



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

ISSUED: August 7, 2001

IN REPLY PLEASE
 REFER TO OUR FILE

R-00006042, R-00006042C0001 et al.,
 C-00014826 - C-00014828, C-00014843, C-00014910,
 C-00015037, C-00015044 - C-00015048, C-00015050
 & C-00015098

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DOCUMENT
 FOLDER

Pennsylvania Public Utility Commission v. Philadelphia Gas Works

311

TO WHOM IT MAY CONCERN:

Enclosed is a copy of the Recommended Decision of Administrative Law Judge Cynthia Williams Fordham.

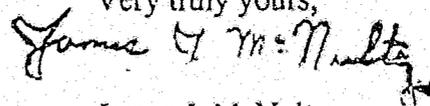
An original and nine (9) copies of signed exceptions to the decision, if any, MUST BE FILED WITH THE SECRETARY OF THE COMMISSION, 2ND FLOOR, KEYSTONE BLDG, 400 NORTH STREET, HARRISBURG, PA OR MAILED TO P.O. BOX 3265, HARRISBURG, PA 17105-3265; a copy in the hands of the Office of Special Assistants, 3RD FLOOR; and a copy in the hands of each party of record no later than August 22, 2001 by 4:30 P.M. 52 Pa. Code §1.56(b) cannot be used to extend the prescribed period for the filing of exceptions or reply exceptions.

Replies to exceptions, if any, must be served on the Secretary of the Commission, in the manner described above, no later than August 30, 2001 by 4:30 P.M. as well as served upon the parties. A certificate of service shall be attached to the filed exceptions.

Exceptions and reply exceptions shall obey 52 Pa. Code 5.533 and 5.535, particularly the 40-page limit for exceptions and the 25-page limit for replies to exceptions. Exceptions should be clearly labeled as "EXCEPTIONS OF (name of party) - (protestant, complainant, staff, etc.)".

Any reference to specific sections of the Administrative Law Judge's Recommended Decision shall include the page number(s) of the cited section of the decision.

Parties are also requested to provide the Commission's Office of Special Assistants with a copy of exceptions/reply exceptions on a computer disk, 3 1/2" in size, in Microsoft Word 6.0 format. If Word 6.0 is not available, either Wordperfect 5.1 or ASCII format is acceptable.

Very truly yours,

 James J. McNulty
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission

v.

Philadelphia Gas Works

Docket Number

R-00006042

R-00006042C0001 et al

C-00014826-C00014828

C-00014843

C-00014910

C-00015037

C-00015044-C-00015048

C-00015050

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AUG 10 2001

RECOMMENDED DECISION

Before
CYNTHIA WILLIAMS FORDHAM
Administrative Law Judge

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I. HISTORY OF THE PROCEEDING

On January 5, 2001, Philadelphia Gas Works ("PGW" or "Respondent") filed Supplement No. 7 to Tariff Gas – Pa. P.U.C. No. 1 to become effective March 6, 2001. In said tariff, PGW proposed changes in rules, regulations and rates calculated to produce \$65,000,000 in additional annual revenues. PGW also filed the testimony of six (6) witnesses.

In addition, PGW filed a petition for waiver of potentially applicable notification and filing requirements and establishment of expedited hearing schedule for base rate proceeding.

Comments to PGW's Petition were filed by the Office of Consumer Advocate ("OCA"), Office of Trial Staff ("OTS"), Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") and the Consumers Education and Protective Association, the Association of Community Organizations for Reform Now, Action Alliance of Senior Citizens of Greater Philadelphia and Tenants' Action Group (collectively "CEPA et al").

PGW filed the revised testimony of its witnesses on February 2, 2001.

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

by hearings and for issuance of a Recommended Decision. The petition for waiver of potentially applicable notification and filing requirements and establishment of expedited hearing schedule for base rate proceedings was granted in part and denied in part. PGW's request for waiver of 52 Pa. Code §53.45(a), which requires that a utility file with the Commission written notice 30 days prior to the filing, was granted. PGW's request to provide notice to customers under the alternative method set forth in 52 Pa. Code §53.45(b)(4) was granted. PGW's request for waiver from providing the information required at 52 Pa. Code §§53.52 and 53.53 was denied.

In accordance with the Commission's order, the matter was assigned to Administrative Law Judge Cynthia Williams Fordham. Johnnie E. Simms, Esquire and Charles F. Hoffman, Esquire, entered a notice of appearance on behalf of the Commission's Office of Trial Staff ("OTS"). The Office of Consumer Advocate ("OCA"), through its counsel, filed a complaint which was docketed at R-00006042C0023. The Consumers Education and Protective Association ("CEPA"), the Association of Community Organizations for Reform Now ("ACORN"), the Action Alliance of Senior Citizens of Greater Philadelphia and the Tenant's Action Group ("TAG") (collectively "CEPA et al"), through their counsel, filed a complaint which was docketed at R-00006042C0027. The Philadelphia Industrial and Commercial Gas Users Group ("PICGUG"), through its counsel, filed a complaint which was docketed at R-00006042C0060. The Office of Small Business Advocate ("OSBA"), through its counsel, filed a complaint which was docketed at R-00006042C0070. Numerous individuals also filed complaints.

Furthermore, on February 8, 2001, the PUC's Law Bureau and the City of Philadelphia filed a Joint Petition for Full Settlement of Philadelphia Gas Works' Petition for the Establishment of Interim Rates and Related Appeal ("Joint Petition") to settle PGW's challenges to the Commission's Order entered November 22, 2000. This was the Order in the interim base rate case filed by PGW on August 8, 2000. PGW asked for an

immediate \$52 million base rate increase. This request was designed to provide the Company with increased revenues until it was able to make its permanent base rate filing in early 2001. Concurrently, PGW filed a request to increase its gas cost rate ("GCR") by \$97 million. The GCR case was litigated on the same expedited schedule as the interim rate case. During the GCR proceeding, the Company presented updated gas costs that increased its requested GCR increase to \$172 million. After analysis of all the positions presented, the Commission awarded PGW an interim rate increase of \$11 million. Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005654 (Order entered November 22, 2000). In addition, the Commission entered an order in the GCR proceeding which authorized an increase in the Company's GCR of \$97 million, the amount requested by the Company in its original filing. Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005619 (Order entered November 22, 2000). On December 29, 2000, the Company filed a quarterly update that increased its GCR, effective January 1, 2001, by \$133 million, in addition to the \$97 million already approved in the Commission's November 22, 2000, GCR Order. Subsequently, the Company filed a Petition for approval to file updates to its GCR on February 1 and March 1, 2001. In an Order entered January 24, 2001, the Commission authorized PGW to provide monthly updates to its GCR in February and March of 2001. Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005619 (Order entered January 24, 2001). The Company has not filed any updates to increase its GCR since the January 1, 2001 increase.

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

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

A prehearing conference in the instant case was held on February 23, 2001.

In accordance with the schedule set forth during the prehearing conference, testimony was filed by the Philadelphia Gas Works ("PGW"), the Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA") and the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG").

On March 12, 2001, OCA filed a Motion to Dismiss Objections and Compel Answers to Interrogatory 31 of OCA SET II and Interrogatories 15, 23-26, 28-32, 34-37, 39-41, 45-46 and 51 of OCA SET III. PGW filed an Answer to the Motion to Compel on March 16, 2001. On March 20, 2001, CEPA et al filed a Letter Memorandum in support of OCA's Motion to Dismiss Objections and Compel Answers.

PGW filed a Motion in Limine on March 21, 2001.

On March 22, 2001, CEPA et al filed a Motion to Dismiss Objections and Compel Answers to Interrogatories CEPA-1 through 21, 23 through 30, 32 through 42 and CEPA-49 of CEPA et al's First Set of Interrogatories. On March 28, 2001, PGW filed an Answer to the Motion.

Two Public Input Hearings were held in this matter on March 28, 2001 and one Public Input Hearing was held in this matter on March 29, 2001 in Philadelphia.

On April 2, 2001, OCA, OTS, PICGUG and CEPA et al filed Answers to the Motion in Limine.

On April 6, 2001, PGW filed Reply to Answers to the Motion in Limine or, in the Alternative, Request for Leave to Respond and the Response to the Answers of PICGUG, CEPA et al, OTS and OCA.

On April 13, 2001, the presiding officer issued Order #3 denying PGW's Motion in Limine.

Order #4, granting OCA's Motion to Dismiss Objections and Compel Answers, was issued on April 17, 2001.

Order #5, granting in part CEPA et al's Motion to Dismiss Objections and Compel Answers, was issued on April 19, 2001.

By Secretarial letter, dated April 24, 2001, the Commission appointed the Law Bureau to designate Special Administrative Counsel to enter an appearance in the rate proceeding and offer the Management Audit Report of the Barrington-Wellesley Group, Inc. into the evidentiary record in this rate proceeding.

On April 26, 2001, Stanley E. Brown, Esquire, entered his appearance as Administrative Counsel. On May 17, 2001, Mr. Brown filed Administrative Counsel Statement 1, the testimony of Perry L. Wheaton, the managing director of the Barrington-

Wellesley Group, Inc. (BWG). The Stratified Management and Operations Audit of Philadelphia Gas Works was marked Administrative Counsel Attachment 1.

By Order #6, dated May 7, 2001, the presiding officer consolidated the following cases with R-00006042 and R-00006042C0001 through R-00006042C0171: Ida Holloway v. Philadelphia Gas Works, C-00014826; Regina M. Krohn v. Philadelphia Gas Works, C-00014827; Zina Hampton v. Philadelphia Gas Works, C-00014828; Mary and Salvatore Danese v. Philadelphia Gas Works, C-00014843; Fredrick Karcher v. Philadelphia Gas Works, C-00014910; Jessie Cardine Hairston v. Philadelphia Gas Works, C-00015037; Cora M. Turpin v. Philadelphia Gas Works, C-00015044; Stella Miller v. Philadelphia Gas Works, C-00015045; Mrs. Frank Boettcher v. Philadelphia Gas Works, C-00015046; Themiah Waters v. Philadelphia Gas Works, C-00015047; Walter Stukowski v. Philadelphia Gas Works, C-00015048; Lester Hebert v. Philadelphia Gas Works, C-00015050; and Florence Preisano v. Philadelphia Gas Works, C-00015098.

Evidentiary hearings were held on May 22, 23 and 24, 2001 in Philadelphia. The following statements and exhibits were entered into evidence: PGW Statements 1.0, 1.1 and 1.2 (Thomas E. Knudsen's direct, redirect and rebuttal testimony) and Exhibits TEK-1 through TEK-6, TEK-Rejoinder 1; PGW Statements 2.0 and 2.1 (Barbara C. Bisgaier's direct and redirect testimony), and Exhibits BB-1 and BB-2; PGW Statements 3.0 and 3.1 (Joseph Bogdonovage's direct and redirect testimony) and Exhibits JRB-1 through JRB-3, Exhibit JRB-Rejoinder 1 and 2 and Volume II-Supporting Financial Information; PGW Statements 4.0 and 4.1 (Craig White's direct and redirect testimony) and Exhibits CW-1, CW-2, CW-R-1, CW Rejoinder 1 and 2; PGW Statements 5.0 and 5.1 (Howard Gorman's direct and redirect testimony) and Exhibits HSG-1, HSG-2 and Volume III-Cost of Service Study; PGW Statement 6.0 (Jay P. Lukens' direct testimony) and Exhibits JPL-1 through JPL-11; PGW Statement 7.0 (Janice Davis' rebuttal testimony); PGW Statement 8.0 (Thomas J. Sullivan's rebuttal

testimony) and Exhibits TJS-1 and 2; Exhibit CE-2 (Richard LeLash's cross-examination exhibit); OTS Statements 1 and 1SR (Charles T. Weakley's direct and surrebuttal testimony) and OTS Exhibit No. 1; OTS Statements 2 and 2SR (Joseph Kubas' direct and surrebuttal testimony) and OTS Exhibit 2; OTS Statements 3 and 3SR (Paul J. Metro's direct and surrebuttal testimony) and OTS Exhibit 3; OTS Statements 4 and 4SR (David F. Keim's direct and surrebuttal testimony) and OTS Exhibit 4; OTS Statement 5 (Kevan Deardorff's direct testimony) and OTS Exhibit 5; OCA Statements 1 and 2SR (Richard LeLash's direct and surrebuttal testimony) and OCA Exhibit 1; OCA Statements 2, 2R and 2S (Ralph Miller's direct, rebuttal and surrebuttal testimony) and OCA Exhibits 2A through 2C; PICGUG Statements 1 and 1-S (Richard A. Baudino's direct and surrebuttal testimony); OSBA Statements 1, 2 and 3 (Brian Kalcic's direct, rebuttal and surrebuttal testimony) and Schedules BK-1 to BK-5; Administrative Counsel Statement 1, (Perry Wheaton's direct testimony), Administrative Counsel Exhibit 1 and Attachment 1-Management and Operations Audit; and CEPA et al Exhibit CE-1.

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

PGW, OTS, OCA, OSBA, PICGUG and CEPA et al filed main briefs on June 21, 2001. PGW, OTS, OCA, OSBA, PICGUG and CEPA et al filed reply briefs on June 29, 2001.

The record consists of 890 pages of transcribed testimony, the statements and exhibits listed above, six main briefs, and six reply briefs.

II. FINDINGS OF FACT

1. The Philadelphia Gas Works ("PGW") is the public utility seeking a base rate increase. Its principal place of business is at 800 West Montgomery Avenue, Philadelphia, PA 19122.
2. PGW is a group of real and personal assets owned by the City of Philadelphia ("City") and used for the acquisition, storage, processing and distribution of natural gas within the City. PGW Ex. TEK-2; Administrative Counsel Attachment 1, VIII-1.
3. The Philadelphia Facilities Management Corporation ("PFMC") is a non-profit corporation organized by the City for the specific purpose of operating PGW. The Mayor of Philadelphia appoints the Board of PFMC pursuant to an agreement between the City and PFMC for the management and operation of the Philadelphia Gas Works dated December 29, 1972 ("Management Agreement"). PGW Ex. TEK-2; Administrative Counsel Attachment 1 (Management Audit), VIII-1.
4. The Management Agreement was incorporated into and approved by an Ordinance of the Philadelphia City Council on December 29, 1972 ("No. 455 of 1972"). Pursuant to the Management Agreement, PFMC is responsible for all operations of PGW. PGW Ex. TEK-2, Section I.
5. Prior to the passage of the Natural Gas Choice and Competition Act ("Act"), PGW's rates, terms and conditions of service were exempt from the jurisdiction, regulation and control of the Pennsylvania Public Utility Commission. Prior to July 1, 2000, PGW was regulated by the Philadelphia Gas Commission ("PGC"), a local agency

of the City provided for by the Philadelphia Home Rule Charter. Management Agreement-TEK Ex. 2, Section VI; Administrative Counsel Attachment 1, VIII-1.

6. The Philadelphia Gas Commission is comprised of two members appointed by the Mayor, two members appointed by Philadelphia City Council and the City Controller. Management Agreement TEK Ex. 2 Section VI; Administrative Counsel Ex. 1, p.15; Administrative Counsel Attachment 1, VIII-1.

7. The Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") is an *ad hoc* association of energy intensive industrial and commercial customers receiving service from PGW under various rate schedules. PICGUG Main Brief, p. 1.

8. PGW is the only PUC regulated municipal natural gas utility in the Commonwealth of Pennsylvania. PGW Ex. TEK-1, p. 17.

9. One third of PGW's customers live at or below 150% of the federal poverty level. Tr. 654.

10. PGW's residential customers represent an unusually high percentage of its total customers.

11. PGW's last base rate increase was in 1991. PGW Ex. TEK-1, p. 15; OCA St. 1, p. 22.

12. PGW utilized its 2000-2001 ("FY 2001") budget as the basis for establishing its revenue requirement. PGW St. 3.0 (Bogdonavage) p. 2.

13. In January 2001, PGW updated its initial budget, which was originally prepared in June 2000, to reflect more recent projections available when PGW made its base rate filing with the Commission. PGW's adjustments also normalized its projected budget information to make it representative of ongoing conditions and the conditions PGW is likely to experience during the period of time in which the rates would be in effect. PGW St. 1.0 (Knudsen), pp. 8-11; PGW St. 3.0, p. 4.

14. In this base rate case, the Company is requesting a \$45 million increase in its customer charge and a \$20 million increase in its volumetric rates. PGW St. 4.1, p. 7.

15. In this base rate case, the Company filed a future test year ending August 31, 2001.

16. On February 22, 2001, the Commission adopted a Settlement Agreement in Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005654 (Order entered November 22, 2000), which granted PGW a base rate increase of \$11 million. This increase reduced the Company's customer charge request from \$45 million to \$34 million and reduced the overall request to \$54 million. OTS St. 1, p. 3.

17. PGW's fiscal year is from September 1 to August 31. Tr. 577; Management Agreement-TEK Ex. 2, Section IV, 1 (a), p.9.

18. PGW's actual 1999-2000 recorded bad debt expense was \$54.6 million compared to PGW's original \$46 million projection. PGW St. 3.0, pp. 3, 10; PGW Ex. JRB-2, p. 1, Col. 1 (actual 1999-2000); Tr. 758.

19. PGW revised its projected accounts receivable balance and bad debt expense in the January 2001 base rate filing to \$186.6 million and \$65.3 million, respectively. PGW St. 3.0, p. 3.

20. PGW deferred \$11.5 million in natural gas purchases from FY 2001 to FY 2002 as part of the interim rate settlement. Tr. 585-86.

21. Approximately 40% of all of PGW's customers have arrearages and PGW's accounts receivable are over \$200 million. PGW St. 3.1, p. 10.

22. PGW's debt service includes 1975 bonds and 1998 bonds. Management Audit X-10.

23. Over the past eight years, debt coverage was never higher than 1.67 times and sometimes it approached the bond covenant minimum of 1.50 times. OCA St. 1, p. 22.

24. PGW's revenues and bad debt write off for the following years were: in 1998 revenues were \$486 million and the bad debt write-off was \$46.5 million which was 9.6% of revenues; and in 1999 revenues were \$463 million and the bad debt write-off was \$36.7 million which was 7.7% of revenues. Management Audit VIII-20 (Ex. VIII-11).

25. OTS' 7.6% bad debt ratio applied to the 1999-2000 gas revenues yielded a bad debt expense of \$42 million, or over \$12 million less than what PGW actually booked. Tr. 758.

26. PGW's 1999-2000 actual bad debt amounted to 10.2% of total gas revenues. Tr. 758.

27. In this case, PGW is claiming an average usage of 100.94 Mcf per residential heating customer and 445.21 Mcf per commercial heating customer. PGW Ex. HSG-1, Schedule 4A, p. 1.

28. PGW experienced billing discrepancies when its Billing, Collections and Customer Service System (BCCS) was implemented in 1999. PGW St. 1, pp. 25-27; Administrative Counsel Attachment 1.

29. In this proceeding, PGW projected that it has 412,910 residential heating customers and 19,061 commercial heating customers. PGW Ex. HSG-1, Schedule 4-1, p. 1.

30. The projected number of customers in the residential heating and commercial heating classes for the last four months of the year 2000 does not match the actual number of customers in these classes for the last four months of 2000. OTS St. 2, p. 16.

31. When the number of actual residential heating customers for each month in the year 2000 is added and the total is divided by 12 months, the average number of residential customers in the year 2000 was 424,099. OTS Ex. 2, Schedule 3, p. 1, Column B.

32. The 424,099 residential heating customers represent 11,189 more customers than PGW claimed in its proof of revenue schedules. PGW Volume III, Ex. HSG-1, p. 1; OTS Ex. 2, Schedule 3, p. 3, line 3.

33. When the 11,189 additional residential heating customers are recognized, the proposed increase in revenues is \$27,114,000. OTS Ex. 2, Schedule 3, p. 4, Column C, line 21.

34. When the number of actual commercial heating customers for each month in the year 2000 is added and the total is divided by 12 months, the average number of residential customers in the year 2000 was 19,061. OTS Ex. 2, Schedule 4, p. 3, Column C.

35. The 19,061 commercial heating customers represent 51 more customers than PGW claimed in its proof of revenue schedules. PGW Volume III, Ex. HSG-1, Schedule 4A, p. 1; OTS Ex. 2, Schedule 4, p. 3, Column C, line 3.

36. When the 51 additional residential heating customers are recognized, the proposed increase in revenues is \$7,149,000. OTS Ex. 2, Schedule 4, p. 4, Column C, line 21.

37. After comparing the actual records for February 2001, PGW concluded that residential customers should be increased by 9,7049 customers and the number of commercial customers should be increased by 700 customers. PGW St. 4.1, pp. 6,7.

38. PGW makes an annual \$18 million payment to the City of Philadelphia pursuant to the Management Agreement. PGW St. 1.0, PGW St. 7, pp.3-5; (Davis); PGW St. Management Agreement Section VII 1. (b) (i)

39. PGW installed 70,000 automatic meter readers during FY 1999 and 2000. Management Audit VIII-17.

40. Prior to the March 1, 2001 interim rate increase, the customer charges for the following classes were as follows: Residential - \$8; Commercial - \$10; Industrial - \$20; Municipal GS - \$10; Municipal MS - \$0; PHA-GS - \$8 and PHA-PHA - \$0. PGW St. 5.0 (Gorman), p. 5; PGW Ex. HSG-1. Schedule 2.

41. With the March 1, 2001 interim rate increase, the customer charges for the following classes are as follows: Residential - \$11.66; Commercial - \$14.57; Industrial - \$29.14; Municipal GS - \$14.57; Municipal MS - \$0; PHA-GS - \$11.66 and PHA-PHA - \$0.

42. The average residential customer charge is \$10.35 a month, the average commercial customer charge is \$16.79 a month and the average industrial customer charge is \$59.50 a month for the seven largest natural gas utilities in Pennsylvania. OTS Ex. 2, Schedule 5.

43. The bill of the company's firm rate customers contains volumetric charges including a commodity charge or base rate charge and a gas rate cost. The gas rate cost includes the following non-fuel costs: the natural gas and purchased electric expenses and non-fuel costs associated with the Company's Customer Responsibility program (CRP), the Conservation Works Program and the Senior Citizen Discount Program. PGW St. 4.0 (White), p. 8.

44. The purchased electric costs represent the electrical usage for the Company's plants and buildings. OTS St. No. 3, p. 33.

45. The Senior Citizen Assistance Program is a twenty percent (20%) discount program that is provided to customers 65 years old or older. Income or need is not a basis for the assistance. Management Agreement-Section VII 7; TEK Ex.2, p. 21; OTS St. 4, p. 5; Management Audit VIII-34 & VIII-35.

46. The costs for the Senior Citizen Assistance Program are non-natural gas costs that are recovered through PGW's GCR mechanism. OTS St. 4, p. 8.

47. The PGC adopted the Customer Responsibility Program ("CRP"), on November 9, 1993 with an effective date of February 7, 1994. CRP is PGW's low-income payment arrangement program. A customer is eligible if the gross household income is at or below 150 percent of the federal poverty level. PGW tariff § 4.50.1 et seq.; OTS St. 4, p. 2; Management Audit VIII-27.

48. In 2001, there were 53,000 customers in CRP. Management Audit VIII-32.

49. The costs for the Customer Responsibility Program are non-natural gas costs that are recovered through PGW's GCR mechanism. OTS St. 4, p. 3.

50. Through the Conservation Works Program PGW provides free weatherization, conservation and education services to the CRP customers. OTS St. 4, p. 5; Management Audit VIII-20.

51. The costs for the Conservation Works Program are non-natural gas costs that are recovered through PGW's GCR mechanism. OTS St. 4, p. 5.

52. By recovering these social costs in the GCR, the Company is assured a dollar for dollar recovery of the non-gas costs. PGW St. 4.1, p. 11.

53. The prevailing rolled-in factor for gas of \$3.18 per Mcf is currently recovered in base rates. OCA St. 1, p. 11

54. Of the \$3.18/Mcf of gas costs recovered in base rates, \$0.0162/Mcf is attributable to purchased electricity costs. These electric costs are usually included in base rates. The remaining \$3.1638 is normally recovered through the GCR. OCA St. 2, p. 19.

55. PGW has 8 District offices in various sections of Philadelphia. PGW St. 1.2, p. 3; Management Audit VIII-22, 23, Ex. VIII-13.

56. Using promotional expenditures, PGW has attracted 21 new customers with a total annual usage of 388,000 Mcf. PGW's incentive payments totaled \$558,103 for these 21 new customers, while those payments have produced an annual or recurring margin estimated at \$511,000. Tr. 568-69, 571; PGW St. 4.1, p. 15.

57. PGW has spent a total of \$558,103 on promotional activities since the inception of the program. PGW St. 4.1, p. 15.

58. PGW does not have the ability to compete against alternate fuel sources by flexing their rates. Tr. 567.

59. In March 2000, Kumar Kirshinchand was appointed interim president and CEO and Thomas Knudsen was appointed interim Chief Financial Officer (CFO). PGW St. 1, p.1; Administrative Counsel Attachment X-1. Tr. 781.

60. PGW's current management team also includes Joseph Bogdonavage, Senior Vice President for Finance, and Craig White, Senior Vice President for Gas Supply and Marketing. PGW St. 1.0 (Knudsen) pp. i, 4.

61. Barbara C. Bisgaier is the managing director of Public Financial Management. She is a financial advisor for the City of Philadelphia for all debt issued by

the City and by its authorities and enterprises, including PGW. PGW Statement 2, pp. 1, 2.

62. The Transition to Excellence program is a program that PGW implemented to improve its operation and its financial condition. PGW St. 1, p. 5; PGW Ex. TEK-3-Implementation Plan.

63. By March 2001, the Company had replaced or abandoned 6.2 miles of cast iron mains which equals about 1/3 of the 18.0 miles need to achieve a 1% replacement rate. OCA St. 1, p. 52.

64. Pursuant to a Commission Order, the Barrington-Wellesley Group, Inc. (BWG) prepared a Stratified Management and Operations Audit of the Philadelphia Gas Works for the Commission. The audit was performed between May and October 2000. The written audit was dated January 2001. Administrative Counsel Attachment 1.

65. On or about March 22, 2001, the Company submitted a formal response to the Audit Report in the form of its Plan for Implementation of the Recommendations in the Stratified Management and Operations Audit ("the Implementation Plan"). PGW Ex. TEK-3.

66. In the Implementation Plan, the Company accepted approximately 73 of 76 recommendations. PGW Ex. TEK-3.

67. PGW filed an interim base rate request on August 8, 2000, asking for an immediate \$52 million base rate increase. This request was designed to provide the Company with increased revenues until it was able to make its permanent base rate filing in early 2001. PGW St. 1, p. 6.

68. On August 8, 2000, PGW also filed a request for an increase in its gas cost rate ("GCR") of \$97 million. PGW St. 1, p. 6.

69. After analyzing the positions presented, the Commission awarded PGW an interim rate increase of \$11 million in Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005654 (Order entered November 22, 2000). The Commission also allowed implementation of the \$97 million GCR increase in Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005619 (Order entered November 22, 2000). OCA St. 1, p. 20; PGW St. 1, pp. 6, 7.

70. Since PGW deemed the \$11 million interim base rate award inadequate, PGW challenged the Commission's decision in the Commonwealth Court of Pennsylvania. The Commission's Law Bureau and PGW settled the appeal allowing the \$11 million base rate increase to be implemented, as well as allowing recovery of \$7 million of bad debt expense through the GCR. Both of these increases were compressed so that the full \$18 million annual amount of the increase would be recovered by the end of PGW's current fiscal year on August 31, 2001. PGW St. 1, pp. 6, 7.

71. On December 29, 2000, the Company filed a quarterly update that increased its GCR, effective January 1, 2001, by \$133 million, in addition to the \$97 million already approved in the Commission's November 22 GCR Order. This brought the total increase in anticipated gas costs for the fiscal year to \$230 million. PGW St. 1, Knudsen, pp. 9, 10.

72. The Company filed a Petition for approval to file updates to its GCR on February 1 and March 1, 2001. In an Order entered January 24, 2001, the Commission authorized PGW to do monthly updates to its GCR in February and March of 2001. Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-00005619 (Order entered

January 24, 2001). The Company has not filed any updates to increase its GCR since the January 1, 2001 increase.

73. PGW did not make a quarterly filing in March 2001 or June 2001 seeking the recovery of an \$11.5 million projected under recovery at the current GCR and is maintaining the current effective rate of \$6.6959/Mcf. OTS Main Brief, p. 9.

74. PGW's Cost Of Service Study (COSS) was completed in December 2000 by R.J. Rudden Associates. PGW St. 5.0 Revised, p. 1, PGW Volume III.

75. PGW's residential customer classes are currently being subsidized by the commercial and industrial customer classes. PICGUG St. 1, p. 9; OSBA St. 1, p. 4; OTS St. 3, p. 11.

76. On June 12, 2001, PGW's commercial paper program was renewed for one year at a level of \$100 million with the condition that PGW must reduce its outstanding commercial paper to \$80 million by the end of FY 2002. This Credit Agreement is between the City of Philadelphia and First Union Bank, PNC Bank, The Bank of Nova Scotia, Mellon Bank and Morgan Guaranty Trust Company of New York. PGW St. 2.2; PGW Ex. BB-3.

77. PGW has eight (8) of transportation customers. Tr. 703.

78. PGW's transportation customers are responsible for purchasing their own natural gas, arranging for the transportation of that natural gas to PGW's city gate, and interacting with the interstate pipeline supplier for this natural gas. Tr. 706-07.

79. PGW's transportation requirements fail to provide any provisions that would allow a customer to aggregate facilities served by multiple accounts and account numbers. PICGUG St. No. 1, p. 16.

80. PGW fails to provide transportation customers with the necessary information regarding balancing and nominations. PICGUG St. No. 1, pp. 19-21.

81. PGW enforces stringent penalties for out-of-balance customers. PICGUG St. No. 1, pp. 19-21.

82. Other natural gas distribution companies ("NGDCs") in Pennsylvania provide balancing and nomination information to transportation customers twenty-four hours a day, seven days a week. PICGUG St. No. 1, pp. 19-21; PICGUG Exhibit 2.

83. PGW fails to provide timely lost and unaccounted for gas information to transportation customers. PICGUG St. No. 1, p. 19.

84. PGW's transportation customers are impacted by PGW's failure to provide lost and unaccounted for gas information. PICGUG St. No. 1, p. 19.

85. PGW's restructuring proceeding will require the Company to unbundle all of its rates in order to implement transportation among all customer classes. OSBA St. No. 1, p. 5.

86. PGW's Cost of Service Study classifies 25% of the Company's investment in distribution mains as customer-related, with the remaining 75% of the investment classified as demand-related. PICGUG St. No. 1S, p. 2; PGW St. No. 5.0, p. 18, PGW St. No. 5.1, pp. 2-3.

III. DISCUSSION

A. **Legal Standards: The Public Utility Code Requirements re: Ratemaking Methodology**

I. Section 2212(c)-Prior Ratemaking Methodology-Cash Flow Method

The Natural Gas Choice Act brought PGW under the jurisdiction of the Commission and provides that PGW is, with certain exceptions, "subject to regulation and control by the commission with the same force as if the service were rendered by a public utility." 66 Pa.C.S. §2212(b). It is undisputed that pursuant to Section 2212(e) of the Act, the Commission is charged with establishing overall rates and charges for PGW. 66 Pa.C.S. §2212(e). Section 2212(e), provides in pertinent part:

Notwithstanding any provision of this title to the contrary, in determining the city natural gas operation's revenue requirement and approving overall rates and charges, the commission shall follow the same ratemaking methodology and requirements that were applicable to the city natural gas distribution operation prior to the assumption of jurisdiction by the commission, and such obligation shall continue until the date on which all approved bonds have been retired, redeemed, advance refunded or otherwise defeased.

