PENNSYLVANIA PUBLIC UTILITY COMMISSION
P. O. BOX 3265, HARRISBURG, Pa 17120

January 25, 1985

IN REPLY PLEASE REFER TO OUR FILE
R-842583
R-842583C001
through
R-842583C008

To All Parties

Pennsylvania Public Utility Commission, et al.
v.
Duquesne Light Company

To Whom It May Concern:

This is to advise you that an Opinion and Order has been adopted by the Commission in public meeting held January 24, 1985.

A Copy of an Opinion and Order has been enclosed for your records.

Very truly yours,

Jerry Rich, Secretary

lg
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PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17120

Public Meeting held January 24, 1985

Commissioners Present:

Linda C. Taliaferro, Chairman
Michael Johnson, dissenting
James H. Cawley
Frank Fischl
Bill Shane, dissenting

Pennsylvania Public Utility Commission	:	R-842583
Armco, Inc.	:	R-842583C001
David M. Barasch, Consumer Advocate	:	R-842583C002
United States Steel Corp.	:	R-842583C003
Shirley Brown, Georgia Dedes and Victoria Finn (PULP/NLS)	:	R-842583C004
American Standard, Inc.	:	R-842583C005
General Motors Corporation	:	R-842583C006
PAJE and Thomas G. Hoffman	:	R-842583C007
LTV Steel Company	:	R-842583C008
v.	:	
Duquesne Light Company	:	

Intervenor: Hospital Council of Western Pennsylvania and Sewickley Valley Hospital

APPEARANCES:

Thomas & Thomas
Charles E. Thomas, Esquire
Charles E. Thomas, Jr., Esquire
Patricia Armstrong, Esquire
Thomas T. Niesen, Esquire
P.O. Box 999
Harrisburg, PA 17108
For: Duquesne Light Company

Julian S. Suffian, Esquire
John N. Quain, Esquire
Robert Frazier, Esquire
Pennsylvania Public Utility
Commission
P.O. Box 3265
Harrisburg, PA 17120
For: Commission Trial Staff

Philip McClelland, Esquire
Gerald Chakerian, Esquire
Robert Haynes III, Esquire
Office of the Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
For: Office of Consumer Advocate

Steer, Strauss, White & Tobias
David F. Boehm, Esquire
2208 Central Trust Tower
5 West 4th Street
Cincinnati, OH 45202
For: Armco, Inc.

Wayne L. Emery, Esquire
Kenneth R. Pepperney, Esquire
Susan L. Rockwell, Esquire
600 Grant Street - Room 1569
Pittsburgh, PA 15230
For: United States Steel Corp.

Michael P. Kerrigan, Esquire
503 North Front Street
P.O. Box 1752
Harrisburg, PA 17105
For: The Hospital Council of Western
Pennsylvania

Buchanan Ingersoll
Stephen A. George, Esquire
600 Grant Street - 57th Floor
Pittsburgh, PA 15219
For: LTV Steel Company

McNees, Wallace and Nurick
William A. Chesnutt, Esquire
Henry R. MacNicholas, Esquire
100 Pine Street
Harrisburg, PA 17108
For: General Motors Corporation and
American Standard, Inc.

Thomas G. Hoffman, Esquire
111 Smithfield Street
Pittsburgh, PA 15222
For: Pennsylvania Alliance for Jobs
and Energy

Pennsylvania Utility Law Project
Otto F. Hoffman, Esquire
213-A North Front Street
Harrisburg, PA 17101
For: Shirley Brown, Victoria Finn and
Georgia Dedes

Evalynn Welling, Esquire
Neighborhood Legal Services Association
1312 East Carson Street
Pittsburgh, PA 15203
For: Shirley Brown, Victoria Finn and
Georgia Dedes

TABLE OF CONTENTS

		Page
I.	INTRODUCTION AND BRIEF HISTORY OF THE CASE	1
II.	RATE BASE AND INCOME STATEMENT UPDATES	4
III.	RATE BASE	9
	A. Fair Value	9
	B. Electric Plant in Service	9
	1. Deloitte Haskins and Sells Study	10
	2. Unrecorded Retired Line Transformers	12
	3. Elrama Sewer Project	13
	C. Depreciation Reserve	14
	D. Additions to Rate Base	19
	1. Plant held for Future Use	19
	2. Cash Working Capital	28
	a. Uncollectible Accounts	28
	b. Prepayments and Deferred Rentals Under Nuclear Lease	29
	c. Deferred Quarto and Warwick Coal Costs	31
	d. Westinghouse Settlement	45
	e. Deferred Income Taxes	47
	f. Accumulated Interest and Preferred Dividends	52
	3. Other Working Capital	53
	a. Fuel Inventory-Eastlake	53
	b. Fuel Inventory-Mansfield	56
	E. Conclusion	58
IV.	REVENUES	59
	A. Adjustment to Year End Level of Operations	59
	B. Annualization for New Customers	61
	C. Late Payment Charges	62
	D. Unbilled Revenues	64
	E. Minimum Bill Revenues	66

