



OFFICE OF CONSUMER ADVOCATE
1425 Strawberry Square
Harrisburg, Pennsylvania 17120

IRWIN A. POPOWSKY
Consumer Advocate

June 19, 1996

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(717) 783-5048

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

ORIGINAL

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

KJR

Dear Secretary Alford:

Enclosed for filing please find an original and three (3) copies of the Office of Consumer Advocate's Answer to the Petition of PSWC for Leave to File A Reply to Comments/Answers and Petition for Leave to Supplement OCA Comments. In addition, please find for filing an original and ten (10) copies of OCA's Supplemental Comments.

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

Enclosures

cc: All Parties of Record
36608

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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 Answer to the Petition of PSWC for Leave to File a Reply to Comments/Answers and Petition for Leave to Supplement OCA Comments, 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. In addition, I have served a true copy of the Office of Consumer Advocate's Supplemental Comments.

Dated this 19th day of June, 1996.

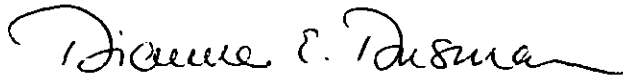
BY U.S. FIRST CLASS MAIL

Thomas P. Gadsden, Esq.
Anthony Decusatis, Esq.
Morgan, Lewis & Bockius
2000 One Logan Square
Philadelphia, PA 19103

Bernard A. Ryan, Jr., Esq.
Office of Small Business Advocate
Suite 1102 Commerce Building
300 North Second Street
Harrisburg, PA 17101

BY HAND DELIVERY

Carol Pennington
Office of Trial Staff
PA Public Utility Commission
Pitnick Bldg., P.O. Box 3265
Harrisburg, PA 17120



Dianne Dusman
Assistant Consumer Advocates
Counsel for:
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
(717) 783-5048 36320

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

Docket No. P-00961036

SUPPLEMENTAL COMMENTS
OF THE OFFICE OF CONSUMER ADVOCATE

Dianne E. Dusman
Assistant Consumer Advocate

Counsel For:
Irwin A. Popowsky

Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
(717) 783-5048

DATED: June 19, 1996

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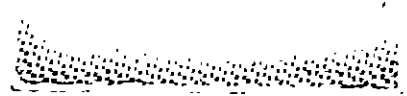


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I. INTRODUCTION.

The purpose of these Supplemental Comments is to correct PSWC's mischaracterizations of the OCA's position, as expressed in Comments and OCA Statement No. 1 by Randy M. Allen, and other errors made in the PSWC Reply.

At this juncture, the OCA will respond generally to the misstatements and errors within the PSWC Reply. Because it is the OCA's understanding that, unless the Petitions are dismissed on legal grounds hearings will follow, further and more detailed responses will be provided to the Company's Reply through testimony during the hearing phase, to the extent still relevant.

II. PSWC HAS NOT DEMONSTRATED A NEED FOR THE DSIC.

Rather than taking the opportunity to provide the Commission with data showing the condition of its own infrastructure, PSWC relies upon the irrelevant statements of others and attacks Mr. Allen's depreciation analysis. PSWC Reply at 3-7. As stated in Comments, PSWC bears the burden of proof as to any rate increase request. That burden is *not* borne by the quotations of others who are commenting on the condition of the nation's infrastructures, nor by the criticisms of Mr. Allen's analysis (even if they were valid). PSWC has still not proved that the requested rate increase is just and reasonable, as required by the Public Utility Code, 66 Pa.C.S. §315(a) & 332(a). OCA Comments 2, 23-26.

To turn to the Company's criticism of Mr. Allen, however, the OCA would first note that in order to challenge the Company's assertions that a surcharge is needed to accelerate improvements, Mr. Allen studied the depreciation reserve to plant ratios of PSWC and twenty-six other large water companies. He noted that PSWC's overall plant was only about two-thirds as depreciated as the others, drawing the inference that it should be further from requiring acceleration of improvements than the others. OCA St. 1 at 16, Attachment 2. The Company's primary criticism of Mr. Allen's analysis is that the ratios relate to *all* utility plant, not to distribution systems alone. PSWC Reply at 7-8. This point appeared to have some merit at first blush. As a check on the validity of this criticism, however, the OCA reviewed PSWC's depreciation study related to utility plant at July 31, 1995, offered in evidence in its most recent rate case, to determine whether the inference from the overall plant applied with equal force to PSWC's infrastructure.

