

The three above-described methods resulted in a comparison group equity cost rate range of 10.8-11.2%, and a determination by the City that the cost rate is at the midpoint or 11.0%. To reflect risk differences between the City and the comparison group, the City added a twenty-five basis point adjustment, with a resultant 11.25% cost of equity recommendation for the City. City St. No. 6 at 50-51.

The City further noted that If the Commission decides to adjust the City's cost of equity rate to reflect a tax savings adjustment (as was done in *Lancaster Sewer 2005*), the City's recommendation as to cost of equity would then be 9.23% (an 18% tax adjustment factor), to reflect that the City's return is not subject to personal income taxes. City St. No. 6 at 51-52.

The City asserted that all other Parties' cost of equity positions, with the exception of the OSBA, were entirely unreasonable, based upon recent Commission decisions in *Aqua PA 2008* and *Columbia Water Company, supra*, and should not be accepted by the Commission. It contended that the low proposed returns of 9.69%, 9.0% and 9.5%, recommended by the OTS, the OCA (including Mr. Poulin) and Kellogg, respectively, would have a negative impact on the City and its customers due to financing disadvantages. The City noted that Value Line's projected returns for the comparison group range from 10.0% to 13.5% and that these returns highlight the unreasonableness of the other Parties' recommendations. It contended that the OCA recommendation of 9.0% was based solely on an erroneous assumption, that utility stock prices should equal book value.

The City claimed that the OCA, the OTS and Kellogg DCF recommended equity cost rates were below the zone of reasonableness due to their growth rate selection, which the City viewed as personally derived, and relied upon historical growth. As an example, the City pointed to the OTS' use of a historical, log linear growth rate

averaging 5.17%, when the average published projected growth rate for the OTS comparison group was 7.52%. OTS Ex. No. 1, Sch. 18. It claimed that Wall Street analysts had already considered historical growth rates in developing their projections. It criticized the OCA and Kellogg market value DCF determinations as relying on a self-calculated growth rate, and contended that these Parties also relied upon internal growth estimates which measure growth in book value, not stock price, and are not a good proxy for investors' growth expectations.

The OCA applied the DCF and the CAPM to two previously-mentioned comparison groups which it termed 'proxy groups' the 'Water Proxy Group' and the 'Gas Proxy Group. OCA St. No. 3 at 2. For the DCF dividend yields, the OCA used the median of the six month and December 2010 dividend yields, and adjusted the results by one-half the expected growth to reflect growth for the coming year. The result was a 3.35% dividend yield for the Water Proxy Group and a 4.15% dividend yield for the Gas Proxy Group. OCA St. No. 3 at 27-28.

For its DCF growth rate analysis, the OCA used both historic and projected growth rates. The OCA concluded that an expected growth rate of 4.25% would be reasonable for the Gas Proxy Group, and an expected growth rate of 5.5% would be reasonable for the Water Proxy Group. OCA St. No. 3 at 37. Therefore, the OCA derived an 8.5% DCF equity cost rate for the Gas Proxy Group and an 8.9% DCF equity cost rate for the Water Proxy Group. OCA St. No. 3 at 38.

For its CAPM analysis, the OCA used 4.25% for the risk-free rate, based on U.S. Treasury bond yields. OCA used the median beta of 0.75 for the Water Proxy Group and 0.65 for the Gas Proxy Group. In deriving the equity risk premium or market premium, the OCA employed a variety of expert sources and determined that the market premium should be 4.68%. Based on these three CAPM inputs for each comparison

group, the OCA calculated a CAPM equity cost rate of 7.80% for the Water Proxy Group and 7.30% for the Gas Proxy Group. OCA St. No. 3 at 40-49.

The OCA gave primary weight to the DCF and concluded that the DCF results of the Gas Proxy Group provided a better indicator than the DCF results for the Water Proxy Group. As a result, the OCA determined that the appropriate equity cost rate for a water company is in the 8.5% to 9.0% range. The OCA checked that range against its CAPM results and noted that the range was reasonable given the lower CAPM results for both comparison groups. As the OCA found that water companies are slightly more risky than gas companies, it recommended the midpoint of the range, or 8.75%, as an appropriate equity cost rate for a water company. OCA St. No. 3 at 49.

The OCA added the 25 basis point risk adjustment used by the City to reflect the risk differential for the City as compared to the average Water and Gas Proxy Group companies. Therefore, the OCA's resulting equity cost rate recommendation for the City is 9.00% ($8.75\% + .25\% = 9.00\%$), before reflection of the tax adjustment factor. The OCA did not accept the sixty basis point leverage adjustment. However, the OCA did adjust its recommended equity cost rate for the City by a tax factor adjustment of 22%, for a final cost of equity recommendation of 7.38%. OCA St. No. 3 at 52-53.

The OCA cited many Commission decisions, including *Columbia Water Company* and *Emporium 2006*, in support of its position that the Commission favors use of the DCF and has relied on the DCF approach for setting equity returns for many years. OCA M.B. at 29-30.

The OTS used the DCF exclusively in deriving a cost of equity recommendation, but used the CAPM as a check on the reasonableness of the result. For the DCF dividend yield, the OTS placed equal emphasis on the most recent spot and

fifty-two week average dividend yields, to avoid problems of short-term aberrations, and derived a 3.35% dividend yield after adjustment for future growth. OTS St. No. 1 at 45. For the growth rate analysis, the OTS used both projected earnings forecast and a log-linear regression analysis to mitigate the effects of lower base year earnings and upward bias. The expected growth rate result for the barometer group prior to the log-linear regression analysis was 7.52%. After the analysis, the average growth rate was 5.17%. This resulted in a DCF range of 8.53 to 10.87%, with a midpoint of 9.69%. The OTS recommended a DCF equity cost rate for Lancaster at the midpoint of 9.69% (7.75% after application of the OTS 20% tax factor adjustment). OTS St. No. 1 at 45-50.

The OTS also performed a CAPM analysis as a check on its DCF cost of equity finding of 9.69%, and as 9.69% is within the top end of the range of CAPM results (8.45% midpoint), the reasonableness of the DCF result was confirmed. OTS St. No. 1 at 51-56.

The OTS pointed to the Commission's decision in *Lancaster Sewer 2005*, wherein the Commission stated that it had relied primarily upon the DCF methodology in arriving at the determination of the proper cost of equity, and that its actions in prior cases did not compel the use of a composite of the DCF and other methods. OTS R.B. at 16-17.

Kellogg applied the DCF, CAPM, and a CE analysis to two water company comparison groups. For the DCF dividend yields, Kellogg used the average daily closing stock price for the most recent three-month period (September – November 2010), and the current annualized dividend rate for each company. The result was a median dividend yield for each group of 3.23%. Kellogg Sch. GAW-3 at 1.

For the DCF growth rate analysis, Kellogg used both historic and projected growth rates, as most utility analysts agree that, in general, historical growth is a reasonable barometer of future growth. Based upon this analysis, Kellogg determined that a proper DCF cost of equity is in the range of 8.2% to 8.9%. Kellogg St. No. 1 at 13-14.

For his CAPM analysis, Kellogg used a three-month average yield (September –November 2010) for 20-year U.S. Treasury bonds of 3.60%. Kellogg used the most current Value Line betas for each company in the comparison groups, in the range of 0.70 to 0.95. Kellogg derived a market risk premium of 5.54%. The resulting cost of capital is in the range of 7.7 to 7.9%. Kellogg St. No. 1 at 16-17.

For its CE analysis, Kellogg used expected returns to be earned on the book value of similar risk enterprises for the study period 1992 to 2009. Based on this analysis, a cost of equity of no more than 9.0% to 10.0% was indicated, according to Kellogg. Kellogg St. No. 1 at 18-20.

Based on these three methodologies, Kellogg determined that primary weight should be given to the DCF and CE analyses, which results in a cost of equity of 8.5% to 9.5% applicable to investor-owned utilities. Due to the City's additional debt leverage, Kellogg used the upper end of the range or 9.5%, and then adjusted this downward by an 18% tax savings factor, to produce a recommended allowed return on equity of 7.8%. Kellogg St. No. 1 at 21-22.

b. ALJ Recommendation

The ALJ agreed with the OTS position and recommended that the City's cost of equity be determined by using the DCF methodology, with another methodology

as a check on the DCF reasonableness. While the City has cited *Aqua PA 2004, supra*, and *PPL 2004, supra*, as authority for its claim that the Commission has rejected sole reliance upon one methodology, such as the DCF, the ALJ disagreed with the City's interpretation. According to the ALJ, in those cases, the Commission agreed that the cost of equity could be determined by using the DCF method, but that other financial models should be used as checks on the reasonableness of the DCF results. The ALJ noted that the Commission specifically addressed the implications of its *Aqua PA 2004, supra*, and *PPL 2004, supra*, holdings in, *supra*, as noted by OTS in its Reply Brief. The Commission stated as follows in *Lancaster Sewer 2005, supra*, 2005 Pa. PUC LEXIS 44, *161.

We have primarily relied upon the DCF methodology in arriving at our determination of the proper cost of common equity. Our previous actions in *PPL, PAWC* and *Aqua* do not compel the use of other methods such as RP and CAPM to form an equity return based upon a composite of the DCF and other methods. However, we conclude that methods other than the DCF, such as the CAPM and RP methods, can be used as a check upon the reasonableness of the DCF derived equity return calculation.

The Commission further confirmed its endorsement of this approach in *Aqua PA, supra*, as follows:

The ALJs recommended determining Aqua's cost of common equity using the DCF method, with other standard financial models (including CE, RP and CAPM) being used as checks upon the reasonableness of the DCF results. Finding the ALJs' recommendation to be reasonable, appropriate and otherwise in accord with the record evidence, it is adopted.

Also, the ALJ noted that even more recently, in *Columbia Water Company, supra*, a 2009 decision, the Commission reaffirmed its use of the DCF as it noted, *at slip*.

op. p. 78: 'we primarily rely on the DCF methodology while using the other cost of equity methodologies as a check on the DCF results. R.D. at 66-67 /

The ALJ noted her agreement with the OTS use of DCF with reliance on the CAPM analysis as a check on the reasonableness of the DCF result and with the fact that OTS used only water utilities companies in its barometer group. As a result, the ALJ recommended a 9.69% cost of equity for the City, prior to reflection of any other adjustments. R.D. at 67-68.

c. Exceptions and Replies

In its Exceptions, the City avers that its DCF derived common equity cost rate of 10.6% should be adopted over the ALJ's adoption of the OTS analysis because the City utilized a more precise methodology than the OTS method. The City maintains that its intent in using multiple capital models was to follow past decisions by the Commission and perform an adequate check upon the reasonableness of the DCF results. The City requests that the results from these other models be taken into consideration in the Commission's decision making process. The City opines that the application of any single model to estimate common equity cost rates is not appropriate because the stock price for which the equity cost rate is being estimated reflects the application of many models used in the valuation of the investment. According to the City, noted financial texts, investor organizations and professional societies all endorse the use of more than one valuation method. City Exc. at 10-12.

In reply, the OTS avers that the City placed too much reliance and emphasis on the RP and CAPM methods with the result that its cost of common equity position is not based on sound ratemaking principles. The OTS states that it has followed

Commission precedent in determining the appropriate cost of equity in this proceeding and its analysis should be adopted by the Commission. OTS R. Exc. at 3-5.