Page

V. EXPENSES 67

A. CAPCO Cancellation Costs 67
B. EEOC Settlement 69
C. Rate Case Expense 72
D. Management Audit Expense 74
E. Uncollectible Accounts Expense (Provision for Uncollectibles) .. 78
F. Tree Trimming 80
G. Net Negative Salvage 81
H. Split Pin Replacement 85
I. Computer Costs 88
J. Leasehold Improvements 89
K. Deferred Oxford Centre Costs 92
L. Reed, Smith, Shaw & McClay Legal Fees 94
M. Edison Electric Institute Dues, Media Communications Dues; and Local Institutional Advertising . 98

1. General Edison Electric Institute Dues 98
2. EEI Media Communications Dues 100
3. Institutional Advertising ... 103

N. Steam Power Maintenance 104
O. Wage Increase 106
P. Early Retirement and Levels of Employees 110
Q. Warwick A&G Expenses 116
R. Depreciation Expense 118
S. Transmission Line Rentals 120
T. Inflation Adjustment 121
U. New Customer Expenses 126
V. Additional Claims 130
W. CAPCO Displacement Training Costs 130

VI. TAXES 134

A. Excess State Tax Adjustment Surcharge Revenues 134
B. Deferred Income Tax 139
C. Ohic State Property Taxes 141
D. Normalization vs. Flow Through .. 142

VII. RATE OF RETURN 150

A. Capital Structure 154
B. Cost of Debt 155
C. Cost of Preferred Stock 157

Page

D. Common Equity 158

1. Duquesne 158
2. Staff 164
3. OCA 167
4. ALJ's Recommendation and Exceptions 170
5. Discussion and Conclusion 170

VIII. RATE STRUCTURE 176

A. Cost of Service Study 177

1. Allocation of Demand Related Production Plant and Expenses 179
2. Allocation of Distribution Plant 186
3. Allocation of General Plant-Account No. 397.4 189

B. Rate Structure 190

1. Rate L Contract Terms 190
2. Minimum Charge Provision 195
3. Customer Class Risk Differential 201
4. Essential Usage-Invested Residential Rate 202
5. Rider No. 18 203
6. Rate L Service Voltage Level Adjustment 210
7. Bill Format 211

IX. CONCLUSION 212

OPINION AND ORDER

BY THE COMMISSION:

I. INTRODUCTION AND BRIEF HISTORY OF THE CASE

On April 27, 1984, Duquesne Light Company (hereinafter Duquesne, Company or Respondent) filed Supplement No. 11 to its Tariff Electric-Pa. P.U.C. No. 15, to become effective June 26, 1984. Supplement No. 11 contained proposed changes in rates, rules and regulations calculated to produce an increase in annual electric revenues of approximately $41,999,934 (4.8%) based upon the future test year level of operations for the twelve month period ending December 31, 1984.

By Order entered May 25, 1984, we noted the suspension of Supplement No. 11 by operation of law and instituted an investigation upon our own motion at R-842583 into the lawfulness, justness and reasonableness of the Company's existing rates, rules and regulations as well as the rates, rules and regulations proposed in Supplement No. 11. Thereafter, on June 8, 1984, Duquesne filed Supplement No. 12 to its Tariff Electric-Pa. P.U.C. No. 15, suspending the effective date of Supplement No. 11 until January 26, 1985.

Complaints against the proposed rates, rules and regulations were filed by: Armco, Inc. (Armco), R-842583C001; David M. Barasch, Consumer Advocate (Consumer Advocate or OCA), R-842583C002; United States Steel Corporation (U.S. Steel or USS), R-842583C003; Shirley Brown, Georgia Dedes and Victoria Finn, Pennsylvania Utility Law

Project/Neighborhood Legal Services (PULP/NLS), R-842583C004; American Standard, Inc. (American Standard), R-842583C005; General Motors Corporation (General Motors or GM), R-842583C006; Pennsylvania Alliance for Jobs and Energy (PAJE) and Thomas G. Hoffman, R-842583C007; and LTV Steel Company (LTV), R-842583C008. The complaints were consolidated with the Commission's investigation for the purpose of hearing, briefing and disposition. The Petition to Intervene of the Hospital Council of Western Pennsylvania and Sewickley Valley Hospital (Hospital Council or Hospitals), filed on June 25, 1984, was granted. The Commission Trial Staff filed its Notice of Appearance on June 1, 1984.