66 Pa.C.S. §2212(e).

The parties differ on their interpretation of this section. PGW submitted a Motion in Limine concerning the proper ratemaking methodology. PGW continues to interpret this section to mean the Commission must fund the budget approved by the PGC.

In the answers to the Motion in Limine and the briefs, the other parties disagreed with PGW's position. OTS stated that the concept "prior ratemaking method" only distinguishes between the ratemaking concepts of PGW's "cash flow method" and the Commission's traditional investor-owned "rate base/rate of return" method. OTS submits that section 2212(e) only requires the Commission to follow PGW's prior ratemaking method of using the "cash flow method" in setting rates. It does not mean that all of the Company's expenses must be covered by rates. OTS Reply Brief pp. 9, 10

OCA stated that throughout this proceeding, PGW has argued that this section of the Act requires that PGW's Management Agreement with the Philadelphia Facilities Management Committee (PFMC) control all aspects of PGW's request, leaving the Commission with little or no discretion. The Company argues that under the Act, the Management Agreement commits the Commission to setting rates to meet all of PGW's identified needs, without the application of any ratemaking principles or law. The Company asserts that the Commission must simply accept any determination of the PGC, which approves PGW's budgets under the Management Agreement, and implement rates to achieve the budget approved by the PGC, without regard to whether the rates are just and reasonable. Under PGW's logic, if the PGC approves a budget, the Commission can do nothing more than approve rates to recover this approved budgeted amount. The OCA submits that PGW's interpretation of the Act is untenable and renders the Act meaningless. OCA M.B., p. 13.

OTS, OCA, CEPA et. al, and PICGUG content that if the Commission's only function is to "rubber stamp" a budget approved by the Philadelphia Gas Commission, there was simply no point in bringing PGW under Commission jurisdiction to be "subject to regulation and control by the commission with the same force as if the service were rendered by a public utility." 66 Pa C.S. §2212(b). Such an interpretation of the Act provides little or no protection to the ratepayers of Philadelphia and could not

be what was intended by the General Assembly in bringing the operations of PGW under the Commission's jurisdiction. OCA M.B., p. 14.

The recently issued Recommended Decision of the Hearing Examiner in PGW's still-pending FY2001 Operating Budget proceeding before the PGC explained the flaw in PGW's interpretation:

PGW asserts that Section IV. of the Management Agreement (regarding operating budget approvals) must be read in conjunction with the Section VII. requirements (regarding rate-setting), but as PGW concedes, "[i]nterpretation of the Management Agreement must also be reconciled with the Gas Choice Act" (citations omitted). From this, PGW concludes that "[p]erforce...this Commission must assure that the budget incorporates sufficient revenues to pay operating and maintenance expenses and costs associated with the programs and policies approved by this Commission...; the City payment; and a reasonable allowance for cash working capital" (citations omitted).

PGW's interpretation of how the Gas Commission's remaining duties under the Management Agreement are to be reconciled with the Gas Choice Act is incorrect. While the Commission retains the obligation to adopt reasonable budgets which project sufficient revenues to cover reasonable operating expenses, as already discussed, the Commission cannot assure that "sufficient revenues" are provided via PGW's rates because it no longer has authority over the legal determination of PGW's revenue requirement, which is now with the PUC's purview (See 66 Pa.C.S. §2212(e)). In addition, there is no specific formula for the determination of PGW's year-end cash balance set forth in the provision for PGW's rates and other project revenues to provide a reasonable and necessary amount of cash or equivalent working capital. Under the Management Agreement, this determination is left to be a matter of judgment, which is to be exercised in the overall exercise of [the Commission's former] rate-setting authority.

PGC Hearing Examiner Recommended Decision, FY2001 Operating Budget and Outyear Forecasts ("PGC R.D.") at 18-20 (May 17, 2001).¹

The Hearing Examiner decided that for budgeting purposes, the PGC should conclude that the authorized rates from the Public Utility Commission which are in effect for FY2001 should be used in establishing a budget for PGW. PGC R.D. pp. 21-22; OCA M.B., p. 15.

The OCA submits that, similar to the conclusion of the PGC Hearing Examiner, a more appropriate reading of the Act is one that gives meaning to all provisions of the Act and the Public Utility Code. 1 Pa. C.S. §1922. OCA argues that the Commission must harmonize and reconcile the Public Utility Code with the ratemaking methodologies in place for PGW. OCA, CEPA et al, OTS and PICGUG contend that the fundamental principle of the Public Utility Code, which is also the fundamental principle applicable to PGW's ratemaking methodology, is that rates must be just and reasonable. 66 Pa. C.S. §1301; Public Advocate v. Philadelphia Gas Commission, 544 Pa. 129, 674 A.2d 1056 (1996). As the Supreme Court made clear in Public Advocate, the rates of PGW must be just and reasonable. Id. In Public Advocate, the Court stated that: "[w]hen examining the 1991-92 rates for PGW, this Court is mindful that no applicable constitutional requirement is more exacting than the requirement of 'just and reasonable' rates." Id. at 1061. The Pennsylvania Supreme Court held the following:

We hold today that the United States Supreme Court guidelines for determining the constitutionality of a rate are

¹ A copy of the Philadelphia Gas Commission Hearing Examiner's Recommended Decision in PGW's FY2001 Operating Budget and Outyear Forecast proceeding is attached hereto and marked "Appendix A."

also applicable to examining rate disputes involving municipal utilities.

674 A.2d at 1062.

See also, Action Alliance v. Philadelphia Gas Commission, 406 A.2d 1155, 1158 (Pa. Commonwealth Ct. 1979) and American Aniline Products, Inc. v. Lock Haven, 288 Pa. 420, 424, 135 A.2d 726, 727 (1927). OCA M.B., pp. 15, 16.

The other parties dismiss PGW's argument that the Commission can only mechanically apply the Management Agreement and "rubber stamp" the findings of the PGC. The Commission cannot simply be required to add up all of the dollars that PGW chooses to spend and pass them on to ratepayers. The Commission must have the authority and discretion to consider the Company's claim and to apply fundamental principles of ratemaking and regulation to any claim of PGW. OCA M.B., p. 16; CEPA etal R.B., p. 3; PICGUG R.B., pp. 3-5.

As OCA witness LeLash testified, PGW has three sources of revenues and capital. It can derive revenue and capital through rates, from debt financing, and through the provision of common equity, *i.e.*, the provision of cash from its owner, the City.² OCA St. 1-S, p. 13. In this proceeding, the Company has argued that a "cash flow method" of ratemaking must be employed under the Act to set the rates and charges of PGW. PGW has interpreted this cash flow method of ratemaking to require that rates be set to meet all of its expenses as identified in the Management Agreement, including

² Mr. LeLash is an independent financial and regulatory consultant. He has testified on cost of service, rate of return, and regulatory policy issues in numerous regulatory proceedings before the Philadelphia Gas Commission, the Federal Energy Regulatory Commission, the Pennsylvania Public Utility Commission and the commissions in other states. Mr. LeLash has also participated and provided testimony on behalf of the Philadelphia Public Advocate in all of PGW's Gas Cost Rate (GCR) proceedings and in other related matters since 1990.

provisions for the Company's cash working capital needs as well as other capital requirements. In other words, under the Company's application of this method, the Company would not derive any revenue or capital from its owner, the City, but would derive all revenue from ratepayers. Under this position, if the Company's short term line of credit or debt financing failed, ratepayers would be required to provide this cash as well.

The OCA disagrees with PGW's definition of the cash flow method. OCA argues that the Company's definition of the cash flow method fails to recognize that the owner of PGW, the City, as well as the ratepayers are responsible for maintaining the utility's operations. OCA St. 1, p.18. Instead, the Company's application of this methodology shifts all burdens to ratepayers, whether or not that is just and reasonable. Mr. LeLash testified:

From the Company's perspective, given its definition of the cash flow method of rate setting, the capital shortfall would be recoverable from ratepayers. However, even PGW must realize that its ratepayers' ability to pay higher and higher rates has been limited because of the GCR increases. Such limits in the ratepayers' ability to pay are amply illustrated by the Company's currently requested rate increase which is justified, for the most part, by its growing bad debt expense.

As should be apparent, even if ratepayers had the responsibility to provide capital for PGW's operations, which I believe they do not, they lack the ability to provide a never ending source of capital.

OCA St. 1, p. 15.

Mr. LeLash explained that, under traditional ratemaking, ratepayers pay only the cost of capital, including working capital, and do not provide the capital itself.

OCA St. 1, p. 13. PGW interprets the cash flow method to require ratepayers to provide the capital itself. OCA M.B., p. 21.

OCA contends that the cash flow method urged by the Company would have this Commission set rates to ensure the fulfillment of PGW's bond covenants, underwrite a dividend payment to the City, and relieve the City of any responsibility to ensure the adequate financing of the operations. The method urged by the Company is to be employed without regard to any other ratemaking standards. OCA St. 1, pp. 26-27. Under the Company's definition, then, ratepayers are required to pay all operating expenses, the cash working capital, and other capital requirements, regardless of issues concerning prudence, service, or the reasonableness of the resultant rates. OCA St. 1, p. 18. The OCA submits that such an interpretation cannot produce rates that are just and reasonable.

In the Order Denying PGW's Motion in Limine, the presiding officer dismissed the idea that the Commission would set rates without exercising discretion or without making any adjustments for expenditures that were not found to be just or reasonable. Order #3, pp. 15-19, dated April 13, 2001.

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

PGW's position is that the Management Agreement and section 2212(f) of the Public Utility Code, 66 Pa. C. S. §2212(f), require it to make the annual \$18 million payment to the City of Philadelphia. PGW R.B. pp.13, 14. The City and PGW contend that the company's access to tax exempt bonds and its exemption from various federal, state and local taxes and fees justify the payment. PGW M.B. 4; PGW St. 7, p. 3. Additionally, PGW cites Public Advocate v. Philadelphia Gas Commission, 654 A. 2d 1156, 1159-60 (Pa. 1996) to support its position. In that case, the Pennsylvania Supreme Court held that the \$18 million payment to the City was just and reasonable.

CEPA et al and PICGUG contend that by systematically refusing to consider a waiver or grant back of the City payment, the City has failed to fully recognize and accept its ownership responsibilities and its accountability for PGW's present financial and operational circumstances. Under the circumstances, CEPA et al, OCA and PICGUG argue that the refusal to commit to an outright waiver or "grant back" of the \$18 million is unreasonable. For the Commission to order waiver of the \$18 million or grant back of that amount is not precluded under the law as applied to the circumstances of this case. The appropriateness of such a waiver or grant back is recognized even by those who have not actually recommended ordering such action. OCA St. 1.0, p. 26. For this reason, CEPA et al, OCA and PICGUG urge the Commission to deny any base rate increase pending commitment by the City to waive or grant back the \$18 million City payment. CEPA M.B., pp. 32-34; OCA M.B., pp. 22, 26; PICGUG M.B., pp. 24, 25.

PICGUG submits that, as owner of PGW, the City should shoulder the responsibility for the fiscal mismanagement that has taken place over several years and agree to waive or grant back the Company's annual \$18 million payment to the City. PICGUG M.B. pp. 24, 25; PICGUG R.B. p.8.

In the Management Audit, the auditors concluded that the \$18 million payment to the City is reasonable and commonplace for municipal utilities such as PGW. Administrative Counsel Attachment No. 1 at X-12.

This is a very controversial issue. Although the consumers at the public input hearing and several parties object to the \$18 million payment, the evidence in the record and the applicable case law demonstrate that the Company does receive benefits which exceed \$18 million due to its status as a municipal utility. Therefore, the requests for the Commission to require the City to waive the \$18 million payment should be rejected. However, the City still has the option to grant the \$18 million back to PGW.

Nevertheless, since the City has not agreed to exercise the option, the \$18 million grant should not be considered when calculating the amount PGW can use to pay its expenses.

3. Bond Covenants

PGW maintains that it has three bond covenants that it must meet:

- a) A covenant that requires PGW to maintain funds that are 150% of its annual debt service obligation;
- b) A covenant that requires PGW and its owner, the City of Philadelphia, to charge rates that permit PGW to have sufficient cash to pay all of its obligations, including its debt service obligations, during each fiscal year in full when they are due; and
- c) A covenant that requires PGW and the City to continuously maintain and operate the Gas Works.

PGW M.B., p. 17.

PGW insists that its various bond covenants require that ratepayers provide through rates all of PGW's financial requirements. Mr. Knudsen stated that "reasonable working capital" is in the City's view by definition the "amount that would allow PGW to have sufficient cash to pay its obligations when they would come due in a particular month (this is also a bond ordinance requirement), and to have sufficient cash at the end of the year to handle obligations in the first several months of the next Fiscal Year, before the next winter heating season started and PGW could again start to collect substantial revenues." PGW St. 1.1 p. 2. Ms. Bisgaier testified "A technical default would occur if PGW paid principal and interest [on its bonds] timely, but did not produce sufficient revenue from rates to cover all of its net operating expenses (which does not include its City payment) and provide the mandated 1.5x debt service coverage from revenues after paying operating and maintenance expenses." PGW St. 2.0, Ex. BB-1, p. 12.

However, OTS, OCA, PICGUG, and CEPA et al contend that neither PGW's Bond Ordinances, nor the First Class City Revenue Bond Act requires that "Project Revenues" be derived only from rates. The 1975 Bond Ordinance requires in pertinent part that the City will "impose, charge and collect in each Fiscal Year such gas rates and charges as shall, together with all other Project Revenues (as defined in the [First Class City Revenue Bond] Act)" cover "all Net Operating Expenses payable during such Fiscal Year." General Gas Revenue Bond Ordinance of 1975, § 4.03(b). The First Class City Revenue Bond Act defines project revenues to include, inter alia, "rates...imposed or charged" and "all subsidies or payments payable by Federal, State or local governments or governmental agencies" for operating costs and debt service" (Emphasis added). 53 P.S. §15902 ("Project Revenues"). The 1998 Bond Ordinance has similar requirements, at least to the extent that a "grant back" of the \$18 million City Payment would be involved. General Gas Revenue Bond Ordinance of 1975, §4.03(b). PICGUG R.B., p. 8; OTS M.B., p. 9; CEPA et al M.B., pp. 32, 33.

CEPA argues that Ms. Bisgaier recognizes that a grant back of the \$18 million would be permissible to meet the debt service ratio covenants contained in PGW's bonds. PGW St. 2.0, Ex. BB-1 p. 17. Moreover, CEPA et al noted that she recognized that payment of the \$18 million City payment is not a requirement of any bond covenant. PGW St. 2.0, Ex. BB-1 p. 16 ("I do not believe that a failure to pay the City would result in a violation of PGW's rate covenant because it is a contractual obligation rather than part of the rate covenant"). CEPA M.B., p. 33.

CEPA notes that in addition to the Section 4.03(b) covenants which have been discussed, both the 1975 and the 1998 Bond Ordinances contain a Section 4.03(d) which is the covenant that the City makes to "continuously maintain in good condition and continuously operate the Gas Works." CEPA argues that in agreeing to this covenant, the City accepts ultimate responsibility for operating the Gas Works, in those

situations where rates or short term borrowing is not available to fully fund the Gas Works enterprise. 1975 Bond Ordinance, §4.03(d); 1998 Bond Ordinance, §4.03(d); CEPA M.B., pp. 33, 34.

4. Burden of Proof

The OCA emphasized that PGW has the burden of proving the justness and reasonableness of every element of the Company's rate increase request. 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 proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

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

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

Lower Frederick Township v. Pa. P.U.C., 48 Pa. Commonwealth Ct., 222, 226-27, 409 A.2d 505, 507 (1980) (emphasis added). See also, Brockway Glass v. Pa. P.U.C., 63 Pa. Commonwealth Ct. 238, 437 A.2d 1067 (1981). The Pennsylvania Supreme Court also has clearly stated that the party with the burden of proof has a formidable task before its position can be adopted by the Commission. Even where a party has established a *prima facie* case, the litigant still must establish that "the elements of that cause of action are

proven with substantial evidence which enables the party asserting the cause of action to prevail, *precluding all reasonable inferences to the contrary.*" Burleson v. Pa. PUC, 501 Pa. 433, 436; 461 A.2d 1234, 1236 (1983) (emphasis added).

With specific reference to base rate proceedings, it is well settled at the Commission and in the Courts that this burden does not shift to intervenors challenging a requested rate increase. The utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one. In contrast, there is no similar burden placed on an intervenor to justify a proposed adjustment to the company's filing. See, e.g., Berner v. Pa. P.U.C., 382 Pa. 622, 116 A.2d 738 (1955). In Berner, the Pennsylvania Supreme Court stated:

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

Berner, 382 Pa. at 631, 116 A.2d at 744.

This standard has been recognized by the Commission in its rate determinations:

[t]he Respondent, Equitable has the burden of persuasion in the issue of the reasonableness of an expense level. *Respondent must affirmatively establish, on the record, that the test-year claim is a reasonable and appropriate amount.*

Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C. 423, 471 (1983) (emphasis added). See also, University of Pennsylvania v. Pa. P.U.C., 86 Pa. Commonwealth Ct. 410, 485 A.2d 1217 (1984).

The OCA submits that it remains incumbent upon the Company to affirmatively demonstrate the reasonableness of every element of its claim and to demonstrate that its rates are just and reasonable.

OCA, OTS, PICGUG and CEPA et al contend that the Company failed to satisfy the burden of proving that it is entitled to a rate increase of \$65 million. OCA R.B.; OTS M.B., p. 65, App. C; PICGUG R.B., pp. 3-8; CEPA et al M.B., p. 11.

5. Rates must be just and reasonable

Regardless of the method used, the rates must be just and reasonable. The requirements in § 2212(e) must be offset by the requirements in §1301 that the rates must be "just and reasonable." OCA M.B. pp.13-17; PICGUG R.B. p. 4.

In Order #3, dated April 13, 2001, the presiding officer stated that

A careful review of Action Alliance, supra, reveals that although the Commonwealth Court described the process of fixing rates for PGW as the cash flow method, the Court stated that "[t]he parties all agree that the rates for gas services in Philadelphia must be just and reasonable." 406 A.2d at 1156-1158. In addition, the Court stated that "without findings by the Philadelphia Gas Commission we do not know what evidence produced in the five days of hearings it believed reliable and without reasons for its adjudication we do not know why it concluded that the proposed rates were just and reasonable." 406 A.2d at 1158. The Court remanded the matter to the PGC for preparation of an adjudication explaining why the proposed rates were just and reasonable.

In Public Advocate v. Philadelphia Gas Commission, supra, the Pennsylvania Supreme Court referred to the constitutional requirement of "just and reasonable" rates set

forth in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607 (1944). The Court held "that the United Supreme Court guidelines for determining the constitutionality of a rate are also applicable to examining rate disputes involving municipal utilities." 674 A.2d at 1062.

Furthermore, the Commission's February 8, 2000 Order in this proceeding indicates that the lawfulness, justness and reasonableness of the rates will be investigated (Order, p. 11, Ordering ¶s 1, 3).

In Action Alliance, supra, a \$40,500,000 rate increase was requested and PGC approved a \$31,312,000 rate increase. 406 A.2d at 1157. Consequently, the PUC should not rubberstamp the proposed rate increase. It is noted that the rate increase is based on a budget that has been submitted to but not approved by the PGC. Therefore, the record must contain information to allow the PUC to determine whether the rates are just and reasonable.
Order #3, pp. 16, 17.

Accordingly, it clear that the rates must be just and reasonable.

6. There is no presumption that rates set pursuant to the Management Agreement/Cash Flow Method are just and reasonable.

PGW contends that rates established pursuant to the Management Agreement and the Cash Flow Method are presumed to be just and reasonable. PGW M.B. p. 16. The other parties correctly dismiss this proposition. PICGUG R.B. pp. 3-5. The cases, including Action Alliance, supra, clearly hold that there must be a determination that the rates are just and reasonable.

Furthermore, PGW submits the findings from the Black and Veatch Engineering Report as evidence that the Company needs at least \$53 million in rate relief. PGW M. B. pp. 35, 37-38. As a part of PGW's bond issuance obligations, the City of Philadelphia commissioned an Engineering Report to examine "the Company's finances

and operations from a broad perspective” and make “financial projections and assessments.” PGW M.B. p. 35. Black and Veatch, an independent engineering firm, performed the Engineering Report.

The other parties state that PGW’s reliance on the Black and Veatch report is misplaced because the Commission does not set rates based on engineering reports. The Commission must determine whether the resulting rate will be just and reasonable. OCA M.B. p.31; PICGUG R.B. p. 8. Since the engineering report did not consider the just and reasonable standard or balance the interests of the ratepayer against the Company’s financial needs, it cannot be used to prescribe the amount of rate relief required.

B. Revenue Requirement

1. Initial Budget

PGW developed its claimed revenue requirement by building from its original, FY 2001 operating budget. After the transfer of ratemaking jurisdiction to the Commission and the initial adjudication of PGW’s interim rate proceeding by the PUC (November 22, 2000), PGW filed its permanent base rate submission with the Commission. The Company maintained the same budget test year (FY 2001, starting September 2, 2000) and the same baseline budget data as it utilized in its interim filing. PGW St. 3.0, pp. 2, 3. The initial budget/test year projections were developed as follows:

Test Year Expenses.

PGW’s initial budgeted expenses reflected its original proposed FY 2001 (September 1, 2000 – August 31, 2001) budget for expenses, debt service and

miscellaneous items. PGW St. 1.0, p. 23. Some of these items were adjusted in the January filing. This budget assumed that PGW would be able to realize significant savings from its "Transition to Excellence" program, including \$16.5 million in force reduction, productivity and other expense savings. PGW St. 1.0, pp. 8, 23; PGW M.B., pp. 25, 26.

Test Year Revenues

PGW stated that the test year revenues were calculated on a fully normalized basis using PGW's most current 30-year average degree day count. While its original (June) projection used 4600 degree days, that level was reduced to 4555 in its January filing to reflect the most current information available. PGW St. 3.0, p. 3. PGW's resulting sales levels, at proposed rates, were projected using PGW's standard forecasting model to estimate usage per customer. PGW St. 4.1, p. 1. PGW has used this model and the underlying data for budget purposes on a regular basis for at least the last 10 years, and in PGW's first GCR filing before the PUC. Tr. 548. PGW's forecasting model calculated the relationship between degree days and usage per customer using historic (pre-2000) customer data, due to the lack of accurate year 2000 ancillary customer usage information. PGW St. 4.1, p. 4; PGW Ex. CW-R-1; Tr. 553-54. To be consistent with the data used to forecast usage, PGW initially used the pre-2000 customer counts to estimate customer charge revenues. PGW St. 4.1, p. 8. In response to OTS witness Kubas' testimony, PGW witness White reviewed these historical customer counts and concluded that the most recent customer count data for March 2001 more accurately identified the number of meters that should be charged a customer charge and thus was more accurate basis for calculating normalized Test Year revenues from the customer charge portion of the rates. PGW St. 4.1, p. 7; Tr. 555. Using these revised customer counts would result in pro forma increases in PGW's customer charges at the levels proposed by the Company. PGW M.B., pp. 26, 27.

Constructing Expenditures & External Financing

PGW submits that it is not subject to a "rate of return/rate base" method of calculating revenue requirement, but its annual Budget/Test Year includes projections of construction expenditures based upon its approved FY 2001 construction budget. PGW Supporting Financial Data, Vol. II, Part 2, Ex. F-1. The two most important items in PGW's construction plan are the refurbishment of PGW's LNG liquefaction facilities and the replacement of cast iron mains at the 1% per year pace recommended by an outside consultant. PGW St. 1.0, p. 35; PGW Ex. TJS-2, p. B-217.

PGW's fully forecasted budget/test year assumed that it would successfully issue \$75 million in new, long term debt in the May-June time frame to fund construction projects over the next several years. PGW St. 3.0, p. 9. Mr. Bogdonavage explained that, in addition to enabling these crucial projects to go forward, the new debt was also used to reimburse the Company for construction projects that had already been undertaken and financed from operating funds in the FY 2001. These reimbursements for past construction allow PGW to replenish its operating working capital. Tr. 583. PGW's FY 2001 cash flow projection included the maximum amount it was able to include from the Construction Fund in FY 2001 regardless of the total amount of the bond that is issued. Tr. 586; PGW M.B., pp. 27, 28.

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

a) Gas Costs – PGW increased the level of natural gas expense assumed in the original budget/test year. The level assumed was not the full \$230 million increase in natural gas costs that was actually reflected in PGW's FY 2000-01 GCR. PGW asserts that it was PGW's best view of a going forward level of natural gas costs.

PGW St. 1.0, pp. 8, 9. This level was projected at \$150 million higher than its original budget/test year level. Id.

b) Bad Debt Expense – PGW contends that while the actual cost of gas is recovered dollar for dollar in PGW's GCR, changes in gas costs affect PGW's base rate revenue requirement in two significant ways. First, higher revenues mean higher uncollectibles and higher bad debt expense. The escalation of projected natural gas expense in FY 2001 caused a significant increase in actual and projected bad debt expense. PGW's actual 1999-2000 recorded bad debt expense was \$54.6 million. PGW St. 3.0, p. 10; Ex. JRB-2, p. 1, Col. 1; Tr. 758. PGW's original projection was a \$46 million bad debt expense. PGW St. 3.0, p. 10. PGW estimated that its projected bad debt expense would be \$65.3 in 2001. Id.

In light of the increase in bad debt expense for the fully forecasted budget/test year, PGW increased its revenue requirement from its \$52 million request to the \$65 million request it filed in January 2001 with the PUC.

c) Cash Working Capital – PGW determines its cash working capital requirements by conducting a monthly cash flow analysis, which compares monthly receipts and disbursements to assure that the Company will have sufficient cash to actually pay its bills when they come due. PGW's analysis for the original fully forecasted test year showed that, at \$65 million, PGW would satisfy its monthly obligations and end the year with \$10.2 million in cash available to fund operations in the first four months of the next fiscal year. PGW Supporting Data, Vol. II, Part 2, Schedule SD-5. PGW contends that this requirement is not beyond the budget or test year; it is a very real cash working capital obligation at the end of each budget year. Tr. 596-97. PGW argues that its only permanent source of short term working capital – its commercial paper program – is fully extended, and PGW has no other permanent sources of cash working capital. PGW St. 1.0, p. 20; Tr. 462.

2. Test Year

PGW's normalized budget/test year results are shown on four key schedules: its Statement of Income;³ cash flow on an annual basis;⁴ cash flow on a monthly basis;⁵ and Debt Service.⁶ The proposed \$65 million increase is projected to produce approximately \$34 million⁷ in net income, and produces debt service coverage for the more demanding of its debt service coverage requirements, reflected in its 1975 Bond Ordinance. PGW contends that while these coverages are higher than the "minimum" required amount (1.5x), these additional amounts are necessary to provide a margin of error as well as to provide the cash working capital that PGW needs to pay its bills. Tr. 752-53.

3. Revenue Adjustments

a. Increase Average Usage per Residential Customer

OTS, through the testimony of its witness Joseph Kubas, addressed the operating revenue issues relating to PGW's request for \$65,000,000 in additional annual revenue filed on January 4, 2001. There are two types of test years. A historic test year is a twelve-month period selected by a Company that represents a recent full year of actual data. OTS St. 2, p. 2. A future test year normally represents a year of actual and projected data ending one year after the end of the historic test year. OTS St. 2, p. 2. In

³ PGW Supporting Financial Data, Vol II, Part 2, Ex. A-1-1.

⁴ PGW Supporting Financial Data, Vol II, Part 2, Ex. A-2.

⁵ PGW Supporting Financial Data, Vol II, Part 2, Ex. SD-5.

⁶ PGW Supporting Financial Data, Vol II, Part 2, Ex. A-3.

⁷ PGW Supporting Financial Data, Vol II, Part 2, Ex. A-1-1.

the instant case, PGW has selected a future test year ending August 31, 2001. PGW's future test year ending August 31, 2001 includes projected customer data, sales and revenues. OTS M.B., p. 10.

In determining present and proposed operating revenue, and expenses, one must be reminded that the Company did not provide operating revenues for the future test year ending August 31, 2001 using present rates.⁸ As OTS witness Kubas explained, PGW determined proposed operating revenues by projecting the average number of customers paying the proposed customer charge, the projected volume of gas, and then making various adjustments for non billed revenue and miscellaneous revenue. OTS St. 2, p. 3. OTS questioned whether PGW's claimed average use per customer and projected number of customers should be relied upon in this proceeding. OTS is of the opinion that PGW has understated both the number of residential heating and commercial heating customers as well as the average use per customer for these classes. OTS St. 2, p. 4. OTS M.B., pp. 10, 11.

PGW is projecting total sales volumes of 58,498,387 Mcf and 512,891 total customers. PGW Ex. HSG-1, Schedule 4-A. In proposing the average number of customers and average usage per customer for the test year ending August 31, 2001, PGW used the historic sales period from September 1, 1999 through August 31, 2000. Additionally, PGW's average usage per customer claim is also based on projections and adjustments made to historic data. In each instance, the average usage adjustments reflect the use of 4,555 normalized heating degree-days to projected total sales. PGW St. 4, p. 4.

⁸ The Company is requesting total adjusted proposed operating revenues of \$755,484,000 for the future test year ending August 31, 2001. See PGW Volume II, Exhibit A-1-1.

Since rates are determined based on normal weather, OTS suggests that a weather normalization calculation is necessary. The OTS calculation demonstrates that PGW has understated the average use per customer for these classes. As OTS witness Kubas explained, "weather normalization" is a methodology⁹ used to restate historic test year actual sales on a per customer basis to reflect the level of sales that the utility would have achieved had actual heating or cooling degree days been equivalent what is "normal." OTS St. 2, pp. 4-5. A weather normalization adjustment is necessary because the establishment of a proper revenue requirement for ratemaking purposes is dependent upon the development of a normal test year. In support of a weather normalization adjustment, OTS witness Kubas testified as follows:

Variations in temperatures have a direct effect on a gas utility's sales related to heating. A colder than normal winter will result in increased gas sales while, conversely, a warmer than normal winter will result in reduced gas sales. It has become the recognized gas industry practice to normalize gas sales, revenues and expenses when actual Degree-days vary significantly from normal degree-days for any given test year.

OTS St.2, p.6.

The Company utilized a two step process in developing normalized usage for the residential and commercial heating class. The first step developed by the Company was the base load usage, which is a non-heating load, determined by averaging sales during July, August and September of 1998. OTS St. 2, p.8. The second step is the development of normal heating usage, which the Company did by adjusting actual historic sales using a computer model and a normal year of 4,555 heating days to determine the normal heating usage. PGW St. 4, p.4. The mathematical calculation for

⁹ See Pennsylvania Public Utility Commission v. Natural Fuel Gas Distribution Company, 83 Pa. PUC 286 (1994).

the two-step process is the base load usage plus the normal heating usage equals the total usage for that particular class. OTS Ex. 2, Schedule 1. By using the two-step process, the Company is claiming an average usage of 100.94 Mcf per residential heating customer¹⁰ and for commercial customers, the Company is claiming an average of 445.21¹¹ Mcf per customer.¹² OTS M.B., pp. 12, 13.

After performing its analysis, OTS concluded that PGW understated the average use per customer for its residential heating and commercial heating customers. Based upon the weather normalized heating load for the year 2000 and using actual sales for July, August and September of 2000 to determine base load, OTS recommends that PGW's average usage per residential heating customer be increased to 103.91 Mcf per year, and the average usage per commercial heating customer should be increase to 477.11 Mcf per year. OTS St. 2, p. 9; OTS M.B., p. 13.

