- The Policy Statement regarding *Small Nonviable Water and Wastewater Systems*, 52 Pa. Code § 69.711 applies to small, financially-troubled water utilities that purchase most of their water from other companies. It does not apply to Aqua. OCA RB at 37; OSBA RB at 10.

- Aqua's proposal is inconsistent with *Popowsky v. Pa. PUC*, 869 A.2d 1144 (Pa. Cmwlth. 2005), which required costs to be extraordinary and non-recurring to be recovered through a surcharge. OCA RB at 38.

- Aqua's purchased water expenses are not volatile, unpredictable, or material. Aqua LUG RB at 4; OCA MB at 81; OTS MB at 36.

- Aqua's proposal would be discriminatory because it would not apply to contract or rider rate customers. OTS MB at 35-37.

2. ALJs' Recommendation

The ALJs recommended that Aqua's proposed PWA be rejected. R.D. at 69. They concluded that Aqua failed to meet its burden of proving that a PWA is permitted or warranted in this case. They also found that the proposal constitutes single-issue rate-making, which is prohibited under Pennsylvania public utility law. *Id.*

3. Exceptions and Replies

Although Aqua excepted to the ALJs' recommendation on this issue, it stated that the need for the PWA would be ameliorated if the Commission adopts the ALJs' recommendation allowing Aqua to recover in rates the price increase recently imposed by the BCWSA (see Section VI.B. *supra*). Aqua Exc. at 3 and 12. If the Commission adopts the ALJs' recommendation on that issue, this exception should be deemed withdrawn. *Id.*

Nevertheless, Aqua argues 'even if the Commission adopts the ALJs' recommendation to recognize the Bucks County rate increase in this case, it should, at a minimum, make clear that a purchased water adjustment established under Section 1307 would not violate the prohibition against single-issue rate-making. Aqua Exc. at 17 note 9. The OSBA argues that there is no reason for the Commission to reach this issue. OSBA R.Exc. at 4. Such an approach would 'avoid prejudicing either Aqua PA or opponents of the PWA in future cases. *Id.*

4. Disposition

Considering our adoption of the ALJs' recommendation to adjust Aqua's rates to reflect the BCWSA rate increase, we consider Aqua's Exception withdrawn. We agree with the OSBA that this means we should not address the question of whether the proposed PWA constitutes single-issue rule-making. Therefore, we will adopt the ALJs' recommendation to disallow the PWA in this case, but we will make clear that our decision on this issue is without prejudice to Aqua's right to propose a purchased water adjustment in the future. Any legal issues presented by that proposal will be addressed at that time.

X. Other Issues

A. Unaccounted-for water

1. Positions of the Parties

In pertinent part, our policy statement at 52 Pa. Code § 65.20 provides:

> In rate proceedings of water utilities, the Commission intends to examine specific factors regarding the action or failure to act to encourage cost-effective conservation by their customers. Specifically, the Commission will review utilities' efforts to meet the criteria in this section when determining just and reasonable rates and may consider those efforts in other proceedings instituted by the Commission.
>
> * * *
>
> (4) *Unaccounted-for water.* Levels of unaccounted-for water should be kept within reasonable amounts. Levels above 20% have been considered by the Commission to be excessive.

The OCA maintains that thirty of Aqua's fifty-six water systems have levels of unaccounted-for water exceeding 20%. OCA MB at 68. The OCA argues that many of these systems were acquired by Aqua years ago, but the Company has not yet taken the necessary steps to reduce the level of unaccounted-for water. For instance, the OCA identified the Roaring Creek system, which was acquired by Aqua about ten years ago, and continues to have an unaccounted-for water level of 28%. The OCA, therefore, recommended that Aqua be required to submit an action plan and schedule for each of its systems with an unaccounted-for water level in excess of 20%. *Id.*

Aqua responded by noting that this Commission has previously held that the policy statement at 52 Pa. Code § 65.20(4) should not be read to mean that each separate area of a utility's service territory must have an unaccounted-for water percentage of 20% or below. *Pa. PUC v. Pennsylvania-American Water Company*, Docket No. R-00016339 (January 25, 2002) (*PAWC 2002*). Aqua also noted that the thirty systems identified by the OCA together represent only 6.3% of Aqua's total system usage. Aqua MB at 86. The portions of Aqua's distribution system that furnish 94% of Aqua's water sales have unaccounted-for water levels of less than 20%. *Id.* Finally, Aqua argued that the majority of systems identified by the OCA suffered from neglect and poor management for protracted periods before being acquired by Aqua. *Id.*

2. ALJs' Recommendation

The ALJs concluded that Aqua met its burden of proving that it is in compliance with the policy statement at 52 Pa. Code § 65.20(4). 'Commission precedent provides that 52 Pa. Code § 65.20(4) should not be read to reach a conclusion that each separate area of a utility's service territory have an unaccounted-for water percentage at 20% or below. R.D. at 71. On a system-wide basis, Aqua's unaccounted-for water is below 20%.

3. Exceptions and Replies

The OCA excepts to the ALJs' recommendation. OCA Exc. No. 3. The OCA continues to argue that many of the systems with excessive levels of unaccounted-for water were acquired years ago, and Aqua has failed to resolve excessive levels of unaccounted-for water despite several rate cases and a distribution system improvement charge to help finance system improvements. OCA Exc. at 22, 26.

The OCA argues that *PAWC 2002* is distinguishable from the present case:

> The OCA submits that the Commission's statement in PAWC 2002, that specifies that 'each' 'separate area' of a utility need not be below the 20% unaccounted-for water standard, applies to instances where a single system or only a few systems within a larger utility, have excess high unaccounted-for water. In that case, it may be unreasonable to hold that a problem exists for the entire utility that would otherwise meet the 20% standard. However, in the case of Aqua, not only a few Aqua systems are problematic, but thirty of Aqua's fifty-six systems have problems of excessive unaccounted-for water.

OCA Exc. at 24.

The OCA argues that the instant case is analogous to *Pa. PUC v. Pennsylvania Gas and Water Co.* 79 Pa. P.U.C. 349, 381 (1993), wherein we stated '[t]he practice of this Commission is to look beyond the number towards an examination of the Company's efforts to mitigate the problem. We encouraged the company there to address the ineffectiveness of its programs to address the high levels of unaccounted-for water. Similarly here, the OCA argues, Aqua has programs in place to address high levels of unaccounted-for water, but those programs have been ineffective. OCA Exc. at 25. Ratepayers' funds are being wasted as a result of the continuing high levels of unaccounted-for water. Thus, the OCA argues that this Commission is justified in ordering Aqua to resolve this problem. *Id.*

Aqua's Reply Exceptions argue that the OCA 'cherry-picks' isolated data to create the impression that Aqua has a serious unaccounted-for water problem. Aqua argues that the data for its system as a whole yields a different perception. Aqua maintains that on a system-wide basis, its unaccounted-for water is well below 20%. Aqua R.Exc. at 12.

Aqua disputes the OCA's assertion that Aqua has owned many systems with excessive unaccounted-for water 'for many years. All but one of the systems identified by the OCA was acquired since 2001. Aqua R.Exc. at 14. In addition, Aqua argues that when it acquires another water company, its first priority is to make the improvements necessary to assure that quality water is furnished in sufficient quantities to meet customer needs. *Id.* at 14-15.

Aqua continues to argue that the Commission previously rejected the OCA's interpretation of the Policy Statement at 52 Pa. Code § 65.20(4). In addition, citing *PAWC 2002*, Aqua argues that this Commission previously found that action plans to reduce unaccounted-for water are 'counter-productive' and contrary to the Commission's broader policy goals. Aqua R.Exc. at 13.

Finally, Aqua argues that the OCA advocates an arbitrary approach to dealing with unaccounted-for water, because:

> [The] witness did not review [Aqua's] program, plans and processes for addressing unaccounted-for water nor did he analyze any site-specific conditions that affect unaccounted-for water in the 30 subsystems he identified. Instead, he tried to hold all of the Company's subsystems to a 20% benchmark without regard to the geographic, operational or cost factors that may exist in each area.

Aqua R.Exc. at 17. Such an approach, according to Aqua, is inconsistent with Commission precedent. *Id.*

4. Disposition

We will adopt the recommendation of the ALJs. This Commission previously rejected the argument that each water system owned by a single utility should be analyzed separately for purposes of determining compliance with the Policy Statement at 52 Pa. Code §65.20(4). *PAWC 2002*. We are not persuaded by the OCA's attempt to distinguish this precedent based on the number of Aqua's systems that have unaccounted-for water levels in excess of twenty percent (20%) because the thirty systems identified by the OCA together account for only 6.3% of Aqua's total system usage. There is no dispute that Aqua's unaccounted-for water, on a system-wide basis, is well below twenty percent (20%).

Additionally, we reject the OCA's contention that Aqua's programs to address high levels of unaccounted-for water are ineffective. OCA Exc. at 25. The OCA's witness made his recommendation without reviewing Aqua's programs for addressing unaccounted-for water. Aqua R.Exc. at 17. Moreover, all but one of the systems identified by the OCA were purchased since 2001. *Id.* at 14. Many of these systems were acquired by Aqua after many years of neglect and poor management by others. *Id.* As Aqua notes, when it purchases such a system, addressing high levels of unaccounted-for water may not be its highest priority. Moreover, we recognize that a substantial time period may be required to identify and address the reasons for large amounts of unaccounted-for water.

Nevertheless, we understand and share the OCA's concern. This Commission has long promoted water conservation. In addition, high levels of unaccounted-for water have an adverse impact on ratepayers. We encourage Aqua to take additional steps to reduce its water loss in those systems with unaccounted-for water levels above 20%.

B. Chemical Contaminants

1. Nitrates

a. Positions of the Parties

The OCA introduced the testimony of a professional engineer concerning primary and secondary Maximum Contaminant Levels (MCLs) established under the Federal Safe Drinking Water Act, 42 U.S.C. §§ 300f *et seq.* and adopted under the Pennsylvania Safe Drinking Water Act, 35 P.S. §§ 721.1 *et seq.* He stated '[c]ompliance with Primary MCLs determines whether the water is safe. Compliance with Secondary MCLs reflects whether the water is aesthetically acceptable. OCA St. No. 4 at 4.

The OCA's witness testified that one of Aqua's water sources has exceeded the Primary MCL for Nitrate. *Id.* He recommended that Aqua notify the Pennsylvania Department of Environmental Protection (DEP) of these test results (if it has not already done so), and follow the directions given by DEP. *Id.* at 6.

Aqua's Manager of Laboratory and Research testified that the recommendation of the OCA's professional engineer was based on test results supplied by Aqua in discovery. Aqua St. No. 11-R at 4. He stated:

> The applicable regulatory standards of the [DEP] require testing for nitrate concentration at the point where water enters the distribution system after treatment. The actual entry point, where water from the Beechwood Well enters the Company's distribution system, is the Beechwood Tank and Booster, as shown in official records of the [DEP and Chester County]. In the data provided to [OCA's witness], samples taken at the wellhead were erroneously identified as samples representative of treated water entering the distribution system. The results of testing [at] the correct point of

entry for testing purposes – show that all samples were below the MCL for nitrates

Id. Aqua's witness further testified that, to his knowledge, there is no instance in all of Aqua's operational and compliance monitoring that the concentration of nitrate exceeded the pertinent Primary MCL. *Id.*

b. ALJs' Recommendation

The ALJs found that Aqua met its burden of proving that it had not violated Pennsylvania public utility law in regard to nitrate levels in its water system. R.D. at 72.

c. Disposition

No Party excepted to the ALJs' recommendation on this issue. Finding the ALJs' recommendation to be reasonable, appropriate and otherwise in accord with the record evidence, it is adopted.

2. Total Dissolved Solids and Hard Water

a. Positions of the Parties

The OCA's professional engineer testified that fifteen of Aqua's water sources have exceeded the Secondary MCLs for total dissolved solids, iron, manganese, and chloride. OCA St. No. 4 at 6. He further testified that if the total dissolved solids contain significant amounts of calcium and magnesium carbonate, problems associated with hard water are experienced. *Id.* at 8. He recommended that Aqua be required to submit an action plan and implementation schedule for each system, stating how Aqua would reduce the total dissolved solids to acceptable levels. *Id.* at 10-11.

Aqua's Manager of Laboratory and Research testified that there are no health effects associated with total dissolved solids, and monitoring for total dissolved solids is not required by either federal or state regulations. Aqua St. No. 11-R at 5. He also testified that there is no state or federal standard for hardness of water, and there is no adverse health effect associated with water hardness. *Id.* at 8.

b. ALJs' Recommendation

The ALJs concluded that Aqua met its burden of proving that it did not violate Pennsylvania public utility law in regard to water hardness or the Secondary MCL for total dissolved solids. R.D. at 73.

c. Disposition

No Party excepted to the ALJs' recommendation on this issue. Finding the ALJs' recommendation to be reasonable, appropriate and otherwise in accord with the record evidence, it is adopted.

XI. Settlement Petitions

A. Legal Standards

Pursuant to our Regulations at 52 Pa. Code § 5.231, it is the Commission's policy to promote settlements. Settlements in contested proceedings help to avoid the time, expense, and uncertainty of litigation. The Commission's policy statement regarding settlements in major rate cases states, in pertinent part, as follows:

> In the Commission's judgment, the results achieved from a negotiated settlement or stipulation, or both, in which the interested parties have had an opportunity to participate are often preferable to those achieved at the conclusion of a fully litigated proceeding.

52 Pa. Code § 69.401. However, the Commission must review proposed settlements to determine whether the terms of the agreement are in the public interest.

With the foregoing in mind, we now review the proposed Settlements.

B. Joint Petition for Settlement between Aqua and the PSA

1. Positions of the Parties

Aqua has an operational relationship with Aqua Resources, Inc. (Aqua Resources) and allocates employees' time and other resources to Aqua Resources. Aqua Statement in Support of Joint Petitions for Settlement (Aqua Statement) at 2. The PSA argued that Aqua's process for installing and testing backflow valves created an unlevel playing field preventing independent plumbing contractors from competing effectively in Aqua's service territory. *Id.* at ¶ 6, 11, 17. The PSA sought to ensure that Aqua was not

inappropriately utilizing ratepayer funds to support its relationship with Aqua Resources. *Id.* at ¶ 14, 18(c).

On April 25, 2008, a Joint Petition for Settlement between Aqua and the PSA was filed (Aqua/PSA Joint Petition). Both Aqua and the PSA submitted statements in support of the settlement and agreed that it was in the public interest. No Party objected to the Settlement.

The key terms of the proposed Settlement are as follows:

- Aqua Resources will become a stand-alone company by the end of 2008. Upon becoming a stand-alone company, Aqua Resources will have its own phone number, employees, trucks, equipment, and will have separate books and records from Aqua.

- Aqua will develop a policy which provides a consistent set of instructions for contact between Aqua and all certified testers. Aqua will seek input from PSA on this policy and will provide a final copy to PSA no later than May 15, 2008.

- Aqua Resources will continue to honor the agreement reached in the Joint Petition for Settlement achieved in Aqua's 2005 base rate case at Docket No. R-00051030 in that Aqua Resources will not offer internal home plumbing services (other than its existing backflow prevention installation and testing services) for a period ending June 22, 2011.

- Aqua will designate a facilitator to address any future concerns or problems with PSA. Information concerning the facilitator will be included in the written policy described above.

- Aqua and PSA have agreed to language that will be contained in Aqua's mailings to customers regarding backflow prevention installation and testing services.

Aqua/PSA Joint Petition at 2-3.

In its Statement in Support of the Settlement Agreement, the PSA stated that the Settlement Agreement addresses its concerns. For example, making Aqua Resources a stand-alone Company addresses the PSA's concerns about the interrelationship between Aqua and Aqua Resources. Moreover, according to the PSA, the Settlement Agreement will help ensure a level playing field among all backflow installers and testers, including Aqua Resources. PSA Statement in Support at 2-3.

In its Statement in Support of the Settlement Agreement, Aqua argued that the Settlement Agreement is in the best interests of the Company and its customers and, therefore, is in the public interest. Aqua added that the Settlement Agreement will ensure that backflow prevention device testing is efficiently performed. Aqua Statement at 2.

