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January 8, 2021

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Re: Pennsylvania Public Utility Commission
v.
The City of Bethlehem – Water Department
Docket No. R-2020-3020256

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Reply Brief in the above-referenced proceeding.

Copies have been served per the attached Certificate of Service.

Very truly yours,

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Certificate of Service

*301919

CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission :
v. : Docket No. R-2020-3020256
The City of Bethlehem – Water Department :

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

Dated this 8th day of January 2021.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Re: Pennsylvania Public Utility Commission :
 :
 v. : Docket No. R-2020-3020256
 :
 The City of Bethlehem – Water Department :

REPLY BRIEF
OF THE
OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

The OCA submits this Reply Brief in response to the Main Brief filed by the City of Bethlehem – Water Department. The OCA does not waive its opposition on contested issues because it does not repeat arguments here and incorporates by reference the arguments and analysis in its Main Brief.

II. SUMMARY OF ARGUMENT

This Commission should not approve any rate increase for Bethlehem at this time. Bethlehem's customers, and indeed the entire Commonwealth, remain firmly in the grip of the COVID-19 pandemic. Due to the extreme economic and personal hardships being endured by Bethlehem's customers, and the public in general, any rate increase at this time would not result in just and reasonable rates. The evidence establishes that a no rate increase approach will not have a material impact on Bethlehem at this time. See OCA M.B., App. A.1, Table I.

The financial impacts of the pandemic will affect every aspect of the ratemaking equation, including revenues, operating expenses, capital expenditures, and the cost of debt yet Bethlehem has not modified its proposals. Based on the evidence presented here, Bethlehem cannot meet its burden of proof to show that its request will result in just and reasonable rates.

The OCA submits that the Partial Settlement should not be approved because it provides a higher than reasonable revenue requirement as discussed below. Although it represents a compromise between I&E and the City, it does not represent a reasonable compromise given the evidence in this proceeding.

If the Commission should decide, however, that it wants to proceed with a "business as usual" approach, the OCA has presented testimony on revenue requirement, including cost of capital that establishes the revenue increase should be no more than \$443,666.¹ See OCA M.B., App. A.2, Tables I-VI.

¹The revenue requirement shown in Appendix A.2, Table 1 is \$446,173, or \$2,507 more than is shown in Ms. Sherwood's Surrebuttal Schedules. The difference appears to be that the Surrebuttal schedules round to two places after the decimal and the Tables go to eight places after the decimal.

III. OVERALL POSITION ON RATE INCREASE

A. Denying The City's Proposed Increase Is A Just And Reasonable Result At This Time.

The OCA presented the testimony of Mr. Rubin to explain that in setting just and reasonable rates, the Commission has the authority, and should exercise that authority at this time, to set a lower rate of return to recognize the impact of the ongoing pandemic on the City's customers. OCA St. 1 at 22–24; OCA St. 1S at 21–22; OCA M.B. at 9–24. In its Main Brief, the City incorrectly claims that the OCA has the burden of proof and that the Commission lacks the authority to deny the City's proposed increase. City M.B. at 10–14. As discussed below, the City's arguments are without merit, are inconsistent with the Public Utility Code, and should be rejected.

In its Main Brief, Bethlehem argues that the Commission “has no authority under the Code to deny the City's rate increase as proposed by the OCA.” City M.B. at 10. Bethlehem argues that the Commission addressed its statutory ratemaking authority in a recent Philadelphia Gas Works case. City M.B. at 11. In Pa. P.U.C. v. Philadelphia Gas Works, Docket No. R-2020-3017206 (Opinion and Order Nov. 19, 2020) (PGW), the Commission ruled on whether a rate increase was required to go into effect at the end of the seven-month suspension period in light of the Governor's Proclamation of a Disaster Emergency. PGW, slip op. at 12–13. Bethlehem's reliance on this decision is incorrect. The Commission's discussion in PGW is focused on the **timing** of the effective date of a rate increase in the context of the Governor's Proclamation, but does not guarantee that **any** rate increase will be approved at the end of the seven-month suspension period. Id. The filing of a rate increase does not guarantee that the utility will receive any rate increase at the end of the seven-month suspension period. The evidence in each case will determine what increase, if any, is approved at the end of the suspension period. The OCA

has explained the legal framework in which the Commission addresses a rate increase request. OCA M.B. at 18–21; OCA St. 1 at 22–24. Bethlehem’s argument that the Commission is required to approve a rate increase at the end of the seven-month suspension period is inconsistent with these basic principles. When it comes to ratemaking, “[a]ll that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level.” Federal Power Comm’n v. Texaco, Inc., 417 U.S. 380, 392–92 (1974) (citing FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942)). On the topic of rate of return, the U.S. Supreme Court has held:

[t]he return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield Water Works & Improvement Co. v. Public Serv. Comm’n, 262 U.S. 679, 693 (1923).

The Court has also held that, “whether a particular rate is ‘unjust’ or ‘unreasonable’ will depend to some extent on what is a fair rate of return given the risks under a particular rate setting, and on the amount of capital upon which the investors are entitled to earn on that return.” Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989) (Duquesne). OCA M.B. at 18–19.

It is clear that the Commission is required to balance the consumer and utility’s interests. “The rate-making process..., *i.e.*, the fixing of ‘just and reasonable’ rates, involves a balancing of the investor and consumer interests . . . and does not insure that the business shall produce revenues.” Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591 (1944) (Hope). “The owners of a property dedicated to the public service cannot be said to suffer injury if a rate is fixed for an experimental period, which probably will produce a fair return on the present fair value of

their property.” Market St. R. Co. v. Railroad Comm’n of Ca., 324 U.S. 548 (1945). OCA M.B. at 19.

During the last large-scale nationwide pandemic, the Influenza of 1918, the Supreme Judicial Court of Massachusetts upheld a public service commission ratemaking order that was not expected to permit the utility to earn a profit due to the abnormal times. Donham v. Public Serv. Comm’n, 232 Mass. 309, 317, 122 N.E. 397, 401 (1919) (Donham). The court stated:

To be just and reasonable, within the meaning of the constitutional guaranty, the rates must be prescribed with reasonable regard for the cost to the carrier of the service rendered and for the value of the property employed therein; but this does not mean that regard is to be had only for the interests of the carrier, or that the rates must necessarily be such as to render its business profitable, for reasonable regard must also be had for the value of the service to the public. And where the cost to the carrier is not kept within reasonable limits, or where for any reasons its business cannot reasonably be so conducted as to render it profitable the misfortune must fall upon the carrier, as would be the case if it were engaged in any other line of business.

Id., (emphases added) (quoting Missouri, Kansas & Topeka Railway Co. v. Interstate Commerce Comm’n, 164 Fed. 645 (1908)). Although the utility was facing hardships of its own, the court noted that it did not deprive the commission of its regulatory responsibility to “exercise its judgment for the protection of the public interests when it does not reduce substantially the revenue proposed to be exacted from the public by the owners of the public utility.” Donham, 232 Mass. at 326, 122 N.E. at 405. In addition, the court emphasized that the rates were “likely to be impermanent and experimental.” Id. In reference to this case, Mr. Rubin testified that:

[t]he idea that ratemaking must adapt to extraordinary conditions is neither new nor novel. A century ago during another serious pandemic, regulators adapted, took actions that provided relief to the public, and did not inflict long-term harm on the utility.

