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OFFICE OF SMALL BUSINESS ADVOCATE

Suite 1102, Commerce Building  
300 North Second Street  
Harrisburg, Pennsylvania 17101

Bernard A. Ryan, Jr.  
Small Business Advocate

May 3, 1996

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96 (717) 783-2525  
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717 783-2831 (FAX)  
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INFO. CONTROL DIV.

John G. Alford, Secretary  
Pa. Public Utility Commission  
Room B-18, North Office Building  
P. O. Box 3265  
Harrisburg, PA 17105

Re: Petition of Philadelphia Suburban Water Company  
for Approval to Implement a Tariff Supplement  
Establishing a Distribution System Improvement  
Charge at Docket No. P-00961036

Dear Secretary Alford:

JLS

I am delivering for filing today the original plus three copies of the:

1. Notice of Intervention of the Small Business Advocate in the above captioned matter;
2. Public Statement of the Small Business Advocate relating to the filing of that Notice of Intervention; and
3. The Answer of the Office of Small Business Advocate to the Petition of Philadelphia Suburban Water Company.

Copies of each of the documents listed above are being served today on all known parties in this proceeding. A Certificate of Service to that effect is enclosed.

Sincerely,

Karen Oill Moury  
Assistant Small Business Advocate

Enclosures

cc: Susan T. Povilaitis, Esquire  
Law Bureau

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Philadelphia Suburban :  
Water Company for Approval to :  
Implement A Tariff Supplement : Docket No. P-00961036  
Establishing a Distribution :  
System Improvement Charge :

Office of  
Small Business Advocate  
Notice of Intervention

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The Office of Small Business Advocate, an agency of the Commonwealth authorized by the Small Business Advocate Act (Act 181 of 1988, 73. P.S. §§399.41 - 399.50) to represent the interest of small business consumers as a party in proceedings before the Pennsylvania Public Utility Commission, files this Notice of Intervention in this proceeding pursuant to the provisions of 52 Pa. Code §5.71(a)(1).

Representing the Office of Small Business Advocate in this proceeding is:

Karen Oill Moury  
Office of Small Business Advocate  
Suite 1102, Commerce Building  
300 North Second Street  
Harrisburg, Pennsylvania 17101  
(717) 783-2525

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*Karen Oill Moury*  
Karen Oill Moury  
Assistant Small Business Advocate

Dated: May 3, 1996

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PUBLIC STATEMENT OF THE  
SMALL BUSINESS ADVOCATE  
CONCERNING THE INTERVENTION OF  
THE OFFICE OF SMALL BUSINESS ADVOCATE IN  
PHILADELPHIA SUBURBAN WATER COMPANY'S PETITION  
FOR APPROVAL TO IMPLEMENT A TARIFF SUPPLEMENT  
ESTABLISHING A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE  
AT DOCKET NO. P-00961036

The Small Business Advocate is authorized and directed to represent the interest of small business consumers of utility services in Pennsylvania under the provisions of the Small Business Advocate Act, Act 181 of 1988, 73 P.S. §§399.41 - 399.50 (the "Act"). The Act further provides that the Small Business Advocate is to issue publicly a written statement stating the specific interest of small business consumers to be protected by the intervention in any proceeding involving those interests before the Public Utility Commission. This Public Statement relates to the filing today by the Office of Small Business Advocate of its Notice of Intervention in the proceeding initiated by Philadelphia Suburban Water Company ("Company" or "PSWC") at Docket No. R-00961036.

By the Petition, PSWC seeks Commission approval to implement a Distribution System Improvement Charge ("DSIC"), pursuant to Section 1307(a) of the Public Utility Code, 66 Pa.C.S. §1307(a). Through this proposed mechanism, PSWC would be able to recover from its customers, including small businesses, some of the costs associated with replacing mains, without filing a base rate case. PSWC contends that the DSIC would allow the Company to replace its aging mains at a faster pace than will be possible if the Company

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must seek base rate relief to recoup the costs of these infrastructure improvements.

Specifically, the DSIC would enable the Company to automatically increase rates through a quarterly surcharge on the customers' bills. Although the first surcharge, which would go into effect on July 1, 1996, is projected to increase revenues by 0.5% over the amount currently billed to all customers other than public fire customers, subsequent quarterly surcharges could increase revenues by as much as 5%.

The Office of Small Business Advocate filed a notice of intervention in this case in order to protect the interests of small business customers which may be affected by PSWC's proposal. Of primary concern to the OSBA is that a full investigation into all aspects of the proposed DSIC is necessary before it is implemented.

In particular, the OSBA notes that the surcharge would be assessed as a percentage of the customer's bill. Prior to approval of the DSIC, the Commission should thoroughly analyze the reasonableness of assessing a surcharge on the basis of a customer's level of consumption. In that regard, the Commission should consider whether it is appropriate to link payment of infrastructure improvements to the amount of water that is consumed by a customer. Further, it is critical for the Commission to review the impact of a potential 5% increase on various customer classes at varying levels of consumption to determine whether just and reasonable rates would result. Finally, the Commission should

ensure that all classes of customers are treated in an undiscriminatory manner.

The Office of Small Business Advocate will participate in any proceedings held by the Commission to investigate the reasonableness and fairness of PSWC's proposal. To the extent that alternative mechanisms are submitted to the Commission for consideration, the OSBA will review those proposals and comment or respond as necessary to protect the interests of the Company's small business customers.

Date: May 3, 1996

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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Petition of Philadelphia Suburban :  
Water Company for Approval to :  
Implement A Tariff Supplement :  
Establishing a Distribution :  
System Improvement Charge. :

Docket No. P-00961036

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**ANSWER OF THE OFFICE OF SMALL BUSINESS ADVOCATE  
TO THE PETITION OF PHILADELPHIA SUBURBAN WATER COMPANY**

The Philadelphia Suburban Water Company ("PSWC" or "Company") filed a Petition for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge ("DSIC"), pursuant to Section 1307(a) of the Public Utility Code, 66 Pa.C.S. §1307(a). By this Petition, PSWC requests permission from the Commission to recover from its customers some of the costs associated with infrastructure improvements, without the need for filing a base rate case. In particular, implementation of the proposed DSIC would enable the Company to automatically increase rates through a quarterly surcharge on the customers' bills. The first surcharge, which would go into effect on July 1, 1996, is projected to increase revenues by 0.5% over the amount currently billed to all customers other than public fire customers. Subsequent quarterly surcharges would increase non-public fire revenues by as much as 5%.

The Office of Small Business Advocate filed a notice of intervention in this case in order to protect the interests of small business customers which may be affected by PSWC's proposal. Of primary concern to the OSBA is that a full review of all aspects


of the proposal, including a consideration of legal and factual issues, is necessary before the Commission approves it for implementation.

By way of Answer to PSWC's Petition, the OSBA submits that if the Commission determines that the proposed DSIC is legally permissible under Section 1307(a), the Commission should not approve the proposal before conducting an investigation and reaching conclusions as to the reasonableness and lawfulness of the proposed tariff supplement. In particular, the OSBA observes that certain components of the DSIC may adversely affect some groups of customers without a valid basis.

Specifically, the OSBA notes that the surcharge would be assessed as a percentage of the customer's bill. Prior to approval of the DSIC, the Commission should thoroughly analyze the appropriateness of assessing a surcharge on the basis of a customer's level of consumption. In that regard, the Commission should consider whether the amount of water consumed by a customer is germane to the way that costs are incurred by the Company for infrastructure improvements. Further, it is critical for the Commission to review the impact of a potential 5% increase on various customer classes at varying levels of consumption to determine whether just and reasonable rates would result. Finally, the Commission should approve a recovery mechanism only after concluding that the costs are fairly distributed among the Company's classes of customers, with no ratepayers being treated in an unreasonably discriminatory manner.

For these reasons, the Office of Small Business Advocate respectfully recommends that the Commission reject Philadelphia Suburban Water Company's Distribution System Improvement Charge, unless and until the Company establishes that the proposal meets all requirements of the Public Utility Code relating to lawfulness, justness and reasonableness of rates.

Respectfully submitted,

  
Karen Oill Moury  
Assistant Small Business Advocate

Dated: May 3, 1996

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Philadelphia Suburban :  
Water Company for Approval to :  
Implement A Tariff Supplement : Docket No. P-00961036  
Establishing a Distribution :  
System Improvement Charge :

CERTIFICATE OF SERVICE

I certify that I am serving copies of the Notice of Intervention, Public Statement and Answer on behalf of the Office of Small Business Advocate by hand delivery upon the persons addressed below:


Thomas P. Gadsden, Esquire  
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Karen Oill Moury  
Assistant Small Business Advocate

Date: May 3, 1996



ORIGINAL

OFFICE OF CONSUMER ADVOCATE  
1425 Strawberry Square  
Harrisburg, Pennsylvania 17120

IRWIN A. POPOWSKY  
Consumer Advocate

May 6, 1996

(717) 783-5048

John G. Alford, Secretary  
PA Public Utility Commission  
Room G-23, North Office Bldg.  
Harrisburg, PA 17105

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Re: Petition of Philadelphia Suburban  
Water Company for Approval to  
Implement A Tariff Supplement  
Establishing a Distribution System  
Improvement Charge  
Docket No. P-00961036

Dear Secretary Alford:

Enclosed for filing please find an original and ten (10) copies of the Office of  
Consumer Advocate's Comments and Statement of Randy Allen.

Copies of the same have been provided to all parties of record as evidenced by the  
attached Certificate of Service.

Sincerely,

Dianne E. Dusman  
Assistant Consumer Advocate

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FOLDER

Enclosures

cc: All Parties of Record  
36608

JLS

CERTIFICATE OF SERVICE

Re: Petition of Philadelphia Suburban Water Company For Approval to Implement A  
Tariff Supplement Establishing a Distribution System Improvement Charge  
Docket No. P-00961036

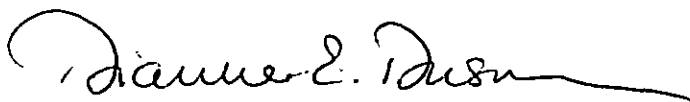
I hereby certify that I have this day served a true copy of the Office Of Consumer  
Advocate's Comments and Statement of Randy Allen, upon parties of record in this  
proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service  
by a participant), in the manner and upon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

Dated this 6th day of May, 1996. By U.S. Mail

Thomas P. Gadsden, Esq.  
Anthony Decusatis, Esq.  
Morgan, Lewis & Bockius  
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Philadelphia, PA 19103

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Office of Small Business Advocate  
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Pitnick Bldg., P.O. Box 3265  
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Dianne Dusman  
Assistant Consumer Advocates  
Counsel for:  
Office of Consumer Advocate  
1425 Strawberry Square  
Harrisburg, PA 17120  
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**ORIGINAL**

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITION OF PHILADELPHIA SUBURBAN  
WATER COMPANY FOR APPROVAL TO  
IMPLEMENT A TARIFF SUPPLEMENT  
ESTABLISHING A DISTRIBUTION SYSTEM  
IMPROVEMENT CHARGE

Docket No. P-00961036

COMMENTS OF THE  
OFFICE OF CONSUMER ADVOCATE

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Dianne E. Dusman  
Assistant Consumer Advocate

Counsel For:  
Irwin A. Popowsky  
Consumer Advocate

Office of Attorney General  
Office of Consumer Advocate  
1425 Strawberry Square  
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DATED: May 6, 1996

JLS

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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITION OF PHILADELPHIA SUBURBAN :  
WATER COMPANY FOR APPROVAL TO :  
IMPLEMENT A TARIFF SUPPLEMENT : Docket No. P-00961036  
ESTABLISHING A DISTRIBUTION SYSTEM :  
IMPROVEMENT CHARGE :

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COMMENTS OF THE  
OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) offers the following comments concerning the above Petition filed by Philadelphia Suburban Water Co. (PSWC or Company), in response to the Notice published in the Pennsylvania Bulletin on April 6, 1996, Vol. 26, No. 14 at 1609-1610. Through its Petition, PSWC seeks permission to implement a surcharge pursuant to Section 1307(a) of the Public Utility Code, 66 Pa.C.S. §1307(a), in order to recover return and depreciation on certain plant constructed between its base rate cases, primarily main replacements. This is an unprecedented request and raises a variety of legal and factual issues. To assist in its analysis of the proposed surcharge, the OCA has sought the assistance of Randy M. Allen, an expert in public utility accounting and regulatory policy.<sup>1</sup> Mr. Allen's verified statement,

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<sup>1</sup> Randy M. Allen is the founder and president of RMA Utility Consulting, a firm that specializes in public utility accounting and regulation. Mr. Allen has nearly seventeen years of experience in the field and has participated as an expert in over 100 gas, electric, telephone, water or wastewater cases before numerous federal and state agency proceedings. His credentials and experience are more fully set forth in his Statement, which is attached hereto, at 1- 4.

attached as OCA Statement 1 (OCA St. 1), will be referred to throughout these Comments.

## II. SUMMARY OF THE OCA'S POSITION

As a threshold matter, the Commission should note that PSWC has the burden of proof in this proceeding. Section 332 of the Public Utility Code states: "Except as may otherwise provided in section 315 (relating to burden of proof) or other provisions of this part or other relevant statute, the proponent of a rule or order has the burden of proof. 66 Pa.C.S. §332(a). In addition, the Company is essentially seeking an increase in current base rates, which PSWC must demonstrate is "just and reasonable." 66 Pa.C.S. §315(a).

For dual reasons, therefore, both because PSWC is the proponent of an order permitting a surcharge *and* because it must show any increase in its rates to be "just and reasonable," PSWC bears the burden of proof in this proceeding. To meet this burden of proof, mere allegations in a petition are insufficient, particularly in light of the extent to which the facts alleged are disputable. If the Commission does not deny the Petition for some or all of the legal reasons set forth below, the petition should be referred to the Office of Administrative Law Judge for development of an evidentiary record and Recommended Decision.

The OCA's major concerns with PSWC's request, which amply justify rejection of the proposal, can be summarized as follows:

1. The proposal is not consistent with Section 1307(a) of the Public Utility Code, and applicable case law, in that it would include capital costs and "disassemble the traditional ratemaking process."
2. The proposal constitutes "piecemeal ratemaking" in that it would permit

PSWC to increase rates due to isolated items of plant, for which future test year claims were also considered in PSWC's most recent base rate case.