2. ALJs' Recommendation

The ALJs agreed that that the Settlement Agreement was designed to prevent or eliminate any unfair advantage that Aqua Resources may have over independent plumbing contractors due to its affiliation with Aqua. The ALJs further found that the proposed Settlement Agreement promotes fair competition between Aqua Resources and independent plumbing contractors with regard to the installation and testing of backflow valves. Accordingly, the ALJs found that the Settlement Petition between Aqua and the PSA to be just, reasonable and in the public interest. As such, the ALJs recommended approval without modification. R.D. at 75.

3. Disposition

No Party excepted to the ALJs' recommendation on this issue. Finding the ALJs' recommendation to be reasonable, appropriate and in accord with the record evidence, it is adopted.

C. Joint Petition for Settlement between Aqua and the HHA

1. Positions of the Parties

The settlement in Aqua's previous rate case resulted in a differential between the rates charged in Aqua's Main Division and the rates charged to HHA customers. In the instant case, the HHA raised issues about the pace at which this differential would be eliminated. Aqua Statement, at 3.

On April 25, 2008, Aqua and the HHA filed a Joint Petition for Settlement which resolved all of the issues between the HHA and Aqua. Both Aqua and the HHA provided statements in support of the Settlement and agreed that it was in the public interest. No Party to the proceeding objected to the Settlement.

The key terms of the proposed Settlement are as follows:

- HHA customers will receive an increase in this case not to exceed 8.0% for the average HHA customer, calculated by comparing existing bills (including the DSIC) to the rates established in this case; and
- HHA customers will, by the end of the second of Aqua's next two rate cases, pay the same rates as Aqua's Main Division customers.

Aqua Statement in Support at 3.

In its Statement in Support of the Settlement Agreement, the HHA represented that the Settlement Agreement resolves all of the HHA's issues. The HHA stated that the proposed Settlement promotes gradualism in ratemaking by transitioning the HHA rates to Main Division levels over a reasonable period of time. As such, the

HHA believes the Settlement to be fair, reasonable, and in the public interest. HHA Statement in Support at 1.

In its Statement in Support of the Settlement Agreement, Aqua explained that the settlement would not only resolve the HHA's Complaint in the instant case, it would also reduce future litigation because the HHA agreed not to challenge Aqua's rate equalization plan in future base rate cases. As a result, Aqua was willing to extend the proposed transition period for equalizing the HHA's rates. Aqua Statement at 4.

2. ALJs' Recommendation

The ALJs concluded that the Settlement was in the public interest and recommended that it be approved without modification. The ALJs explained that in its original filing Aqua proposed to increase rates for the typical customer in this division by approximately 9%, but the HHA's expert estimated that the typical HHA customer's bill would actually increase by approximately 13%. The ALJs stated that the proposed Settlement provided for a more gradual transition from the current rate structure to equalization with the rate structure in Aqua's Main Division at the conclusion of Aqua's next two rate cases. The ALJs also stated that the proposed Settlement permitted the Company to earn sufficient revenue to fulfill its obligation to provide adequate, efficient, safe and reasonable service and facilities as required by 66 Pa. C.S. § 1501. R.D. at 65.

3. Disposition

No Party excepted to the ALJs' recommendation on this issue. Finding the recommendation to be reasonable, appropriate and in accord with the record evidence, it is adopted.

D. Joint Petition for Settlement between Aqua and the Property Owners

1. Positions of the Parties

The Masthope community is located in the Pocono Mountains and consists largely of seasonal customers. Aqua proposed rates that would move that division closer to the seasonal rate structure that the Commission previously approved for seasonal communities. The Property Owners proposed refinements in this rate structure. Aqua Statement at 5. In addition, the Property Owners desired fire protection. *Id.* at 4.

On April 25, 2008, Aqua and the Property Owners filed a Joint Petition for Settlement which resolved all of the issues between the Property Owners and Aqua (except that the Property Owners reserved the right to oppose the application, to the CS Division, of any PWA approved by the Commission in this case or any subsequent case, given that the CS Division does not utilize any purchased water to serve its customers). Both Aqua and the Property Owners provided Statements in Support of the Settlement and agreed that it was in the public interest. No Party objected to the Settlement.

The key terms of the proposed Settlement are as follows:

- Aqua will prepare a cost and engineering study to determine the feasibility of providing fire protection service.
- The following charges and usage allowances will apply:
    - For Residential customers:
        - 5/8-inch meter charge of $23.00 per month, which includes the first 3,000 gallons of water;
        - Next 7,000 gallons per month at $0.35 per 100 gallons;

- All usage over 10,000 gallons per month will be charged at the lower of $0.70 per 100 gallons or the block 2 seasonal rate; and

- The availability charge is eliminated.

- For Commercial Customers:

  - 5/8-inch meter charge of $23.00 per month, which includes the first 3,000 gallons of water;

  - For 5/8-inch meter customers:

    - Next 7,000 gallons per month at $0.6494 per 100 gallons (existing seasonal rate);

    - Next 23,300 gallons per month at $0.5712 per 100 gallons (existing seasonal rate);

    - Next 300,000 gallons per month at $0.4763 per 100 gallons (existing seasonal rate); and

    - All usage over 333,300 gallons per month at $0.4366 per 100 gallons (existing seasonal rate).

  - 2-inch meter charge of $50.00 per month, which includes no water;

  - For 2-inch customers:

    - First 10,000 gallons charged at $0.6494 per 100 gallons;

    - Next 23,300 gallons per month at $0.5712 per 100 gallons (existing seasonal rate);

    - Next 300,000 gallons per month at $0.4763 per 100 gallons (existing seasonal rate); and

    - All usage over 333,300 gallons per month at $0.4366 per 100 gallons (existing seasonal rate).

Aqua and the Property Owners Settlement Petition at 2-4.

2. ALJs' Recommendation

The ALJs concluded that the Settlement was in the public interest and recommended that it be approved without modification. The ALJs noted that under the proposed Settlement, no residential customer would receive an increase of more than 25%. In addition, the ALJs noted that approximately 58% of the year-round customers would see increases in the 15% to 25% range, rather than the 25% to 40% range, as originally proposed by Aqua. R.D. at 67. The ALJs further concluded that the rate structure and design elements provided a just and reasonable distribution of the revenue increase among the various customer classes. *Id.*

3. Disposition

No Party excepted to the ALJs' recommendation on this issue. Finding the recommendation to be reasonable, appropriate and in accord with the record evidence, it is adopted.

XII. CONCLUSION

We have carefully reviewed the record as developed in this proceeding, including the ALJs' Recommended Decision and the Exceptions filed thereto. Aqua initially requested an overall revenue increase of $41,700,000, or about 13.6%. The ALJ recommended an allowable revenue increase in the amount of no more than $40,222,060. R.D. at Table I.

Based on our review, evaluation, and analysis of the record evidence, we conclude that Aqua is entitled to an opportunity to earn income available for a return of $113,701,782. *See*, Tables I – III, attached hereto and made a part hereof. In furtherance of such objective, Aqua is authorized to establish rates that will produce not in excess of $341,248,824 in jurisdictional operating revenues. The increase in annual operating revenues authorized herein of $34,427,517 is approximately 82.6% of the $41,700,000 originally sought and an increase of approximately 11.2% over revenues generated through current rates. The approved cost of common equity of 11.0% is reasonable, appropriate and in accord with the record evidence. As such, the Exceptions filed by the various Parties hereto, are granted or denied, as discussed *supra*. Accordingly, the ALJs' Recommended Decision is adopted only to the extent that it is consistent with this Opinion and Order.

XIII. ORDER

THEREFORE; IT IS ORDERED:

1. That the Exceptions filed by Aqua Pennsylvania, Inc. on July 3, 2008, to the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, are granted or denied, consistent with this Opinion and Order.

2. That the Exception filed by the Aqua Large Users Group, on July 3, 2008, to the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, is granted, consistent with this Opinion and Order.

3. That the Exceptions filed by the Office of Consumer Advocate, on July 3, 2008, to the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, are granted or denied, consistent with this Opinion and Order.

4. That the Exceptions filed by the Office of the Small Business Advocate, on July 3, 2008, to the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, are granted or denied, consistent with this Opinion and Order.

5. That the Exceptions filed by the Office of Trial Staff, on July 3, 2008, to the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, are granted or denied, consistent with this Opinion and Order.

6. That the Recommended Decision of Administrative Law Judges Charles E. Rainey, Jr. and Guy M. Koster, issued on June 18, 2008, is adopted only to the extent that it is consistent with this Opinion and Order, and is otherwise rejected.

7 That Aqua Pennsylvania, Inc. shall not place into effect the rates contained in Supplement No. 82 to Tariff Water-Pa. P. U. C. No. 1, which have been found to be unjust and unreasonable and therefore, unlawful.

8. That Aqua Pennsylvania, Inc. is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings here, to produce revenues not in excess of $341,248,824.

9. That Aqua Pennsylvania, Inc.'s tariffs, tariff supplements, or tariff revisions may be filed upon less than statutory notice, and pursuant to the provisions of 52 Pa. Code §§ 53.31 and 53.101, may be filed to be effective for service rendered on and after the date of entry of the instant Opinion and Order.

10. That Aqua Pennsylvania, Inc. shall file detailed calculations with its tariff filing, which shall demonstrate to this Commission's satisfaction that the filed rates comply with the proof of revenue, in the form and manner customarily filed in support of compliance tariffs.

11. That Aqua Pennsylvania, Inc. shall comply with all directives, conclusions and recommendations contained in the instant Opinion and Order that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

12. That the Joint Petition for Settlement between Aqua Pennsylvania, Inc. and the Hedgerow Homeowners Association is approved in its entirety and without modification.

13. That the Joint Petition for Settlement between Aqua Pennsylvania, Inc. and the Masthope Property Owners Council is approved in its entirety and without modification.

14. That the Joint Petition for Settlement between Aqua Pennsylvania, Inc. and the Philadelphia Suburban Association of Plumbing Heating Cooling Contractors is approved in its entirety and without modification.

15. That Aqua Pennsylvania shall allocate the authorized increase in operating revenue to each customer class and rate schedule within each class in the manner prescribed in this Opinion and Order.

16. That the Complaint of Hedgerow Homeowners Association, at Docket No. C-2008-2032100, is deemed satisfied.

17. That the Complaint of Masthope Property Owners Council, at Docket No. C-2008-2036861, is deemed satisfied.

18. That the Complaint of Philadelphia Suburban Association of Plumbing Heating Cooling Contractors, at Docket No. C-2008-2014695, is deemed satisfied.

19. That the Complaint of the Office of Consumer Advocate, at Docket No. C-2008-2014357, is dismissed.

20. That the Complaint of the Office of Small Business Advocate, at Docket No. C-2008-2014350, is dismissed.

21. That the Complaint of Aqua Large Users Group, at Docket No. C-2008-2018913, is dismissed.

22. That the Complaints of the Borough of Athens (C-2008-2025823), Borough of Sayre (C-2008-2025811) and Borough of South Waverly (C-2008-2025879), are dismissed.

23. That the following Complaints are dismissed:

Complainant(s)	Docket No.
James M. McMaster, Esquire	C-2008-2018880
Richard J. Gage	C-2008-2018971
Gregory E. Hindle	C-2008-2019340
Miki Suzanne Borich	C-2008-2020081
John R. Carty	C-2008-2014341
William G. Toole, III	C-2008-2014342
John C. Cellucci, Esq.	C-2008-2014343
Marie Shively	C-2008-2014345
Quang Dinh	C-2008-2014346
Paul R. Cress	C-2008-2014347
Peter Crane	C-2008-2014348
Frederick Reece	C-2008-2014349
Margaret C. Hindenach	C-2008-2014351
Rodney and Shanya Pressley	C-2008-2014354
Susan O. Vansomeren	C-2008-2014355
Stephen Calderaro	C-2008-2014356
Lisa Curran	C-2008-2014360
Paul Barry	C-2008-2014362
Werner G. Schmidt, Jr.	C-2008-2014364
Ernest J. DiFilippo	C-2008-2014365
Ronald Zeibig	C-2008-2014368
Frank J. Toti, Jr.	C-2008-2019362
Richard P. Odato	C-2008-2018882
Theodore C. Dmytryk	C-2008-2014658
Anne W Banse	C-2008-2014682

Daniel Consenza	C-2008-2033589
Rodney Pierre Lomax	C-2008-2033630
Michael Hemphill	C-2008-2033761
Charles W Coombs, Jr.	C-2008-2036493
Bernard L. Zaber	C-2008-2035055
Kathleen Newlin	C-2008-2016261
John Dillon	R-00072111C002
Joseph Silva	R-00072711C001
Thurston C. Jones, Sr.	C-2008-2036153
Thomas J. Detelich	C-2008-2043727

24. That the Pennsylvania Public Utility Commission's inquiry and investigation in Docket No. R-00072711, *et al.* is terminated and the record closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: July 17, 2008

ORDER ENTERED: July 31, 2008

Attachments: Tables I through III

TABLE I Income Summary

Aqua Pennsylvania, Inc.

R-00072711

[1]	[2]	[3]	[4=2+3]	[5]	[6=4+5]	[7]		[8=6+7]
				Commission				
	Pro Forma Present Rates (1)	Company Adjustments (1)	Pro Forma Present Rates (Revised) (1)	Adjustments (2)	Pro Forma Present Rates	Revenue Increase		Total Allowable Revenues
	$	$	$	$	$	$		$
Operating Revenue	306,821,307	0	306,821,307	0	306,821,307	34,427,517	(3)	341,248,824
Expenses:								
O & M Expense	104,238,123	0	104,238,123	402,743	104,640,866	176,500		104,817,366
Depreciation	53,598,054	0	53,598,054	0	53,598,054	0		53,598,054
Taxes, Other	10,952,598	0	10,952,598	0	10,952,598	210,683		11,163,281
Income Taxes:								
State – Current	9,105,800	0	9,105,800	(38,590)	9,067,210	3,400,629		12,467,839
Federal – Current	29,547,700	0	29,547,700	(121,690)	29,426,010	10,723,897		40,149,907
Federal – Deferred	5,480,053	0	5,480,053	0	5,480,053	0		5,480,053
ITC – Amortized	(129,457)	0	(129,457)	0	(129,457)	0		(129,457)
Total Expenses	212,792,871	0	212,792,871	242,463	213,035,334	14,511,709		227,547,043
Income Available for Return	94,028,436	0	94,028,436	(242,463)	93,785,973	19,915,809		113,701,782
Rate Base	1,340,051,344	0	1,340,051,344	771,553	1,340,822,897			1,340,822,897
Rate of Return	7.02%		7.02%		6.99%			8.48%

Notes: (1) Company Initial Brief, Appendix A, pp. 2 Revised & 81 Revised, 5/2/2008

(2) As detailed on Table II

(3) Commission allowed increase in annual revenues

TABLE I(A) Rate of Return

Aqua Pennsylvania, Inc.