It must be noted that in determining its total usage and customer counts, PGW utilized the historic sales period of September 1, 1999 through August 31, 2000, together with adjustments, projections and customer counts for the test year ending August 31, 2001. OTS St. 2, p. 7. OTS is of the opinion that the Company's actual sales for the year 2000 should be the basis for projecting the number of customers and weather-normalized usage in this proceeding. The use of the Company's actual sales for the year 2000 is required by PGW's admission that the Company had a history of billing discrepancies that were corrected during 2000. PGW St.1, p. 25. Accordingly, OTS urges the Commission not to rely on projections, base load, and heat load calculations made before the billing discrepancies were corrected in the year 2000. OTS St. 2, p. 10.

¹⁰ 41,679,007 Mcf divided by 412,910 customers.

¹¹ 8,486,143 Mcf divided by 19,061 customers.

¹² See PGW Exhibit HSG-1, Schedule 4A, page 1

By increasing PGW's projected use per residential heating customer to 103.91 Mcf per year when determining proposed rates,¹³ the Company will receive \$12,892,000 in additional revenue at proposed rates.¹⁴ Likewise, by increasing PGW's projected use per commercial heating customer to 477.11 Mcf per year when determining proposed rates,¹⁵ the Company will receive \$6,859,000 in additional revenue at proposed rates.¹⁶

In the rebuttal phase of the proceeding, PGW's witness, Craig White testified that OTS' average use per customer analysis was incorrect. PGW St. 4.1, p. 2. Mr. White suggested that the Company's forecasted gas model is a highly accurate predictor of PGW's sale levels. PGW St. 4.1, p. 1. In support of the Company's position, Mr. White provided a schedule that compares firm sendout to projected sales using the Company's forecasting model. PGW St. 4.1, p. 2. Mr. White testified that the calculated sendout in the schedule utilized the same customer counts, same base load factors, same heating load per degree day factors, and the same monthly historical utilization factors that were used in preparing the projected, fully forecasted test year for this rate filing. Id. Along with the previously described inputs and replacing the number of average heating degree days with the actual number of heating degree days, Mr. White concluded that for the most recent five month period from November 2000 through March 2001, PGW's forecasting model was only off by 2%. PGW St. 4.1, p. 3.

¹³ See OTS Exhibit No. 2, Schedule 3, page 2, column D, Line 4.

¹⁴ See OIS Exhibit No. 2, Schedule 3, page 2, column C, Line 14.

¹⁵ See OTS Exhibit No. 2, Schedule 4, page 2, column C, Line 4.

¹⁶ See OTS Exhibit No. 2, Schedule 4, page 2, column C, Line 14.

OTS suggests that PGW's analysis is seriously flawed and lacking in evidentiary support. PGW's analysis only utilized five months, while OTS' analysis covered twelve months. As OTS witness Kubas explains, the five months selected by PGW witness White occurred during a period of record high gas prices. OTS St. 2SR, p. 3. OTS submits that the normalizing of sales based on five months is not long enough for a proper analysis. In addition, the data for this period was skewed by high gas prices, combined with PGW's requested rate increases. These factors undoubtedly caused PGW's customers to use less gas. OTS contends that Mr. White's suggestion that gas prices have "fluctuated" in the past and the computer has been accurate in the past is unsupported by any empirical evidence. Tr. 552. OTS argues that Mr. White has provided no evidence that gas prices were ever as high as they were this past winter and that the computer model was accurate in the past. As Mr. White explained, "the key to any forecasting model, is the consistency and accuracy of the input data that is used to develop the factors that are utilized to project sales and send-out." Tr. 548. OTS submits that Mr. White's explanation is the key to the problem with the Company's forecasting model since there is no independent method of determining the consistency and accuracy of the model when there is no evidence of what numerical input data was used to develop the factors, which determined the projected sales and send-out. OTS M.B., p. 16.

OTS argues that by Mr. White's own admission, all of the inputs utilized for the Company's claimed Filing time period, which was September 1, 1999 through August 31, 2000, were utilized for the time period of November 2000 through March 2001. It is possible that some of these inputs have changed over time and should have been updated.¹⁷ With respect to PGW's calculated sendouts using inputs, there is no record evidence or schedules detailing with any numerical specificity outlining the inputs that were utilized. OTS contends that no other party in this proceeding, other than PGW knows what base load factors were utilized; what heating load per degree day factors

¹⁷ See OTS St. No. 2SR, at page 2-3.

were utilized; or what monthly historical utilization factors were utilized. There can be no dispute that any questions surrounding the numerical factors utilized by PGW in its computer model would have to be answered in the negative, as PGW simply identified the inputs without the numerical identification of the factors that were inputted into the computer model. OTS M.B., p. 17.

In comparison, OTS' assumptions and inputs for determining the appropriate average use per customer are described and illustrated in OTS Statement No. 2 and OTS Exhibit No. 2. Based on the actual number of customers and monthly sales volumes in 2000, OTS determined the base load for each residential heating class customer.¹⁸ After reviewing the actual sales volumes and heating degree day data and assuming that base load is the sales in July, August, and September 2000, OTS witness Kubas determined that the base load should be 2.25 Mcf per month per residential heating customer.¹⁹ The 2.25 Mcf per month was calculated by dividing the monthly sales for the months of July, August, and September 2000 by the number of customers (2,891,933 divided by 1,285,035 = 2.25).²⁰ By using the average base load per customer, Mr. Kubas was able to determine the total base load volumes for the residential heating class, which is quantified by using the number of customers each month multiplied by the average base load for the residential heating class.²¹

OTS witness Kubas' analysis used the average base load per customer to determine the average annual normalized sales for each residential heating class

¹⁸ See OTS St. No. 2, at page 10.

¹⁹ See OTS St. No. 2, at page 10.

²⁰ See OTS Exhibit No. 2, Schedule 3, page 1, column E, line 34.

²¹ See OTS Exhibit No. 2, Schedule 3, page 1, column D.

customer.²² By dividing the total normalized usage of 44,069,567 Mcf,²³ by the average of 424,099 customers,²⁴ Mr. Kubas determined that the total annual normalized usage for January 2000 through December 2000 was 103.91 Mcf.²⁵ The difference between OTS' annual normalized usage of 103.91 Mcf and the Company's Filing of an annual normalized usage of 100.94, results in a difference of 2.97 Mcf.²⁶

Consequently, OTS is recommending that the Company increase the projected use per residential heating customer to 103.91 Mcf per year when determining proposed rates.²⁷ OTS M.B., p. 19.

Mr. Kubas did a similar analysis with respect to the commercial customers, and determined an average use per commercial customer of 477.11 Mcf²⁸ and the normalized usage was 9,094,190 Mcf,²⁹ which results in a total average annual sales for January 2000 through December of 477.11 Mcf.³⁰ The difference between OTS' recommended annual normalized usage of 477.11 Mcf and the Company's claimed usage of 445.21 is 31.90 Mcf for the average commercial heating customer.³¹

²² See OTS Exhibit No. 2, at page 12.

²³ See OTS Exhibit No. 2, Schedule 3, page 1, column J, line 16.

²⁴ See OTS Exhibit No. 2, Schedule 3, page 1, column B, line 24.

²⁵ See OTS Exhibit No. 2, Schedule 3, page 1, column E, line 24.

²⁶ See OTS Exhibit No. 2, Schedule 3, page 2, column C, line 4.

²⁷ See OTS Exhibit No. 2, Schedule 3, page 2, column D, line 4.

²⁸ See OTS Exhibit No. 2, Schedule 4, page 1, line 24.

²⁹ See OTS Exhibit No. 2, Schedule 4, page 1, column D, line 6.

³⁰ See OTS Exhibit No. 2, Schedule 4, page 1, column E, line 24.

³¹ See OTS Exhibit No. 2, Schedule 4, page 2, column C, line 4.

Thus, OTS is recommending that the Company increase the projected use per commercial heating customer to 477.11 Mcf per year when determining proposed rates.³² OTS M.B., p. 19.

OTS submits that the Company's projection of the number of residential and commercial heating customers and the usage for these customers is incorrect. PGW is projecting 412,910 residential heating customers and 19,061 commercial heating customers. PGW Ex. HSG-1, Schedule 4-1, p.1. OTS presented a monthly analysis illustrating the Company's projected 412,910 residential heating customers and 19,061 commercial heating customers in OTS Exhibit No. 2, Schedule 1. After reviewing the Company's filing, OTS is recommending that the projected number of residential heating customers should be increased by 11,189, and the number of commercial heating customers should be increased by 51. OTS St. 2, p. 16; OTS M.B., p. 20.

The Company's projected number of customers in the residential heating and commercial heating classes for the last four months of 2000 does not match the actual number of customers in these classes for the last four months of 2000. OTS St. 2, p. 16. OTS correctly asserts that the actual number of residential heating and commercial heating customers that PGW served in calendar year 2000 should be the guide in determining the projected number of customers and projected sales in this instant proceeding.

To determine the average number of residential heating customers in this case, OTS added the number of actual residential heating customers for each month in the year 2000, and divided the total by 12 months. The result of OTS' analysis indicates that the average number of residential customers in the year 2000 was 424,099. OTS Ex. 2,

³² See OTS Exhibit No. 2, Schedule 4, page 2, column D, line 4.

Schedule 3, p. 1, column B. OTS' calculation of 424,099 is 11,189 more than the 412,190 residential heating customers claimed by the Company in its proof of revenue schedules. PGW Volume III, Exhibit HSG-1, p. 1; OTS Ex.2. Schedule 3, p. 3, line 3. OTS states that there are 51 more actual commercial heating customers for the year 2000 and PGW projected (19,112 - 19,061). PGW Ex. HSG-1, Schedule 4A, p. 1; OTS Ex. 2, Schedule 4, p. 3, column C, line 3. OTS M.B., p. 21.

OTS suggests that by recognizing the additional residential heating customers, the proposed increase in revenues is \$27,114,000. OTS Ex. 2, Schedule 3, p. 4, column C, line 21. Mr. Kubas provided a detailed explanation as to how the additional residential heating customers will affect a number of the proposals as follows:

The Company will receive customer charge revenue from these additional 11,189 residential heating customers paying the proposed \$15.00 monthly customer charge. This would increase proposed revenue by \$2,014,000 ($11,189 \times 15.00 \times 12$),³³ as shown on OTS Exhibit No. 2, Schedule 4, page 3, column C, line 18. The Company will also receive sales revenue from these 11,189 additional residential heating customers paying the commodity and GCR. Assuming that these customers will use an average of 100.940 Mcf per year, as projected by the Company, the additional Mcf sales for these 11,189 additional residential heating customers would be 1,129,546 Mcf (See OTS Exhibit No. 2, Schedule 3, page 3, column C, line 6). The additional sales revenue associated with this 1,129,546 Mcf is \$11,860,000, as shown on line 15. The total additional revenue for the residential heating class including customer charge and sales is \$13,874,000, as shown on line 21. If the Commission also accepts my recommendation described above to increase the average sales to 103.913 Mcf per year, the additional volumes associated with all customers including the additional 11,189 residential heating customers would be 2,390,560 Mcf, as

³³ If OTS' recommended customer charge is adopted, the proposed revenue increase will be \$1,611,216 ($11,189 \times 12.00 \times 12$).

shown on OTS Exhibit No. 2, Schedule 3, page 4, column C, line 6. The total additional revenue for the residential heating class for these two adjustments is \$27,114,000 as shown on line 21. OTS Ex. 2, Schedule 4, p. 4, column C, line 21.

b. Increase Average Usage per Commercial Customer

OTS performed a corresponding quantification of the increase in proposed revenue by recognizing the 51 additional commercial heating customers. With the recognition of the 51 additional commercial heating customers, the additional revenue for the commercial heating class would be \$7,149,000. OTS St. 2, pp. 19-20. Mr. Kubas provided the following testimony regarding the additional commercial heating customers:

The Company will receive customer charge revenue from these 51 additional commercial heating customers paying the proposed \$25.00 monthly customer charge. This would increase proposed revenue by \$15,000 ($51 \times 25.00 \times 12$)³⁴ as shown on OTS Exhibit No. 2, Schedule 4, page 3, column C, line 18. The Company will also receive sales revenue from these 51 additional commercial heating customers paying the commodity and GCR. Assuming that these customers will use an average of 445.21 Mcf per year, as projected by the Company, the additional Mcf sales for these 51 additional residential heating customers would be 22,711 Mcf (See OTS Exhibit No. 2, Schedule 4, page 3, column C, line 6). The additional revenue associated with this 22,711 Mcf is \$256,000, as shown on line 15. The total additional revenue for the commercial heating class including customer charge and sales is \$271,000, as shown on line 21. If the Commission also accepts my recommendation described above to increase the average sales to 477.11 Mcf per year, the additional volumes associated with all customers including the additional 51 commercial customers would be 632,379 Mcf, as shown on OTS Exhibit No. 2, Schedule 4, page 4, column C, line 6. The total additional revenue for the commercial heating class for these two adjustments is \$7,149,000, as shown on line 21.

OTS St. 2, pp. 20, 21.

³⁴ If OTS-recommended customer charge is adopted, the proposed revenue increase will be \$11,016 ($51 \times 18.00 \times 12$).

In response to OTS' recommended increase in residential and commercial heating customers, PGW witness White testified that "while Mr. Kubas' recommended increase in total customers may be reasonable, the suggested increase in annual usage per customer is not reasonable." PGW St. 4.1, p. 8. Accordingly, PGW conceded that revenue should be increased by slightly less than \$2 million to reflect the additional revenue the Company will be receiving from these additional customers paying the proposed monthly customer charges. PGW St. 4.1, p. 8. PGW reached the conclusion that additional customers should be added by reviewing the Company's billing records for February 2001 and comparing those numbers to the number of customers projected in the original filing for March 2001. After comparing the actual records for February 2001 and the projected numbers for March 2001, PGW concluded that the residential customers should be increased by 9,709 customers and the number of commercial customers should be increased by 700 customers. PGW St. 4.1, pp. 6, 7.

OTS has provided detailed calculations that are adjusted for aberrations. Due to the Company's billing problems they initially used the incorrect number of customers. The Company has agreed to revise its numbers. Inasmuch as OTS explained in detail its calculations and the Company concurred that additional customers should be added, OTS' recommendation is approved. Accordingly, the number and average use of the Company's residential heating and commercial heating customers will be increased based on OTS' calculations.

4. Expense Adjustments

a. The Company's base rate case expense should be adjusted

PGW claimed \$825,000 of rate case expense as an annual expense for the future test year. OTS Statement 1, p. 9; OCA M.B., pp. 38, 39. OTS recommended the

following two adjustments to the \$825,000 claim: disallow the \$100,000 consulting fee for Lukens Energy Group and normalize the remaining rate case expense over a two year period. OTS Statement 1, p. 9. These adjustments would reduce the Company's rate case expense claim by a total of \$362,000. OTS Statement 1, Ex. 1, Schedule 5. OCA concurs in requesting that the rate case expense be normalized over a two year period. OCA St. 1, p. 37, Schedule 9; OTS M.B., pp. 30, 33, 34; OCA M.B., pp. 38, 39.

1) \$100,000 Payment to Lukens

In its base rate Filing with the Commission, PGW requested as part of its rate case expense, \$100,000 for Lukens Energy Group, Inc. PGW engaged the Lukens Energy Group, Inc. to review the cost-of-service study and develop a revenue requirement that PGW would require if the Company were an investor owned utility. OTS Statement 1, p. 10. In its case in chief, PGW witness Knudsen described PGW witness Lukens' direct testimony as follows:

Finally, Mr. Lukens of Lukens Energy Group, Inc. will present an analysis (PGW Statement 6) showing that PGW ratepayers would be required to pay significantly higher rates if PGW were not a municipally owned utility. It is my hope that this testimony will assist the parties in understanding the inherent differences between traditional rate making for privately owned utilities and the Cash Flow Method required for PGW as a municipal utility with unique legal requirements.

PGW Statement 1, p. 5.

PGW witness Lukens described the purpose of his direct testimony as follows:

I have been asked by Philadelphia Gas Works (PGW) to review the Cost of Service filed in this case and develop an estimate of cost of service that PGW would require if it were

an investor-owned utility (IOU). The hypothetical circumstance that I have in mind in preparing this testimony is that PGW is sold to private investors. The principal differences between PGW's costs as a municipal entity vis-a-vis an IOU structure result from elimination of PGW's tax exempt status and the need to pay investors a competitive return on capital.

PGW Statement 6, p.4.

OTS contends that the revenue requirement PGW would require if it were an investor owned utility has no relevance in this proceeding. Having a consultant to provide testimony distinguishing a municipal owned utility from an investor owned utility served no useful or relevant purpose in this proceeding. OTS M.B., p. 31.

In response to OTS' recommendation to disallow the \$100,000 consulting fee for the Lukens Energy Group, Inc., PGW, through its witness, Joseph R. Bogdonavage, stated that the testimony was submitted "in direct anticipation" of a party trying to argue that a ratemaking approach for non-municipal utilities should be used in this case. PGW St. 3.1, p.11.

OTS indicates that the problem with PGW's attempt, in the rebuttal phase of the proceeding, to suggest that the testimony was prepared in "anticipation" of an issue being raised in this proceeding is simply without merit. OTS notes that PGW witness, Mr. Bogdonavage, acknowledged on cross-examination, that neither Mr. Knudsen nor Mr. Lukens, the only PGW witnesses to address the purpose for Lukens' direct testimony in the Company's case-in-chief, described the Lukens' direct testimony as being prepared in the "anticipation of an issue" presented by other parties in their direct testimony. Tr. 604; OTS M.B., p. 32.

OTS cited Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corp., 54 Pa. PUC 401, 416-417, 40 PUR4th 101, 117-118 (1980), to support its position. In that case, the Commission provided the following insight as to their responsibility in adjudicating rate case expense as follows:

. . . .If a particular utility should decide to expend more or less than its allowance, for whatever reason it may choose, that is a management decision for it to make. Our decision in this and every case is to determine the reasonable annual expense allowance to be charged to ratepayers. (emphasis supplied).

According to OTS, the associated expense for the Lukens Energy Group should not be included in the reasonable annual expense allowance to be charged to PGW ratepayers. Only prudently incurred expenses are incorporated in rate case expense claims, and it is the burden of the public utility to prove that the rate case expenses incurred are just and reasonable. Allegheny Center Associates v. Pa. Public Utility Commission, 131 Pa. Commonwealth Ct. 352, 570 A.2d 149 (1990). OTS claims that PGW has failed its to sustain burden of proving that the expenses associated with the Lukens Energy Group are relevant and, thus, should be included a rate case expense claim. It is OTS' opinion that there was absolutely no need for PGW to present testimony that PGW ratepayers would be required to pay significantly higher rates if PGW were not a municipally owned utility, since that it is not an issue in this proceeding. OTS M.B., p. 33.

Consequently, OTS requested that the consulting fee of \$100,000 rate case expense claim for the Lukens Energy Group, Inc. be disallowed. OTS M.B., p. 33

PGW contends that the recommended disallowance is contrary to PGW's ratemaking method and the Public Utility Code's requirement that the Commission ensure that PGW's rates are sufficient to satisfy its bond covenant to pay its obligations

when they become due. In addition, PGW states that the PGC never denied rate case expense based on such reasons. PGW M.B., p. 48.

OTS submits that there is no evidence that a witness before the PGC discussed the difference between a municipally owned utility and an investor owned utility. OTS argues that this testimony is totally irrelevant to set rates using the cash flow method. OTS M. B., pp. 31-33; OTS R. B., p. 10.

After reviewing the testimony and the relevant cases, my recommendation is that the \$100,000 expense for the Lukens testimony should be disallowed because it is not a just and reasonable expense. It is clear that there are differences between municipally owned utilities and investor owned utilities. Therefore, it was not necessary for the Company to provide expert testimony concerning the revenue requirement for an investor owned utility. The testimony is not relevant to this proceeding and ratepayers should not be required to pay for it. Since it is not a reasonable expense, it should be disallowed.

2) The Rate Case Expense Should be Normalized

The other adjustment for PGW's rate case expense claim is OTS' and OCA's recommendation that the remaining rate case expense should be normalized over a two-year period. OCA St. No. 1, p. 37. As OTS witness Weakley explained, the Commission views prudently incurred rate case expense as an ongoing, although recurring at irregular intervals, expense relative to the rendering of utility service. OTS St. 1, p. 9. Based upon the fact that rate case expense is ongoing, although recurring at irregular intervals, the rate case expense is subject to normalization for ratemaking purposes, not amortization. OTS St. 1, p. 9; OTS M.B., p. 34.

OCA witness LeLash stated that:

PGW has included \$825,000 in the test year budget for rate case expenditures for lawyers and consultants. Though FY 2000 Rate Case Expense was amortized over a two-year period and included in the FY 2001 budget, FY 2001 Rate Case Expense was not amortized in the FY 2001 budget. It is normal ratemaking procedure to normalize such expenses over the period between rate cases. Since it is expected that PGW will file its next base rate case with its restructuring filing in 2003, it is proper to normalize Rate Case Expense over two years, the same normalization period utilized by the Company. Schedule 9 shows this normalization resulting in a \$412,000 downward adjustment to expense.

OCA St. 1, p. 37.

PGW does not have a recent history of filing base rate cases since the last base rate increase was in 1991.³⁵ PGW Ex. TEK-1, p.15. PGW filed this instant request for a base rate increase in January 2001, and the result of its restructuring filing will not become effective until either late 2002 or early 2003. Therefore, two (2) years is a reasonable normalization period to be imposed in this proceeding for rate case expense. OTS St. 1, p. 10. It should be noted that PGW used a two (2) year period for its rate case expense incurred during its Interim Filing with the knowledge that Company would be filing this base rate increase before the expiration of two (2) years. Consequently, OTS and OCA request that the recommended two (2) year normalization period for PGW's rate case expense should be adopted by the Commission. OTS M.B., p. 34; OCA M.B., pp. 38, 39.

Since there are no objections from any party, the rate case expense will be normalized over a two year period. This reduces the Company's rate case expense claim by \$262,000. OTS Ex. No. 1, Schedule 5.

³⁵ This analysis excludes the interim rate Filing at Docket No. R-00005654.

b. The Company's Budgeted Expenses for Promotional Expenses
Should Be Reduced

In this proceeding, the Company has claimed \$1,645,000 for promotional expenses. PGW Vol. II Revised Ex. C-4. PGW allocated the \$1,645,000 for promotional expense as follows: (1) Major Accounts - \$1,210,000 and (2) \$435,000 allocated for various residential conversion incentives for developer and customers for appliance conversions. OTS Ex. 1, Schedule 6.

The nature of PGW's promotional activities were explained by OTS witness Weakley as follows:

Promotional dollars are used to compete against alternate fuel sources. These promotional dollars are aimed at new construction or existing facilities that wish to convert to natural gas. The incentive dollars are designed to offset the equipment costs to the customer and make the installation of gas appliances more attractive. Promotional Activities are mainly incentive payments to attract new or expand existing demand for gas service. PGW's marketing department expects an increase in these expenditures primarily due to the planned initiative to aggressively promote the use of natural gas in the market place.

OTS St. 1, pp. 11-12

Initially, OTS recommended that the total claim for promotional activities be denied because other utilities do not recover such costs in their distribution rates. Id. However, PGW witness Mr. White testified, on cross-examination, that PGW did not have the ability to compete against alternate fuel sources by flexing their rates. Tr. 567. In recognition of the Company's inability to flex its rates, OTS modified its recommendation to allow \$385,000 for Promotional Activities to be recovered from

PGW's ratepayers. Tr. 743. Although PGW has budgeted approximately \$1.6 million for Promotional Activities during each of the last two years, since the inception of the program, the total incentive payments have totaled only \$558,103, for approximately twenty-one (21) customers. Furthermore, PGW has not expended more than \$383,193 for Promotional Activities in any one year. In fact, PGW only expended \$383,193 in 1999 and \$94,120 in 2000. Consequently, OTS opined that PGW's Promotional Activity claim should be limited to \$385,000, an amount that is reasonable and represents some proximity to the actual amounts expended in the past.

Therefore, OTS recommends that PGW should be allowed to recover \$385,000 for Promotional Activities.

PGW suggests that OTS' adjustments regarding the Promotional Expenses are unreasonable and inconsistent with the legal standards in this case. Although PGW welcomes the change in OTS' position, PGW posits that the recommendation violates the legal standards governing this proceeding. Section VII of the Management Agreement/ Ordinance requires that rates be set to cover all of PGW's operating expenses. The PGC has authorized these costs in PGW's prior, as well as, FY 2001 budgets. Moreover, PGW contends that the PUC has never disallowed these amounts. PGW M.B., p. 47. PGW submits that the PUC is also required to ensure that PGW's rates allow it to satisfy its bond covenants, which include a covenant to pay its obligations when they come due. If the PUC only allows revenues sufficient to pay \$385,000 of PGW's \$1.6 million expense, it will not have complied with the mandates of Section 2212(e) of the Code.

Moreover, PGW argues that its efforts to attract new or expanded load helps all of its customers. PGW St. 4.1, pp. 15-17; Tr. 567-72. Unlike other utilities who may expend these funds on cooperative advertising with developers, PGW's promotional expenses are utilized to offset capital and equipment costs associated with the conversion to or expansion of natural gas use. PGW St. 4.1, pp. 16; Tr. 571. PGW provides no

incentives below a 12% internal rate of return, which can amount to more than double the Company's cost of capital expended on the incentives. PGW St. 4.1, p. 15. In addition, PGW engages these customers in a service contract, typically for the exclusive use of gas, with a duration that ensures that PGW receives an adequate rate of return. Tr. 568-69, 571. To date, PGW has attracted 21 new customers with a total 388,000 Mcf in annual usage. While PGW's one time incentive payments totaled \$558,103, those payments have produced an annual -- or recurring -- margin estimated at \$511,000. Id. PGW argues that this type of load growth, particularly from customers who are highly likely to pay their bills, benefits PGW's overall financial condition and thereby benefits all of its customers. PGW M.B., pp. 47, 48.

OTS counters that the Company will not be in violation of Section VII of the Management Agreement if ratepayers do not fund the budgeted \$1.6 million for Promotional Expenses. The Company admits that since the inception of the program it has only expended \$558,103 and no more than \$383,193 in any one year although \$1.6 was budgeted each year. OTS M.B., pp. 37-39; OTS R. B., p. 10.

The record shows that OTS recognized that it is beneficial for PGW to utilize promotional funds to attract new customers. Therefore, PGW will be able to recover funds spent on promotions from rates. The question is the proper amount to be included in the revenue requirement for Promotional Activities. Since other companies have a "flex rate" or an economic rider, there is no evidence to show that the other companies have asked the Commission to approve promotional expenses. Thus, the Commission did not disallow promotional expenses because it was not necessary. PGW only spent \$94,000 on promotional activities in 1999-2000. (See PGW Revised Ex. C-4 in Vol. II.) Inasmuch as the Company has failed to show that it has expended more than \$385,000 in one year for promotional expenses, it has not demonstrated that it is just and reasonable to include \$1.6 million for promotional expenses. However, the record

evidence demonstrates that it is appropriate for PGW to have \$385,000 in promotional expenses.

c. The Company's Bad Debt Expense Should be Adjusted

In this proceeding, PGW has made a claim for bad debt expenses, which the Commission normally defines as uncollectible account expense. As explained by OTS witness Weakley, uncollectible accounts are specific receivables that are determined to be uncollectible in whole or part, either because the debtors do not pay or because the creditor finds it impracticable to enforce payment. OTS St. 1, pp. 5, 6. Those accounts deemed uncollectible are charged against income. OTS M.B., p. 35.

It is important to note that for ratemaking purposes, utilities generally compute uncollectible account expense on an annual prospective basis. While the uncollectible account expense is a prospective claim, the proper calculation begins with an historic analysis of actual net write-offs to gross revenues to develop an historic write-off ratio. OTS St. 1, p. 6. For calculating purposes, net write-offs are gross write-offs less recoveries of amounts previously written off. As Mr. Weakley testified, this ratio is then applied to projected revenues to determine the proper prospective allowances. OTS M.B., p. 35.

OTS witness Weakley provided the following description of how the Company's claim for uncollectible account expense was developed:

The Company's bad debt expense is based on funding the bad debt reserve balance. The Company projects the ending accounts receivable balance by assuming that 90.5% of billed revenues will be collected and by estimating amounts that will be written-off during the year. The Company then takes the estimated ending accounts receivable balance and applies a reserve factor of 35% resulting in its claimed bad debt

expense for the future test year. The Company's bad debt expense is the amount needed to adjust the bad debt reserve balance to the desired level. The Company's bad debt claim should not be used in setting rates since it does not reflect actual write-offs. (emphasis added). OTS St. 1, pp. 6, 7; OTS M.B., pp. 35, 36.

Based on a desire to adjust the bad debt reserve balance to a desired level, the Company's revised claim for bad debt expense is \$65 million. OTS submits this amount is inappropriate. OTS M.B., p. 36.

OTS proposes that the appropriate allowance for PGW's uncollectible account expense is \$61.1 million.³⁶ OTS is recommending a write-off percentage of 7.6160% based on a five-year average of actual net write-offs to gross revenues. OTS St. 1, p. 7. Accordingly, when the write-off percentage is applied to the projected total future test year sales revenues of \$802.6 million, the result is an allowance of \$61.1 million.³⁷

OTS proposed the use of a five-year analysis of prior years uncollectible accounts expense. OTS submits that a five-year historic analysis is current enough to reflect present customer payment tendencies and sufficiently long enough to levelize any fluctuation in write-off activity by the Company. OTS St. 1, p. 8. OTS' bad debt recommendation is consistent with the Commission decision in the interim rate proceeding of Pennsylvania Public Utility Commission, et.al v. Philadelphia Gas Works, R-00005654 (Order entered November 22, 2000), which provides in pertinent part as follows:

³⁶ See OTS Exhibit No. 1, Schedule 4.

³⁷ The write-off ratio of 7.6169% should be employed to determine the uncollectible accounts expense attributable to the final base rate gas revenues to be determined in this proceeding.

Based upon the evidence before us, we shall adopt the position of the OTS and base PGW's uncollectible accounts expense upon the application of the recommended bad debts percentage of 7.3922 percent. We arrive at this conclusion for a number of reasons. First, we find the OTS method of determining the bad debt percentage to be reasonable and consistent with the Commission's policy of allowing known and measurable adjustments. We are mindful that the purpose of an adjustment such as this is to determine a normal level of expense by levelizing fluctuations in this expenses such as: write off or collection activities by PGW, economic conditions, or increased consumption due to weather. We are also of the opinion that the five-year period chosen by the OTS is of sufficient length to achieve that purpose. Further, we find the PGW bad debt percentage of 8.4 percent to be speculative in nature in that it has submitted no calculation to support the reasonableness of this proposal.

OTS M.B., pp. 36, 37.

OTS submits that the bad debt percentage 7.6160 is known and measurable, and the recommendation is based on a five-year average of actual net write-offs to gross revenues.³⁸ OTS M.B., p. 37.

OCA recognizes that it is difficult to analyze the bad debt expense. OCA is the only party that suggests an increase to the Company's bad debt estimate. OCA M.B., p. 39.

The recommendations and expenses must be based on calculations that can be reviewed to determine whether they are reasonable. Since PGW's figure is not substantiated and OTS has proposed an amount based on historical data, OTS'

³⁸ See OTS Exhibit No. 1, Schedule 4.

recommendation for bad debt account expense adjustment should be adopted by the Commission.

d. OCA's Expense Adjustments Accepted by PGW

In his direct testimony, OCA witness LeLash proposed ten adjustments to the Company's claimed level of expenses in FY 2001. These adjustments are contained in Schedules 6-15 (appended to OCA St. No.1). As for one-time expenditures to be normalized, Mr. LeLash made adjustments to BCCS Remediation (\$800,000), Consultant Studies/Costs (\$424,000), Non-Recurring Expenses (\$1,840,000), and Rate Case Expense (\$412,000).³⁹ Regarding expenditures which are not representative of future operating conditions and, therefore, to be eliminated, Mr. LeLash made adjustments to Employee Consultants (\$258,000), Equipment Rentals and Leasing Information Technology (\$632,000), Lobbying Expenses (\$115,000), Operating Leases (\$601,000), and Non-Recurring Material Purchases (\$100,000). Finally, Mr. LeLash made an additional adjustment to partially offset the Company's amortization of its regulatory asset for CRP arrearages (\$1,637,000). In total, the above adjustments result in a downward adjustment of \$6.8 million to the Company's revenue requirement. OCA M.B., pp. 32, 33.

