue allocation and the alternative proposals offered by parties are all

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<sup>21</sup> OCA suggests that the Commission should use this first distribution-only rate case as an opportunity to take a "fresh look" at how costs should be allocated because such issues "may not have been examined in the same detail" in proceedings involving fully bundled service. OCA Main Brief, p. 117 n.38. PPL Electric disagrees, and notes that Commission decisions reflect a full understanding of OCA's proposals regarding cost allocation. *See, e.g., Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 85 Pa. PUC 306, 393 (1995). Given OCA's repeated unsuccessful advocacy of its "peak and average" methodology for PPL Electric, PPL Electric suggests that the Commission strongly consider the proposal of the Department of Defense to establish a formal policy requiring allocation of electric utility distribution plant to be consistent with NARUC guidelines and use of peak demand, not average demand. *See* DOD Main Brief, p. 18.

too familiar. As in prior cases, parties advocate different divisions of PPL Electric's revenue increase which will, in the end, advance the interests of their respective constituencies.

PPL Electric's proposal for revenue allocation reflects the Company's understanding of this time of transition as well as a just and reasonable balancing of the diverse interests of its residential, industrial, and commercial customers. As explained in testimony and in PPL Electric's Initial Brief, the Company established three key objectives for revenue allocation – a total bill increase on residential rate schedules of less than 10%, a total bill increase on all other rate schedules below 10%, and movement towards system average rate of return for each customer class. PPL Electric Initial Brief, p. 166. Each of these objectives were achieved, *see id.*, and the resulting allocation should be approved by the Commission.

In the initial briefs of other parties in this proceeding, four principal critiques of PPL Electric's class revenue allocation were offered: (1) PPL Electric has not followed its own cost of service study (OSBA Main Brief, p. 9; PPLICA Main Brief, p. 92); (2) PPL Electric's use of system average return instead of dollar subsidy misstates the progress PPL Electric is making towards alleviating cross-subsidization of customer classes (OSBA Main Brief, pp. 8-9; PPLICA Main Brief, p. 93); (3) PPL Electric's use of a "total bill" concept as a guide to revenue allocation is inappropriate (PPL ICA Main Brief, p. 93; DOD Main Brief, p. 20); and (4) PPL Electric should do more to eliminate subsidies more quickly (PPLICA Main Brief, pp. 94-95; DOD Main Brief, p. 23). Taken individually, or collectively, none of these critiques justify altering PPL Electric's revenue allocation in any way.

With respect to cost of service studies, the Commission's understanding of the role of such studies in the allocation of revenue is long established:

This commission has historically recognized the cost of service study for what it is: a useful tool for testing the reasonableness of the proposed allocation of the revenue requirement. Rarely, if ever, is revenue requirement allocated strictly on the basis of cost of service results. In most instances, and this case is no exception, *the revenue allocation is based primarily on other factors* such as economic impact and rate continuity with some modification due to cost of service considerations.

*Pa. P.U.C. v. Duquesne Light Co.*, 51 PUR 4th 198, 252 (Pa. 1983). While OSBA and PPLICA object that PPL Electric either "disregarded" its cost study (OSBA) or failed to adjust allocations to reflect the distribution plant associated with industrial customers (PPLICA), both parties are essentially arguing that PPL Electric did not give sufficient weight to cost of service calculations and unduly emphasized gradualism in this proceeding. Under Commission precedent, where PPL Electric has proposed a just and reasonable allocation of revenue based upon a variety of appropriate factors, including adjustment of rates based upon cost of service, OSBA's and PPLICA's arguments should be rejected.