Applying the same method of calculating the ratio to just Account 322, Mains and Accessories, that is, dividing the accumulated depreciation balance by the original cost, yields

11.93%¹ - *even less than* the 15.27% ratio applicable to all plant in service. In addition, the Company's depreciation witness, William Stout, stated as follows in the study:

The results of the statistical analyses for these groups [all Mains and Accessories] were inconclusive, *because the average service lives are quite long and the average ages of surviving property are relatively young*. That is, historical indications of complete survivor characteristics have not yet materialized. However, *moderately high mode curves with long service lives were indicated*. Generally, the survivor curve estimates are typical of those used in the water industry.

Pa. P.U.C. v. Philadelphia Suburban Water Co., Docket No. R-953343, Exh. No. 6-A, Part II, Depreciation Study, at 16 (emphasis added).

It would therefore appear that PSWC's data and statistics concerning its own infrastructure do not support the relief it is seeking. Further, the comments by Mr. Stout would also contradict an *urgent* need to do something and would tend to indicate that ample time is available to study the condition of the infrastructure. The OCA submits that time *should* be taken to assess the true magnitude of the problem, if any, before rushing to grant a rate increase.

Therefore, because PSWC has failed to show a need for the surcharge mechanism and because other evidence contradicts that a need exists, the Petition should be denied.

¹ The accumulated depreciation balance, \$28,198,163, divided by the net original cost of Account 322, Mains and Accessories, \$236,446,850 yields 11.93%. PSWC Exh. 6-A, Part II, at Revised Page 27, from the record of *Pa. P.U.C. v. Philadelphia-Suburban Water Co.*, Docket No. R-953343.

III. THE SURCHARGE PROPOSAL IS CONTRARY TO SECTION 1307(A) OF THE PUBLIC UTILITY CODE, AS INTERPRETED BY THE COMMONWEALTH COURT.

The proposed surcharge is designed to recover capital costs, that is, return and depreciation on main extensions and improvements between base rate cases. This is contrary to the holding in *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 Commonwealth Court held in *PIEC* that the use of a Section 1307(a) mechanism to recover expenses is lawful, but that the costs of physical facilities may not be included in the adjustment mechanism.” *Id.* OCA Comments at 6-10.²

PSWC has asserted that the above “misstates the holding” of the *PIEC* case. PSWC Reply at 11. It rejects the Commonwealth Court’s discussion concerning capital costs and rate base items as dictum. *Id.* This is simply incorrect. The Court clearly decided that the Commission had erred in permitting costs of physical facilities through a surcharge. The Court stated:

Because Section 523 of the Code does not permit the recovery of incentives outside of a base rate case and the calculation for incentives was not supported by substantial evidence in the record, we will reverse those parts of the PUC’s December 13, 1993 order, *in addition to the allowance of costs for physical facilities through a surcharge.*

PIEC at 1353 (emphasis added). Even the Court’s Order concluding the opinion confirms that the statements within *PIEC* concerning whether plant items can be includible in a 1307(a) surcharge are not mere dicta. The Court’s ordering paragraph states:

² The Commonwealth Court also held in an earlier case that capital costs, in that case the principal and interest of a “PennVest” loan, could not be recovered through a 1307(a) surcharge mechanism. *Masthope Rapids Property Owners Council v. Pennsylvania Public Utility Commission*, 135 Pa. Commw. 437, 581 A.2d 994 (1990). *Id.*

AND NOW, this 9th day of January, 1995, the order of the Public Utility Commission, dated December 13, 1993, No. I-900004, is affirmed, *except to that part allowing recovery of incentives and costs of physical facilities through the surcharge mechanism and adopting the calculation for incentives, which is reversed.*

Id. Thus, the quotations concerning excluding the costs of physical facilities from a surcharge mechanism are *essential* to the Court's review and decision to reverse the portion of the Commission's Order which permitted the costs of physical facilities to be recovered through the surcharge mechanism -- and that portion of the opinion cannot be dismissed as dictum.³ While PSWC is correct that the Court affirmed the Commission Order as to DSM expense items (PSWC Reply at 11), it has disregarded the fact that the Court reversed the Order as to incentives and the costs of physical plant.