R-00072711

[1]	[2]	[3]		[4]	[5]	[6]
	Structure	Cost		After-Tax Weighted Cost	Effective Tax Rate Complement	Pre-Tax Weighted Cost
Total Cost of Debt				2.89%		2.89%
Long-term Debt	49.20%	5.88%		2.89%		2.89%
Short-term Debt	0.00%	0.00%		0.00%		0.00%
Preferred Stock	0.00%	0.00%		0.00%		0.00%
Common Equity	50.80%	11.00%	(1)	5.59%	0.585065	9.55%
	100.00%			8.48%		12.44%
Pre-Tax Interest Coverage (12.87/2 89)	4.30					
After-Tax Interest Coverage (8.73/2.89)	2.93					

Notes:

(1) Commission Allowance

TABLE I(B) Revenue Factor
Aqua Pennsylvania, Inc.
R-00072711

100%	1.00000000
Less:	
Uncollectible Accounts Factor (1)	0.00512670
PUC, OCA, OSBA Assessment Factors (2)	0.00611960
Gross Receipts Tax	0.00000000
Other Tax Factors	0.00000000
	0.98875370
State Income Tax Rate (3)	0.09990000
Effective State Income Tax Rate	0.09877649
Factor After Local and State Taxes	0.88997721
Federal Income Tax Rate (3)	0.35000000
Effective Federal Income Tax Rate	0.31149202
Revenue Factor (100% Effective Tax Rates)	0.57848519

Notes: (1) Company Exhibit 1-A, p. 36
(2) Company Exhibit 1-A, pp. 61, 62 & 62-1
(3) Company Exhibit 1-A, p. 66

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TABLE II Summary of Commission Adjustments

Aqua Pennsylvania, Inc

R-00072711

[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]
Adjustments	**Rate Base**	**Revenues**	**Expenses**	**Depreciation**	**Taxes-Other**	**State Income Tax**	**Federal Income Tax**
	$	$	$	$	$	$	$
RATE BASE:							
Payroll Cap. Ratio (1)	771,553						
REVENUES:							
						0	0
EXPENSES:							
Payroll Cap. Ratio (1)			(771,553)			77,078	243,066
Normalize Legal Fee (2)			(116,500)			11,638	36,702
Cost to Serve New Cust. (3)			(39,804)			3,976	12,540
Purchased Water (4)			1,459,500			(145,804)	(459,794)
Price Level Adj. (5)			(128,900)			12,877	40,608
DEPRECIATION:							
				0		0	0
TAXES:							
Interest Synchronization						1,645	5,188
TOTALS	771,553	0	402,743	0	0	(38,590)	(121,690)

Notes: (1) OTS St. 2 at 6, 8; OTS MB at 10; R.D. at 16, 17

(2) Uncontested Issue: OCA MB at 36; AP R.B. at 21; R.D. at 21

(3) Uncontested Issue: OCA M.B. at 36, 37; OCA St. 1-S, Sch. LKM-15 S at 1; AP M.B. at 21-22; R.D. at 21

(4) Annual increase in wholesale water purchases from Bucks County; AP Petition Ex. 1-D; R.D. at 3, 4

(5) Concomitant adjustment to increased purchased water expense from Bucks County; AP Petition Ex. 1-D; R. D. at 3, 5

TABLE III Interest Synchronization
Aqua Pennsylvania, Inc.
R-00072711

	Amount $
Company Rate Base Claim	1,340,051,344
Less Commission Adjustments (1)	771,553
Commission Rate Base	1,340,822,897
Weighted Cost of Debt	2.89%
Commission Interest Expense	38,749,782
Company Interest Expense Claim (2)	38,766,249
Commission Adjustment	16,467
Company Adjustment	0
Net Commission Interest Adjustment	16,467
State Corporate Net Income (CNI) Tax Rate	9.99%
State Income Tax Adjustment	1,645
Commission Interest Adjustment	16,467
Commission State CNI Tax Adjustment (3)	**1,645**
Commission Adjustment for F.I.T.	14,822
Federal Income Tax Rate	35.00%
Commission F.I.T. Adjustment (4)	**5,188**

Notes: (1) From Table II Column 2
(2) Company Exhibit 1-A(a) Revised, p. 71, 3/18/08
(3) To Table II Column 7
(4) To Table II Column 8

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held June 30, 2011

Commissioners Present:

Robert F. Powelson, Chairman
John F. Coleman, Vice Chairman
Tyrone J. Christy
Wayne E. Gardner
James H. Cawley

Pennsylvania Public Utility Commission	R-2010-2179103
Office of Consumer Advocate	C-2010-2197988
Connie Speelman	C-2010-2198077
George Poulin	C-2010-2198619
Herbert B. Watson, Sr.	C-2010-2198821
Lawrence LaStella	C-2010-2199946
Katherine E. Swisher	C-2010-2200324
Fred L. Phillips	C-2010-2200532
Galen Harrill	C-2010-2200534
Hordoffa Bulcha	C-2010-2200594
Mrs. Paul Viscuso	C-2010-2201209
Anton Koenig	C-2010-2201794
Barry J. Leed	C-2010-2202121
Douglas Wooley	C-2010-2202868
Rosalie Pasquini	C-2010-2204301
Anton Koenig	C-2010-2204311
Rosemary Wilson	C-2010-2204407
Jennifer Troupe Rummel	C-2010-2204410
Judith Mitchell	C-2010-2204414
Judith Ciotola	C-2010-2204415
Office of Small Business Advocate	C-2010-2204436
Jonathan Winterling	C-2010-2204454
William and Geri Gilbert	C-2010-2206497
Brian Ickes	C-2010-2206528
Kellogg Company	C-2010-2206541
George Knerr	C-2010-2208880
David Fiorillo	C-2010-2213105

v.

City of Lancaster – Bureau of Water

TABLE OF CONTENTS

OPINION AND ORDER

BY THE COMMISSION:

Before the Pennsylvania Public Utility Commission (Commission) for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Kandace F. Mellilo, issued on April 27, 2011, relative to the above-captioned general rate increase proceeding, and the Exceptions and Replies filed with respect thereto.

Exceptions to the Recommended Decision were filed by the City of Lancaster – Bureau of Water (Lancaster or City), the Office of Trial Staff (OTS), the Office of Consumer, Advocate (OCA), Kellogg Company (Kellogg) and Mr. George Poulin on or before May 17, 2011.

The City, the OTS, the OCA, the Office of Small Business Advocate (OSBA), Kellogg and Mr. George Poulin each filed Reply Exceptions on or before May 27, 2011.

I. History of the Proceeding[1]

On August 27, 2010, the City filed Supplement No. 40 to Tariff Water – Pa. P.U.C. No. 6, with the Commission to become effective October 26, 2010, containing

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[1] For a full and complete history, please refer to the Recommended Decision at 1-9.

proposed changes in rates, rules, and regulations calculated to produce $8,608,024[2] (99.8%) in additional annual revenues for the customers located outside the City limits. The rates and service of these customers are subject to the jurisdiction of the Commission, pursuant to 66 Pa. C.S. §§ 1301 and 1501. By letter dated June 3, 2010, the City had been granted an extension of time, until August 31, 2010, to file using an historic test year (HTY) ending December 31, 2009, and a future test year (FTY) ending December 31, 2010.

The Press Release prepared by the City concerning the rate increase request indicated that, if the entire request was approved, the total bill for a residential customer using 12,000 gallons of water per quarter, with a 5/8 inch meter, would increase from $33.59 to $63.38 per quarter, or by 88.7%. Tr. 87-88; City Statement (St.) No. 3 at 15.

On September 8, 2010, the OCA filed a Formal Complaint against the proposed rate increase. The OTS filed a Notice of Appearance on October 21, 2010. The OSBA filed a Formal Complaint on October 5, 2010. Kellogg, a large industrial customer, filed a Formal Complaint on October 22, 2010.

The remaining Formal Complainants, most of which elected 'inactive' status, were as follows:

Connie Speelman at Docket No. C-2010-2198077

George Poulin at Docket No. C-2010-2198619

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[2] As will be further discussed herein, the City subsequently revised its requested revenue increase to $8,192,036, as a result of various agreements and a Partial Settlement. Pursuant to the Partial Settlement, the portion of the rate increase specifically required to fund the OPEB (Other Post Employment Benefits) Trust Fund would not be effective until an Irrevocable Trust Agreement has been finalized and filed with the Commission. Partial Settlement, page 2.

Herbert B. Watson, Sr. at Docket No. C-2010-2198821

Lawrence LaStella at Docket No. C-2010-2199946

Katherine E. Swisher at Docket No. C-2010-2200324

Fred L. Phillips at Docket No. C-2010-2200532

Galen Harrill at Docket No. C-2010-2200534

Hordoffa Bulcha at Docket No. C-2010-2200594

Mrs. Paul Viscuso at Docket No. C-2010-2201209

Barry J. Leed at Docket No. C-2010-2202121

Douglas Wooley at Docket No. C-2010-2202868

Anton Koenig at Docket Nos. C-2010-2204311 and C-2010-2201794

Rosalie Pasquini at Docket No. C-2010-2204301

Rosemary Wilson at Docket No. C-2010-2204407

Jennifer Troupe Rummel at Docket No. C-2010-2204410

Judith Ciotola at Docket No. C-2010-2204415

Judith Mitchell at Docket No. C-2010-2204414

Jonathan Winterling at Docket No. C-2010-2204454

St. Philip the Apostle Church at Docket No. C-2010-2206276

William and Geri Gilbert at Docket No. C-2010-2206497

Brian Ickes at Docket No. C-2010-2206528

George Knerr at Docket No. C-2010-2208880

Anna Williams at Docket No. C-2010-2209068

David Fiorillo at Docket No. C-2010-2213105

Glass House Inc. at Docket No. C-2010-2215377

By its Order entered October 21, 2010, at Docket No. R-2010-2179103, the Commission noted that Supplement No. 40 to Tariff Water – Pa. P.U.C. No. 6 would be suspended by operation of law until May 26, 2011, unless permitted by Commission Order to become effective at an earlier date. The Order also instituted an investigation

into the lawfulness, justness, and reasonableness of proposed Supplement No. 40, and existing rates, rules, and regulations. The Order directed that the case be assigned to the Office of Administrative Law Judge (OALJ) for the scheduling of such hearings as may be necessary, culminating in the issuance of a Recommended Decision. This matter was then assigned to ALJ Kandace F. Mellilo for the conduct of hearings, culminating in a Recommended Decision for the consideration of the Commission.

On October 29, 2010, the City filed Revised Suspension Supplement No. 40 to Tariff Water – Pa. P.U.C. No. 6, to extend the suspension date of proposed rates from May 26, 2011 to June 23, 2011, to coincide with a scheduled Public Meeting date. The stated purpose of the extension was to provide sufficient time to completely and reasonably litigate the case, with an opportunity for both litigation and settlement efforts.

Public input hearings were held as scheduled on December 2, 2010, at 1:30 p.m. and 6:30 p.m. at the Manheim Township Public Library and VFW Post 7294, respectively. Six witnesses testified on the record at the Manheim Township Public Library and three witnesses testified at the VFW later that day. A summary of the public input testimony will be provided in a subsequent section of this Opinion and Order.

On January 5, 2011, the City filed Revised Suspension Supplement No. 40 to Tariff Water – Pa. P.U.C. No. 6, to further extend the suspension date of proposed rates from June 23, 2011 to June 30, 2011. This was agreed to by the City because the Commission had changed the June 23, 2011 Public Meeting date to June 30, 2011.

Hearings were held as scheduled on Tuesday, February 1, 2011, in Harrisburg. Due to the stipulation into the record of most of the testimony, the remaining scheduled hearing days of February 2 and 3, 2011 were cancelled as unnecessary. The Parties at the hearing presented prepared statements, including the prepared rejoinder of

the City which was presented at the hearing and was supplemented by oral testimony of its witnesses. A total of forty-two statements, some with accompanying exhibits, schedules, and appendices, were admitted into evidence: Eighteen by the City, nine by the OCA, six by the OTS, three by the OSBA and six by Kellogg. A total of forty-one separate exhibits were admitted: Twenty-seven by the City, six by the OTS, and eight by Kellogg. Two separate stipulations were admitted: OSBA and OCA Joint Stipulation No. 1 and OSBA and Kellogg Joint Stipulation No. 1.

A total of five City witnesses appeared at the hearing for oral rejoinder and cross-examination, and the remaining witnesses were excused as their testimony was admitted by stipulation. Transcripts of the proceeding containing a total of 299 pages were produced.

On February 22, 2011, the City and the OCA filed a Joint Petition in Partial Settlement of Rate Investigation (Joint Petition or Partial Settlement) to resolve issues concerning: (1) Other Post-Employment Benefit (OPEB) expenses (benefits other than pensions); (2) depreciation; and (3) salaries, wages and other expenses related to vacancies. While no other Party joined in the Partial Settlement, the OTS, which was the only other Party with a previously stated position regarding these matters, indicated that it would not oppose the Partial Settlement. The City provided a Statement in Support as an Appendix to the Partial Settlement and the OCA provided a Statement in Support with its Main Brief.

By letter dated February 28, 2011, the ALJ sent a copy of the Partial Settlement to all Parties of record, whether active or inactive, and provided the opportunity for the submission of comments/objections by March 15, 2011.

In accordance with the Procedural Order dated November 4, 2010, Main Briefs were filed by the City, OCA, OTS, OSBA and Kellogg on February 24, 2011, and Reply Briefs were filed by the City, OCA, OTS, OSBA and Kellogg on March 10, 2011. Mr. George Poulin, a pro se Complainant, submitted a letter, which was provided to the major Parties, in which he requested that the City's revenue increase be capped at $4,304,012. In addition, the City provided upon request an addendum to its Main Brief tables (Schedule A-5) showing the allocation of the stipulated rate base reductions between inside and outside customers.

On March 8, 2011, the ALJ received a second letter from Mr. George Poulin, dated March 6, 2011 (March 6 letter), which specifically responded, *inter alia,* to the terms of the Partial Settlement and requested that the Partial Settlement be rejected. No other comments/objections were received from the other Parties concerning the Partial Settlement.

The record closed on March 17, 2011, after the receipt of Reply Briefs and comments on the Partial Settlement.

ALJ Mellilo's Recommended Decision was issued on April 27, 2011. In her Recommended Decision, the ALJ found that the City's proposed Supplement No. 40 to Tariff Water- Pa. P.U.C. No. 6, proposing an annual increase of $8,608,024, should be rejected. The ALJ stated that the rates contained in the Supplement were not just and reasonable or otherwise in accordance with the Public Utility Code (Code) and the Commission's Regulations. The ALJ recommended that the Partial Settlement which mitigates the rate increase be approved. The ALJ further recommend that the Commission issue an Opinion and Order directing the City of Lancaster – Bureau of Water to file a tariff allowing for recovery of no more than $7,393,104 in additional base rate revenue or $16,087,906 in total allowable revenues, if the Irrevocable Trust

Agreement is finalized and proof provided to the Commission by the end of the suspension of rates. The ALJ stated that if the Irrevocable Trust Agreement is not finalized and filed by this time, then the Commission's Opinion and Order should direct the City of Lancaster – Bureau of Water to file a tariff allowing for recovery of no more than $6,914,657 in additional base rate revenue or $15,609,459 in total allowable revenues, subject to the remainder being placed into effect when the Irrevocable Trust Agreement is finalized and filed. Also, the ALJ recommended that the City should also be required to supplement the record with cost support for the $83 restoration charge in a document identified as City Exhibit No. 8 and to either justify or change its existing commodity block rate structure in its next base rate case.

Exceptions and Reply Exceptions to the Recommended Decision were filed as noted above.

On June 8, 2011, the City filed Revised Suspension Supplement No. 40 to Tariff Water – Pa. P.U.C. No. 6, to further extend the suspension date of proposed rates from June 30, 2011 to July 15, 2011. This was agreed to by the City at the Commission's request to accommodate the administrative process.

II. Overview of the City Water System

The City owns and operates a public water supply system which currently serves approximately 17,365 accounts within the City and approximately 29,073 accounts outside the City. Its service territory includes all of the City of Lancaster, Lancaster Township, Manheim Township, Millersville Borough, West Lampeter Township and portions of East Lampeter, Pequea, Manor, West Hempfield, and East Hempfield Townships. The City water system also provides water for resale to other public water suppliers through service agreements with East Petersburg Borough Authority, Leola

Sewer Authority and West Earl Authority. City St. No. 1 at 4, 6. Only water service provided to customers outside the City limits is subject to rate and service regulation by the Commission, pursuant to Section 1301 of the Code, 66 Pa. C.S. §1301.

III. General Principles

The most fundamental principle in Commission rate proceedings is that resultant rates must be just and reasonable and in conformity with the Regulations and Orders of the Commission. 66 Pa. C.S. §1301. In addition, a public utility[3] is entitled to such rates as will provide it the *opportunity* to earn a fair rate of return on the value of its property dedicated to public service. *Pennsylvania Gas and Water Co. v. Pa. P.U.C.* 19 Pa. Commw. 214, 341 A.2d 239 (1975) (emphasis added); *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia (Bluefield)*, 262 U.S. 679, 692-3 (1923).