OSBA's and PPLICA's criticisms of PPL Electric for measuring its progress in moving customer classes closer to the system average rate of return are also misplaced. The Company measures movement toward cost of service based on a rate class' relative contribution to the system average rate of return. For example, under the Company's cost of service of study, Rate Schedule RS will provide a 1.60% return under present rates, or 41% of the present system average return of 3.91%. Under proposed rates, Rate Schedule RS will provide a return of 5.29%, or 60% of the proposed system average return of 8.80%. Thus, on a relative basis, Rate Schedule RS provides a greater

percentage of system average return under proposed rates than under present rates and is therefore moving toward cost of service. This approach is consistent with the manner in which PPL Electric has measured cost of service in all prior rate proceedings and is fully consistent with Commission precedent on this issue. *Pa. P.U.C. v. Pennsylvania Power & Light Co.*, 55 PUR 4th 185, 250 (1983). Several parties, notably OSBA and PPLICA, criticize the Company's approach and recommend an alternative method which purports to measure subsidies on an absolute dollar basis rather than on a percentage basis. OSBA Main Brief, pp. 8-9; PPLICA Main Brief, p. 93. PPL Electric strongly objects to such an approach because it can produce seriously misleading results.

For example, assume hypothetically there are two utilities (A and B), each of which has residential rates that produce a 4% return on rate base, as compared to an 8% system average return. Assume further that the rates of utility A are twice the level of utility B's rates. Under PPL Electric's approach, the residential customers of each utility are contributing 50% of the system average return (4% divided by 8%). Under the OSBA/PPLICA approach, utility A will show an absolute dollar subsidy twice the level of utility B, solely because its rates are twice as high and not because of any difference in rate structure. In other words, the OSBA/PPLICA approach is flawed because it fails to account for differences in overall rate levels. As applied to this case, the OSBA/PPLICA approach is misleading because it compares absolute dollar subsidies at two different rate levels, *i.e.*, present and proposed rates. As a result, the dollar subsidy calculated by OSBA/PPLICA partially reflects differences in class contribution to cost of service, but also includes difference in dollar subsidies resulting from different rate levels. This

“apples and oranges” comparison is not useful, and indeed, is affirmatively misleading in attempting to measure class contribution to overall cost of service.

Similarly, PPLICA’s and DOD’s objections to PPL Electric’s use of a “total bill” concept in revenue allocation should be disregarded by the Commission. As Mr. Krall explained, PPL Electric believes that the combined impact of changes in distribution rates and the transmission service charge pass-through should be considered in the context of their impact on the total bill. PPL Electric St. 4-R, p. 34. Notably, OCA, Wal-Mart, and OSBA supported or relied upon the “total bill” concept. See OCA St. 1, p. 21; PaEc St. 1, p. 9; OSBA St. 1, p. 28.

Finally, the proposal of PPLICA (and, to a slightly lesser extent, the proposals of DOD and OSBA) to rapidly reduce rate class subsidies clearly violate the concept of gradualism that is properly reflected in PPL Electric’s proposal. For example, under PPLICA’s proposed allocation, each rate class would immediately move 50% closer to the system average rate of return, with 25% reductions in each of the following two years. PPLICA Main Brief, pp. 95-96. The current subsidies reflected in PPL Electric’s rates evolved over decades, and should not be eliminated too quickly, particularly when PPL Electric and Pennsylvania remain in a transition to a fully competitive retail market.

The proposals of PPLICA and DOD to establish shifting revenue allocations over multiple years (PPLICA Main Brief, pp. 98-99) or multiple rate cases (DOD Main Brief, p. 23) also are in tension with traditional rate-making principles. PPL Electric is unaware of any case involving a Pennsylvania electric utility in which the Commission imposed future extensive re-allocation of revenue requirements between classes over time.<sup>22</sup> And,

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<sup>22</sup> *Pa. P.U.C. v. Tri-gen Phila. Energy Corp.*, Docket No. R-00016941 (June 28, 2002), cited by PPLICA, involved a phase-in of a rate increase, not future reallocations of revenue requirements.

as the OCA properly notes, the effect of such a proposal would be to lock in components of future rates based upon information filed in this proceeding, which would – at the very least – lead to more complicated future proceedings in which parties must determine, with hindsight, whether past rulings should be maintained.