3. The proposal violates the matching principle in that it would permit PSWC to collect increased revenues due to a rate base element which has increased since the conclusion of the future test year in the most recent case, while ignoring changes in other rate base items, expenses, revenues and costs of capital which, if considered, might decrease rates.

4. The proposal would unfairly alter the balance of risks between ratepayers and shareholders established by the last base rate order, approving rates which incorporated a cost of equity based upon the business risk to which PSWC was exposed at the time.

5. The surcharge would create bad regulatory policy in that it would not only eliminate an incentive to control costs between rate cases, but also would generate an incentive to increase spending in order to avoid reduction of the surcharge to zero, which would occur if the authorized return is reached.

6. The allegations in the Company's Petition are insufficient to demonstrate that this rate increase is "just and reasonable" and many of the facts alleged in support are disputable. Most notably, the assertion that the items of plant which are to be included in the surcharge are "non-revenue producing and non-expense-reducing" and the assertion that accelerated improvement is needed, among several others, are unsubstantiated.

Each of the above major points is discussed more fully below.

### III. LEGAL ARGUMENT

#### A. Introduction

The OCA submits that PSWC's surcharge request is tantamount to a base rate increase request, to be adjusted every quarter. As such, the request raises threshold legal and policy issues which should be decided before proceeding further. This request is not lawful under the Public Utility Code and applicable precedents; further, the surcharge would create bad regulatory policy in that it would eliminate an incentive to control costs between rate cases. On these bases, set forth more fully below, the Commission should deny the PSWC Petition.

#### B. The Surcharge Proposal Is Contrary To Section 1307(a) Of The Public Utility Code.

The Company frames its request for the infrastructure surcharge under Section 1307(a) of the Public Utility Code. Petition at 1. The Company argues that recovery of the return and depreciation related to the plant items is lawful and compares its request to Demand Side Management (DSM) and Clean Air Act Amendment (CAAA) costs in the electric industry; "take-or-pay" and gas supply realignment costs in the natural gas industry; and PennVest loan obligations in the water industry. Petition at 19-21. The OCA submits that the Company's reliance upon Section 1307(a) as a legal basis for its rate increase request is misplaced and its interpretation of precedents interpreting that section is misguided.

Section 1307(a), in pertinent part, reads as follows:

**(a) General Rule.**--Any public utility . . . may establish a sliding scale of rates or such other method for the automatic adjustment of the rates of the public utility *as shall provide a just and reasonable return on the fair value of the property used and useful in the public service, to be determined upon such equitable or reasonable basis as shall provide such fair return.* A tariff showing the scale

of rates under such arrangement shall be first filed with the commission and such tariff, and each rate set out therein, approved by it. The commission may revoke its approval at any time and fix other rates for any such public utility if, after notice and hearing, the commission finds the existing rates unjust and unreasonable.

66 Pa.C.S. §1307(a) (emphasis added). Thus, one of the 'limiters' set forth in Section 1307(a) is that any automatic rate adjuster may provide *no more than* a just and reasonable return on used and useful property. As a practical matter, and especially because this automatic adjustment proposal would permit the Company to recover return dollars on new plant based on its last authorized return,<sup>2</sup> it will simply be impossible to determine whether the Company is earning *no more than* a just and reasonable return on its used and useful plant.

In an apparent attempt to render its proposal consistent with Section 1307(a), PSWC has proposed a rate of return "cap." Petition at 5, 26. According to the Petition, the DSIC will be reset at zero if the most recent earned rate of return exceeds the rate of return used to calculate the fixed costs under the DSIC. OCA St. 1 at 13-14. This cap, however, provides no assurance that customers will be protected from excessive returns or unreasonable rates while the surcharge would be in effect. As Mr. Allen explains:

... The Cap does not limit earnings based on a reasonable rate of return determined within the capital markets *as they may exist at the time of each quarterly calculation*. Specifically, the Cap has its basis in the Company's last authorized capital structure, cost of debt and preferred stock (unless such cost rates are lower than the last authorized

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<sup>2</sup> As discussed later in these Comments, approving the surcharge will in and of itself reduce business risk, thus rendering (all else equal) PAWC's last authorized return too high. See Section III.C., *infra*. Because PSWC's last base rate case was settled, PSWC has proposed to use PAWC's last authorized cost of equity of 11.25%. Petition, Exhibit B at 2. Since the filing of the Petition, however, the Commission entered a final order in *Pa. P.U.C. v. Citizens Utility Water Company of Pa. (Citizens)*, Docket No. R-00953300, on March 29, 1996. The cost of equity for Citizens was determined to 10.8% (*id.* at 98); however, even that lower equity cost would not reflect the lower business risk of a utility with a DSIC.

levels). The return on equity will either equal the last authorized level for PSWC, if authorized within the past 2 years, *or the most recent level authorized by the Commission for an investor-owned water utility having revenue in excess of \$10.0 million* (Petition, page 25), assuming one has been adopted. As the Company is well aware, the financial risks of PSWC are not necessarily as high as other water companies in Pennsylvania, therefore, *the most recent authorized rate of return on equity for another company may have no realistic relationship to PSWC capital costs*. This poses another potential risk that ratepayers will be paying on an unreasonably high rate of return to the benefit of shareholders.

OCA St. 1 at 13-14 (emphasis added). Thus, as Mr. Allen explains, ratepayers are at risk for paying either a higher return level than is justified at the time payments are made, or at a rate set too high for PSWC because the rate may be "borrowed" from another utility adjudication.

In addition, Section 1307(a) has been held not properly utilized for recovery of such plant items as return on plant and capital costs. Recently, the Commonwealth Court decided that use of Section 1307(a) to recover DSM expenses is lawful, *so long as capital costs are not included in the adjustment mechanism* and so long as it is not utilized to "disassemble the traditional ratemaking process." *Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission*, 653 A.2d 1336 (1995), *aff'd per curiam*, 75 M.D. Appeal Docket 1995 (Order entered February 13, 1996)(*PIEC*). The PSWC surcharge runs directly contrary to the recent *PIEC* decision.

By way of background, the DSM surcharge proposal in *PIEC* was based on an Order of the PUC seeking methods to address barriers to the development of DSM programs, namely utility concerns about cost recovery. The statutory basis for the Order was Section 524 of the Public Utility Code, 66 Pa.C.S. §524, which requires each electric utility to submit to the PUC each year information concerning future plans to meet customer demand. *PIEC*, 653 A.2d at 1340-1341. The Commonwealth Court considered DSM expenses, *but not capital costs related*

to DSM programs, to be recoverable through a 1307(a) surcharge mechanism. *Id.* at 1347. A specific provision of the Code, Section 1319, specifically permits the recovery of all “prudent and reasonable costs” associated with a conservation or load management program. 66 Pa.C.S. §1319. Section 1319 refers to Section 1315 which states that the cost of facilities except for “nonrevenue producing, non-expense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities” shall not be made part of the rate base nor otherwise included in rates until such time as the facilities are “used and useful in the public service.” 66 Pa.C.S. §1315. In the course of deliberating on the PIEC’s argument that the DSM costs are not “used and useful” and thus should not be currently recoverable, the Court clearly stated that costs related to new physical facilities are *not* to be the subject of a surcharge:

... Section 1315 expressly applies only to determine when the costs of construction or expansion of facilities may be included in the rate base. *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 430, 490 A.2d 806 (1985). *See also Barasch v. Pennsylvania Public Utility Commission*, 516 Pa. 142, 532 A.2d 325 (1987), *aff’d*, 488 U.S. 299, 109 S.Ct. 609, 102 L.Ed.2d 646 (1989). Section 1315 is only applicable to the extent that DSM costs relate to physical facilities and is not relevant to determine whether the cost recovery methods approved by the PUC are violative of the Code. *Because new physical facilities are appropriate costs only within the rate base under Section 1315, in the unlikely event that DSM programs require new physical facilities, those costs should be raised in a base rate case only, subject to the restrictions of Section 1315, and not through the surcharge mechanism.*

PIEC at 1347 (emphasis added).<sup>3</sup> Thus, a surcharge inclusive of return revenues on new physical

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<sup>3</sup> In its Reply To The Answer Of The Office Of Trial Staff (Reply), PSWC interprets this passage of the Court’s Opinion to mean that its concern was only with electric utilities attempting to recover costs related to facilities before they are “used and useful.” Reply at 5. The OCA disagrees. The clear import of the Court’s opinion is that the costs of *all* rate base items--whether

facilities, the costs of which are to be raised in a base rate case only, has been deemed by the Commonwealth Court unequivocally *not to be appropriate within the meaning of Section 1307(a)*. As the proposed PSWC surcharge seeks to recover return and depreciation on base rate items outside the context of a base rate case, the proposal runs directly contrary to the Commonwealth Court's decision in *PIEC* and should be rejected.

Other factors distinguish the DSM surcharge considered in the *PIEC* case from the PSWC proposal under consideration. In the Order reviewed by the Court, the Commission had held that DSM costs were unique, in that "a successful plan would result in decreased demand for electricity and decreased revenues" -- and that in light of this factor a special mechanism for recovery of costs was appropriate. *Id.* at 1342. Clearly, infrastructure improvement costs are far from unique; rather, they are routine and necessitated by the utility's obligation to serve the public.<sup>4</sup> And, as noted elsewhere in these Comments, the charges PSWC seeks to recover would have an effect *precisely the opposite* of the DSM programs -- in other words, improved and expanded infrastructure is likely to increase demand and revenues while reducing expenses. *See* OCA St. 1 at 12-13. Thus, several facts at work in *PIEC* - statutory requirements, the reducing

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fitting within the Section 1315 exception or not--are to be claimed in a base rate case *only* and not through a Section 1307(a) surcharge mechanism.

<sup>4</sup> Section 1501 of the Public Utility Code states that "[e]very public utility shall furnish and maintain adequate, efficient, safe, and reasonable service and facilities, and shall make all such repairs, changes, alterations, substitutions, extensions, and improvements in or to such service and facilities as shall be necessary or proper for the accommodation, convenience, and safety of its patrons, employees, and the public." 66 Pa.C.S. §1501. This is the statutory basis for a utility's "obligation to serve" members of the public who need utility service. It should also be noted that the general rule is that the responsibility for providing capital necessary to add facilities and to make improvements is that of the utility, not the ratepayers. *See McCormick v. Pa. P.U.C.*, 409 A.2d 962, 964 (1980).

effect of DSM on demand and revenues<sup>5</sup>, and the unique nature of the costs - are either absent or contraindicated in the present case.

Moreover, the Commission had further held that the DSM costs could be recovered through an annual surcharge *for a limited period*, that *annual prudence reviews* of ongoing and proposed DSM programs had to be prepared and reviewed by the Bureau of Conservation, Economics and Energy Planning, with input from consumer groups; and that recovery of the costs were to be customer class specific. *Id.* at 1342-1343. Thus, although Section 1307(a) of the Code formed the statutory basis for the DSM expense surcharge, other cautionary and protective mechanisms were at work in that case which are not proposed here.

The Petitioner had also argued before the Commonwealth Court that Section 1307 should be reserved for costs, such as fuel costs that are large in magnitude, volatile and beyond the control of utility management. In support of this position, the Petitioner cited *Masthope Rapids Property Owners Council v. Pennsylvania Public Utility Commission*, 135 Pa. Commw. 437, 581 A.2d 994 (1990) (*Masthope*), in which the Commonwealth Court held that a water utility could not recover the principal and interest of a loan received under the Water Facilities Restoration Act, 32 Pa.C.S. §§7501-7518 through a Section 1307 automatic adjustment clause.

In *Masthope*, the Court held that the surcharge requested was inappropriate, because “the function of the typical automatic adjustment clause is to permit rapid recovery of a

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<sup>5</sup> The Court did, however, recognize that the DSM surcharge, if permitted to recover “lost revenues” resulting from DSM efforts could result in unjust and unreasonable rates by ignoring increases in revenues from other sources, as argued therein by the OCA, and remanded noting that the issue was “not yet ripe for judicial review.” PIEC at 1352-1353. Because the PSWC surcharge also ignores increases in overall revenues, the risk of unjust and unreasonable rates is also presented by its proposal.

specific *identifiable* expense item, with a more comprehensive analysis upon reconciliation of actual costs with previously projected costs used to establish the effective rate.” *Masthope* at 447-48, 581 A.2d 999-1000 (emphasis in original). Distinguishing *Masthope* and deciding against the PIEC’s argument, the Commonwealth Court stated as follows:

*Although we agree that Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process, the General Assembly did not limit the allowance of automatic adjustment to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the PUC or the utilities to initiate the automatic adjustment of costs within specific procedures.*

*PIEC* at 1349 (emphasis added). Thus, while noting that use of Section 1307(a) was not quite so limited as the PIEC had argued, the Commonwealth Court nonetheless rejected the use of Section 1307(a) for items which would result in disassembly of the traditional ratemaking process, which precisely describes the relief sought by PSWC in its Petition.

So, although PSWC relies upon *PIEC* to justify its request (Petition at 20-21), its reliance is misplaced. It is part of the holding of *PIEC* that Section 1307(a) is usable to recover unique revenue-reducing costs; so long as capital costs are not included; and so long as it is not used to “disassemble” the traditional ratemaking process. The relief sought by the Petition under consideration seeks a return of and on routine plant costs for which claims are made in every base rate case, contrary to the Court’s opinion in *PIEC*. Such a 1307(a) surcharge would run contrary to numerous traditional rate setting principles to the extent that the traditional ratemaking process is, in fact, “disassembled.”

C. Because The Surcharge Would Guarantee PSWC A Return Upon A Portion Of Plant, It Is Contrary To The Fundamental Principle That Utilities Are Entitled Only To An Opportunity To Earn A Fair Rate Of Return on Investment.

PSWC has requested permission to recover through the surcharge “the fixed costs (depreciation and *pre-tax return*) of certain non-revenue producing, non-expense reducing distribution system improvement projects completed and placed in service between base rate cases.” Petition at 1 (emphasis added). Because PSWC is asking that profits on certain plant items be collected through an adjustable surcharge between-rate cases, its request is unprecedented and contrary to fundamental principles of ratemaking in Pennsylvania.