OCA St. 1 at 24.

Here in Pennsylvania during the Great Depression, the Public Service Commission (PSC) called on utilities to reduce rates so that they would earn no more than 6% on their rate base. Re

Utility Rates During Economic Emergency, 3 P.U.R. NS 123 (Pa. PSC 1934) (attached to OCA’s Main Brief as Appendix E). In recognition that societal economic conditions should affect utility ratemaking, the PSC stated, “this Commission should take cognizance of the present economic conditions prevailing in the United States and as such economic conditions particularly affect the welfare of the people of this commonwealth.” Id. at 124.

Similar to the result of the case in Massachusetts during the Influenza and the PSC’s action in response to the Great Depression, the OCA’s proposal to deny Bethlehem’s proposed increase in rates reflects both a viable and reasonable solution to the abnormal and unexpected set of circumstances under which the Commission is currently tasked with developing just and reasonable rates for a population of ratepayers financially distressed by a nationwide pandemic. It is clear from the case law that denying Bethlehem’s requested rate increase due to the current societal economic conditions would be an appropriate and valid exercise of the Commission’s authority in this proceeding.

Bethlehem also argues, without support, that the burden of proof is placed on OCA because “this is an issue created by the OCA. . . .” City M.B. at 11. Bethlehem’s argument is without merit. Bethlehem has the burden of proof to establish the reasonableness of each and every element of its proposed rate increase and demonstrate that its proposed rates are just, reasonable, and in the public interest. OCA M.B. at 5–7.

Bethlehem also claims that the steps it is taking to assist customers through March 21, 2021 means that a rate increase is appropriate. City M.B. at 11–12. However, the increase proposed by Bethlehem will take effect on April 21, 2021, after Bethlehem’s assistance ends.²

² Bethlehem indicates that payment arrangements will continue after March 31, 2021. The City must continue to offer payment arrangements pursuant to Chapter 14 of the Public Utility Code.

Bethlehem claims that the Commission is “not denying rate increases because of the pandemic” citing PGW. City M.B. at 12. Bethlehem’s position reflects a fundamental misunderstanding of the OCA’s position in this case and fails to recognize that each utility’s situation is unique. The OCA specifically addressed Bethlehem’s need for a rate increase and is not recommending that Bethlehem should have rates that are inadequate to ensure the provision of safe and reliable service to its customers. OCA St. 1 at 26. As described in the OCA’s testimony, Bethlehem could continue operations, recover all of its expenses, and have additional money left over. OCA St. 1 at 26. In these extraordinary times, denying Bethlehem’s rate increase is a reasonable—and temporary—outcome until fewer customers are suffering financially and the future is more ascertainable for ratemaking.

OCA’s primary position, no increase in rates, would result in a reasonable return in these circumstances. Specifically, the costs rates and overall return, under the no increase scenario would be:

Weight Average Rate of Return				
Capital Component	Proposed Ratio	Cost Rate	14% Tax Adjusted	Weighted
Long Term Debt	48.00%	5.77%		2.77%
Fund Equity	52.00%	6.45%	5.55%	2.88%
Total	100.00%			5.65%

OCA Hearing Exh. # 1. While perhaps not as much profit as Bethlehem would like³, an overall return of 5.65% is more than adequate in these times. See OCA App. A.1, Table IA; OCA Hearing Exh. #1. As OCA Witness Rubin stated: “Most Pennsylvania businesses would be absolutely

³ The OCA’s revenue requirement recommendation, absent any consideration of the pandemic, results in an overall deficiency of \$443,666 at an overall rate of return of 6.57%. See App. A.2, OCA Table I; OCA St. 2S at 1; Sch. SLS-1; OCA St. 3 at 6; Exh. DJG-17. Bethlehem proposed an overall rate of return of 8.21%. City St. 2, Sch. 1

thrilled if they could pay all their bills, make all of their debt payments, and still have enough money left over. When compared to the economic devastation gripping its service territory, I cannot find anything just or reasonable about increasing Bethlehem's water rates at this time." OCA St. 1 at 26.

Bethlehem further argues that it would not have a sufficient surplus under the OCA's recommendation that no increase be granted in this proceeding. City M.B. at 13–14. To support that claim, Bethlehem points to debt coverage levels for the proxy group. Id. The OCA contends that the comparison to the investor-owned utilities' coverage ratios is not relevant to what coverage ratio is appropriate in this proceeding. It is important to note that Bethlehem has not presented any evidence that its 2018 coverage ratio of 1.3x (City St. 1R at 5) is in violation of any of its debt covenants. Moreover, the overall return of 5.65% resulting if the rate increase is denied, is only 92 basis points lower than the OCA's financial expert recommended (6.57%) under the "business as usual" approach. See OCA St. 3 at 6. Ratemaking for Bethlehem's PUC-jurisdictional customers is done under rate base/rate of return. For all of the reasons set forth in the OCA's Main Brief and Mr. Rubin's testimony, an overall return resulting from a denial of the rate increase that is less than the "business as usual" approach is reasonable at this time.

In its Main Brief, Bethlehem repeats its arguments that the current unemployment rates are not unprecedented. City M.B. at 12. The OCA addressed Bethlehem's selective, incomplete view of the indicators discussed by Mr. Rubin. OCA M.B. at 11–15. As Mr. Rubin explained, the unemployment rates are not the only indicator that he reviewed. OCA St. 1S at 2–4. Ms. Heppenstall focused solely on the unemployment figures but did not provide any rebuttal to the economic indicators and data presented by Mr. Rubin. One important indicator is the initial unemployment claims which had dipped since March 2020 but had started to climb again at the

end of November. OCA St. 1S at 2; Sch. SJR-1 Updated. Mr. Rubin also updated other indicators such as the loss of household income, has stayed the same. OCA St. 1S at 2; Sch. SJR-6S. The impact on small businesses is also looking worse as of November than it did in September when Mr. Rubin's testimony was filed. OCA St. 1S at 2.

As Mr. Rubin further explained, when the Company's case is properly adjusted to remove improper expenses and capital costs, the Company's financial situation is reasonable. Mr. Rubin testified:

Further, I am advised that after reflecting the OCA's accounting adjustments using a rate base - rate of return approach, the effect of my recommendation would be that Bethlehem would recover all of its allowable operating expenses, its full hypothetical cost of debt, and a return on equity of approximately 6.45%. In light of the devastating effects of the pandemic on the City's customers, I consider this to be a just and reasonable result.

OCA St. 1S at 5. The OCA submits that the Commission should exercise its authority to deny Bethlehem's rate increase request for the reasons set forth above and in Mr. Rubin's testimony.