The Code provides that the burden of establishing the justness and reasonableness of its rates is clearly on the City as to rates charged to customers outside its municipal boundaries. 66 Pa. C.S. §§ 315(a) and 1301. The Pennsylvania Commonwealth Court has interpreted Section 315(a) of the Code as follows:

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

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[3] The Public Utility Code provides that public utility service being provided by municipal corporations, beyond their corporate limits, shall be subject to rate regulation by the Commission, with the same force, and in like manner, as if such service were provided by a public utility. 66 Pa. C.S. §1301.

Lower Frederick Twp. v. Pa. P.U.C. 48 Pa. Commw. 222, 226-227 409 A.2d 505, 507 (1980) (emphasis supplied). *See also, Brockway Glass v. Pa. P.U.C.* 63 Pa. Commw. 238, 437 A.2d 1067 (1981).

Substantial evidence is such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. *Dutchland Tours, Inc. v. Pa. P.U.C.* 19 Pa. Commw. 1, 337 A.2d 922 (1975).

The Commission has affirmed the utilities' burden of proof in base rate proceedings in numerous cases including, *Pa. P.U.C. v. Aqua Pennsylvania, Inc.* R-00038805, Order entered August 5, 2004, slip. op. at 7; *Pa. P.U.C. v. National Fuel Gas Distribution Corp,* 1994 Pa. P.U.C. LEXIS 134 *5 (1994); *Pa. P.U.C. v. Breezewood Telephone Company (Breezewood),* 74 PA PUC 431 (1991); and, *Pa. P.U.C. v. Equitable Gas Co.* 57 PA PUC 423, 471 (1983). In the *Breezewood* case, the Commission made the following ruling with respect to Breezewood Telephone Company's (BTC) burden of proof:

> Thus, where a party has raised a question concerning an element at issue, the affirmative burden of proving justness and reasonableness of its claim is upon BTC.

74 PA PUC at 442.

It is also well-established that the burden of proof does not shift to parties challenging a requested rate increase. Instead, the utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one and that burden remains with the public utility throughout the course of the rate proceeding. There is no similar burden placed on parties which are challenging a

proposed rate. As stated by the Pennsylvania Supreme Court in *Berner v. Pa. P.U.C.* 382 Pa. 622, 631 116 A.2d 738, 744 (1955):

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

This does not mean, however, that in proving its case, a public utility must affirmatively defend claims that no Party has questioned. As held by the Pennsylvania Commonwealth Court:

> While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.

Allegheny Center Assocs. v. Pa. P.U.C. 131 Pa. Commw. 352, 359, 570 A.2d 149, 153 (1990); *see also, Pa. P.U.C. v. Equitable Gas Co.* 73 PA PUC 310, 359-60 (1990).

When, as in the instant case, a rate filing involves a municipality serving both nonjurisdictional (inside) and jurisdictional (outside) customers, the costs of service must be allocated between the two groups. In this rate case, the City developed a revenue requirement on a total water system basis, and then prepared a cost of service study (COSS) (City Ex. No. 4-A) which allocated operation and maintenance (O&M) expenses, depreciation expense and rate base to jurisdictional customers based upon certain allocation factors. These allocation percentages are to be based upon some reasonable relationship to the jurisdictional customers' relative cost, as compared to the total system cost of service.

The opposing Parties have challenged various elements of the City's rate filing, and those issues remaining for litigation will be addressed in accordance with the previously mentioned standard rate case principles. However, the City and the OCA have also agreed to a Partial Settlement, unopposed by all but one party, with respect to certain issues. The focus of inquiry for determining whether a proposed settlement should be recommended for approval is not a 'burden of proof" standard, as is utilized for contested matters. Instead, the benchmark for determining the acceptability of a settlement or partial settlement is whether the proposed terms and conditions are in the public interest. *Warner v. GTE North, Inc.* Docket No. C-00902815, Opinion and Order entered April 1, 1996; *Pa. P.U.C. v. CS Water and Sewer Associates*, 74 PA PUC 767 (1991). All objections to the Partial Settlement are considered in determining whether the Partial Settlement should be recommended to be approved.

The policy of the Commission is clearly to encourage settlements and the Commission has stated that settlement rates are often preferable to those achieved at the conclusion of a fully litigated proceeding. 52 Pa. Code §§5.231, 69.401. A full settlement of all the issues in a proceeding eliminates the time, effort and expense that would otherwise have been used in litigating the proceeding, while a partial settlement may significantly reduce the time, effort and expense of litigating a case. A settlement, whether whole or partial, benefits not only the named parties directly, but, indirectly, all customers of the public utility. This is because even a partial settlement tends to reduce rate case expenses; an expense which, if prudently incurred, are entitled to be recovered from ratepayers by public utilities as a cost of regulation. *Butler Township Water Company v. Pa. P.U.C.*, 81 Pa. Cmwlth. 40, 473 A.2d 219 (1984) (*Butler Township*).

As we proceed in our review of the various positions espoused in this proceeding, we are reminded that we are not required to consider expressly or at great length each and every contention raised by a party to our proceedings. *University of*

Pennsylvania, et al. v. Pa. P.U.C. 485 A.2d 1217, 1222 (Pa. Cmwlth. Ct. 1084). Moreover, any Exception or argument that is not specifically addressed herein shall be deemed to have been duly considered and denied without further discussion.

IV Rate Base

The City's final claimed net rate base is $132,730,611 ($90,865,029 jurisdictional), as shown in the City's Main Brief tables at Sch. A-1 at 1, 3. The City also provided an addendum to its Main Brief tables on April 12, 2011 (Sch. A-5), which showed the allocation of the stipulated reduction to rate base between the inside and outside customers. The City's rate base claim is comprised of the original cost of existing plant facilities, and proposed FTY additions including the Susquehanna and Conestoga membrane treatment plants, less accumulated reserves for depreciation and contributions in aid of construction (CIAC). In addition, the City included a claim for cash working capital and for prepaid expenses.

In the rebuttal phase of the proceeding, the City updated its accrued depreciation claim from $21,965,912 to $22,363,526, to bring forward the accrued depreciation an additional six months to the FTY ended December 31, 2010. City St. No. 5-R at 3. However, as will be addressed below, it appears that the City did not adjust its annual depreciation expense claim in its Main Brief tables to $3,387,716, as shown in City St. No. 5-R, attachment p. 4, but retained its annual depreciation expense claim at $3,373,507, which was the City's claim as of June 30, 2010 ($2,340,703 jurisdictional). See, City Ex. No. 5-B, p. II-6; City Main Brief tables, Sch. A-1 at 1, 3. The City's annual depreciation expense claim was, however, adjusted as a result of the Partial Settlement with OCA to $2,190,684 (jurisdictional). City Main Brief (M.B.) tables, Sch. A-1 at 3.

The OTS and the OCA have proposed several rate base adjustments to the City's claims, some of which were 'fall out' adjustments attributable to other adjustments. However, no Party proposed any disallowance of the approximately $90 million plus additions to utility plant related to the new membrane treatment facilities. The rate base issues involve depreciation, cash working capital, prepayments, and CIAC.

A. Depreciation Expense

1. Positions of the Parties

The City's original claim for annual depreciation expense was $3,373,507 as of June 30, 2010. City Ex. No. 5-B.

The OCA objected to the City's depreciation expense claim, which was based upon calculations using the Equal Life Group (ELG) remaining life method. The OCA contended that the City's property and depreciation records were insufficient to provide the level of detail and accuracy necessary to support use of these precision-dependent procedures. OCA St. No. 2 at 9. Through use of the whole-life average service life method, the OCA recommended a $301,000 reduction in the City's allowable depreciation expense (final litigation position). OCA St. No. 2 at 10; Partial Settlement at 6-7 Mr. Poulin, in his comments to the Partial Settlement, agreed with the OCA that the City's record keeping was inadequate, but recommended that the City's entire depreciation claim be denied until a depreciation methodology had been approved by the Commission. March 6 letter.

In the Partial Settlement, the City and the OCA agreed to split the difference in their depreciation expense positions, for a disallowance of $150,500 in the City's depreciation expense claim. The Settlement reflected the City's agreement to

calculate depreciation rates without use of the ELG procedure in this case. The City also agreed to 'upgrade its plant and depreciation accounting and records and obtain verification from its auditors that its accounting procedures and reporting are consistent with PaPUC requirements for Class A Water Utilities. In addition, the City agreed to improve its plant accounting and reporting before it implements the ELG procedure in its next base rate case. Partial Settlement at 6-7

The OTS indicated that the City's proposed annual depreciation expense claim of $3,373,507 was acceptable, but that the accrued depreciation claim must be brought forward to account for the additional six months of depreciation expense remaining in the test year. OTS St. No. 3 at 7.

In rebuttal, the City revised its accrued depreciation claim to $22,363,526 as of December 31, 2010. The City also contended that its annual depreciation expense claim correspondingly should be updated to $3,387,716, to reflect depreciation expense as of December 31, 2010. City St. No. 5-R at 3, attachment Table 1 at 4. The OTS disagreed, and during surrebuttal, asserted that the City's depreciation expense claim should remain at $3,373,507. OTS St. No. 3-SR at 4.

The City argued that the revision of its accrued depreciation claim to reflect the appropriate level at December 31, 2010, necessitated a corresponding increase to annual depreciation expense from $3,373,507 to $3,387,717. City M.B. at 10. However, in the tables attached to its Main Brief, the City indicated that the $3,373,507 amount was as of December 31, 2010. City M.B. Sch. A-1 at 1.

The OTS contended that an increase in the annual depreciation expense to $3,387,717 was not required because the $3,373,507 amount already reflected the

December 31, 2010 test year level, citing to City Ex. No. 4-A, Sch. B at 6. OTS M.B. at 9-10.

The OTS further explained that the City itself had characterized the $3,373,507 depreciation amount as being based on a FTY ended December 31, 2010; therefore, the $3,373,507 already matched the City's accrued depreciation claim which had been brought forward to December 31, 2010. OTS R.B. at 5.

2. ALJ Recommendation

The ALJ concluded that the proposed resolution contained in the Partial Settlement is in the public interest and should be approved. According to the ALJ, the OCA had explained that annual depreciation expense in the revenue requirement is dependent upon the level of detail and accuracy in the City's accumulated depreciation through the City's use of the ELG procedure. The ALJ agreed with the OCA that the City's depreciation records were not sufficiently accurate for these purposes and to settle this matter, the City agreed to improve its plant accounting and reporting before implementing the ELG procedure in its next base rate case. As the City's depreciation study was performed using ELG and the associated depreciation rates were, therefore, suspect, the ALJ noted that the OCA and the City agreed that depreciation rates will be calculated without ELG for this case and that the difference in associated depreciation should be split equally for settlement purposes. According to the ALJ, this is a reasonable resolution and provides for improvement in the City's record keeping before the City can again propose the use of the ELG procedure. R.D. at 17.

With regard to the OTS issue as to the proper level of depreciation expense for the test year ended December 31, 2010, the ALJ agreed with the City's litigation position that the proper level of depreciation expense as of test year ended December 31,

2010, is $3,387,717 if that expense is to be based upon the City's depreciation study utilizing the ELG procedure. However, according to the ALJ, the City has agreed in the Partial Stipulation not to utilize the ELG procedure for purposes of calculating depreciation in this case. The ALJ noted that in the tables attached to the City's Main Brief, the City reflected an adjusted annual depreciation expense in which it appears that the City has agreed, for purposes of effectuating the Partial Settlement, to essentially accept the OTS adjustment and utilize the lower annual depreciation expense amount of $3,373,507 for purposes of this proceeding. The ALJ stated that this is an appropriate resolution of the OTS depreciation expense adjustment and she recommended it be approved. R.D. at 18.

3. Exceptions and Replies

In his Exceptions, Mr. George Poulin disagrees with the ALJ's approval of the Partial Settlement. Mr. Poulin avers that the negotiation between the City and the OCA was conducted contrary to the prehearing conference orders and that he was not aware of the Partial Settlement in this case until he received a copy of the agreement. Mr. Poulin opines that the Partial Settlement has a considerable impact on the ALJ's recommendation and he thought it would be helpful to the decision making process if he would have been furnished with a copy of this information. Poulin Exc. at 1.

In reply, the City states that the Partial Settlement between the OCA and itself is in the best interest of its customers and should be adopted. The City avers that Mr. Poulin's accusations that the City did not follow the prehearing order in regard to the settlement are unfounded. The City references page 8 of this order where it states that parties are encouraged to commence settlement discussions as soon as possible and that no settlement would be filed prior to the opportunity for consumer input in the public input hearings. The City maintains that it did not file any settlement documents until

after the public input hearings and that several members from the City attended both public input sessions to field questions from consumers. The City also noted that pursuant to the prehearing order, each Complainant received copies of the Partial Settlement and had the opportunity to file comments, including Mr. Poulin. City R. Exc. at 2.

The City avers that, as admitted by Mr. Poulin in his March 6 letter, it did reach out to him to answer any questions he had about the Partial Settlement. The City states that it and the OCA came to the Partial Settlement agreement because they felt that the positions outlined in the agreement were warranted based on the evidence provided in the case, and the proper safeguards under the Partial Settlement agreement were put into place. The City opines that the Commission should adopt the Partial Settlement. City R. Exc. at 2-3.

4. Disposition

Based upon the evidence of record, we are in agreement with the ALJ that the Partial Settlement is in the public interest and should be approved. We are not convinced by Mr. Poulin that the Parties to the Partial Settlement failed to adhere to the direction of the ALJ within the prehearing conference orders. As pointed out by the City, it did reach out to Mr. Poulin to discuss the Partial Settlement, it did provide him with a copy of the Joint Petition and it did provide Mr. Poulin and all other Complainants an opportunity to submit comments on the Partial Settlement. This was all that was required of the Parties by the ALJ's Procedural Order issued November 4, 2010. While it was unfortunate that Mr. Poulin was not included within settlement discussions by the Parties, if that was his stated desire to participate, and while we would encourage the Parties to be inclusive of individual complainants in the future in such discussions, there was no such requirement in this instance. Therefore, the Exceptions filed by Mr. Poulin are denied.

With regard to the substance of the depreciation issue, we agree with the ALJ that the Partial Settlement provides a reasonable resolution of this issue. Within the Partial Settlement, the City has agreed to improve its plant accounting and reporting before implementing the ELG procedure, has agreed to upgrade its plant and depreciation accounting, has agreed to have its consultant calculate depreciation rates without ELG and has agreed to calculate resulting depreciation rates designed to approximately equally split the $301,000 depreciation expense difference between the City and the OCA. We find this resolution reasonable and in the public interest and, therefore, adopt the recommendation of the ALJ to approve

B. Utility Plant in Service

1. Positions of the Parties

The City originally proposed to shorten the life spans for the structures remaining at the Susquehanna and Conestoga Treatment Plants after the membrane upgrades were completed, by ten and eighteen years respectively. City Ex. No. 5-B at I-2; OCA St. No. 2 at 12. The OCA disagreed with the City's proposal to shorten the life spans of the existing structures and also disagreed with the City's forty-year service life estimate for Account 320 – Purification System Equipment. OCA St. No. 2 at 12-16. The OCA argued that the City does not have any plans to retire or remove the structures and, in fact, intended to continue using them. The OCA further asserted that the City's proposal regarding Account 320 was purely arbitrary and not based on analysis. OCA St. No. 2 at 16.

In the Partial Settlement, the City and OCA agreed to resolve their life span and service life differences through improvements in the City's plant accounting and

reporting and an adjustment to depreciation expense. No other Party took issue with the City's life span or service life proposal for treatment facilities.

2. ALJ Recommendation

The ALJ agreed with the City and the OCA that the Partial Settlement regarding this issue, which requires reporting and record keeping improvements and a depreciation expense adjustment, is reasonable and in the public interest. Accordingly, she recommended that it be approved. R.D. at 19.

3. Disposition

Consistent with our discussion with regard to the previous issue, Mr. Poulin's Exceptions to the approval of the Partial Settlement are denied and the recommendation of the ALJ to approve the Partial Settlement is adopted. We agree with the ALJ that the City's agreement within the Partial Settlement to improve its plant accounting and reporting is in the public interest and is hereby approved.