Among the most basic of the principles of ratemaking is that public utilities are never guaranteed a return on investment in utility plant; rather, they are entitled to no more than a *reasonable opportunity to earn a fair rate of return* on investment in used and useful plant. This principle was recognized as early as 1933 by the United States Supreme Court in *Public Service Commission of Montana v. Great Northern Utilities*:

The due process clause of the Fourteenth Amendment safeguards against the taking of private property, or the compelling of its use for the service of the public without just compensation . . . But it *does not assure to the public utilities the right under all circumstances to have a return upon the value of the property so used.* The use of, or the failure to obtain patronage, due to competition, does not justify the imposition of charges that are exorbitant and unjust to the public. The clause of the Constitution here invoked does not protect the public utilities against such business hazards.

289 U.S. 130, 135 (1933) (citations omitted; emphasis added); *see also Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 567 (1945)(utilities not assured a return on the value of utility property under all circumstances). Similarly, the appellate courts of Pennsylvania have

recognized that the primary objective of public utility regulation is first and at all times to protect and serve the interest of the public - not to establish a monopoly *nor to guarantee the security of investment* in public service corporations. *Colombo v. Pa. P.U.C.*, 159 Pa. Super. 483, 487, 48 A.2d 59, 61 (1946) (quoting from *Hoffman v. Public Service Commission*, 99 Pa. Super. 417, 429 (1930)). The surcharge proposal runs contrary to this basic principle because it would guarantee collection of the full amount of return dollars on specific items of rate base, between base rate cases, rather than simply permitting PSWC an opportunity to earn a return on the new plant.

Permitting collection of the full amount of return on even a portion of rate base undermines the objective of service to and protection of the public recognized by the courts, in that it tends to guarantee a return on that particular portion of shareholder investment.

Protection of the public--rather than the security of shareholder investment--is to be accomplished by regulatory commissions in their role as a proxy for competitive forces in the marketplace. As one commentator elaborated on this principle:

Public utilities have always operated within the framework of a competitive system. They must obtain capital, labor, and materials in competition with unregulated industries. *Adequate profits are not guaranteed them. Regulation, then, should provide incentives to adopt new methods, improve quality, increase efficiency, reduce costs, develop new markets and expand output in line with consumer demand.* In short, regulation is a substitute for competition and should attempt to put the utility sector under the same restraints competition places on the industrial sector.

C. Phillips, *THE REGULATION OF PUBLIC UTILITIES* (2ND ED. 1988) at 165-166. Consistent with this theory of regulation as a substitute for market forces, the Pennsylvania appellate courts have recognized that the ultimate goal of utility regulation is to protect the public by assuring adequate

service at reasonable rates -- while providing the utility a fair *opportunity* to secure a reasonable return. *Pennsylvania Public Utility Commission v. Pennsylvania Gas & Water Co.*, 492 Pa. 326, 339, 424 A.2d 1213, 1220 (1981); *Kirkwood Partnership v. Pa. P.U.C.*, 133 Pa. Commw. 478, 486, 576 A.2d 1167, 1171 (1990).

Acting in its role as protector of the public against unreasonably high rates, this Commission determined the fair rate of return for Pennsylvania-American Water Co. (PAWC) in its last rate case, which PSWC proposes to use to calculate its surcharge.<sup>6</sup> *Pa. P.U.C. v. Pennsylvania-American Water Co.*, Docket No. R-943231, Opinion and Order of July 24, 1996, at 39-65. In doing so, the Commission noted the well-known *Bluefield* standard employed in every rate case: a public utility is entitled to rates which will *permit* it to earn a return on the value of its used and useful property equal to that generally being earned by other comparable businesses with similar and uncertainties. *Id.* at 39-40 (citing *Bluefield Waterworks and Imp. Co. v. P.S.C. of West Virginia*, 262 U.S. 679 (1923)). This Commission noted that the "return finding should consider the financial costs being incurred, so that the utility has the *opportunity to recover its present cost of capital or to attract needed capital at reasonable costs.*" *Id.* at 41 (quoting *Pa. P.U.C. v. Pennsylvania Power Co.*, 55 PaPUC 552 (1982)(emphasis added)). The PUC also considered the well-recognized principle that determining return requires a balancing of ratepayer and shareholder interest:

The interest of the company and its investors are to be considered along with those of the customers, all to the end of *assuring adequate service to the public at the least cost, while at the same*

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<sup>6</sup> As noted earlier, however, the appropriate cost of equity to utilize would be that determined by the Commission in *Pa. P.U.C. v. Citizens Utilities Water Company of Pennsylvania*, Docket No. R-00953300, Order of March 29, 1996, which was 10.80%.

*time maintaining the financial integrity of the utility involved.*

*Id.* at 41-42 (quoting *Pa. P.U.C. v. West Penn Power Co.*, 73 PaPUC 454 at 502-503 (1990) (emphasis added)). These principles provided the backdrop for the Commission's determination in the last PAWC case that a fair overall return was 9.57%, incorporating a return on common equity of 11.25%. *Id.* at 65. The Commission specifically agreed with the Administrative Law Judge in that he had "properly accounted for risk by using the upper end of the OTS and OCA [common equity return] ranges." *Id.* at 64. Among the business risks accounted for in the most recent cost of equity finding is that related to construction of plant necessary to provide service *following* the conclusion of that case and *prior to* filing another base rate case, which leads to "attrition." Regulatory commissions have various methods of dealing with attrition, i.e., use of the future test year and inflation adjustments, but business and financial risks are also reflected in the risk-adjusted cost of common equity, as is true in Pennsylvania. See Phillips, THE REGULATION OF PUBLIC UTILITIES (3rd ed. 1993) at 407-408.

Consistent with this idea and following consideration of all of the financial and business risks to which PAWC was exposed, the Commission established a fair rate of return for PAWC. The return determination was, of necessity, based upon all of the financial and business risks to which PAWC was known to be exposed *at the time*. Now, if the Petition under consideration were granted, an element of risk which was reflected in the cost of equity determination which PSWC would utilize to calculate the surcharge would be eliminated. This potential de facto "double count" would be unfair to ratepayers and serve only to benefit shareholders at the ratepayers' expense.

In an attempt to meet such concerns surrounding the return issue raised by the

surcharge design, the Company has proposed that a cap of 5% be placed upon the surcharge and that it be reduced to zero if the Company were to achieve the rate of return the Commission allowed the Company in the last case if within the last two years -- or the most recent level authorized by the Commission for an investor-owned water utility having revenues in excess of \$10.0 million per year. Petition at 5, 25.<sup>7</sup> These facets of the design do not address the concerns that the Company would be *guaranteed a return on the particular items of plant included* and that implementation of the surcharge--a business risk reducer--would render the return figure proposed to be used too high. Albeit a small percentage of the Company's rate base, guaranteeing a return on any item of plant is inappropriate and, along with ignoring the impact of the surcharge on business risk, would constitute a failure to protect the interests of the public by assuring adequate service at the least cost.

On the other hand, because the surcharge revenues would be quite small compared to the Company's overall revenues, PSWC does not and cannot argue that, without the surcharge, current rates are inadequate, nor that its financial integrity would be jeopardized in the near future. The Company states only that the surcharge is "needed if PSWC is to have a *meaningful*

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<sup>7</sup> There are only two Pennsylvania water utilities other than PSWC with revenues in excess of \$10,000,000: Pennsylvania-American Water Co. and Citizens Utilities Water Company of Pennsylvania. The Commission recently determined the cost of equity for Citizens to be 10.80% at a capital structure of 55% long-term debt and 45% equity. *Pa. P.U.C. v. Citizens Water Company of Pa.*, Docket No. R-00953300, Commission Opinion and Order of March 29, 1996, at 90-98. By virtue of this Order, PSWC would be required to recalculate its DSIC utilizing the equity rate of 10.8%, in lieu of the 11.25% cost of equity it has utilized to calculate the surcharge. See *Pa. P.U.C. v. PAWC*, Opinion and Order of July 24, 1995, at 65. Nonetheless, the Citizens' cost of equity determination was made pursuant to traditional ratemaking principles just as PAWC's was and therefore, of necessity, would reflect the higher level of business risk experienced by a utility without an infrastructure surcharge.

opportunity to recover its capital costs on revenue-neutral<sup>8</sup> distribution system improvement projects and thereby *remain in a position to attract needed capital* at the lowest possible cost for all of its construction requirements.” Petition at 9-10 (emphasis added). This leads to an strong inference that current rates continue to be just and reasonable rates -- but, that the surcharge is requested only due to the Company’s *perceived* need for accelerated improvements beyond a level that current rates would permit -- a need which has not been substantiated.<sup>9</sup>

As Mr. Allen states:

... [T]he Company’s 1995 annual report claims that its growth in 1995 dividends was due to an expansion of the Board’s confidence in the Company’s strategy of growth through acquisitions, revenue increases from customer growth and timely rate relief that should permit positive financial results to continue into the future. as the Chariman and President of PSWC concluded, “the Company . . . is growing in customers, revenues, profits and overall shareholder value.” In addition PSWC was named one of the three “TOP INCOME CHOICES” for water utilities in the November 1994 issue of MONEY magazine. As reported, water utilities are seen as an extremely low-risk way to earn at least 9% a year.

OCA St. 1 at 6-7: Thus, not only would permitting collection of return on new plant through a surcharge run contrary to well-established rules of ratemaking, such an extraordinary remedy does not appear needed for PSWC which appears currently to have a reasonable opportunity to earn a fair return on utility investment. The Petition therefore should be denied.

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<sup>8</sup> As argued below, the OCA does not agree with this characterization of the plant involved and believes that the improvements are both revenue-producing and expense-reducing. See Section III.C., *infra*, and Statement of Randy Allen at 12-13.

<sup>9</sup> See Section III.G., *infra*.

D. The Plant Proposed To Be Included For Purposes Of The Surcharge Calculation Is Not “Non-Revenue Producing and Non-Expense Reducing.”

In seeking permission to collect return and depreciation on infrastructure improvements and extensions, the Company borrows a phrase from Section 1315 of the Public Utility Code, which creates an exception to the “used and useful” principle for electric utilities. 66 Pa.C.S. §1315. An electric utility *may* include in rate base (even if not currently used and useful) “such nonrevenue producing, non-expense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities . . . .” The Company appears to suggest that recovery of fixed costs of mains in current rates outside the context of a base rate case is permissible because, it asserts, the plant items are “non-revenue producing, non-expense reducing distribution system improvements.”

The OCA questions the asserted “non-revenue producing, non-expense reducing” nature of these items of plant. As Mr. Allen states, replacing, cleaning and lining aging distribution mains will result in reduced ongoing O&M expenses for repairs and maintenance. OCA St. 1 at 12. As well as these indirect impacts, the proposed surcharge will *directly* reduce depreciation expenses and overall return. *Id.* at 12-13.

Thus, main replacements by their nature can and will reduce future expenses, both directly and indirectly. The Company’s characterization of these projects as “non-revenue producing and non-expense reducing” is incorrect. The proposal to permit collection of return and depreciation on these projects, while countervailing changes in other parts of the ratemaking formula are not to be considered, lacks merit. In essence, the Company seeks to charge current customers for the fixed costs related to accelerated infrastructure improvement -- but to deny

them the benefits of the direct and indirect expense reductions which will result from them.

Because of the inequity which would inure to ratepayers due to this surcharge, the Commission should deny PSWC's Petition.

E. The PSWC Proposal Would Constitute Piecemeal Ratemaking And Would Violate The Matching Principle.

In Pennsylvania, as in most jurisdictions, rates for public utilities are set using what is known as the "test year concept," which requires taking a "snapshot" of the utility's revenues, expenses, and capital costs during a one-year period. *Green v. Pennsylvania Public Utility Commission*, 473 A.2d 209, 213-215 (1984). The object of using a test year is to reflect typical conditions. *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 178 Pa. Super. 46, 66 (1955). Test year expenses may be adjusted or normalized where atypical or non-recurring. *Pa. P.U.C. v. Pennsylvania Power Co.*, 85 PUR4th 323, 379 (1982). Of importance to the test year concept, however, is that revenues, expenses and capital costs are to be simultaneously reviewed for the same test period. As Mr. Allen explains:

The heart of the Company's Petition attacks the very core of the test year concept of cost-based ratemaking. That is, PSWC wants to avoid the components of regulatory lag that go against shareholders, while retaining the components that benefit shareholders. This asymmetrical approach violates sound ratemaking principles, including piecemeal ratemaking, the matching principle and the test year concept. The test year concept calls for the use of consistency, in that if you look beyond the snapshot test period for one item, you must also look beyond the period for all items that affect the level of rates. This consistency has been one of the cornerstones of ratemaking for many years. Only in this manner can revenues, expenses, and capital costs be synchronized.

OCA St. 1 at 8-9. Furthermore, in Pennsylvania, a utility may use a "future test year" in discharging its burden of proving new rates "just and reasonable." 66 Pa.C.S. §316(e). As mentioned earlier, the use of a future test year is one means of dealing with the problem of

attrition, in that it permits the regulator to adjust historic test year data for both known and measurable and projected changes. Phillips, THE REGULATION OF PUBLIC UTILITIES (3rd ed.1993) at 407. Again, however, even with the use of a future test year, all elements of the ratemaking formula are to be considered together to arrive at a reasonable level of rates going forward. The PSWC proposed surcharge would constitute piecemeal ratemaking and violate the matching principle because it asks the Commission to consider only isolated elements of rates which are increasing -- and nothing more. Mr. Allen explains this problem as follows:

The proposed treatment represents piecemeal ratemaking because rates will be changed to reflect the effect of only two limited cost of service items which were already considered for the future test year in the last base rate proceeding. The matching principle will be violated because rates will be based on revenues and expenses at a different point in time than that at which rate base will be measured. As a result, the Company will earn a return on investment to serve a level of customers for which operating income will not be reflected in base rates. It has been a long-standing principle that when rates are changed, all components of revenue requirements must be open to review and analysis to ensure that all changes are reflected and the Company has no more, or less than a reasonable opportunity to earn a reasonable return based on a matched snapshot period of time.