B. OCA Opposition To Settlement

On December 28, 2020, the City and I&E filed a Joint Petition for Approval of Partial Settlement of Rate Investigation (Joint Petition or Partial Settlement). The proposed Partial Settlement was Attachment A to the City's Main Brief. The OCA respectfully requests that the Commission deny the Partial Settlement. The level of the rate increase and the lack of other provisions that have been raised in this proceeding are fatal flaws that render the Partial Settlement not in the public interest. The OCA respectfully requests that the Commission carefully consider the arguments on all of the issues contained herein as well as in the OCA's Main Brief and reach a determination based on the evidence of record in this proceeding. Denying the City's requested rate increase due to the current societal and economic conditions is based on the record evidence in this proceeding that establishes that the City would earn an overall

return of 5.65% under existing rates. The OCA’s revenue requirement recommendation, absent any consideration of the pandemic, results in an overall deficiency of \$443,666 at an overall rate of return of 6.57%. See App. A.2, OCA Table I; OCA St. 2S at 1; Sch. SLS-1; OCA St. 3 at 6; Exh. DJG-17. Although less than a “business as usual return”, it is sufficient for the City to cover its debt costs, operation and maintenance expenses and provide safe, adequate and reliable service. OCA M.B. at 15–22. For the reasons set forth below, the OCA submits that the Partial Settlement should be rejected. Relying on the record in this case to deny the rate increase, rather than accepting the Non-Unanimous Settlement, would be an appropriate and valid exercise of the Commission’s authority in this proceeding.

1. Legal Standards

While it is the Commission's policy to encourage settlements between the parties, 52 Pa. Code § 5.231, the terms and conditions of any settlement must nevertheless be in the public interest. Pa. P.U.C. v. York Water Co., Docket No. R-00049165 (Order entered Oct. 4, 2004); see also, Pa. P.U.C. v. C.S. Water and Sewer Assocs., 74 Pa. PUC 767 (1991); Pa. P.U.C. v. PPL Utilities Corporation, Docket No. M-2009-2058182 (Order entered November 23, 2009); Pa. P.U.C. v. Phila. Gas Works, Docket No. M-00031768 (Order entered January 7, 2004); Warner v. GTE North, Inc., Docket No. C-00902815 (Order entered April 1, 1996). The Commission has defined the public interest as including ratepayers, shareholders, and the regulated community and it is determined by examining the effect of the proposed settlement on these entities. Pa. P.U.C. v. Bell Atlantic-Pennsylvania, Inc., Docket No. R-00953409 (Order entered September 29, 1995). In the event of a non-unanimous settlement, the Commission’s standards for review are the same as those for deciding a fully contested case. Joint Application of West Penn Power Company d/b/a Allegheny Power, Trans-Allegheny Interstate Line Company and FirstEnergy Corp., Docket Nos.

A-2010-2176520, and A-2010-2176732 (Opinion and Order entered March 8, 2011). The City bears the burden of proof to establish the justness and reasonableness of every element of its requested rate increase and its proposed Partial Settlement. OCA M.B. at 5–7. The City must meet that burden by a preponderance of the evidence. Se-Ling Hosiery v. Marguilies, 70 A.2d 854, 856 (1950). A preponderance of the evidence is established by presenting evidence that has sufficient weight to “tip the scales” on the side of party presenting it. Id. The non-unanimous proposed settlement must also be supported by substantial evidence consistent with statutory requirements. Popowsky v. Pa. P.U.C., 805 A.2d 637 (Pa. Cmwlth. 2002); ARIPPA v. Pa. P.U.C., 792 A.2d 636 (Pa. Cmwlth. 2002). For a Commission decision to be supported by substantial evidence, it must be supported by such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. Dutchland Tours, Inc. v. Pa. P.U.C., 337 A.2d 922 (Pa. Cmwlth. 1975).

2. The Partial Settlement Should Be Rejected.

The Partial Settlement provides for an increase in water revenues of \$689,932. City M.B., Attachment A, Partial Settlement ¶ 16 (a). The Partial Settlement represents a substantial increase that, given the evidence of the impact of the ongoing COVID-19 pandemic on Bethlehem’s ratepayers, should be denied in its entirety just as Bethlehem’s originally proposed increase should be denied. OCA M.B. at 9–24. The OCA notes that its “business as usual” case, including cost of equity and accounting adjustments results in a revenue requirement of \$443,666. OCA M.B., App. A.1; OCA St. 1S.

In a recent rate case during the pandemic, denial of the rate increase was the outcome recommended by the ALJ. ALJ Dunderdale concluded:

No party herein recommended Columbia Gas should never be allowed to raise rates, instead arguing that raising rates during the present times is inappropriate and

contrary to the public interest, as Pennsylvanians grapple with a bleak economic future.

Those parties advocated that the Commission should not rely on predictions based on data collected prior to the pandemic. To them, Columbia Gas' argument – that a rejection of the increase will expose customers and the public to safety risks because investors will be denied a fair rate of return – belied the fact that Columbia Gas' investors still receive a rate of return, though perhaps smaller than expected, while investors in other areas of the financial markets may not receive as much due to the downturn in the marketplace caused by COVID-19. Columbia Gas' ratepayers, both individuals and businesses, have been devastated by the pandemic.

Pa. P.U.C. v. Columbia Gas of Pa., Inc., Docket No. R-2020-3018835, R.D. at 47 (Dec. 4, 2020)

(Columbia Gas). The ALJ also addresses the legal standard for the review of the proposed rate increase:

Columbia Gas is correct that the law permits a utility to approach the Commission with an increase request for the purpose of ensuring that rates are just and reasonable and cover all prudently incurred costs. However, no constitutional provision, statute, regulation or policy statement guarantees a utility will receive a requested base rate increase. In fact, there is no guarantee the utility will receive an approved rate which gives the utility an opportunity to earn a return for the investors. Though not often seen, the Commission review of an utility request to increase the base rate may find the interests of the ratepayers and the public interest require a decreased rate for the utility because, upon review of all costs, the Commission determines the utility requires less than it currently receives.

Columbia Gas, R.D. at 49.

3. Revenue Requirement And Scaleback

The OCA submits the City could continue operations, recover all of its expenses, its full hypothetical cost of debt, and a return on equity of approximately 6.45%. OCA St. 1S at 5. The OCA submits that the overall rate of return of 5.65% without any change in rates is more than adequate in this time of a pandemic. See OCA M.B., App. A.1, Table I. The OCA's Main Brief and this Reply Brief contain a full discussion of this issue. See III. A., *supra*; OCA M.B. at 9–24.

Permitting the City to increase its base rates by \$689,932 is not supported by the evidence of record in this case. In these extraordinary times, maintaining current rates is a reasonable—and temporary—outcome until fewer customers are suffering financially and the future is more

ascertainable for ratemaking. Moreover, the OCA submits that the Commission should not rely on the City's projections and related assumptions, which were developed before the pandemic emerged, to consider a rate increase. Even assuming some of Bethlehem's FTY projections are accurate, OCA Witness Sherwood concluded that PAWC had a revenue deficiency of \$443,666 under a "business as usual" ratemaking approach. See OCA St. 2S at 1-2; OCA Hearing Exh. # 1. In other words, a much more modest increase in rates is all that could be supported in a "business as usual" case. The proposed Partial Settlement increase is not supported and would still constitute a sizeable increase in rates while Bethlehem's customers continue to deal with the pandemic and its economic impact.