A Prehearing Conference was held on June 28, 1984. Twenty-five days of evidentiary hearings were held between July 19, 1984 and October 10, 1984, before Administrative Law Judge (ALJ) Joseph P. Matuschak. In addition, public input hearings were held on August 6, 1984, at Baden, Pennsylvania, and on August 7, 1984 at Pittsburgh, Pennsylvania.

Main Briefs were filed by Duquesne, the Staff, the OCA, U.S. Steel, Armco, LTV, the Hospital Council and jointly by American Standard and General Motors.

Reply briefs were filed by Duquesne, the Staff, the OCA, Armco, LTV and jointly by American Standard and General Motors.

The ALJ's Recommended Decision was issued for exceptions on November 30, 1984. Exceptions were filed by the Respondent, the Staff, the OCA, LTV, USS, and Armco. Replies to Exceptions were filed by the Respondent, the Staff, the OCA, LTV, USS, American Standard and GM (jointly) and the Hospitals.

II. RATE BASE AND INCOME STATEMENT UPDATES

Duquesne's rate base claim set forth in the data accompanying its application in this proceeding, appears in Exhibit 1B, pages D1-D2. Its claim, applicable to Pennsylvania jurisdictional operations, is $1,815,899,916. During the course of the proceedings, Duquesne's rate base claim was updated in Exhibits 9A & 9B, which were marked for identification on October 3, 1984 (Tr. 2935). During a colloquy at transcript pages 2940-2942, counsel for the OCA objected to an update of the rate base claim, unless the update merely reflected matters previously testified to by a witness. Subsequently, at transcript pages 2988-3001, counsel cross-examined the sponsoring witness for these exhibits. From our reading of that portion of the transcript the questions appear to be in the nature of discovery regarding the changes or differences between these exhibits and the material appearing in Exhibit 1B, and certain clarification regarding the matters shown in the exhibits. There were a total of only four additional hearing days until the close of the record on October 10, 1984, during which time Mr. Waddington, Duquesne's sponsoring witness for Exhibits 9A & 9B did not reappear. On October 10, 1984, when Duquesne moved the admission of its many statements and exhibits, the OCA interposed a more formal objection to the admission of these exhibits and also to Exhibit 2H which was an updated income statement which

had been marked for identification on October 4, 1984[1/] (Tr. 3794-3795). This objection was overruled. The OCA again interposed an objection to consideration of these exhibits in its Main Brief.

The updated rate base exhibit (Ex. 9B), increases the rate base claim from $1,815,899,916 to $1,833,760,602 or by $17,860,686. The ALJ commented upon this subject, as follows:

> The Consumer Advocate complains that Duquesne Exhibit 9B was not provided to the parties until October 3, 1984, shortly before the record was closed on October 10, 1984. It asserts that there was little, if any, time for an orderly examination of the claims for the increase.
>
> Duquesne asserts that since in a future test year it is essential that any known changes in the projected plant construction be shown, it did so, showing some increases and some decreases. It further states that the increased dollars are detailed in Duquesne Exhibits Nos. 9A and 9B by account and description and reflected updated in-service dates, retirements and costs to be expended in the remainder of the future test year, which costs it states were not challenged by the Consumer Advocate. Additionally, it states that the OCA's own witness testified that the most recent date should be used and that he urged

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1/ Although Exhibit 2H was marked for identification on October 4, 1984, Mr. Atkinson, the sponsoring witness did not appear and authenticate the exhibit until October 9, 1984 (Tr. 3439).

an examination of the costs to establish the accuracy of the Company's projections and their inclusion in measure [sic] of value. (OCA St. No. 2). It submits that such updating has been done in Duquesne's prior rate proceedings before this Commission.

The Consumer Advocate cites our order of April 17, 1979 in Pa. P.U.C. v. West Penn Power Company (R-78100685), wherein we rejected West Penn's attempt to make late wholesale, blanket revisions to the future estimates of the test year data to reflect new actual data. That case must be distinguished from the limited adjustments involved here. We said in that case, however:

> On the other hand, we do not regard the initial future test year as a perfect device to predict the future, or to constitute the sole basis for ratemaking, or as a straight-jacket confining West Penn or the Commission. Appropriate adjustment will be given consideration on an individual basis, with due regard given, but not limited, to the time of their submission, the nature and reliability of such adjustments, the opportunity for testing, the effect upon the orderly process of the rate proceeding, the time constraints, and more satisfactory basis for decision. [Slip, p. 13; emphasis supplied]

* * * * *

[W]e reject the objection of the Consumer Advocate to such revision. The revision was such as by necessity was required to be submitted toward the end of the hearing process, in order to catch the latest changes in projected plant

construction. The changes were few in number and were such as could be inquired into without extended time for testing. Such updating is not unusual in rate proceedings.