OCA St. 1 at 10. Without doubt, the PSWC surcharge would adjust base rates for increasing fixed costs based on infrastructure improvements, ignoring all other changes in components of the ratemaking formula. As such, the surcharge would constitute piecemeal ratemaking and, at the same time, violate the matching principle which is integral to the test year concept. As such, the surcharge should be rejected.

F. The Surcharge Would Constitute Bad Regulatory Policy In That It Would Eliminate An Incentive To Control Costs Between Rate Cases And Generate An Incentive To Spend.

As noted in Section II.B., above, regulatory agencies are to act as substitutes for market forces toward public utilities. Regulation should attempt to impose the same restraints on

a utility as market forces place upon the industrial sector, by providing incentives to increase efficiency and reduce costs. See C. Phillips, THE REGULATION OF PUBLIC UTILITIES (3RD ED. 1988) at 155-156. Because rates are set prospectively based upon a test year period, unforeseen events and changes in prices following the effective date of new rates may impact either way on the level of revenues available for return or shareholder dividends built into the new rates. In this way, traditional rate base/rate of return regulation generates an incentive to utility management to control or reduce costs -- and to increase the level of efficiency of operation between rate cases -- in order to enhance profit for shareholders. Implementation of the proposed surcharge would substantially reduce this existing incentive. Considering this factor *alone*, such a surcharge would constitute bad regulatory policy.

Reducing the existing incentive to control costs would not be the only result of the surcharge, however. As Mr. Allen explains in his Statement:

The proposed treatment would be bad policy because it would create a disincentive for PSWC to achieve cost reductions through productivity and efficiency improvements, partly because the Company plans to use the increased financial results "to absorb increases in other categories of costs..." and because PSWC can avoid the rate of return cap by not reducing expenses already included in rates. In other words, by avoiding regulatory review on a fairly regular basis, the company can relax its attempt to reduce costs which would enable it to avoid the Cap.

OCA St. 1 at 17 (citation omitted). Thus, for the reasons explained by Mr. Allen, the proposed infrastructure improvement surcharge constitutes bad policy for dual reasons: it would eliminate an incentive to control above-the-line costs and generate an incentive to spend. As such, the PSWC Petition should be denied.

G. The Proposed Surcharge Would Alter The Balance of Risks Between Ratepayers And Shareholders By Transferring An Element Of Risk To Ratepayers, With No Substantial Resulting Benefit to Ratepayers, Thus Generating A Windfall To Shareholders.

As long ago as *Smyth v. Ames*, the United States Supreme Court addressed the issue of the need for regulators to balance the interests of ratepayers and shareholders when rates are set. 169 U.S. 466, 546 (1898). Indeed, a fair balancing of interests and of the financial and business risks involved with utility operation is central to the process of rate setting. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The OCA has set forth in Section III.C., above, the standards applied by this Commission in determining the cost of equity for the purpose of establishing “just and reasonable” rates. In doing so, the Commission also establishes a fair balance of risks between the ratepayers and shareholders. As noted by Mr. Allen:

Adoption of the proposed surcharge would reduce the risk of regulatory lag even further, if not completely insulating the Company from such risk. Without reducing the Company’s authorized rate of return accordingly, the proposed surcharge would enable PSWC to collect current rates based upon the degree of risk to which it was exposed during the last base rate case, plus the surcharge revenues. . . The result of the proposed treatment would be that PSWC will avoid the components of regulatory lag that work against shareholders, while retaining the components that benefit shareholders.

OCA St. 1 at 8, 18. The Commission denied a proposal made by Pennsylvania-American Water Co. (PAWC) several years ago which would have had a similar result, that is, shareholders would have been benefitted to the detriment of ratepayers. PAWC had filed a Petition for Declaratory Order which sought, among other items, AFUDC accrual treatment for its investment in main extensions. The Commission denied that Petition with prejudice, for reasons that are also

applicable here:

We are of the opinion that *the PAWC proposal totally insulates the utility from risk normally incident to capital additions associated with new customers. Although we agree with the Company that the current policy statement contains general principles that could result in very broad interpretations resulting in "uneconomic extensions," we do not agree that the Company should be unduly insulated from risk occurring during construction through to rate base recognition of main extensions. . . .*

Commission Opinion and Order of March 8, 1994, Docket No. P-00930717 (attached to these Comments and marked Exhibit A) at 11-12 (emphasis added). The proposed surcharge would go *even further* than the PAWC-proposed AFUDC treatment toward insulating the Company from risk, in that it would permit *collection* -- not just *accrual*-- of the return and depreciation revenues on new plant on a current, ongoing basis. The Company's assertions concerning the alleged ratepayer benefits to result from the surcharge are spurious, and certainly do not offset the transferred risks and quarterly increases in rates.

Because the surcharge would unfairly alter the balance of risks between ratepayers and shareholders established by the most recent rate order--without providing any offsetting benefits--the Company's Petition should be denied.

H. The Company's Petition Is Not Support By Fact Or Empirical Data.

The Company seeks this surcharge in order to enable it to *accelerate* its investment in new mains to replace aging water distribution infrastructure, "comply with evolving regulatory requirements imposed by the Safe Drinking Water Act; develop and implement solutions to regional water supply problems and participate in the costs of extending facilities to serve new customers. Petition at 2. The Company never specifies which SDWA requirements are evolving to the point where additional revenues are required. PSWC does, however, give a little

more detail about the need to accelerate infrastructure replacement, asserting that because it has 3,180 miles of mains and is currently replacing approximately 15 miles per year, all of the needed improvements in existing facilities will take approximately 212 years. *Id.* As Mr. Allen points out, however, these assertions fail to support an urgent need for one to five percent more than PSWC collects in base rate revenues:

Th[e Company's] statement [that it must find a way to substantially increase its rate of infrastructure rehabilitation] is based upon the erroneous conclusion that all of the infrastructure replacements or rehabilitation are required within 66 years. In reality, 66 years is not the actual remaining life of current infrastructure investments, but the average remaining life of such investment. Instead of needing to complete the replacement and rehabilitation work within 66 years to "...avoid a serious shortfall between the end of the service lives of existing property and the replacement or rehabilitation of that property", the Company actually has 132 years. In addition, the Company has not provided a vintage year break down of the required capital work to enable proper investigation into its claims.

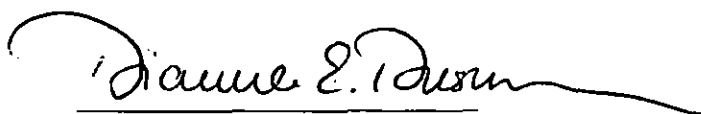
OCA St. 1 at 19-20 (emphasis in original; references omitted). A major premise on which the PSWC is based, therefore, is questionable. Furthermore, as noted above in Section II.C., the Company's characterization of the plant it seeks to include in the surcharge as "non-revenue producing and non-expense reducing" is incorrect. OCA St. 1 at 12-13. Although these are two major inaccuracies in the PSWC Petition, numerous other statements which are made in support of the Petition are either incorrect or unsupported. OCA witness Randy M. Allen has addressed these erroneous or questionable in detail in his Statement, attached to these Comments.

Because the Petition is unsubstantiated by fact and unsupported by any empirical data supporting a need for acceleration of infrastructure improvement, the Commission should deny the relief sought by PSWC.

IV. Conclusion.

The DSIC surcharge proposed by PSWC runs contrary to the Public Utility Code and to several well-established principles of sound ratemaking, would constitute bad regulatory policy, and is unsupported by fact or empirical data, for all of the reasons set forth more fully above and in the Statement of Randy M. Allen, attached to these Comments. The Commission should, therefore, reject the proposed surcharge.

Respectfully submitted,



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Dated: May 6, 1996

# APPENDIX - A

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

Public Meeting held December 15, 1993

Commissioners Present:

David W. Rolka, Chairman  
Joseph Rhodes, Jr., Vice-Chairman  
John M. Quain, Statement attached  
Lisa Crutchfield  
John Hanger

Re: Petition of Pennsylvania-American  
Water Company for a Declaratory  
Order: (1) Finding its Proposed Tariff  
Supplement in Compliance With the  
Commission's Policy Statement at  
52 Pa. Code §69.171; and (2) Approving  
the Accrual of Post-In-Service AFUDC on a  
Portion of the Main Extension That  
Would be Funded by the Company  
Pursuant To Such Proposed Tariff  
Supplement

Docket No.  
P-00930717

**OPINION AND ORDER**

**BY THE COMMISSION:**

This is the matter of the Petition of Pennsylvania-American Water Company ("PAWC" or "Company") for a Declaratory Order: (1) Finding its Proposed Tariff Supplement in Compliance With the Commission's Policy Statement at 52 Pa. Code §69.171; and (2) Approving the Accrual of Post-In-Service AFUDC on a Portion of the Main Extension That Would be Funded by the Company Pursuant To Such Proposed Tariff Supplement ("Petition" hereafter) filed pursuant to Section 331(f) of the Public Utility Code, 66 Pa. C.S. §331(f) and 52 Pa. Code §5.42.

As noted, the Petition requests the issuance of an Order that:

(1) Finds that the utility's proposed tariff supplement is in compliance with the Commission's Policy Statement at 52 Pa. Code §69.171; and

(2) Approves the accrual of an Allowance for Funds Used During Construction ("AFUDC") on the Company's investment in uneconomic main extensions.

On September 23, 1993, the Commission's Office of Trial Staff ("OTS") and the Office of Small Business Advocate ("OSBA") filed responses to the Petition.

On September 27, 1993, the Office of Consumer Advocate ("OCA") filed its response to the Petition.

For the reasons set forth below, we shall deny the Petition, without prejudice.

### Discussion

PAWC, after summarizing the essential legal principles on which this Commission based its statement of policy regarding the extension of facilities, takes the position that in view of its large size, it is unlikely that any single main extension to a bona fide service applicant would satisfy the standards of the policy statement. Consequently, according to PAWC, all main extensions requested by bona fide service applicants would have to be constructed at the utility's sole cost, notwithstanding that the revenue to be derived from the extension would not support such an investment. Petition, para. 5, p. 3.

Additionally, for reasons which are argued in a Memorandum of Law attached as Appendix B to the Petition, PAWC notes its disagreement with our interpretation of Ridley Township v. Pennsylvania Public Utility Commission, 172 Pa. Superior Ct. 472, 94 A.2d 168 (1953) (Ridley Township hereafter).

In its Memorandum of Law, PAWC argues that Ridley Township did not remove this Commission's discretion to consider the cumulative [emphasis added] effect of utility-funded main extensions in determining when bona fide service applicants should make customer advances. The utility refers us to Sherman v. Pennsylvania Public Utility Commission, 90 Pa. Superior Ct. 523 (1927) which it holds is the seminal case establishing the pertinent considerations involving uneconomic extensions of facilities. The following quotation is taken from Sherman:

We are not to be understood as holding that the extension of service of a public utility is dependent on the profit which may reasonably be expected therefrom; in proper cases such extensions may be ordered though the immediate result of the expansion may entail financial loss to the company; but the company should not be subjected to unreasonable expenditures, nor the consuming public be unduly burdened, because of the scattered section of the city in advance of its normal growth, when there is no rational expectation of the event justifying the expenditure.

Petition at B-2, citing Sherman v. PUC.

PAWC uses the holding in Sherman v. PUC to clarify how the customer advance or extension deposit mechanism has evolved. Under the customer advance mechanism, the service applicant is placed with the initial obligation to advance the cost of the main extension, subject to credits or refunds for each customer that takes service from the main within a designated period in the future (PAWC cites 10 -15 years as its norm). The credits or refunds are determined by reference to the utility investment that is economically justified by the anticipated revenue from an average customer. See Petition, B-3, citing Investigation of Accounting and Ratemaking Associated With Contributions in Aid of Construction and Customer Advances, Docket No. I-8800893 (Order entered June 14, 1989).

In its Memorandum of Law, PAWC further argues that the customer advance mechanism was considered and tacitly approved in Altoona v. PUC, 168 Pa. Superior Ct. 246, 77 A.2d 740 (1951), and in other cases subsequent to Sherman in United Natural Gas Company v. Pennsylvania Public Utility Commission, 153 Pa. Superior Ct. 252, 33 A.2d 752 (1943), and Fayette County Gas Company v. Pennsylvania Public Utility Commission, 153 Pa. Superior Ct. 271, 33 A.2d 761 (1943).

Finally, in its Memorandum, PAWC cites Ridley and post-Ridley decisions in support of its customer contribution position.

We turn to the proposed tariff revisions of PAWC's Petition. PAWC analyzed inquiries it received over a recent 18-month period from those who it determined would have been bona fide service applicants and concluded from this analysis that an investment of \$14 million would have been required to extend service to these customers. See Petition at page 5. Annualized, this investment was calculated at \$9.33 million. In an effort to mitigate the alleged cumulative adverse financial impact upon the utility of extensive investment in uneconomic main extensions, PAWC proposed certain revisions discussed below.

The pertinent tariff revision proposes to accrue Post-In-Service AFUDC on that portion of its investment in a main extension that is not supported by the revenues to be produced thereby. The revenue-supported investment in those facilities is determined by the following equation:  $I = NR \text{ Divided by } [DR + CC]$ .<sup>1</sup>

The amount of revenue supported investment will be recalculated at the conclusion of each base rate case, but not less frequently than one year. Based on the formula set forth, above, and PAWC's recent data, its revenue supported investment for a residential customer is \$1,900. See Petition at 10.

Also, PAWC requests that this Commission issue a declaratory order authorizing it to separately identify Post-In-Service AFUDC and record it as a deferred debit by applying the Company's AFUDC rate as determined in its most recent base rate case to its non-revenue supported investment in uneconomic main extensions. Specifically, PAWC proposes to record the entry pertaining to the non-revenue supported portion of the main extension from the date that the extension is placed in service

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<sup>1</sup> Where: I is PAWC's investment that is revenue supported; NR is the average net revenue per customer for the customer classification (residential vs. commercial) and reflects gross revenue less additional operating expenses incurred to serve the customer; DR is the average depreciation rate for facilities installed to serve an average residential customer (expressed as a decimal); and CC is the pre-tax weighted average cost of capital determined on the basis of the rate of return approved in the Company's last fully-litigated base rate proceeding and its currently effective marginal state and federal income tax rate.

until the effective date of rates reflecting the property in rate base, as an appropriate debit to Account 146 (Other Deferred Debits (Main Extensions)), and credit to Account 526 (Miscellaneous Non-Operating Revenues (Main Extensions)).