In its Reply Exceptions, the OCA notes that the Commission has relied on the DCF approach for setting returns on equity for many years. The OCA avers that the language in *Columbia Water* supports the approach taken by the ALJ, namely, the primary use of the DCF methodology and the use of the other methodologies as checks on the reasonableness of the DCF results. Furthermore, the OCA opines that the City's additional models suffer from many flaws and should be rejected. OCA R. Exc. at 6-7

In its Reply Exceptions, Kellogg notes its support for the assessment of other cost models as a check on the reasonableness of the DCF method. In its opinion, those models support the reasonableness of the ALJ's recommendation, based on the DCF model, of a 9.69% cost of equity. Kellogg further asserts that the City's CAPM and CE models produced excessive results because of their use of inconsistent data. Kellogg R. Exc. at 3-4.

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 that the City's cost of equity in this proceeding should be based upon the use of the DCF methodology with the other methodology results used as a check on the reasonableness of the DCF results. We find that is exactly what was recommended within the position of the OTS in this proceeding. We note that we have primarily relied upon the DCF methodology in arriving at previous determinations of the proper cost of equity and utilized the results of methods other than DCF, such as the CAPM and RP methods, as a check upon the reasonableness of the DCF derived equity return

calculation, tempered by informed judgment. We are not persuaded by the arguments of the City that we should alter that procedure in this particular proceeding.

Based upon our analysis and review of the record evidence, we adopt the ALJ's recommended adoption of the OTS methodology, but do not accept the ALJ recommendation that the cost of equity be set at 9.69%. Instead, and based upon our prior determination to utilize the City's actual capital structure to determine an appropriate cost structure, and informed judgment, we find it reasonable and appropriate to adjust the City's cost of equity upward to 10.00% in this proceeding. We note that a higher cost of equity is necessitated by our adoption of the City's actual capital structure, but it is important to note that our allowance of a 10.00% return on equity falls squarely within the range of the DCF results as calculated by the OTS (8.53 to 10.87%). We conclude that 10.00% is the appropriate cost of equity allowance in this proceeding and also find that, based on our other conclusions to be discussed *supra*, that this cost of equity should not be further adjusted.

Based upon the foregoing discussion, we shall deny the Exceptions of the City, and we adopt the finding and recommendation of the ALJ, in part, and adopt a cost of equity for the City of 10.00% as being reasonable and appropriate under the circumstances in this proceeding.

5. Risk Adjustment

a. Positions of the Parties

The City proposed a twenty-five basis point adjustment in the cost of equity to reflect the risk difference between the City and the comparable group. In its Main Brief, the City argued that this adjustment was warranted due to the additional business

risk associated with its small size, capital intensity, a high variability in earnings, and the debt leverage in the proposed OTS, OCA and Kellogg capital structures. City M.B. at 46-49

The OCA accepted the City's twenty-five basis point adjustment to account for greater financial risk as the City of Lancaster has a lower bond rating than the average of the two OCA comparable groups. OCA M.B. at 41.

The OTS opposed reflection of the City's proposed twenty-five basis point adjustment which it characterized as unnecessary. The OTS disputed the City's claim that a smaller company requires less financial leverage than a larger company to balance out investment risk, and contended that size does not negatively impact the utility industry. The OTS pointed to the City's low cost of debt as evidence that small size has not affected the City. The OTS also disagreed with the City's capital intensity claims and contended that the City's calculation had not been supported. It disputed the City's contentions concerning a low bond rating as purely speculative. Finally, the OTS asserted that the City's debt service coverage is adequate without the need for further 'add-ons. OTS M.B. at 40-44; OTS R.B. at 17-18.

Kellogg made no specific risk adjustment in its cost of capital study for the City's business or financial risk, but as stated previously, used the upper end of the equity cost rate range for its recommendation. Kellogg contended that no other risk adjustment was appropriate, especially because the municipality had the ability to tax. Kellogg M.B. at 28.

b. ALJ Recommendation

The ALJ recommended that the City's twenty-five basis point adjustment for additional financial and business risk vis-à-vis the comparable group be rejected. The ALJ noted that this adjustment is at least partially to reflect an increased financial risk, as indicated by reference of the Parties to the increased debt leverage vis-à-vis the comparable group, and alleged associated bond rating differences. However, the ALJ stated that she had already accounted for any additional financial risk through a recommendation of a hypothetical capital structure for the City. According to the ALJ, any further financial risk adjustment, without quantification of the portion which is business risk and the portion which is financial risk, would at least be a partial double count. R.D. at 69.

Furthermore, the ALJ stated that the purpose of the hypothetical capital structure was to avoid the necessity for risk adjustments for capital structures, such as the City's, which are over weighted with debt when compared to a barometer group. Use of the hypothetical capital structure places the City on an 'equal footing' to the comparison group and therefore, no further adjustment is necessary. R.D. at 69

c. Disposition

No Party excepts to the ALJ's recommendation in regard to the ALJ's rejection of the City's twenty-five basis point risk adjustment. We agree with the finding of the ALJ that the risk adjustment is not appropriate in this proceeding but differ with her reasoning employed as we did not adopt the ALJ's recommendation to use a hypothetical capital structure. We are persuaded by the arguments of the OTS and Kellogg that this adjustment is simply unnecessary and note that we have concluded previously that a higher cost of equity be adopted to reflect our adoption of the City's

actual capital structure. No additional risk adjustment is warranted in this instance. Finding the ALJ's conclusion that the risk adjustment be rejected as reasonable, appropriate and in accordance with the record evidence, it is adopted.

6. Leverage Adjustment

a. Positions of the Parties

The City asserted that an additional sixty basis point market-to-book adjustment is required to the DCF-derived cost of equity to account for the application of a market-derived DCF cost rate to a book value cost rate. It explained that market-derived cost rates reflect the financial risk or leverage associated with capitalization ratios based on market value, and therefore must be adjusted for book value. The City contended that a similar adjustment was accepted by the ALJ and the Commission in *Lancaster Sewer 2005*. City M.B. at 44, 49-50; City R.B. at 32-34.

The OCA and the OTS rejected the City's proposed sixty basis point market-to-book adjustment as lacking logical or empirical basis. These Parties indicated that the proposal was not really a 'leverage' adjustment, and the OCA contended that a market-to-book ratio above 100% simply means that the company is expected to earn more than investors require. No adjustment is needed in that situation, according to the OCA. OCA M.B. at 41-43; OCA R.B. at 14-15; OTS M.B. at 44-46.

Kellogg used the high end of its cost of equity range for the City and did not specifically adopt the leverage adjustment. Kellogg M.B. at 28-29; Kellogg R.B. at 19.

The OSBA proposed a 10.78% return on equity cap, based upon the Commission's award in *Aqua PA 2008*. To the extent that the Commission has considered market-to-book adjustments in the past when the DCF is understating the cost of equity, the OSBA's position is relevant to this issue. OSBA M.B. at 5.

b. ALJ Recommendation

The ALJ recommended that the sixty basis point market-to-book adjustment be accepted as the Commission has concluded that the DCF method tends to understate the equity cost rate when market-to-book ratios are greater than 100%, which they are at present. According to the ALJ, the Commission has accepted a market-to-book adjustment in many cases including *Lancaster Sewer 2005*, *PPL 2004*, *Aqua PA 2004*, and *Pa. P.U.C. v. Philadelphia Suburban Water Co.* 219 PUR 4th 272 (2002). The ALJ concluded that the 9.69% DCF-derived cost of equity for the City is understated and that the sixty basis point adjustment is necessary. As a result, the ALJ's recommended cost of equity for the City is 10.29% (9.69% + .60% = 10.29%). R.D. at 71-72.

c. Exceptions and Replies

In its Exceptions, the OTS contends that the ALJ's recommendation is in error because it assumes that an adjustment to calculated cost of common equity findings is necessary. The OTS avers that the addition of this discretionary adder does nothing but inflate the objective return on equity by adding subjective basis points. The OTS opines that the ALJ's reasoning, that the DCF analysis understates the cost of equity when market-to-book ratios are greater than 100%, is flawed. The OTS points out that the Commission failed to include a leverage adjustment in *Aqua 2008*, wherein the market-to-book ratio was also greater than 100%. The OTS maintains that it would be unwarranted to grant this adjustment especially if the Commission would grant the use of

a hypothetical capital structure. However, the OTS avers that any enhancements to the results of the market based DCF calculations are unnecessary and will harm ratepayers whether a hypothetical or actual capital structure is used. OTS Exc. at 6-8.

In its Exceptions, the OCA argues that an upward adjustment to the DCF result is not needed in this situation. According to the OCA, when market value exceeds book value that means a company is expected to earn more than investors require, and therefore, it would be illogical to adopt an additional leverage adjustment. The OCA states that the City's proposal would raise the ROE for utilities that already have high returns on common equity and lower the ROEs for utilities that have low returns on common equity. Furthermore, the OCA submits that no regulatory commissions have adopted the City's leverage adjustment previously. OCA Exc. at 8-10.

Kellogg also excepts to the ALJ's recommendation submitting that the ALJ erred and that it agrees with the arguments raised by the OCA. Kellogg avers that it did not endorse a market-to-book 'leverage adjustment' in this case because of the City's significant debt leverage. Instead, Kellogg states that it utilized the upper end of its market based cost of equity findings to establish the cost of equity. Kellogg avers that no further adjustment to the cost of equity is appropriate because the DCF is applied to a book value rate base, as the Commission determined in *Aqua PA 2008* and other cases. Kellogg Exc. at 12-13.

In reply, the City notes that while it agrees that a leverage adjustment is not always warranted, the current case is distinguishable from the *Aqua 2008* case and further avers that other Commission rulings support the use of a leverage adjustment. The City states that the Commission has accepted a market-to-book adjustment in many other cases including *PPL 2004*, *Aqua PA 2004* and *Pa. P.U.C. v. Philadelphia Suburban Water Co.* 219 PUR 4th 271 (2002). The City also points out that the OCA's claim that

no regulatory commission has ever adopted its leverage adjustment is untrue, citing to the 2005 *Lancaster Sewer* rate case in which a leverage adjustment was adopted by the Commission. City R. Exc. at 12-15.

d. Disposition

Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we shall reject the recommendation of the ALJ on this issue. We are persuaded by the arguments espoused by the OTS, the OCA and Kellogg that the ALJ's recommendation is in error as any adjustment to the results of the market based DCF as we have previously adopted are unnecessary and will harm ratepayers. Consistent with our determination in *Aqua 2008* there is no need to add a leverage adjustment to the 10.00% DCF based cost of equity determination previously adopted in this proceeding.

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

7. Tax Adjustment

As stated by the Commission in *Lancaster Sewer 2005*, 2005 Pa. PUC LEXIS 44, *148, this particular issue arises due to the fact that interest paid to municipal bond holders is exempt from taxation. Thus, a tax savings factor has been recognized based upon the premise that investors will accept a lower return in exchange for the tax exemption.

a. Positions of the Parties

According to the City, if the Commission decides that a tax adjustment on the equity cost rate is warranted it recommends a maximum tax adjustment of 18%, as was granted by the Commission in *Lancaster Sewer 2005*. This adjustment factor was based on the spreads between corporate and municipal bonds with similar credit ratings and with matching terms or lives. City St. No. 6 at 52. The City noted that Kellogg has accepted the 18% tax adjustment factor. The OSBA has not taken a position on this issue. OSBA R.B. at 5.