The OCA has excepted (OCA Ex., p. 1). Although the ALJ's comments quoted above address only Exhibits 9A & 9B and he does not address Exhibit 2H[2/] elsewhere in his Recommended Decision, the OCA objection at transcript page 5794 clearly extended to both the updated rate base exhibits (9A & 9B) and the updated income statement (Ex. 2H). Similarly, the OCA's objection voiced in its Main Brief (pp. 2-4) encompasses all three exhibits mentioned above. Consequently, it appears clear to us that the ALJ intended to reject the OCA objection as to all three exhibits.

As we have mentioned above, the OCA has excepted. That exception extends to all three exhibits and is essentially an extension of the objection raised before the ALJ. It presents an issue frequently raised with regard to the timeliness of updates to exhibits. In our view it is one thing to update exhibits to correctly reflect matters which have arisen during cross and redirect examination and reflect any concomitant adjustments such as depreciation expense associated with a rate base change and the resultant

---

2/ The significant changes from Exhibit 1B, pages I1 through I4 to Exhibit 2H, are (1) an increase in revenues of approximately $7 million; (2) an increase in expenses of approximately $1.3 million; (3) an increase in depreciation expense of approximately $1 million; and, (4) associated and other changes in income and gross receipts taxes.

income tax effect; it is another thing to update exhibits to reflect the quarterly updates required by the Commission's rules. In the latter instance consternation on the part of Complainants and the Staff who may be required to redo much of their presentation is understandable. On the other hand, a timely update by the utility to reflect more current actual data is reasonable. We have observed instances in which the ALJ, in the scheduling process, has established a final date for the service of updated rate base and income statement exhibits, in order to ensure that the other parties have an adequate opportunity to respond thereto, and consequently are accorded due process. We find that this practice is commendable and we would like to see this practice followed in every instance because all other parties would be notified well in advance that they must expect to be confronted with updated exhibits, and the timing of that event. In this instance this procedure was not followed and based upon the timing here we conclude that the presentation of these exhibits one week prior to the close of the record was insufficient time to constitute the due process to which the OCA was entitled. Consequently, finding that the OCA was denied due process as a result of the untimely presentation of the updated exhibits, we reverse the ruling of the ALJ and exclude from the evidentiary record, Duquesne Exhibits 9A, 9B, and 2H.[3/] Accordingly, the OCA's exception is granted.

3/ There are a few exceptions to this general exclusion. In those instances in which the updated material is a mere recitation of matters or changes elicited during cross or redirect examination we shall admit and consider that updated material. These instances will be clearly identified.

III. RATE BASE

A. Fair Value

The Respondent presented only an original cost measure of value in this proceeding. Consequently, this proceeding has been litigated by all parties on the basis that the original cost measure of value of the Respondent's electric plant, plus rate base additions and deductions will be deemed to represent its fair value rate base. For these reasons we shall adopt as the fair value of the Respondent's rate base, the original cost measure of value as it shall be hereinafter determined. The Respondent's claimed rate base, on a Pennsylvania jurisdictional basis, is $1,815,899,916.[4/]

B. Electric Plant in Service

Duquesne's claim for undepreciated electric plant in service as of December 31, 1984, the end of the future test year, net of retirements associated with environmental control construction work in progress and customer advances for construction, is $2,472,634,965

4/ Duquesne Exhibit 1B, p. D1.

(Exhibit 1B, p. D2). The parties to the proceeding have proposed a number of adjustments to this claim which we shall address below.

1. Deloitte Haskins & Sells Study

Deloitte Haskins and Sells (DH&S), commencing in 1981, performed a study and analysis of Major Projects Construction Management, Transmission and Distribution Facilities Construction Management and the Continuing Property Records System of Duquesne. DH&S was paid $1,365,119 during the period February 1981 through May 1983. These costs were charged to Construction Order #1 and were cleared on a monthly basis to projects in Construction Work in Progress.

Staff witness Rose opined in his testimony that these costs were erroneously capitalized and alternatively proposed that rate base be reduced by the amount of $1,365,119 and that these costs be amortized over a three year period.

In its Main Brief (pp. 30-31), the Staff urges that these costs be disallowed and that the Company's rate base be reduced by the entirety of these costs and that there be no amortization of them.[5]

5/ See also the Staff's comments at page 2 of its Reply Brief.

In its Main Brief (pp. 22-23), Duquesne argues that these costs were properly capitalized, but states that if the Commission disagrees, then its expense claim must be adjusted to reflect the amortization proposed by Staff witness Rose.

Staff's response (Reply Brief, p. 2), is that it is not bound by the opinion of its witness and urges total disallowance of this expense.