PGW has accepted Mr. LeLash's recommended adjustments for BCCS Remediation (Schedule 6), Consultant/Studies Costs (Schedule 7), Non-Recurring Expenses (Schedule 8), Equipment Rentals & Leasing Information Technology (Schedule 11), and amortization of PGW's regulatory asset for CRP arrearages (Schedule 15). The Company also accepts Mr. LeLash's adjustment for non-recurring material purchases. However, PGW desires to amortize the adjustment over 3 years, rather than normalize it. OCA M.B., pp. 32, 33.

³⁹ The rate case expense adjustment was discussed in III.B 4.a.2).

In accepting Mr. LeLash's adjustments for BCCS Remediation, Consultant/Studies Costs, and Non-Recurring Expenses, Company witness Bogdonavage stated:

(e)ach of these adjustments reflects a determination that they are non-recurring and are applicable to a number of years. Therefore, PGW has determined that it will be amortizing on its books these items over the periods that Mr. LeLash has indicated. Accordingly, it is appropriate to make these adjustments for ratemaking purposes.

PGW St. 3.1 at 8.

Mr. Bogdonavage also accepted Mr. LeLash's adjustments for Equipment Rentals & Leasing Information Technology and amortization of PGW's regulatory asset for CRP arrearages. PGW St. 3.1, p. 9. Consequently, the OCA submits that Mr. LeLash's adjustments for BCCS Remediation, Consultant/Studies Costs, Non-Recurring Expenses, Equipment Rentals & Leasing Information Technology and amortization of PGW's regulatory asset for CRP arrearages be adopted by the Commission.

As for Non-Recurring Material Purchases, the Company made \$150,000 in Non-Recurring Material Purchases in anticipation of the work stoppage in May 2001. OCA witness, Mr. LeLash proposed that this expense be normalized over a three year period. Mr. LeLash explained:

Since this expense occurs only when the union contract is being renegotiated, it should be normalized for ratemaking purposes over the life of the contract. Accordingly, Schedule 14 shows the recommended normalization of three years which is based on the term of the existing contract.

OCA St. No. 1, pp. 39-40.

PGW states that it accepts the adjustment, but as an *amortization* over 3 years rather than a *normalization*. PGW St. 3.1, p. 9. The OCA submits that a normalization for ratemaking purposes is appropriate because renegotiation of the union contract and the need for material purchases are normal operating expenses. OCA M.B., pp. 33, 34.

The adjustments for BCCS Remediation, Consultant Studies/Costs, Non-Recurring Expenses, Employee Consultants, Equipment Rentals and Leasing Information Technology and the adjustment to partially offset the Company's amortization of its regulatory asset for CRP arrearages BCCS Remediation Consultant/Studies Costs, Non-Recurring Expenses, Equipment Rentals & Leasing Information Technology and amortization of PGW's regulatory asset for CRP arrearages are approved since they were accepted by PGW. Although PGW accepted the \$150,000 adjustment for Non-Recurring Material Purchases, PGW wanted to amortize it over three years rather than normalize it over three years. OCA's recommendation of normalization for this type of expense is appropriate. Consequently, the expense will be normalized over a three year period.

e. Lobbying Expenses

PGW has claimed recovery for lobbying expenses. PGW No. 3.1, p. 8. PGW witness Mr. Bogdonavage testifies that the PGC has permitted the inclusion in rates of lobbying expenses, and therefore, argues that the Commission should continue to include these expenses. PGW St. 3.1, pp. 6-7. The Company further claims that PGW will violate its bond covenants if rates are not sufficient to cover its obligations in FY 2001. *Id.* at 9. PGW's argument is that because the Company spent \$115,000 for Lobbying, the Company should be able to recover the costs. OCA disagrees with PGW's position that the lobbying expense is an appropriate item for recovery from ratepayers.

Furthermore, OCA contends that PGW's assertion that the PGC's allowance of recovery of lobbying expenses requires the Commission to allow such recovery demonstrates the unreasonableness of the Company's arguments in this case. As OCA witness LeLash explained:

I believe Mr. Bogdonavage's position is somewhat flawed as stated. The apparent corollary would be that if the PGC had not included some expense category in rates previously, it could not be recovered in the future. In my view, this appears to have the PGC, de facto, continuing to set rates by virtue of whatever it authorizes, eventually, within PGW's operating budget. This certainly does not appear to be compatible with the intent of the Act, and it appears to require the PUC to potentially grant rates which it would otherwise determine not to be just and reasonable.

OCA St. No. 1-S, p. 12.

OCA noted that the Commission has disallowed the recovery of lobbying expenses from ratepayers because the inclusion of these costs were unjust and unreasonable. OCA M.B., pp. 34, 35.

The Commission has ruled that lobbying expenses do not have a direct ratepayer benefit and as such cannot be included in rates. In Pa. P.U.C. v. Pennsylvania-American Water Co., 79 Pa. P.U.C. 25, 66 (1993), the Commission disallowed the portion of membership dues to local organizations which related to "lobbying and legislative advocacy functions of those organizations." Approximately 31% of the dues were disallowed because of the relationship to lobbying and legislative advocacy of the organizations. Id. In Pa. P.U.C. v. Duquesne Light Co., 59 Pa. P.U.C. 67, 118 (1985), the Commission examined the dues paid to an association of investor-owned utilities (Edison Electric Institute). Id. at 117. Duquesne claimed \$213,377 in dues. Approximately 20% of the organization's activities were devoted to "legislative

advocacy, broadly defined.” Id. at 118. The Commission held that “(w)e believe that the record establishes that a substantial portion of EEI’s activities are of no benefit to ratepayers.” Id. The Commission did not permit recovery from ratepayers of the percentage that related to the organization’s legislative advocacy activities. Id. Pa. P.U.C. v. National Fuel Gas Dist. Corp., 84 Pa. P.U.C. 134, 196 (1995); Pa. P.U.C. v. Metropolitan Edison Co., 60 Pa. P.U.C. 349, 382 (1985). In the Met-Ed case, the Commission followed the Duquesne case with respect to Met-Ed’s and Penelec’s claims for membership dues to the Edison Electric Institute (EEI). Metropolitan Edison Co., 60 Pa. P.U.C. 349, 382 (1985). The expense was reduced to eliminate the percentage that went towards lobbying and legislative activities expenses. Id. at 382. The Commission again held that the excluded percentage for lobbying expenses did not provide a direct ratepayer benefit. Id. at 381-382.

In the National Fuel Gas Dist. Corp. ("NFGD") case, the Commission followed the Metropolitan Edison case above and disallowed the expenditures of the Governmental Affairs Department that related to lobbying. Pa. P.U.C. v. National Fuel Gas Dist. Corp., 84 Pa. P.U.C. 134, 196 (1995). The Commission held that “NFGD did not prove that the services provided by New York Division’s Government Affairs, Marketing and Public Affairs and Public Relations Departments confer any benefit to ratepayers or are necessary for the provision of natural gas service.” Id. at 196. The Commission found that the Department in question served as a conduit of information between the government and the Company. Id. The Commission found that there was no ratepayer benefit to the lobbying expenses. Id.

The Commission has determined in the above-referenced cases that lobbying expenses should not be paid by ratepayers. As stated in the Duquesne, Metropolitan Edison, and National Fuel cases, ratepayers do not receive a direct benefit from these costs, and therefore, the ratepayers should not be required to pay such

expenses. Accordingly, OCA's recommendation to remove lobbying expenses is granted.

f. Operating Leases

OCA witness LeLash recommended that the operating leases be capitalized rather than expensed. OCA St. No. 1, p. 39. Mr. LeLash explained the issue as follows:

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

Id.

The Company retained the \$601,000 of expenses in FY2001 even though it proposes to capitalize these leases. OCA St. 1, p. 39. The OCA submits that the \$601,000 expense in FY2001 should be eliminated from the operating budget because these costs have been capitalized by the Company. Id. The Company did not respond to this adjustment. Thus, OCA requested that a downward adjustment of \$601,000 be adopted as reflected in OTS St. 1, Schedule 13. OCA M.B., pp. 32, 37.

Inasmuch as the Company failed to demonstrate that the operating leases should be expensed rather than capitalized, OCA's recommendation to eliminate the \$601,000 expense from the operating budget is approved.

g. Employee Consultants

The Company made a claim for \$258,000 for former employee consultants. OCA St. No. 1, p. 38. The OCA submits that these former employee consultant salaries should be eliminated. OCA witness LeLash stated that:

PGW has hired several former employees on a temporary basis as consultants in order to retain needed operational experience. The reply to OCA-III-49 lists four employees whose contractual salaries are included in the FY 2001 test year budget. Of those listed, only one is expected to remain with the Company for an extended period of time, as a gas supply consultant. Since the other consultants will not be remaining with the Company and their duties are expected to be performed by other PGW employees, their budgeted salaries should be eliminated for ratemaking purposes. As shown on Schedule 10, elimination of former employee consultant salaries results in a \$258,000 downward adjustment to expense.

Id.

The Company did not rebut this adjustment during the case. Therefore, the OCA requested that the \$258,000 downward adjustment for the elimination of the former employee consultant salaries be adopted as reflected in OTS St. 1, Schedule 10. OCA M.B., pp. 32, 37, 38.

Since the Company failed to demonstrate that the \$258,000 expense for former employee consultant salaries is necessary, the OCA recommendation to eliminate this expense is approved.

5. Other Parties' Recommended Revenue Requirement

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

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

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

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

It is recommended that the Commission approve OTS' recommendation for a \$33 million increase in addition to the \$11 million interim rate increase. Although there are service problems, the entire rate increase should not be denied pending resolution of the problems. In light of the prior rate relief in March 2001, the \$33 million is a reasonable rate.

C. Rate Structure/Cost of Service

1. Cost of Service Study

Pursuant to the Company's filing, PGW proposes a \$65 million rate increase in this proceeding consisting of increases in both the customer charge and the volumetric rates of each customer class. The proposed customer charge increase will generate \$44.5 million of the overall proposed rate increase, while the remaining \$20.5 million will be generated through a volumetric rate increase. OTS St. 3, p. 10. With respect to the volumetric rate increase, PGW proposes an allocation based upon the Company's COSS.

In this proceeding, PGW submitted the testimony and accompanying COSS prepared and presented by Howard Gorman of R.J. Rudden Associates, Inc. ("Rudden"). Vol. III. According to Mr. Gorman, "Rudden was retained by PGW to perform an unbundled, fully allocated COSS, which was completed in December 2000." Gorman's Direct Testimony, PGW Statement No. 5.0, p. 2. One of the purposes of the COSS was to assign the total costs incurred by PGW to each customer class, and to compare the costs assigned to each customer class to the revenue produced by the rates proposed by the Company. *Id.* PICGUG's M.B., pp. 31-33.

According to the Company's COSS, the residential classes (heat and non-heat) are receiving significant and unjustifiable subsidies from the Company's commercial and industrial customers. Specifically, PGW's residential classes are paying less than their cost to serve, while PGW's commercial and industrial customers are paying more than their cost to serve. PICGUG St. 1, p. 9; OSBA St. 1, p. 4. Even in light of this subsidy, PGW's recommended rate allocation for the rate increase proposed in this proceeding is fairly consistent among the classes. PGW proposes a 10.5% overall increase for the residential classes, while the commercial and industrial classes would

receive an increase of about 8.8%. PICGUG St. No. 1, p. 9. Based upon this increase, however, the significant subsidy provided to the residential classes by the commercial and industrial classes would still remain. The residential classes will receive a subsidy of \$36.6 million at the Company's proposed rates, and the commercial and industrial customers will provide the bulk of this subsidy. Id. at 9-10.

a. OCA's Recommended Changes

OCA recommends that the following three major allocations in the cost of service study ("COSS") be modified: 1) the classification of 25% of distribution mains investment as customer-related and the allocation on the basis of the number of customers in each customer class; 2) the allocation of the entire amount of administrative and general (A & G) salaries (account 920) and office supplies and expenses (account 921) on the basis of labor; and 3) the allocation of A & G credit of \$12 million for duplicate charges in accordance with the allocation of Construction Work in Progress. OCA M.B., p. 40.

OCA submits that since mains are constructed to deliver gas, not merely to connect customers to the system, the entire investment in mains should be allocated on the basis of the gas they deliver or the loads they serve. OCA St. 2, p. 22; OCA M.B. p. 40; OCA R.B. p. 36. Therefore, OCA disagrees with PGW witness Gorman's classification of 25% of this investment as customer-related and the allocation on the basis of number of customers in each customer class. PGW St. 5.0, p. 18. OCA maintains that the mains differ from service lines and they have no independent value to PGW's customers. OCA M.B. pp. 40, 41.

OCA's witness Miller allocated the investment in distribution mains using the peak and average demand method. OCA St. 2, p. 21. In this method, the demand allocation factors reflect the class' average use of energy as well as its total usage on system peak days. OCA cites Pa. P.U.C. v. West Penn Power Co., 73 Pa. P.U.C. 454

(1990) and Pa. P.U.C. v. Philadelphia Electric Company, 61 Pa. P.U.C. 589 (1986) to support its argument that the peak and average demand method be used. OCA M.B. pp. 41, 42.

OCA contends that the A & G expenses should not be allocated on the basis of labor since some of the expenses are more closely related to PGW's plant investment. OCA St. 2, p. 21; OCA M.B. p. 42. OCA dismisses PGW's witness Gorman's reliance on FERC's acceptance of an allocation of A & G expenses based on direct labor costs. PGW St. 5.1, p. 3; OCA M.B. pp. 43, 44.

Furthermore, OCA submits that the \$12 million credit in the A & G expense category should not be allocated with the allocation of Construction Work in Progress. OCA St. 2, p. 22; PGW Ex. HSG-2, Sch. 1, p. 3, lines 119-122, 124. OCA contends that the credits should be allocated the same way as the costs they are reversing OCA M.B. pp. 44, 45. In his rebuttal testimony Mr. Gorman agreed with OCA's position on this matter. PGW St. 5.1, p. 4; OCA M.B. p. 45.

b. Other Parties' Positions

PICGUG, OSBA and OTS accepted the COSS presented in this case. These parties believe that the COSS was performed in a reasonable manner. Although they do not agree with all of Mr. Gorman's allocations, they agree that the COSS can be used as a guide to determine the cost responsibility for PGW's customer classes. PICGUG M.B., pp. 26, 27, 31; OSBA M.B. pp. 2-5; OTS M.B., p. 54. OTS requests that the Commission order the Company to provide a cost of service study for present rates as well as proposed rates in the restructuring case. OTS M.B., p. 55.

PICGUG objects to the COSS adjustments made by OCA. PICGUG M.B., p. 31. PICGUG supports PGW's position regarding the classification of 25% of the

Company's investment in distribution mains as customer-related and 75% of the investment classified as demand related. PGW St. 5.0, p. 18; PICGUG M.B., pp. 31, 32. PICGUG rejects OCA's suggestion that the peak and average demand method be used to allocate the entire amount of the investment. PICGUG asserts that natural gas distribution companies plan and invest in distribution mains to attach customers to the system regardless of how or when they take service. PGW St. 5.1, pp. 2-3; PICGUG St. 1S, p. 2; PICGUG M.B., pp. 32, 33.

Since the COSS is being used merely as a guide in this proceeding, the adjustments requested by OCA are not warranted. The parties used the COSS that was presented to make their arguments. At this point in the proceeding, additional revisions are not necessary. Consequently, OCA's recommendation to change the cost of service study is denied. The Commission should accept OTS' recommendation and order the Company to provide a cost of service study for present rates as well as proposed rates during the restructuring proceeding.

2. Revenue Allocation Between the Rate Classes

PICGUG and OSBA note that pursuant to PGW's Cost of Service Study ("COSS") submitted in this proceeding, PGW's residential customer classes are receiving significant and unjustified subsidies from the commercial and industrial classes. PICGUG St. No. 1, p. 8. The commercial and industrial customer classes are receiving service from PGW at rates significantly above their cost to serve, while the residential customer classes are receiving service at rates significantly below their cost to serve. *Id.* at 8-9. Therefore, PICGUG states that in order to begin to remove the existence of this subsidy, any rate increase granted to PGW in this proceeding must be allocated in full to the residential customer classes. PICGUG objects to the Company's proposed rate structure which continues to allocate a portion of the proposed rate increase to the commercial and industrial customer classes. PICGUG M.B., pp. 26, 27. PICGUG suggests that in order

to begin to move away from such subsidization, a larger portion of the rate increase must be passed to the residential customer classes. PICGUG St. 1, pp. 9-12; PICGUG M.B., pp. 26-31.

PICGUG and OSBA suggest that removing this subsidy is also vital in light of PGW's forthcoming restructuring proceeding. In the restructuring proceeding, PGW will be required to unbundle its rates in order to provide all customers the opportunity to transport natural gas on the Company's system. Kalcic's Direct Testimony, OSBA St. 1, p. 5. Currently, PGW's transportation rates are not cost-based and, as a result, contribute to the subsidization of the residential customer classes. Thus, the Company's current transportation customers are placed at a competitive disadvantage compared to transportation customers on other NGDCs' systems. PICGUG St. 1, pp. 21-22. In order to ensure full and successful transportation in the future, PICGUG and OSBA argue that PGW's first step must be to provide cost-based transportation rates in this proceeding, while also taking the necessary steps to begin to remove the subsidy currently being provided to the residential customer classes. PICGUG M.B., pp. 30, 31; OSBA M.B., pp. 6, 7.

PICGUG asserts that the OCA's claims that PGW's COSS is improper must be rejected as unsubstantiated and unsupported. PICGUG St. 1S, pp. 2-4. The OCA's proposed modifications to the Company's COSS fail to recognize the cost causation principles behind the Company's allocations and would improperly allocate costs away from the Company's residential customer classes to the commercial and industrial customer classes. *Id.* For these reasons, PICGUG recommends that the OCA's proposal be rejected. PICGUG M.B., pp. 31-33.

Since the aforementioned subsidy results in unreasonably higher rates for PGW's commercial and industrial customers, PICGUG submits that the Company's proposed rate allocation must be modified. PICGUG recommends that the total revenue

requirement granted to PGW in this proceeding be assigned to PGW's residential classes. (It should be noted that PICGUG is not recommending a rate decrease for the commercial and industrial customers in this proceeding. PICGUG St. 1, p.10). Under this proposal, the overall rates for the residential classes would increase from the 10.5% proposed by PGW to 13.2%, resulting in a 2.7% increase from PGW's original proposal. PICGUG St. 1, p. 11. Although this modification would still result in a remaining subsidy of \$23 million in the residential classes, PICGUG asserts that allocating the entire rate increase to the residential classes would require the Company to take the first step in moving the residential classes to their cost to serve, while the commercial and industrial customers would be provided some rate relief from the unreasonably high rates they are currently facing. Id.; Kalcic's Rebuttal Testimony, OSBA St. No. 2, p. 3.

PICGUG suggests that if the PUC decides not to allocate the full rate increase to the residential customer classes, the Commission could alternatively allocate a larger increase to the residential classes than that already recommended by the Company. For example, the residential class could receive three times the percentage increase given to the other classes. PICGUG St. 1, p. 11. Another option would be to target the residential class with an increase of 1.25 times the system average increase of 15.1%, with a downward adjustment to the Company's proposed across the board increase to the firm non-residential classes. OSBA St. 1, pp. 7-8. Either of these proposals would mitigate the increase to the residential customer classes. Although these options would result in a remaining subsidy to the residential classes. PICGUG and OSBA contend that this modification would move towards the proper direction in eliminating the subsidy underwritten by the commercial and industrial customer classes. PICGUG St. 1, pp. 11-12; OSBA St. 1, p. 8.

OTS recommends that PGW increase rates to the LBS Large Direct, TriGen Direct and NGV Direct customer classes to recover costs allocated to them. OTS M.B.

pp. 56, 57; OTS St. 3, pp. 11, 12. OTS suggests that the rates to GTS Trans customer class should be reduced. OTS M.B. p. 57.

OTS' recommended revenue allocation retains the current volumetric charge for all classes except the residential class. Since the residential class is being subsidized by the other customer classes, OTS proposes that the residential class receive a volumetric decrease after the other classes obtain the maximum reduction. OTS M.B. p. 58; OTS Ex. 3, Schedule 3 – Revised.

OSBA states that the residential class' base rate would have to be increased to 26.65% to fully recover its cost of service. OSBA proposes a modest increase for the commercial and industrial classes. OSBA submits that the residential class should bear most of the increase. OSBA M.B., pp. 3, 5; OSBA St. 1, p. 4, Schedule BK-1.

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

3. Rate Design

PGW proposes to increase the Customer Charge of the Commercial class from \$10.00 to \$25.00. PGW St. 4, p. 7. The Company's rationale for this customer charge increase includes, among its other arguments, a comparison of PGW's customer charge to other natural gas utilities throughout Pennsylvania. *Id.* at 4-7.

The OSBA proposes an increase in the Commercial customer charge from \$10.00 to \$17.50, and applies the residual increase necessary to recover the class revenue target to the Commercial commodity charge, which increases from \$7.1200 per Mcf to \$7.1897 per Mcf. OSBA St. 1, p. 10. OSBA states that its proposal mitigates the rate impact that the \$25.00 charge would visit upon smaller Commercial ratepayers, while still providing the rate relief that PGW claims that it needs. In addition, moving the Commercial customer charge to \$17.50 brings PGW more in line with the current statewide Commercial customer charge average of \$16.79 as calculated by Mr. Metro. OTS Exhibit No. 3, Schedule 5.

OSBA suggests that PGW's proposal to increase the Commercial customer charge from \$10.00 to \$25.00 is excessive for a number of reasons. First, PGW's proposal would result in a 150% increase to the Commercial customer charge. This is not the "application of the concept of gradualism" that PGW advocates. OTS Ex. No. 3, Schedule 1, p. 2. Second, any 150% increase is suspect in and of itself. Finally, PGW did not pay attention to its own testimony where it compared its proposed Commercial customer charge to that of other Pennsylvania utilities. A simple review of PGW Statement No. 4 shows that \$25.00 is far beyond the Commercial customer charge of nearly every utility that PGW chooses to list. OSBA M.B., pp. 8, 9.

The OSBA rate design proposal in this proceeding also takes into account the possibility that PGW may be granted less than its requested amount of base rate relief. The OSBA recommends that the Commercial customer charge remain fixed at \$17.50 regardless of the level of increase ultimately allowed. The reduced Commercial class revenue requirement should then be realized by scaling back the Commercial class commodity charge, thereby providing PGW with a 75% increase in its Commercial customer charge independent of the final level of rate relief granted by the Commission.

The OSBA submits that its recommended rate design is responsive to PGW's revenue stability concerns. PGW St. 4 (Revised), p. 5; OSBA M.B., p. 9.

a. Customer Service Charge

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

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

PGW St. 4.0, pp. 6, 7; PGW Ex. HSG-1, Sch. 2; Supp. #9 to Tariff Gas Pa. P.U.C. No. 1 Second Revised, p. 83; PGW M.B., pp. 62-65.

OSBA proposes an increase in the commercial customer charge from \$10 to \$17.50.

In the interest of gradualism, OTS is proposing a residential customer charge of \$12, a commercial charge of \$18 and industrial customer charge of \$50. OTS M.B., pp. 61-64.

OCA suggests that the residential customer charge be \$11.50. OCA M.B., p. 56; OCA Ex. 2-B, Table REM-1.

Based on the evidence, it is reasonable to accept OTS' proposal to increase the residential customer charge to \$12.00, increase the commercial charge to \$18 and increase the industrial charge to \$50.

b. Commodity Charge

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

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

OSBA recommended a commodity charge of \$7.1897 for the commercial class if the entire \$65 million increase were awarded. OSBA requested that the charge be scaled back proportionately if the increase was less. OSBA M.B., pp. 2, 8.

OTS suggested that the proposed volumetric charge for residential customers be increased from \$6.6130 to \$7.0051 with the other classes remaining at \$7.12. OTS St. 3, p. 15 (Revised); OTS M.B., p. 58.

OCA proposes a commodity charge of \$10.3895. OCA M.B., p. 56; OCA Ex. 2-B, Table REM-1.

In light of the cost of service, it is reasonable to keep the non-residential classes at their present rates and grant a small increase for the residential class. Consequently, OTS' recommendation should be approved.

4. Recovery of Non-Gas Costs in GCR

a. Introduction

PICGUG argues that the Commission should reallocate certain non-gas costs, such as electricity and bad debt expenses which are currently contained in the Company's Gas Cost Rate ("GCR") to base rates. Other NGDCs in Pennsylvania collect only pure gas costs through the Purchased Gas cost ("PGC") mechanism. PICGUG M.B., p. 5. PGW recovers electricity and bad debt expenses and non-gas expenses related to the Company's Customer Responsibility Program ("CRP") and Conservation Works Program ("CWP") through the GCR. Since PGW is guaranteed to recover these costs, there is no incentive to efficiently and effectively manage the costs of these programs. PICGUG M.B., p. 33; OCA St. 1 (LeLash) pp. 48-50; OTS St. 4, p. 3.

The Company's firm rate customer's bill contains two volumetric charges plus a monthly customer charge. The volumetric charge consists of a base rate charge and a Gas Cost Rate, which presently includes various non-fuel costs under PGW's existing tariff. More specifically, the Company's GCR includes:

- Natural gas and purchased electric expenses; and
- Non-fuel costs associated with the Company's Customer Responsibility Program (CRP), the Conservation Works Program and the Senior Citizen Discount Program. PGW M.B., pp. 66, 67.

Historically, the Company has collected these costs through the GCR because it assured dollar-for-dollar recovery of these non-gas costs. Philadelphia City Council mandated these social programs and the method was accepted by the PGC.

Moreover, it assured that these costs were collected in the year in which they were incurred, with virtually no build-up or over/under collection. PGW M.B., p. 67.

OTS asserts that non-gas costs are not properly recoverable through the GCR. These programs are part of the Company's current tariff. PGW contends that pursuant to Section 2212(d) of the Public Utility Code, the Commission may only make tariff modifications to those changes initiated by the Company. While the Commission is constrained from acting on the tariff in this matter, the Company intends to re-examine the social costs issue in its Restructuring Proceeding.

PGW argues that recovering these social costs in the GCR is proper because it provides a mechanism for dollar-for-dollar recovery of these costs and thus helps lessen the financial risks of under-recovery on the Company's ratepayers. Unlike investor-owned utilities, the Company has no shareholders to absorb under-recovery of social program costs. Accordingly, PGW suggests that a sure way to ensure full recovery of these costs is to include them in the GCR, and that this issue should be re-examined in the Company's Restructuring Case. PGW M.B., p. 67.

Currently, PGW's GCR recovers expenses for electricity, the CWP, the CRP, and bad debt. OCA St. 1, p. 46. Normally, the GCR reflects the gas costs paid by the Company. The use of the GCR mechanism to recover the aforementioned non-gas costs guarantees that PGW will recover all of its CRP and CWP costs while providing no incentive for the Company to either control program costs or manage the size of the programs. Keim's Direct Testimony, OTS St. 4, p. 3.

Although the PUC directed PGW to address the appropriateness of including non-gas costs in its GCR, PGW chose not to address these costs in any substantive manner or provide any recommendations in its filing concerning the recovery of non-gas costs. See Pa. Public Utility Commission v. Philadelphia Gas Works, Docket

No. R-00005619, Order (Nov. 22, 2000), p. 10; PGW St. 4.0, p. 10. While PICGUG asserts that the GCR must be revised to remove non-gas costs, PGW's lack of proposals regarding this issue may hinder a full reallocation of these costs. Since the restructuring filing will include a base rate filing, as well as the necessary unbundling proposals, PICGUG proposes that some of the cost reallocations be done during the Company's restructuring proceeding. OCA St. 1, p. 48; PICGUG M.B., p. 34.

To begin the primary steps for this reallocation, PICGUG suggests that the PUC consider performing some selective reallocation in this proceeding, while leaving the more complex reallocations for the Company's restructuring proceeding. OCA St. 1, p. 48. Specifically, both bad debt and electricity expenses, which are currently being recovered through the GCR, are non-gas costs that could be recovered in base rates. *Id.* at 48-49. Conversely, PGW is currently recovering \$3.18 per Mcf of gas costs through the base rates. Because this amount is a "gas cost," it would be more properly recovered in the GCR. *Id.* at 49. By removing the rolled-in gas costs from the base rates to the GCR and reallocating the bad debt expense and electricity expense from the GCR to the base rates, the Commission will be providing the first steps in ensuring that PGW's GCR only recovers gas costs, similar to other NGDCs throughout Pennsylvania. *Id.* at 48-49. PICGUG M.B., p. 34.

Due to PGW's failure to present any proposals regarding this matter, PICGUG believes that a full reallocation of non-gas costs from the GCR may not be practical at this time. The OTS proposes that the costs from the Company's CRP and CWP should be recovered through base rates instead of the GCR mechanism. OTS St. 4, pp. 3, 6. PICGUG suggests that this proposal is more complex than simply removing the bad debt and electricity expenses from the GCR. PICGUG asserts that the OTS provides no explanation for how this reallocation will be accomplished. Although the OTS claims that the net impact of the proposed adjustments would be zero on a customer's bill, PICGUG submits that the OTS's failure to provide further explanation results in great

difficulty for determining whether the reallocation is appropriate. Id. PICGUG M.B., pp. 34, 35.

- b. The OTS, OCA and PICGUG recommendation that the recovery of purchase electricity costs be excluded from the GCR mechanism.

As explained by OTS witness Metro, PGW includes in the Total Applicable Fuel Expense in its GCR approximately \$965,000 for purchased electric.⁴⁰ The purchased electric costs represent the electrical usage by the plants and buildings of the Company. Accordingly, it is easy to classify purchased electric expenses as a non-natural gas cost.⁴¹ OTS is of the opinion that purchased electric expense should be removed from the fuel cost and properly included in the Company's Operations and Maintenance Claim in base rates. OTS M.B., p. 44. OCA and PICGUG agree that the purchased electricity cost should be a base rate item. OCA M.B., p. 57.

With the removal of purchased electric expense from PGW's GCR, approximately \$965,000 will be removed from the Total Applicable Fuel Expense and placed into Operations and Maintenance Expenses. OTS M.B., p. 44.

The recovery of purchased electricity costs should be excluded from the GCR mechanism in this proceeding. These costs should be in the base rates.

- c. The OTS and PICGUG recommendation that the recovery of bad debts be excluded from the GCR mechanism.

OTS and PICGUG object to bad debts being recovered in the GCR mechanism since it is not a gas cost. In the settlement for the interim base rate case, PGW was allowed to collect \$7 million to defray the bad debt expense. In addition,

⁴⁰ See OTS St. No. 3, at page 32.

⁴¹ See OTS St. No. 3, at page 33.

PGW is allowed to retain overrecovered GCR revenues up to \$18 million for bad debts. Therefore, the Commission has taken the Company's situation into account and provided relief. Accordingly, the recommendation to exclude bad debts from the GCR is approved.

- d. The OTS recommendation that the recovery of senior citizen discount costs be removed from the GCR mechanism.