The OTS recommended a tax adjustment factor of 20% for the City. The OTS claimed that the City had failed to provide any support in this case for its recommended 18% tax adjustment, other than the fact that an 18% factor was adopted in *Lancaster Sewer 2005*. OTS St. No. 1 at 56-57. The OTS asserted that the tax rate of 20% represents the marginal tax rate for the largest block of municipal investors. OTS M.B. at 47-52; OTS R.B. at 19-20.

The OCA recommended a 22% tax adjustment factor. The OCA conducted a study of yields on 30-year AA-rated industrial bonds versus 30-year AA-rated national and Pennsylvania municipal bonds over the past year. According to the OCA, the average spread over that year for the industrial series over municipal was 22%. OCA St. No. 3 at 52-53. The OCA cited to several cases in support of tax savings recognition, including a 1998 Lancaster Water case wherein a 28% tax savings adjustment was upheld by the Commonwealth Court.⁷ OCA M.B. at 43-44; OCA R.B. at 15-16.

⁷ See, *City of Lancaster Water v Pa. P.U.C. (Lancaster Water 2001)*, 769 A.2d 567 (Pa. Commw. 2001), *appeal denied*, 568 Pa. 725, 797 A.2d 916 (2002).

b. ALJ Recommendation

The ALJ recommended that the Commission adopt a tax savings adjustment, as it has done for many years in municipal utility base rate cases. *See, Lancaster Sewer 2005; Lancaster Water 1999; City of Bethlehem, supra.* In addition, Commonwealth Court has expressly approved utilization of a tax savings adjustment recognizing the difference in long-term bond costs for taxable bonds versus municipal or tax-free bonds, as was recommended by the OTS herein. *Lancaster Water 2001 supra.*

The ALJ further recommended that the OTS 20% tax savings factor adjustment be adopted in this case. She agreed with the OTS that the City has not met its affirmative burden of proof as to the justness and reasonableness of its proposed 18% tax adjustment, but has endeavored to support its position only through critiquing other Parties' positions. According to the ALJ, this is insufficient. The ALJ found that OTS has provided sufficient support for its position and has adequately responded to the criticisms of the City. The ALJ stated that she was particularly persuaded by OTS' 20% marginal tax rate evidence and concluded that it was this tax savings rate which is the most appropriate to use. R.D. at 75.

c. Disposition

No Party excepts to the ALJ's recommendation in regard to her adoption of the OTS recommended 20% tax savings factor adjustment. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

E. Conclusion

Based on the foregoing, the Commission concludes that the City's actual capital structure should be used for determining the weighted cost of capital in this proceeding. The City's cost of equity capital is appropriately determined by the DCF analysis performed by the OTS, with other methods utilized as a check on the reasonableness of the DCF results. The Commission adopts a recommended cost of equity rate of 10.00%, exclusive of any tax adjustment. In addition, the market-to-book adjustment of .60% is not granted and the City's proposed twenty-five basis point adjustment for financial and business risk is rejected. The tax savings factor to be used is the 20% factor appropriately supported by the OTS, for a tax-adjusted equity return of 8.00% ($10.00 \times .80 = 8.00\%$).

The following table summarizes our determinations concerning the city's capital structure, cost of debt and cost of common equity, as well as the resulting weighted costs and overall tax adjusted rate of return of 5.21%:

Capital Type	Ratio	Cost Ratio	Weighted Cost	Tax Adjusted	Tax adjusted Return
Debt	83.80	4.66	3.91	4.66	3.91
Equity	16.20	10.00	1.62	8.00	1.30
Total	100.00		5.53		5.21

VIII. Rate Structure and Rate Design

This section of the Opinion and Order addresses allocation issues, particularly as they relate to inside and outside customers, and the design of rates to recover these costs. Public utility rates should enable the utility to recover its cost of providing service and should allocate this cost among the utility's customers. *West Penn, supra.*

In this rate filing, the City was required to prepare a cost of service study, which is contained in City Ex. No. 4-A, as revised at City Ex. No. 3-R-1. Since the Commission has jurisdiction only with respect to customers outside of the City, it is necessary to support the proposed outside customer rates with costs associated with providing water service to these customers. The information in City Ex. No. 4-A includes a description of the methods used in the study, the allocation of costs, and the factors on which the allocations were based.

A. Cost of Service Methodology

1. Positions of the Parties

The City's cost of service study was based on the widely used base-extra capacity method of cost allocation. According to the City, the base-extra capacity method is preferred in the industry and has been accepted by the Commission on numerous occasions. City St. No. 3R at 8. During the rebuttal stage, the City prepared a revised cost of service study (City revised COSS) to reflect acceptance of some OCA allocation changes and certain maximum day ratios proposed by Kellogg. City St. No. 3R at 6; City Ex. 3-R-1

The OCA accepted the base-extra capacity methodology as used in the City's original and revised COSS, but presented various modifications to the allocation factors in an alternate COSS (OCA COSS), which was revised in surrebuttal testimony. OCA St. No. 4, Sch. SJR-8; OCA St. No. 4S, Sch. SJR-8 Revised. OCA M.B. at 46. The OCA submitted that the Kellogg COSS was flawed even as a commodity-demand COSS, as indicated by, for example, the allocation of the City's new treatment plant. Specifically, the OCA pointed out that Kellogg allocated itself \$1.93 million of the City's \$94.7 million investment in the treatment plant, or about two percent of the treatment plant's rate base value, even though Kellogg uses more than four percent of the City's water. OCA M.B. at 54; OCA St. No. 4R at 11.

The OSBA did not take issue with the City COSS, as revised, but proposed different class revenue allocations based upon the results of that study. OSBA St. No. 1 at 2-3.

Kellogg rejected the City revised COSS in favor of its own COSS (Kellogg COSS) which utilized the commodity-demand methodology for allocation of certain costs. Kellogg St. No. 2 at 11-13; Kellogg Ex. HSG-1. The Kellogg COSS was also updated within surrebuttal testimony. Kellogg St. No. 2SR, Ex. HSG-1R. Kellogg described the base-extra capacity methodology utilized in the City revised COSS as allocating four basic categories of cost – base, extra capacity, customer and fire protection costs. The calculation of the extra capacity costs is the focus of Kellogg's concern, as this calculation, central to the base-extra capacity method, must be based on a determination of 'maximum day' and 'maximum hour' usage by class as compared to the system maximum day and maximum hour. Customer class demand studies are performed to provide an empirical basis for these numbers, which can significantly affect the resulting allocation factors, according to Kellogg. Kellogg M.B. at 32-34.

Kellogg's interpretation of the City's discovery responses was that the City had relied upon a 1990 Pennsylvania-American Water Company (PAWC) customer class demand study dated February 20, 1991 (1991 PAWC study), and a 1996 Philadelphia Suburban Water Company (PSWC) customer class demand study in developing the 'maximum day' and 'maximum hour' ratios. Consequently, Kellogg concluded that demand data in the City COSS was outdated, unreliable, and inappropriate to use as a reasonable proxy for the City.

In lieu of the 1991 PAWC study data, Kellogg used a 2009 PAWC customer class demand study (sample data for 1993-2000), and actual 2009 data for Kellogg (to the extent that a separate customer class is established for Kellogg) in the Kellogg COSS. Kellogg claimed that the reliability of the 2009 PAWC study using 1993-2000 data had been acknowledged by the City; whereas, the reliability of the 1991 PAWC study had been questioned. The 2009 PAWC study also showed significantly lower maximum day and maximum hour factors for the industrial class in comparison to the other classes, according to Kellogg. Kellogg M.B. at 36-40.

Kellogg also contended that the base-extra capacity methodology does not appropriately allocate capacity costs in accordance with causation. Moreover, it asserted that the methodology is inconsistent as costs that vary with usage are allocated based on average usage, while costs that reflect maximum demand are allocated both on average usage and maximum day/maximum hour extra demand. Kellogg claimed that, out of the City's proposed revenue requirement of \$24.9 million, approximately 70% of costs are driven by capacity requirements. Kellogg M.B. at 45-48.

As a result of perceived cost allocation deficiencies in the City's base-extra capacity COSS, Kellogg advocated that the commodity-demand methodology be used to allocate costs. In its COSS, Kellogg took the capacity costs that the City allocated using

base-extra capacity allocators and allocated them based on Maximum Day and Maximum Hour allocators. Kellogg urged the Commission to reject the City revised COSS. Kellogg M.B. at 47.

The City responded that Kellogg's use of the commodity-demand methodology was not consistent with the Commission's preference for the base-extra capacity method for water COSS. The City also contended that the Kellogg COSS was invalid for reliance upon unsupportable and mismatched class demand data as previously discussed. It contended that, contrary to Kellogg's assertions, the base-extra capacity method does reflect maximum and average demands. It submitted that the revised COSS prepared by the City using the Commission-preferred base-extra capacity method should be used for allocation and rate design purposes in this proceeding. City M.B. at 69-75; City R.B. at 41.

2. ALJ Recommendation

The ALJ noted that the Commission has repeatedly stated that cost of service studies are to be utilized as 'guides, and are not considered to be an exact science. *PPL 2004, supra; see also, Pa. P.U.C. v. PAWC*, 71 PA PUC 210, 283 (1998); *Pa. P.U.C. v Duquesne Light Co.* 57 PA PUC2, 51 PUR 4th 198 (1983). However, in accordance with *Lloyd v. Pa. P.U.C. et al. (Lloyd)*, 904 A.2d 1010, 2006 Pa. Commw. LEXIS 438 (2006), as noted by the OSBA, the revenue allocations to the various classes must be based on a cost of service study. R.D. at 82.

The ALJ recommended that the City revised COSS, using the base-extra capacity methodology, be utilized in this proceeding for purposes of allocating costs/revenues and designing rates. She stated that, the base-extra capacity method is preferred in the industry and has been accepted by the Commission on numerous

occasions. The ALJ claimed she was unaware of any COSS prepared under the commodity-demand method that has been accepted by the Commission. The ALJ also noted that the base-extra capacity method is considered superior by the AWWA Manual M1 which states that the base-extra capacity method better reflects system diversity than the commodity-demand method. The ALJ recommended that the Kellogg COSS be rejected. R.D. at 82-83.

3. Exceptions and Replies

In its Exceptions, Kellogg first criticizes the City's use of the 1991 PAWC Customer Class Demand Study as being outdated and unreliable. Also, Kellogg avers that the 1996 PSWC Study used by the City is outdated and has not been shown to be a reasonable proxy for the City. According to Kellogg, the 2009 PAWC Demand Study it used, which used sample data for the period 1993-2000, is more reliable, more recent and applicable to the City's service area. Kellogg states that despite the clear superiority of the data it used, the ALJ agreed with the OCA's and the City's claims that the Kellogg allocation study relied upon 'unsupportable and mismatched class demand data. Kellogg submits that there is nothing unsupportable or mismatched about the data utilized by its witness as the use of 2009 data for Kellogg and data from the 2009 PAWC study was reasonable given that the City has never performed a customer class demand study, was unable to provide more recent customer load data for its customers and that Kellogg had actual data available for itself. Kellogg Exc. at 13-19.