C. Depreciation Reserve

1. Positions of the Parties

The City updated its accrued depreciation in the rebuttal phase of this proceeding from $21,965,912 to $22,363,526, and this resolved the OTS issue that the depreciation reserve should be brought forward an additional six months, to correspond with the end of the FTY OTS St. No. 3-SR at 3-4.

The OCA also took issue with the City's depreciation reserve, claiming that the City's plant accounting and reporting were insufficient to support its calculations. The OCA further explained that currently, the City does not maintain its accumulated depreciation by plant account. Also, according to the OCA, it is difficult or not possible to reconcile the City's ratemaking book depreciation reserve and its financial and reporting depreciation reserve. OCA St. No. 2 at 18; OCA St. No. 2S at 5.

To resolve the dispute concerning depreciation reserve, the City and the OCA entered into the Partial Settlement.

2. ALJ Recommendation

The ALJ agreed with the City and the OCA that the Partial Settlement regarding this issue is reasonable and in the public interest. According to the ALJ, the Partial Settlement addressed the OCA's concern by providing for improvement in the City's plant accounting and reporting and verification that its procedures are consistent with Commission and GASB requirements. The ALJ found that this provision will help to improve the accuracy and reliability of the accumulated depreciation balance used to calculate the City's depreciation rates. As the Partial Settlement also provides for the calculation of depreciation rates without ELG in this case and for a splitting of the OCA's depreciation expense adjustment, the ALJ recommended that it be approved.

3. Disposition

Consistent with our discussion with regard to the previous issues, Mr. Poulin's Exceptions to the approval of the Partial Settlement are denied and the recommendation of the ALJ to approve the Partial Settlement is hereby adopted.

D. Additions to Rate Base (Prepayments)

1. Positions of the Parties

In its original filing, the City claimed $120,866 ($83,124 jurisdictional) for prepayments as part of its overall rate base claim. These prepayments were payments made by the City in advance of actual goods and services received, and included operating expenses such as insurance premiums, membership fees, postal box rentals and equipment and maintenance contracts. City Ex. No. 3-A (Ex. D, X-6), Ex. No. 3-B, Sch. 4.

The OTS opposed the City's claim contending it was duplicative of the same O&M expenses which had already been included in the City's cash working capital (CWC) rate base claim. The OTS asserted that the one-eighth method utilized by the City for computing the CWC component incorporates the annual expense claim for all cash O & M expenses. OTS St. No. 2 at 31.

The OTS further noted that the City failed to address the OTS prepayment adjustment in its Main Brief and, as a result, argued that the City had failed to meet its burden of proof pursuant to 66 Pa. C.S. §315(a), and the rate base adjustment should be recommended to be approved. OTS M.B. at 11-12.

The City acknowledged that it had not responded to this issue in testimony or in its Main Brief and further indicated that it concurred with the OTS recommendation and that $120,866 ($83,124 jurisdictional) should be removed from the rate base claim. City R.B. at 4.

2. ALJ Recommendation

The ALJ recommended that prepayments of $120,866 ($83,124) be removed from rate base as the City has acknowledged it should be removed. R.D. at 22.

3. Disposition

No Party excepts to the ALJ's recommendation in regard to the prepayments adjustment. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

V Revenues

The ALJ noted that under the category 'Revenues' in its Main Brief, the City indicated that it had made certain revenue adjustments, which were noncontroversial. These adjustments were as follows: (1) an adjustment to reflect a rate increase for inside customers, effective January 4, 2010; (2) an adjustment for net gain and loss of customers during the FTY; (3) an adjustment for private fire line revenue; and (4) an adjustment to impute revenues for City-owned properties that are not billed for water service. City M.B. at 12. No Party challenged the City's recitation of these four adjustments, and they, therefore, will be accepted, except as otherwise noted in the tables attached to this Opinion and Order.

The OCA indicated that the only revenue issue it had raised was related to rate design allocation factor adjustments. This resulted in an upward adjustment to Other Operating Revenues of $74,481 ($74,462 as modified in Sch. SJR-9 (revised)). OCA M.B. at 11; OCA St. Nos. 4 at 9 and 4-S, Sch. SJR-9 and revised; OCA St. No. 1 at 28,

Sch. MAB-21. These allocation factor adjustments will be addressed in the Rate Structure and Rate Design section of this Opinion and Order, *infra*.

The OTS raised a revenue issue concerning the allocation of rental income from the City's leasing of space on water storage tanks for cellular antennas. OTS M.B. at 13-14. We will also address this issue in the Rate Structure and Rate Design section, *infra*.

VI. Expenses

The OCA and OTS have proposed adjustments to the City's original claim for O&M expenses in the following areas: (1) early retirement expenses; (2) maintenance – vehicles expense; (3) grounds maintenance – contract services; (4) chemical expenses; (5) professional services expense; (6) OPEB expense; and (7) rate case expense. The OCA proposed an additional adjustment with respect to employee vacancies and related medical insurance, Social Security and Medicare expenses and the OTS proposed an adjustment with respect to power expense.[4] (OTS St. No. 2 at 15-20).

Prior to the rejoinder phase of this case, the Parties resolved all of the above-mentioned O&M expense adjustment issues, with the exception of employee vacancies and related expenses, OPEB expense and rate case expense.

In the Partial Settlement, the City and the OCA resolved their differences with respect to employee vacancies and related expenses and OPEB expenses. The OTS,

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[4] In its Main Brief, in separate sentences on page 14, the City stated that it had accepted both the OTS and the OCA proposed adjustments to power expense. However, as noted in the City's footnote reference to City St. No. 4R, pp. 6-7 in support of these statements, the adjustment accepted was the OTS adjustment.

which did not join in the Partial Settlement, nonetheless agreed not to oppose the Partial Settlement and to reflect the agreed upon adjustments in its Main Brief tables. Partial Settlement, footnote 1. In his March 6 letter, Mr. Poulin objected to the proposed resolution of the OPEB expense and apparently advocated at least a one-year waiting period after establishment of the trust fund before rates to fund the OPEB Trust Fund could be effective.

Accordingly, the only remaining O&M contested issue among the Parties, other than Mr. Poulin, is the rate case expense issue. These matters will be addressed below. Kellogg also has an issue concerning regulatory expense allocation (rate case expense) which would impact the overall level of rate case expense to be borne by inside customers. This matter will be addressed in the Rate Structure and Rate Design section of this Opinion and Order.

A. Agreed Upon Expense Issues

As stated above, the Parties agreed to resolve various expense issues, prior to the rejoinder phase, as evidenced at the following locations in the record: (1) early retirement expenses (City St. No. 4R at 9); (2) maintenance – vehicles expense (City St. No. 4R at 9); (3) grounds maintenance – contract services and other expense variances) (City St. No. 4R at 9-10); (4) chemical expenses (City St. No. 4R at 5-6); (5) professional services expense (City St. No. 4R at 8-9: OCA St. No. 1S at 9); and (6) power expense (City St. No. 4R at 6-7). The City reflected these adjustments in the rate case tables attached to its Main Brief.

B. OPEB

1. Positions of the Parties

In direct testimony. both the OCA and the OTS had proposed to disallow the City's claim for increased OPEB expenses because the increase reflected the actuarially determined annual required contribution (ARC) rather than the pay-as-you-go amount. These Parties asserted that, since no trust fund had yet been established, no actuarially determined contributions had yet been made and it would be improper to recognize this unpaid amount in rates. Also, the Commission's policy statement at 52 Pa. Code §69.351(b) (4) states as follows:

> If the Commission, after examination, grants current rate recognition of OPEB costs exceeding the pay-as-you-go amount, the excess amount should be placed in a dedicated trust fund.

Accordingly. the OCA and the OTS recommended that only the pay-as-you-go amount be reflected in rates, and that recognition of the ARC amount in rates await establishment of an irrevocable trust fund, payment of the ARC amount and appropriate safeguards. OCA St. No. 1 at 21-26, OCA St. No. 1S at 10-14; OTS St. No. 2 at 20-27· OTS St. No. 2-SR at 8-12.

In rebuttal, the City proposed that rates sufficient to begin payments into an established OPEB Trust Fund be approved, contingent on trust fund establishment requirements similar to those in *Pa. P.U.C. v. PGW.* Docket No. R-2009-2139884. City St. No. 2R at 1-4. The City offered further clarification of its position in rejoinder testimony. which provided the terms for the Partial Settlement on this issue, entered into

between the City and the OCA and unopposed by the OTS. City St. No. 2-OR. These provisions are as follows:

OPEB: Other than Pension Employee Benefits

The OPEB issue is settled as follows:

The City receives an annual amount for outside-City customers of $810,618, provided that it agrees to:

a. No later than April 1, 2011, the City of Lancaster will begin the process to establish an OPEB Trust Fund; and

b. Provide to the Commission and the active parties to this proceeding, a complete copy of the Irrevocable Trust Agreement in a subsequent submission filed with the Commission to inform them that the Trust Agreement has been finalized. The Irrevocable Trust shall be established prior to the effective date for the portion of the rate increase specifically required to fund the OPEB Trust Fund; and

c. Begin monthly OPEB deposits into the Irrevocable Trust in the first full month following Commission approval of this Settlement or the filing of the Trust Agreement, whichever is later. Understanding that during the transition year of 2011, the entire Annual Required Contribution will not be deposited into the Irrevocable Trust, and the monthly Trust contributions shall be equal to 1/12th of the 2011 Annual Required Contribution of $1,191,735 ($810,618 jurisdictional) less the actual expenses paid for retiree medical insurance premiums paid directly from the Water Fund in 2011, prior to the establishment of the Trust; and

d. For 2012 and beyond, the monthly Trust contributions shall be equal to 1/12th of the Annual Required Contribution amount for the current year as shown in the then current OPEB Actuarial Valuation; and

e. The City shall also deposit into the OPEB Trust Fund any payments from Water Fund retirees paid to the City as contributions for retiree medical insurance and the City will make a corresponding reduction to medical insurance pro forma expense of $204,000 or $138,761 jurisdictional; and

f. Maintain an accurate account of all monthly OPEB deposits and during the initial five (5) year period, provide a quarterly report and a yearly summary to the Commission and the active parties to this case; and

g. If, in any year, the required contribution is not made, then the active parties shall have the right to take action before the PA PUC in order to enforce these provisions and request penalties.

Partial Settlement at 5-6.

The OCA asserted that the terms of the Partial Settlement represented a fair resolution of this issue as the rates established in this case would not reflect the additional ARC amount unless and until the City established the dedicated trust fund and met certain conditions. In addition, according to the OCA, the Partial Settlement provided for information on a regular basis to allow for appropriate monitoring going forward after the higher amount is included in rates. OCA Statement in Support at 2-3

The only Party opposing this proposed Partial Settlement of the OPEB issue was Mr. Poulin who, as stated above, apparently proposed a one-year waiting period prior to reflection of the ARC amount in rates. March 6 letter.

2. ALJ Recommendation

The ALJ concluded that the proposed resolution of the OPEB issue in the Partial Settlement, which would disallow rate recognition of the additional ARC amount

until an irrevocable trust fund is established and certain conditions are met, is in the public interest and should be recommended to be approved. According to the ALJ, the Partial Settlement does not immediately provide for a rate increase sufficient to fund the ARC amount, but instead, places the burden on the City to first establish the Irrevocable Trust and provide proof to the Commission and the active Parties that the Trust Agreement has been finalized.[5] The ALJ states that this satisfies Mr. Poulin's concern who, as an active party, would be provided a copy of that Irrevocable Trust Agreement when it is filed with the Commission. R.D. at 28-29.

In addition, according to the ALJ, the Partial Settlement sets forth funding and reporting requirements and Mr. Poulin, as an active party to this case, would be provided copies of the quarterly reports and yearly summary of deposits for the initial five year period. If, in any year, the required contribution is not made, the active Parties would have the right, under the Partial Settlement, to take action before the Commission to enforce the provisions of the Partial Settlement and request penalties. As a result, the ALJ found the above protections in the Partial Settlement to be sufficient to safeguard ratepayers and assure that the appropriate trust fund is established and that required contributions are made and utilized for their intended purpose. R.D. at 29.

Finally, the ALJ considered Mr. Poulin's request that there be a one-year waiting period after finalization of the Trust Agreement before the ARC amount is reflected in rates. The ALJ stated that Mr. Poulin had not provided specific support for this delay, other than his stated position that the increase will represent a hardship to consumers in these difficult economic times. The ALJ concluded that the Partial Settlement does take these economic realities into consideration and provides appropriate

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[5] The establishment of a dedicated trust fund prior to reflection of OPEB amounts in excess of the pay-as-you-go amount is also consistent with the Commission's policy statement at 52 Pa. Code §69.351(b)(4), *supra*.

safeguards to consumers. The ALJ recommended that the proposed resolution of the OPEB issue in the Partial Settlement be approved by the Commission. R.D. at 29-30.

The ALJ noted further that the Partial Settlement contemplates the possibility of a two-stage rate increase; one at the end of the rate suspension period in this case and another when the irrevocable trust fund is finalized and appropriate notice is provided to the Commission. Accordingly, the Tables attached to the Recommended Decision provided for these two possibilities. The ALJ explained that the first Table will set forth the result after reflection of the ARC amount in rates and the alternate Table will set forth the pay-as-you-go (normal) cost which would be reflected in rates until the irrevocable trust fund is finalized. This alternate amount, as shown on City St. No. 2R, attachments Section 1(Actuarial Valuation) at 4, for the Water Fund, is $493,969 (total) or $335,998 (jurisdictional) after application of the 68.02% allocation factor (City St. No. 2-OR at 4). This results in a $474,620 reduction in the $810,618 amount provided in the Partial Settlement ($810,618 $335,998 = $474,620) plus the impact on cash working capital and associated costs. R.D. at 30.

3. Disposition

Consistent with our discussion with regard to the previous issues, Mr. Poulin's Exceptions to the approval of the Partial Settlement are denied and the recommendation of the ALJ to approve the Partial Settlement is adopted. We are in agreement with the ALJ that the resolution of the OPEB issue within the Partial Settlement is in the public interest and is hereby approved. We note the agreement within the Partial Settlement that a portion of the requested rate increase required to fund the OPEB Trust Fund will not be permitted to become effective until the irrevocable trust fund is finalized. Accordingly, the tables attached to this Opinion and Order will reflect the two-stage rate increase which results.

C. Employee Vacancies

1. Positions of the Parties

The OCA proposed the disallowance of pro forma salary and related medical insurance and Social Security/Medicare expenses associated with four vacancies which were not planned to be filled until after the end of the FTY and/or had not yet been filled. These positions were as follows: Water Plant Operation I-GF. additional Meter Reader, Water/Wastewater Utilities Manager, and Building Maintenance Specialist. OCA St. No. 1 at 4-7

In the Partial Settlement, the City and the OCA agreed that these positions would not be filled for the purpose of setting the revenue requirement in this case. As a result, the total pro forma expenses for the salary, medical insurance and social security/Medicare expenses are reduced by the following amounts: $99,013 ($65,276 jurisdictional) for the first two positions; $28,2886 ($19,341 jurisdictional) for the next position; and $36,707 ($25,218 jurisdictional) for the last position. The City and the OCA, asserted that this resolution was fair and reasonable and in the public interest.

2. ALJ Recommendation

The ALJ agreed with the City and the OCA that the Partial Settlement regarding this issue is reasonable and in the public interest. According to the ALJ, the Partial Settlement provides a resolution of these issues that is reasonable, given the evidence in this proceeding. The ALJ recommended that the proposed resolution of employee vacancies in the Partial Settlement be approved. R.D. at 32.

3. Disposition

Consistent with our discussion with regard to the previous Partial Settlement issues, Mr. Poulin's Exceptions to the ALJ's approval of the Partial Settlement are denied and the recommendation of the ALJ to approve the Partial Settlement is adopted. We agree with the ALJ that the resolution of the employee vacancy issue within the Partial Settlement is in the public interest and is hereby approved. We note that within the Partial Settlement, the City has agreed that it will not fill the positions of Water Plant Operation I-GF. Meter Reader, Water/wastewater Utilities Manager or Building maintenance Specialist for the purpose of setting the revenue requirement in this case.