Because none of the criticisms or proposals of other parties to this proceeding justify any change in PPL Electric's proposed revenue allocation, the Company's proposed allocation should be adopted by the Commission.

## **N. RATE DESIGN**

### **1. Residential Rate**

In this proceeding, PPL Electric has proposed to increase its residential customer charge from \$6.47 to \$12.20 per month to more accurately reflect the cost of service, with *the first 200 kWh of distribution service incorporated into the customer charge*. PPL Electric Initial Brief, p. 168. The OCA and OTS have objected to this proposal on the ground that it does not accurately reflect PPL Electric's customer costs and includes usage charges. However, neither party addresses the rationale for PPL Electric's proposal: that substantial number of residential bills with zero kWh usage (180,000) or less than 200 kWh usage (1.2 million) are issued each year, reflecting the large number of vacation homes and cabins in the Company's service territory. PPL Electric Initial Brief, 169; PPL Electric St. 6-R, p. 10.

Under PPL Electric's current rate structure, these low usage customers are not paying their proportionate share of fixed costs required to serve a typical residential customer. PPL Electric St. 6-R, p. 11. PPL Electric's proposal will help eliminate this problem with minimal or no impact on other higher usage customers. The Commission should approve PPL Electric's customer charge and the related adjustments to the residential rate blocks, as described in PPL Electric's Initial Brief, pp. 168-69.

### **2. Street Lighting**

In this proceeding, the PLUG has made its initial appearance, seeking what no other party has sought: no increase whatsoever on the ground that its use of electricity is a "public good" that should be paid for by all other PPL Electric customers. PLUG Main Brief, p. 13. To justify this freeze in rates, PLUG has analogized the provision of street lighting to fire hydrants, suggested that a burnt out streetlight is functionally equivalent to

interruptible service, and criticized PPL Electric for not instituting patrols throughout its service territory to determine if streetlights are functioning properly.

The Commission should reject both the factual contentions of PLUG and its request to avoid any increase in this proceeding. As set forth below, the reality is that street lighting customers already are heavily subsidized by other customer classes, and PLUG has entirely failed to show that it receives anything less than reasonable service. The increase PPL Electric has proposed for the streetlighting class (SL/AL) of 9.9% on a “total bill” basis remains consistent with PPL Electric’s class revenue allocation objectives of not increasing rates for any customer class by more than 10% and moving each class closer to system average rate of return, and should be approved by the Commission.

**a. Street Lighting Is Already Subsidized And Should Not Be Treated As A Public Good.**

Under present rates, SL/AL customers pay only 26% of the system average rate of return, and under PPL Electric’s proposed rates, this percentage increases to 31%. PPL Electric Initial Brief, p. 167. On a true cost of service basis, SL/AL customers would be receiving a 40% increase. Nevertheless, despite this substantial subsidization, PLUG asserts that it should not receive any increase because street lighting is a “public good” equivalent to fire hydrants under the Public Utility Code. The Commission should reject PLUG’s claim.

PLUG’s assertion that street lighting is a “public good” proves too much. Under PLUG’s expansive analysis, many municipal government services could be treated as “public goods,” with the costs of those services which are traditionally paid through taxes reallocated to private parties. *See* PPLICA Main Brief, 42 (discussing “slippery slope”

of “public good” analysis leading to PLUG’s improper proposal). In the case of street lighting, PLUG’s proposal would effectively shift PPL Electric’s proposed increase in street lighting costs for an individual municipality from local taxes to ratepayers throughout PPL Electric’s territory, these increased costs would be imposed, on customers who may be located nowhere near the municipality and will not obtain the “public good” asserted by PLUG.