OCA witness Garrett, using a Discounted Cash Flow (DCF) analysis and a Capital Asset Pricing Model (CAPM), demonstrated that under a business as usual approach for Bethlehem, the market-derived cost of common equity is 8.50%, (7.31% after the tax factor adjustment) and an overall rate of return of 6.57%, based upon a capital structure of 48.00% debt and 52.0% common equity. OCA St. 3 at 6, Fig. 1; Exh. DJG-17. If the OCA's recommendation that no increase be approved as a result of the ongoing COVID-19 pandemic and the related economic impact on the City's customers is adopted, the resulting overall rates of return of 5.65% (with a capital structure of 52.0% cost of common equity and 48.0% cost of debt), and reflecting the tax factor adjustment represents a fair rate of return that balances the interests of consumers and the utility and would be in the public interest. See OCA Hearing Exh. # 1; OCA M.B. App. A.1, Table I(A). As such, there is record evidence showing that it is not necessary to increase rates in order for the City to earn a fair rate of return, and certainly there is evidence that such a substantial rate increase cannot be supported.

After the COVID-19 pandemic has passed, Bethlehem can file again for a rate increase when the City's financial projections will be founded on more stable, and thus predictable, economic conditions. There is no need for the rate increase contained in the Partial Settlement, particularly given the economic hardships and uncertainties accompanying the COVID-19 pandemic as well as the uncertainties surrounding the City's projections. See OCA St. 1 at 19–27; OCA St. 1S at 5.

As Mr. Rubin further explained, when the Company's case is properly adjusted to remove improper expenses and capital costs, the Company's financial situation is reasonable. Mr. Rubin testified:

Further, I am advised that after reflecting the OCA's accounting adjustments using a rate base - rate of return approach, the effect of my recommendation would be that Bethlehem would recover all of its allowable operating expenses, its full hypothetical cost of debt, and a return on equity of approximately 6.45%. In light of the devastating effects of the pandemic on the City's customers, I consider this to be a just and reasonable result.

OCA St. 1S at 5. The proposed revenue requirement in the Partial Settlement is not supported by the evidence in this proceeding and should not be approved.

The OCA does not oppose the OSBA scaleback proposal that is reflected in OSBA's testimony and in the Partial Settlement. See OCA M.B. at 67. However, as set forth above, the OCA submits that no increase should be granted, and in those circumstances, a scaleback would not be necessary as rates will remain at the current levels.

4. Other Provisions

Regarding the provision related to the elimination of the Lower Saucon Honor System Rate (Partial Settlement ¶ 16(b)), the OCA does not oppose that provision and did not oppose

Bethlehem's proposal in its filing, in OCA's testimony. However, due to the rate increase contained in the Partial Settlement, the OCA submits that the Partial Settlement should be rejected.

Regarding the provision related to Unaccounted for Water (Partial Settlement ¶ 16(c)), it is consistent with the OCA's testimony and is contained in the OCA's Stipulation with the City. City M.B., Attachment B, ¶ 4. Thus, denial of the Partial Settlement would not prevent the stipulation between the City and OCA from being implemented.

Regarding the provision related to the Customer Class Demand Study, the OCA has not taken any position on this issue. This provision is not material to the determination of the appropriate revenue requirement in this proceeding. However, due to the rate increase contained in the Partial Settlement, the OCA submits that the Partial Settlement should be rejected.

IV. ISSUES RESOLVED AMONG THE PARTIES

In the OCA's Main Brief, the OCA addressed the issues resolved with Bethlehem. OCA M.B. at 25.

V. RATE BASE

A. Plant In Service

The OCA addressed plant in service in Section V.A of its Main Brief. OCA M.B. at 26–28. The City initially projected utility plant in service to be \$197,701,395 for the HTY ending December 31, 2019, and \$201,950,540 for the FTY, a projected increase of approximately \$4.3 million in utility plant in service. OCA M.B. at 26; OCA St. 2 at 6. The OCA recommended that five projects that the City included in this figure that were not expected to be in service until after December 31, 2020 should not be included under plant in service in the FTY. OCA M.B. at 26; OCA St. 2 at 6. The following are the five projects: Well Generator, Water Treatment Plant Lower Roof Replacement, Hecktown Road Bridge Main Replacement, WTP Emergency Generator, and the Fire Pump Station Engineering and Construction. OCA St. 2 at 6–7. The City, in rebuttal, agreed to remove the Well Generator, Water Treatment Plant Lower Roof Replacement, and Hecktown Road Bridge Main Replacement projects from plant in service, but disagree on the WTP Emergency Generator and the Fire Pump Station Engineering and Construction projects. OCA M.B. at 26–28; City St. 3R at 4. The OCA addressed the City’s argument and submits that these two expenses should not be included in the FTY as they will be completed outside of the test period in its Main Brief. OCA M.B. at 26–28.

In its Main Brief, the City continues to claim that the WTP Emergency Generator should be included in the plant in service figure, arguing that it is a necessary capital item and that scheduling the generator for operation would take less than six weeks as of December 15, 2020. City M.B. at 17. The City also claimed in its Main Brief that the Fire Pump Station should be included in the plant in service figure, arguing that the station is a necessary system improvement and that “[i]nstallation and construction will be completed once the City receives the remaining

component parts.” City M.B. at 17–18. However, the City does not state when it will receive the remaining component parts. See City M.B. at 17–18. The OCA addressed the City’s argument in its Main Brief. OCA M.B. at 26–28.

The OCA maintains that these two projects should be excluded from plant in service as they are still not in service and the City offers no evidence to establish when they will be in service. See City M.B. at 17–18. The City cites Pa. P.U.C. v. Pennsylvania-American Water Co., 97 PUR4th 469 (1988) to support its assertion that “a utility is entitled to a return on investment in property which is essential to the continued operation of the utility.” City M.B. at 18. However, it is well-settled law that the utility has the burden of proving “that the property sought to be included in the rate base is used and useful in the public service” before it is entitled to a return from ratepayers for the investment. Pa. P.U.C. v. Pennsylvania-American Water Company, 97 PUR4th 469 (1988). The Company has not shown that the projects will be used and useful in the test year selected by the Company. The City also cites Pennsylvania-American Water Co. for its argument that the Company in the case was allowed to claim projects that would be operating and in service shortly after the end of the future test year. However, the City fails to mention that in Pennsylvania-American Water Company, “certain vital components” of the disputed project were going to be completed and in service as of the end of the future test year. Pennsylvania-American Water Company, 97 PUR4th at 469. In the present case, no “vital components” of the two disputed projects were completed and in service as of the end of the future test year. Further, as stated in the OCA’s Main Brief, while the City’s “rationale for including these projects . . . is that the projects would have been completed had the unforeseen circumstances in 2020 not occurred”, “the unforeseen circumstances that delayed the projects in 2020 are still an issue heading into 2021 and could continue to delay the completion of these capital projects.” OCA M.B. at 26–28; OCA St.