PAWC requests authorization to accrue Post-In-Service AFUDC for accounting purposes only. It states that if such authorization is granted, it intends to claim such Post-In-Service AFUDC as a part of its plant costs for all such main extensions that will be placed in service on or before the end of the applicable future test year utilized in rate filings made after or pending when the Commission issues the declaratory order sought here.

The Petition concludes with the acknowledgement that the Company does not share this Commission's view that the common law prohibits mandatory customer advances from bona fide service applicants.<sup>2</sup> As a result, the Company has advised all service applicants that it will continue to adhere to its existing tariff, as required by 66 Pa. C.S. §1303. PAWC states that if the Commission were to approve its requested tariff revision, "virtually all" pending complaint proceedings involving requests for service and extension of facilities could be resolved. Thus, suggests PAWC, administrative efficiency could result from our expedited consideration of the instant petition.

As noted, the OTS, the OCA and the OSBA responded to the Petition. We summarize their positions below.

The OTS requests that this Commission reconsider our interpretation of controlling case law and statement of policy concerning service extensions. The OTS agrees with the Company's review and interpretation of the abundance of case law which is cited as support for the proposition that a utility may require a contribution from a customer requiring a main extension where the revenue stream from the extension will be less than the utility's

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<sup>2</sup> We continue to paraphrase PAWC's position, noting that it is not an entirely accurate statement of the Commission's policy statement.

cost of construction. However, the OTS also urges us to deny the relief sought by PAWC in the Petition.

OTS' opposition to the relief requested is grounded in the observation that in failing to request a contribution from the bona fide service applicant seeking the extension, the Company will have insulated itself from the potential adverse effects of the policy statement. However, the OTS takes the position that the relief will, in all likelihood, materially and adversely affect PAWC's existing customers. See OTS Answer, pp. 2-3. Therefore, the OTS would support a request for a contribution from the customer seeking an uneconomic main extension rather than endorse the AFUDC relief in the Petition.

Additionally, the OTS notes that, as a general rule, AFUDC is a cost which accrues during construction. After construction is completed, no additional claims for carrying costs are allowed. See OTS Answer, page 6, citing Green v. Pennsylvania Public Utility Commission, 81 Pa. Commonwealth Ct. 55, 60, 473 A.2d 209 (1984).

Finally, the OTS objects to the PAWC proposal as excessive "fine tuning", antithetical to the usual ratesetting process. Pennsylvania Electric Company v. Pennsylvania Public Utility Commission, 509 Pa. 324, 502 A.2d 130 (1985). As a consequence, the OTS avers that no legitimate purpose is served by permitting deferred accounting treatment of Post-In-Service AFUDC.

The OCA also opposed the PAWC Petition. First, the OCA observed that the Company admits that any given main extension request is unlikely to present material hardship or create an undue burden for its ratepayers. Therefore, the OCA does not agree that the Petition is consistent with the Commission's policy statement.

Also, the OCA objects to the definition of bona fide service applicant. Implicit in the proposed tariff's definition is a more restrictive view of who is a bona fide service applicant. The Company's definition would exclude those persons whose water needs are adequately met by an alternative water source, such as a private well. See OCA Answer, p. 2. This is objectionable, as it,

inter alia, affords the Company's employees too much discretion in determining whether an applicant's water source is adequately meeting the applicant's needs.

Additionally, the OCA noted that if one were to consider the issue in the aggregate, PAWC has presented no specific facts to demonstrate that such requests have been, or will be in the future, unreasonably burdensome. According to the OCA, the vast majority of service requests would require projects which could be constructed over a period of three to six months and require expenditures of only several thousand dollars each. See OCA Answer, pp. 4-5.

Also, the OCA offers specific criticism of the Company's formula to determine the revenue supported investment in the facilities necessary to provide service. The OCA avers that the formula is without evidentiary support. See OCA Answer, p. 7. Also, the OCA states that PAWC does not support its rationale for using only a single year's worth of net revenues, depreciation, and return to determine its revenue supported investment. OCA Answer, p. 8. Also, the derivation of the AFUDC rate is unclear, notwithstanding the Company's citation to its prior rate proceeding.

At pages 10-13 of its Answer, the OCA further articulates its position. Essentially, the OCA emphasizes that the proposition that a public utility may refrain from meeting its obligations to serve the public simply because doing so would not enable it to make a profit is contrary to the "franchise concept". See OCA Answer, citing Milwaukee Electric Railroad Company v. Milwaukee, 252 U.S. 100, 105 (1920). In light of this Commission's determination of PAWC's cost of equity at 11.0% and an overall return of 9.6% from its most recent base rate proceeding, and assuming an estimated annual expenditure of \$9.33 million to meet the service requests is accurate, the OCA concludes that the annual expense for facilities extensions would comprise only 1.89% of the Company's rate base (\$491,788,654). OCA Answer, pp. 11-12. Therefore, according to the OCA, PAWC is not threatened with financial impairment by such requests for service.

Concerning PAWC's request for authorization to accrue Post-In-Service AFUDC on the plant necessary to meet its obligations to serve the requested main extensions, the OCA is opposed to the giving PAWC relief in the nature of "early window" accounting treatment. Usually, the Commission has granted early window petitions in situations where the capital investment involved in the specific project represents a disproportionate increase to a utility's rate base and where rate considerations could present potential harm to public health and safety concerns. OCA Answer, citing Petition of Mechanicsburg Water Company for Declaratory Order, Docket No. P-910500 (Order entered September 25, 1991) and Re Pennsylvania Power Company, 59 Pa. P.U.C. 541 (1985). The OCA cites, by analogy, a recent unsuccessful request for early window treatment concerning the Hershey Treatment Plant, to make the point that the present case is not comparable to the magnitude of the investment which the Commission considers substantial enough to warrant early window accounting treatment relief. See Docket No. P-920603 (Order entered October 22, 1992). Consequently, the OCA urges that PAWC's request for deferred accounting treatment be denied.

The OCA concludes its Answer with a response to the particular paragraph averments of the Company's Petition. Notably, we shall summarize the OCA's quintessential reply to the argument of PAWC: "The Commission has essentially stated, and the OCA agrees with its interpretation, that unprofitability of an extension cannot extinguish a utility's obligation to serve the public pursuant to 66 Pa. C.S. § 1501." OCA Answer, p. 16.

In the Answer of the OSBA, it argues that a business entity should not automatically be excluded from applying for or qualifying for a cost-free main extension pursuant to the Commission's policy statement. It refers us to a recent Order wherein this Commission, in affirming an Interim Emergency Order issued by ALJ Solomon (Order dated March 24, 1993), indicated that a business customer of a fixed utility qualifies as a bona fide applicant under the Commission's policy statement. See OSBA Answer, referencing Crums Mill Associates, et al. v. Dauphin Consolidated Water Supply Company, Docket No. C-009341810 (Order entered April 16, 1993). A decision on the merits of that case is pending. Id.

The OSBA goes on to elaborate its objection to the definition of applicant which would exclude business customers.

On consideration of the Petition, and the well stated positions of the OTS, the OCA, and the OSBA in their respective answers, we shall, as noted, deny PAWC's request, without prejudice.

In its Memorandum, we find it somewhat inconsistent that PAWC would argue that we are in error when we view Ridley Township as standing for the proposition that this Commission is without authority to consider the cumulative effects of an uneconomic main extension,<sup>3</sup> when PAWC would advocate what we consider its proposal to evaluate a request for service extension in isolation from the effects of such an extension on the overall profitability of the Company. We agree with the ultimate conclusion of the Memorandum, that is that this Commission has the discretion to determine the circumstances under which a utility shall be required to extend its facilities without a contribution from a service applicant. Yet, we do not entirely agree with the Company that the cost vs. revenues analysis, isolated to the uneconomic extension, is necessarily the advised course resulting from a reading of the appellate decisions.

Additionally, we find that another major area of controversy here is the PAWC's request for AFUDC for the "non-revenue supported portion of each main extension" or "Post-In Service AFUDC".

AFUDC is, in essence, a capitalization of funds used during the construction period of some particular rate base item (a

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<sup>3</sup> Our policy statement, contrary to PAWC's argument, states in pertinent part that "Only if a given extension of service would materially handicap the utility in securing a fair return on its investment or would place an undue burden on utility customers as a result of rate increases is the utility permitted to require a contribution-in-aid-of-construction from the service applicant. It is the Commission's policy to closely follow the common law established by the Pennsylvania appellate courts in reviewing the application of fixed utility line extension tariff provisions regardless of the language or parameters of a given line extension rule."

nuclear power plant, for example). Traditionally, a utility may accrue AFUDC until the particular project is put into service. At that time AFUDC stops being accrued and is capitalized, eventually to be included as part of the asset.

Some of the objectives accomplished through the use of AFUDC are the following:

1. The cost of the plant, including the construction financing cost, is fully recognized.
2. The utility operation is shielded from cost associated with construction activity.
3. The present customer is not burdened with supporting an investment designed for future needs.
4. The Company, by capitalizing the financing costs, is afforded an opportunity to recover these costs whenever the plant is placed in service (through depreciation of the costs and a return thereon until they are fully depreciated).
5. The customer of the future will pay the full cost of the facility constructed for his use<sup>4</sup>

PAWC argues that results of inquiries made over an 18-month period revealed that the Company could be required to make an investment of approximately \$14 million to extend service to those customers who could be considered as bona fide customers pursuant to the Commission's Policy Statement at 52 Pa Code §69.171. See Petition at 5. The Company argues that its earnings would be effected if an investment of that magnitude were to be made over an 18-month period and that regulatory action is required to mitigate the earnings erosion that will take place as a result of full, literal compliance with the Policy Statement.

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<sup>4</sup> See Deloitte, Haskins and Sells Public Utilities Manual, page 53.

The OTS, and the OCA properly note that PAWC's request for AFUDC differs from the traditional form in that it proposes to accrue AFUDC until the facilities are recognized in rate base as opposed to when the asset placed in service. This means, essentially, that AFUDC will be accrued until the next rate case is completed, and the facilities are, after due consideration by this Commission, included in rate base. Therefore, more AFUDC will be capitalized under the PAWC proposal than we have customarily recognized. Additionally, PAWC maintains that it will accrue post-in-service AFUDC on only the non-revenue supported portion of the facilities.

PAWC submits that it plans for and makes an orderly expansion of its distribution system on an annual basis. The Company states that investments in main extensions not made at the Company's initiative or pursuant to its own plan create unique problems in obtaining timely rate base recognition. PAWC continues that it attempts to time its rate increase requests such that the proposed future test year ends not long after the in-service dates of major construction projects. Consequently, the gap between the completion of Company-funded main extensions and the date that they are reflected in rates would thus become a new and significant source of earnings attrition for the Company.

On consideration of the position of PAWC, we are of the opinion that PAWC's AFUDC proposal should not be adopted at this time. Our determination is based on the following reasons which we will discuss in detail, below: 1) PAWC is totally insulated from risk; 2) the post-service AFUDC proposal is contrary to Commission practice and may result in the Company being overcompensated for its use of funds; and 3) given the Commission's Notice of Proposed Rulemaking,<sup>5</sup> adoption would be premature.

We are of the opinion that the PAWC proposal totally insulates the utility from risk normally incident to capital additions associated with new customers. Although we agree with the Company that the current policy statement contains general

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<sup>5</sup> See Advance Notice of Proposed Rulemaking On Line Extensions, adopted at Public Meeting of November 10, 1993.

principles that could result in very broad interpretations resulting in "uneconomic extensions", we do not agree that the Company should be unduly insulated from risk occurring during construction through to rate base recognition of main extensions. The observation of the OTS regarding "fine tuning" of expenses is applicable here.

Also, we disagree with the Company's proposal to accrue AFUDC beyond the in-service date of the facilities. We believe that the AFUDC accrued beyond the in-service date will inappropriately inflate the ratemaking value of the facilities. We believe further that the risk of installing main extensions is not comparable to the construction of a major facility such as a nuclear generating plant or large water treatment plant. We believe that the AFUDC proposal will make the Company more than whole given that the return for the use of funds during construction will be capitalized, thus resulting in a return on a return.

Finally, as noted, we have, at the Public Meeting of November 10, 1993, voted to initiate a rulemaking to establish regulations for line extension policies. PAWC, in its Petition, concedes that, "If the Commission has made a final decision that the Policy Statement will not be revisited or reconsidered, then it is essential that the Commission reconcile the goals expressed therein with the need for equitable regulatory treatment of the substantial added investment in utility property that would be required by a literal application of the principles embodied in the Policy Statement". Our rulemaking may address some of PAWC's concerns. However, considerations identified in the policy statement will continue to be applied to matters concerning facilities extensions.

#### Conclusion

Our conclusion regarding the instant Petition is that, in light of the initiation of the proposed rulemaking, the Petition should be denied, and the Company be given the opportunity to resubmit the subject of its Petition during the rulemaking; **THEREFORE,**

**IT IS ORDERED:**

1. That the Petition of Pennsylvania-American Water Company for a Declaratory Order... be and is, hereby, denied, without prejudice.

**BY THE COMMISSION**



**John G. Alford,  
Secretary**

(SEAL)

ORDER ADOPTED: December 15, 1993

ORDER ENTERED: **MAR** 8 1994

PENNSYLVANIA PUBLIC UTILITY COMMISSION  
Harrisburg, Pennsylvania 17105

PETITION OF PENNSYLVANIA-  
AMERICAN WATER COMPANY FOR  
A DECLARATORY ORDER

PUBLIC MEETING-  
DECEMBER 15, 1993  
DEC-93-OSA-256  
DOCKET NO. P-930717

STATEMENT OF COMMISSIONER JOHN M. QUAIN

I support the recommendation of the Office of Special Assistants to deny the petition of Pennsylvania-American Water Company ("PAWC") for the issuance of a company specific declaratory order as it relates to a policy for line extensions.

PAWC raises cogent arguments concerning the financial impact of our existing Policy Statement for line extensions. However, I am committed to using the investigation process initiated at public meeting on November 10, 1993 for the resolution of such issues.