This basic understanding led to other misinterpretations concerning the case. The above quote belies PSWC's comment that "the issue of whether the fixed costs of plant in service could be recovered under Section 1307 was not directly presented." PSWC Reply at 12 (emphasis in original). PSWC's arguments concerning the flexibility the Commission has pursuant to 1307(a) also lack merit (PSWC Reply at 15), because the Court's decision limits that flexibility to "dollar-for-dollar" expense recovery, to the exclusion of the costs of physical plant. The above quote also undercuts the Company's argument that the Court was only concerned about potentially non-used and useful property, due to its references to Section 1315 of the Code. PSWC Reply at 13-14. Because the Court was actually reviewing and deciding whether the portion of the Commission's

³ "Dictum" is defined as "a remark 'by the way,' that is, an observation or remark made by a judge in pronouncing an opinion upon a cause, concerning some rule, principle, or application of law, or the solution of a question suggested by the case at bar, but not necessarily involved in the case or essential to its determination; any statement of the law enunciated by the court merely by way of illustration, argument, analogy or suggestion." Black's Law Dictionary, 5th Edition, at 409.

costs of physical plant to be recovered through a 1307(a) surcharge mechanism was correct, its concern was with *any* claims for recovery of plant costs.

PSWC's argument, therefore, that its inclusion of the costs of only used and useful plant takes its proposal outside the scope of the *PIEC* decision are not well-founded. Moreover, its argument that the proposed DSIC will not "disassemble the traditional ratemaking process" lacks merit as well. The Court in *PIEC* made the specific point that a Section 1307(a) surcharge "... flows through only expenses and changes to those expenses *without including any profit or other recovery*; this is known as 'dollar-for-dollar' recovery." *PIEC* at 1341 (emphasis added). The Court also pointed out, in rejecting the appellant's single issue ratemaking argument, that "no party has asked for specific recovery of a line item that traditionally would be requested in a rate-making procedure." *PIEC* at 1350. Because PSWC asks for profit to be included in its surcharge to be calculated based upon items traditionally requested in a base rate proceeding, its proposal unquestionably would disassemble traditional ratemaking.

PSWC also states that "perhaps most importantly, the OCA ignores this Commission's prior decisions approving the use of Section 1307 adjustment clauses to recover fixed costs associated with other utility plant investments, such as up-grades to coal-fired generating units, principal and interest on PennVest obligations and gas company costs 'related to new facilities to implement restructuring brought about by FERC Order 636.'" PAWC Reply at 19-20.

The OCA does not believe that the above examples support the Company's request. Only one electric utility has attempted to invoke 52 Pa. Code § 57.124 (the promulgation of which was required by the passage of 55 Pa. C.S. 514), which would permit a surcharge for a return and depreciation on coal-fired plants; that request was denied and the Order was not appealed. *See In*

re Petition of West Penn Power Company, Docket No. P-910511, *et seq.*, Opinion and Order of March 19, 1992, at 47. The PennVest Policy Statement, 52 Pa. Code § 69.363, has not, to the OCA's knowledge, been invoked by a water utility to attempt to implement a surcharge to collect principal and interest on PennVest loans.⁴ Neither of the two, therefore, has yet been subject to legal challenge in the Commonwealth Court, based upon the rule of law now established by the *PIEC* holding; however, the OCA has consistently taken the position before the Commission that 1307(a) surcharges are not to include rate base items. Also, as for the gas utility transition costs regulation, 52 Pa. Code § 69.363, PSWC has taken a phrase out of context to attempt to prove its point: "costs related to new facilities to implement restructuring brought about by FERC Order 636." This phrase refers only to new *pipeline* facilities, not facilities of the Pennsylvania local distribution companies (LDCs). To the OCA's knowledge, none of the surcharges implemented pursuant to this regulation permit recovery of return and depreciation on items of LDC plant.