2S at 8–10. Thus, considering the uncertainty that the COVID-19 pandemic continues to cast over different aspects of everyday life, it would be unreasonable to include these two projects in the test year based on the City’s speculation as to when they will be complete and in service.

B. Cash Working Capital

The OCA addressed cash working capital in Section V.B of its Main Brief. OCA M.B. at 29. The City’s rate base claim includes a Cash Working Capital claim of \$576,313. OCA M.B. at 29. The OCA’s adjustment to CWC is \$14,260. OCA M.B. at 29. The parties agree on the one-eighth method and the final adjustment will be based on the final level of expenses. OCA M.B. at 29; City M.B. at 20–22.

VI. REVENUES

The OCA did not make any adjustments to the present level revenues reflected by the City.

VII. EXPENSES

A. Introduction

The OCA addressed the City's expense claims in Section VII of its Main Brief. OCA M.B. at 31–41.

B. Chemical Expense

The OCA addressed the adjusted increase to the chemical expense in Section VII.B of its Main Brief. OCA M.B. at 31. The City's original adjusted increase to the chemical expense was \$6,292. OCA St. 2S at 8. However, as part of its testimony and responses to data requests, the City altered its adjusted increase to \$24,927. OCA St. 2 at 4. As discussed in the City's and the OCA's Main Briefs and in Ms. Sherwood's testimony, the parties are in agreement with this expense. OCA M.B. at 31; City M.B. at 31; OCA St. 2S at 8.

C. Uncollectible Account Expense

The OCA addressed the adjustments to the uncollectible account expense in Section VII.C of its Main Brief. OCA M.B. at 31–32. As discussed in the City's and the OCA's Main Briefs and in Ms. Sherwood's testimony, the parties are in agreement with this expense, agreeing on \$100,620 to reflect the uncollectible accounts and for \$39,584 of that amount to be allocated to Outside-City customers. OCA M.B. at 31–32; City M.B. at 24; OCA St. 2S at 2.

D. Social Security

The OCA addresses the adjustments to Social Security expenses under salaries and wages, Section VII.E, *infra*.

E. Salaries And Wages

The OCA addressed the adjustments to salaries and wages in Section VII.E of its Main Brief. OCA M.B. at 32–34. The City adjusted the salaries and wages for Water Supply and Treatment and Water Maintenance by a collective \$378,527 and made a corresponding adjustment for Social Security. OCA St. 2 at 7–8. The City proposed pro forma adjustments to the HTY for 2019 and to the FTY for 2020. OCA St. 2 at 8. The City included an increase in union contract wages in the FTY (2020) that was not slated to go into effect until January 1, 2021. OCA St. 2 at 8. As discussed in the OCA’s Main Brief, Ms. Sherwood does not agree with the water department’s use of the pro forma salaries and wages rates for the FTY, explaining that “[t]he expense falls outside the test period as the raises will not go into effect until January 1, 2021[, which] violates the matching principal which requires revenues and expenses to be from the same period.” OCA St. 2 at 8. Thus, Ms. Sherwood adjusted the salaries and wages expense levels for 2020, which results in an overall reduction in salaries and wages of \$79,697. OCA St. 2 at 8. Ms. Sherwood further recommended that the Social Security expense for the FTY be \$304,839.57. OCA St. 2 at 8.

In its Main Brief, the City disagreed with Ms. Sherwood’s recommendations. City M.B. at 27–28. The City argued that the Commission should include the union contract expense in the City’s salaries and wage expense figure, even though the contract was slated to go into effect on January 1, 2021, making it fall outside of the test period. City M.B. at 27. The City also argued that, because of its position on the salaries and wages expense, the OCA’s related social security adjustment should also be denied. City M.B. at 28. The OCA addressed these issues in its Main Brief, pointing out through Ms. Sherwood’s testimony that the City “chose to use a FTY that corresponds to the calendar year and reflects the accounting results during that 12-month period and not beyond that period.” OCA M.B. 32–34 (citing OCA St. 2S at 4). The City “could have

chosen a fiscal year for the FTY period or utilized a fully projected FTY to include the Salaries and Wages Expense and the associated Social Security Expense increases that are anticipated to occur on January 1, 2021,” but chose not to. OCA M.B. 32–34 (citing OCA St. 2S at 4). In Pa. P.U.C. v. City of Lancaster – Sewer Fund, Docket No. R-00049862 (Opinion and Order Aug. 26, 2005) (affirmed in relevant part, reversed in part in an unpublished Commonwealth Court decision) (Lancaster 2005), the Commission adopted an adjustment to exclude a post-test year debt service payment that fell outside of the test year. Lancaster 2005, slip op. at 119–21. The Commission held that consideration of a post-test year debt service payment, which reached beyond the historic test year figures used for all the other rate-making elements, was contrary to basic ratemaking principles. Id. at 70. The Commission reasoned that the City failed to elect a future test year that would have included May 2005 revenue, expense and capital data and it did not adequately justify to the Commission that it was appropriate to use a post-test year expense level for one single item. Id. at 32.

The City cited cases where the Commission granted exceptions to the matching principle, which holds that expenses and revenues should be synchronized as of the end of the test period. City M.B. at 27–28 (citing Pa. P.U.C. v. City of Bethlehem (Water), 160 PUR4th 375, 386 (1995); Pa. P.U.C. v. Keystone Water Company, 58 Pa. P.U.C. 437, 454–56 (1984)). However, these were decided before utilities had the option to file a Fully Forecasted Future Test Year, something that the City chose not to do. See 66 Pa. C.S. § 315. Further, neither of these cases were decided in the middle of a global pandemic. Id. The OCA maintains its primary position that it would not be just or reasonable to impose a rate increase on customers at this time due to the COVID-19 pandemic devastating the health and economy of the Commonwealth. OCA St. 1 at 26. However, if the Commission finds a rate increase necessary at this time, the Commission should not apply

the exception to the matching principle given the negative effects that the additional cost will have on ratepayers. See OCA St. 1 at 26.

F. East Allen Township Expenses

The OCA addressed the adjustments to the East Allen Township expenses in Section VII.F of its Main Brief. OCA M.B. at 34–36. Ms. Sherwood used the actual expense levels from 2017, 2018, and 2019 expenses (\$4,048, \$11,648, and \$34,605, respectively) and normalized them to account for fluctuations and one-time expenses in equipment maintenance expense. OCA St. 2S at 6. Thus, her recommended adjustment to the equipment maintenance expense is \$17,838 for the City, \$6,586 of which is allocated to Outside City customers. OCA St. 2S at 6. The City argued, without any evidence, that the most recent year’s expenses for the maintenance expense are more representative of the expenses going forward. OCA St. 2S at 5. The City repeated this argument in its Main Brief. City M.B. at 28–29. The OCA addressed the City’s argument in its Main Brief, pointing out that the ratemaking technique of normalization is “used to smooth out the effects of an expense item that occurs at regular intervals, but in irregular amounts, and is a proper adjustment to make the test year expense representative of normal operations.” Pa. P.U.C. v. Total Environmental Solutions, Inc., 2008 Pa. PUC LEXIS 42, *98 (2008). In the case at bar, the types of equipment repairs vary annually, as well as the expenses incurred. OCA St. 2S at 5–6. This annual cost variance is reflected in the 2017-2019 equipment maintenance expenses (\$4,048 in 2017; \$11,648 in 2018; and \$34,605 in 2019). OCA St. 2S at 5–6. Thus, it is unreasonable to expect that the annual equipment maintenance expense will remain at the 2019 levels given the historical expenses in prior years. OCA St. 2S at 5–6. Thus, the actual expense levels from 2017, 2018, and 2019 should be used and normalized to account for fluctuations and one-time expenses.