The ALJ concluded that the expense was prudently incurred, but because the benefit derived was of a question-able nature he recommended essentially that the expense be shared by stockholders and ratepayers by its exclusion from rate base and its amortization over a three year period.

Duquesne has excepted, in a perfunctory manner, to the ALJ's exclusion from rate base urging, however, that if the costs are excluded from rate base, the ALJ's recommendation that the costs be amortized over three years is proper. In our view, Duquesne has offered no more than a bare assertion that capitalization is appropriate for this expense. On the other hand, the Staff has not excepted to the ALJ's recommendation that this expense be amortized over

a three year period. We conclude that a proper resolution of this matter is to adopt the ALJ's recommendation and deny the Company's exception.

2. Unrecorded Retired Line Transformers

Staff witness Rose proposed a reduction in rate base of $615,603 representing the net average cost of retired line transformers included in plant in service accounts, it having been discovered during a continuing property record audit that the Respondent does not reconcile the control account (FERC Account No. 368, Line Transformers) or the CPR ledger with the subsidiary accounts for overhead transformers.

Noting that Duquesne had stated in its Main Brief (p. 23) that this adjustment was appropriate, the ALJ recommended that this rate base adjustment be made. No party has excepted to this recommended adjustment and, otherwise finding it appropriate, we shall make this adjustment.

3. Elrama Sewer Project

The OCA proposed a rate base reduction of $709,873 and a concomitant depreciation expense reduction of $36,230, pertaining to a sewer construction project at the Elrama power station. The basis for this proposal was that the project was not scheduled for completion until July 1985 and the OCA stated that there was some question whether the project would be completed at that time because of a delay in the issuance of the necessary permits by the Department of Environmental Resources.

This adjustment was proposed by the OCA on the contingency that the Commission adopted or considered the updated rate base claim reflected in Duquesne Exhibits 9A-9B. (Tr. 3795 and Main Brief, pp. 32-34). Since we have excluded Duquesne's Exhibits 9A and 9B from the record and our consideration, this proposal of the OCA, has become moot. Additionally, with Exhibits 9A and 9B excluded from the evidentiary record the proposed adjustment is without a factual foundation.[6/]

6/ Our exclusion of Duquesne's Exhibits 9A and 9B results in the exclusion of the Company's claim in this regard.

The Company excepted to the ALJ's recommended rate base and expense adjustment with regard to this item. We conclude that this exception has been mooted as well.

C. Depreciation Reserve

Duquesne's claim with regard to its calculated depreciation reserve is $589,998,478 (Exhibit 1B, p. D2). The OCA proposes that the Company's adjusted book reserve of $593,517,535 be utilized rather than the Company's proposed calculated reserve. The OCA summarized the arguments in support of this proposal, as follows:

> First, OCA submits that a calculated reserve bears no relationship to the appropriate depreciation reserve measure for ratemaking purposes, namely, the measure of the investment the Company has already recovered from ratepayers through rates. Second, the use of a calculated reserve does not result in a depreciated original cost measure of value that conforms with Pennsylvania law, the Uniform System of Accounts or the depreciation reserve shown in any company financial reports. Third, Duquesne's adjusted book reserve is a reasonably accurate representation of the accrued depreciation recovered from ratepayers that can be adopted by this Commission consistent with its prior orders that adopted book reserve.

OCA Main Brief, p. 26.

With regard to the OCA's third point, Duquesne witness Waddington had the following comments:

> The fact that depreciation accruals have been recorded on a company's books does not necessarily mean that the recorded dollar amounts have been charged to or received from the ratepayers. Only if the actual revenues received from ratepayers equalled the total cost of service, including recorded depreciation expense, would it be logical to draw the conclusion expressed by Mr. Larkin. Generally, recorded book depreciation is not fully recovered through rates charged to the ratepayers. (Emphasis added)

Duquesne Statement No. 9-1, p. 3. The thrust of Mr. Waddington's testimony is that the view that all expenses are recovered before profit is earned is somehow incorrect. Suffice it to say, we do not concur in Mr. Waddington's viewpoint. Rather, we subscribe to the more conventional, mainsteam view that all expenses must be considered to be recovered before profit is earned. This aside, in its Main Brief (pp. 23-31) Duquesne argues at length regarding the inappropriateness of the use of the book depreciation, including therein, additional quotations from the testimony of Mr. Waddington. Duquesne also stated that "[t]ime and time again this Commission and the appellate courts of Pennsylvania have rejected the contention that book reserve should be used." (Main Brief, p. 28). This statement is followed by more than a full page of

citations.[7] Conversely, the OCA Main Brief contains citations of four Commission Opinions and Orders during the January 1981 - March 1983 period wherein the Commission adopted the use of a book depreciation reserve. Thus the Commission has moved to use of a book depreciation reserve in recent cases when the existing book reserve was deemed appropriate for use.