PGW's Senior Citizen Discount ("SCD") program is a customer assistance program which provides for reduced monthly charges to those customers who are City residents, 65 years of age or older, and pay for gas service at their residence. OTS Statement 4, p. 5. Customers meeting the age and residential requirements pay only 80 percent of their total monthly bill for gas service and receive a discount of 20 percent. The cost of the program for the twelve months ended August 2001 is \$21,884,717. OTS Ex. 4, Schedule 1, p. 4; OTS M.B., p. 47.

The SCD program costs are being recovered through PGW's GCR mechanism. OTS Ex. 4, p. 8.⁴² It is undisputed that SCD costs are non-gas costs, and it is OTS' position that since the costs are non-gas costs, such costs do not belong in the GCR mechanism. OTS recommends that the recovery of the SCD program costs should be in base rates since inclusion of these program costs in base rates will encourage management to exercise additional control over the program so as to keep it within the cost constraints built into rates. OTS Ex. 4, p. 9; OTS M.B., p. 48.

The SCD program costs should be in base rates instead of the GCR. This issue should be deferred until the restructuring proceeding to permit PGW and the other parties to fully address this issue.

⁴² See OTS Exhibit No. 4, at page 8.

- e. The OTS recommendation that the recovery of the Conservation Works Program costs be excluded from the GCR mechanism.

As OTS witness Keim explained, the Conservation Works Program ("CWP") is a customer program designed to provide cost-effective energy savings to PGW's low-income customers who participate in the Customer Responsibility Program ("CRP") and is intended to reduce the overall long-term costs of the CRP. OTS Statement 4, p. 5. The program provides energy conservation measures such as thermostats, weather stripping, insulation, etc.

While OTS is not disagreeing with the concept of the program, OTS does disagree with the recovery mechanism. In that regard, like the CRP program, the CWP costs are recovered in PGW's GCR mechanism, which OTS submits improperly provides for dollar-for-dollar recovery of non-gas costs. OTS argues that with the dollar-for-dollar recovery available for the CWP program there is no incentive for PGW to control the program's costs. OTS M.B., p. 46.

Consequently, like the CRP program, the CWP costs should be recovered through an allowance in base rates. As Mr. Keim explained, base rate recovery for the costs of the CWP is the proper method since the annual cost is a fixed, budgeted amount, without the volatility of gas costs.⁴³ Moreover, the CWP expenses have been stable in recent years, can easily be projected, and are not volatile.

OTS suggests that the amount of CWP costs to be included in base rate should be \$2,200,000.⁴⁴

⁴³ See OTS St. No. 4, at page 6.

⁴⁴ See OTS Exhibit No. 4, Schedule 2, at page 2.

Although the CWP costs should not be recovered in the GCR mechanism, my recommendation is that this issue be deferred until the restructuring proceeding to allow PGW and the other parties to fully address this issue.

- f. The OTS recommendation that the recovery of the Customer Responsibility Program costs be excluded from the GCR mechanism.

PGW's Customer Responsibility Program ("CRP") is a low-income customer assistance program, which appears to be similar to other Customer Assistance Programs ("CAP") of other Pennsylvania gas utilities.⁴⁵ As OTS witness Keim explained, CAPs are designed as alternatives to traditional collection methods for low income, payment troubled customers. Generally, customers participating in CAP programs agree to make monthly payments based on household family size and gross income. OTS M.B., p. 44.

While PGW's CRP appears to comply with most of the requirements for low-income customer assistance programs as contained in the Commission's Order Regarding Revisions to the Customer Assistance Program Policy Statement, there is one element of the program that OTS submits needs to be revised.⁴⁶ The revision concerns the method of recovery of CRP program costs incurred by PGW. The costs associated with the CRP program are recovered through PGW's GCR mechanism. OTS is of the opinion that recovery through the GCR mechanism is improper since (1) the costs of the CRP are non-gas costs and do not belong in the GCR mechanism; and (2) the reason the costs are in the GCR mechanism is to guarantee PGW will recover all of its costs

⁴⁵ See OTS St. No. 4, at page 2.

⁴⁶ See Customer Assistance Program Policy Statement at Docket No. M-00991232 (Order entered April 9, 1999).

associated with the CRP program.⁴⁷ No other Pennsylvania gas utility is recovering its customer assistance program costs through its GCR mechanism, but rather through their base rates. Recovering customer assistance program costs through base rates, where the amount of the expense allowed is fixed, provides an incentive for those gas utilities to manage the costs and size of the program. As the CRP program is presently constituted, PGW has no incentive to manage the costs and size of the program, since the costs have a fully guaranteed recovery through the GCR mechanism. OTS M.B., pp. 44, 45.

OTS recommends that the CRP costs of \$36,852,448 be removed from the GCR mechanism and recovered in base rates.⁴⁸ OTS M.B., p. 46.

It is clear that the costs of the CRP program should not be recovered in the GCR. However, my recommendation is to defer this issue until the restructuring proceeding to allow PGW and the other parties to address this issue.

5. Tariff Changes

a. PGW's proposed revisions

1) Nonstandard Rates

The Company proposes to modify its tariff by adding a new section 2.3 to allow it to enter into individual contracts with commercial and industrial customers at negotiated prices and/or terms and conditions of service for an agreed upon period of

⁴⁷ See OTS St. No. 4, at page 3.

⁴⁸ See OTS St. No. 4, at page 5 and OTS Exhibit No. 4, Schedule 1, page 4.

time. PGW St. 4.0, p. 10. This flexibility will allow the Company to offer individual, alternative pricing solutions to customers when they are faced with competitive fuel offerings, or to lure them back when they use an alternative fuel. Since this arrangement offers rates and/or terms of service that are different than PGW's standard schedule, the Company characterizes these arrangements as "non-standard contracts." PGW St. 4.0, pp. 10-12.

OCA supports the Company's proposal to be allowed to negotiate non-standard rates for some of its customers. OCA suggest three changes to section 2.3. OCA M.B., pp. 58, 59. OCA argues that the revisions are necessary to ensure that the sales customers are not disadvantaged by the contracts PGW negotiates under section 2.3. OCA M.B., p. 59.

After reviewing the proposed modifications, my recommendation is that PGW's proposal be adopted without revision. OCA's suggestions are too restrictive.

2) BPS Price Ceiling

The Company proposes to clarify the rate schedules for BPS-S and BPS-L to remove any confusion over the maximum price that the Company can charge its BPS customers.

Presently, the rate schedules can be read to limit the maximum price that the Company can charge its BPS customers to 90% of the General Service (GS) rate for commercial customers, even if that rate is below PGW's cost of gas. To eliminate this confusion, the Company proposes to eliminate the 90% provision. The Company prefers that it be permitted to charge at least 110% of the cost of gas used to serve the BPS-S and

BPS-L classes. PGW M.B., p. 66. OCA concurs with the decision to remove the BPS price ceiling of 90% of the GS rate from the tariff. OCA M.B., pp. 59, 60.

Therefore, the Company's request should be adopted.

b. OTS' Proposed Revisions

It should be noted that PGW and OTS have agreed to meet in an attempt to resolve OTS' proposed tariffs issues.

In this proceeding, OTS witness Metro raised several tariff issues addressing PGW's service. The tariff issues were: (1) PGW's tariff needs to have tariff language that defines the curtailment rules and priority of service; (2) PGW's NGV tariff should be eliminated; (3) PGW provides interruptible service to apartment complexes that may not have alternate fuel; (4) PGW's transportation tariff does not comply with the Commission's Transportation Regulations; and (5) PGW does not read all of its customers' meters on a timely basis. OTS St. 3, pp. 25-26. In response, PGW witness White testified that 'PGW is willing to continue to work with the Trial Staff at the conclusion of this base rate proceeding – in a workshop environment – to determine whether a specific plan and tariff provision could be mutually agree to.' PGW Statement 4.1, p. 14. PGW and OTS have agreed to meet in a workshop environment in order to find a mutually agreeable solution to the tariff issues addressed in OTS witness Metro testimony. PGW M.B., p. 70; OTS M.B., p. 53.

c. PICGUG's Proposed Revisions

PICGUG asserts that PGW's current transportation requirements are inadequate, antiquated and too discretionary to actually permit any form of true transportation on the Company's system. Other NGDCs in Pennsylvania have been

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

Since the Natural Gas Choice and Competition Act ("Competition Act") requires PGW to present a restructuring filing no later than July 1, 2002, PICGUG submits that this filing must set forth the means for unbundling all of the Company's rates in order to provide all customers the ability to transport natural gas on the Company's system. 66 Pa. C.S. §2212(g). Since other NGDCs were already providing large industrial and commercial customers the opportunity to transport natural gas prior to restructuring, their restructuring proceedings were limited to merely expanding transportation programs to include residential and small commercial customers. Conversely, because PGW effectively prohibits most customers from transporting on the Company's system, PGW's restructuring proceeding will require significant and profound changes to the Company's transportation regulations in order to provide all customers the ability to transport natural gas on the Company's system. Tr. 704-06; PICGUG M.B., pp. 7, 8.

Inasmuch as massive changes will be required as part of PGW's restructuring proceeding, PICGUG contends that PGW should be required to modify its transportation rules now to provide an orderly and working transportation system for large industrial and commercial customers, similar to those present on other NGDCs' systems prior to restructuring. By providing these modifications in this proceeding, PGW will be making the initial steps towards the overall restructuring of the Company's natural gas transportation system. Moreover, providing a sound basis for large industrial and commercial transportation customers in this proceeding will allow for an easier transition

of PGW's entire system during the Company's restructuring proceeding. PICGUG M.B., p. 8.

PICGUG presents several recommendations in this proceeding regarding the modification of PGW's transportation rules and regulations. The purpose of these recommendations is to expand the Company's current transportation requirements, which are so rigid and archaic as to prevent almost all of PGW's large industrial and commercial customers from transporting on the Company's system. Contrary to PGW's claims, these proposed modifications are proper in light of the Competition Act and the Public Utility Code. White's Rebuttal Testimony; PGW St. 4.1, p. 18; PICGUG M.B., pp. 8, 9.

According to Section 2212(b), "commencing July 1, 2000, public utility service being furnished or rendered by a city natural gas distribution operation within its municipal limits shall be subject to regulation and control by the commission with the same force as if the service were rendered by a public utility." 66 Pa. C.S. §2212(b). Section 2212(d) supplements this provision with the following:

A city natural gas distribution operation shall continue to provide natural gas supply and natural gas distribution services to its customers under the prior tariff and the policies or programs existing on the date that the commission assumes jurisdiction over the city natural gas distribution operation until the effective date of the final order entered by the commission approving the restructuring plan and new tariff of the city natural gas distribution operations unless such effective date has been stayed by a court of competent jurisdiction, in which event the prior tariff will continue in force until such stay has been dissolved. Subject to subsection (s), the commission shall resolve all questions, disputes or conflicts arising under the prior tariff. Nothing in this section shall prevent a city natural gas distribution operation from requesting or, if so requested, the commission from approving modifications to the prior tariff at any time

prior to the effective date of the final order approving the restructuring plan and new tariff.

66 Pa. C.S. §2212(d).

The purpose of this provision was to provide PGW with some level of comfort regarding the rates and services that will be provided by the Company during the transition time between jurisdiction over PGW shifting to the PUC and the conclusion of the Company's restructuring proceeding.

The Public Utility Code, however, provides that:

[e]very public utility shall furnish and maintain adequate, efficient, safe and reasonable services and facilities Such services and facilities shall be in conformity with the regulations and orders of the commission. Subject to the provisions of this part and the regulations or orders of the commission, every public utility may have reasonable rules and regulations governing the conditions under which it shall be required to render service.

66 Pa. C.S. §1501.

Accordingly, PICGUG notes that a public utility must ensure reasonable and adequate service for all of its customers through rules and regulations established by the Commission. PICGUG M.B., p. 10.

PICGUG contends that PGW should not be permitted to take advantage of this provision by continuing to provide inadequate and unreasonable transportation service to its customers, contrary to Commission rules and regulations. The changes proposed by PICGUG to the Company's transportation rules and regulations are timely, and, even more importantly, past due. Compared to other Pennsylvania NGDS that have

permitted industrial customers to transport natural gas since the mid-1980's, PGW's restrictive and anachronistic regulations provide unreasonable barriers to transporting that cannot and should not be permitted. Baudino's Surrebuttal Testimony, PICGUG St. 1S, p. 5. In addition, PICGUG submits that allowing only PGW to propose modifications to its tariff will not provide an appropriate solution, as PGW does not recognize the problems inherent in its transportation system. PICGUG M.B., p. 10.

PICGUG states that the proposed modifications would not so substantively modify PGW's transportation rules and requirements as to move forward with full customer choice prior the Company's restructuring proceeding. Instead, the proposed modifications would merely place PGW's transportation programs at the same level as other NGDCs, prior to the onset of the Competition Act. As a result, the interests of PGW must be balanced with the requirements of the Commission and the needs of PGW's customers in order to ensure that PGW is providing the same level of service as that of other NGDCs in Pennsylvania. PICGUG argues that to allow PGW to provide inadequate service until after the conclusion of its restructuring proceeding, in approximately 2003, is both unfair and unjust to PGW customers. PICGUG M.B., p. 11.

1) PGW's Volume Eligibility Requirement For Transporting Natural Gas Must Be Lowered

According to PICGUG, PGW's current transportation requirements unreasonably inhibit the ability of customers to transport natural gas on the Company's system through excessive volumetric requirements. PICGUG St. 1, pp. 14-16. PGW's tariff states that "[t]ransportation service shall be provided by the Company within its service territory as agent for the individual Customer or for a Buyer Group of no more than three individual Customers who contracts for transportation and delivery by the Company of at least 75,000 Mcf of gas per year." PGW Tariff Gas – Pa. PUC No. 1, p. 113. Because this excessive requirement in effect prohibits most large industrial and

commercial customers from transporting on PGW's system, the PUC should lower PGW's minimum volumetric requirement to 5,000 Mcf. PICGUG St. No. 1, pp. 14-16; PICGUG M.B., p. 11; PGW M.B., p. 68. In the alternative PICGUG has proposed a minimum volumetric requirement of 15,000 Mcf. PICGUG M.B., p. 15.

PICGUG states that PGW's minimum volumetric requirement is stringent when compared to other NGDCs in Pennsylvania. PECO Energy Company ("PECO"), an NGDC providing natural gas service to suburban areas outside of Philadelphia to customers with whom PICGUG members must compete, allows for a minimum consumption level of 5,000 Mcf per year for transportation eligibility. PICGUG Direct Examination Exhibit No. 1. While PGW has rejected the notion of providing transportation service similar to that currently provided by other NGDCs, PGW has aligned itself with the other NGDCs for purposes of its Customer Charge. PGW has proposed that the Company's Customer Charges should be increased in order to compare more favorably to other NGDCs' customer charges throughout Pennsylvania. PGW St. No. 4.0, pp. 5-7. PICGUG submits that If PGW intends to charge the rates set forth by other NGDCs, then the Company should also be required to provide services equivalent to these higher rates. PICGUG M.B., pp. 11, 12.

In addition, the Commission's regulations provide greater opportunity for customers to transport natural gas by permitting more reasonable minimum volumetric requirements. Pennsylvania regulations provide that the "minimum volume of transported natural gas that entitles a customer to transportation service may not be greater than 5,000 Mcf per customer or buyer group per year." 52 Pa. Code §60.3(a). Because this minimum volumetric requirement is much lower than that currently provided by PGW, the Company's transportation rules and regulations do not comply with Commission regulations. Metro's Direct Testimony, OTS St. 3, pp. 30-31. As a result, PGW should be required to modify its minimum volumetric requirement to meet that set forth by the Commission. Id. PICGUG M.B., p. 12.

PICGUG notes that for approximately twenty years, other large industrial and commercial customers have had the opportunity to transport their own natural gas on other Pennsylvania NGDCs' systems. Unfortunately, PGW's unwillingness to move forward with the other NGDCs has left PGW's customers at a competitive disadvantage. If a customer does not meet PGW's volumetric requirements, the customer has no choice but to accept natural gas sales service from PGW, while other large industrial and commercial customers in the marketplace have the opportunity to shop for and seek out Natural Gas Suppliers ("NGS") that can offer cost-efficient savings. As a result, PGW's service to its transportation customers continues to remain inadequate and unreasonable. PICGUG M.B., p. 13.

PGW argues that PICGUG's proposed modifications are inappropriate and would result in a shock to PGW's system if large numbers of customers were to begin transporting. PGW St. 4.1, pp. 18-19. PICGUG states that PGW fails to provide any evidence, though, that the Company could not handle increased transportation on its system. Rather, PGW provides vague and unsubstantiated assertions that increasing the number of transportation customers on the Company's system is not feasible. *Id.*; PICGUG St. 1S, pp. 5-6. As a result, PGW's argument is nothing more than a futile attempt by the Company to persuade the PUC that it is not capable of doing a job that other Pennsylvania gas utilities have been doing successfully for years. PICGUG St. 1S, pp. 5-6; PICGUG M.B., pp. 13, 14.

Moreover, PGW has admitted that the Company's current transportation customers are responsible for purchasing their own natural gas, arranging for the transportation of that natural gas to PGW's city gate, and interacting with the interstate pipeline supplier for this natural gas. Tr. 706-07. In addition, the Company has stated that a transportation customer has an obligation to determine, for itself, whether it is in balance with PGW's system. *Id.* 699-701. Therefore, based upon PGW's concessions

that a transportation customer handles the majority of the issues associated with transporting the natural gas, it is unclear as to why PGW's minimum volume requirements could not be lowered to allow additional customers to transport. Moreover, considering the fiscal problems PGW faces, allowing more customers to maintain responsibility for transporting their own natural gas should ease PGW's burden and allow the Company to focus upon other issues it currently faces.

PGW contends that these issues should be addressed during PGW's restructuring proceeding. PGW St. 4-1, p. 18.

In light of PGW's constant claims of systemic problems regarding PICGUG's proposed lowering of the volumetric requirement, PICGUG has proposed an alternative recommendation in this proceeding. Specifically, if the PUC is concerned with PGW's ability to handle the volume of additional transportation customers that would be eligible for enrollment if the transportation requirement were lowered to 5,000 Mcf, then the Commission could consider the higher alternative of 15,000 Mcf. PICGUG St. 1S, p. 7. Although this level is three times greater than that provided for in Commission regulations, this minimum volumetric requirement would still allow the Company to expand transportation services to more of the Company's larger customers. Moreover, lowering the requirement to 15,000 Mcf would continue to allow the Company more experience in handling transportation customers prior to PGW's forthcoming restructuring proceeding, which will require the unbundling of all of the Company's rates. PICGUG M.B., p. 15

PGW's position that tariff changes should be deferred until the restructuring proceeding should be rejected. This change will facilitate the changes that will occur in the restructuring proceeding.

2) PGW's Transportation Customers Must Be Permitted to Aggregate Facilities Serviced by Multiple Accounts.

PGW's current transportation regulations fail to provide any provisions that would allow a customer to aggregate facilities served by multiple accounts and account numbers, in order to qualify for transportation service. PICGUG St. 1, p. 16; PICGUG M.B., p. 15.

Many large industrial and commercial customers have numerous facilities with various accounts. Many of these customers could satisfy PGW's minimum volume requirement if their accounts could be pooled. As a result, PGW's system would be open to greater competition in the natural gas marketplace. In addition, as noted by PGW, the transportation customer has the responsibility for purchasing and arranging these natural gas deliveries. Tr. 706-07. By allowing a customer to compile all accounts and/or facilities, PGW is further eliminating the burden upon the Company to arrange for the sale and delivery of natural gas to all of these accounts. PICGUG M.B., p. 16.

PICGUG states that the ability to aggregate facilities provides a large industrial or commercial customer greater cost-efficiency. By combining their facilities, the customer can obtain the best price for natural gas overall from a natural gas supplier instead of negotiating each transportation contract separately. PICGUG M.B., p. 16; PGW M.B., p. 68.

PGW requests that this tariff change be rejected in this proceeding. This recommendation should be implemented to foster competition in the marketplace.

3) PGW Should Expand the Buyers Group

PICGUG submits that PGW's requirement that "[t]ransportation service shall be provided by the Company...for a Buyer Group of no more than three individual Customers" is also antiquated and unreasonable. PGW Tariff Gas – Pa. PUC No. 1, p. 113; PICGUG St. 1, pp. 16-17. By limiting a Buyers Group to three customers or less, PGW is stifling transportation on the Company's system. PICGUG maintains that this limitation of three customers to a Buyers Group is merely one more hindrance to a customer attempting to transport natural gas on PGW's system. PICGUG M.B., pp. 16, 17.

Other NGDCs in Pennsylvania allow for larger Buyer Groups. PECO permits a Buyers Group of up to ten individual customers and has the discretion to increase the group to eleven or more. PICGUG Direct Examination Exhibit No. 1: PICGUG St. 1S, pp. 6-7; PGW M.B., p. 68. A larger Buyers Group enables a customer or marketer to acquire a larger volume of gas and potentially reduce the cost for everyone in the group. PICGUG St. 1, p. 17. Similarly, a larger Buyers Group allows for the offsetting of imbalances among customers, thereby reducing the potential daily and monthly imbalance for the group. *Id.* PICGUG M.B., p. 17.

In light of PGW's restrictive transportation regulations, a larger Buyers Group would enable a greater number of customers to meet PGW's minimum volumetric requirement. Similarly, by increasing the size of the Buyers Groups, PGW customers with more than one account would have the opportunity to compile those accounts in cost-efficient manner. PICGUG recommends that the PUC require PGW to enlarge its Buyers Group requirement to permit a minimum of at least ten customers per Buyers Group with the discretion to increase the group to eleven or more customers. PICGUG M.B., p. 17.

PGW's request to defer all tariff changes until the restructuring proceeding should be rejected. The Buyers Group should allow for the inclusion of up to 10 individual customers.

4) PGW's Transportation Customers Must Be Permitted to Make Intra-day Nominations

PICGUG argues that once PGW's stringent requirements for allowing a customer to transport on the Company's system are met, the transportation customer still faces further, and unreasonable, restrictions that inhibit the customer's ability to transport natural gas quickly and efficiently. PICGUG M.B., p. 18.

Specifically, PGW's tariff provides that a customer

may modify the quantities it intends to have delivered to Company's City Gate in accordance with the monthly and daily nomination procedure of the delivering pipeline. All delivery arrangements must be coordinated with the Company's Gas Control Dispatcher in a manner deemed acceptable by the Company. Company shall, within the limitations of its system, assist in this balancing effort.

PGW Tariff Gas – Pa. PUC No. 1, p. 117.

PICGUG contends that PGW's tariff seems to indicate that a customer may modify its nominations on PGW's system, as long as these modifications are in accordance with the monthly and daily nomination procedure of the delivering pipeline. Tr. 708; PGW M.B., p. 69. In reality, the guarantee of this nomination is not automatic. Instead, PGW, based upon its sole discretion, determines whether operational conditions on the Company's system will allow for such a nomination modification. Tr. 691-95; PICGUG M.B., p. 18.

PICGUG submits that although transportation customers on PGW's system may request intra-day modifications from PGW, the customers do not know whether this modification will be granted. PICGUG St. 1, pp. 17-18. Since PGW retains sole and unfettered discretion over this decision, PGW can choose to deny a nomination based upon operational conditions or for any reason. *Id.* Although PGW indicates that it has never denied an intra-day nomination, PGW has only eight customers with transportation contracts at this time. Tr. 694-695, 706. As a result of the limited number of customers with transportation contracts, PGW most likely does not encounter numerous intra-day nominations on a regular basis. *Id.* at 706. PICGUG M.B., pp. 18, 19.

As required by the Competition Act, PGW will be unbundling its rates as part of the Company's restructuring proceeding to allow for transportation by the residential, commercial and industrial classes. When this occurs, hopefully the number of customers and marketers on PGW's system will increase dramatically. This leads to the conclusion that PGW's requests for intra-day nominations will also increase. As a result, PGW must have in place some mechanism by which a transportation customer can determine whether an intra-day nomination will be accepted. PGW's first alternative would be to follow the policy set forth in the Company's tariff (*i.e.*, an intra-day nomination meeting the delivering pipeline's requirements will be approved by PGW) minus the discretionary aspect adhered to by PGW. PICGUG St. 1, p. 18. Since PGW claims that following the provisions set forth in the Company's tariff will threaten the Company's operational system, an alternative would be for PGW to explicitly state the conditions and/or criteria under which it will accept intra-day nomination changes from transportation customers in light of any system integrity concerns. Tr. 693; PICGUG St. 1, p. 18. PICGUG submits that setting forth such criteria will not implicate the integrity of PGW's system, instead it will eliminate the undue discretion the Company currently maintains with respect to accepting nomination changes from its customers and will

clarify the Company's transportation requirements to the benefit of its customers.
PICGUG M.B., p. 19.

This recommendation, like the previous recommendations, will assist PGW in becoming more competitive and place it in a better position for the restructuring proceeding. Thus, PICGUG's request should be granted.

5) PGW Must Be Required to Provide Daily Imbalance Information to Transportation Customers

PICGUG contends that PGW fails to provide any method by which transportation customers can check nominations or be notified of imbalances, although PGW imposes severe penalties for customers out of balance. PICGUG St. 1, pp. 19-21. To alleviate the additional burden placed on transportation customers, PGW should be required to implement a means of communications by which a customer can check on nominations or be notified of imbalances twenty-four hours a day, seven days a week, similar to that provided by other NGDCs. *Id.* PICGUG M.B., pp. 19, 20.

PGW's tariff provides that imbalances may be permitted within a range of +/- 10% on a daily basis if adjusted within +/- 5% by month's end. PGW Tariff Gas – Pa. PUC No. 1, p. 117. The Company provides customers the option of obtaining emergency gas when gas is not available under the applicable retail sales service, with the cost of this service placed at \$10 for each thousand cubic feet of gas used and a minimum charge for this service of \$100 per occurrence. If the customer uses this service after being notified that the service is unavailable, or uses this service in excess of authorized limitations, such usage is billed at a rate of \$20 for each Mcf. *Id.* Consequently, a customer out of balance on PGW's system using "unauthorized use" natural gas is subject to very stiff penalties. PICGUG St. 1, pp. 19-21; PICGUG M.B., p. 20.

Based upon the aforementioned imbalance penalties, PICGUG submits that it is essential that the Company provide timely daily information regarding imbalances to its customers. PECO provides its transportation customers and marketers with daily imbalance information via the Internet. PICGUG St. 1, p. 20. Columbia Gas of Pennsylvania, Inc. ("Columbia") has an electronic bulletin board that is used for nomination and scheduling gas deliveries on its system. *Id.*; PICGUG Direct Examination Exhibit No. 2. Currently, PGW customers may attempt to contact PGW in an effort to review their metering or determine how much gas is being burned at their facility. Tr. 700-01. PGW does not, however, provide a mechanism by which customers can contact the Company twenty-four hours a day, seven days a week to determine this information. *Id.* PICGUG M.B., pp. 20, 21.

PGW indicated that it is in the process of developing a web site that will allow transportation customers the opportunity to perform online nominations. PGW M.B., p. 69. However, PGW does not plan to have this web site available until September 1, 2003. PICGUG St. 1, p. 20; PGW M.B., p. 69. Moreover, PGW has not provided any details regarding the web site, its accessibility or any information that would be provided on the site. PICGUG M.B., p. 21. While PGW's undertaking is a positive step, it is not reasonable to require transportation customers to wait until 2003 to receive the needed information, especially in light of the stiff penalties invoked by PGW for customer imbalances. PICGUG M.B., p. 21.

PGW suggested that it is the customer's responsibility, not PGW's, to obtain and review the necessary information regarding imbalances. According to PGW, "the customer has an obligation to know where they are. If they want to review the metering or determine how much gas is burdened in their facility, it would behoove them to do so that so they would not overrun their nomination." Tr. 700. PGW does not indicate how a customer can handle such responsibility when PGW does not provide the necessary means by which to access this information. PICGUG notes that other NGDCs, such as

PECO and Columbia, believe it necessary to provide such information to their transportation customers through a twenty-four hour a day, seven day a week mechanism. PICGUG M.B., p. 21.

Even more intriguing is the fact that PGW suggests that transportation customers must handle their own responsibilities because "[t]his is an unbundled world." Id. Throughout this proceeding, PGW has argued that system integrity will be compromised if the Company's transportation requirements are modified to increase the ability of large industrial and commercial customers to transport on the Company's system or to meet the transportation requirements of other NGDCs throughout Pennsylvania. PICGUG contends that If PGW believes that transportation customers maintain their own facilities and responsibilities with respect to transporting natural gas, then modifying PGW's system to meet PUC requirements should not be problematic. PICGUG M.B., pp. 21, 22.

It is unreasonable to wait until 2003 for this information to be available on the proposed website. PGW should provide daily imbalance information to its transportation customers at least by 2002.

6) PGW Must Be Required to Provide Timely Lost and Unaccounted for Gas Information to Transportation Customers

PICGUG notes that although transportation customers are impacted by the Company's lost and unaccounted for gas factor ("LUFGE"), this factor is not stated in PGW's tariff, nor is there any mechanism by which PGW is required to provide this information to transportation customers. PICGUG St. 1, p. 19. In order to allow transportation customers to plan nominations and deliveries accurately, PGW should provide the Company's LUFGE factor on January 1 of each year, with this factor to remain

in effect for twelve months. *Id.* This proposal would not jeopardize PGW's system or result in any significant burden on PGW, but provide additional information needed by transportation customers to ensure accurate and efficient natural gas deliveries. PICGUG M.B., p. 22.

The Company stated that it has had transportation tariffs in effect since the mid-1980s and presently offers transportation service to various customers.⁴⁹ PGW St. 4.1 (White), pp. 18-19; Tr. 679; Tariff Gas-Pa. P.U.C. No. 1. Original Page No. 113. It continues to reject any tariff modifications proposed by the parties.

PICGUG's recommendation regarding providing the lost and unaccounted for gas factor should be implemented. This information is essential for PGW's transportation customers.

D. Management Audit

Pursuant to Commission Order, the Barrington-Wellesley Group, Inc. (BWG) prepared a Stratified Management and Operations Audit of the Philadelphia Gas Works from June through September 2000. Administrative Counsel Attachment 1.

On or about March 22, 2001, the Company submitted a formal response to the Audit Report in the form of its Plan for Implementation of the Recommendations in the Stratified Management and Operations Audit ("the Implementation Plan"). PGW Ex.

⁴⁹ PGW St. 4.1 (White) at 18-19; Tr. 679; Tariff Gas-Pa. P.U.C. No. 1, Original Page No. 113.

TEK-3. In the Implementation Plan, the Company accepted approximately 73 of 76 recommendations.

CEPA et al contends that the findings in the audit report justify the denial of any rate increase until the service is adequate. CEPA et al M.B., pp. 13-18.

PGW objects to the use of the Management Audit to deny rate relief. PGW M.B., pp. 73-75. PGW states that the auditor's last visit was in October 2000. Tr. 719. Furthermore, the audit took place during a time of dynamic change. PGW M.B., p. 76.

E. Quality of Service

PGW claims that the Company's base rate request cannot be dismissed due to alleged service inadequacies. PGW M.B. p. 53. PGW asserts that it is providing reasonable service. PGW M.B. p. 53.

PICGUG suggests that PGW realize that requiring that customers pay higher rates without providing better service does not meet the Public Utility Code's requirements of "just and reasonable rates" 66 Pa. C. S. §1301; PICGUG R.B. p. 6. PICGUG implores the Commission to ensure that there is a balance between the financial concerns of the Company and the burden faced by its ratepayers. Thus, PICGUG recommends that the Commission focus on the short term goal of restoring the Company to financial health. PICGUG R.B. p. 7.