Apparently recognizing that its “public good” argument cannot stand alone, PLUG attempts to squeeze into the framework of the Public Utility Code by analogizing street lighting to fire hydrants, which do receive specific preferential treatment with respect to allocation of costs in public utility rate proceedings. *See* 66 Pa. C.S. § 1328 (providing that rates for public fire protection service may not exceed 25% of cost of service). As PPL Electric explained in its Initial Brief, street lighting service and fire hydrant service are quite different - street lighting operates continuously every night, while fire hydrants operate only at times of fire. The two services are simply not analogous, and the Commission should not confer such a statutory benefit where none now exists. *See* PPL Electric Initial Brief, p. 174.

**b. PPL Electric Is Providing Quality Service To Streetlighting Customers**

PLUG’s second argument for paying no increase whatsoever is its contention that it is receiving a lesser quality of service than other customers or is receiving the equivalent of interruptible service. PLUG is plainly wrong for several reasons.

First, PLUG’s assertion regarding Hampden Township’s “experience” of streetlight maintenance difficulties is “typical” is completely unsupported by the record. Hampden Township was the *only* municipality in PPL Electric’s entire service territory

that has offered any complaint regarding streetlight maintenance. Indeed, among PLUG's six members, only Hampden Township expressed any service concerns, and those concerns have been fully addressed. *See* PPL Electric Initial Brief, 175 & n.48.

Second, in light of PLUG's failure to actually demonstrate a substantial problem with street lighting in PPL Electric's territory, its complaints regarding PPL Electric's current relamping and maintenance policies are unsupported. As described in testimony and in PPL Electric's Initial Brief, under the Company's group relamping program, lights are replaced before their expected expiration, which substantially reduces outages. PPL Electric Initial Brief, pp. 174-75. For lights that are reported out, PPL Electric has established procedures to repair 90% of those lights within three days. While a small percentage of lights take longer to repair, the issues with those lights are often more complex and require further maintenance efforts. Tr. 1015-16; *see also* PPL Electric St. 4-R, p. 16 (explaining unfeasibility of providing feedback on outage reports with 170,000 outdoor lights throughout service territory).

Third, PLUG's theory that PPL Electric should assume responsibility for patrolling municipalities throughout its territory to identify street lights that are out of service makes no sense. As a general matter, no other customer class receives this special service. And, given PPL Electric's group relamping program, the likelihood of outages is very low. Moreover, for those lights that do unexpectedly stop working, PLUG's contention that municipalities lack the resources to monitor these lights is curious, at best. Municipal police clearly are already patrolling each street on a regular basis for a variety of general safety reasons. Noting a nonfunctioning street light (and its subsequent repair) is a relatively straightforward task that could not cause any substantial

additional expense. And, any minor expense or inconvenience obviously would be far less expensive than the cost of funding special PPL Electric patrols (PPL Electric St. 6-R, p. 14). And, if these costs were incurred, they would be directly assignable to SL/AL customers and would result in increased street lighting rates.<sup>23</sup>

Fourth, PLUG's contention that it is receiving interruptible service and PPL Electric is therefore overrecovering costs for firm service is plainly in error. As discussed above, PLUG has entirely failed to show that there is any significant municipal street light outage problem existing in PPL Electric's service territory. Furthermore, PLUG's suggestion that a burned out streetlight constitutes interruption of service equivalent to an interruptible rate is nonsensical. The purpose of an interruptible rate is to permit intentional interruption during high usage or high cost periods, which do not occur when street lights are operating (i.e., at night).

Because PLUG has failed to offer any reason why its heavily subsidized rates should not be increased by 9.9% and moved towards system average rate of return, the Commission should approve PPL Electric's proposed rate increase for SL/AL customers.