Next, Kellogg submits that, contrary to the ALJ's conclusion, the data relied upon by the City is unreliable and outdated and should be rejected. Kellogg states that the 1991 PAWC study relied upon by the City is older and unreliable and should give the Commission concern. Kellogg opines that the ALJ's position is in error and should be rejected. Kellogg further asserts that although the base-extra capacity methodology

for cost allocation has been utilized by this Commission for many years to allocate costs for water utilities, the base-extra capacity methodology does not appropriately allocate capacity costs in accordance with the causation of such costs. Kellogg claims that the simple fact is that the costs of certain facilities are driven by the capacity or demand needed to serve them, and not by a weighted average of usage and extra demand. Kellogg submits that while there is well-established commission precedent to utilize the base-extra capacity methodology, this does not justify continuing to use the methodology when it is not supported by principles of cost causation. Kellogg Exc. at 19-24.

In reply, the City asserts that Kellogg's arguments are not supported by the record evidence. According to the City, the base-extra capacity method is preferred in the industry and has been accepted by the Commission. As noted by the ALJ, the City is unaware of any COSS prepared under the commodity-demand method that has been accepted by the Commission. The City cites the AWWA Manual M1 which states that the base-extra capacity method better reflects system diversity than the commodity demand method. The City opines that Kellogg's criticism of the base-extra capacity shows that it does not fully understand the methodology and avers that the Kellogg witness had not conducted a cost of service allocation study for a water utility prior to this proceeding. City R. Exc. at 15-17

In regard to Kellogg's claim that the 2009 PAWC Demand Study is more reliable, the City asserts that there was no 2009 PAWC study ever done as part of a COSS for PAWC. The City maintains that this 'newer' demand data to which Kellogg refers appears in the PAWC rate case study in 2001 and that Kellogg attempts to support its position using data that was never there. The City avers that the ALJ correctly noted that Kellogg used a mix of demands for different time periods, different utilities and different generations of technologies when estimating class demands. The City further maintains that it provided ample support for the basis of its COSS and that its witness

used sources in addition to the 1991 PAWC study for purposes of estimating class demand factors. According to the City, its witness used his judgment based on observations of Lancaster's service areas, filed studies conducted by his firm for other Pennsylvania water utilities and generally accepted maximum day and hour ratios. City R. Exc. at 17-18.

In its reply exceptions, the OCA first points out that the commodity-demand and base-extra capacity methods are intended to produce similar results citing the AWWA M1 Manual, 5th Ed. at 59. Secondly, the OCA posits that while a treatment plant must be sized to meet maximum demands, the plant is used every hour of every day to meet both average and maximum demands. Therefore, according to the OCA, costs for the treatment plant should be allocated based on both average and peak demands. The OCA maintains that the extra cost of the plant to meet maximum-day demands should be allocated to customers based on their peak demands, but much of the plant's cost should be allocated on average demand. The OCA asserts that Kellogg's position ignores this reality by considering only the maximum day demands. The OCA opines that the base-extra capacity method is preferred as it is more precise and more transparent. Furthermore, the OCA criticizes Kellogg's analysis as it did not measure demands for the same time periods for all customer classes. The OCA avers that by selecting demand data from different time periods, Kellogg has artificially and unreasonably altered the relative relationship among the customer classes. OCA R. Exc. at 13-15.

In its Reply Exceptions, the OSBA notes that it accepted the City's COSS and avers that even if the Commission were to accept Kellogg's COSS, there would be no difference in the relative rate increase needed to bring the Commercial class to cost. The OSBA maintains that under each Party's final COSS, the outside-City Commercial class would need a relative rate increase of no more than 1.21 times the outside-City system average increase in order to be at cost of service. OSBA R. Exc. at 5-7.

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 that the Commission adopt the City's revised COSS using the base-extra capacity methodology. We are in agreement with the City and the OCA that the base-extra capacity method is preferred in the industry and has been previously accepted by this Commission. As stated by the OCA, for example, the costs for the treatment plant should be allocated based on both average and peak demands not just the maximum day demands as used by Kellogg. We also recognize that Kellogg utilized demand data from different time periods which has artificially altered the relative relationship among the classes. This is unacceptable.

Based upon the foregoing discussion, we shall deny the Exceptions of Kellogg, and adopt the finding and recommendation of the ALJ.

B. Cost Allocation

1. Rental Income from Cellular Antennae Leases

a. Positions of the Parties

In the City revised COSS, the City used factor 17 to allocate \$239,910 in rental income that it receives from cellular antennae leases on water tanks outside the City that serve outside customers. Using factor 17 resulted in 31.1% of these revenues being allocated to inside-City customers and 68.9% being allocated to outside-City

customers, although 100% of the water tank costs are allocated to outside-City customers (using factor 5B). City St. No. 3R, at 4; OCA St. No. at 7.

The OCA objected to the City's allocation of rental income. The OCA stated that, as outside-City customers are being asked to support all of the cost of the water tanks, they should receive all the revenue from leasing space on those tanks, using allocation factor 5B. OCA St. No. 4 at 7. Both the OTS and Kellogg agreed with the OCA position on this issue. OTS St. No. 2 at 28-29; Kellogg St. No. 2SR at 8.

In response to the OCA's position, the City characterized the OCA's opposition to the rental income allocation as being based on the location of the tanks outside the City. The City indicated that the location was immaterial to how the revenue should be allocated. The City stressed that the City had invested in water facilities that provide an opportunity to receive rental income, thus reducing the overall cost to provide water service. Accordingly, this rental income, according to the City, should be a credit to the allocated cost of providing water service to all customers both inside and outside the City. City St. No. 3R at 4; City St. No. 3-OR (redacted), at 1-2. City M.B. at 67-68.

In response to the City, the OCA supported its position that customers which are allocated 100% of the cost of a facility should also benefit through receiving credit for 100% of the rental income associated with those facilities. OCA cited to prior Commission decisions in *Pa. P.U.C. v. Roaring Creek Water Co. (Roaring Creek 1997)*, 87 PA PUC 826 (1997); and *Pa. P.U.C. v. UGI Corp. (UGI 1982)*, 56 PA PUC 575 (1982), which held that utilities must credit customers for income from rental property since the capital costs of the premises were included in rate base. The OCA also cited to a recent case, *Columbia Water Company, supra*, wherein the ALJ and the Commission determined that a water company's rental income from rate base property must be included in revenues for ratemaking purposes. Referring to these cases, the OCA

reasoned that since only outside-City customers are paying the costs of the water tanks generating the income, only outside-City customers should receive the revenue associated with that property through allocation factor 5B. OCA M.B. at 48-50.

b. ALJ Recommendation

The ALJ agreed with the OCA position on this issue and recommended that it be adopted by the Commission. According to the ALJ, and contrary to the City's characterization, the OCA's position is not based on the location of the water tanks; it is based on the subset of customers who are actually paying the costs of the tanks. The ALJ observed that the City had not disputed the OCA's claim that 100% of the costs of the facilities are being allocated to outside-City customers through allocation factor 5B. She stated that in accordance with the Commission precedent cited by the OCA (*Columbia Water Company; Roaring Creek 1997; UGI_1982; supra*), the rental income should be credited 100% to the outside-City customers. Accordingly, the ALJ stated the City revised COSS should be changed to use allocation factor 5B instead of allocation factor 17 with respect to the rental income received for the cellular antennae leases. R.D. at 86-87.

c. Disposition

No Party excepts to the ALJ's recommendation in regard to her adoption of the OCA's position concerning rental income from cellular antennae leases. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

2. Reimbursement for Meter Labor

a. Positions of the Parties

This issue relates to the reimbursement provided by Lancaster Sewer customers to Lancaster Water customers for costs relating to the meter shop as the water meter readings are used to bill sewer customers. In its original COSS, the City allocated meter shop costs and reimbursement for meter labor using factor 8 (all customers with meters), which resulted in an allocation of about 66% to outside-City customers and about 34% to inside-City customers.

In rebuttal, the City changed its position. According to the City, the meter labor reimbursement revenues should have been allocated mostly to the benefit of inside-City customers, because only about 16% of outside-City water customers are also sewer customers. In contrast, the City states that about 84% of the inside-City water customers are sewer customers. The City developed a revised allocation factor, factor 12A, in the City revised COSS to allocate meter labor revenue by the number of meter readings for sewer bills, which resulted in inside-City customers receiving credit for 84% of the reimbursement instead of about 34%. However, the meter shop cost allocation was not similarly changed. The impact of this revision is that outside-City customers continue to be allocated about 66% of the meter shop costs but now only receive 16% of the reimbursement from sewer customers. Inside-City customers continue to be allocated about 34% of meter shop costs, but now receive 84% of the meter labor reimbursement revenues. City St. No. 3R at 5-6; City Ex. No. 3-R-1, Sch. B at 3; Sch. C at 30.

The OCA challenged this mismatch in the meter labor reimbursement. The OCA objected to the unfairness of the revised proposal, and determined that, based on the reduction in reimbursement, outside-City customers would pay an average of \$9.80 per

meter annually, while inside-City customers would pay only \$1.55 annually per meter. The OCA recommended a return to the City's original proposal, and a corresponding correction to the City revised COSS to use factor 8 for meter labor reimbursement, consistent with the allocation of related costs. OCA St. No. 4S at 3-6.

The City responded that the meter labor reimbursement is for meter reading costs, not meter maintenance costs, and cites to City Ex. No. 3-R-2. City R:B. at 40.

b. ALJ Recommendation

The ALJ recommended that the Commission accept the OCA position on this matter and that the City revised COSS be changed again to use factor 8 for meter labor reimbursement. According to the ALJ, the City has the burden of proof and she was not convinced by the City's justification for the change from factor 8 to a new factor 12A for the meter labor reimbursement. The ALJ maintained that this issue should be resolved similarly to the rental income issue, *supra*, in that the reimbursement for meter labor costs should be allocated in the same manner in which the costs are allocated, through factor 8 as advocated by the OCA. The ALJ further noted that the City has not established that it has changed the cost allocation to factor 12A, but has only changed the meter labor reimbursement to factor 12A. In her view, this causes a mismatch as outside-City customers continue to be allocated about 66% of meter shop costs but receive only about 16% of the meter labor reimbursement. The ALJ opined that the mismatch is improper and must be corrected through the COSS change as noted above. R.D. at 88.

c. Exceptions and Replies

The City maintains that the meter reading labor reimbursement should have been allocated mostly to the benefit of the inside-City customers and that factor 12A is

used to properly reflect how these costs should be allocated. The City avers that the revenue received from the City's Sewer Fund was for reimbursing the Water Fund for meter reading costs because the sewer utility uses the meter reading information for billing purposes. The City believes this revision correctly and fairly allocates costs based on the number of meter readings for sewer bills. The City criticizes the OCA position as these dollars have nothing to do with a meter 'labor' issue. In its opinion, doing what the OCA suggests would cause a 'mismatch' and unfairly give benefits to many customers who are not contributing to the reimbursement costs of both the sewer and water systems. City Exc. at 18-21.

In reply, the OCA avers that if the City position is adopted, the effect would be to allocate more than 84% of this revenue to inside-City customers even though inside-City customers pay only 36% of the meter shop's costs. The OCA opposes this mismatch because meter shop costs are correctly allocated to all customers with meters. The OCA states that the effect of its allocation is that inside-City and outside-City customers are generally allocated an equivalent amount of the net costs of the meter shop, between \$6.50 and \$7.00 per meter per year. In contrast, the OCA avers that the effect of the City's proposal would be that outside-City customers would pay six times more per meter than would inside-City customers, \$9.80 per meter per year versus \$1.55. Additionally, the OCA submits that it makes no difference whether the costs are for meter reading or maintenance. The OCA points out that the City has allocated meter-related costs in one way, but then allocated the reimbursement in a different way. OCA 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 agree with the analysis of the OCA that the City's proposal results in a mismatch of 84% of the revenue related to the meter reimbursement being allocated to inside-City customers who pay only 36% of the costs of the meter shop. This result is unreasonable and is not accepted. The City is directed to allocate meter shop costs and the reimbursement for meter labor in its COSS using factor 8, as it originally proposed.