PSWC's arguments attempting to distinguish *PIEC* are incorrect and should be accorded no weight. The Company's Petition should therefore be dismissed as violative of Section 1307(a), as recently interpreted by the Commonwealth Court in *PIEC*.

⁴ The OCA did file a Petition For Review of this Policy Statement, but later agreed to withdraw it on the basis that an appeal would only be "ripe" if a utility was permitted to implement a surcharge pursuant to it. The OCA maintains that any surcharge implemented pursuant to the Policy Statement would violate *Masthope Rapids Property Owners Council v. Pa. P.U.C.*, 135 Pa. Commw. 437, 581 A.2d 994 (1990), and now *PIEC* as well.

IV. THE OCA DOES NOT DENY THAT INFRASTRUCTURE NEEDS EXIST FOR WATER UTILITIES IN GENERAL.

The Company states that the OCA “apparently rejects the notion that water utility infrastructure is badly in need of rehabilitation and replacement.” *Id.* at 2-3. This accusation is simply wrong and misrepresents the OCA’s position as set forth in Comments.

It is the OCA’s position that if a utility company needs a rate increase, it bears the burden of proving the basis for the rate increase and that such an increase will be “just and reasonable” pursuant to the Public Utility Code. OCA Comments at 2, 3. The OCA has stated that the PSWC allegations concerning the need to accelerate infrastructure improvements in its Petition are not sufficient to prove the need for a 0.5% (much less a 5%) increase in its base rates. *Id.* at 22-23. Mr. Allen provided specific testimony as to the numerous unsubstantiated claims included in the PSWC Petition. OCA St. 1 at 18-23. Neither the OCA nor Mr. Allen has stated *anywhere* in the OCA’s submission that the water utility infrastructures of water companies in general are *not* in need of rehabilitation and replacement. Such needs undoubtedly exist. Whether they, in fact, exist for PSWC to the extent that a 0.5 to 5% surcharge on base rates is needed and is just and reasonable is the core issue here, and that is the issue addressed by the OCA in its Comments and in Mr. Allen’s Statement.

V. COMMENTS REGARDING PSWC'S FINANCIAL HEALTH ARE PERTINENT TO WHETHER IT SHOULD BE GRANTED THIS RATE INCREASE.

The Commission should not ignore that PSWC is requesting permission to charge its customers from 0.5% to 5% more than the base rates determined to be "just and reasonable" less than one year ago. Yet, the Company wants the Commission to "turn a blind eye" to its current financial picture and to simply take it on faith that, without the DSIC, its access to capital markets will ultimately be jeopardized if it accelerates improvements now to the extent that it needs to, to avoid future problems.

It would be unfair to ratepayers to grant PSWC's extraordinary request without closely scrutinizing the asserted bases for the need for an increase and the Company's current financial health. Yet, PSWC states that the OCA's observations concerning PSWC's and its parent, Philadelphia Suburban Corporation's, current financial health are "irrelevant to the issue at hand and in no way detract from the merits of PSWC's proposal." PSWC Reply at 9-10. If the Commission were even to determine the surcharge request to be legal, it must then determine whether it should or should not be granted -- and the Company's current financial picture would be highly relevant to resolving that question.

As the Company has pointed out, the OCA recommended and the Commission approved a cost of equity inclusive of amounts reflective of the level of financial risk. Thus, if the surcharge were approved as requested, the Company would be collecting revenue dollars based upon the cost of equity inherent in its current rates, *plus* additional return dollars on infrastructure improvement and extension projects, calculated using PAWC's most recent cost of equity, 11%. OCA Comments at 11-13.

PSWC is essentially seeking surcharge revenues projected to be \$145,395 quarterly (\$581,580 annually), upon implementation, *in addition to* the net income available for return currently built into rates of approximately \$34,926,000.⁵ *Id.* at 14. In light of this, the Company's financial condition is highly relevant to whether the relief it seeks should be granted and the Commission should consider all aspects of it.