In the interim, my preferred approach is to handle issues related to the existing line extension policy statement on a case by case basis, rather than a declaratory order for a single company.

I wish to emphasize that my vote to deny the Petition should not be interpreted as a denial of the substantive arguments raised by the Company. Rather, it represents my preference for the procedural vehicle already established for the disposition of line extension issues.

Nevertheless, I encourage PAWC to raise the arguments set forth in its petition in any future litigation which may arise during the pendency of our line extension rulemaking.

12-15-93

DATE

  
JOHN M. QUAIN, COMMISSIONER

COMMONWEALTH OF PENNSYLVANIA

**ORIGINAL**

BEFORE THE

PUBLIC UTILITY COMMISSION

PETITION OF )  
PHILADELPHIA SUBURBAN )  
WATER COMPANY FOR )  
APPROVAL TO IMPLEMENT )  
A TARIFF SUPPLEMENT )  
ESTABLISHING A )  
DISTRIBUTION SYSTEM )  
IMPROVEMENT CHARGE )

DOCKET NO. P-00961036

**DOCUMENT  
FOLDER**

STATEMENT OF RANDY M. ALLEN

ON BEHALF OF THE

OFFICE OF CONSUMER ADVOCATE

RECEIVED  
96 MAY -6 PM 4:03  
PA. P. U. C.  
INFO. CON. CONTROL DIV.

**DOCKETED**  
MAY 10 1996

May 6, 1996

**RMA** UTILITY CONSULTING

REGULATORY **M**ANAGEMENT **A**CCOUNTING

8775-M Centre Park Drive #357 Columbia, Md 21045 (410) 995-1625 Fax: (410) 995-1118

JLS

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**STATEMENT OF RANDY M. ALLEN**

**INTRODUCTION AND SCOPE**

1 Q. PLEASE PROVIDE YOUR NAME AND BUSINESS AFFILIATION.

2 A. My name is Randy M. Allen and I am the founder and president of RMA Utility  
3 Consulting at 8775-M Centre Park Drive #357, Columbia, Maryland, 21045. RMA Utility  
4 Consulting is a firm that specializes in litigation support, negotiation, and technical  
5 expertise in public utility accounting, taxation, and regulation.

6 Q. ON WHOSE BEHALF ARE YOU FILING THIS STATEMENT?

7 A. I am filing this statement on behalf of the Pennsylvania Office of Consumer Advocate  
8 (OCA).

9 Q. WHAT IS THE PURPOSE OF YOUR INVOLVEMENT IN THIS PROCEEDING?

10 A. RMA Utility Consulting was retained by OCA to provide independent analysis and expert  
11 response to the ratemaking and regulatory policy issues raised by Philadelphia Suburban  
12 Water Company's (PSWC's or Company's) Petition for Approval to Implement a Tariff  
13 Supplement Establishing a Distribution System Improvement Charge (DSIC). I will  
14 specifically address how the Petition is contrary to generally accepted ratemaking  
15 principles and sound regulatory policy.

16 Q. PLEASE PROVIDE A SUMMARY OF YOUR EDUCATIONAL BACKGROUND  
17 AND PUBLIC UTILITY REGULATORY EXPERIENCE.

18 A. I have close to 17 years of direct public utility accounting, taxation, ratemaking and  
19 regulatory experience and have testified or presented reports in over 100 gas, electric,

1 telephone, water or wastewater cases before the Federal Energy Regulatory Commission  
2 and regulatory agencies in Arizona, Florida, Georgia, Idaho, Louisiana, Maine, Nevada,  
3 New Jersey, New York, Pennsylvania, Texas, Utah, Virginia and West Virginia. I have  
4 also testified before legislative committees, district courts and various municipalities in  
5 Texas. I received a Bachelor of Science Degree in Accounting from Bentley College in  
6 Waltham, Massachusetts in June 1979. I am a Certified Public Accountant licensed in the  
7 States of Maryland and Texas, and I am a member of the American Institute of Certified  
8 Public Accountants and the Maryland Association and Texas Society of Certified Public  
9 Accountants. I served as the Chairman of the National Association of State Utility  
10 Consumer Advocates (NASUCA) Accounting and Tax Committee for two years (1988-  
11 1990) and was an observation member of the National Association of Regulatory Utility  
12 Commissioners (NARUC) Staff Subcommittee on Accounts (1988-1990). I have  
13 presented numerous papers and participated on panels before state and national  
14 professional associations and societies on utility ratemaking issues.

15 Q. WOULD YOU PLEASE PROVIDE A SUMMARY THAT DESCRIBES THE  
16 SPECIFIC JOB RESPONSIBILITIES YOU HAVE HAD OVER YOUR  
17 REGULATORY CAREER?

18 A. From June 1979 to August 1983, I was employed by Dallas Power & Light Company  
19 (Texas Utilities Electric Company) as an accountant. For approximately two years, my  
20 duties included various general accounting functions, preparation of rate filing schedules,  
21 and review of written testimony for rate increase applications brought before the Public  
22 Utility Commission of Texas. During my last two and one-half years with the Company, I

1 served as Supervisor of Corporate Taxation where I was responsible for federal tax  
2 research and accounting, and all state and local tax research, reporting and accounting.

3 In September 1983, I was employed by the Public Utility Commission of Texas and  
4 obtained the position of Manager of Electric Accounting as a Chief Accountant III. In this  
5 position, I was responsible for supervising the electric accounting staff, assisting in the  
6 development of ratemaking procedures and policies, and testifying on cost of service and  
7 invested capital issues in rate cases brought before the Commission.

8 In June 1985, I joined the engineering and consulting firm of R.W. Beck and Associates as  
9 a Supervising Analyst. In this position, I was responsible for supervising the day-to-day  
10 accounting activities associated with rate increase analyses of gas and electric investor-  
11 owned utilities and presenting testimony and/or reports before municipal and state  
12 jurisdictional agencies. In July 1986, I was employed by Pannell Kerr Forster (PKF), an  
13 international certified public accounting and consulting firm, as a Managing Supervisor.

14 In this position, my responsibilities included the examination, review and analysis of rates  
15 and rate increase applications of municipal and investor-owned electric, gas, telephone,  
16 water and wastewater utilities, and the presentation of testimony on accounting matters.

17 Following a merger between PKF and a local accounting firm, my department was  
18 disbanded and the office eventually closed. For approximately six months, I worked as an  
19 Executive Consultant for Resource Management International, Inc., performing municipal  
20 rate studies and forecasting results of operations for municipal revenue bond financings.

1 In December 1987, I joined the Texas Office of Public Utility Counsel as the Director of  
2 Regulatory Accounting. In this position, I was responsible for managing and formulating  
3 expert testimony regarding electric and telephone utility regulatory accounting issues,  
4 assisting Public Counsel in developing policies and negotiating positions, and presenting  
5 policies and negotiating settlements on behalf of the Public Counsel. I also provided  
6 outside independent consulting services regarding gas and water utility matters when my  
7 schedule permitted.

8 In October 1990, I joined Exeter Associates, Inc., as a Senior Regulatory Accountant. In  
9 this position, I analyzed various rate and regulatory issues and provided testimony in  
10 electric, gas, telephone and water proceedings. In December 1995, I founded RMA  
11 Utility Consulting.

12 Q. IN CONNECTION WITH THIS PRESENT CASE, HAVE YOU PERFORMED  
13 AN EXAMINATION AND REVIEW OF THE COMPANY'S PETITION?

14 A. Yes, I have reviewed the Company's Petition and various other publicly available  
15 Company data.

16 Q. WOULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING  
17 THE PETITION?

18 A. Yes. I have concluded that the proposed DSIC treatment is (1) contrary to sound  
19 regulatory policy, (2) violates generally accepted ratemaking principles, (3) provides the  
20 Company with more than a reasonable opportunity to earn a reasonable return, and (4) is  
21 unsubstantiated by the Petition.

22 Q. WOULD YOU PLEASE BRIEFLY EXPLAIN THE COMPANY'S REQUEST?

1 A. The Company has requested the Commission's approval to establish a DSIC to allow it to  
2 recover the fixed costs (depreciation and pre-tax return) of certain "non-revenue  
3 producing, non-expense reducing distribution system improvement projects completed and  
4 placed in service between base rate cases." (Petition, page 1, Section I.1.)

5 Q. WHAT DOES THE COMPANY CLAIM THE DSIC WILL ACCOMPLISH?

6 A. According to PSWC, "the DSIC is designed to provide the Company with the resources it  
7 needs to accelerate its investment in new utility plant to replace aging water distribution  
8 infrastructure, facilitating compliance with evolving regulatory requirements imposed by  
9 the Safe Drinking Water Act ("SDWA") and the implementation of solutions to regional  
10 water supply problems." (Petition, page 2, Section I.1.) (Emphasis added) It should be  
11 noted that in 1994, the Company claimed it had already met or exceeded all of the current  
12 standards of the SDWA. In addition, the Company has received proclamations from both  
13 the Pennsylvania House of Representatives and the Montgomery County Board of  
14 Commissioners for its commitment to quality drinking water. Further, PSWC has the  
15 lowest customer complaint ratio of any investor-owned public utility in the  
16 Commonwealth-for the third consecutive year regarding quality water and service. (1994  
17 annual report to stockholders) It appears as though the Company's message to its  
18 stockholders and the investment community is not entirely consistent with the dim  
19 prediction of future water quality degradation the Company is now using to argue for the  
20 DSIC.

21 Q. WHY DOES THE COMPANY BELIEVE THE DSIC IS THE NEEDED  
22 SOLUTION?

1 A. The Company claims that “innovative alternatives to traditional base rate filings are  
2 essential if the Company is to meet the engineering, environmental and financial challenges  
3 of infrastructure replacement and rehabilitation.” (Petition, page 2, Section I.1.)  
4 Apparently, the Company believes the DSIC is the only mechanism that will provide it  
5 with the “...resources it needs to make improvements in a timely and orderly fashion.”  
6 (Petition, page 3; Section I.1.) PSWC also expresses concern about its ability to maintain  
7 access to the capital markets “on reasonable terms.”

8 Q. WHY DOES PSWC ASSERT THAT IT IS CONCERNED ABOUT ACCESSING  
9 THE CAPITAL MARKETS?

10 A. It is the Company’s claim that the relatively risk-free nature of the water business is a  
11 thing of the past, where “sources of supply were abundant, water quality concerns were  
12 few and capital requirements were minimal and largely attributable to requests for new  
13 service.” (Petition, pages 5-6, Section II.8.) PSWC now blames legislative and regulatory  
14 initiatives for the need to significantly invest in new utility plant. This increased need for  
15 improved infrastructure, and tightened credit rating benchmarks, (Petition, page 9, Section  
16 II.15.) has led PSWC to conclude that it must incorporate innovative alternatives to  
17 traditional base rate regulation if it “is to have a meaningful opportunity to recover its  
18 capital costs....” (Petition, page 10, Section II.16.)

19 Q. DO YOU HAVE ANY INFORMATION TO INDICATE THAT PSWC IS  
20 HAVING ANY SUCH TROUBLE?

21 A. No. In fact, the Company’s 1995 annual report claims that its growth in 1995 dividends  
22 was due to an expansion of the Board’s confidence in the Company’s strategy of growth  
23 through acquisitions, revenue increases from customer growth and timely rate relief that

1 should permit positive financial results to continue into the future. As the Chairman and  
2 President of PSWC concluded, "the Company...is growing in customers, revenues, profits  
3 and overall shareholder value." In addition, PSWC was named one of the three "TOP  
4 INCOME CHOICES" for water utilities in the November 1994 issue of MONEY  
5 Magazine. As reported, water utilities are seen as an extremely low-risk way to earn at  
6 least 9% a year.

7 REGULATORY POLICY AND GENERALLY ACCEPTED SOUND RATEMAKING  
8 PRINCIPLES

9 Q. WOULD THE PROPOSED DSIC REPRESENT GOOD REGULATORY POLICY?

10 A. No. While good regulatory policy creates incentives for utilities to achieve cost  
11 reductions through productivity and efficiency improvements, the DSIC would provide a  
12 disincentive to make such cost reductions. This would happen, in part, because as the  
13 Company states, it "would be in a better position to absorb increases in other categories of  
14 costs..." if the DSIC was approved. (Petition page 18, Section IV. 26d.) In addition,  
15 because of the unexplained Rate of Return Cap included in the Petition, an incentive exists  
16 to hold down return by not reducing expenses already included in rates so that the Cap  
17 mechanism would not result in an elimination of the DSIC. Adoption of the proposed  
18 surcharge would reverse the normal incentives to reduce expenses and increase efficiency  
19 at work between base rate filings.

20 Another ratemaking policy ties the determination of the rate of return on equity to a  
21 determination of normal business risks encountered by individual utilities. Regulatory lag  
22 has always been one such risk considered by regulators. Since Pennsylvania uses a future  
23 test year concept for ratemaking purposes, the risk of regulatory lag is significantly

1 reduced compared to a historical test year concept jurisdiction. Adoption of the proposed  
2 surcharge would reduce the risk of regulatory lag even further, if not completely insulating  
3 the Company from such risk. Without correspondingly reducing the rate of return to be  
4 used by PSWC to calculate the surcharge, the proposed surcharge would represent bad  
5 regulatory policy.

6 Q. DO THE ALLEGATIONS IN PSWC'S PETITION SUPPORT ANY  
7 VARIATION FROM PRINCIPLES OF GOOD REGULATORY POLICY?

8 A. No. In fact, the Petition contains several inconsistencies. While the Company stresses  
9 the need for the DSIC is related to the accelerated portion of infrastructure  
10 improvements, it has included both the ongoing normal level of such replacements and  
11 the accelerated component in the DSIC mechanism. On its face, and assuming all  
12 allegations are correct, the Petition would justify surcharge treatment for only the  
13 incremental improvements between base rate cases in excess of the 15 miles per year,  
14 not all improvements.