Based upon the foregoing discussion, we shall deny the Exceptions of the City, and adopt the finding and recommendation of the ALJ.

3. Regulatory Expenses

a. Positions of the Parties

This issue involves the same costs as the rate case expense issue previously addressed. Kellogg has used the term 'regulatory expenses' but they are properly characterized as 'rate case expenses.'

Kellogg proposed that 'regulatory' or 'rate case expenses' which were 100% allocated to outside-City customers in the City revised COSS, be allocated among all rate classes, including inside-City customers. Kellogg stated that the expenses should be universally allocated because the COSS is used to determine the revenue requirement and revenue allocation for all classes, both inside and outside the City. Accordingly, the Kellogg COSS allocated approximately 31.4% of costs to inside-City customers, according to Kellogg Ex. HSG-1, Sch. A at 1; Kellogg Ex. HSG-1, Sch. C at 4; Kellogg St. No. 2 at 13.

The City failed to address Kellogg's issue in its rebuttal testimony. The ALJ noted that the matter could involve a legal question as to jurisdiction since the issue

involved whether the Commission was empowered to allocate regulatory costs to non-regulated inside-City customers. She noted that a similar issue had been raised in *Lancaster Sewer 2005* and the Parties were referred to that case for possible legal precedent. Tr. 181-182.

In its Main Brief, the City referred to *Lancaster Sewer 2005, supra*, as requiring that 100% of 'regulatory' or 'rate case expenses' be allocated to outside-City customers. M.B. at 75-76.

Kellogg did not discuss *Lancaster Sewer 2005* in its Reply Brief or endeavor in any way to distinguish the holding in that case from the instant situation. Instead, Kellogg relied upon the City's failure to address the issue at the appropriate time in its testimony as being deemed a waiver of any objection, and asserted that Kellogg's position should therefore be adopted. Kellogg R.B. at 30-31.

b. ALJ Recommendation

The ALJ recommended that the Commission reject Kellogg's proposed allocation of regulatory expenses to inside-City customers in the COSS. The ALJ offered that while it would have been preferable for the City to have addressed the matter in its testimony, she concluded that the matter involves a jurisdictional question which cannot be waived by the Parties. According to the ALJ, as stated by the Pennsylvania Supreme Court in *Roberts v. Matorano*, 427 Pa. 581, 235 A.2d 602 (1967), jurisdiction may not be conferred by the parties where none exists. Indeed, subject matter jurisdiction is a prerequisite to the exercise of the power to decide a controversy. *Hughes v. Pa. State Police*, 152 Pa. Commw. 409, 619 A.2d 390 (1992), *alloc. den.* 637 A.2d 293 (1993). R.D. at 90.

The ALJ noted that Kellogg proposed an allocation to inside customers of a portion of the costs associated with preparation of the COSS for this rate case, contending that costs are determined on a system-wide basis and inside-City customers should therefore share in these costs. She stated that as in *Lancaster Sewer 2005*, the proposal would entail an allocation of the cost of regulation to non-regulated customers, and there is no authorization for this cost assessment in the Public Utility Code. The ALJ concluded, therefore, that these regulatory costs are appropriately assessed 100% to outside-City customers, in accordance with Commission precedent in *Lancaster Sewer 2005, supra*. R.D. at 91.

c. Exceptions and Replies

In its Exceptions, Kellogg avers that it has been unable to find any place where the Commission rejected a similar adjustment in *Lancaster Sewer 2005* and submits that there is no precedent supporting this position. Furthermore, Kellogg opines that the absence of rebuttal testimony on this issue is determinative of the issue in Kellogg's favor. Kellogg Exc. at 25.

In reply, the City notes that it did produce the relevant part of the *Lancaster Sewer 2005* rate case Recommended Decision which clearly discusses and rejects the notion that rate case expense should be split between inside and outside customers. The City avers that the arguments rejected in that case were the same arguments that Kellogg used in its testimony and briefs in this proceeding. The City maintains that since outside customers caused the costs to be incurred, it is reasonable that they bear 100% of the costs. City R. Exc. at 19-20.

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 find that the expenses at issue here, the rate case expenses associated with the preparation and litigation of this proceeding, are a direct result of this Commission's regulatory requirements. As such, they are not incurred or caused by inside-City customers of Lancaster. It is simply against the basic principle of cost causation to allocate the cost of regulation to non-regulated inside-City customers. Inside-City customers did not require the City to expend these funds and they should not be required to contribute to the recovery of such costs.

Based upon the foregoing discussion, we shall deny the Exceptions of Kellogg, and adopt the finding and recommendation of the ALJ.

C. Revenue Allocation

1. Positions of the Parties

The Parties proposed the following class revenue allocations at the City's full revenue request, using the City COSSs unless noted otherwise (source OSBA Sch. BK-1R, BK-2R):

<u>Outside Rate Class</u>	<u>City % Increase</u>	<u>OSBA % Increase</u>	<u>OCA % Increase</u>	<u>Kellogg % City COSS</u>	<u>Kellogg % Rev. COSS</u>
Residential	90.6%	89.2%	86.8%	91.8%	94.5%
Commercial	127.5%	127.5%	127.0%	127.5%	126.3%
Industrial	148.1%	157.6%	156.3%	132.7%	101.4%
Oth. Water Util.	97.1%	98.5%	96.9%	97.1%	140.4%
<u>Private Fire</u>	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>	<u>20.0%</u>	<u>0.0%</u>
Sys. Ave.	105.0%	105.0%	103.5%	105.0%	104.0%

The City stated that its proposal was reasonable and makes a significant move towards cost of service indicators and, as such, should be adopted. City St. No. 3R at 2.

Kellogg made proposals using the City's COSSs, if accepted, and the Kellogg COSS. The Commission has already recommended *infra* that the Kellogg COSS be rejected due to the flaws previously discussed.

Kellogg indicated that in the event the Commission does not adopt the Kellogg COSS and elects to use the City COSS, as revised, the Commission should nonetheless adjust the City revised COSS to utilize the maximum day and maximum hour ratios and 1.51 system maximum day ratio it has recommended. If these ratios are utilized, according to Kellogg, the cost indicated increase to the industrial class based on the City revised COSS would be reduced, and Kellogg's proposed revenue allocation would be reasonable. Kellogg advocated rejection of the 1.50 maximum day ratio for the industrial class as had been proposed by the City. Kellogg M.B. at 52.

In the event the Commission rejects the Kellogg COSS and the above-mentioned maximum day and maximum hour ratios, Kellogg nonetheless proposed that

the increase to the industrial class (148.1% in the City M.B. at 72) be mitigated to a much larger extent than proposed by the City. Kellogg emphasized the economic impact of such a large increase on its operations, as noted in the testimony of its Plant Manager Timothy Fritz, and urged the Commission to apply principles of gradualism to moderate the effect. Kellogg M.B. at 54.

In response to Kellogg's significantly lower revenue allocation to the industrial class, particularly when using the Kellogg COSS, the City noted that both the OSBA and the OCA had recommended higher increases to the outside industrial class of 157.6% and 156.3%, respectively. The City claimed that a higher increase of 164.2% to the industrial class was indicated by the City COSSs, but that the City had proposed a 148.1% increase to mitigate rate shock. City St. No. 3R at 7.

The OCA allocated a greater percentage increase to the industrial class and a lesser percentage to residential customers. In support of its allocation, the OCA indicated that the City's proposed industrial rates would recover less than the cost of service and the proposed residential rates would recover more than the cost of service. The OCA noted that the City's rationale for limiting the increase to the industrial class was so that no class received more than a 150% increase in rates. However, the OCA observed that the system average increase in the City revised COSS is 105.0%; thus, the maximum increase to the industrial class should be approximately 157.5%, and the OCA revenue allocation proposal is within this limit. OCA M.B. at 55.

The OCA noted another concern with the City's proposed under recovery from the industrial class in that the City's third block consumption charge, a rate used almost exclusively by industrial customers, is less than the base cost of water. OCA St. No. 4 at 11. The OCA posited that, as a general rule, a utility should never sell water to a permanent retail customer at less than the base cost of water. OCA M.B. at 55-56.

The OSBA proposed a greater movement towards cost of service than the City's proposal. OSBA St. No. 3 at 1. Similar to the OCA, the OSBA would allocate an over 150% increase to the industrial class (157.6% as indicated in OSBA Sch. BK-1R).

The OSBA disputed the City's contention that the OSBA proposed revenue allocation does not reflect gradualism. The OSBA asserts that its proposal does reflect gradualism, because its revenue allocation falls short of moving to full cost of service in this case. Also, like the OCA proposal, the OSBA proposal limits class increases to no more than 1.50 times the system average, which restricts movement of the industrial class towards cost of service. OSBA St. No. 3 at 1-2.

The City responded to the OSBA proposal observing that it generally moved revenues closer to cost of service for the residential and industrial classes, but that the City proposal mitigated the increase to industrial customers, which required the highest increase based on cost of service indicators. The City contended that to remove most of the subsidy in one rate case was not consistent with gradualism, and that the City would support moving all classes to cost of service in the next case. City St. No. 3R at 2.

2. ALJ Recommendation

The ALJ concluded that the City's revenue allocation proposal is the most reasonable and recommended that it be used by the Commission. According to the ALJ, this proposal appropriately balances the competing interests so that no one class bears an inordinate share of the allowed revenue increase. It is also based on and supported by the City revised COSS. In response to the OSBA's position that more movement towards cost of service is warranted, the ALJ noted that the Commonwealth Court in *Lloyd, supra*, considered whether subsidization of one customer class by another class could be

acceptable, so long as movement towards cost was being accomplished. As noted by the ALJ, the Court ruled that gradualism could not justify continued subsidization over an extended period of time, but that a plan for gradual elimination of the subsidy could be possible. The City correctly observed that the OSBA's proposal in this case moved too quickly to remove almost all subsidies and therefore was not reasonable. In the opinion of the ALJ, the City's plan for moving the classes to cost of service in the next base rate case, is reasonable and in accord with the public interest. R.D. at 94-95.

3. Exceptions and Replies

In its Exceptions, the OCA submits that the ALJ's recommendation should not be adopted and requests that the City's revenue allocation be modified to permit approximately \$61,000 more revenue to be recovered from the Industrial class than the City proposed. Specifically, the OCA avers that rates should be established to recover the cost of serving each customer class, with a limit that no class receive an increase of more than 1.5 times the outside-City system average rate increase. The OCA offers that any amount unrecovered due to that limitation should be recovered from the other retail classes in proportion to that class's revenues. The OCA also opines that every effort should be made to ensure that the third-block charge is at least equal to the base cost of water. OCA Exc. at 14-15

Kellogg also excepts to the ALJ's recommendation stating that if the ALJ was seeking to provide some reasonable moderation of the revenue increase to the industrial class, the City's allocation of a rate increase that is 1.41 times the system average increase does not accomplish it. Kellogg avers that the City's proposal does not balance the interests of achieving cost of service and gradualism. Kellogg opines that the City's proposed revenue increase to the industrial class should be mitigated to a much larger extent than proposed because of the magnitude of the increase. Also, Kellogg

faults the ALJ for failing to give adequate consideration to the economic impact of this increase on the industrial class. As a result of this impact, Kellogg submits that the Commission should more gradually move industrial and Kellogg rates toward cost-of-service, moderating the impact to limit the effect on job reductions and possible plant relocations and outsourcing of processes. Kellogg further submits that the rate increase to the industrial class should be set somewhere between 101.4% and 132% at the proposed revenue requirement, or somewhere between 98% and 126% of the system average increase, depending upon Commission use of the Kellogg Allocation Study or the City Allocation Study. Kellogg Exc. at 26-31.