As to the use of a book reserve for Duquesne, the Commission in its Opinion and Order in the proceeding at R-80011069 said:

> The Consumer Advocate also recommends that the commission initiate a generic depreciation study in order that a more accurate measure of depreciation will be available in future rate proceedings. Duquesne opposes this recommendation. We do not believe that a generic investigation is appropriate, at least at this time. We believe that this is a subject which is best approached on a case by case basis. Although we reject the use of the book depreciation reserve in this proceeding, the subject is not so [sic] closed in future proceedings by any means, and it is one in which we have a continuing interest. More will be said on this subject under the topic of depreciation expense. The Administrative Law Judge recommended the use of the calculated depreciation reserve as

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7/ We would note that in the first three Commission Opinions and Orders cited, which are the most recent, the use of the book depreciation reserve was not rejected upon theoretical grounds, but rather, upon the ground that an analysis of the adequacy and appropriateness of the existing book reserve had not been completed by the Staff.

> presented by the respondent. The exceptions of the Consumer Advocate and the Commercial Complainants have been considered and are accordingly denied. (Emphasis added)

54 Pa. P.U.C. 695, 706 (1981). Additionally, under the subject of depreciation expense the Commission said:

> The Consumer Advocate opposed the use of a calculated depreciation reserve, urging the adoption of accumulated provision for depreciation reflected on the books of the company (book reserve). We rejected this position. The Consumer Advocate also sought an investigation into the proper method of calculating the depreciation reserve and depreciation expense. We rejected this request as well. The third request by the Consumer Advocate as set forth in Consumer Advocate Statement No. 3 at pp. 16, 17 was:
>
> "The Commission should order Duquesne to keep records of the accumulated depreciation reserve determined by the study, and to add to that figure depreciation expense at the annual rates approved by the Commission. This will insure that an accurate depreciation reserve will be established for rate-making purposes."
>
> This request cannot be granted entirely because of our acceptance of a calculated depreciation reserve in this proceeding. However, the depreciation expense claimed in this proceeding is of necessity based upon accrual rates by class of property. <u>We shall order herein that the respondent keep records of depreciation accruals by depreciable group, predicated upon the depreciation expense allowed in this proceeding commencing with the effective date of the rates established pursuant to this Order. These records are to be established and maintained in order that a ready comparison may be drawn between the amounts</u>

> booked to the book reserve and the amounts collected in revenues from the rates established pursuant to this order. (Emphasis added).

Id at 735. These comments are a clear indication that the Commission intended to consider the adoption of a book depreciation reserve in future proceedings. It is our understanding that the Company completed a study regarding its book depreciation reserve in December 1983 and that since that date there have been communications between the Staff Depreciation Committee and the Company regarding timely accrual procedure and other matters. It is our desire that the Staff and the Company pursue and resolve outstanding disagreements, issues and questions with all dispatch in order for the adoption of a book depreciation reserve to be a viable alternative in Duquesne's next general rate increase application proceeding. With this objective in mind we shall direct that the Staff and the Company file a written report with the Secretary of the Commission (joint or individual as the parties desire), not later than March 15, 1985 and every 45 days thereafter, advising the Commission regarding (1) any matters then outstanding upon which the parties have not agreed; (2) the nature of the disagreement between the parties; and (3) the estimated date of final resolution of each outstanding issue.[8/]

8/ It is our expectation that all matters will be resolved not later than July 31, 1985.

In this proceeding the ALJ recommended the adoption of Duquesne's calculated reserve, apparently believing that the necessary analysis of the Company's book reserve had not been completed. The OCA has excepted. The Staff has been silent on this subject in both its Main and Reply Briefs. However, as mentioned above, we are informally advised that the analysis of Duquesne's book depreciation reserve and associated matters has not been completed. Accordingly, we shall adopt the Company's calculated depreciation reserve in this proceeding. The OCA's exception is denied.

D. Additions to Rate Base

1. Plant held for Future Use

Duquesne's claim for land held for future use is $535,889 (Ex. 1B, p. E12). OCA witness Larkin proposed that this entire amount be excluded from rate base on the basis that the land was not used and useful and also because the Company had allegedly transferred a large portion of this amount to the Land Held for Future Use account for ratemaking purposes, while at the same time it remained in the Construction Work in Progress Account on the Company's books (OCA St. 3, pp. 4-6).