G. Water Filtration Expenses

The OCA addressed the adjustments to the water filtration expenses in Section VII.G of its Main Brief. OCA M.B. at 36–38. Several of the expenses included in the expenses for the water filtration, specifically, the department contracts expense, heating oil expense, and equipment maintenance expense, vary annually, depending on the needs of the system. OCA St. 2 at 9–10. The adjustment for the heating oil expense was resolved among the parties. See OCA M.B. at 36–38; City M.B. at 30. However, the department contracts expense and the equipment maintenance expense remain at issue. See OCA M.B. at 36–38; City M.B. 29–31.

The City claims \$196,413 as the department contracts expense and disagrees with normalizing the expense. City M.B. at 30. The OCA addressed the City’s claim in its Main Brief, finding that the normalized expense for the department contracts expense is \$172,364 and pointing out that the City provided no justification as to why the expense should not be normalized. OCA M.B. at 37; OCA St. 2S at 6–7. In its Main Brief, the City continues to fail to articulate why the expense for department contracts should not be normalized. See City M.B. 29–30.

The City also disagreed with normalizing the equipment maintenance expense. OCA St. 2S at 6–7. The OCA addressed this argument in its Main Brief, where the OCA recommended to normalize the equipment expense and an adjustment to the expense of \$24,728 for the City, of which \$9,130 should be allocated to Outside City customers. OCA M.B. at 38; OCA St. 2S at 7. In the City’s Main Brief, the City reiterated its argument that the 2019 expense, the highest in the 2017-2019 period, should be used instead of a normalizing the expense from 2017-2019, arguing that the 2019 expenses were due to “necessary and emergency repairs” which “happen every year.” City M.B. at 30–31. However, the City fails to articulate why, if “necessary and emergency

repairs” occur every year in differing amounts, normalizing the expense is not proper. See City M.B. 30–31.

H. Rate Case Expense

The OCA addressed the rate base expense in Section VII.H of its Main Brief. OCA M.B. at 38–41. The City proposed to normalize its projected \$414,560 rate case expense over a period of three years. OCA St. 2 at 10. The City’s justification for the three year normalization period is that the period between the current and the last rate case, filed in 2013, was an abnormality and that prior cases filed between 2007 and 2011 followed a pattern more reflective of how the City expects to file rate cases in the future. OCA St. 2S at 3. The OCA addressed this claim in its Main Brief, arguing instead that, consistent with Commission precedent, a 52-month normalization period should be applied, and adjusting the rate case expense by \$78,325. OCA M.B. at 40–41.

The City repeated its argument in support of a three year normalization period in its Main Brief. City M.B. at 25–26. However, a three year normalization period would be contrary to Commission precedent. As discussed in the OCA’s Main Brief, the Commission has consistently held that that rate case expenses are normal operating expenses, and normalization should, therefore, be based on the historical frequency of the utility’s rate filings. OCA M.B. at 40–41 (citing Popowsky v. Pa. P.U.C., 674 A.2d 1149, 1154 (Pa. Cmwlt. 1996); Pa. P.U.C. v. Columbia Water Co., 2009 Pa. PUC LEXIS 1423 (2009); City of Lancaster (Sewer Fund) v. Pa. P.U.C., 793 A.2d 979 (Pa. Cmwlt. 2002) (Lancaster 2002); Pa. P.U.C. v. Roaring Creek Water Co., 73 Pa. PUC 373, 400 (1990); Pa. P.U.C. v. West Penn Power Co., 119 PUR4th 110, 149 (1990)). In recent cases the Commission reiterated that the normalization period is determined, “by examining the utility’s actual historical rate filings, not upon the utility’s intentions.” OCA M.B. at 40–41 (citing Pa. P.U.C. v. City of Lancaster, 2011 Pa. PUC LEXIS 1685 (2011) (Lancaster 2011); Pa.

P.U.C. v. Metropolitan Edison Co., 2007 Pa. PUC LEXIS 5 (2007); Pa. P.U.C. v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 slip op. at 65 (Order entered May 18, 2017) (City of Dubois)). Basing the normalization period on historical filing frequency is reasonable because it represents known and measurable data.

In its Main Brief, the City continues to speculate that going forward, it will be filing rate increase cases more frequently. City M.B. at 25–26. The City cites to reasons why its last rate increase cases were not filed in two-year intervals, such as being “involved in a long running rate case related dispute with Lower Saucon Township” and having one of its rate cases involve settlement terms that took longer than two years to address. City M.B. at 25–26. However, the City does not state how, going forward, the same or other circumstances will not similarly keep it from filing rate increase cases more frequently than it has in the past. See City M.B. at 25–26. There are many reasons why a utility may not file rate cases as frequently as it may project. The City’s continued speculation as to the frequency of its rate cases going forward, is contrary to Commission precedent that the normalization period is determined, “by examining the utility’s actual historical rate filings, not upon the utility’s intentions.” Popowsky v. Pa. P.U.C., 674 A.2d 1149, 1154 (Pa. Cmwlth. 1996). Thus, the OCA maintains its position that a 52-month normalization period should be applied in this case.

I. Depreciation Expense

The OCA made adjustments to the plant in service claims, as discussed in Section V, *supra* and Section V of OCA’s Main Brief. OCA M.B. at 26–29. The related depreciation expense adjustments are shown in Schedule SLS-2S.

VIII. RATE OF RETURN

A. Introduction

The City used a tax-adjusted overall return of 7.42% in calculating its proposed rate increase. City M.B. at 33, footnote 60. The City’s argument (City M.B. at 33–44) that it is entitled to a return on equity of 10.20% are without merit under a “business as usual” approach and are wholly without merit in the midst of the COVID-19 pandemic. OCA M.B. at 42–61. As set forth in the testimony of David J. Garrett, the market-based return on equity is no more than 8.50%, (7.31% after the tax factor adjustment) resulting in an overall rate of return of 6.57%, based upon a capital structure of 48.00% debt and 52.0% common equity, under a “business as usual” approach. OCA St. 3 at 6, Fig. 1; Exh. DJG-17. As discussed in Section III, *supra*, the OCA’s primary position is that no increase is necessary given the ongoing COVID-19 pandemic and its related, ongoing impact on Bethlehem’s customers and economy. The resulting overall rate of return of 5.65% at current rates (using the same capital structure of 52% equity and 48% debt), represents a fair rate of return that balances the interests of consumers and shareholders and would be in the public interest. See, supra, Section III; OCA Hearing Exh. #1; OCA M.B. App. A.1, Table I and I(A).