### **3. Traffic Lighting**

In addition to its efforts to avoid any increase in rates for street lighting, PLUG has proposed in this proceeding that PPL Electric offer unmetered service to traffic signals instead of metered service, as presently provided. PLUG Brief, p. 16. PLUG also proposes that the Commission require PPL Electric to include a provision in its tariff for unmetered service for traffic signals with LED lights installed by its next distribution

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<sup>23</sup> PLUG's suggestion that it fears municipal liability under the Pennsylvania Judicial Code, 42 Pa. C.S. § 8542(b)(4), as a result of a nonfunctioning street light, *see* PLUG Main Brief, p. 10, appears theoretical at best. PLUG offered no testimony establishing any actual concerns based upon this statute, let alone any evidence of a municipality being held liable as a result of a PPL Electric light not functioning.

case, and to offer programs at unspecified funding levels to subsidize the conversion of incandescent traffic lights to LED lights. *See id.*, p. 17.

The justifications PLUG articulates for unmetered traffic signals are that (1) traffic lighting systems have “a large amount of directly assignable equipment” with strictly defined usage patterns, and (2) LED lights, which are very efficient and have long lives, will result in very little fluctuations in electric usage. PLUG also explains that “simple math” reveals “huge savings” with its “demand side” LED conversion program. *See id.*, pp. 16-17. Because these justifications are flawed and wholly inadequate, the Commission should reject PLUG’s proposals.

As an initial matter, the “directly assignable” nature of traffic signal equipment is irrelevant to the metered rates charged for traffic lighting. PPL Electric does not own the traffic lights and their related equipment; thus, unlike street lights, there are no costs for PPL Electric to “directly assign.” Moreover, as PPL Electric explained its Initial Brief, there is a wide variation in actual usage at intersections, even where equipment appears to be similar. PPL Electric Initial Brief, p. 171.

More importantly, the essence of PLUG’s proposal is that PPL Electric should remove the meters now currently installed in intersections and accurately measuring energy usage and attempt to estimate load that clearly varies from intersection to intersection. *See id.* This makes little sense, and PLUG never explains why an unmetered service is preferable to accurate, metered results. Because PPL Electric accurately measures load now, those PLUG members and others who choose to install LED lights will immediately realize their savings. PPL Electric Initial Brief, p. 172.

Finally, PLUG's proposal for a program to subsidize conversions from incandescent lights to LED is far too vague for consideration by the Commission. While PLUG may believe "simple math" demonstrates the benefits of such a program, PLUG did not share that "simple math" on the record in this proceeding, nor does it explain why PPL Electric ratepayers should be subsidizing such a program. PLUG does assert, for the first time on brief, that there is a related program in California, but without providing citation or without offering any details of these programs for the record. In evidence, PLUG also referred to a New Jersey program but gave no citation or details.

Because PLUG has failed to justify establishing an unmetered rate for traffic lighting in PPL Electric's territory or creating any programs related to LED traffic lights funded by ratepayers, the Commission should reject PLUG's traffic lighting proposals.

#### **4. Rule Changes**

##### **a. Rule 5A**

As part of this proceeding, PPL Electric has proposed a change to Tariff Rule 5A to clarify the customer's responsibility beyond the point of delivery. PPL Electric St. 6, p. 16. The language PPL Electric is proposing to add reads as follows (addition emphasized):

*The customer assumes full responsibility for the energy and facilities at and beyond the point of delivery. Interruption of service and variation in supply characteristics (including, but not limited to, high or low voltage, operation of protection or control devices, single phasing of three phase service, and phase reversal) can occur. To prevent or limit damage from such events it is the Customer's responsibility to purchase and install protective devices and/or install or otherwise provide for alternate power supplies that are available from third parties to protect Customer's facilities and property. The customer's use of service shall not cause damage to Company's equipment or impair this service to other customers.*

PPL Electric St. 6, Exhibit OGK-6. During hearings, counsel for PPLICA questioned Mr. Kasper, PPL Electric's Manager of Pricing and Contract Administration, in detail regarding this proposal:

"Q. And I believe, looking at your testimony, you categorize this as a clarification, correct?

"A. That's correct.

"Q. Now, does that mean that PPL is really, in your mind, seeking to maintain the status quo?

"A. That's correct.