In reply, the City reiterates that in order to mitigate rate shock, it proposed that no class should receive more than a 150% increase in rates. With regard to OCA's concern with the third block consumption charge, Lancaster notes that it is only giving a subsidy to customers in the third block for purposes of gradualism, and that in the next rate case, it plans to move all classes to the cost of service. The City opines that the OCA's recommendation to permit \$61,000 of additional revenue to be recovered from the Industrial class when compared to the City's cost allocation is a significant movement which should be rejected. City R. Exc. at 20-21.

In reply to Kellogg's argument, the City states that while it is increasing the rates for Industrial customers, it will still be charging this class below the cost to serve water in order to avoid rate shock. City R. Exc. at 22.

In its Reply Exceptions, the OCA responds to Kellogg by noting that the City's proposed rates for outside-City customers would recover less than the cost of service from Industrial customers and more than the cost of service from Residential customers. The OCA avers that if Kellogg's alternative revenue allocation proposal were adopted, the disparity would increase even more. The OCA opines that its allocation

provides a reasonable balance by moving the Industrial class toward cost of service but limiting that movement so that no class receives more than a 150% increase above the system average increase. OCA R. Exc. at 17-18.

In reply to the OCA exceptions, Kellogg states that the OCA's proposal for an increased revenue allocation to the industrial class is inappropriate as every dollar of rate increase to the industrial class is potentially harmful to industrial operations and manufacturing jobs in the Lancaster community. Kellogg avers that the purpose of a policy of gradualism is to moderate impacts by moving classes toward cost of service over more than one rate case. According to Kellogg, the OCA, the City and the ALJ seek to move the industrial class almost the entire way to the City's cost of service rather than moving part of the way in this case and the rest of the way in the next rate case. Also, Kellogg avers that the OCA's argument concerning the third block consumption charge assumes a fiction that every customer uses the same amount of water each hour of the year and should be rejected. Kellogg R. Exc. at 6-9.

The OSBA also responded to both Kellogg and the OCA by noting that it did not except to the ALJ's decision on this subject because resolution of this issue should have no impact on the rate increase imposed on the Commercial class. The OSBA states that regardless of the full requirement revenue allocation proposal adopted by the Commission, the relative rate increase needed by the Commercial class to reach its cost of service is 1.21 times the system average increase. OSBA R. Exc. at 7-12.

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 conclude that the ALJ's adoption of the City's revenue allocation

proposal provides the most appropriate balance between the competing interests in this case. While this proposal does not transition the City's revenue allocation totally to cost of service in this proceeding per *Lloyd*, it endorses the concept of gradualism in that a reasonable transition plan to cost based rates over a reasonable timeframe is contemplated. The City recognized the importance of mitigating the rate increase to the industrial class and we find that its proposal is reasonable, in the public interest and is adopted. We also agree with the City that removal of the entire subsidy in one rate proceeding is not consistent with the principle of gradualism.

Based upon the foregoing discussion, we shall deny the Exceptions of Kellogg and the OCA, and adopt the finding and recommendation of the ALJ.

D. Scale Back

1. Positions of the Parties

If the Commission grants an increase less than what the City originally proposed, the City recommended that the original proposed increase be scaled back proportionately by class (except for Private Fire which should receive no increase). The City's position is that the entire scale back should come from consumption charges and the proposed customer charges should be left unchanged. The City indicated that it had not increased its customer charges in more than five years, and that the customer charge increases requested were fair, reasonable, and results in a lower customer charge than those of most water utilities in Pennsylvania. City Ex. No. 4-A, Sch. F: City R.B. at 48.

According to Kellogg, the scale back should be performed in the same way as the allocation of the City's proposed revenue requirement, with Private Fire being

maintained at the present level of revenue and all other classes, except Other Utilities, being set at cost of service. Kellogg R.B. at 36.

The OCA proposed a scale back which would result in each class (except private fire which should receive no increase) recovering approximately the same percentage of the class's cost of service as would be recovered under the OCA rate design. The OCA indicated that its rate design was not substantially different from the City's. The OCA opposed the Kellogg proposed scale back as it is based on the Kellogg COSS which the OCA has recommended be rejected. The OSBA proposal, according to the OCA, would require that the COSS be re-run and that final rates be re-designed to recover the applicable percentage of cost of service. OCA R.B. at 24-25.

The OSBA proposed a proportional scale back based on each class' increase. The OSBA claimed that the OCA proposed scale back would require a re-run of the OCA COSS. OSBA M.B. at 11.

2. ALJ Recommendation

The ALJ recommended that the City's proposed scale back be approved and she expressed her agreement with the City that the entire scale back should come from consumption charges and not the customer charge, for the reasons stated by the City. The ALJ noted that no Party has objected to the proposed increase in the customer charge. R.D. at 97

3. Exceptions and Replies

In its Exceptions, the OCA submits that a proportional scale back is a reasonable method to reflect any reduction in the claimed revenue requirement and it

ensures that all customer classes are provided some relief from the Company's full request if it is determined that the City should receive less than its full rate request. However, unlike the City's recommendation, the OCA recommends a proportional scale back to both customer and volumetric charges. The OCA avers that the effect of the ALJ adopting the City's as filed customer charges is a 176% increase for customers with 5/8-inch meters. The OCA compares this increase to the overall 85% revenue increase as recommended by the ALJ. The OCA maintains that its recommendation to scale back both the customer charges and volumetric charges would mitigate the size of the customer charge increase, while still giving the City an opportunity to recover its approved revenue requirement through higher volumetric rates. According to the OCA, its proposal would provide a stronger price signal to customers to conserve water. OCA Exc. at 16.

In reply, the City avers that the record evidence supports the ALJ's recommendation that the entire scale back should come from consumption charges and the proposed customer charges should be left unchanged. The City avers that it has not increased its customer charges in over five years and the proposed customer charges are fair, reasonable and results in a lower customer charge than most water utilities in Pennsylvania. Lancaster suggests that it could have proposed an even higher customer charge than what it requested but did not do so in order to mitigate rate shock. The City states that it is essential that it receive the full amount of the requested customer charge so that it can continue to provide safe and reliable water service. In response to the OCA's water conservation argument, the City opines that its proposed rate increase provides, by itself, a strong incentive and signal to customers to conserve water. City R.Exc. at 23-24.

4. Disposition

Upon our consideration of the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we shall reject the recommendation of the ALJ on this issue. While we conclude that it is entirely appropriate that the City scale back its proposed increase proportionally based on the Commission allowance within this Opinion and Order, we are cognizant of the concerns expressed by the OCA and believe they have merit. We agree with the OCA that a proportional scale back to both customer and volumetric charges is more appropriate than the City's proposal. While we acknowledge the City's comments that the proposed customer charges are fair as proposed, and still lower than some other water utilities, they still equate to a significant increase in the amount of these charges. According to the City's proposal, customer charges are being increased 176% while the total overall revenue increase approved by the Commission is only 72.7%. As a result, we find that the proposed customer charges should also be scaled back and the City transition these charges to cost based rates over a more reasonable timeframe.

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

E. Tariff Structure

1. Separate rate for Kellogg

a. Positions of the Parties

Kellogg has proposed that it be placed in a separate rate class regardless of the COSS used or alternatively, that the industrial class be segmented to reflect

differences in usage characteristics among the customers in the class. Kellogg St. No. 2 at 3. Kellogg based its position on data which showed unique service characteristics and a better load factor when compared to other customers in the industrial class. Kellogg St. No. 2SR at 4-5, 9-10; Kellogg M.B. at 55-57.

The City and the OCA disputed Kellogg's claims that it had justified a separate rate class. The City noted that Kellogg's load factor was 1.27 and 1.42 in 2009 and 2010, respectively, while the other large industrial customers' composite load factor was 1.40 and 1.52 in 2009 and 2010, respectively. Kellogg's load factor was therefore somewhat lower but not significantly lower and certainly not significant enough to warrant a separate class, according to the City. The City further observed that Kunzler, which is part of the industrial group, has a lower load factor than Kellogg. City St. No. 3-OR (redacted) at 5; City M.B. at 78-79. The OCA also stated that Kellogg had not shown that the characteristics of Kellogg are significantly different from characteristics of other large customers who would remain in the general, industrial, and resale classes. OCA St. No. 4R at 2; OCA M.B. at 57-58.

b. ALJ Recommendation

According to the ALJ, the City has justified its continued classification of Kellogg in the industrial class due to similarities of usage and the lack of compelling unique service characteristics. Accordingly, she recommended that Kellogg's request to be placed in a separate customer class be denied. The ALJ also observed that Kellogg's alternative request, that the industrial class rate structure be modified to reflect differences in usage, was an issue which was not sufficiently addressed of record. However, the ALJ recommended that OSBA's request for an investigation by the City of separate rate schedules for its rate classes in the next base rate case be approved. The ALJ believed this will address Kellogg's alternative request. R.D. at 98.

c. Exceptions and Replies

In its Exceptions, Kellogg notes that while it supports the ALJ's proposal that in its next rate proceeding, the City should investigate separate rate schedules, the evidence showing Kellogg's unique load characteristics relative to the rest of the industrial class is available currently and justifies the establishment of a separate rate class for Kellogg. Kellogg avers that its 1.27 maximum month ratio is the lowest of the five largest industrial customers by a significant margin, with the next lowest customer having a maximum month ratio of 1.43. Furthermore, Kellogg avers that it is more than twice as large as any other customer and while that may not be a sufficient reason for its own rate class, it should be a significant consideration. Kellogg Exc. at 32.

In reply, the City states that the maximum month-to-average month data for Kellogg shows that in 2009 the ratio was 1.27 and in 2010, the ratio was 1.42. According to the City, this compares to the other large customers in the class that have a composite ratio of 1.40 in 2009 and 1.52 in 2010. Lancaster opines that Kellogg's ratios are somewhat lower than the group, but not significantly, and certainly not enough to warrant a separate class. City R. Exc. at 22-23.

In its Reply Exceptions, the OCA submits that Kellogg has not provided a reasonable basis for treating it differently from other customers using millions of gallons per month. OCA R. Exc. at 19.

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 unconvinced by the record evidence that Kellogg's characteristics are that unique or significant to require a separate rate class. We are in agreement with the City and the OCA that Kellogg has failed to provide sufficient basis in this proceeding to warrant granting its request.

Based upon the foregoing discussion, we shall deny the Exceptions of Kellogg and adopt the finding and recommendation of the ALJ.