The following tables show the resulting return under the no increase scenario and the resulting return recommended by OCA under the “business as usual” scenario:

Weighted Average Rate of Return				
Capital Component	Proposed Ratio	Cost Rate	14% Tax Adjusted	Weighted Cost
Long Term Debt	48.00%	5.77%		2.77%
Fund Equity	<u>52.00%</u>	6.45%	5.55%	<u>2.88%</u>
Total	100.00%			5.65%

OCA Hearing Exh. # 1.

Capital Component	Proposed Ratio	Cost Rate	14% Tax Adjusted	Weighted Cost
Long Term Debt	48.0%	5.77%		2.77%
Fund Equity	<u>52.0%</u>	8.50%	7.31%	<u>3.80%</u>
Total	100.0%			6.57%

OCA St. 3 at 6; Figure 1; Exh. DJG-17.

As explained in the OCA’s testimony and Main Brief, the City’s proposed 10.2% return on equity on a capital structure that contains too high a proportion of equity should be rejected. In addition to the flaws and inconsistencies with basic financial principles contained in the City’s rate of return analysis, the City’s 10.2% return on common equity includes multiple, unsupported adders (80 basis points for Bethlehem’s small size, 20 and 10 basis points for Bethlehem’s business risks) that should be rejected. OCA St. 3 at 64–68; OCA M.B. at 46–61. The OCA will not repeat the arguments contained in its Main Brief but will highlight the flaws in the City’s arguments.

B. The Legal Framework For Determining A Fair Rate Of Return

The OCA addressed the legal framework for determining a fair rate of return. OCA M.B. at 43–46. The Commission is responsible for protecting the public interest. City of Pittsburgh v. Pa. P.U.C., 126 A.2d 777, 785 (Pa. Super. 1956) (City of Pittsburgh). Generally, a public utility is entitled to no more than a reasonable opportunity to earn a fair rate of return on shareholder investment. The Court in City of Pittsburgh stated that “[i]t is the function of the commission in fixing a fair rate of return to consider not only the interest of the utility but that of the general public as well. The commission stands between the public and the utility.” Id. The City would have the Commission set the cost of capital above a market-based result which does not consider the interest of the general public. As discussed below, in VIII. E., the City’s unfounded criticism that Mr. Garrett’s analysis is inconsistent with the legal framework guiding rate of return determinations and should be disregarded.

C. Capital Structure

The City proposes a capital structure of 45% debt and 55% equity. City St. 2 at 13. This is a hypothetical capital structure, proposed by the City pursuant to recently enacted Section 1301(b) of the Public Utility Code. 66 Pa. C.S. § 1301(b). Section 1301(b) requires the Commission to “employ an imputed capital structure of comparable public utilities” in setting rates, *inter alia*, for systems like the City. 66 Pa. C.S. § 1301(b). Mr. Garrett and Mr. Walker used the same proxy group. The difference in the recommended capital structures is due primarily to Mr. Walker’s reliance on long term projections which, as discussed below, are not reasonable to use compared to the more current information used by OCA witness Garrett. OCA M.B. at 46–49; OCA St. 3 at 73-81; OCA St. 3S at 8–9.

OCA witness Garrett recommended a capital structure of 48% debt and 52% equity based on more reliable information than City witness Walker. OCA M.B. at 46–49. Mr. Garrett used

the 2020 debt ratios for the proxy group because they were current, reliable and accurate. OCA M.B. at 48–49. In its Main Brief, the City presents the projected 2024 debt and equity ratios which it claims supports Mr. Walker’s use of a higher equity ratio. City M.B. at 35. The flaw in City witness Walker’s use of projected 2023-2025 ratios is that these are long-term estimates which are not reliable or accurate. OCA M.B. at 48–49.

In its Main Brief, the City mistakenly states that Mr. Garrett relied on short term debt in determining his capital structure. City M.B. at 34. In his surrebuttal, Mr. Garrett pointed out that this is incorrect. Mr. Garrett and Mr. Walker both used Value Line’s report for the capital structure analysis and used figures described in the report as “Long-Term Debt Ratio”. OCA St. 3S at 8. The City’s argument is factually incorrect and without merit.

Mr. Garrett addressed the importance of finding the optimal debt ratio in the rate base/rate of return framework (compared to a company’s incentive to optimize capital structure when operating in the competitive market). OCA St. 3 at 73–78. The OCA’s recommended hypothetical capital structure of 48% debt and 52% equity is reasonable for ratemaking, derived properly from the proxy group, and should be adopted for the reasons set forth in Mr. Garrett’s testimony and in the OCA’s Main Brief.

D. Cost Of Debt

Mr. Garrett did not recommend an adjustment to the City’s proposed cost of debt of 5.77%. OCA St. 3 at 6; OCA M.B. at 49.

E. Cost Of Equity

1. Introduction

The City proposes a 10.2% cost of equity based on City witness Walker's use of the Discounted Cash Flow method (DCF), the Capital Asset Pricing Model method (CAPM), and the Risk Premium method (RP). City M.B. at 36–44. To that analysis, City witness Walker added 110 basis points (80 basis points for Bethlehem's small size, 20 and 10 basis points for Bethlehem's business risks). The City's cost of equity is greatly overstated. OCA witness Garrett set forth his recommendation that establishes that the market-based return on equity should be no more than 8.5%. He also provided testimony that establishes the flawed financial analyses conducted by City witness Walker and the lack of support for the additional basis points added by City witness Walker. OCA M.B. at 49–61; OCA St. 3 at 23–73; OCA St. 3S at 3–7.

In its Main Brief, the City argues that Mr. Garrett's "business as usual" approach violates basic principles. City M.B. at 38–40. The City's arguments should be rejected. Mr. Garrett's analyses are fully consistent with the requirements of determining the cost of capital for a utility subject to the Commission's jurisdiction. See OCA St. 3 at 11–21; OCA M.B. at 43–46. Bethlehem's vague statements about supposed "innuendos" in Mr. Garrett's testimony (see City M.B. at 39) should be rejected. Mr. Garrett's proper application of fundamental financial principles, as discussed in the OCA's Main Brief, results in a reasonable cost of capital. City witness Walker's disregard for those fundamental financial principles, however, results in a recommended return on equity that is far beyond a range of reasonable return on equity, which he then inflates with unsupported adders.

The City also threatens that an equity return less than 10.2% would somehow prevent it from securing financing. City M.B. at 39. The City's statement is directly contradicted by the record in this proceeding. The City recently issued \$6.5 million in AA-rate bonds. OCA St. 1 at 27. The terms ranged from 1-14 years at interest rates ranging from 0.5% to 1.6%. Id. The OCA

submits that the City’s arguments regarding the “violation of basic precepts” must be rejected and the Commission should determine a reasonable cost of equity, if a “business as usual” approach is utilized, is Mr. Garrett’s market-derived cost of equity of 8.5%. Contrary to Bethlehem’s proposal, awarding an ROE that is too far above a regulated utility’s cost of equity runs the risk of being at odds with Hope and Bluefield, especially during the unique circumstances created by an unprecedented pandemic. OCA St. 3 at 9. As discussed above, in Section III, the fair rate of return that results from denying the rate increase is less than 1% lower than a reasonable cost of capital and is a reasonable result because it permits the City to cover its debt costs (with a reasonable coverage levels), its expenses, earn a return and provide safe, adequate and reliable service.