In its Main Brief the OCA's first contention is that inclusion of land held for future use is precluded by the provisions of 66 Pa. C.S. §1315. The argument is, in pertinent part, as follows:

The statute entitled "Limitation on consideration of certain costs for electric utilities," at 66 Pa. C.S. §1315, provides:

> Except for such nonrevenue producing, nonexpense reducing investment as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.
> (Emphasis added).
>
> The clear and unambiguous language of this statute applies directly to the claimed amounts for Land Held For Future Use. The word "facility" used in the statute is defined in the Public Utility Code to include "real...property." 66 Pa. C.S. §102. Further, "used and useful" is defined in §1315 as property which...is presently providing actual utility service to the customers. Obviously mere planning or preparation to use real property does not meet this standard. Thus Land Held For Future Use cannot be included in rate base.
>
> OCA contends that this statute supercedes [sic] any case precedent or prior Commission practice regarding Land Held For Future Use. Thus, whether there is a definite plan for use occurring within some period of years is simply immaterial. (Footnote omitted)

OCA Main Brief, pp. 16-17.

We responded to a similar contention in our Opinion and Order in the proceeding at Pennsylvania Public Utility Commission v. Penn Power Company, R-832409, (April 11, 1984), as follows:

> Second, OCA argues that Section 1315 of the Public Utility Code, 66 Pa. C.S. §1315, signed into law on December 30, 1982, when read in conjunction with Section 102 of the Code, 66 Pa. C.S. §102, requires that no utility property, including real property, should be considered used and useful until it is actually used in providing present utility service. The land upon which this claim is based will not be used in the future test year, and therefore OCA contends that the entire claim should be disallowed.
>
> * * * * *
>
> Turning to the OCA's argument that Section 1315 of the Public Utility Code precludes the inclusion of property, including real property, as used and useful until actually placed in service, we repeat here our contrary legal conclusion as stated in Pa. P.U.C. v. Metropolitan Edison Co., Docket No. R-822249 (October 9, 1983):
>
> While the cost of unimproved land or land rights might be considered to be a component of "the cost of construction of a facility", as that term is used in the statute, the subject of plant held for future use, has, historically, been a subject separate and distinct from that of construction work in progress. We believe that it would be an unreasonable reading of the statute, to apply the definition of used and useful in such a manner as to result in a reversal of Commission practice regarding plant held for future use, in the face of legislative silence on this separate and distinct regulatory subject."

> See also, Pa. P.U.C. v. Pennsylvania Power & Light Co., (PP&L) Docket No. R-822169 (August 22, 1983); Pa. P.U.C. v. Philadelphia Electric Co., Docket No. R-822291 (November 23, 1983); Pa. P.U.C. v. Pennsylvania Electric Co., Docket No. R-822250 (October 19, 1983).

Mimeo, pp. 26-28. The ALJ recommended that this contention of the OCA be rejected. The OCA has excepted. We have reviewed the OCA's argument on brief and in its exception most carefully, and find no reason to depart from the conclusion which has been reached on all occasions when the OCA has raised this contention. Accordingly, we deny the OCA's exception and reject this ground, as a basis for its proposed adjustment.

The OCA's second contention is that:

> The Uniform System of Accounts establishes Account 105 for Land Held For Future Use and Account 107 for Construction Work In Progress (CWIP). On cross-examination, Mr. Helfer, the Company's sponsoring witness, admitted that $403,664 of the claim, relating to Perry Units I and II, had been transferred from Account 107 (CWIP) on the Company's actual books to Account 105 (Land Held For Future Use) solely for rate case purposes.
>
> Q. I ask you to refer to Roman I-A-14. I ask you to turn to page four of four.
>
> A. Yes, sir.
>
> Q. You have two items there, item four and five which indicate land for Perry Unit No. 1 and Perry Unit No. 2 and beneath both of those items you say transferred from account 107.

Could you explain the nature why that land was transferred from account 107. to account 105?

A. The land was transferred from account 107 to account 105 strictly for rate filing. The land exists in Duquesne's accounting system in account 107 construction work in progress at this time.

In order to have this land claimed properly before this Commission we transferred to account 105 plant held for future use.

Q. So this transfer is basically only for this rate case, is that correct?

A. That is correct.

Tr. 1186-7. (Emphasis added.)

OCA submits that this highly artificial legerdemain should not be permitted. The emphasized portion of Mr. Helfer's testimony leaves no doubt as to the Company's motives: if the land had been left in CWIP where it belongs, then it could not earn a cash return because it would be excluded from rate base under this Commission's policy of excluding most CWIP from rate base.

OCA Main Brief, pp. 17-18.

The Company's response to this contention was:

As for the OCA's second contention, the fact that approximately 80% of these dollars are recorded in Account 107 does not affect the validity of the Company's rate base claim. The claim is for land, not for normal construction work in progress and the Company does not accrue AFUDC on these dollars. The Company's claim for Land Held For Future Use is entirely consistent with prior Duquesne rate Orders and the policy of this Commission to include in rate

base land held for future use when there are definite plans for its use within a reasonable period of time. The OCA's adjustment should be denied.