2. Evaluation of GMS Rate Structure

a. Positions of the Parties

The OSBA raised concerns regarding the outside-City General Metered Service (GMS) rate structure, which contains a three-step declining block consumption charge applicable to all residential, commercial and industrial customers. The OSBA observed that the City had not explained why its existing GMS rate structure continued to be appropriate. Specifically, the OSBA noted that the City had not (1) provided evidence in support of the number of GMS rate blocks; (2) explained why the rate blocks were sized appropriately; or (3) explained why its existing GMS rate structure was preferable to establishing separate rate schedules for its outside-City residential, commercial and industrial customers. The OSBA asserted that changes to the rate structure would create intra-class rate impacts which should be examined. Therefore, the OSBA recommended that the Commission direct the City to investigate the propriety of the City's existing GMS rate structure in its next base rate proceeding, and to sponsor changes to that rate structure, if indicated. OSBA St. No. 1 at 7-8.

In response to the OSBA's proposal, the City claimed that its existing rate structure was proper, and indicated that no changes to that structure were warranted. The

City indicated that it was not receptive to the OSBA's recommended investigation. City St. No. 3R at 3. Furthermore, the City asserted that if it believes there is a reason to re-examine the revenue allocation and any adjustment to rate blocks in the next rate case, it should be the entity to recommend it. City R.B. at 49.

b. ALJ Recommendation

The ALJ found that the OSBA proposed rate structure investigation had considerable merit and that the need for this investigation had not been rebutted by the City. She recommended that it be required in the next base rate case. According to the ALJ, the City completely failed to respond to any of the questions posed by the OSBA, despite the opportunity to do so. The ALJ recommended that all of these questions will be included as part of the investigation recommended herein. R.D. at 100.

b. Disposition

No Party excepts to the ALJ's recommendation to require the City to perform a rate structure investigation within its next base rate case. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. The City is so directed.

3. Minor Tariff Changes

a. Positions of the Parties

During the course of this proceeding, the OCA identified three wording changes that should be made to the City's proposed tariff in Sections 7.8 (meter testing) and 12.4 (termination). OCA St. No. 4 at 13. The City recommended certain

modifications and the OCA agreed to these recommendations by the City. OCA St. No. at 13. The OCA requested that these modifications be adopted by the Commission and included in the compliance tariffs in this case, and the City had not opposed this request. OCA M.B. at 58; City R.B. at 49.

b. ALJ Recommendation

The ALJ reviewed the OCA requested changes, and noted an inconsistency which was requested to be clarified. According to the ALJ, the inconsistency concerned the City's proposed increase in its Restoration – Reconnection Charge in Section 8.4 of its tariff, from \$63 to \$90, which was unopposed by any Party. City Ex. No. 4-B. The ALJ explained that Section 8.4 and Section 12.4 now conflicted over the proper amount of the charge as Section 12.4 contained a \$10 charge that should be changed to \$90. R.D. at 101.

When she requested clarification of the above-mentioned inconsistency, the ALJ was informed by the City that Sections 8.4 and 12.4 were to contain the same restoration fee, but that the restoration fee was \$83, not \$90. According to the ALJ, the City indicated that the original \$90 proposed restoration charge had been updated to \$83 in a subsequent discovery response, and it provided a copy of that response (response to OTS-RS-20-D), which included a cost calculation. The ALJ noted that the OCA agreed with the City that the restoration charge should be corrected to \$83 instead of \$90. R.D. at 102.

The ALJ concluded that the proposed restoration fee of record should be corrected to be consistent with the intent of the Parties and the supporting cost calculation. The ALJ further explained that while she supplied a copy of the discovery response and associated tariff language change to the Secretary's Bureau for inclusion in

the case file, the document was not yet a part of the evidentiary record. To remedy this oversight, she recommended that the record be reopened for the limited purpose of admitting this discovery response and associated tariff language change into the record, so that the record contains the correct information. The ALJ directed that this document be marked for identification as City of Lancaster Exhibit No. 8, and she directed the City to supply the requisite number of copies of this document to the Secretary's Bureau with a request that it be included in the evidentiary record. R.D. at 102.

Accordingly, the ALJ recommended that the proposed tariff changes in the OCA Main Brief, as corrected herein, be approved.

According to the ALJ, the revised Section 7.8 is to read as follows:

The meter will be tested upon the written request of the Customer and refund made if a meter is found to be fast at any test in accordance with the Rules set forth in the Water Regulations of the Pennsylvania Public Utility Commission. The Customer shall pay a deposit in advance for testing of the meter in accordance with fees established by the Commission in 52 Pa. Code §65.8(h). If the meter tested upon such request shall be found to be accurate within the limits specified by the Commission, the fee shall be retained by the City; but if not so found, then the cost thereof shall be borne by the City and the fee deposited by the Customer shall be refunded.

The ALJ recommended that Section 12.4 of the tariff (\$10 reconnection fee) be revised in order to be consistent with Section 8.4 (which is to contain an \$83 reconnection fee).

According to the ALJ, Section 12.4 is to state as follows:

If any monthly or quarterly bill for water service is not paid within thirty (30) days after the date on which the bill is rendered, a penalty of one and one-quarter percent (1 – ¼%) of the amount of said bill shall be imposed thereon, and further, the water shall be shut off after giving the customer ten (10) days written notice of the utility's intention to do so. Upon payment by the customer of an additional charge of eighty-three dollars (\$83.00) as the charge for restoring service, the customer will be returned to service.

R.D. at 102-103.

c. Disposition

No Party filed Exceptions to the ALJ's recommendations in these matters. Finding the ALJ's recommendation to be reasonable, we adopt these minor tariff changes as clarified by the ALJ.

IX. Public Input Sessions

ALJ Mellilo conducted two public input hearings on December 2, 2010, in the service territory of the City. The ALJ highlighted the substance of the nine testimonies received that day, as follows:

A. Manheim Township Public Library

1. Rosemary Wilson

Rosemary Wilson, a Formal Complainant in this proceeding at Docket No. C-2010-2204407, testified that she was not totally against any rate increase. However, she did object to the size and timing of the within proposed increase, and indicated

particular concern about the economic impact of the proposed rate increase on local businesses and industry.

2. William Laudien

William Laudien testified as the township manager of Lancaster Township, which is within the service territory of the City outside of Lancaster's corporate limits. Mr. Laudien stressed the need for an equitable distribution of the rate increase between inside and outside customers. He emphasized that any rate increase granted to the City with respect to its outside customers should not provide revenue to the general operating fund of the City of Lancaster.

3. Katherine Swisher

Katherine Swisher, a Formal Complainant at Docket No. C-2010-2200324, testified as a customer who, like Ms. Wilson, was concerned about the impact of the rate increase on small businesses. She indicated that the magnitude of the rate increase showed a lack of City planning and contended that the City should have provided for replacement of treatment facilities through plant depreciation.

4. Robert S. Krimmel

Robert S. Krimmel testified as the township manager of East Hempfield Township, which is within the service territory of the City but outside of Lancaster's corporate limits. Like Mr. Laudien, Mr. Krimmel stressed the need for an equitable distribution of the rate increase between inside and outside customers. He made a comparison between the water rates of an Authority which serves in the Township, and the City's rates, and found that the Authority's rates were much less. He urged the

Commission to consider the normal ratemaking issues in this case including: (1) were the expenses prudently incurred? (2) was there removal of plant from rate base that was no longer used and useful? (3) was there excess capacity? (4) were customer advances and CIAC removed from rate base? (5) was the allocation of the rate increase just, reasonable and nondiscriminatory? (6) was the allowed rate of return fair? (7) was the rate design and structure appropriate? and (8) was the cost of service study accurate and appropriate?

5. Lawrence Downing

Lawrence Downing testified as a township commissioner in Manheim Township. He requested consideration of a phase-in based upon the magnitude of the requested increase.

6. Herbert B. Watson, Sr.

Herbert B. Watson, Sr. a senior citizen, testified on behalf of himself and other seniors with regard to the economic impact of the increase on fixed income consumers. He indicated that seniors had already been informed they would be receiving no cost of living (COLA) increase in Social Security benefits.

B. Millersville VFW

1. Thomas Tamski

Mr. Tamski, a retired West Lampeter Township resident and outside-City customer, expressed concern that outside customers were going to be subsidizing inside-City customers if the rate increase was approved.

2. Robert E. Fink

Mr. Fink, a retired customer, expressed concern about the rate disparity between inside and outside-City customers.

3. George Poulin

Mr. Poulin, a Formal Complainant at Docket No. C-2010-2198619 and the only *pro se* Complainant to submit written comments/objections on the Partial Settlement testified as to impact of the increase on customers like him who are on fixed incomes. He criticized the City's requested 11.25% return on equity as excessive, particularly at a time when consumers are barely earning any interest on a bank savings account. R.D. at 103-106.

C. Response to Public Input Testimony

The City specifically addressed the public input testimony in its Main Brief.

In response to concerns about the amount of the increase, the City indicated that the increase was being driven primarily by the treatment plant upgrades, and no Party had claimed they were unnecessary. City M.B. at 84.

In response to testimony about whether customers inside the City were paying their 'fair share, the City indicated it was planning to increase the rates of inside customers so as to produce the same rate of return as proposed for outside customers. The proposed increase to inside customers is in addition to the approximate 30% increase that became effective in January 2010 for inside-City customers only. City M.B. at 59.

In response to testimony about customer hardship, the ALJ noted that a reduction in the proposed increase has been reflected in the Partial Settlement. This proposal, along with the various other stipulations of the Parties, effectively reduced the City's requested increase to less than \$8.2 million, according to the City. City M.B. at 86. The impact of the ALJ's Recommended Decision would further reduce the City's allowed increase. Also, the ALJ explained that rates to fund the OPEB Trust Fund would not go into effect unless and until the City finalizes an Irrevocable Trust Agreement. R.D. at 107.

In response to Mr. Poulin's position that the increase be limited to 50% of the requested amount, the ALJ concluded that this request was not supported by the evidence of record. According to the ALJ, Mr. Poulin's specific adjustments, some of which coincide with the OCA's prior or current positions, have been considered as noted throughout her Recommended Decision. R.D. at 107.

X. Conclusion

We have reviewed the record as developed in this proceeding, including the ALJ's Recommended Decision and the Exceptions and Reply Exceptions filed thereto. The City initially requested an overall revenue increase of \$8,608,024, or 99.8%. The City subsequently revised its requested revenue increase to \$8,192,036, as a result of various agreements and the Partial Settlement. The ALJ found that the City's proposed Supplement No. 40 to Tariff Water- Pa. P.U.C. No. 6 should be rejected. According to the ALJ, the rates contained in the Supplement are not just and reasonable or otherwise in accordance with the Public Utility Code and applicable regulations. The ALJ recommended that the Partial Settlement which mitigates the rate increase be approved. R.D. at 107.

The ALJ further recommended that the Commission issue an Opinion and Order directing the City 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 revenue, if the Irrevocable Trust Agreement is finalized and proof provided to the Commission by the end of the suspension of rates. The ALJ recommended 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 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. The ALJ further 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. R.D. at 107-108.

Based on our review, evaluation and analysis of the record evidence, we have adopted the ALJ's recommendations in all areas except capital structure, cost of equity and the proposed scale back, as discussed above. The resulting revenue increase is \$5,787,910, or about 67.1 percent as the Irrevocable Trust Agreement has not been finalized as of the date of this Opinion and Order. The total allowable revenue increase, once the Irrevocable Trust Agreement has been finalized and filed with the Commission, is \$6,265,621, or about 72.7 percent. As such, the Exceptions filed by the various Parties hereto, are granted or denied, as discussed *supra*. Accordingly, the ALJ's Recommended Decision is adopted as modified by this Opinion and Order.