2. Business And Financial Risk

Mr. Garrett explained the concepts of firm-specific risk and market risk and the relationship between risk and return. OCA St. 3 at 21–30; OCA M.B. at 50–53. Market risk is the only type of risk for which investors expect a return. OCA St. 3 at 26. City witness Walker added 30 basis points to his results for Bethlehem’s specific risks. OCA St. 3 at 67–71; OCA M.B. at 59–60. This adder is not based on accepted financial principles because investors do not require additional basis points for these firm-specific risks. OCA St. 3 at 67–68; OCA M.B. at 59–60. These adders should be rejected.

3. Proxy Group

Mr. Garrett chose to use the same proxy group as City witness Walker. OCA M.B. at 53; OCA St. 3 at 22.

4. The Commission Should Adopt the Equity Cost Rate And Overall Return Calculated By Mr. Garrett As The Appropriate “Business As Usual” Cost of Capital For Bethlehem

a. Discounted Cash Flow Analysis

Mr. Garrett used a Quarterly Approximation Discounted Cash Flow (DCF) Model⁴ that accounts for the quarterly growth of dividends. OCA St. 3 at 30; OCA M.B. at 53–58. The DCF model is based on the concept that “the value of a security is equal to the present value of the future cash flow that it generates.” Id. Cash flow from stocks is in the form of dividends paid to investors. Id. Mr. Garrett explained that there are “three primary inputs in the DCF model⁵: (1) stock price; (2) dividend; and (3) long-term growth rate.” OCA St. 3 at 30. The stock price and dividend are recorded data for the proxy group while the growth rate projection needs to be estimated. Id. at 30–31. Mr. Garrett explained each component of his DCF analysis. OCA St. 3 at 30–47; OCA M.B. at 53–56. He also provided a critique of City witness Walker’s DCF analysis. OCA St. 3 at 47–48; OCA M.B. at 57–58.

The City argues that Mr. Garrett’s DCF growth rate is “unrealistically low”. City M.B. at 41. The City’s arguments are without merit. Mr. Garrett noted that qualitatively, using the projected annual U.S. GDP as the long-term growth rate, as used by Mr. Walker, for each utility overstates the growth rate because it is unlikely that utilities’ growth rate would be higher than the GDP.⁶ OCA St. 3S at 4. In addition, even if a specific utility’s historical earnings growth outpaces GDP growth over some period of time, its earnings would not outpace GDP growth over the long run and it would be unreasonable to assume such growth rates to infinity, as is required in the DCF

⁴ Mr. Garrett explained that there are several variations of the DCF model. OCA St. 3 at 30; Appendix A. He notes that the quarterly model that he used here produces the highest cost of equity estimates compared to other DCF model variations. Id.

⁵The Quarterly Approximation DCF Model is shown in Equation 2. OCA St. 3 at 31.

⁶ As Mr. Garrett noted, by using the average U.S. GDP growth rate, there are companies that will have higher than average growth rate and those that will have lower than average growth rate. OCA St. 3S at 4. Typically, the younger, high growth firms reinvest earnings into growth opportunities rather than paying dividends, while low-growth stocks have higher dividend yields.

model. Id. at 4–5. Also, it is inappropriate to assume a utility’s historical earning growth would exceed GDP in the DCF model because they are not “qualitative” growth rates (i.e., based on a new product, or market, for example) and contribute to the circular reference problem. OCA St. 3S at 5; OCA St. 3 at 44–45, 70–71.

b. Capital Asset Pricing Model

Mr. Garrett performed a CAPM analysis that resulted in a cost of equity of 5.9%. OCA St. 3 at 49–60; OCA M.B. at 58. Recognizing that the Commission relies on the DCF, the OCA notes that Mr. Garrett’s CAPM result supports the DCF result he calculated. Mr. Garrett’s CAPM result compares with City witness Walker’s CAPM result of 9.2%. OCA St. 3 at 60; OCA M.B. at 58–59. Mr. Walker then added 80 basis points to this result for a size premium adjustment. In its Main Brief, the City criticizes Mr. Garrett for not including a size adjustment. City M.B. at 43. However, a size adjustment is not necessary and should be rejected for the reasons set forth in Mr. Garrett’s testimony. OCA St. 3 at 64–67; OCA M.B. at 59. The Commission rejected a similar claim in Pa. P.U.C v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 (Order entered May 18, 2017) (City of Dubois) finding that a size adjustment, along with other adjustments proposed by the City, was “simply unnecessary and are contrary to the public interest.” City of DuBois, slip op. at 105.

In its Main Brief, the City repeats an unsupported criticism that Mr. Garrett’s CAPM reflects market premiums that he used as coming from “articles”. City M.B. at 42. As noted by Mr. Garrett, Mr. Walker mischaracterizes the sources Mr. Garrett relied on for the ERP (in addition to his own calculation of the ERP). OCA St. 3S at 5–7. The surveys are not the opinion of one person, they are expert surveys that include the opinions of more than 2,000 experts in the U.S

regarding the ERP. Id. at 7. Moreover, Mr. Garrett noted that he chose the highest result out of the range (6.0%). Id.

5. Conclusion

There is no support for the City's proposed 10.2% return on equity and it is not market-based or consistent with fundamental financial principles. The City's arguments should be rejected.

IX. TAXES

The City did not claim any income taxes for ratemaking purposes.

X. RATE STRUCTURE

The OCA's primary position is that no increase should be granted as discussed in Section III, *supra*. The OCA will not oppose the OSBA scaleback proposal if an increase is granted to Bethlehem. OCA M.B. at 63. As indicated above, the revenue requirement contained in the Partial Settlement is unsupported and so the OCA takes no position on the City's explanation in its Main Brief (City M.B. at 46–47) regarding the rate design agreed to in the Partial Settlement.

XI. MISCELLANEOUS ISSUES

The City and the OCA agree that an appropriate resolution of the issues raised in OCA witness Fought's testimony (OCA Statements 5 and 5S) is reflected in the Stipulation attached as Attachment B to the City's Main Brief. OCA M.B. at 68; City M.B. at 48.

XII. CONCLUSION

As set forth in the OCA's Main Brief and in this Reply Brief, the OCA respectfully requests that the Commission deny any rate increase to Bethlehem at this time. The City's customers are experiencing substantial economic and personal hardships as a result of the continuing COVID-19 pandemic, and any rate increase at this time would not result in just and reasonable rates. Should the Commission determine, however, that it will proceed in a business as usual manner, then the OCA's alternative position should be adopted and Bethlehem should receive an increase of no more than \$443,666. The Partial Settlement should not be approved.

Respectfully Submitted,

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