15 Q. PLEASE EXPLAIN FURTHER WHY THE SURCHARGE WOULD  
16 CONTRADICT SOUND RATEMAKING PRINCIPLES.

17 A. No. The heart of the Company's Petition attacks the very core of the test year concept of  
18 cost based ratemaking. That is, PSWC wants to avoid the components of regulatory lag  
19 that go against shareholders, while retaining the components that benefit shareholders.  
20 This asymmetrical approach violates sound ratemaking principles, including piecemeal  
21 ratemaking, the matching principle, and the test year concept. The test year concept calls  
22 for the use of consistency, in that if you look beyond the snapshot test period for one item,  
23 you must also look beyond the period for all items that effect the level of rates. This

1 consistency has been one of the cornerstones of ratemaking for many years. Only in this  
2 manner can revenues, expenses, and capital costs be synchronized.

3 Q. WHEN IS THE USE OF SPECIAL SINGLE ISSUE SURCHARGES  
4 APPROPRIATE?

5 A. Traditionally, the use of such surcharges are limited to unique expenses that have a  
6 significant financial impact and are either outside of management's control, or are  
7 particularly volatile in nature. Also, such surcharges do not generally apply to capital  
8 costs and rate base items.

9 Q. DOES THE PROPOSED SURCHARGE MEET THESE CRITERIA?

10 A. No. The Company has not shown that the impact of infrastructure improvements and  
11 additions between rate cases has a significant financial impact, nor that they are outside  
12 the control of management, nor that the related casts are volatile in nature. As will be  
13 seen, the financial impact of the proposed DSIC is not material. Further, there is no  
14 question that the issue of maintaining infrastructure to provide safe and adequate service is  
15 central to fulfilling the utility's obligation to serve, and that the planning and progress of  
16 such construction is completely within the control of management, as is the frequency of  
17 base rate filings. Finally, the Company's construction budgeting process, use of vintage  
18 year plant data and historical experience have, therefore, enabled PSWC to maintain  
19 infrastructure as part of a construction program feasible within the traditional ratemaking  
20 process.

21 Q. WHY WOULD THE PROPOSED DSIC REPRESENT PIECEMEAL  
22 RATEMAKING AND VIOLATE THE MATCHING PRINCIPLE?

1 A. The proposed treatment represents piecemeal ratemaking because rates will be changed  
2 to reflect the effect of only two limited cost of service items which were already  
3 considered for the future test year in the last base rate proceeding. The matching  
4 principle will be violated because rates will be based on revenues and expenses at a  
5 different point in time than that which rate base will be measured. As a result, the  
6 Company will earn a return on investment to serve a level of customers for which  
7 operating income will not be reflected in base rates. It has been a long-standing  
8 principle that when rates are changed, all components of revenue requirements must be  
9 open to review and analysis to ensure that all changes are reflected and the Company  
10 has no more, or less, than a reasonable opportunity to earn a reasonable return based on  
11 a matched snapshot period of time. The Company's proposal would result in a  
12 guaranteed recovery of a return on main infrastructure replacements and could possibly  
13 generate a return higher than would be justified if all components of the ratemaking  
14 formula were considered during the surcharge effective period.

15 Q. ARE THERE ANY SPECIFIC EXAMPLES OF SUCH REVENUE AND COST  
16 CHANGES THAT PSWC'S PROPOSED DSIC IGNORES?

17 A. Yes. The Company's earnings can be affected by many changes in revenue and cost  
18 events, some under the control of the Company, such as declining real dollar costs per  
19 customer resulting from the company working "extremely hard to keep its expenses in  
20 check," (Petition page 9, Section II.14.) and some not under the Company's control, such  
21 as increased sales growth or a decline in capital costs brought on by a change in the  
22 economy. The regulatory process is full of annualizations and normalizations which are  
23 aimed at meeting sound regulatory principles. Some examples include the annualization

1 of sales at a point in time that matches the level of plant included in rate base, the  
2 recalculation of actuarial determined accruals to account for current economic conditions,  
3 and the normalization of accrual reserves to reflect more current conditions. The point is  
4 that base rates should not be adjusted unless all revenue requirement components are  
5 subject to regulatory scrutiny, and the DSIC would effectively increase base rates  
6 without such scrutiny.

7 Q. ARE THERE ANY RATE BASE ITEMS THAT THE COMPANY'S PROPOSAL  
8 IGNORES?

9 A. Yes. At the same time the Company is investing in additional plant infrastructure, it is  
10 recovering outstanding plant investment in the form of depreciation expense. This  
11 recovery is recorded in the depreciation reserve in recognition that ratepayers have  
12 returned capital to the Company. This collection of depreciation reduces the Company's  
13 capital costs.

14 Q. ARE THERE LIKELY EXAMPLES OF REDUCED EXPENSES THAT WOULD  
15 IMPACT UPON CURRENT RATES?

16 A. Yes. Since the Company's last rate case, the country has experienced a significant  
17 reduction in the annual rate of medical cost increases. Rather than the 12% used by the  
18 Company's actuary in developing the accrued postretirement benefits in the last rate case,  
19 medical costs actually increased at a rate below inflation. This means that actuaries across  
20 the country are adjusting their accrual calculations to include a medical trend rate that  
21 better matches current conditions. Reducing PSWC's accrual from a 12% rate to a more  
22 currently representative rate would significantly reduce the postretirement benefits  
23 expense.

1 Q. DOES THE COMPANY MENTION THE ISSUE OF INCREASED SALES?

2 A. Yes. PSWC states that "if sales to existing customers grew at a rate sufficient to offset the  
3 Company's mounting capital costs, the lag in recognition of new plant additions would  
4 obviously pose a far less serious problem." (Petition pages 8-9, Section II.14.) In  
5 addition, the Company states in its 1994 annual report that it "is growing in customers,  
6 revenues, profits and overall shareholder value. The Company also indicates that between  
7 1971 and 1994 the average residential gallons sold per customer fell by over 18%.  
8 However, total average consumption per customer between 1992 and 1994 has actually  
9 increased by 0.69%. The Company also fails to report that the declining consumption in  
10 previous years was partially in response to conservation measures.

11 Q. ARE THERE ANY OTHER COST SAVINGS ISSUES?

12 A. Yes. In its notice of filing of the Petition (Petition Exhibit H), PSWC explains that the  
13 DSIC "...should also allow PSW to level the cost of water losses and leak repairs." A  
14 reduction in water losses and leaks directly results in a reduction for unaccounted for  
15 water which is a cost included in rates.

16 "NON-REVENUE PRODUCING AND NON-EXPENSE REDUCING" PLANT

17 Q. ARE THERE WAYS IN WHICH THE PROPOSED DSIC WILL AFFECT  
18 EXPENSE LEVELS?

19 A. Yes. Contrary to PSWC's claims, replacing, cleaning, and lining aging distribution mains  
20 will result in reduced ongoing O&M expenses for repairs and maintenance. In addition,  
21 the Company attempts to support its proposed DSIC by arguing that "customers would  
22 obviously benefit from the reduction in rate case frequency and the resulting reduction in  
23 associated administrative costs..." (Petition page 18, Section IV.26d.) (Emphasis added)

1 According to the Company, "...PSWC would be in a better position to absorb increases in  
2 other categories of costs..." if the DSIC was approved. (Petition page 18, Section  
3 IV.26d.)

4 Q. DOES THE PROPOSED DSIC RESULT IN ANY OTHER EXPENSE  
5 REDUCTIONS?

6 A. Yes. The proposed DSIC will result in direct reductions to depreciation expense and  
7 overall return. If approved, the DSIC mechanism will result in the acceleration of  
8 replacing and rehabilitating distribution plant earlier than would be required by the related  
9 age of such property. This will result in the new plant having a longer estimated useful life  
10 than the replaced or rehabilitated plant. To the extent the average remaining life becomes  
11 longer than the current average of 66 years, the related depreciation rates should be  
12 reduced. Unless these reduced rates are reflected in cost of service through a base rate  
13 filing, these reduced costs will not benefit ratepayers. Likewise, as the Company moves  
14 from its current debt ratio of 50.15% toward 60%, the more costly equity return will  
15 represent a lower percentage of the total capital structure. This in turn will reduce the  
16 Company's overall cost of capital, yet such savings will not be reflected as reduced rates  
17 without a base rate filing. Specifically based on Exhibit B of the Petition and as presented  
18 on Attachment 1, this change in capital structure will reduce the pre-tax rate of return by  
19 109 percentage points.

20 RATE OF RETURN CAP

21 Q. WOULD YOU PLEASE SUMMARIZE THE RATE OF RETURN CAP  
22 INCLUDED IN THE DSIC?

1 A. According to the Petition, the DSIC will be reset at zero if the most recent rate of return  
2 exceeds the rate of return used to calculate the fixed costs under the DSIC. (Petition, page  
3 5, Section I.7., and page 26, Section VI.40.)

4 Q. DOES THIS RATE OF RETURN CAP PROVIDE CUSTOMERS WITH ANY  
5 REAL PROTECTION AGAINST EXCESSIVE RETURNS DUE TO EXPENSE  
6 REDUCTIONS?

7 A. No. The Cap does not limit earnings based on a reasonable rate of return determined  
8 within the capital markets as they may exist at the time of each quarterly calculation.  
9 Specifically, the Cap has its basis in the Company's last authorized capital structure, cost  
10 of debt and preferred stock (unless such cost rates are lower than the last authorized  
11 levels). The return on equity will either equal the last authorized level for PSWC, if  
12 authorized within the past 2 years, or the most recent level authorized by the Commission  
13 for an investor-owned water-utility having revenue in excess of \$10.0 million (Petition  
14 page 25, Section VI.35.), assuming one has been adopted. Since PSWC has not had a  
15 litigated equity return determination in the past two years, its DSIC calculation presented  
16 on Exhibit B of the Petition uses the 11.25% ROE from PAWC's last litigated rate case.  
17 However, since the filing of the Petition, the Commission has adopted a lower 10.8%  
18 ROE in the Citizens Utilities Water Company litigated case. As the Company is well  
19 aware, the financial risks of PSWC are not necessarily as high as other water companies in  
20 Pennsylvania, therefore, even the most recent lower authorized rate of return on equity for  
21 Citizens may have no realistic relationship to PSWC capital costs during the effective  
22 period. This poses another potential risk that ratepayers will be paying on an unreasonably  
23 high rate of return to the benefit of shareholders.

1 Q. SHOULD THE PRE-TAX RATE OF RETURN EVEN BE USED TO  
2 CALCULATE THE FIXED COST IF THE DSIC IS ADOPTED?

3 A. No. By including equity return in the DSIC, PSWC is not including just the cost of  
4 obtaining funds for infrastructure, but also a level of shareholder profit which by itself  
5 reflects increased net revenue and creates additional tax expense. Considering that PSWC  
6 is far from obtaining a 60% debt ratio, it is most likely that any accelerated funds will  
7 come from debt sources, not equity issuances.

8 SUBSTANTIATION AND BURDEN OF PROOF

9 Q. HAS THE COMPANY PROVIDED ANY ANALYSES OR EMPIRICAL  
10 STUDIES TO SUBSTANTIATE ITS POSITION?

11 A. No. There are no studies to show how or why infrastructure improvements require  
12 acceleration. What little data is presented is contradictory. There has been no showing  
13 that the Company faces any increased risks of recovering its investments under base rate  
14 regulation. In fact, these same arguments in regard to infrastructure replacement and  
15 rehabilitation have been raised since at least 1991. (Public Utility Fortnightly, September  
16 1, 1991, page 11) The mere immaterial nature of the original proposed DSIC of 0.45%  
17 and the maximum cap of 5% calls the Company's claims into question. If the Company  
18 could show that it was facing increased capital risks, it has not provided any justification  
19 for transferring that risk from shareholders to ratepayers outside of a base rate case.

20 The recurring theme of the Company's Petition is that the economic and regulatory  
21 pressures of recent years require it to accelerate its activities. According to PSWC,  
22 revenue-neutral infrastructure replacement projects are a large and increasing component  
23 of the total construction budget. (Petition page 8, Section II.13.) To support this claim,

1 the Company provided a bar graph on Exhibit D with no supporting empirical data. A  
2 visual review, however, indicates that there was an increase during 1992 through 1994,  
3 with relatively no change from 1994 to 1995. In fact, 1994 capital additions reflected a  
4 2.1% decline from 1993. Of course, this experience is affected by the Company's  
5 acquisitions completed in 1994 as reported in the 1994 annual report to stockholders.

6 Q. IS IT YOUR CONCLUSION THAT PSWC'S MAINS ARE RELATIVELY  
7 YOUNG?

8 A. Yes. I performed a study of the percentage level of mains depreciated by PSWC as of  
9 December 31, 1993, compared to other large water utilities with over \$100,000,000 of  
10 distribution plant. The lower the ratio of depreciation reserve to depreciable plant, the less  
11 depreciated and the younger the plant is, and the longer remaining useful life it has. This  
12 study, which is presented on Attachment 2, reveals that in 1993 PSWC had experienced a  
13 reserve to plant ratio of 15.27%. The other large water companies experienced a  
14 weighted average ratio of depreciation reserve to depreciable plant of 21.91%, with  
15 PSWC being the third lowest of these companies. This suggests that PSWC is only about  
16 two-thirds as depreciated as the other large companies and should be further from  
17 requiring accelerated plant replacements than other water companies.

18 Q. DO YOU AGREE WITH THE COMPANY THAT MAINTAINING ACCESS TO  
19 CAPITAL MARKETS "HAS BEEN MADE ALL THE MORE DIFFICULT BY  
20 STANDARD AND POOR'S ("S&P") TIGHTENING OF THE RATINGS  
21 BENCHMARKS FOR WATER UTILITIES?" (Petition, page 9, Section II.15.)

1 A. No. The issuance of tightened benchmarks in and of itself does not prevent “meaningful  
2 opportunity to recover capital costs...” (Petition, page 10, Section II.16.) Besides, these  
3 new benchmarks were published approximately 4 years ago in June 1992.

4 CONCLUSIONS

5 Q. WOULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING  
6 THE COMPANY’S PETITION?

7 A. As stated earlier, I have concluded that the proposed DSIC treatment is (1) contrary to  
8 sound regulatory policy, (2) violates generally accepted ratemaking principles, (3)  
9 provides the Company with more than a reasonable opportunity to earn a reasonable  
10 return, and (4) is unsubstantiated by the Petition.