D. Rate Case Expense Normalization

1. Positions of the Parties

The City initially claimed a total rate case expense for this proceeding of $481,334, normalized over a two-year period, or $240,667 annually. In rejoinder, the City testified that rate case expenses associated with this case needed to be updated to $535,926 ($267,963 annually). City St. No. 4 at 6; City St. No. 4-OR at 4.

The City's two-year normalization was based on the projected filing of the City's next base rate case. The City indicated that it has capital projects outlined in its twenty-year Master Plan that total $17,685,000 over the next five years, in addition to normal operating cost increases, and these expenditures will require more frequent filings. Also, according to the City, the instant filing was delayed due to staff time needed for the new membrane treatment plants, and as a result of this delay, the City was

able to file one case to recover the treatment plant costs and save rate case expense. City St. No. 4R at 7-8.

The OCA proposed a $120,334 reduction (jurisdictional) to the City's claim, based upon the approximate four (4) year average interval between the filing of the City's last four rate cases, on 12/23/1998, 2/5/2001, 12/9/2005, and 8/27/2010 (the current case). This reduction would now be increased to $133,982, based upon the City's claimed rate case expense increase to $535,926 ($267,963 annually), for an annual allowance of $133,981 ($267,963 – $133,982 = $133,981). OCA asserted that it has long been the practice of the Commission to normalize pro forma rate case expense based upon the average interval between prior rate case filings, as that is 'known and measureable' data for this purpose. OCA indicated that, while the City may intend to file within two (2) years, there is no guarantee that it will do so. OCA St. No. 1 at 11-13; OCA St. No. 1-SR at 7-8.

The OTS proposed a reduction of $115,102 in the City's rate case expense claim, which results in an allowable rate case expense of $125,565 ($240,667 $115,102 = $125,565), based upon an approximate 46-month average interval between the filing of the City's last four base rate cases. The OTS adjustment would now be increased to $128,156, based upon the City's claimed rate case expense increase to $535,926 ($267,963 annually), for an allowable rate case expense of $139,807 ($267,963 $128,156 = $139,807). Similar to the OCA, the OTS asserted that the City's two-year normalization was based upon a speculative future rate case filing date which was inconsistent with the Commission's past normalization practice. OTS St. No. 2 at 12-15; OTS St. No. 2-SR at 6-8.

The City argued that its future filing date was not speculative. The City claimed that it had adequately presented, in this case, a time line for future infrastructure

improvements that will cause it to come in for another rate case in two years. According to the City, rates in this proceeding should be established so as to permit recovery of rate case expenses before the next increase in two years. City M.B. at 17-18; City R.B. at 6.

The City also mentioned, in its Reply Brief, an additional post-hearing rate case expense of $125,256 as of February 28, 2011. City R.B. at 6. The City followed up with a letter dated March 17, 2011, requesting for the first time, that the additional $125,256 in rate case expense be included in the normalized level of allowable expenses in this case. In addition, the City requested that any Recommended Decision or Final Commission Order include a true-up to permit recovery of all future rate case expenses incurred in this matter, regardless of amount, and apparently without provision for other Parties to respond. The City argued that no Party had objected to the level of rate case expense presented of record, which was $535,926, and suggested that this was an indication of the Parties' acquiescence to any level of rate case expense eventually claimed.

In response, the OCA cited several cases wherein rate case expense normalization was based upon the historical average between rate case filings. *See, Pa. P.U.C. v. City of Lancaster Sewer*, 2005 Pa. P.U.C. LEXIS 44 (*Lancaster Sewer 2005*); *Popowsky v. Pa. P.U.C.* 674 A.2d 1149, 1154 (Pa. Commw. 1996) (*Popowsky*); *Pa. P.U.C. v. Roaring Creek Water Co.*, 73 PA PUC 373, 400 (1990); *Pa. P.U.C. v. National Fuel Gas Dist. Corp.* 84 PA PUC 134, 175 (1995); *Pa. P.U.C. v. West Penn Power Co.* 119 PUR4th 110, 149 (PA PUC 1990) (*West Penn*). It noted that the City had cited no precedent for the allowance of a normalization based upon future intentions. The OCA emphasized that four years was the approximate average interval between the filing of the City's last four rate cases, including the present one, and observed that the City had not accurately predicted its future filing frequency in the past. It noted that, while the City had requested a rate case expense normalization of eighteen months in its 2006 case, it

did not file the next case for fifty-six months. It characterized historical filing frequency as the only information that met the 'known and measurable' criteria for granting expense claims in rate cases. OCA M.B. at 14-16, OCA R.B. at 2-3.

In its response, the OTS noted that the Commission practice is to normalize rate case expense as it is a recurring expense wherein the amount incurred in the test year is greater or lesser than that which the public utility may be expected to incur annually during the estimated life of new rates. *Butler Township, supra.* The Parties agreed that rate case expense should be normalized; however, the OTS, like the OCA, disagreed with the City's use of a two-year normalization period as it is based upon future intentions, not actual experience. The OTS advocated use of a forty-six month normalization period as it represents the average interval between the City's last four base rate cases, including the current case, and therefore is more reliable, reasonable, and measureable. OTS M.B. at 19-22; OTS R.B. at 9-11.

The OCA and the OTS did not have a specific opportunity to respond to the City's additional rate case expense request as the extra record amount of $125,256 and the true-up was not mentioned until the City's Reply Brief and thereafter.

2. ALJ's Recommendation

The ALJ recommended that the Commission reject the City's requested two-year normalization period. The ALJ noted that in *Lancaster Sewer 2005, supra,* the City had proposed an eighteen-month normalization of rate case expenses based upon future expectations. The Commission rejected this approach and concluded that the normalization period should be based upon the City's actual history of rate filings and not speculations as to future filings. The Commission's ruling is in accord with *Popowsky, supra,* wherein the Commonwealth Court held that the period of rate case normalization

is to be determined by examining the utility's actual history of rate filings, not the utility's intentions. The ALJ agreed with the OTS and the OCA that the City's proposed normalization period is based on speculation and is, therefore, inconsistent with the fundamental ratemaking principle that all ratemaking claims be based upon known and measurable expenses. *West Penn, supra.* R.D. at 36.

The ALJ noted that the OTS proposal for a forty-six month normalization period and the OCA proposal for a forty-eight month normalization period are both based upon the filing intervals between the last four City base rate cases, and the two month difference is apparently due to rounding. The ALJ recommended, to more precisely calculate the normalization period, that the 1421.67 average number of days between rate cases be used to derive a 47-month average between rate cases (1421.67/12 = 47.4 or 47 rounded). She recommended that the City's last established rate case amount of record, which is $535,926 as of January 31, 2011, be normalized over a period of forty-seven months. The result is a total annual rate case expense allowance of $136,832 ($535,926/47 x 12 = 136,832). R.D. at 36.

In response to the City's request for the additional rate case expense of $125,256 (as of February 28, 2011) and all future claims through a true-up, the ALJ recommended that this request be denied. The ALJ noted that the City's request relates to alleged expenses that are not part of the record, and cannot be considered in her Recommended Decision. 66 Pa. C.S. §332(d). According to the ALJ, no Party has had a full and fair opportunity to respond to these claims, as there was no evidence submitted for the record, no cross-examination, and no provision for testimony or exhibits; therefore, no due process was provided. Furthermore, the City's request for a true-up to permit recovery of all future rate case expenses, regardless of justness and reasonableness, constitutes a request to circumvent the Code and case law. 66 Pa. C.S. §315(a); *Popowsky, supra.* Rate case expenses do not qualify for the automatic

adjustments provided by law under 66 Pa. C.S. §1307. Also, contrary to the City's contentions, the acceptance by the Parties of a certain level of rate case expense (*i.e.* the $535,926 that was included in the evidentiary record) cannot be construed as a continuing acceptance of any additional level of rate case expense, regardless of the amount. R.D. at 36-38.

3. Exceptions and Replies

In its Exceptions, the City asserts that its update of rate case expenses as of February 28, 2011, took place before the close of the record, was included within the rate case file of this proceeding and should have been considered by the ALJ. The City avers that all Parties did have a chance to review the City's claim and respond if they believed these expenses were not just or reasonable. The City further opines that it should be allowed to update its rate case expense numbers, not only through the close of the record, but also through the exceptions, reply exceptions and until the Compliance Tariff is complete. City Exc. at 5-9.

The City argues that it has made significant efforts to eliminate rate case expenses by accepting certain recommendations of other Parties and attempting to settle with the Parties in the case in order to avoid further litigation. The City refers to the Partial Settlement as an example of its successful avoidance of additional rate case costs. The City requests that the Commission should allow Lancaster to recover legitimate rate case expenses that are incurred until the litigation process is complete and to provide Parties with its actual invoices as needed. According to the City, it would be unjust to suggest that Lancaster not be entitled to recoup its rate case expenses through to the conclusion of the case. City Exc. at 9-10.

In response, the OTS states that the fact that this additional rate case expense amount of $125,256 was not presented until Reply Briefs and in a letter dated March 17 2011, establishes a *prima facie* case that no Party was given the opportunity to respond as there is no provision for response to Reply Briefs. The OTS opines that the burden of proof is on the utility and it is up to the City to provide enough evidence to meet its burden and support its claim. The OTS avers that the City did have the option to supplement the record with the invoices as the Commission's rules of practice and procedure establish that a party may petition to reopen the record in a proceeding at any time after the record is closed, but before a final decision has been issued. The OTS maintains that the City failed to avail itself of this option. If it had done so, the other Parties would have been given an opportunity to review the supporting evidence and respond accordingly. According to the OTS, the City's failure to act has put it in a position where it is now asking the Commission to allow a further increase in rates based on non-record evidence. OTS R. Exc. at 5-8.

In its Reply Exceptions, the OCA opines that the City fails to recognize the distinction between the broader rate case file and the more narrow evidentiary record. According to the OCA, the physical inclusion of the City's March 17 2011, letter in the rate case file means the letter is a matter of record. However, the OCA points out that the contents of the letter were not moved or admitted into the evidentiary record and cannot be relied on to support a higher expense claim. 52 Pa. Code § 5.402. Furthermore, the OCA states that the other Parties did not have a specific opportunity to respond to the Company's request for an additional $125,256. The OCA maintains that the City did not request recovery until March 17 2011, the day the record closed. The OCA notes that the City had the opportunity to estimate a reasonable level of costs to complete the known phases of litigation but failed to do so. OCA R. Exc. at 2-5.

In its Reply Exceptions, Kellogg avers that the amounts in question were not claimed on the record of this proceeding and, absent a request to reopen the record or a stipulation of the Parties allowing such update, cannot be allowed based upon a letter or a position taken in its Reply Brief. Kellogg R. Exc. at 2-3.

4. Disposition

Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we shall adopt the recommendation of the ALJ on this issue. We agree with the ALJ's recommendation that the normalization period for rate case expenses for the City should be set at forty-seven months. This normalization period is reasonable as it is based upon the actual filing intervals between the last four base rate filings of the City, not on the City's projection of potential future filings. Furthermore, we also adopt the recommendation of the ALJ that the City's additional request of $125,256 for additional rate case expense should be denied. While we agree with the City that the amount in question may have been included within the case file of this proceeding, this request occurred too late in the proceeding to allow the intervening Parties to respond to its accuracy and reasonableness. Simply stated, the City's request for an increased amount of rate case expense was not included within the evidence of record and therefore, cannot be permitted.

Based upon the foregoing discussion, we shall deny the Exceptions of the City, and we adopt the findings and recommendations of the ALJ. We find that the total allowable rate case expense allowance in this proceeding should be based on the City's last established rate case amount of record, which is $535,926 as of January 31, 2011, normalized over a period of forty-seven months. The result is a total annual rate case expense allowance of $136,832 ($535,926/47 x 12 = 136,832).

VII. Rate of Return

A. Introduction

It has been determined in this Commonwealth that a public utility is entitled to an opportunity to earn a fair rate of return on the value of its property which is dedicated to public service. *Pennsylvania Gas & Water Company v. Pennsylvania Public utility Commission,* 341 A.2d 239 (Pa. Cmwlth. 1975). This is consistent with longstanding decisions by the United States Supreme Court, including *Bluefield Water Works and Improvement Company v. Public Service Commission of* West Virginia *(Bluefield),* 262 U.S. 679, 690-93 (1923) and *Federal Power Commission v. Hope Natural Gas Company (Hope Natural Gas),* 320 U.S. 591, 603 (1944). In *Bluefield, supra,* the United States Supreme Court provided criteria by which regulators are guided for purposes of determining a fair rate of return for a public utility. The Court said:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment and business conditions generally.

The United States Supreme Court focused particularly upon the equity return in *Hope Natural Gas*, stating:

> It is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends.
>
> [T]he return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.

The overall rate of return position of the Parties is summarized in the following tables:

CITY OF LANCASTER

Capital Type	Capital Structure	Cost Rate	Weighted Cost
Long-Term Debt	50%	4.66%	2.33%
Common Equity	50%	11.25%	5.63%
Total	100%		**7.96%**

OTS

Capital Type	Capital Structure	Cost Rate	Weighted Cost
Long-Term Debt	83.8%	4.66%	3.91%
Common Equity	16.2%	9.69%	1.57%
Total	100%		**5.48%**

OCA

Capital Type	Capital Structure	Cost Rate	Weighted Cost
Long-Term Debt	83.8%	4.66%	3.91%
Common Equity	16.2%	8.75%	1.42%
Total	100%		**5.33%**

KELLOGG

Capital Type	Capital Structure	Cost Rate	Weighted Cost
Long-Term Debt	83.6%	4.66%	3.90%
Common Equity	16.4%	9.50%	1.56%
Total	100%		**5.46%**

B. Capital Structure

Capital structure involves a determination of the appropriate proportions of debt and equity used to finance the rate base. This is crucial to developing the weighted cost of capital, which, in turn, determines the overall rate of return in the revenue requirement equation. OTS St. No. 1 at14.

1. Positions of the Parties

The Capital Structure recommendations of the Parties in this proceeding are summarized in the following table:

Capital Type	City (1)	OCA (2)	OTS (3)	Kellogg (4)
	(%)	(%)	(%)	(%)
Debt	50.00	83.80	83.80	83.60
Common Equity	50.00	16.20	16.20	16.40
Total	**100.00**	**100.00**	**100.00**	**100.00**

(1) City St. No. 6 at 10, Sch. 1
(2) OCA St. No. 3 at 13
(3) OTS St. No. 1 at 7· OTS Ex. No. 1, Sch. 1
(4) Kellogg St. No. 1 at 2

As noted above, the City proposed a 50.00% debt/50.00% equity hypothetical capital structure for use in this proceeding (pro forma at December 31, 2010): City St. No. 6, Sch. 1. The other Parties proposed the use of the City's actual capital structure as of December 31, 2009, of 83.8% debt/16.20% equity, with Kellogg's slightly different actual capital structure likely due to rounding. OTS St. No. 1 at 12; OCA St. No. 3 at 13; Kellogg St. No. 1 at 6. Since Mr. Poulin apparently accepted the OCA cost of capital recommendations, he also by implication accepted the OCA recommended actual capital structure, from which these cost rates are derived. March 6 letter; OCA St. No. 3, Ex. JRW-1.

The City proposed the use of a hypothetical capital structure due to the City's atypical actual capital structure of 83.8% debt/16.20% equity as of 12/31/2009. The City asserted that its recommended 50.00% debt/ 50.00% equity hypothetical represented current water industry practice and was in line with Standard & Poor's (S&P's) implied ratios based upon published financial benchmarks. Lancaster contended that use of an industry standard eliminated the large cost rate adjustments resulting from differences in financial risk between the comparison group and the City. The City further noted that the Commission had used these more conventional ratios in past cases involving water utility systems. City St. No. 6 at 10-11.

The City compared its hypothetical capital structure recommendation to the composite capital structure of its comparison group, *infra*: the Water Group Followed by Analysts (Water Group). Lancaster's analysis indicated that the hypothetical ratio compared favorably to the Water Group on a current and projected (2014) basis, with a debt percentage of 50.0%, 49.70%, and 50.0% for the City, current, and projected Water Group, respectively. The equity ratios were 50.0%. 50.3% and 49.5% for the City.

current Water Group and projected Water Group, respectively. City St. No. 6 at 11, Table 1.