XI. ORDER

THEREFORE;

IT IS ORDERED:

1. That the Exceptions filed by the City of Lancaster – Bureau of Water, the Office of Trial Staff, the Office of Consumer Advocate and the Kellogg Company on or before May 17, 2011, to the Recommended Decision of Administrative Law Judge Kandace F. Melillo are granted or denied, consistent with this Opinion and Order.
2. That the Exceptions filed by Mr. George Poulin on May 16, 2011, to the Recommended Decision of Administrative Law Judge Kandace F. Melillo are denied.
3. That the Recommended Decision of Administrative Law Judge Kandace F. Melillo, issued on April 27, 2011, is adopted, to the extent it is consistent with this Opinion and Order.
4. That the City of Lancaster – Bureau of Water shall not place into effect the rates contained in Supplement No. 40 to Tariff Sewer Pa. P.U.C. No. 6, which have been found to be unjust, unreasonable and, therefore, unlawful.
5. That the Joint Petition in Partial Settlement of Rate Investigation filed in this matter on February 22, 2011, is hereby approved.
6. That the City of Lancaster – Bureau of Water is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and

regulations, consistent with the findings herein, to produce revenues not in excess of \$14,960,423 if the Irrevocable Trust Agreement is finalized and proof provided to the Commission by the end of the rate suspension period.

7. That if the Irrevocable Trust Agreement is not finalized and filed by the end of the rate suspension period, then the City of Lancaster – Bureau of Water is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings herein, to produce revenues not in excess of \$14,482,712, subject to the remainder being placed into effect when the Irrevocable Trust Agreement is finalized and filed.

8. That the City of Lancaster – Bureau of Water’s tariffs, tariff supplements, or tariff revisions described in Ordering Paragraphs 6 and 7 above, may be filed upon less than statutory notice, pursuant to the provisions of 52 Pa. Code §§53.31 and 53.101, and may be filed to be effective for service rendered on and after the date of entry of the instant Opinion and Order.

9. That the City of Lancaster – Bureau of Water 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.

10: That the City of Lancaster – Bureau of Water shall comply with all directives, conclusions and recommendations contained in the Commission’s Opinion and Order that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

11. That the City of Lancaster – Bureau of Water upgrade its plant and depreciation accounting and records and obtain verification from its auditors that its accounting procedures and reporting are consistent with Pennsylvania Public Utility Commission requirements for Class A Water Utilities as well as with GASB requirements.

12. That the record of this proceeding be reopened for the limited purpose of admitting into evidence the interrogatory response (response to OTS-RS-20-D), including cost calculation, and associated tariff language change (identified as City Exhibit No. 8) to support the change in the Restoration – Reconnection Charge in Sections 8.4 and 12.4 of the tariff, and that the City of Lancaster – Bureau of Water provide the requisite number of copies to the Secretary's Bureau, and that the record thereafter be closed.

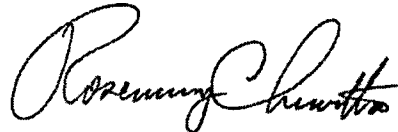
13. That the City of Lancaster – Bureau of Water evaluate the propriety of its existing commodity block rate structure and, in its next base rate filing, either propose separate rates for each customer class, based on cost of service, or provide justification for maintaining the existing rate structure. The following matters shall be specifically addressed in any justification for maintaining the existing structure: (a) support for the number of GMS rate blocks; (b) support for the size of the rate blocks; and (c) an explanation of why the existing GMS rate structure is preferable to establishing separate rate schedules for the outside-City residential, commercial and industrial customers.

14. That the Formal Complaints filed at Docket Nos. C-2010-2197988; C-2010-2198077; C-2010-2198619; C-2010-2198821; C-2010-2199946; C-2010-2200324; C-2010-2200532; C-2010-2200534; C-2010-2200594; C-2010-2201209; C-2010-2201794; C-2010-2202121; C-2010-2202868; C-2010-2204301; C-2010-

2204311, C-2010-2204407, C-2010-2204410; C-2010-2204414; C-2010-2204415; C-2010-2204436; C-2010-2204454; C-2010-2206497, C-2010-2206528; C-2010-2206541, C-2010-2208880; and, C-2010-2213105, against the proposed rate increase at Docket No. R-2010-2179103, are sustained, in part, and denied, in part, consistent with this Opinion and Order.

15. That the Pennsylvania Public Utility Commission's inquiry and investigation at Docket Number R-2010-2179103 is terminated and the cases closed in this and all associated cases at Docket Nos. C-2010-2197988; C-2010-2198077, C-2010-2198619; C-2010-2198821, C-2010-2199946; C-2010-2200324; C-2010-2200532; C-2010-2200534; C-2010-2200594; C-2010-2201209; C-2010-2201794; C-2010-2202121, C-2010-2202868; C_2010-2204301, C-2010-2204311, C-2010-2204407, C-2010-2204410; C-2010-2204414; C-2010-2204415; C-2010-2204436; C-2010-2204454; C-2010-2206497, C-2010-2206528; C-2010-2206541, C-2010-2208880; and, C-2010-2213105.

BY THE COMMISSION,



Rosemary Chiavetta
Secretary

(SEAL)

ORDER ADOPTED: June 30, 2011

ORDER ENTERED: July 14, 2011

Tables – Pre Irrevocable Trust Agreement

TABLE I
City of Lancaster - Bureau of Water
INCOME SUMMARY - Pre Irrevocable Trust Agreement
R-2010-2179103

	Pro Forma Present Rates 12/31/2009 (1)	Test Year Adjustments (1)	Pro Forma Present Rates 12/31/2010 (1)	Commission Adjustments	Commission Pro Forma Present Rates	Commission Revenue Increase	Total Allowable Revenues
	\$	\$	\$	\$	\$	\$	\$
Operating Revenue	8,558,113	63,349	8,621,462	73,340	8,694,802	5,787,910	14,482,712
Expenses:							
O & M Expense	8,366,918	69,232	8,436,150	(877,797)	7,558,353	0	7,558,353
Depreciation	854,349	1,486,354	2,340,703	(150,500)	2,190,203	0	2,190,203
Taxes, Other	0	0	0	0	0	0	0
Income Taxes:							
State	0	0	0	0	0	0	0
Federal	0	0	0	0	0	0	0
Total Expenses	9,221,267	1,555,586	10,776,853	(1,028,297)	9,748,556	0	9,748,556
Income Available for Return	(663,154)	(1,492,237)	(2,155,391)	1,101,637	(1,053,754)	5,787,910	4,734,156
Rate Base	26,888,268	65,466,229	92,354,497	(1,487,783)	90,866,714		90,866,714
Rate of Return	-2.47%		-2.33%		-1.16%		5.21%

(1) Exhibit 3-B, Schedule 1, Page 3 of 3

TABLE I(A)
 City of Lancaster Bureau of Water
 RATE OF RETURN
 R-2010-2179103

	Structure	Cost	Weighted Cost
Total Cost of Debt	83.80%	4.66%	3.91%
Long-term Debt	83.80%	4.66%	3.91%
Short-term Debt	0.00%	0.00%	0.00%
Preferred Stock	0.00%	0.00%	0.00%
Common Equity	16.20%	8.00%	1.30%
	<u>100.00%</u>		<u>5.21%</u>

TABLE II
 City of Lancaster Bureau of Water
 SUMMARY OF ADJUSTMENTS Pre Irrevocable Trust Agreement
 R-2010-2179103

<u>Adjustments</u>	<u>Rate Base</u>	<u>Revenues</u>	<u>Expenses</u>	<u>Depreciation</u>	<u>Taxes-Other</u>	<u>State Income Tax</u>	<u>Federal Income Tax</u>
RATE BASE:							
City Post Rejoinder Adj.							
City Main Brief Sch A-1, p.3	(1,489,468)						
Prepayments	(82,641)						
Partial Settlement	150,500						
Accum. Depc.	(66,174)						
CWC							
REVENUES:							
City Post Rejoinder Adj.		(1,176)					
City Main Brief Sch A-1, p.3		74,516					
Rental Inc. OTS St. No. 2-SR							
EXPENSES:							
City Post Rejoinder Adj.			(261,578)				
City Main Brief Sch A-1, p.3			(479,088)				
OPEB Pre ITA			(137,131)				
Rate Case Expense							
DEPRECIATION:							
Partial Stlmt Annual. Depc.				(150,500)			
TAXES:							
TOTALS	<u>(1,487,783)</u>	<u>73,340</u>	<u>(877,797)</u>	<u>(150,500)</u>	<u>0</u>	<u>0</u>	<u>0</u>

Tables – Post Irrevocable Trust Agreement

TABLE I
City of Lancaster Bureau of Water
INCOME SUMMARY Post Irrevocable Trust Agreement
R-2010-2179103

	Pro Forma Present Rates 12/31/2009 (1)	Test Year Adjustments (1)	Pro Forma Present Rates 12/31/2010 (1)	Commission Adjustments	Commission Pro Forma Present Rates	Commission Revenue Increase	Total Allowable Revenues
	\$	\$	\$	\$	\$	\$	\$
Operating Revenue	8,558,113	63,349	8,621,462	73,340	8,694,802	6,265,621	14,960,423
Expenses:							
O & M Expense	8,366,918	69,232	8,436,150	(403,177)	8,032,973	0	8,032,973
Depreciation	854,349	1,486,354	2,340,703	(150,500)	2,190,203	0	2,190,203
Taxes, Other	0	0	0	0	0	0	0
Income Taxes:							
State	0	0	0	0	0	0	0
Federal	0	0	0	0	0	0	0
Total Expenses	9,221,267	1,555,586	10,776,853	(553,677)	10,223,176	0	10,223,176
Income Available for Return	(663,154)	(1,492,237)	(2,155,391)	627,017	(1,528,374)	6,265,621	4,737,247
Rate Base	26,888,268	65,466,229	92,354,497	(1,428,455)	90,926,042		90,926,042
Rate of Return	-2.47%		-2.33%		-1.68%		5.21%

(1) Exhibit 3-B, Schedule 1, Page 3 of 3

TABLE II
 City of Lancaster Bureau of Water
 SUMMARY OF ADJUSTMENTS Post Irrevocable Trust Agreement
 R-2010-2179103

<u>Adjustments</u>	<u>Rate Base</u>	<u>Revenues</u>	<u>Expenses</u>	<u>Depreciation</u>	<u>Taxes-Other</u>	<u>State</u> <u>Income Tax</u>	<u>Federal</u> <u>Income Tax</u>
	\$	\$	\$	\$	\$	\$	\$
RATE BASE:							
City Post Rejoinder Adj.							
City Main Brief Sch A-1, p.3	(1,489,468)						
Prepayments	(82,641)						
Partial Settlement	150,500						
CWC	(6,846)						
REVENUES:							
City Post Rejoinder Adj.		(1,176)					
City Main Brief Sch A-1, p.3		74,516					
Rental Inc. OTS St. No. 2-SR							
EXPENSES:							
City Post Rejoinder Adj.			(261,578)				
City Main Brief Sch A-1, p.3			(4,468)				
OPEB Post ITA			(137,131)				
Rate Case Expense							
DEPRECIATION:							
Partial Stmt Annual. Depec.				(150,500)			
TAXES:							
TOTALS	<u>(1,428,455)</u>	<u>73,340</u>	<u>(403,177)</u>	<u>(150,500)</u>	<u>0</u>	<u>0</u>	<u>0</u>