⁵ The source for this amount is PSWC's most recent quarterly Financial Report For The Twelve Months Ending March 31, 1996, Sch. A1.

VI. THE DSIC WOULD GUARANTEE PSWC A RETURN OF AND ON NEW AND IMPROVED MAINS, CONTRARY TO THE FUNDAMENTAL RATEMAKING PRINCIPLE THAT UTILITIES ARE TO HAVE AN OPPORTUNITY TO EARN A FAIR RETURN ON INVESTMENTS.

The OCA maintains that the DSIC would not be lawful because it would guarantee PSWC a return on *a portion* of its used and useful plant. OCA Comments at 11-15. Mr. Allen also articulated this issue in his Statement. OCA St. 1 at 10, 18. The Company states, however, that “[t]hroughout their written submissions, the OCA and Mr. Allen repeatedly assert that the DSIC would ‘guarantee’ PSWC a fair return on its investment.” PSWC Reply at 24. The Company also says that “the DSIC does not provide a comprehensive guarantee of cost recovery, as the OCA and Mr. Allen suggest.” *Id.*

In making these arguments, PSWC has misstated the OCA’s position. The OCA has stated *only* that the DSIC would guarantee a return on the portion of the plant utilized to calculate the surcharge, and as such, is contrary to the basic ratemaking principle that utilities are to have the opportunity to earn a fair return on investment. OCA Comments at 11-12. PSWC has not meaningfully refuted that the DSIC would guarantee it a return on the *portion* of used and useful plant utilized to calculate the surcharge.

Moreover, PSWC states that the OCA’s legal analysis is “fatally flawed” because the authorities relied upon, although they do not require that utilities be guaranteed a return, also “do not prohibit regulators from establishing ratesetting procedures that create a reasonable assurance of a utility’s actually achieving the rate of return nominally allowed in a rate order.” PSWC Reply at 25. The DSIC is *designed to include a level of profit* on the plant placed in service between rate cases --

this is definitely more than a “reasonable assurance” of achieving an allowed rate of return, even if only with respect to a portion of the Company’s plant in service.

PSWC goes even further in distorting the OCA’s position on the surcharge when it suggests that the OCA has “confidently asserted that existing ratesetting procedures are working well” and “has offered no meaningful alternative proposal.” PSWC Reply at 2. The OCA has indeed pointed out the various ways in which the surcharge proposed would violate fundamental ratesetting principles in Pennsylvania-- and the OCA *has* commented on the fact that existing procedures appear to have worked quite well for this particular water utility, whose parent company appears as one of three top income choices by the investment community and described as “an extremely low risk way to earn at least 9% a year.” Comments at 16; Statement at 6-7. And, the OCA would simply point out that in light of the fact that PSWC *has not proved* a need for additional revenues, it is not incumbent upon the Consumer Advocate to suggest a “meaningful alternative” method of collecting those additional revenues from ratepayers.

VII. THE DSIC WOULD VIOLATE THE FUTURE TEST YEAR AND MATCHING PRINCIPLES.

The OCA has asserted that the DSIC would constitute piecemeal ratemaking and violate the future test year and matching principles, in that it would increase rates based upon increases in only a few items while ignoring other items such as reduced expenses and increased revenues which might work in the ratepayers' favor. OCA Comments at 18-19; St. 1 at 8-12. In response, PSWC repeatedly asserts that Mr. Allen does not understand the future test year concept in Pennsylvania. PSWC Reply, 2-3; 8-9. This misstatement is partially based upon a typographical/editorial error in Mr. Allen's Statement.⁶ OCA St. 1 at 21.

As the OCA accounting consultant in several recent base rate proceedings, Mr. Allen was and is still well aware that the future test year periods do not necessarily end simultaneously with the rates taking effect. Having corrected the error, Mr. Allen's point is still a valid one: the use of future test years lessen the impact of regulatory lag and the business risk related to lag is accounted for when determining the cost of equity.