The City contended that the Commission will use hypothetical capital structures in municipal utility cases where the actual capital structure is atypical, and cited to *Lancaster Sewer 2005, supra; Pa. P.U.C. v. City of Lancaster Water (Lancaster Water 1999),* 197 PUR 4th 156, 161-162 (1999); and *Pa. P.U.C. v. City of Bethlehem, (City of Bethlehem),* 84 PA PUC 275, 304 (1995). The City emphasized the *Lancaster Sewer 2005, supra,* holding wherein the Commission agreed with the ALJ that Lancaster's actual capital structure of 73.23% debt/26.77% equity was atypical and a hypothetical capital structure should be used. City M.B. at 24-25. The City also cited to *Pa. P.U.C. v. Borough of Media (Borough of Media),* 77 PA PUC 446 (1992) wherein the Commission had previously considered whether a municipal utility such as the City should be viewed differently than investor-owned utilities in terms of financial risk of its capital structure. The Commission ruled that the Borough was in the business of providing water outside of its corporate limits, and would therefore be treated as a business enterprise with respect to its capital structure.

In addition, the City referenced *Carnegie Natural Gas Co. v. Pa. P.U.C. (Carnegie Natural Gas),* 433 A.2d 938, 940 (Pa. Commw. 1981), wherein the Commonwealth Court concluded that, when a utility's actual capital structure is too heavily weighted on either the debt or equity side, the Commission must make adjustments. *Carnegie Natural Gas* was viewed by the City as particularly relevant since the utility therein was wholly-owned by U.S. Steel, similar to the City which has a 'subsidiary' relationship with the City of Lancaster. Also, like the City, the utility in *Carnegie Natural Gas* was not in control of its capital structure and did not raise its own capital in the markets. The Court in *Carnegie Natural Gas* stated that, under these circumstances, the resulting capital structure of the subsidiary may be atypical, and

appropriate adjustments can be accomplished through a comparison to a barometer group's capital structure. The City contended that, just as in *Carnegie Natural Gas*, it had proposed an adjustment to its atypical capital structure that was consistent with the capital structures of the Water Group utilized in the City's cost of capital analysis. City M.B at 26-27.

The OCA advocated use of the City's actual capital structure because it would be inappropriate to allow the City to benefit by collecting revenues in the form of higher rates to fund capital costs that do not exist. The OCA emphasized that the City of Lancaster had the discretion to capitalize the Water Fund in any manner that it saw fit, and it did not need to meet public market norms for capital structure ratios. According to the OCA, use of the actual capital structure was appropriate since this is the capital structure that funds the City's jurisdictional rate base. OCA St. No. 3 at 14; OCA St. No. 3S at 2-3.

The OCA cited to several Commission cases in support of its position, including *Emporium 2006*; *Emporium 2001*; *Lancaster Water 1999*; and *Pa. P.U.C. v. Western Utilities, Inc. (Western Utilities),* 88 PA PUC 124 (1998). The OCA contended that Pennsylvania courts have upheld the Commission's use of the actual capital structure, and that hypothetical capital structures have generally been used to reduce costs to ratepayers, not increase costs. *Emporium Water v. Pa. P.U.C.* 955 A.2d 456 (Pa. Commw. 2008), *appeal denied,* 599 Pa. 702, 961 A.2d 860 (2008); *T.W. Phillips Gas and Oil Co. v. Pa. P.U.C.* 81 Pa. Commw. 205, 217, 474 A.2d 355, 362 (1984). In other words, according to the OCA, a hypothetical capital structure may be used by the Commission where a utility's actual capital structure would be unreasonable and uneconomical. *Big Run Tel. Co. v. Pa. P.U.C. (Big Run),* 68 Pa. Commw. 296, 301-02, 449 A.2d 86, 89 (1982). In the instant case, in the OCA's view, it would be unreasonable and uneconomical to use a hypothetical rather than the actual capital structure as it would

require ratepayers to pay higher equity costs which the utility does not incur. OCA M.B. at 20-25.

The OTS also advocated rejection of the City's proposed hypothetical capital structure and use of the actual capital structure for cost of capital purposes. The OTS stated that using a 50% debt/50% equity capital structure would shift 33.8% of the City's capital from debt to equity, thus allowing the City to charge its customers the higher equity cost rate for that portion of misplaced capital. In the OTS' view, it would be inappropriate to use a hypothetical capital structure and thereby allow the City to charge higher rates for capital costs that do not exist. OTS St. No. 1 at 11-14.

OTS further submitted that the City's reliance on comparisons to the capital structures of publicly-traded water companies for its proposed capital structure adjustment was in error because the City is not publicly traded and those capital structure ratios are therefore meaningless. OTS M.B. at 26-27. OTS disputed the City's assertion that a large financial risk adjustment would be necessary if the actual capital structure was used as the City is able to attract capital at a very low 4.66% debt cost rate. The OTS, like the OCA, asserted that it was the City's decision to capitalize the Water Fund at 84% debt/16% equity and that this decision should stand. OTS M.B. at 27-28.

Kellogg stated that it is essential, due to the magnitude of the City's requested rate increase, to use the City's actual capital structure for determining weighted cost rates so as not to unduly burden ratepayers. Kellogg used an actual capital structure ratio of 83.6% debt/16.4% equity which differed very slightly (20 basis points) from the actual capital structure ratio of 83.8% debt/16.2% equity used by the OCA and the OTS. Kellogg conducted an analysis of other municipal water utilities' capital structures and found a wide variation in ratios. Kellogg indicated that the City's actual debt ratio had been significantly lower in recent years, but had risen precipitously due to financing of

the new membrane treatment facilities. According to Kellogg, despite the greatly increased debt percentage, the City had been able to secure financing at competitive interest rates and that the same market forces that require lower debt ratios for investor-owned utilities do not hold true for municipal utilities. Kellogg St. No. 1 at 2-8.

Kellogg argued that the City had not demonstrated the reasonableness of using a hypothetical capital structure for the City in this case. Kellogg submitted that the Commission should re-examine its holding in *Borough of Media, supra,* in light of the *Bluefield* and *Hope Natural Gas, supra,* principles of allowing a utility only to earn a return sufficient to attract capital and maintain financial integrity. According to Kellogg, allowing a return based on a capital structure which reflects more equity than actually utilized effectively produces a higher cost of equity than is justified. Kellogg M.B. at 4-15.

2. ALJ Recommendation

The ALJ recommended that the City's proposed hypothetical 50.00% debt/ 50.00% equity capital structure be used for determining the City's cost of capital in this proceeding. The ALJ cited *Carnegie Natural Gas, supra,* wherein the Commonwealth Court ruled that the Commission must make adjustments to a utility's capital structure when that capital structure is too heavily weighted on either the debt or equity side. The ALJ stated that the Court also ruled that appropriate adjustments can be accomplished through comparison to a barometer group's actual capital structures. According to the ALJ, the Court held that the Commission need not show actual harm to ratepayers (*e.g.* higher debt costs) before imposing a hypothetical capital structure. *See also, Pa. P.U.C. v. The Columbia Water Company (Columbia Water Company),* Docket No. R-2008-2045157 *et al.* Opinion and Order entered June 10, 2009 at 67-71. R.D. at 47

According to the ALJ, the City presented comparative evidence that its actual capital structure was atypical when compared to the composite capital structures of the water utilities in its barometer group. The ALJ observed that the equity ratios of these barometer group companies were more than three times larger than the City's 16% actual common equity ratio. She noted that the hypothetical capital structure recommended by the City compared favorably with these comparable companies' capital structures. Many of these same water utilities were utilized in the barometer groups of those Parties that performed a cost of capital analysis. Also, the ALJ stated that she considered the arguments that investor-owned utility capital structures should not be used for comparison purposes and did not find them to be persuasive. Instead, she agreed with the City that investor-owned utility comparisons are appropriate. R.D. at 48.

The ALJ noted that in *Borough of Media*, the Commission specifically addressed the question as to whether a municipal utility should be evaluated differently than an investor-owned utility in terms of the financial risk of its capital structure. She stated that in that case, the Commission ruled that the Borough was in the business or providing water outside of its corporate limits, and would, therefore, be treated as a business enterprise with respect to its capital structure. R.D. at 49.

The ALJ also maintained that use of the City's actual capital structure would warrant an additional and substantial equity return adjustment. She stated that use of a hypothetical capital structure would avoid the necessity for risk adjustments for capital structures that would otherwise be overweighted with debt when compared to a barometer group. R.D. at 50.

3. Exceptions and Replies

In its Exceptions, the OTS contends that such use of a hypothetical capital structure in this proceeding would adversely affect ratepayers and is not needed. According to the OTS, the ALJ fails to provide any justification or sustainable support for the conclusion that the City's capital structure is unreasonable or uneconomical. The OTS avers that this proceeding is not so far removed from *Emporium 2006, Emporium 2001* and *Western Utilities.* The OTS notes that in those cases it appeared that the concern of the Commission was in shifting low cost equity into higher cost debt. The OTS opines that while the disparity between the debt cost and the claimed equity return in those cases may have been larger than it is in this case, there would still be a substantial portion of low cost debt that would have to be shifted to higher cost equity should the Commission impose this hypothetical capital structure. OTS Ex. at 3-6.

In its Exceptions, the OCA submits that the actual capital structure represents the City's decision on how to capitalize its' rate base and this actual capitalization forms the basis upon which the Water Bureau and the City attract capital. The OCA notes that the City's debt rate of 4.66% fully reflects the capitalization determined by the City to be appropriate. The OCA criticizes the ALJ's reliance on the comparison of the City's capital structure to the comparison's group's capital structures because the companies in the comparison groups are publicly traded companies and need to meet public market norms for capital structure ratios. According to the OCA, the City is not traded as a separate entity and does not need to meet those same requirements. OCA Exc. at 4-5.

Furthermore, the OCA avers that if there is low cost debt that is being treated as higher cost equity through the use of a hypothetical capital structure, then ratepayers are paying excessive costs and not receiving the benefit of the lower cost debt. The OCA maintains that the Commission has an obligation to, among other things; protect consumers from excessive costs of capital. *Pa. P.U.C. v. Carnegie Natural Gas*

Co. 54 PaPUC 381, 392 (1981). The OCA states that the way to protect consumers in this case is to use the actual capital structure, which would allow consumers to pay the costs incurred to capitalize the City's rate base. OCA Exc. at 5-7

Kellogg also excepted to the ALJ's recommendation to utilize a hypothetical capital structure. Kellogg avers that, notwithstanding the prior Commission decisions cited by the ALJ, utilization of a hypothetical capital structure for the City will result in excessive rates in violation of the standards established in the cases of *Bluefield* and *Hope Natural Gas.* According to Kellogg, the proposed capital structure would produce rates for the City which exceed those necessary for a utility to maintain its existing capital and attract new capital. Kellogg states that by allowing a hypothetical capital structure for a municipal utility that has been able to maintain a debt cost of 4.66% despite its financial leverage, the ALJ fails to recognize that the risks and uncertainties faced by the City do not correspond with the risks and uncertainties of investor owned utilities, which are compelled to utilize a more balanced capital structure. Kellogg Exc. at 4-6.

Kellogg submits that although there are circumstances where the use of a hypothetical capital structure may be appropriate, the City did not demonstrate the reasonableness of using a hypothetical capital structure in this case. According to Kellogg, this is because it did not show that the increase in financial leverage has a substantial impact on the cost of debt to the City. Kellogg avers that there is extensive evidence in this case showing that the City's cost of debt does not change significantly as a result of changes in the amount of debt in its capital structure. In fact, Kellogg maintains that the City has been able to substantially increase the debt funding of the Water Fund without increasing its debt cost. This increase in the debt portion of the capital structure without an increase in its debt cost speaks to the significant difference between the effect of leverage on municipal debt cost as compared to investor owned

debt cost and makes using investor owned capital structure a poor proxy for municipal utility capital structures, according to Kellogg. Kellogg Exc. at 6-8.

Additionally. Kellogg submits that the *Borough of Media* decision should be revisited by the Commission because allowing a capital structure for a municipal utility which reflects more equity than actually utilized effectively produces a higher return on equity than is justified to meet the objectives of attracting capital and maintaining financial integrity. Kellogg avers that while there can be little dispute that in that case a hypothetical capital structure was allowed, that determination was not based upon any specific finding that the capital structure resulted in additional financial risk. Rather, Kellogg notes that the Commission's justification for its decision was only that because Media was in the business of providing water service beyond its municipal limits, the capital structure should reflect that by use of the hypothetical capital structure. The Commission did not state that the borough of Media experienced additional financial risk because of its capital structure. Kellogg Exc. at 10-12.

In reply, the City opines that the arguments espoused by the OTS, the OCA and Kellogg to use Lancaster's actual capital structure are not supported by evidence and would break from the Commission's past practice and regulatory policies. The City argues that the ALJ reiterated the case law it cited and agreed that it fully supported the use of a hypothetical capital structure. The City cites *Carnegie Natural Gas* wherein, contrary to the arguments made by the other Parties, the Commonwealth Court held that the Commission need not show actual harm to ratepayers before imposing a hypothetical capital structure. City R. Exc. at 3-4.

The City also notes that the other Parties continue to debate whether a municipal utility should be evaluated differently than an investor owned utility in terms of the financial risk of its capital structure. Lancaster refers to the *Borough of Media* case

which specifically addresses this question, wherein the Commission ruled that the Borough was in the business of providing water outside of its corporate limits, and would therefore be treated as a business enterprise with respect to its capital structure. The City reiterates that this rationale was confirmed by the Commission with respect to municipal utilities in subsequent cases including *Lancaster Sewer 2005*, *Lancaster Water* 1999 and the *City of Bethlehem* 1995. City R. Exc. at 4-5.

4. Disposition

Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we are persuaded by the arguments of the opposing Parties to adopt the City's actual capital structure and shall reject the recommendation of the ALJ on this issue. We conclude that based upon the unique circumstances in this proceeding that the actual capital structure must be used for ratemaking purposes to achieve a fair balance between consumers and the City. The OTS, the OCA as well as Kellogg have correctly argued that the use of a hypothetical capital structure will produce an inflated overall rate of return that would adversely affect customers.

In considering this matter, we note that we have employed the hypothetical capital structure in prior proceedings. In 1974, the Commonwealth Court considered the capital structure of the Dauphin Consolidated Water Supply Company, a wholly-owned subsidiary of GWC, a holding company. *See Lower Paxton Township v. Pennsylvania Public Utility Commission and Dauphin Consolidated Water Supply Company*, 317 A.2d 917 (Pa. Cmwlth. 1974) (*Lower Paxton*). In considering this issue, the Court stated, as follows:

> In this case, the record discloses that Dauphin has a capital structure wherein 100 % is equity capital. Under such circumstances the PUC must make adjustments based upon substantial evidence in order to reach a fair result. In such cases our Superior Court has approved PUC adjustments whereby the capital structure and cost of capital of the parent company were utilized in determining the same for the subsidiary. It is also conceivable that there may be evidence on the record which will permit the PUC to utilize the capital structure and cost of capital statistics of comparable public utilities instead of those of the company or its parent.

Id. at 921 (citations omitted).

The *Lower Paxton* case indicates that, while the Commission must make adjustments to a utility's unbalanced capital structure, those adjustments are subject to the Commission's discretion. Accordingly, while the Court allows for a hypothetical capital structure, it does not mandate its use. In examining the facts of the case before them, the Court observed, as follows:

> The PUC concluded that it believed a capital structure of 55 % debt and 45 % equity was the 'most probable and practical for use in these proceedings. The capital structure of a public utility is a determination representing a judgment figure which should be left to the regulatory agency and should not be disturbed except for a manifest abuse of discretion. The record does not disclose such an abuse of discretion.

Id. at 921-922.