F. Miscellaneous Issues

1. PGW's Senior Citizen Discount Program

Pursuant to a City Ordinance, PGW provides a Senior Citizen Assistance Program to its customers who are 65 years of age or older. Administrative Counsel Ex. 1, Attachment 1 at VIII-34, ¶30. Over 90,000 seniors in this program receive a 20% discount.

In addition to requesting that the cost recovery for PGW's Senior Citizens Discount Program be transferred from the GCR mechanism to base rates, OTS has three recommendations. First, OTS suggests that the Program be closed to any additional customers as of the date of the Order in this proceeding. Second, the Commission should find that it is appropriate to phase out the program and request the Philadelphia City Council pass an ordinance to that effect. Third, all customers currently in the Program should be re-certified for eligibility. OTS M.B. p. 59.

OTS argues that the Program should be closed because the Program does not satisfy the just and reasonable standard and the future cost of the Program may become so large that it is unmanageable. Since customers who receive the senior citizen discount are not means-tested for income eligibility, some customers who are in the program have the ability to pay their gas bill. OTS submits that having all senior citizens being eligible for the 20 percent discount regardless of income fails the just and reasonable standard of section 1308(c) of the Public Utility Code, 66 Pa. C. S. §1308(c). OTS M.B. pp. 50, 51.

OTS is recommending a phase out period over five (5) years to ease the transition period for PGW's senior citizen customers. OTS St. 4, p. 11. OTS M.B. 51,

52. Mr. Keim recommended that the discount be reduced by four percent (4%) each year. The discount would be sixteen percent (16%) in the second year, twelve percent (12%) in the third year, eight percent (8%) in the fourth year and four percent (4%) in the final year of the phase out. OTS St. No. 4, p. 11, OTS M.B. pp. 51, 52.

OTS recognizes that Philadelphia City Council must approve the elimination of the program. OTS M.B. p. 52. Consequently, OTS recommends that the Commission direct PGW to submit a plan to the City that phases out the Program over a five year period. OTS Exhibit 4, Schedule 3, OTS M.B. p. 52.

It should be noted that BWG recommended the elimination of the Senior Citizen Assistance Program to save the Company \$13 million. Administrative Counsel Ex. 1, Attachment 1 at VIII-38, Recommendation 16; Tr. 716. PGW rejected this proposal in its initial comments, its Implementation Plan and its Main Brief. PGW Ex. TEK-3, Transmittal Letter and Response to Recommendation VIII-16; PGW Ex. TEK-5, ¶15, PGW M.B. pp. 78-80.

PGW explains that it cannot eliminate the Senior Citizen Program because it was created by an Act of the Philadelphia City Council and, therefore, must be changed by City Council. PGW St. 1.2 at 7-8; PGW Ex. TEK-5, ¶15.

A review of section 2212(r) of the Public Utility Code, 66 Pa.C. S. §2212(r), is instructive.

(r) Senior citizens.-

(1) The commission may approve a program designed to provide discounted rates for natural gas distribution and supply services to senior citizens residing in the service territory of a city natural gas distribution operation provided

that such rates and the terms of such program are just and reasonable.

(2) Individual ratepayers who, as of the date the initial tariff of a city natural gas distribution operation becomes effective pursuant to subsection (d), are properly receiving discounted gas rates pursuant to the terms of a program specifically designed to provide assistance to senior citizens contained in the prior tariff shall be entitled to continue to receive such discount under the terms of the prior tariff unless and until the program is modified by ordinance of the governing body of the city, in which event such individuals shall be entitled to receive only the discount provided under the terms of the modified program, as it may be further modified by ordinance from time to time thereafter.

(3) Nothing in this title shall require the commission to approve the continuation of the program identified in paragraph (2) in whole or part for any person other than an individual identified in paragraph (2)

The above referenced section authorizes the Commission to approve a Senior Citizen Discount Program or discontinue the current program. In addition, it allows for the Commission to grandfather the current participants when the initial tariff becomes effective. In the instant proceeding OTS is the only party requesting the elimination of this program. This topic has not been fully explored in this proceeding. Some of the participants in the public input hearings requested that the program be retained. However, since City Council would have to approve legislation to modify or eliminate the program and the parties have not addressed the issue of elimination of the program in detail, OTS' recommendation should be denied in this proceeding. This issue should be addressed in the restructuring proceeding.

IV. CONCLUSIONS OF LAW

1. PGW is a "City natural gas distribution operation" as defined in Section 102 of the Public Utility Code, 66 Pa.C.S. §102.

2. The Commission has jurisdiction over the parties and subject matter in this proceeding.

3. The utility requesting the rate increase has the burden of proving that the rate involved is just and reasonable. Section 315(a) of the Public Utility Code, 66 Pa. C.S. §315(a).

4. Regardless of the method used, the rates must be just and reasonable. The requirements in § 2212(e) must be offset by the requirements in §1301 that the rates must be "just and reasonable." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 607 (1944); Public Advocate v. Philadelphia Gas Commission, 544 Pa. 129, 674 A.2d 1056 (1996).

5. There is no presumption that rates set pursuant to the Management Agreement/Cash Flow Method are just and reasonable. Action Alliance v. Philadelphia Gas Commission, 406 A.2d 1155 (Pa. Commonwealth Ct. 1979).

6. Only prudently incurred expenses are incorporated in rate case expense claims, and it is the burden of the public utility to prove that the rate case expenses incurred are just and reasonable. Allegheny Center Associates v. Pa. Public Utility Commission, 131 Pa. Commonwealth Ct. 352, 570 A.2d 149 (1990).

7. The Commission has ruled that lobbying expenses do not have a direct ratepayer benefit and as such cannot be included in rates. Pa. P.U.C. v. Duquesne Light Co., 59 Pa. P.U.C. 67, 118 (1985); Pa. P.U.C. v. Metropolitan Edison Co., 60 Pa. P.U.C. 349, 382 (1985); Pa. P.U.C. v. Pennsylvania-American Water Co., 79 Pa. P.U.C. 25, 66 (1993); Pa. P.U.C. v. National Fuel Gas Dist. Corp., 84 Pa. P.U.C. 134, 196 (1995).

8. The Company has not sustained its burden of proving that a rate increase of \$65 million is just and reasonable.

V. RECOMMENDED ORDER

THEREFORE,

IT IS RECOMMENDED (Subject to Commission Review and Approval):

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

2. That within thirty (30) days of the entry of the Commission's Opinion and Order, the Philadelphia Gas Works is hereby authorized to file a Tariff supplement designed to change rules, regulations and rates calculated to produce \$33,000,000 in additional revenue in addition to the \$11,000,000 interim relief implemented in March 2001.

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

4. That the tariff filed by the Philadelphia Gas Works will include a volumetric charge of \$7.0051 for the residential customers and the charge for the other classes will remain the same.

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

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

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

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

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

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

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

12. That the Company will file a cost of service study for present and proposed rates during the restructuring proceeding.

13. That the Office of Trial Staff's recommendation to increase rates to the LBS Large Direct, TriGen Direct and NGV Direct customer classes is granted.

14. That the Office of Trial Staff's recommendation to reduce the rates to the GTS Trans customer class is granted.

15. That the recommendation to transfer the electricity cost and the bad debt expenses which are currently contained in the Company's Gas Cost Rate ("GCR") to base rates be approved.

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

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

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

19. That the Philadelphia Gas Works shall meet in a collaborative with the Office of Trial Staff to resolve tariff issues.

20. That the Philadelphia Industrial and Commercial Gas Users Group's recommendation to lower the volume eligibility requirement for transporting gas to 15,000 is granted.

21. That the Philadelphia Industrial and Commercial Gas Users Group's recommendation to permit transportation customers to aggregate facilities serviced by multiple accounts, to expand the buyer's group to a maximum of ten individual customers, to permit transportation customers to make intra-day nominations and to require the Philadelphia Gas Works to provide daily imbalance information to transportation customers are granted.

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

23. That the formal complaints filed by the Office of Consumer Advocate at Docket No. R-00006042C0023; the Consumers Education and Protective Association, Association of Community Organizations for Reform Now, Action Alliance Senior Citizens of Greater Philadelphia and Tenant's Action Group at Docket No. R-00006042C0027; the Philadelphia Industrial Commercial Gas Users Group at Docket No. R-00006042C0060; and the Office of Small Business Advocate at Docket No. R-00006042C0070 are sustained to the extent consistent with the Commission Order, and, otherwise, denied and dismissed.

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

Date:

August 2, 2001

Cynthia Williams Fordham
CYNTHIA WILLIAMS FORDHAM
Administrative Law Judge

APPENDIX
A

BEFORE THE CITY OF PHILADELPHIA - GAS COMMISSION

IN THE MATTER OF THE FISCAL YEAR :
2001 CONSOLIDATED BUDGET/OVERSIGHT :
REVIEW OF PGW'S PROPOSED FY 2001 :
OPERATING AND CAPITAL BUDGETS AND : FILED
OUTYEAR FORECASTS; PGW'S PROPOSED :
FY 1997-1999 CAPITAL BUDGET RECONCIL- :
IATION; PGW'S PROPOSED \$52 MILLION : JUNE 19, 2000
BASE RATE INCREASE; PGW'S PROPOSED :
AMENDMENT TO REGULATION 12.1 OF TARIFF; :
PGW'S PROPOSED FY 2001 GAS COST RATE :

RECOMMENDED DECISION

FY 2001 Operating Budget and Outyear Forecasts

Before
JANET PARRISH, ESQ.
Senior Hearing Examiner

May 17, 2001

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IV. SUMMARY OF RECOMMENDATIONS 40

I. PROCEDURAL HISTORY

A. INTRODUCTION

This budget proceeding has an unusually lengthy procedural history, which warrants a brief discussion and summary before it is set forth. The proceeding commenced slightly later than usual in mid-June 2000 when the Philadelphia Gas Works ("PGW") filed its proposed FY 2001 Operating Budget and other proposals, and the initial public hearings were completed by late August 2000. In the interim, as of July 1, 2000, the Philadelphia Gas Commission's ("the Commission" or "PGC") authority to adjudicate PGW's base rate increase, Gas Cost Rate ("GCR") and other tariff proposals was transferred to the PA Public Utility Commission ("PUC") by the Natural Gas Choice and Competition Act ("Gas Choice Act" or "NGCCA") (66 Pa.C.S. §2201 *et seq.*, in particular §2212 regarding city natural gas distribution operations). In early August 2000, PGW filed proposed base rate and GCR increases with the PUC.

When the Commission's hearings were recessed in August 2000, key components of PGW's filing, which had been directed to be filed by the Commission in its FY 2000 Operating Budget Order, had still not been submitted. Specifically, PGW had not filed the required Five Year Financial and Management Plan, which was to underlie the proposed budget and future years' forecasts, or the required organizational restructuring plan, thereby preventing the Commission from concluding its budget review. Consequently, in October 2000, the Commission was forced to approve interim spending authority for PGW for FY 2001, which – to enforce some appropriate cost-cutting controls – was generally limited to 95% of the prior year's approved operating expense line items.

As is discussed in more detail in my Memorandum to the Gas Commissioners dated October 6, 2000, PGW sought approval of both the Commission and City Council for a \$45 million "temporary advance" from the City of Philadelphia to enable it to pay operating expenses, including debt service payments, pending receipt of interim rate relief from the PUC. Concurring in the Commission's recommendation, City Council approved the loan, but limited it to \$20 million pending PGW's submission of an adequate Five Year Financial and Management Plan (Bill No. 000583). Finally, in December 2000, in order to gain access to the final \$25 million tranche of the City loan, PGW submitted to the Commission an outline of a Five Year Plan which, according to PGW and the City Administration, was incomplete, unfinished and in need of revision. In January 2001, this Plan outline, when taken together with the Administration's commitments to complete it and to participate in a PGW Recovery Team co-chaired by the Mayor, Council President

and Chair of the Commission, was deemed to constitute an adequate Five Year Plan as contemplated by the ordinance (Resolution No. 010027).

As of the issuance of this Recommended Decision, PGW has yet to complete or to submit a revised Five Year Plan, thereby continuing to preclude a meaningful review of the operating budget forecast for the future fiscal years 2002 through 2006. However, with close to two-thirds of the current fiscal year having gone by, it appeared that the most reasonable and realistic, though unsatisfactory, thing to do was to adopt a finalized FY 2001 Operating Budget.

Doing so was complicated by the fact that there had been some critical changes in operating assumptions resulting from rate-setting actions taken by the PUC (some of which resulted from a February 2001 settlement between the PUC and PGW/the City regarding PGW's interim base rate increase request, the PUC's initial Order regarding which had been appealed by PGW and the City to Commonwealth Court). It has not generally been the Commission's practice to revise PGW's operating budgets which have been proposed in mid-fiscal year, based on year-to-date actual data, except for significant changes in factors which do not fall within the realm of normal operational variation. Thus, PGW's initial revised filings dated February 23, 2001 (incorporating PGW's proposals included in its January 5, 2001 \$65 million permanent base rate increase filing with the PUC and various revisions to budgeted operating expenses based on year-to-date actual data¹), and March 6, 2001 (which was also tied to the January 5, 2001 PUC filing) were, after discussion among the Hearing Examiner and the parties, not deemed to be an appropriate basis for going forward. Ultimately, revised financial schedules dated April 3, 2001 were submitted and reviewed at public hearings held on April 19, 2001.

B. HISTORY OF THE PROCEEDING

At its regular meeting on June 6, 2000, the Commission indicated that, in accordance with past practice, it intended to conduct a consolidated review of PGW's proposed Operating and Capital Budgets for FY 2001 with associated outyear forecasts (see also PGC Exhibit 2).

On June 19, 2000, PGW filed with the Commission its proposed Operating Budget for FY 2001 and its proposed Capital Budget for FY 2001 and Forecast for Fiscal Years

¹See Direct Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042 (rev. 02/02/01) at 3-4.

2002-2006; its proposed Gas Cost Rate ("GCR") for FY 2001; and its proposed amendments to Rates GS, MS and PHA and Regulation 12.1 of PGW Gas Service Tariff No.10 ("Tariff") (proposed \$52 million base rate increase and proposed amendment to senior citizen discount) (PGW Exhibits 2 through 6; PGW Statements 1 through 5). PGW requested that all of these matters be consolidated for hearing and that the proceeding be conducted in accordance with Gas Commission Regulation No.1 (PGW Exhibit 2).

On June 21, 2000, the Commission notified PGW that it would initiate a consolidated proceeding to review the filings, but that the budget filings were not complete (PGC Exhibit 6). PGW supplemented its filings on June 30, 2000 (PGW Statements 6 and 7) and again on July 7, 2000 (PGW Exhibits 7 through 11, 14 and PGW Statements 8 through 11).

On July 10, 2000, Hearing Examiners Janet Parrish, Esq. and Tarleton D. Williams commenced formal proceedings² in these matters with a pre-hearing conference, of which written notice dated June 22, 2000 was given to all parties on the Commission's normal service list and of which public notice was published in various local newspapers as required by Regulation No.1 (PGC Exhibits 3, 4 and 5). PGW, the Public Advocate ("PA" or "the Advocate"), and the Philadelphia Industrial and Commercial Gas Users Group ("PICGUG") entered their appearances. The School District of Philadelphia (represented by Mondre Energy, Inc.), the Gas Works Employees Union ("GWEU"), the Consumers Education and Protective Association ("CEPA"), Tenants' Action Group of Philadelphia ("TAG"), and the Action Alliance of Senior Citizens ("AASC") also expressed their intent to participate in the proceeding.³ The purpose of the pre-hearing conference was to determine the dates of hearings, the procedures for taking testimony and other procedural matters.

The schedule and procedures established were intended to enable the Commission to review the filings in a reasonably expeditious manner, while ensuring that a fair opportunity was given for those representing PGW's ratepayers and other interested

²The balance of this procedural history as well as the discussion in this Recommended Decision will focus on the components of PGW's filings other than the proposed FY 2001 Capital Budget and Outyears Forecast, which were the subject of Recommended Decisions issued by Hearing Examiner Williams on November 27, 2000, March 27, 2001 and April 17, 2001.

³Ultimately, in addition to the Advocate, the active parties intervening in this matter were PICGUG, the School District, GWEU, CEPA, and Delaware Valley Healthcare Council of HAP/Delaware Valley Energy Options, Inc. ("DVHC"). Subsequently, both DVHC and the School District withdrew as active participants and requested inactive status (DVHC Exhibit 2; letter dated October 10, 2000 from Jackie Sparkman to Senior Hearing Examiner). TAG, Action Alliance of Senior Citizens and one individual also had inactive participant status.

parties to challenge or question PGW's proposals or present other alternatives for the Commission's consideration. The schedule and procedures also took into account that, effective July 1, 2000, under the terms of the Gas Choice Act, the Gas Commission no longer had authority to make final, binding determinations with respect to PGW's base rate increase request, its request to amend the Tariff provisions regarding the senior citizen discount,⁴ and the proposed FY 2001 GCR. Regardless, litigation initiated by City Council seeking to have these provisions invalidated was then and still is pending in the Commonwealth Court. The Commission therefore determined that it was prudent to continue to conduct this proceeding in accordance with Regulation No.1. Moreover, the intent was, as always, to make the necessary record in this proceeding to support any actions the Commission might deem appropriate within the scope of its continuing authority to review and approve PGW's proposed budgets and forecasts⁵ and to exercise its oversight responsibilities vis-à-vis the Philadelphia Facilities Management Corporation ("PFMC") (Transcript ("Tr.") 8-15, 54-58, 62-67).

The Hearing Examiners confirmed the proceeding schedule and procedures in a Pre-Hearing Memorandum Order dated July 13, 2000 (PGC Exhibit 8). On July 17, 2000, the Commission transmitted to the City Department of Records PGW's proposed Tariff changes for public inspection, in accordance with Section 8-407 of the Philadelphia Home Rule Charter (PGC Exhibit 12). Formal discovery occurred and informal discovery meetings were held on July 26 and 27, 2000, August 1, 2000 (via telephone conference call), and August 7, 2000 (PGC Exhibits 16, 18, 20 and 22).

On July 21, 2000, PGW filed the Direct Testimony of Janice Davis, the City's Finance Director, on behalf of the City of Philadelphia (PGW Statement 12). Pre-hearing memoranda were filed on July 31, 2000 by PGW (PGW Exhibit 17), the Advocate (PA Exhibit 2), the School District (SD Exhibit 2), the Union (GWEU Exhibit 2), PICGUG (PICGUG Exhibit 2), and CEPA (CEPA Exhibit 2).

On August 1, 2000, the Hearing Examiners issued a Supplemental Pre-Hearing

⁴While the PUC was given the exclusive authority to approve changes to PGW's base rates, GCR and Tariff, under the provisions of the Gas Choice Act, PGW's proposal to amend the senior citizen discount must be made to the City Council of Philadelphia (66 Pa. C.S. 52212(r)).

⁵Section 2212(s) of the Gas Choice Act provides: "Nothing contained in this Title shall be construed to abrogate or limit the executive or legislative powers of a city that owns a city natural gas distribution operation to legislate or otherwise determine the powers, functions, budgets, activities and mission of the city natural gas distribution operation or any related entity created under [52212(m)], including but not limited to the ownership, governance, management or control thereof."

Order Regarding Schedule And Other Matters (PGC Exhibit 21). On August 2, 2000, PGW filed its revised proposed GCR (PGW Exhibit 18), in accordance with its GCR filing with the PUC. On August 3, 2000, PGW filed revised financial statements reflecting the impact of the increased GCR amount (PGW Exhibit 19).

On August 11, 2000, the Advocate filed the Direct Testimony of its witness Michael A. Bleiweis (Part I, Capital Budget) (PA Statement 1) and the Union filed the Direct Testimony of Joseph G. Given (GWEU Statement 1). On August 15, 2000, the Advocate filed the Direct Testimony of Michael A. Bleiweis (Part II, Operating Budget) (PA Statement 2); the Prepared Direct Testimony of Ralph E. Miller (PA Statement 3); and the Direct Testimony of Richard W. LeLash (PA Statement 4). On August 15, 2000, CEPA filed the Testimony of Lance Haver (CEPA Statement 1). PICGUG and the School District, the other active parties at that time, did not file any testimony.

After public notice was given of the hearing dates and proceeding schedule in accordance with Regulation No.1 (PGC Exhibits 10 and 15), and Commission-approved customer bill inserts were used to notify PGW customers of the nature of its requests and the public hearing dates (PGW Exhibit 20), public hearings were held on August 17, 18, 21, 22 and 23, 2000. Public input from 13 individuals (some representing organizations) was taken during the August 17, 18 and 23 hearings. In addition, an evening public input session was held on August 22, 2000, at which an additional ten individuals testified. During the hearings, all of the witnesses who pre-filed testimony were questioned by PGW, the Advocate, the Commission's Hearing Examiners, the Commission's Executive Director and the School District. Also testifying during the hearings on behalf of PGW were: Dennis E. Stinson, Senior Vice President, Operations; Sherry N. Rubin, Vice President & Chief Information Officer; John P. Straub, Vice President, Human Resources; Joseph F. Golden, Jr., Treasurer; Joseph Szlanic, Director, Technical Services, Information Technology Department; Paul J. Donohue, Director, Accounts Receivable; Patrick H. Durkin, Director, Gas Supply and Transportation; William Muntzer, Director, Marketing and Supply Services; William J. Ambrose, Jr., Director, Employees Services; Brian Schenk, Manager, Distribution Department; Abdol R. Nayak, Manager, Gas Processing Department; John G. Kelly, Project Manager for LNG Plant; William J. Gallagher, Manager, Corporate Planning; Randy Gyory, Manager, Program Management Office; Cristina Coltro, Manager, Energy Assistance Programs; David Griesing, Esq., Associate General Counsel; Joe Trainer, R.J. Rudden Associates; and Colbert G. Narcisse, Vice President, Merrill Lynch.

After these initial hearings, hearings were recessed to the call of the Hearing Examiners, pending PGW's completion of its budget filings in accordance with the Commission's Order (Tr. 1481-1482). PGW had represented that it would file the

required Five Year Strategic Plan, first in August (PGW Exhibit 14) and then, in the near future (e.g., Tr. 26-27, 95). By the September 26, 2000 Commission meeting, PGW had still not filed this Plan nor the other documents which the Commission required for completing its review of the proposed budget and forecast (Order dated October 17, 2000 at page 2). Consequently, the Commission authorized PGW to continue operating spending at levels which did not exceed 95 percent of the actual FY 2000 spending for approved line items, excepting natural gas expense, until the Commission took final action on the FY 2001 operating budget (Id. at ordering paragraph 1).

On December 18, 2000, PGW filed its proposed Strategic Plan and Five Year Financial Forecast⁶ (PGW Exhibit 29). This Hearing Examiner then scheduled an informal discovery meeting on January 8, 2001 and reconvened the hearings in this proceeding on January 11, 2001 (PGC Exhibit 28). On January 16, 2001, I issued a Memorandum to the Commissioners providing a Preliminary Assessment of PGW's Five Year Strategic Plan and Update on PGW's Cash Situation and Projections (PGC Exhibit 38). Subsequently, PGW and the City Administration acknowledged that PGW's Five Year Plan was unfinished and incomplete and committed to revise and complete it (Resolution dated January 22, 2001 at page 3; Transcript of January 22, 2001 Commission Meeting at 22-24).⁷ To date, the Plan has not been revised and remains unfinished and incomplete.⁸

On February 9, 2001, PGW agreed that it was appropriate to file a revised FY 2001

⁶When, in October 2000, City Council approved an ordinance authorizing a \$45 million "temporary advance" from the City of Philadelphia to PGW, it limited PGW to drawing no more than \$25 million from this restricted account "until such time as the Gas Commission has informed City Council, and City Council has concurred by Resolution, that PGW has submitted an adequate Five Year Financial and Management Plan" (Section 2(c) of Bill No. 000583).

⁷Additionally, that day, the Mayor and the President of City Council agreed to Chairwoman Tasco's suggestion that they form a Recovery Team to complete the recovery plan necessary to address and fix PGW's financial and operational crisis (Resolution dated January 22, 2001 at page 3). The Commission concluded that PGW had submitted an outline for a Five Year Financial and Management Plan, which together with the Mayor's and PGW's commitments to revise and complete the plan and with the creation of the Recovery Team, constituted an adequate Five Year Financial and Management Plan as contemplated by City Council Ordinance (Id.). On February 28, 2001, the Council President and the Chairwoman withdrew from the Recovery Team, stating that their "participation on the Recovery Team merely creates a perception of involvement, where none exists" and that "[a]ccordingly...[they] no longer wish[ed] to be considered members of what has become a phantom Recovery Team" (letter dated February 28, 2001 to Mayor Street from Council President Verna and Councilwoman Tasco).

⁸According to Mr. Knudsen, there are now additional uncertainties about PGW's future management and status which make it difficult to finalize a five year strategic plan (response to HE-46; Tr. 1990-1992).

operating budget, incorporating the impacts of PGW's dramatically increased GCR (PGC Exhibit 39). On March 6, 2001, PGW filed revised FY 2001 financial statements (PGW Exhibit 42), and on March 15, 2001, PGW filed the accompanying narrative (PGW Exhibit 43).

On March 20, 2001, this Hearing Examiner notified the Service List that, while further review of the outyear budget forecast was not possible without PGW's completed Five Year Strategic Plan, the Commission would move to conclude its review of the FY 2001 Operating Budget (PGC Exhibit 40). Accordingly, an informal discovery meeting was held on March 27, 2001. On April 2, 2001, this Hearing Examiner conducted a telephone conference call with PGW and the Advocate⁹ regarding the scope of the Commission's review and established a further schedule for concluding the Operating Budget review (PGC Exhibit 41). The parties agreed that PGW's revised FY 2001 Operating Budget should be based on its original filing, updated solely to reflect the base rate and GCR increases approved by the PUC and the associated impacts on bad debt expense and other directly related line items (Id.).

On April 5, 2001, PGW filed the Supplemental Direct Testimony of Thomas E. Knudsen together with supporting exhibits (PGW Statement 13). On April 12, 2001, the Advocate filed the Supplemental Direct Testimony of Michael A. Bleiweis (PA Statement 5). On April 19, 2001, the Hearing Examiners reconvened public hearings in this matter. Public input was received from six individuals. In addition, Messrs. Knudsen, Bogdonavage and Bleiweis were further questioned by the parties, the Hearing Examiners and the Commission's Executive Director. Also presenting testimony on behalf of PGW was Michael A. Bush, Manager, Accounts Receivable.

At the conclusion of these evidentiary hearings, the total number of transcript pages stood at 2,147 and there were a total of 105 exhibits (48 PGW exhibits; 42 PGC exhibits; five PA exhibits; and ten exhibits from other active parties). There were also 36 transcript requests ("TR-") directed to PGW,¹⁰ the responses to which are considered to be part of the record of this proceeding. Also considered part of the record are all responses, revised and supplemental responses to data requests propounded by (and not subsequently withdrawn by) the Advocate (PA-1 to PA-192); PICGUG (PICGUG-1 to PICGUG-25); the School District (SD-1 to SD-266); the Union (GWEU-1 to GWEU-8); this

⁹The remaining active parties – PICGUG, GWEU and CEPA – did not participate in this phase of the proceeding.

¹⁰One of these was also directed to one of the Advocate's witnesses.

Hearing Examiner (HE-1 to HE-48)¹¹; the Commission's Executive Director (ED-1 to ED-6); and by the parties during informal discovery (ID-1 to ID-25).

On May 3, 2001, PGW and the Advocate submitted their final position statements (respectively, "PGW Brief" and "PA Brief"). This Recommended Decision follows.

II. LEGAL STANDARD FOR REVIEW AND APPROVAL OF OPERATING BUDGET

The relevant standard for review and approval of PGW's proposed Operating Budget for FY 2001 is set forth in Section IV §2(a) of the Agreement Between The City Of Philadelphia And The Philadelphia Facilities Management Corporation For The Management And Operation Of The Philadelphia Gas Works ("Management Agreement"):

There shall be prepared annually an operating budget for the ensuing year and an operating forecast for four (4) years comprising the ensuing year and the three (3) years next following. Such budget and forecast shall be prepared by the Company with the aid of the Director of Finance; shall be consistent with the accounting methods prescribed in Section IV (1); and in general shall be in form and extent satisfactory to the Director of Finance and Gas Commission. The operating budget and forecast shall be subject to the approval of the Gas Commission.

This Agreement was adopted by an ordinance passed by the City Council of Philadelphia on December 29, 1972. The ordinance has statutory effect. School District of Philadelphia v. Zoning Board of Adjustment, 417 Pa. 277, 207 A.2d 864 (1965); Action Alliance, Etc. v. Philadelphia Gas Commission, 45 Pa. Cmwlth. 234, 241-42, 406 A.2d 1155, 1158 (1979). The Common Pleas Court of Philadelphia County has held that this Commission's final Order in the FY 1994 Operating Budget proceeding was not an appealable adjudication within the meaning of the Local Agency Law, 2 Pa.C.S. §751 et seq (Tenants Action Group, Inc. et al v Philadelphia Gas Commission et al, C.P. Phila. No. 9312-0828, Order dated April 20, 1994, Avellino, J.).

Both through written and oral testimony, the City's Director of Finance informed the Commission that PGW's budget submission was in a form with sufficient detail to meet her requirements.

¹¹The response to HE-43 is outstanding.

Prior to the effective date of the Gas Choice Act, the Commission was obligated by Section VII of the Management Agreement to fix rates which will in each fiscal year produce revenues sufficient to pay all of PGW's operation and maintenance costs and expenses and the interest and amortization becoming due on PGW's debt (as detailed in Section VII ¶1(a)(i) through (v)). Moreover, rates must be set to produce revenues sufficient to make an annual payment of \$18 million to the City, to provide appropriations for prepayment of debt and capital additions approved by the Commission and City Council, and to provide cash working capital in such amounts determined necessary by the Company and approved by the Commission (as detailed in Section VII ¶1(b)(i) through (iii)). This rate-setting obligation was transferred to the PUC effective July 1, 2000 (66 Pa.C. S. §2212(b) and (e)).

The Gas Choice Act recognizes that, notwithstanding the transfer of the Commission's previous regulatory functions and authority to the PUC, the City retains its executive and legislative powers to "...determine the powers, functions, budgets, activities and mission of [PGW]..., including but not limited to, the ownership, governance, management or control thereof" (66 Pa. C. S. §2212(s)).¹²

The General Gas Works Revenue Bond Ordinance of 1975 ("1975 Ordinance") requires PGW to maintain a debt service coverage level of at least 1.5x. In light of enactment of the General Gas Works Revenue Bond Ordinance of 1998 ("1998 Ordinance"), PGW will no longer issue bonds under the 1975 Ordinance (PGW Exhibit 29 in FY 1999 Consolidated Budget Proceeding). The 1998 Ordinance maintains the 1.5x debt service coverage requirement, but provides more financial flexibility and increases the coverage cushion through transitioning PGW from a parity lien structure to a senior/junior lien structure (Id.).

¹²Under the terms of the Management Agreement and Sections 2212(f) and (s) of the Gas Choice Act, only the City (i.e., the Mayor and City Council) can determine whether to forego or grant back the annual \$18 million City payment currently provided for in Ordinance. I therefore do not address the Advocate's request for a Commission Order to "break the log jam" on this issue (PA Bref at 2, 15-21).

III. DISCUSSION

- A. IN REVIEWING AND APPROVING PGW'S PROPOSED FY 2001 OPERATING BUDGET AT THIS POINT IN THE FISCAL YEAR, THE MOST REASONABLE BUDGETING ASSUMPTION IS THAT PGW'S FY 2001 REVENUES WILL REFLECT THE PUC-AUTHORIZED INTERIM BASE RATES AND GAS COST RATE FACTORS, CONSISTENT WITH THE GAS COMMISSION'S PRIOR BUDGET REVIEW PRINCIPLES AND PRACTICES AS WELL AS APPLICABLE LAW.