"Q. Okay. So, PPL will continue to comply with whatever reliability or service outage regulations the Commission imposes?

"A. That's correct.

"Q. And, in the future, any changes to that?

"A. Yes.

"Q. And this language is not meant to address that?

"A. No." Tr. 1025-1026.

Despite this extensive colloquy, PPLICA has now asserted that PPL Electric is attempting to narrow its responsibilities under the Public Utility Code to furnish and maintain adequate, efficient, safe, and reasonable service and facilities, in accordance with 66 Pa. C.S. § 1501. PPLICA Main Brief, p. 59. PPLICA is wrong.

As Mr. Kasper testified, *supra*, PPL Electric is not attempting to change the status quo, and is committed to complying with all Commission regulations and orders relating to reliability and service outages. But these regulations do not, as PPLICA seems to suggest, guarantee continuous electric service. In fact, Section 1501 of the Public Utility Code specifically provides that service should be "reasonably continuous and without

unreasonable interruption and delay.” 66 Pa.C.S. § 1501. And, other provisions of PPL Electric’s tariff address PPL Electric’s statutory obligations with respect to outages. Rule 4 of PPL Electric’s existing tariff provides:

“The Company [PPL Electric] uses reasonable diligence to preserve continuity of service, but in the event of an interruption or curtailment of service, Company shall not be subject to any liability, penalty or payment for or on account of any such interruption or curtailment . . . .”

PPL Tariff – Electric Pa. P.U.C. No. 201, Rule 4. The proposed revision to Rule 5A simply reiterates the law and PPL Electric’s current tariff that PPL Electric does not guarantee continuous service and that outages can occur, and notifies customers that they have the responsibility to install necessary devices to protect their electric equipment. Their clarification is entirely proper and in accordance with existing law.

**b. Rule 8B**

PPL Electric has also proposed an addition to Rule 8B to clarify measurement from separate points of delivery. PPL Electric St. 6, p. 18. Specifically, PPL Electric has proposed changing Rule 8B to read as follows:

Measurement from metering equipment *for separate points of delivery* are never combined for billing purposes except temporarily pending completion of necessary changes in Company’s facilities.

PPL Electric St. 6, Ex. OGK-6 (emphasis added). The result of this clarification is a narrowing of the rule to exclude combination of meters where the equipment is not associated with separate points of delivery.

The Department of Defense has stated that it will only accept this clarification if PPL Electric will assure the Department of Defense that no military installation that PPL Electric services will incur greater billings as a result of this rule change. While PPL

Electric has provided such assurance for one identified facility, Carlisle Barracks, *see* PPL Electric St. 6-R, pp. 1-2, PPL Electric cannot provide any such assurance for unidentified facilities. Because the Department of Defense did not propose such a condition prior to briefing or identify the facilities for which it would like such assurance, the Commission should reject the Department's condition on this tariff change and approve PPL Electric's tariff addition as proposed. Moreover, DOD's objection makes no sense. PPL Electric's proposal narrows the application of the rule against conjunctive billing. If PPL Electric's amendment is rejected, DOD will be more at risk than if PPL Electric's proposal is accepted.

**IV. CONCLUSION**

For all of the foregoing reasons, the Public Utility Commission should approve, in its entirety, Supplement No. 38 to Tariff Electric Pa. P.U.C. No. 201 and permit PPL Electric Utilities Corporation to increase its distribution rates and transmission charge pass-through, as proposed therein, effective for service rendered on and after January 1, 2005.

Respectfully submitted,



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## CERTIFICATE OF SERVICE

I hereby certify that I have this day served two copies of the foregoing **“Reply Brief of PPL Electric Utilities Corporation”** upon the participant(s), listed below, in accordance with the requirements of §1.54 (relating to service by a participant):

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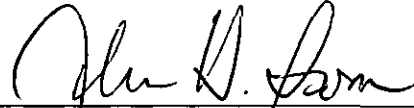
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