11 Q. WHY WOULD THE PROPOSED DSIC TREATMENT EXEMPLIFY BAD  
12 REGULATORY POLICY?

13 A. The proposed treatment would be bad policy because it creates a disincentive for PSWC  
14 to achieve cost reductions through productivity and efficiency improvements, partly  
15 because the Company plans to use the increased financial results “to absorb increases in  
16 other categories of costs...” (Petition page 18, Section IV. 26d.), and because PSWC can  
17 avoid the rate of return Cap by not reducing expenses already included in rates. In other  
18 words, by avoiding regulatory review on a fairly regular basis, the Company can relax  
19 its attempt to reduce costs, while enable it to avoid the Cap. In addition, adoption of the  
20 proposed surcharge would reduce the risk of regulatory lag even further than the use of a  
21 future test year concept, if not completely insulating the Company from such risk.

22 Finally, proposed treatment would reflect bad regulatory policy by allowing specialized

1 treatment of routine expenditures that does not exist in a non-monopoly, competitive  
2 world.

3 Q. HOW DOES THE PROPOSED TREATMENT VIOLATE GENERALLY  
4 ACCEPTED RATEMAKING PRINCIPLES?

5 A. The result of the proposed treatment is that PSWC will avoid the components of  
6 regulatory lag that go against shareholders, while retaining the components that benefit  
7 shareholders. This asymmetrical approach violates sound ratemaking principles, including  
8 piecemeal ratemaking, the matching principle, and the test year concept. It relies on an  
9 inconsistent view beyond the snapshot test period to reflect the effect of only two limited  
10 cost of service items and will base rates on revenues and expenses at a different point in  
11 time than that which the rate base will be measured. Finally, rates will be changed without  
12 all components of revenue requirements being open to review and analysis.

13 Q. HOW COULD THE PROPOSED SURCHARGE PROVIDE THE COMPANY  
14 WITH MORE THAN A REASONABLE OPPORTUNITY TO EARN A FAIR  
15 RETURN?

16 A. The proposed treatment allows the Company to break off a single issue component of net  
17 operating income as a reconcilable separate surcharge which guarantees recovery of the  
18 associated rate of return. At the same time, the Company's earned return is not  
19 reconcilable for changes in revenues and expenses not separately broken off. Finally, the  
20 positive effects on risks and net operating income of the proposed treatment itself are not  
21 reconciled with the current rates.

22 Q. PLEASE IDENTIFY THE UNSUBSTANTIATED CLAIMS INCLUDED IN THE  
23 PETITION?

1 A. The following provides a number of these unsubstantiated claims that raise significant  
2 concern regarding the merits of the Petition:

3 • *Innovative alternatives to traditional base rate filings are essential if the Company is to*  
4 *meet the engineering, environmental and financial challenges of infrastructure*  
5 *replacement and rehabilitation.* (Petition, page 2, Section I.1.) -- The Company fails to  
6 show that traditional base rate filings fail to adequately address the issue of infrastructure  
7 replacements and rehabilitation. In fact, the amount of utility plant additions and  
8 replacements made since the previous rate decision is among the considerations the  
9 Company uses when deciding to file a base rate case. Further, aggressive main cleaning  
10 and lining is a part of the Company's normal operations. (1994 annual report)

11 • *The magnitude of the problem is formidable.* (Petition, page 2, Section I.1.) -- The  
12 Petition fails to show that a problem even exists, let alone attempt to quantify the  
13 magnitude of the problem. The Company has failed to prove that it cannot access capital  
14 markets at reasonable costs under base rate regulation, that it even needs to accelerate its  
15 infrastructure replacements and rehabilitations, or that the resulting affect of the DSIC is  
16 even material in nature. In its 1994 annual report to stockholders; the Company even  
17 reported a 2.1% decline in capital additions.

18 • *...it is imperative that the Company find a way to substantially increase its rate of*  
19 *infrastructure rehabilitation.* (Petition, page 3, Section I.2.) -- This statement is based on  
20 the erroneous conclusion that all of the infrastructure replacements or rehabilitation are

1 required within 66 years. In reality, 66 years is not the actual remaining life of current  
2 infrastructure investments, but the average remaining life of such investment. Instead of  
3 needing to complete the replacement and rehabilitation work within 66 years to "...avoid a  
4 serious shortfall between the end of the service lives of existing property and the  
5 replacement or rehabilitation of that property" (Petition, page 13, Section III.22.), the  
6 Company actually has 132 years. In addition, the Company has not provided a vintage  
7 year break down of the required capital work to enable proper investigation into its claims.

8 • *...any degradation of quality or flows would present unique public health and safety*  
9 *concerns.* (Petition, page 3, Section I.1.) -- Nobody would deny the fact that a  
10 degradation of water quality could present health and safety concerns. However, the  
11 Company includes this statement in a way to imply that it will realize a degradation of  
12 water quality if it does not receive the proposed DSIC. There is no information contained  
13 in the Petition that addresses water quality in any empirical manner, let alone proving  
14 imminent degradation.

15 • *Simply stated, the integrity of the Company's distribution system and its future viability*  
16 *may be jeopardized if it is not given the necessary regulatory flexibility to deal with this*  
17 *problem.* (Petition, page 7, Section II.10.) -- Once again, the Company has provided no  
18 data to substantiate any "problem."

19 • *...it is critically important that PSWC maintain access to the capital markets on*  
20 *reasonable terms. While this task would be formidable under normal circumstances, it*

1 has been made all the more difficult by Standard and Poor's ("S&P") tightening of the  
2 ratings benchmarks for water utilities. (Petition, page 9, Section II.15.) -- While it is  
3 important for PSWC to maintain access to capital markets, the Company has not provided  
4 any data to support its claim the S&P's benchmarks have actually made it "all the more  
5 difficult" to maintain such access. The tightened benchmarks, on the other hand, were  
6 published 4 years earlier in June 1992.

7 • *Consequently, even for a water utility that files for rate relief on an annual basis, there*  
8 *is, on average, a six to seven month gap when its investment in revenue neutral,*  
9 *replacement plant is earning neither a paper (i.e., AFUDC) nor a cash return.* (Petition,  
10 page 12, Section III.20.) -- This type of regulatory lag does not exist in a future test year  
11 state because the rates are placed in service on the first day of the 12-month period for  
12 which cost of service and rate base are measured. Instead, regulatory lag can only result  
13 if the level of actual investment during the rate year is greater than the level of future test  
14 year investment used to set rates. This type of regulatory lag is considered as part of  
15 normal business risks and is accounted for in advance when setting the rate of return on  
16 equity. This is undoubtedly one of the reasons that S&P identified Pennsylvania as "a  
17 supportive regulatory environment" in Pennsylvania-American's last credit report.

18 • *Without the DSIC, the cost recovery and attrition problems created by infrastructure*  
19 *replacement and main extension projects will only get worse...* (Petition, page 13, Section  
20 III.21.) -- The Company has provided no empirical study of attrition to support an  
21 argument that it is a problem. As addressed previously throughout this Statement, the

1 revenue growth and expense declines suggest negative attrition, which actually improves  
2 the Company's ability to recover costs.

3 • *...the growth in rate base confronting PSWC is not dissimilar, at least in percentage*  
4 *terms, to that experienced by the electric utility industry in the 1980s with the completion*  
5 *of nuclear generating plant construction. (Petition, page 14, Section III.23.) -- There is*  
6 *no basis for comparing the water industry to the electric industry. Even S&P recognizes*  
7 *the generally low business risk in the water utility industry. In fact, it is partially due to*  
8 *the very differences in the financial ratios pointed out by PSWC that the 2 industries are*  
9 *different in nature, and that the water industry is less risky. Finally, PSWC's caveat that*  
10 *its statement is true "at least in percentage terms" creates serious doubt as to its validity,*  
11 *because percentages are no substitute for absolute data.*

12 • *Establishment of the DSIC would enable the Company to address, in an orderly and*  
13 *comprehensive manner, the problems presented by aging transmission and distribution*  
14 *systems. (Petition, page 16, Section IV.26a.) -- Considering the lack of empirical data, it is*  
15 *clear that the Company's proposal is not comprehensive. The Company has not provided*  
16 *any plan of action, any break down of the level of investment by age or date of*  
17 *replacement, and has overstated the age of infrastructure investment. As previously*  
18 *shown, PSWC actually has the third youngest infrastructure of large water companies*  
19 *across the country.*

1 • *Approving a mechanism for prompt and reasonable cost recovery for these kinds of*  
2 *projects will give the Company the operating flexibility to properly plan for and to*  
3 *accelerate the pace at which these projects are undertaken and completed.* (Petition, page  
4 17, Section IV.26b.) -- The only operating flexibility the Company needs is to request a  
5 reasonable and necessary level of future test year infrastructure investment within the  
6 confounds of a base rate filing. If the requested level is supportable, it will be included in  
7 rate base and receive proper treatment. The Company already admitted that "...absent a  
8 mechanism like the DSIC, the Company will have no choice but to continue to seek base  
9 rate relief on a regular basis ..." (Petition, page 14, Section III.22.) This statement alone  
10 is proof enough that the DSIC is not the end-all approach it is made out to be. By  
11 adopting the proposed treatment, the Company is given more of a blank check approach  
12 to invest over time without meeting the traditional reasonable and necessary tests. Once  
13 again, since Pennsylvania operates as a future test year state, the base rate process  
14 provides the operational flexibility the Company needs.

15 • *This analysis is not mere hyperbole...* (Petition, page 18, Section IV.26e.) -- In light of  
16 the fact that PAWC provided no analysis regarding deferral of infrastructure rehabilitation,  
17 the Petition should not be granted because it is unsubstantiated. Although some of the  
18 statements may be true of water companies generally, the acceptance or rejection of the  
19 Petition should be based on the facts and circumstances as they relate to PSWC, not to  
20 other water companies.

21 Q. DOES THIS CONCLUDE YOUR STATEMENT?

22 A. Yes, it does.

STATE OF MARYLAND            )  
  )  
COUNTY OF HOWARD         )        SS:

Personally appeared before me, a Notary Public in and for said State and County, Randy M. Allen, Founder and President of RMA Utility Consulting who, being duly sworn according to law, deposes and says that the facts set forth in the foregoing Statement are true and correct to the best of his knowledge, information and belief.

Randy M. Allen  
Randy M. Allen, President

Sworn to and subscribed before me

this 6th day of May, 1996

M. Lynn Murdza  
Notary Public

M. LYNN MURDZA  
NOTARY PUBLIC STATE OF MARYLAND  
My Commission Expires October 2, 1999

PHILADELPHIA SUBURBAN WATER COMPANY  
EFFECT OF 60 PERCENT DEBT RATIO

	<u>AMOUNT</u>	<u>RATIO</u>	<u>REVISED AMOUNT</u>	<u>REVISED RATIO</u>	<u>COST RATE</u>	<u>WEIGHTED COST</u>	<u>TAX FACTOR</u>	<u>PRE-TAX WEIGHTED COST</u>
LONG-TERM DEBT	\$178,375	50.15%	\$339,776	60.00%	8.00%	4.80%		4.80%
PREFERRED DIVIDENDS	\$5,643	1.59%	\$7,210	1.27%	8.93%	0.11%	1.709212	0.19%
EQUITY	<u>\$171,641</u>	<u>48.26%</u>	<u>\$219,307</u>	<u>38.73%</u>	11.25%	<u>4.36%</u>	1.709212	<u>7.45%</u>
TOTAL	<u>\$355,659</u>	<u>100.00%</u>	<u>\$566,293</u>	<u>100.00%</u>		9.27%		12.44%
AUTHORIZED IN DOCKET NO. R-00943231						<u>9.58%</u>		<u>13.53%</u>
DIFFERENCE						<u>-0.31%</u>		<u>-1.09%</u>

PHILADELPHIA SUBURBAN WATER COMPANY

DEPRECIATED PLANT RATIO

	<u>DEPRECIABLE PLANT</u>	<u>PERCENT OF TOTAL</u>	<u>DEPRECIATED RATIO</u>	<u>WEIGHTED RATIO</u>
Baton Rouge	\$110,388,963	1.64%	35.80%	0.59%
Bridgeport	\$276,322,114	4.10%	30.82%	1.26%
California American	\$154,183,185	2.29%	26.80%	0.61%
California Water	\$522,614,109	7.75%	27.08%	2.10%
Connecticu Water	\$163,848,000	2.43%	24.49%	0.59%
Elizabethtown	\$418,802,383	6.21%	18.77%	1.17%
Florida Cities	\$139,952,572	2.07%	25.20%	0.52%
Hackensack	\$419,163,649	6.21%	17.34%	1.08%
Illinois	\$213,867,812	3.17%	25.77%	0.82%
Indiana	\$146,547,334	2.17%	19.86%	0.43%
Indianapolis	\$306,076,358	4.54%	22.65%	1.03%
Jamaica	\$169,630,910	2.51%	22.38%	0.56%
Louisville	\$394,192,829	5.84%	29.14%	1.70%
Middlesex	\$115,371,341	1.71%	16.77%	0.29%
New Jersey-AM	\$609,693,502	9.04%	14.97%	1.35%
Ohio Water	\$108,265,838	1.60%	15.69%	0.25%
Palm Coast	\$105,356,630	1.56%	30.70%	0.48%
Pennsylvania-American	\$669,653,701	9.93%	12.45%	1.24%
San Gabreal	\$125,352,698	1.86%	25.76%	0.48%
San Hose	\$287,746,360	4.27%	31.29%	1.33%
Southern Cal	\$347,332,954	5.15%	22.31%	1.15%
Southern States	\$150,738,625	2.23%	21.52%	0.48%
Spring valley	\$122,548,141	1.82%	24.55%	0.45%
St Louis	\$370,339,089	5.49%	19.94%	1.09%
Tennessee	\$100,289,595	1.49%	22.53%	0.33%
West Virginia-AM	\$197,976,919	2.93%	17.92%	0.53%
<b>Total</b>	<u>\$6,746,255,611</u>	<u>100.00%</u>		<u>21.91%</u>
<b>Philly Suburban</b>	<u>\$425,284,000</u>	<u>100.00%</u>	<u>15.27%</u>	<u>15.27%</u>

Source: NAWC 1993 Financial & Operating Data.