⁶ The statement should read: "Regulatory lag is reduced in a future test year state because rates are placed in effect soon after the 12-month period for which cost of service and rate base are measured. Regulatory lag is considered as part of normal business risks and is accounted for in advance when setting the rate of return on equity. This is undoubtedly one of the reasons that S&P identified Pennsylvania as 'a supportive regulatory environment' in Pennsylvania-American's last credit report." OCA St. 1 at 21, lines 10-17.

VIII. THE INFRASTRUCTURE IMPROVEMENT CHARGE WOULD UNFAIRLY ALTER THE BALANCE OF RISKS BETWEEN RATEPAYERS AND SHAREHOLDERS ESTABLISHED IN THE MOST RECENT BASE RATE PROCEEDING.

The OCA has pointed out that the ratesetting process involves a balancing of interests and risks between ratepayers and shareholders, and that a surcharge would unfairly affect that balance to the detriment of ratepayers. OCA Comments at 21-22. PSWC has failed to meaningfully respond to this concern -- and points out only that the OCA has "ignored" the benefits of the DSIC. PSWC Reply at 30-32. The purported benefits are that the DSIC "would enable the Company to address, in an orderly and comprehensive manner, the problems presented by an aging distribution system," thus favorably impacting water quality, service reliability and the ability of PSWC to maintain adequate fire flows. *Id.* at 31. The OCA does not accept that PSWC is unable to address these problems, *without* the DSIC, in an orderly and comprehensive manner and in the normal course of business.

Another purported "benefit" is that PSWC *might* be able to stretch out the period between base rate filings. Petition at 18; PSWC Reply at 34. The OCA does not accept that longer periods between base rate cases are a "benefit" which justify *quarterly* rate increases, particularly where those quarterly increases to an extent would doubly compensate shareholders for what will be greatly reduced business risk. Moreover, no commitment to refrain from filing base rate increases has been made -- the Company has merely suggested that this may be the case. The Company's claims that ratepayers will benefit from this are spurious and in no way justify granting the Company's Petition.

The OCA has reviewed the customer input concerning the PSWC and PSWC proposals and virtually all of the nearly two hundred customers who have commented are vehemently

against this surcharge for reasons similar to those expressed in the OCA's Comments. Those who have protested or filed a complaint are also unable to see any substantial benefit resulting from quarterly increases which will quite *possibly be in addition to* yearly increases. The Commission should therefore deny these requests.

IX. THE PROPERTY TO BE INCLUDED IN THE DSIC CALCULATION WILL PRODUCE REVENUE AND REDUCE EXPENSES.

The OCA set forth in detail all of the ways that rehabilitated mains will tend to generate revenues and reduce expenses. OCA Comments at 17-19; OCA St. 1 at 13-15. PSWC also does not deny that to an extent expenses will be reduced by infrastructure improvements. PSWC Reply at 33-34. PSWC's only responses to these points are that although expenses will be reduced "in individual instances, . . . aggregate expenses will continue to rise." *Id.* PSWC's attempts to explain away reduced expenses should be disregarded.

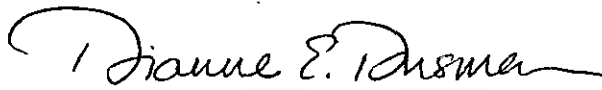
The whole point of utilizing the "non-revenue producing / non-expense reducing" standard is to determine whether it would violate the matching principle to permit the costs of certain items of plant to be recovered. This requires assessing whether the items of plant in question will in and of themselves tend to produce revenue or reduce expenses; increases in overall expenses are really not material to this issue.

Because the DSIC will collect return and depreciation on new plant while changes in other factors of the ratemaking formula might work in ratepayers' favor if considered, the matching principle will be violated. The Commission should therefore reject the DSIC.

X. CONCLUSION.

PSWC has failed to meet the challenge of proving that the DSIC is needed. It has also failed to effectively defend its proposal in response to the OCA's arguments that the DSIC would violate fundamental principles of ratemaking in Pennsylvania. The PSWC Petition seeking permission to implement the surcharge should therefore be denied.

Respectfully submitted,



Dianne E. Dusman
Assistant Consumer Advocate

Counsel for:
Irwin A. Popowsky
Consumer Advocate

Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
(717) 783-5048

Dated: June 19, 1996

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