Another case where the company had a capital structure of 100 % equity was Carnegie Gas. In *Carnegie Natural Gas Company v. Pennsylvania Public Utility*

Commission, 433 A.2d 938 (Pa. Cmwlth. 1981) (*Carnegie*), the Court sanctioned adjustments to a utility's capital structure where the actual capital structure is out of balance. In *Carnegie*, the Commonwealth Court echoed the general rule followed in the *Lower Paxton* case:

> Where a utility's actual capital structure is too heavily weighted on either the debt or the equity side, the commission, which is responsible for determining a capital structure which allocates the cost of debt and equity in their proper proportions, must make adjustments to the utility's capital structure.

Id. at 940.

When the Court considered the record evidence in *Carnegie*, it observed the variability of capital structures in the barometer groups of both the small and large gas companies. From this evidence, the Court assumed that the Commission had the right to exercise discretion with regard to setting a hypothetical capital structure:

> From these figures we cannot extract an infallibly correct capital structure to which the commission must absolutely adhere. However, we conclude that the record does contain substantial evidence upon which the commission properly exercised its discretion by imputing to Carnegie a hypothetical capital structure within a fair and realistic range.

Carnegie at 941.

Clearly, the Commission has discretion in whether to use a hypothetical capital structure. However, the Commission must always balance the interest of the utility and the customers when considering a hypothetical capital structure. The Commonwealth Court stated that a water company with a variable capital structure was

not entitled to have its cost of capital computed on an ideal capital structure. Thus, there are no magic numbers for the proper percentage of debt and equity. However, the Court also concluded that 'it was proper for the commission to adjust the existing capital structure to arrive at one which would be fair and reasonable to both the utility and the ratepayers in the computation of the cost of capital. *Riverton Consolidated Water Company v. Pennsylvania Public Utility Commission*, 140 A.2d 114, 121-122 (Pa. Super. 1958) (*Riverton*).

In the instant proceeding, we agree with the Exceptions of the OTS that this case is not so far removed from *Emporium 2006, Emporium 2001* and *Western Utilities*, as in those cases it seemed that the concern of the Commission was in shifting low cost equity into higher cost debt. While the disparity between the debt cost and the claimed equity return in those cases may have been larger than it is in this case, there would still be a substantial portion of low cost debt that would have to be shifted to higher cost equity if the ALJ's recommendation to utilize the hypothetical capital structure is adopted. We note that the City's debt cost rate in this proceeding is at 4.66%, which reflects the City's ability to tax. This illustrates that the City's taxing power lowers the City's financial risk when compared to an investor-owned utility. Since Lancaster's status as a municipally owned utility provides it with the opportunity to obtain debt at this low cost rate as a result of the City's ability to tax, this low cost debt should not be shifted to higher cost equity at the expense of the City's customers. As a result, we do not find that the City has to be treated like an investor owned utility for ratemaking purposes.

Additionally, we note that the actual capital structure represents the City's decision, in which it has full discretion, on how to capitalize the Water Bureau's rate base. This actual capitalization forms the basis upon which the Water Bureau and the City attract capital. The City's debt cost rate of 4.66%, which all Parties have accepted

for ratemaking purposes, fully reflects the capitalization determined by the City to be appropriate. We find that the ALJ's reliance on the comparison of the City's capital structure to the comparison groups' capital structures inappropriate in this instance. The utilities in the comparison group are publicly traded companies that need to meet market norms for capital structure ratios. As the City is not traded as a separate entity and does not need to meet these same requirements the use of a hypothetical capital structure is misplaced. We find that using the City's hypothetical capital structure would impose excessive costs on customers because it requires customers to pay equity returns of over 10 percent on debt that costs, on average, 4.66 percent. On the other hand, use of the actual capital structure, as espoused by the OTS, the OCA and Kellogg, does not result in excessive costs to customers.

Based upon the foregoing discussion, we shall grant the Exceptions of the OTS, the OCA and Kellogg and will reject the finding and recommendation of the ALJ.

C. Cost of Debt

The City proposed to use its embedded long term debt cost rate of 4.66% at December 31, 2010. City St. No. 6R at 11. This cost of debt was accepted by the Parties performing a cost of capital analysis and was unopposed by any Party. The ALJ recommended that the Commission accept the City's 4.66% actual embedded cost of debt rate for use in this case. R.D. at 51. No Exceptions were filed to this issue. Finding the recommendation of the ALJ to be reasonable, we adopt it without further comment.

D. Cost of Equity

1. Overview

Although there are various models used to estimate the cost of equity, the Discounted Cash Flow (DCF) method applied to a barometer group of similar utilities, has historically been the primary determinant utilized by the Commission. The DCF model assumes that the market price of a stock is the present value of the future benefits of holding that stock. These benefits are the future cash flows of holding the stock, *i.e.* the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than dollars received today, the cash flow must be 'discounted' back to the present value at the investor's rate of return.

2. Summary

In the instant proceeding, six of the active Parties (the City, OCA, OTS, OSBA, Kellogg, and Mr. Poulin) presented a cost of equity position or limitation on a reasonable rate of return on equity. The Parties' positions were generally developed through comparison groups' market data, costing models, reflection or rejection of risk and leverage adjustments, and a tax savings adjustment, as will be further addressed, *infra*. The following table summarizes the cost of common equity claims made and the methodologies used by the Parties in this proceeding. It should be emphasized that the OSBA did not perform a study, and that its equity position is only a cap.

	DCF (%)	CAPM (%)	RP (%)	ROE (%)	Risk (%)	Leverage (%)	ROE (%)	Tax Adjusted (%)
CITY	10.6	10.5	10.2	10.4	0.25	0.6	11.25	9.23
OCA-Water	8.9	7.8		8.75	0.25	0	9.00	7.38
OCA-Gas	8.5	7.3	--					
OTS	8.53 to 10.87	8.45		9.69	0	0	9.69	7.75
Kellogg	8.2 to 8.9	7.7 to 7.9	**CE** 9.0 to 10.0	9.5	0	0	9.5	7.80
OSBA				10.78			10.78	

The City. proposed a common equity cost rate of 11.25%, based on the results of DCF. Risk Premium (RP), and Capital Asset Pricing Model (CAPM) studies, and risk (25 basis points) and leverage adjustments (60 basis points). The City's analysis used market data from a comparison group of six water companies, the Water Group. After adjusting the common equity cost rate for an 18% tax adjustment factor, the City's resulting cost of equity is 9.23% (6.95% overall). City St. No. at 29: City Ex. No. 6-A, Schs. 1, 2, 14, 19 and 20.

The OCA proposed a common equity cost rate of 9.0%, based primarily on the results of its DCF analysis, and to a lesser extent the CAPM, with allowance of the additional risk adjustment of 25 basis points and no leverage adjustment. The OCA used market data from both a gas and water comparison group, based upon its assessment that

financial data for the water group was insufficient. The OCA adjusted its common equity cost rate by a 22% tax adjustment factor, to derive a tax-equivalent equity cost rate for the City of 7.38% (5.11% overall). OCA St. No. 3 at 2-3, 53. Mr. Poulin adopted the OCA position on cost of equity and overall rate of return. March 6 letter.

The OTS proposed a common equity cost rate of 9.69%, based on the DCF results and the CAPM as a check, with no additional risk or leverage adjustment. The OTS used market data from a barometer group of six water companies, four of which were also in the City's comparison group. After adjusting the common equity cost rate for a 20.00% tax adjustment factor, the OTS' resulting cost of equity is 7.75% (5.16% overall). OTS St. No. 1 at 43-44, 51, 57; OTS Ex. No. 1, Schs.1- 2; City Ex. No. 6-A, Sch. 7.

Kellogg proposed a common equity cost rate of 9.50%, based primarily on the DCF. with consideration of the CAPM and Comparable Earnings Method (CE), and with a recommendation at the high end of the range in lieu of any further risk or other adjustments. Kellogg used market data for two comparison groups: a group of eight Value Line water utilities and the same comparison group of six water companies used by the City. After adjusting the common equity cost rate for an 18% tax adjustment factor, Kellogg's resulting cost of equity is 7.80% (5.175% overall). Kellogg St. No. 1 at 9-10, 22-23.

The OSBA proposed a cost of equity cap of 10.78%, based on the return on equity granted in *Pa. P.U.C. v. Aqua Pennsylvania, Inc. (Aqua PA 2008)*, 2008 WL 4145509, 17 (Pa. P.U.C. 2008). The OSBA took no position on the other issues relating to the equity cost rate, and took no position on the overall rate of return. OSBA St. No. 3 at 5.

3. Comparison Groups

a. Positions of the Parties

As the City's common stock is not traded, the Parties performing a cost of capital analysis (the City, OCA, OTS, and Kellogg) used market data from groups of utility companies, termed comparison or barometer groups, which have reported information and are asserted to be of similar risk.

Each Party utilized a comparison group of water utilities, but the OCA also advocated use of a comparison group comprised only of natural gas distribution companies. The only area of controversy concerning barometer groups is the OCA's use of this gas proxy group.

The City opposed use of the OCA's comparison group of natural gas distribution companies given the availability of data for water companies. City St. No. 6R at 19. As support for its position, the City observed that every other Party performed their studies using only water comparison groups. City M.B. at 33.

The City cited to *Columbia Water Company, supra,* a 2009 Commission case, wherein the OCA had made similar arguments for use of a gas company comparison group in determining cost of equity for a water utility. According to the City, the ALJ in that case agreed with the OTS position that natural gas distribution companies were too dissimilar to be used as a proxy for a water distribution company in a rate of

return analysis.[6] The City indicated it was unaware of any Commission ruling that had permitted a gas group to be used as a comparison group in a water rate case. City M.B. at 33-34. In its Reply Brief, the City reiterated its arguments, and concluded that the Commission should not include data from the gas group in its analysis to determine the appropriate return on equity for a water utility. City R.B. at 21.

The OCA asserted that a gas proxy group should be used, in addition to a water comparison group, because the financial data and analysts' coverage of the water companies was very limited. The OCA highlighted the regulatory similarities between the two industries and indicated that the return requirements should be comparable, although it noted that gas distribution companies face competition; whereas, water utilities do not. OCA St. No. 3 at 11

In its Main Brief, the OCA explained that sufficient data was not available for the DCF analysis using water data alone, and that it had used selection criteria for its gas group to enhance comparability. The OCA also noted that it had assessed the relative riskiness of the water and gas proxy groups and had found that the gas group was actually slightly less risky than the water group. The OCA took this factor into account in determining a cost of equity recommendation for the City. OCA M.B. at 26-27. Based on the foregoing, the OCA concluded that it had provided sufficient support for its use of natural gas distribution companies in its cost of capital analysis. OCA R.B. at 8-9.

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[6] While the City is correct that the ALJ in *Columbia Water Company* specifically ruled against use of gas companies as a proxy for a water company in barometer groups, it does not appear that the Commission specifically ruled on the issue in its Opinion and Order.

b. ALJ Recommendation

The ALJ recommend that only comparison groups containing water utilities be used for determining the City's cost of equity in this proceeding. The ALJ stated that she had not been convinced that gas companies are sufficiently comparable and therefore would not recommend that the Commission depart from its past practice of determining water utility rates of return through reported financial and analysts' data for other water utilities. The ALJ noted that it is particularly telling that, while the OCA contended there was insufficient data to perform a DCF analysis, all of the other Parties performed their studies using only data regarding water utilities. R.D. at 55-56.

c. Exceptions and Replies

In its Exceptions, the OCA maintains that the gas proxy group provides relevant information as an addition to the water proxy group results and the Commission should consider such in its cost of equity determination. The OCA reiterates that the financial data needed to perform a DCF analysis for the Water Proxy Group is limited, while the data for gas companies are much more complete. The OCA notes that the return requirements of investors in these industries are similar as both industries are capital intensive, heavily regulated and provide for the distribution and delivery of an essential commodity. Furthermore, the OCA opines that the DCF results for the Gas Proxy Group provide a better indicator than the DCF results for the Water Proxy Group. OCA Exc. at 11-13.

In response, the City notes that the OCA's arguments for use of the gas comparison group have previously been rejected by the Commission, *Columbia Water Company*. In fact, the City states that it is not aware of the Commission ever allowing a gas group to be used as a comparison group in a water case. City R. Exc. at 10-12.

d. Disposition

Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we shall adopt the recommendation of the ALJ on this issue. We are not persuaded by the arguments of the OCA that insufficient financial data is available to perform a DCF analysis for water companies as each of the other Parties presented DCF studies using only data from other water utilities. We would also disagree with the OCA's statement that the industries are that similar considering the traditionally regulated nature of water utilities in Pennsylvania as compared to the more competitive and restructured natural gas industry in which Pennsylvania consumers are no longer limited to purchase natural gas from its traditional natural gas distribution company. For this reason, we agree with the City and the ALJ that natural gas distribution companies are too dissimilar from a water distribution company to be used as a proxy in a rate of return analysis.

Based upon the foregoing discussion, we shall deny the Exceptions of the OCA, and we adopt the finding and recommendation of the ALJ that comparison groups containing water utilities only be used for determining the City's cost of equity in this proceeding.

4. Cost Rate Models

a. Positions of the Parties

The City developed its cost of equity recommendation using the DCF CAPM, and RP models. According to the City, several different models should be employed as the security price for which the equity cost rate is being estimated reflects

the application of many models. The City also cautioned about the impact of recent mergers and merger speculation on stock prices and indicated that these impacts must be considered when determining the weight to be given to the DCF results. City St. No. 6 at 28-31.

The City derived an average dividend yield of 3.5% for its barometer Water Group, based upon the most recent months' yield at the time of direct testimony preparation, July 2010, and the twelve-month average yield ending July 2010. This was adjusted for ½ the expected growth rate, for a resultant dividend yield of 3.6%. City St. No. 6 at 32; City Ex. No. 6-A, Sch. 14.

For its growth rate, the City used both historical and projected growth rates from four sources for the Water Group as shown in City Ex. No. 6-A, Sch. 15: First Call, Reuters, Zacks Investment Research and Value Line. According to the City, historical growth rates were not separately shown in its analysis because they are already considered in the projections. The City concluded that the range of growth rates supports the reasonableness of an expected 7.0% growth rate based on five-year projected growth rates. The City then derived a 10.6% market value DCF cost rate for its comparison group (3.6% + 7.0% = 10.6%). City St. No. 6 at 35.

The City further indicated that less weight should be given to the market value DCF result due to current market capitalization ratios and the impact the market-to-book ratio has on the DCF results. The City applied the Hamada Model and determined that the comparison group market value DCF result should be adjusted upward by at least 0.6% since it is going to be applied to book value. The end result is that the City's book value DCF cost rate for the comparison group is 11.2%. City St. No. 6 at 40-42.

Regarding the CAPM analysis, the City indicated that the CAPM is based on the assumption that investors hold diversified portfolios and that the market only rewards non-diversifiable risk when determining the price of a security because company-specific risk is removed through diversification. Further, investors are assumed to require higher returns for additional risk. This assumption is captured through use of a beta that provides an incremental cost of an additional risk over and above a risk-free rate (a long-term Treasury yield of 4.3%). The City used a beta of 0.73 for the comparison group. City St. No. 6 at 42-43.

A market premium is also necessary to determine a CAPM derived cost rate. The market premium is then multiplied by the company specific beta to develop a risk adjusted market premium. The City determined that the average projected market premium is 10.1%, based upon the Value Line average projected total market return for the next three to five years of 14.4%, less the risk free rate of 4.3%. The City performed adjustments to reflect that Value Line market premiums have been on the high side and to reflect small size risk. After considering historical and projected returns, as impacted by market volatility, the City derived an average market value CAPM for its comparison group of 10.5%, or 11.1% after application of the 0.6% leverage (market-to-book) adjustment previously mentioned (10.5% + 0.6% = 11.1%). City St. No. 6 at 43-45.

In its RP analysis, the City determined the common equity investors' premium over the long-term debt cost for the comparison group to be 4.5%, based upon the published projected and probabilistic forecasted risk premium. Adding the risk premium of 4.5% to the prospective cost of newly issued long term debt of 5.7% resulted in a market value risk premium derived cost of equity of 10.2% (4.5% + 5.7% = 10.2%). The City then added the 0.6% leverage adjustment previously discussed, for a 10.8% book value cost of equity. City St. No. 6 at 45-49.