This being the first operating budget review by the Gas Commission since the effective date of the Natural Gas Choice and Competition Act, and this review occurring contemporaneously with various rate-setting proceedings before the PUC, we are - as Knudsen put it - "in new territory here" (Tr. 1981). Particularly during the tail end of this proceeding, there was considerable discussion and difference of opinion as to the scope of the Commission's budget review and the manner in which it should or should not take into account the rate-setting actions of the PUC during the course of this fiscal year.

Knudsen posits that "...we are putting ourselves back sometime in the summer of last year and we are looking forward *as if you [the Commission] had the authority to recognize a level of rate relief that's required to meet certain basic needs of [PGW], and you have to state what those needs are*" (emphasis added) (Tr. 1981). More specifically, Knudsen asserted,

the appropriate approach is to go back in time, look at this year, look at the collateral issues around this year, meaning what should the year-end level of cash be, because you have certain obligations going forward into the subsequent fiscal period, and then if the programs are appropriate, which they were because you had certain limiting factors, you could not abrogate the collective bargaining agreement, you could not change certain programs...such as the senior citizen discount¹³ - in other words, there were things that were in place, in addition to the fact that the place was in chaos this year... - if you find that those elements of a budget are appropriate, then you have to find a level of revenue to support that and then you have to also assign a writeoff for bad debt, and that

¹³This alleged inability to change the senior citizen discount program did not stop PGW from budgeting a \$1.5 million increase in revenues which would allegedly result from closing the program to new applicants (see PGW Exhibit 3 at Ex. A-1; PGW Statement 2 at 5-6).

package then becomes your recommendation.
(Tr. 1987-1988).

PGW maintains that the evidence in this proceeding is that "there is a revenue deficiency in the FY 2001 Operating Budget of \$52 Million" (PGW Brief at 13; see also Tr. 1980-1982), and that the Commission should essentially disregard the PUC-authorized interim base rates now in effect, for reasons that I will review below. PGW argues that "...under the Gas Choice Act, [the] Commission *must assume* that the PUC will provide *rates consistent with the applicable legal standards*, including the Management Agreement" (emphasis added) (PGW Brief at 10). Or, as PGW also put it, "[t]he Commission has the obligation to approve a level of program expenditures and must, under the law [footnote omitted], assume that the PUC will set rates to generate revenue sufficient to comply with this local determination" (*Id.* at 2).

There are several reasons why, particularly given the posture of this proceeding, PGW's approach is incorrect.

1. PGW's Recommended Approach Is Not Consistent With Past Commission Practice For Reviewing Budgets At Mid-Fiscal Year.

As discussed earlier, the Commission was precluded from completing its review of PGW's original filing within the Commission's preferred time frame (i.e., within the first or second month of PGW's fiscal year) due to the incompleteness of the filing. The filing remained incomplete as of the most recent hearings in April 2001.¹⁴ During the intervening period, there have been several occurrences that are not within the realm of normal operational variations, e.g., variation in weather or minor variances from projected expenses, which change underlying budget assumptions significantly.

¹⁴As mentioned earlier, PGW has not yet submitted a complete Five Year Financial and Management Plan to the Commission, notwithstanding the commitments made by both PGW and the Mayor earlier this year. Indeed, at the April 19, 2001 hearing, Knudsen was representing that it would be difficult for PGW to formulate such a plan, given all of the further uncertainties about its future (Tr. 1990-1992; see also response to HE-46: "All of this activity makes defining a future path for the utility difficult at best."). Knudsen also stated that PGW "...should be in a position to submit the [revised/completed] package for review in two weeks time" (response to HE-46). About a month later, this "package" has yet to be delivered. It is therefore both surprising and disturbing that PGW recently [mis]informed the PUC that "All PGW activity before the Philadelphia Gas Commission is complete," and that "FY 2001 Strategic Plan is complete; working on FY 2002 update." (PGW Monthly Progress Report to the PUC in Docket No. R-00005654 dated May 10, 2001 at 1).

When such mid-fiscal year review of operating budgets has occurred in the past, the Commission has taken the position that such significant changes should be reflected for budgeting purposes, but that it is unnecessary to update every line item for year-to-date actual results in order to reflect changes within the scope of normal operational variation (see 2d of Two Orders dated October 29, 1996 regarding FY 1997 Operating Budget at ordering paragraph 1.A.).¹⁵

The parties in this proceeding agreed that the Commission should go forward on this basis. PGW therefore presented financial statements which reflected the PUC-approved \$11 million¹⁶ interim rate increase plus \$7 million bad debt expense recovery through the GCR (effective March 1, 2001) and a total of \$230 million¹⁷ in GCR increases approved by the PUC for FY 2001 (PGW Statement 13 at 2 and at revised Ex. A-1). Consistent with this position, Bogdonavage conceded that the \$45 million temporary advance to PGW from the City - which was approved by City Council subsequent to the original budget filing - was also such a "one-time event" which "should be imputed into the operating budget" to effectively "plu[g] that gap" in year-end cash balances¹⁸ (Tr.

¹⁵As noted in my Recommended Decision on PGW's revised FY 1997 Operating Budget filed in response to this Commission Order, "...PGW projected a number of other changes, which were not strategic plan-related, but rather adjustments related to changes in weather, gas prices, and other normal operating conditions, and which reflected actual-estimated data available for the first five months of the fiscal year [citation omitted]. It would not have been appropriate to review these changes or suggest mid-year budget adjustments based upon them, and no effort was made to do so [citation omitted]....What would be appropriate, as witnesses for both the Company and the Advocate recognized, is to update either the compliance budget or the revised budget for the most current, quantifiable update on strategic initiatives [citation omitted]." (Revised FY 1997 Operating Budget Recommended Decision at 12); see also FY 1999 Operating Budget Recommended Decision at 17).

¹⁶The PUC approved an additional \$7 million for bad debt expense associated with the much higher gas cost rates being billed, which was to be recovered by August 31, 2001 through an increase in the GCR factor (even though this is not a gas cost) (PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619 at pp. 4, 6 and at ordering paragraph 1). PGW added this to the \$11 million base rate increase to show a total interim base rate increase of \$18 million in its revised financial statements (PGW Statement 13 at Rev. Ex. A-1).

¹⁷PGW showed this as a \$185 million "GCR Adjustment" in its revised financial statements, to reflect the increments approved by the PUC above the \$42 million GCR increase embedded in the revenue projections in the original budget filing (PGW Exhibit 3 at Ex. A-1; PGW Statement 13 at Rev. Ex. A-1). The \$185 million also reflects the increase from the originally budgeted natural gas expense of \$294.593 million to the revised natural gas expense of \$479.593 million (PGW Statement 13 at rev. Ex. A-1).

¹⁸Without taking into account the subsequently-authorized City loan, PGW's revised financials projected a negative year-end cash balance of (\$48.7 million) (Tr. 1976). All else being equal, taking

1976-1977).

From this mid-fiscal year vantage point, the most realistic and reasonable budgeting assumption for the Commission to make, consistent with its past practice, is that PGW will have revenues during FY 2001 based on the interim rate relief approved by the PUC in its Order adopted February 21, 2001 (approving the Joint Petition for Settlement submitted by PGW, the City and the PUC Law Bureau) and on the GCR increases approved by the PUC.¹⁹ This is effectively what Black & Veatch concluded in their engineering report prepared in connection with PGW's planned revenue bond issuance (response to ID-23).²⁰

into account the \$45 million City loan proceeds reduces the budgeted negative year-end cash balance to (\$3.7 million) (Tr. 1976-1977). As Bleiweis observed, taking into account actual results through February 2001, PGW's projected year-end cash balance was \$33 million (PA Statement 5 at 7-8 and at MAB-14; Tr. 2026-2027). However, he conceded this would be reduced by about \$3.6 million - rather than increased - when the actual March 2001 cash receipts were factored in (Tr. 2027-2028). I take notice that, according to PGW's more recent daily cash receipts reports, in April 2001 receipts ran about \$4.2 million below projections which, all else being equal, would indicate a further reduction in the year-end cash balance to about \$25 million. By contrast, as of mid-May 2001, cash receipts for that month were running about \$6 million above projections. I also take notice that PGW's most recent projection, which takes into account all of the factors which go into determining the year-end cash balance, is that it will be \$34 million; however, factoring in its one-time ability to defer about \$11.5 million of natural gas purchase obligations to early FY 2002, PGW maintains that its net year-end cash balance would be \$22 million (Rebuttal Testimony of Joseph R. Bogdonavage dated May 2001 in PUC Docket No. 00006042 at 2). This falls within the \$20 to \$25 million range anticipated by the PGW/City-PUC interim rate settlement (Joint Petition for Settlement in PUC Docket No. R-00005654 at §25).

¹⁹It is also most realistic and reasonable to project natural gas expense, bad debt expense and similarly impacted revenue and expense items which are reflective of these significant rate increases (see discussion in Section III.B. below).

²⁰Based on the normal length of time for a PUC rate proceeding, Black & Veatch assumes that PGW will not have any further base rate increase until after the start of FY 2002, specifically in early October 2001 (response to ID-23; Tr. 2046-2047). Even if this case were to be settled, so that any further rate increase could begin to be collected sooner, PGW concedes this is unlikely to have a significant effect during the few remaining months of FY 2001 (Tr. 1987). Black & Veatch nevertheless concluded that PGW would have sufficient revenues to be able to satisfy its bond covenants for FY 2001, and that so long as PGW obtained \$53 million per year in permanent base rate relief on a levelized basis (compared to rate levels existing *prior to implementation of the interim rate increase in March 2001*) for FY's 2002 through 2006, it would continue to be able to satisfy those covenants (response to ID-23; see also Rebuttal Testimony of Thomas E. Knudsen dated May 2001 in PUC Docket No. R-00006042 at 6 and Rebuttal Testimony of Thomas J. Sullivan dated May 2001 in PUC Docket No. R-00006042).

2. PGW's Argument That The Interim Base Rates In Effect Are Not Legally Binding On The Commission Because They Are "Interim" Mischaracterizes The PUC's Orders And PGW's Filing.

PGW claims that "...this Commission is not bound, as a matter of law, by the level of rates approved in [the PUC interim rate] proceeding since those rates are, by definition, interim and subject to either a subsequent order to refund or an increase in the case now pending before the PUC [footnote omitted]" (PGW Brief at 15). PGW is correct that the interim rates "are subject to refund at the conclusion of a full base rate case if the [PUC] determines that a lower level of rates is just and reasonable" (see PUC Order in Docket No. R-00005654 adopted November 21, 2000 at ordering paragraph 2) – but this argument does not further PGW's position, because it only indicates that, for budgeting purposes, it might be assumed that PGW's revenues for this fiscal year will be even lower than shown in the most recent revised financial statements.

Contrary to PGW's representation, though, these interim rates could not be increased in the pending permanent base rate proceeding. This same PUC Order (at ordering paragraph 3) explicitly provides that "PGW must not seek to recoup additional revenues from ratepayers if the [PUC] ultimately determines that a higher level of base rates is just and reasonable." This condition was not modified by the PUC's subsequent interim rates order and therefore remains in effect (see PUC Order in Docket Nos. R-00005654 and R-00005619 adopted February 21, 2001 at ordering paragraphs 2 and 3).

PGW also mischaracterizes its interim rate filing as "not seek[ing] relief sufficient to provide cash or revenue for the full Fiscal Year 2001" and "not present[ing] a request to provide rates adequate to fund the entire operating and capital budgets for FY 2001" (PGW Brief at 16). In fact, PGW's interim rate filing sought a \$52 million increase in base rates, intended to provide a \$35 to \$40 million cushion of cash at the end of FY 2001 (PUC Order in Docket No. R-00005654 adopted November 21, 2000 at 7). PGW claimed that this amount of relief was required to ensure that it had sufficient liquidity at the end of the current fiscal year to meet its bond indentures and cover expenses at the beginning of the next fiscal year (Id.). It was the intervenors in that proceeding – not PGW – who urged the PUC to limit the interim rate relief to that necessary to maintain financial health through the winter heating season (Id.), as the PUC had indicated was the limited purpose of the interim rate proceeding (Id. at 8; see also Id. at 10, 12-13).

Nevertheless, since the PUC stated that any further rate relief was to come only through a full base rate proceeding (to be initiated by PGW filing no later than January 1, 2001) and after review of the then-pending management audit (Id. at 10, 12), and since, under state law, the PUC determination on the permanent base rate request is unlikely to

come before October 6, 2001 (that is, about one month into FY 2002) (response to ID-23; Tr. 2046-2047), I do not see how the FY 2001 revenue requirement will be addressed by anything other than the interim rate case.

In sum, there is nothing in this record to support an assumption that a roll-back of the interim rates is likely; and, under the PUC's Orders as well as applicable law, there is no basis on which it could reasonably be assumed that the interim rates in effect during the FY 2001 period will be increased retroactively. It is clear that PGW's interim rate filing and the PUC's adjudication thereof apply directly to the 2001 fiscal year. Thus, the most reasonable budgeting assumption is that adopted by Black & Veatch, which is that for planning purposes, revenues for FY 2001 will reflect the interim rates in effect from March 1, 2001 through August 31, 2001.

3. For Budgeting Purposes, Once Rates Have Been Set For A Particular Fiscal Year, The Commission Must Utilize Revenue Projections For That Fiscal Year Based On Those Rates.

PGW objects that for the Gas Commission to take the position outlined in the two preceding sections is to effectively turn the "preservation of powers" section of the Gas Choice Act on its head – as Knudsen characterized it, that

You are positing that they've given you so much revenue to work with, you go to the Company, you go as the determiner of budgets and cut the hell out of the place because that's the only way you're going to be able to make \$18 million work this year.²¹ (Tr. 1984).

In taking action on the proposed FY 2001 Operating Budget, the Commission should not adopt PGW's position for several reasons. As just discussed, PGW's rates for FY 2001 have been established by the entity with the legal authority to do so and, indeed, these interim base rates have been agreed to by PGW and the City (see Joint Petition for

²¹Knudsen's position would appear to be at odds with PGW's representation to the PUC that this level of interim rate relief combined with the other financial and operational steps outlined in the parties' Joint Petition for Settlement was expected to be sufficient to enable PGW to meet its financial obligations through January 2002 (see Joint Petition for Settlement at ¶29; also see ¶¶25 through 27). The PUC found this expectation to be "noteworthy" (PUC Order dated February 21, 2001 at 8). The PUC also noted PGW's agreement that "if these steps are not sufficient...[PGW] will consider additional rate relief to meet any shortfall only as a last resort and only after pursuing in good faith all other sources of revenue reasonably available" (emphasis in original) (id.).

Full Settlement of Philadelphia Gas Works' Petition for the Establishment of Interim Rates and Related Appeal in PUC Docket No. R-00005654 and PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619).²² The Advocate maintains, "[o]nce rates for a particular fiscal year have been determined, as in this case, the Gas Commission must budget expenditures based on estimates of revenues from existing rates and other sources" (PA Brief at 7). PGW responds that "[i]t is...not appropriate [for the Commission] merely to match proposed expenditures to current rate resources" (PGW Brief at 19, n.28; see also *id.* at 19). But, PGW does not indicate how it would be proper or legal under the Gas Choice Act for the Commission to ignore rate orders duly adopted by PGW's rate setting authority or their impact on revenues in this particular fiscal year.²³

Certainly, if PGW had timely completed its budget filing and thus, this budget review had been able to be concluded at the beginning of the fiscal year, the Commission would have had to make its best judgment based on the information available at that time as to the reasonableness of PGW's projected revenues for FY 2001 and beyond, including those being requested from and anticipated to result from rate action by the PUC. Had that occurred, the question of what weight the PUC had to give PGW's approved Operating Budget under the Gas Choice Act would have been squarely framed. However, timing is everything. Under the current circumstances, wherein the PUC has taken rate action which is effective during FY 2001 prior to the Commission's taking final action on the proposed FY 2001 Operating Budget, this question becomes academic.²⁴

PGW relies heavily on the fact that, under the Gas Choice Act, the Gas Commission retains authority to approve (or, in the language of the Gas Choice Act,

²²One of the conditions of the settlement was that PGW, PFMC and the City would withdraw their appeal of the PUC's November 21, 2000 Order to the Commonwealth Court (Joint Petition for Settlement at ¶30, see also PUC Order adopted February 21, 2001 at ordering paragraph 3).

²³The much-cited Section 2212(e) of the Natural Gas Choice and Competition Act provides in pertinent part: "Notwithstanding any provision of this title to the contrary, *in determining the city natural gas distribution operation's revenue requirement and approving overall rates and charges*, the [PUC] shall follow the same ratemaking methodology and requirements that were applicable to the City natural gas distribution operation prior to the assumption of jurisdiction by the [PUC] and such obligation shall continue until the date on which all approved bonds have been retired, redeemed, advance refunded or otherwise defeased...." (emphasis added).

²⁴The Advocate asserts that, since the issue of PGW's FY 2001 revenue requirement has already been decided by the PUC, "[p]rinciples of mootness bar the Commission from addressing this issue [citation omitted]" (PA Brief at 6). Perhaps a more apt characterization would have been that principles of *res judicata* or something like them apply; that is, the matter has already been decided, even if not wholly on the merits, and cannot be re-litigated in another forum.

"determine") PGW's operating budget (see 66 Pa. C.S. §2212(s)). I take notice that, in the pending permanent base rate proceeding (PUC Docket No. R-00006042), PGW asserts that the PUC may not, in the context of a rate making proceeding for PGW, make adjustments to expenses contained in its approved budget or which have been approved in prior budgets and that once the Gas Commission has approved PGW's budget, "the PUC will be obligated to fund that budget" (see, e.g., PGW's Motion in Limine at ¶¶22 and 24).²⁵ Similarly, in this proceeding, PGW maintains that "[n]othing in the Gas Choice Act modifies or affects in any way the authority granted to the Commission with regard to review and approval of the Operating and Capital Budgets under the Management Agreement or the City Charter" (PGW Brief at 15).

In this proceeding, I cannot and indeed do not need to resolve the difficult, first-impression question as to whether the City's control over PGW's budgets is as absolute as PGW asserts and as Section 2212(s) of the Gas Choice Act seems to provide,²⁶ or whether it will be held to yield at least in part to the impact of the PUC's rate determinations or even possibly to the PUC's authority under Section 1705 of the Public Utility Code (arguably applicable to PGW pursuant to Section 2212(c) of the Gas Choice Act²⁷) to review, reject and/or opine on utilities' budgets, both in non-rate setting and rate-setting contexts.

²⁵PGW repeats this position in its objections to various interrogatories posed by CEPA et al in the PUC permanent base rate proceeding: "...Instead, this proceeding is to ensure that the identified expense has traditionally been included in PGW's operating budget and to set rates so as to cover the operating budget as approved."

²⁶PGW maintains that permitting the PUC to use the rate setting process to disallow expenditures approved by PGW's budgeting authority, the Gas Commission, "would directly infringe on the City's right to operate and manage the Gas Works, a right specifically guaranteed by...Section 2212(s)" (emphasis in original) (PGW's Motion in Limine at ¶25).

²⁷Under the Gas Choice Act, effective July 1, 2000, the provisions of the Public Utility Code apply to PGW "with the same force as if [it] was a public utility..." but only "to the extent not inconsistent with this section [2212]" (66 Pa. C.S. §2212(c)). Thus, the question to be resolved (possibly, ultimately by the courts) is the extent to which and under what circumstances the PUC's exercise of its rate-setting authority over PGW under Section 2212 or any other applicable sections of the Public Utility Code and/or the PUC's application of its Section 1705 budget review and rejection powers are inconsistent with other provisions of Section 2212, in particular the "preservation of powers" to the City contained in Section 2212(s) ("Nothing contained in this Title shall be construed to abrogate or limit the executive or legislative powers of [the City]; to legislate or otherwise determine the...budgets...of [PGW]....").

4. PGW's Position Does Not Recognize The Differences Between Budget Review And Rate-Setting Processes Nor Take Into Account That The Scope Of Budget Review Is Different Once Disconnected From Rate-Setting.

Putting aside the question of the legal weight to be afforded PGW's approved budgets under the Gas Choice Act, PGW's position fails to recognize that, as a practical matter, the nexus between the budget approval and rate setting processes is different when two different entities each have responsibility for only one of these two processes than when a single entity, the Gas Commission, was responsible for both and thus had the ability to weigh them together.²⁸

Generally speaking, the Commission's budget review is to ascertain whether PGW's assumptions both as to revenues and expenses for a given fiscal year are reasonable or not, and to require appropriate adjustments, up or down. Historically, the Commission has focused primarily on whether the proposed budgeted expenses are reasonable and whether PGW will be able to satisfy its debt service coverage covenants.²⁹ Consistent with its obligations under the Management Agreement and the bond ordinances, the Commission has also made reference to the fact that PGW's projected revenues must be sufficient to cover the enumerated operating expenses, including the annual City payment. Formerly, if it determined that projected revenues were insufficient to cover approved operating expenses, debt service, City payment, etc., the Commission had the authority to increase rates and/or to mandate reductions in operating expenses.

PGW asserts that Section IV. of the Management Agreement (regarding operating budget approvals) must be read in conjunction with the Section VII. requirements (regarding rate-setting), but as PGW concedes, "[i]nterpretation of the Management

²⁸PGW characterizes the Gas Commission's former methodology for setting rates and approving a budget as follows: "The approach followed by the PGC was to rule upon whether specific activities and operations were properly included in the budget. Once that determination was made, the PGC was obligated to fund the operation at whatever level it had authorized" (Motion in Limine at ¶25). This overly simplistic description posits that the Commission's rate setting was completely disconnected from budget review or from any assessment of whether the revenue requirement associated with funding the proposed expenses would meet the "just and reasonable" standard which the Commission recognized was applicable (Memorandum Opinion and Order dated March 19, 1992 at 5).

²⁹In regard to the latter, the Commission indicated that it regarded a projected debt service coverage ratio in the range of 1.7x to 1.9x to be an appropriate target (under the 1975 Bond Ordinance) for budgeting purposes, but subsequently approved "tighter" operating budgets which projected debt service coverage ratios closer to the 1.5x minimum and therefore required PGW to operate with less of a cushion (see FY 1997 Operating Budget Recommended Decision at 37-38).

Agreement must also be reconciled with the Gas Choice Act" (PGW Brief at 9). From this, PGW concludes that "[p]erforce...this Commission *must assure* that the budget incorporates sufficient revenues to pay operation and maintenance expenses and costs associated with the programs and policies approved by this Commission...; the City payment; and a reasonable allowance for working capital" (emphasis added) (Id. at 9-10).

PGW's interpretation of how the Gas Commission's remaining duties under the Management Agreement are to be reconciled with the Gas Choice Act is incorrect. While the Commission retains the obligation to adopt reasonable budgets which project sufficient revenues to cover reasonable operating expenses, as already discussed, the Commission cannot *assure* that "sufficient revenues" are provided via PGW's rates because it no longer has authority over the *legal determination* of PGW's revenue requirement, which is now within the PUC's purview (see 66 Pa. C.S. §2212(e)). In addition, there is no specific formula for the determination of PGW's year-end cash balance³⁰ set forth in the provision for PGW's rates and other project revenues to provide a reasonable and necessary amount of cash or equivalent working capital.³¹ Under the

³⁰PGW's cash flow from operations is generally negative from September through December and, under its historic rate structure, PGW books about 65% of all of its revenues during the winter months of December through March (Knudsen Direct Testimony in PUC Docket No. R-00006042 (rev. 02/02/01) at 20). Therefore, PGW has asserted that it needs \$35 to \$40 million in "positive cash" at fiscal year-end to be able to meet its gas purchasing and debt service obligations during the fall and following winter (Id.). Black & Veatch projects, without comment on its adequacy, an ending cash balance for FY 2001 of \$425,000 (response to ID-23 at B-52, B-54) (significantly less than the \$22 million net year-end cash balance most recently forecast by Bogdonavage in his Rebuttal Testimony in PUC Docket No. R-00006042 at 2). Taking into account the assumed deposit into the Capital Improvement Fund of \$110 million during FY 2001 resulting from the anticipated revenue bond issuance, Black & Veatch projects year-end cash balances for FY 2002 through FY 2006 which represent from 3 or 4 weeks (a low of \$13.7 million) to 9 weeks (a high of \$37.5 million) of O&M expenses (response to ID-23 at B-52, B-54). The lower cash balances "reflec[t] PGW's intent to repay its short-term debt obligations by 2005" (Id. at B-52). Black & Veatch opines that all of "[t]hese projected year-end cash balances should be sufficient for PGW to accommodate normal fluctuations in expenditures for utility operations" (Id.).

³¹The "formula" in the Management Agreement for the fixing of PGW's rates and charges (which also takes into account other revenues qualifying as "project revenues") provides that the revenues to thereby be produced in each fiscal year will be sufficient, among other things,

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

(Section VII.1.(b)(iii)). To my knowledge, the Commission has not articulated a specific standard as to the appropriate targeted amount for fiscal year-end cash reserves. An allowance for cash/working capital is not explicitly referenced in the rates "formula" contained in the Bond Ordinances, however

Management Agreement, this determination is left to be a matter of judgment, which is to be exercised in the overall exercise of [the Commission's former] rate-setting authority.

Unlike the review of the current fiscal year's proposed Operating Budget, rate-setting requires the normalization of expenses to ascertain what rates would be reasonable not just for one year but for some period of time. This is also the case under the "cash flow method" applicable to PGW under the Management Agreement. As is set forth in Section VII.5., "Such rates may provide for sufficient revenue to stabilize them over a reasonable number of years."³²

It should be noted that PGW's financial statements for FY 2001 filed with the PUC in support of its \$65 million permanent base rate request show PGW's projected results for the fiscal year "...on a fully normalized or fully forecasted basis. This means that [PGW] has used levels of gas costs and bad debt expense that we believe are representative for the period in which the rates will be in effect" (Direct Testimony of Thomas E. Knudsen in PUC Docket No. 00006042 (revised 02/02/01) at 14 (emphasis added)). As Knudsen emphasized, "[i]t is important to note that these fully forecasted results do not include the most recent higher gas costs or the associated provision for uncollectible" (*Id.* at 8). Thus, unlike the original or revised FY 2001 Operating Budgets before this Commission, the PGW rate filing reflects a "normalized" natural gas expense for the FY 2001 "test year" which incorporates \$150 million in cost over original budget, rather than the revised budgeted natural gas expense, which reflects the full \$230 million in approved GCR increases (*Id.* at 8, 17-18; compare PGW Exhibit 43). Concomitantly, for rate-setting purposes, PGW has posited annual bad debt expense of \$65 million, rather than the \$72 million linked to its higher, actual GCR costs (Knudsen Direct Testimony (rev. 02/02/01) at 2; compare PGW Exhibit 43 and PGW Statement 13 at rev. Ex. A-1). In short, PGW's rates still have to be set to satisfy normalized expenses over some reasonable period of time, or else they would constantly be subject to change.³³

(see Section 403(b) of both the 1975 and 1998 Bond Ordinances).

³²Similarly, under Section 403(g) of the 1975 Bond Ordinance, the City covenants that "it has, by Ordinance, authorized the imposition of rates and charges by the Gas Commission *sufficient from time to time* to comply with Rate Covenant set forth in Section 403(b)...."

³³Knudsen opines that "PGW's rate allowances...also must assure that PGW's *actual results* satisfy the minimum financing requirements imposed by PGW's bond ordinances and its Management Agreement" (Knudsen Direct Testimony (rev. 02/02/01) at 16). In reality, this matter is not quite so absolute. This Commission has previously declined to be the guarantor of PGW's financial results, and has indicated that it may not be compelled to, in effect, increase rates after the fact to compensate for management's failure or inability to conform revenues and expenses to budget (FY

Finally, a rate making proceeding uses a different approach to assessing the necessity and reasonableness of projected expenditures, because it also requires a determination whether, in the end, the rates that would be required to fund such expenses (which, standing alone, could be considered reasonable for budgeting purposes) can also be considered "just and reasonable" for rate making purposes (Public Advocate v. Philadelphia Gas Commission, ___ Pa. ___, 674 A.2d 1056 (1996); Action Alliance, supra, 406 A.2d at 1158; see also Memorandum Opinion and Order dated March 19, 1992 In the Matter of a Proposed Base Rate Increase by the Philadelphia Gas Works for Fiscal Year 1991-1992 at 5).

For prudential reasons (given the pending City Council litigation challenging the legality of the Gas Choice Act), an effort was made, particularly during the outset of this proceeding, to conduct it as if it remained a Regulation No.1 proceeding and to keep the record as broad as possible (see PGC Exhibit 8). In the interim, that litigation has not been decided; the PUC has taken a series of rate-setting actions; and this Commission still has no rate-setting authority. This being the case, a full-blown ratemaking record – which was not required for the Commission's due diligence review of the proposed budget – was not made and is not before the Commission.³⁴

For all the foregoing reasons, the Commission should assume for budgeting purposes that the PUC-approved interim base rates plus the PUC-approved GCR increases

1995 Debt Service Coverage Gap/FY 1996 Operating Budget Recommended Decision at 28-29, and see Order regarding FY 1996 Operating Budget adopted November 9, 1995 at 1-2). In certain instances, PGW may have to look to other project revenues in order to satisfy its debt service coverage requirements. In other instances, the Commission has authorized rate adjustments which, while they were not rate increases, had the effect of generating additional revenues, sufficient to meet PGW's operating or debt service coverage requirements (Order of May 22, 1991; Memorandum Order in re: interim approval of increase in customer charge dated May 10, 1999).

³⁴Such a record is critical to the ratemaker because the beginning and end of the relevant inquiry is not, as PGW suggests, that it is in dire need of cash, or that its short-term financial objectives (see PGW Statement 13 at 4; PGW Brief at 17, 19) are generally proper. Rather, in a rate-setting context, the decision maker must also assess a broader array of issues which impact on the determination of just and reasonable rates. Among other issues which have relevance to PGW's situation, the decision maker could reasonably examine the extent to which the utility's owner's and/or manager's actions or decisions negatively impacted cash resources. Further, the amount of rate relief which is appropriate to enable the utility to meet its financial and operational objectives would also have to be weighed against the need to avoid a huge run-up in rates ("rate shock") which could be unduly burdensome to ratepayers, while exacerbating the downward financial spiral which the utility is entering, or has already entered. Thus, while PGW is obviously correct that it is past time to move away from the "one-time fixes" favored by the prior City Administration (see PGW Brief at 18), a determination of what would be just and reasonable rates under the applicable law and all of the circumstances requires some judgment, not merely a mathematical calculation.

are in effect for FY 2001, and project revenues (and relevant expenses) for FY 2001 accordingly. This is not to opine on the adequacy of the interim rates (which were the result of a litigation settlement between PGW/the City³⁵ and the PUC), nor on whether they meet the "just and reasonable" standard, and the Commission may wish to so state in its final Order in this proceeding.

- B. THE COMMISSION SHOULD ADOPT PGW'S REVISED FY 2001 FINANCIAL STATEMENTS AS THE BASIS FOR THE APPROVED FY 2001 OPERATING BUDGET, AFTER MAKING CERTAIN ADJUSTMENTS TO PROJECTED REVENUES AND EXPENSES WHICH ARE, FOR THE MOST PART, NOT IN DISPUTE.

1. Recommended Adjustments To Projected Revenues For FY 2001

- a. *Operating Revenues Should Be Premised Upon Normal Heating Degree Days of 4,555.*

PGW's initial operating budget filing was, as usual, premised upon normal weather of 4,600 heating degree days (PGW Statement 1 at 4). However, in light of recent experience with winter weather that was 10 to 15% warmer than normal with its accompanying negative impact on PGW's cash flows, PGW proposed that budgeted revenues be reduced by \$4 million to recognize the effect on marginal revenues that a 3% warmer than normal year would have (Id. at 4-5; PGW Exhibit 3 at Ex. A-1).

Thereafter, in its permanent base rate filing with the PUC, PGW adjusted its degree day forecast to reflect more precisely the 30 year historical average of 4,555 heating degree days, which is just less than 1% lower than the 4,600 norm which had been in use (PGW Exhibit 43 at 2; Tr. 1904-1905; see also Direct Testimony of Craig White in PUC Docket No. R-00006042, rev. 02/02/01, at 2-3 and Direct Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042, rev. 02/02/01, at 3). This "resulted in

³⁵As a departmental commission of the City, the Gas Commission would be constrained from opining on the reasonableness or the adequacy of this negotiated settlement. In fact, for the Commission to find that the interim rates agreed to by the City were insufficient to meet all of the mandated bond covenants – as PGW in effect is requesting – could presumably subject the City to a possible declaration of default by the bondholders.

ultimately approved by the PUC by Order adopted February 21, 2001.

Under the terms of the approved settlement, “[i]n exchange for [certain] commitments by PGW and the City [related to obtaining permanent management for PGW by September 30, 2001; streamlining PGW’s governance structure; and implementation of the PUC Management Audit],” in addition to receiving the initially approved \$11 million interim base rate increase, PGW was “permitted to recover an additional \$7 million through its GCR, compressed so as to be collected by August 31, 2001, to account for additional bad debt expense produced by dramatically higher than projected natural gas costs incurred by PGW” (PUC Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619 at 3-4).³⁶ This combined total of \$18 million was reflected in PGW’s revised financial statements as a “Proposed Base Rate Increase” line item (PGW Statement 13 at rev. Exhibit A-1; see also *Id.* at 2; Tr. 1905).

For the reasons set forth in Section III.A. above, for purpose of the FY 2001 Operating Budget, the Commission should approve the revenue projection of \$18 million shown in PGW’s revised Exhibit A-1, not the \$52 million originally budgeted, to reflect the impact of base rate increases during FY 2001.³⁷

d. Budgeted Revenues Should Reflect The Incremental Effect Of The Gas Cost Rate (“GCR”) Increases Authorized By The PUC.

In the original budget filing natural gas expense was projected to increase by some \$41.6 million over FY 2000 to \$294.593 million (PGW Exhibit 3 at Ex. A-1). Accordingly, PGW projected a 73.8 cent increase in the FY 2001 GCR from \$1.0982 per mcf to \$1.8362 per mcf (PGW Statement 2 at 4).

By early August 2000, when PGW filed its proposed FY 2001 GCR request with the PUC, natural gas costs had risen and PGW was projecting a further \$55 million increase in these costs to \$349.068 million (PGW Exhibit 19). Based on these projections, the PUC approved a \$97 million increase in PGW’s GCR from \$1.0982 to

³⁶Under the terms of the settlement, PGW was also permitted to hold in reserve any GCR overcollection that it incurs, not to exceed \$25 million, to insure it had sufficient cash to meet its bond covenants through January 2002 (*Id.* at 4).

³⁷It should be noted that, even under the \$18 million “Proposed Base Rate Increase” scenario reflected in the revised financial statements, and without having made the adjustments I recommend herein (many of which PGW concurred in) which improve coverage, PGW projects it will fully satisfy its debt service coverage requirements (PGW Statement 13 at revised Exhibit A-3).

\$3.0445 per mcf, effective November 22, 2000 (Order adopted November 21, 2000 in Docket No. R-00005619).

When gas prices continued to escalate, PGW filed a quarterly update to its GCR pursuant to the PUC's November 22, 2000 Order, increasing its GCR-applicable gas costs by some \$133 million and thus, increasing the GCR to \$6.1985 per mcf effective January 1, 2001 (Pa. PUC v. PGW, Docket No. R-00005619 -- Quarterly Update filed December 29, 2000). This was also reflected as a further \$150 million increase to budgeted natural gas expense, to the total of \$479.593 million contained in PGW's most current projected Statement of Income (PGW Statement 13 at rev. Exhibit A-1). Consistent with the November 2000 and January 2001 approved GCR increases totaling \$230 million, PGW projects a \$185 million increase to both revenues and natural gas expense over what was shown in the original budget (*id.*).

It should be reiterated that, when the PUC approved the interim rates settlement with PGW and the City, it authorized a further increase in the GCR (to \$6.6959 per mcf effective March 1, 2001) to reflect recovery through the GCR of \$7 million in additional bad debt expense (Order adopted February 21, 2001 in Docket Nos. R-00005654 and R-00005619). As mentioned earlier, PGW added the latter sum to the \$11 million interim base rate increase also made effective March 1, 2001, and showed them together on its revised financial statements as an \$18 million "Proposed Base Rate Increase" line item (PGW Statement 13 at rev. Exhibit A-1). Thus, this most recent adjustment did not increase the budgeted natural gas expense from \$479.593 million (*id.*).

For the reasons set forth in Section III.A. above, for purpose of the FY 2001 Operating Budget, the Commission should approve, in addition to the originally budgeted non-heating and heating revenues, a GCR Adjustment revenue line item of \$185 million.

e. *Unbilled Gas Adjustment Should Be Modified Accordingly To Reflect The Foregoing Interim Base Rate And GCR Increases.*

The concomitant impact of the above referenced rate increases on the line item capturing unbilled gas revenues³⁸ as of the end of the fiscal year was shown in the revised Exhibit A-1 to PGW Statement 13 to be a \$2.1 million increase over the originally budgeted \$1.5 million. There was no dispute about this impact.

³⁸The Unbilled Gas Adjustment line item captures the volume of gas used but unbilled at August 2001, calculated at the average price per mcf (PGW Statement 2 at 6).

I therefore recommend that Unbilled Gas Adjustment revenues for FY 2001 be budgeted at \$3.6 million, as shown in revised Exhibit A-1 to PGW Statement 13.

2. Recommended Adjustments To Projected Operating Expenses For FY 2001

a. *Budgeted Natural Gas Expense Should Reflect The PUC-Approved GCR Increases In Effect During FY 2001.*

As detailed in Section III.B.1.d. above, natural gas price increases since the original budget was filed have resulted in PUC approval of some \$230 million in GCR increases, the incremental effect of which on revenues was shown as a \$185 million "GCR Adjustment" in the April 3, 2001 updated financial statements (PGW Statement 13 at rev. Exhibit A-1). Concomitantly, a \$185 million increase in projected Natural Gas Expense, from \$294.593 million to \$479.593 million, was shown (id.).

For the reasons set forth in Sections III.A. and III.B.1.d. above, the Commission should approve budgeted Natural Gas Expense for FY 2001 of \$479.593 million.

b. *Budgeted Gas Processing Expense Should Tie To Budgeted Natural Gas Expense.*

PGW's most current financial statements reflect a minor decrease in Gas Processing Expense from the originally budgeted \$13.835 million to \$13.787 million (PGW Statement 13 at rev. Exhibit A-1). Bogdonavage explained that this change was "reflective of the changes that happened because we used an update during the fiscal year for natural gas pricing and also the utilization of our storage....it's just one of the normal items, as we change natural gas, as we change the GCR, it's one of the fall-throughs that affects working capital" (Tr. 1911-1913). The Advocate had no objection (Tr. 1913).

Consistent with the foregoing recommendations to incorporate the GCR Adjustment to budgeted revenues and the concomitant increased Natural Gas Expense, I recommend that the Commission reduce budgeted Gas Processing Expense by \$48,000 from \$13.835 million to \$13.787 million, as shown in PGW Statement 13 at revised Exhibit A-1.

c. *Budgeted Bad Debt Expense Should Be Reflective Of Dramatically Increased Gas Cost Rates, But Be Set At A Level That Reflects The Expectation That PGW Will Pursue Aggressive Collection Of Bills.*

PGW's original FY 2001 operating budget projected \$46 million in bad debt expense, or 7.1% of budgeted operating revenues, compared to \$44 million estimated-actual bad debt expense for FY 2000 (PGW Exhibit 3 at Exhibit A-1; PGW Statement 2 at 8; PGW Statement 3 at 2). "The substantial rise in this expense reflects PGW's acknowledgment that, due to delayed customer billings as a result of problems with the billing system, the ability to collect a substantial portion of outstanding receivable balances at historical collection levels will be difficult" (PGW Statement 2 at 8-9). Still, as a percent of total gas revenues, bad debt expense was projected to decline from the FY 2000 estimated-actual level of 8.5% "due to anticipated improvements in the billing and collection system and adequate reserve balances for FY 2000" (PGW Statement 3 at 2). In reality, bad debt expense for FY 2000 was \$54.642 million, or close to 10.7% of total billed revenues³⁹ (PGW Statement 13 at rev. Exhibit A-1 and at Smyth Testimony – Schedule 1 (Revised)).

During the course of this fiscal year, as it filed for and received approval of increases to the GCR (which for the most part are being collected on a very compressed time frame), PGW increased its projected bad debt expense significantly (Tr. 1923-1925). As mentioned earlier, in its pending permanent base rate filing with the PUC (which incorporates somewhat lower, "normalized" gas expenses but also assumes a \$65 million base rate increase), FY 2001 bad debt expense is projected at \$65.3 million, or \$19.3 million higher than the original budget (PGW Exhibit 42 at revised Exhibit A-1; PGW Exhibit 43 at 3). But taking into account the actual GCR increases in effect for FY 2001 together with the \$18 million interim base rate increases, PGW increased projected FY 2001 bad debt expense by another \$7 million, to \$72.013 million, or just under 9% of total billed revenues⁴⁰ (PGW Statement 13 at rev. Exhibit A-1 and at Smyth Testimony – Schedule 1 (Revised)).

In other words, while in its original budget, PGW optimistically projected that it would collect 94% of all billed revenues, PGW downgraded this projection to 87% in its most current filing, or somewhat less than the 88% collections rate experienced for FY

³⁹\$54.642 million ÷ \$513.113 million = 10.65%.

⁴⁰72.013 million ÷ \$800.350 million = 8.99%.

2000 (Id. at Smyth Testimony – Schedule 1 (Revised); Tr. 1924-1925). Thus, the deterioration from the recent historical collections rate of 92% of all billed revenues is projected to persist during FY 2001 (Tr. 1921-1925). PGW therefore anticipates a fiscal year end customer receivables balance of nearly \$206 million, compared to \$141 million for FY 2000 and significantly lower balances in the preceding fiscal years⁴¹ (PGW Statement 13 at Smyth Testimony – Schedule 1 (Revised); Tr. 1926-1927). Similarly, PGW retreated from its original budget projection that the FY 2001 reserve factor would be 33%, i.e., an improvement over the actual FY 2000 reserve factor of 39%, and replaced it with a 35% reserve factor “to be conservative in [its] approach,” even though, as Bogdonavage conceded, it has no empirical evidence to back this projection (PGW Statement 13 at Smyth Testimony – Schedule 1 (Revised); Tr. 1937-1939).⁴²

These worsening projections were vetted during the August 2000 consolidated budget hearings; again, with respect to PGW's \$45 million City loan request in early October 2000; further, with respect to its Five Year Strategic Plan in the January 11, 2001 hearing, and again, during the April 19, 2001 consolidated budget hearing. Factoring in deletion of the marginal revenue budget adjustments discussed in Sections III.B.1.a. and b. above, and utilizing the FY 2000 actual ending receivables balance and FY 2001 actual beginning reserve balance, FY 2001 customer receivables are projected to increase slightly to \$208 million, while the projected bad debt expense increases by \$770,000 to \$72.783 million (response to TR-30; Tr. 1918-1921).

Knudsen acknowledged that, in order to achieve its projection of collecting 87% of

⁴¹PGW's fiscal year-end customer accounts receivable were \$97 million for FY 1999 and \$88 million for FY 1998 ((PGW's Audited Financial Statements for the Years Ended August 31, 1999 and 1998).

⁴²Multiplying the projected year-end receivables balance by the reserve factor yields the estimated bad debt expense, as shown in the response to TR-30:

Bad Debt Expense	FY 2000 (Actual)	FY 2001 (6/19/00)	FY 2001 (Revised)
Year-End Net Receivable (\$000)	141,080	138,029	207,951
(times) Reserve Factor	38.73%	33.33%	35.00%
Total Bad Debt Expense (\$000)	54,642	46,000	72,783

However, as Bleiweis and Bogdonavage discussed and agreed, the projected bad debt expense is a representative estimate, subject to fine-tuning and finalization based on the post-fiscal year collectibility study done by PGW's outside auditors and based on the judgments ultimately made (Tr. 1939-1943).

the billed amounts, PGW would have to substantially improve its collection efforts for the balance of the fiscal year (Tr. 1929-1930). He indicated that PGW would pursue collections through a new soft-core telephone dunning effort, plus field collections activities, including termination of service (Tr. 1930; see also Tr. 2049-2096). PGW also anticipates receipt of some \$22 to \$24 million in LIHEAP and Crisis grants on behalf of low-income customers, substantially above last year's receipts (Tr. 1928-1929).

The dramatic growth in PGW's receivables and bad debt expense projected for FY 2001 is alarming, because it indicates the downward cash spiral effect of increasing rates significantly - as billings increase and are not/cannot be paid, cash recovery does not keep pace, ultimately contributing to the need to raise rates again to pull in more cash from a decreasing pool of paying customers. On the one hand, PGW's projections - albeit not backed by empirical evidence - appear to be fairly realistic, taking into account all of the relevant factors (such as, increased rates, customer demographics, and the recent history of billing problems and lack of normal collections efforts). On the other hand, as I have consistently advised the Commission during the past two fiscal years, PGW has a significant amount of revenue tied up in uncollected and collectible billings, and has the responsibility to make reasonable efforts to turn these into cash.⁴³ In the past two years, however, PGW has done an abysmal job of doing so. Thus, keeping the budgeted bad debt expense "tight" - particularly at a time when PGW needs to maximize its year-end cash balance - should provide some incentive to PGW to maintain an aggressive stance towards collections.

I take notice that, in the most recent PGW testimony filed in the pending permanent base rate proceeding before the PUC, Knudsen has represented that PGW is

...working hard to reduce the bad debt expense. But, that action is projected to generate \$5-10 million, at best, under the circumstances. That would be an important contribution but not a solution [for PGW's need to generate cash]....

(Rebuttal Testimony of Thomas E. Knudsen in PUC Docket No. R-00006042 dated May

⁴³See, for example, PGC Exhibit 38 ("Preliminary Assessment Of PGW's Five Year Strategic Plan Dated December 2000/Update On PGW's Cash Situation And Projections" (Memorandum to Commissioners dated January 16, 2001)) at 3-4, 8-9; "Recommendations For Commission Action On PGW's Request For Approval Of \$45 Million Temporary Advance From City Of Philadelphia" (Memorandum to Commissioners dated October 6, 2000) at 3, 5, 9; "Recommendations For Commission Action On PGW's Petition To Increase Its Commercial Paper Authorization From \$85 Million To \$100 Million" (Memorandum to Commissioners dated November 5, 1999) at 1, 4-7.

2001 at 10-11). While it is not clear exactly what "action" Knudsen refers to here, a \$5 to \$10 million reduction in projected bad debt expense would be a commendable achievement and would wipe out the projected year-end negative earnings position, while improving PGW's already positive year-end cash balance (see fn.18 in Section III.A.1. above).

I also take notice that, according to PGW's most current revised estimates for FY 2001 (which incorporate the known and definite changes in projected natural gas expense for this period), bad debt expense is projected at \$69.995 million (Rebuttal Testimony of Joseph R. Bogdonavage in PUC Docket No. R-00006042 dated May 2001 at 2 and at Exhibit JRB-2, p.1), or about \$2.8 million lower than in the most recent estimate before this Commission. I am not suggesting that it is appropriate to substitute this number for the one before this Commission, because there are other variances in the projected revenue and expense line items from the budget figures being reviewed here. Rather, I cite this as further indication that there is some "give" in PGW's bad debt expense projection.

The Advocate made no specific recommendations with respect to projecting bad debt expense.

Taking into account all of the foregoing, I recommend that the Commission reduce PGW's budgeted bad debt expense for FY 2001 by \$5.0 million from its revised estimate of \$72.783 million⁴⁴ (shown in the response to TR-30) to \$67.783 million.

- d. *Although In The Future PGW Should Specify The Line Items In Which It Will Achieve Its Projected \$10 Million Cost Savings/Productivity Improvements, For Purpose Of The FY 2001 Operating Budget, This Line Item Is Consistent With The Commission's Interim Spending Authority Order And Should Be Approved.*

PGW included in its original budget filing a projected \$10 million adjustment for unspecified Cost Savings/Productivity Improvements – in addition to a projected \$2.5 million adjustment for Personnel Reductions/Retirements (PGW Exhibit 3 at Exhibit A-1).

⁴⁴Although this revised estimate factors in actual receivables and reserve balance data that, standing alone, might not warrant a change from the original budgeted amount, it also factors in changed assumptions about the \$4.0 million degree day and \$1.5 million Senior Citizen Discount marginal revenue impacts which should be adopted, consistent with my recommendations about these two revenue line items.

PGW itemized the \$10 million Cost Savings as follows:

*Reductions to overtime	\$2.5-\$3.0 million
*Personnel Reductions/Retirements	\$2.5 million
*Further attrition, productivity	\$2.7-\$3.95 million
*Reductions in material, purchased services	\$1.0-\$1.5 million

(response to PA-17). This response showed that PGW was counting the \$2.5 million savings projected to come from Personnel Reductions/Retirements twice (Tr. 459-461). However, PGW maintained that in fact, it would strive to cut \$10 million *in addition to* the \$2.5 million (Tr. 460). PGW was also assuming at that time that it would be able to reduce health insurance costs by \$4 million, "reflecting anticipated changes in coverages for both active and retired employees" (Tr. 1953; PGW Statement 2 at 8).

Currently, PGW maintains the expectation that it will achieve the \$10 million in "undocumented savings" plus \$2.5 million due to retirements, but has "backed off of the [\$]4 and ha[s] [\$]3 million as the reduction in the health benefits" (Tr. 1953). In addition, Bogdonavage "backed off" the goal of achieving a total of \$15.5 million in budgeted savings:

- it's not necessarily savings. They can be achieved in two ways. We can have the revenues come in also. Because of the billing system, we have had some problems identifying what revenues are still yet to be billed. So I wouldn't say that they're cost savings. Obviously PGW will do everything it can to hold down the costs.

(Tr. 1950; see also Tr. 1951-1952). As Bogdonavage acknowledged, PGW's earlier projections were that it might not make its 1.5x debt service coverage requirement. Therefore, "...at that point in time we...said that PGW would have to do something, and at this point, we used an expense reduction rather than a revenue increase," essentially as a "plug" in order to make coverage (Tr. 1952).

Bleiweis notes that it is not really proper to use such unspecified budget plugs, rather than detailing by line item where such cost savings will be achieved (PA Statement 5 at 3-4). Bogdonavage concurred that it would be beneficial for PGW's budgeting process in the future to identify the specific areas where cuts were going to occur rather than a lump sum figure, as was done here (Tr. 1959):

Rather than trying to look at just a fictitious \$10 million number and try to manage to that, we will be able to manage

to a departmental spending level, which will be a lot more beneficial to everybody who is looking at the Company. (Tr. 1960-1961).

Bogdonavage opined that "[t]he [\$]2.5 [million personnel cost reductions] will definitely happen and probably will be far exceeded" (Tr. 1953). However, PGW has not made much headway towards meeting the \$10 million cost savings goal. PGW's monthly status report to City Council and the Commission regarding achievement of this goal showed that through February 2001, i.e., halfway through the fiscal year, PGW had only achieved \$4.2 million of its total goal on a net basis⁴⁵ (PGW Exhibit 46; Tr. 1945). Bogdonavage opined that these net savings would continue to grow as PGW got closer to the end of the fiscal year and capital spending was increased during the traditional construction season (Tr. 1948-1949). After subsequently reviewing the March 2001 financial reports, he found that in fact PGW did not "ma[k]e much progress in the month of March" (Tr. 2130). Bogdonavage expects that savings will increase after March, however, "because of the amount of retirees that we expect to have leave the Company on May 1" (*id.*). From this statement, it can be inferred that PGW is relying heavily on retirements to achieve cost savings,⁴⁶ but has not yet undertaken a serious or thorough effort to wring out other operating expense reductions.⁴⁷

For example, given PGW's less than full embrace of some specific cost savings being recommended for consideration by the Advocate, at least in next year's budget review (such as, the \$275,000 cost of the employee cafeteria⁴⁸ and the cost associated with some 40 management personnel's use of PGW cars for personal and commuting purposes - see PA Statement 5 at 15-21; Tr. 2016-2025), it is apparent that such

⁴⁵Factored into the total \$4.216 million net savings was \$1.771 million for overall payroll/personnel savings (PGW Exhibit 46).

⁴⁶Of course, there are potential down sides (such as, inadequate personnel levels) and offsetting costs to be incurred (such as, the need to obtain purchased services or re-hire recent retirees as consultants, see Tr. 2131-2135) as a result of a dramatic number of retirements or other attrition.

⁴⁷It does appear, however, whether by default or design, that PGW is again not likely to spend the full budget of \$6.7 million for the Marketing Department (Bogdonavage Rebuttal Testimony in PUC Docket No. R-00006042 at Exhibit JRB-2).

⁴⁸Even though in its responses to PA-158, PA-169 and PA-185, PGW set out a formula for calculating the "subsidy" associated with the cafeteria, during the hearings, Knudsen quibbled over semantics: "Subsidy is maybe a misnomer...subsidy I don't think is quite the right term" (Tr. 2018). Although insisting he was "not saying there is no subsidy," he maintained it should not be called that (Tr. 2022).

potential areas for cost reduction have not been factored into the \$10 million goal. Bleiweis also questions the necessity of the budgeted \$240,000 (33%) increase in Dues & Subscriptions expenditures over the FY 2000 estimated- actual amount of \$714,000 (PA Statement 5 at 21, citing PGW Exhibit 3 at Exhibit C-4). Though I agree with Bleiweis that the \$10 million cost savings goal for FY 2001 is therefore "conservative," that is, that additional cuts should be achievable (PA Statement 2 at 20-21), on this record and in the absence of a Five Year Plan with detailed departmental goals, it is not possible to specify a more aggressive goal.⁴⁹

While, taken individually, the items identified by the Advocate and other expense areas do not represent huge dollars, to achieve PGW's overall goal will require relentless pursuit of such opportunities to pare unnecessary expense. Such a comprehensive effort would also signal that PGW is not still just about business as usual. I believe that this was the intent of the Commission's grant of FY 2001 interim operating spending authority, directing PGW to hold its non-gas operating expenditures to 95% of last year's actual spending levels (Order dated October 17, 2000 at ordering paragraph 1).

I therefore recommend that the Commission approve an Operating Budget line item capturing the total projected \$10 million in Cost Savings/Productivity Improvements for FY 2001. I further recommend that the Commission require PGW to specify in its proposed FY 2002 Operating Budget the specific line items wherein the projected cost reductions and productivity improvements will occur, which must be linked to specific PGW departmental goals as set forth in a revised and completed Five Year Financial and Management Plan.

- e. *The Advocate's Proposed Accounting And Miscellaneous Operating Expense Adjustments Are Largely Unopposed By PGW, And Should Generally Be Approved.*

The Advocate's witness Bleiweis proposed a series of budget adjustments totaling \$6.6 million which, if adopted, would have the effect of doubling the projected debt service cushion (i.e., the funds available above the 1.5x minimum debt service coverage)

⁴⁹In August 2000, the City Finance Director opined that PGW's \$10 million goal was indeed "aggressive" and that its proposed operating budget reflected "pain" (Tr. 461-462). More recently, PGW maintains that its cost-cutting targets are more aggressive than those recommended by the Management Audit performed for the PUC (after eliminating certain Management Audit recommendations PGW rejects as not feasible or not within its control) (response to ID-25 at letter dated March 22, 2001 from Thomas E. Knudsen to Thomas Sheets).

from \$6.5 million to \$13.1 million (PA Statement 5 at 8-15 and at Schedule MAB-3; Tr. 2000). Bleiweis testified that, while his recommended adjustments would help coverage (and in some instances, cash), he had proposed them primarily because they were "proper accounting" (Tr.1998-1999). In summary, Bleiweis proposed the following:

1. **BCCS Remediation** – the budgeted one-time expenditure of \$1 million should be amortized over five years, reducing FY 2001 expense by \$800,000.
2. **Marketing Consultant Studies** – the non-recurring budgeted expenditure of \$530,000 should be amortized over five years, reducing FY 2001 expense by \$424,000.
3. **Various Non-Recurring Expenses** – the budgeted one-time expenditures of \$300,000 for Emergency Operations (related to renegotiation of the labor agreement) and \$2 million for Training Costs– V.P. Customer Affairs should be amortized over five years, reducing FY 2001 expense by \$1.840 million.
4. **Rate Case Expense** – the budgeted \$825,000 expenditure for the FY 2001 rate case should be amortized over two years, the expected period between rate cases, reducing FY 2001 expense by \$412,000.
5. **Non-Recurring Material Purchases** – the budgeted expenditure of \$150,000 for non-recurring material purchases in preparation for a possible work stoppage should be amortized over three years, the length of the most recent labor agreement, reducing FY 2001 expense by \$100,000.
6. **Operating Leases** – \$601,000 for operating leases should be eliminated from the Operating Budget because such costs are now being included in PGW's FY 2001 Capital Budget (see also Order and Resclution dated May 3, 2001 at Resolution paragraph 1).
7. **CRP Regulatory Asset** – the budgeted \$3.75 million amortization amount should be reduced by \$1.6 million to reflect an anticipated offset to this charge from receipt of Crisis grants, based on the prior five year average.
8. **Information Technology Equipment Rentals & Leasing** – the budgeted \$632,000 expenditure for PC's, laptops and additional computer storage space should be eliminated because these acquisitions and projects have been deferred.
9. **Lobbying Expense** – the budgeted \$115,000 expenditure for lobbying consulting services should be eliminated because such expenses are ownership expenses which are not allowed by the PUC for ratemaking purposes.
10. **Employee Activity Costs** – the budgeted \$41,000 for the Quarter Century Service Club Banquet, a celebration attended by PGW employees and retirees, bears no

relation to safe, reliable and affordable service and should be canceled.

During the hearings, Bogdonavage indicated that PGW was largely in agreement with the proposed adjustments, but had a few reservations that it needed to verify (Tr. 2000-2008, 2015-2016). PGW was given the opportunity to finalize its response via a transcript request, TR-32 (Tr. 2016). That response shows that PGW agrees with nearly all of Bleiweis' proposed adjustments, except that:

- (1) PGW proposes a three-year, rather than a five-year, amortization period for BCCS Remediation costs, consistent with past practice;
- (2) PGW opposes a three-year amortization for \$150,000 of Non-Recurring Material Purchases, because it duplicates an amount included in the other Non-Recurring Expenses line item of \$300,000 for Emergency Operations in connection with the labor agreement renegotiations (which, PGW maintains, should be amortized over three years, not five years as Bleiweis suggested); and
- (3) PGW opposes a disallowance of the \$115,000 Lobbying Expense (response to TR-32; see also Tr. 2000-2001, 2006-2007).

Under PGW's position, there would be a \$6.3 million expense reduction, compared to the Advocate's \$6.6 million (response to TR-32), which has a comparably salutary impact on coverage for FY 2001.

PGW's three-year amortization for BCCS costs is based on past practice and is reasonable. As to the overlap between the two Non-Recurring Expense items, this was probably an inadvertent error on Bleiweis' part. Moreover, although he recommended a five-year amortization period for the Emergency Operations item, it is clear from his recommendation of a three-year amortization period for the labor negotiations-related Material Purchases item that he would agree with PGW's three-year amortization period.

Thus, the record clearly supports the deferral of \$3,303,500 in FY 2001 expenses to future fiscal years (see response to TR-32).⁵⁰ In addition, the parties are in agreement that \$1.274 million in cash expenditures budgeted for FY 2001 should be eliminated from

⁵⁰BCCS Remediation (\$667,000) + Marketing Studies (\$424,000) + Emergency Operations (\$200,000) + Training Costs - V.P. Customer Affairs (\$1,600,000) + Rate Case Expense (\$412,500) = \$3,303,500.

TABLE 1
PGW Statement of Income (Excerpts) (Dollars in Thousands)

Line Item	Original Budget (6/19/00)	Interim Budget (95% of FY 2000 Actual)	Revised Budget (4/03/01)	Recommended Adjustments to Rev Budget	Recommended Budget
Non-heating Rev	106,778	n/a	106,778	0	106,778
Gas Trans Serv Rev	3,509	n/a	3,509	0	3,509
Heating Revenues	463,816	n/a	463,816	0	463,816
Base Rate Increase	52,000	n/a	18,000	0	18,000
GCR Adjustment	-	n/a	165,000	0	165,000
Net Marginal Rev	(4,000)	n/a	(4,000)	2,400	(1,600)
Change in Sr Cit Disc	1,500	n/a	1,500	(1,500)	0
Unbilled Adjustment	1,500	n/a	3,600	0	3,600
Total Gas Revenues	625,103	n/a	778,203	900	779,103
Total Other Revenues	24,348	n/a	28,729	0	28,729
Total Operating Rev	649,451	n/a	806,932	900	807,932
Natural Gas Expense	294,593	294,593*	479,593	0	479,593
Gas Processing Exp	13,835	13,248	13,787	0	13,787
Bad Debt Expense	46,000	45,600	72,013**	(5,000)	67,783
Personnel Reduce/Ret	(2,500)	n/a	(2,500)	0	(2,500)
Advocate's Adjustments	n/a	n/a	n/a	(4,578)	(4,578)
Cost Savings/Produce	(10,000)	n/a	(10,000)	0	(10,000)
Total Operating Exp	529,557	491,081*	740,522	(5,578)	730,944
Operating Income	119,894	n/a	66,410	10,478	76,888
Other Income	5,774	n/a	5,774	0	5,774
Inc Before Interest	125,668	n/a	72,184	10,478	82,662
Interest Expense	57,780	n/a	57,780	0	57,780
Net Income Before City Payment	67,888	n/a	14,404	10,478	24,882
Net Earnings/(Loss)	49,888	n/a	(3,596)	10,478	6,882

Sources: PGW Exhibit 3; PGW Statement 13 (Rev. Ex. A-1); responses to TR-30 & TR-32; PGW's Interim Monthly Spending Plan for FY 2001 (filed 11/13/00).

* / The Commission's Order dated October 17, 2000 authorized continuing operating spending during FY 2001 at levels not to exceed 95% of actual spending in FY 2000 for line items in the approved FY 2000 operating budget, except for natural gas expense. 95% of the preliminary FY 2000 actual non-gas operating expenditures totaled \$196.488 million; \$196.488 + \$294.593 (originally budgeted natural gas expense for FY 2001) = \$491.081 million.

** / PGW later revised bad debt expense to \$72.783 million (response to TR-30).

DATE: September 19, 2001

REP

SUBJECT: R-00006042, R-00006042C0001 et al.,
C-00014826 - C-00014828, - C-00014843, C-00014910, C-00015037,
C-00015044 - C-00015048, C-00015050 & C-00015098

TO: Cheryl W. Davis, Director
Office of Special Assistants

FROM: James McNulty
Secretary
nvl

Pennsylvania Public Utility Commission v. Philadelphia Gas Works

Copies of the Recommended Decision have been served upon all parties of interest.

Exceptions have been filed by:

Philadelphia Gas Works
CEPA et al
Office of Consumer Advocate
PICGUG

Reply Exceptions have been received from:

CEPA et al
Office of Small Business Advocate
Office of Consumer Advocate
Office of Trial Staff
PICGUG
Philadelphia Gas Works

DOCUMENT
FOLDER

cc: Susan Hoffner, ALJ