Company Reply Brief, p. 45.

The properties which the OCA asserts were improperly transferred from Account 107 to Account 105 are the sites for Perry Unit Nos. 1 and 2. The Company states that it does not accrue AFUDC[9/] on these properties and neither the OCA nor its witness disputes this statement. The OCA's position as enunciated by its witness Larkin is that the Company could and should be accruing AFUDC and that this is the "proper" ratemaking treatment to be accorded this land, rather than inclusion in rate base.

We believe it appropriate to look to the Uniform System of Accounts for guidance on this subject. The Uniform System Accounts is set forth in 18 CFR,[10/] Part 101. Electric Plant Instruction 3(17) therein describes the allowance for funds used during construction, as follows:

> (17) "Allowance for funds used during construction" includes the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used, not to exceed, without prior approval of the Commission, allowances computed in accordance with

9/ Allowance for Funds Used During Construction.

10/ Code of Federal Regulations.

> the formula prescribed in paragraph (a) of this sub-paragraph. No allowance for funds used during construction charges shall be included in these accounts upon expenditures for construction projects which have been abandoned. (Emphasis added)..

By its limitation on the allowance to funds used for construction, this provision excludes funds representing the cost of land held for future use and seemingly land even when it becomes associated with a construction project. The exclusion of AFUDC for land held for future use has given rise to the practice of the Commission permitting the inclusion of land held for future use in rate base when it meets established qualifying criteria.11/ In the proceeding at Pa. P.U.C. v. Penn Power Company, R-811510, 55 Pa. PUC 552 (1981), the OCA proposed as an alternative to rate base inclusion that an allowance similar to AFUDC be booked in a "side account". The Commission rejected this proposal. Here the factual situation is not entirely analogous for construction has commenced and the property has been transferred to Account 107, Construction Work in Progress, and transferred back to Account 105, Electric Plant Held for Future Use, for "ratemaking purposes". It seems clear that the Company's retransfer of the property is designed to qualify the property for continued inclusion in rate base.

11/ The criteria historically applied is: (1) a definitive plan for use; and, (2) an anticipated in service date within 10 years of the test year. (Pa. P.U.C. v. Penn Power Company, 55 Pa. PUC 552, 557 (1982).

This controversy gives rise to several questions.

1. Is property transferred to Account 107 eligible for the accrual of AFUDC under the Uniform System of Accounts?

2. If the answer to the preceding question is no, should this Commission permit the accrual of AFUDC as an exception to the Uniform System of Accounts?

3. If the answer to the preceding question is yes, should such transfers and commencement of AFUDC accrual be permitted between rate case proceedings with the resultant duplicative return, i.e. continued rate base inclusion reflected in current rates, plus an AFUDC accrual?

4. Is continued rate base inclusion after transfer to Account 107 appropriate and a preferred alternative to accrual of AFUDC?

5. Should rate base inclusion of property be terminated upon transfer to Account 107 even if AFUDC accrual is not permitted?

The Company in its Reply Brief states that the Company's claim "is entirely consistent with prior Duquesne rate Orders". If, by this, the Company is attempting to say that there have been previous transfers from Account 107 to Account 105 for "ratemaking purposes", we are unaware of this fact. We believe that this is a case of first impression. We note that the Staff has not addressed this subject in its Briefs and consequently we do not have the

benefit of the Staff's views on this subject. Consequently, we conclude that the most appropriate course at this point is to reject the OCA proposal for the accrual of AFUDC and to consider the Company's claim under our historic criteria for rate base inclusion.

While there does not appear to be any substantial question but that the majority of the Company's claim meets the criteria of a definitive plan and an in-service date within 10 years, this cannot be said for the land associated with Perry Unit No. 2. The matter of the future of that unit is decidedly unclear at this time. The alternatives being considered by the CAPCO Companies[12/] are: (1) reactivating construction work (essentially terminated at this point); (2) speeding up the pace of construction after reactivation; (3) deferring reactivation until after Perry Unit No. 1 is in service; and (4) cancellation.[13/] Understandably, Duquesne as a minority owner is unable to dictate such a decision or foretell what decision may be made. However, the consequence is that we do not have before us even a base assertion that the land for the Perry Unit No. 2 site will be in service within 10 years or ever. We therefore conclude that Duquesne has not met its burden of proof as to this item and, accordingly, we shall deny $201,832 of its claim, representing the investment in land associated with the siting of Perry Unit No. 2.

12/ Duquesne is only one of several owners of Perry Unit No. 2 with a 13.7% interest.

13/ Transcript pages 200-210.

2. Cash Working Capital

a. Uncollectible Accounts

Staff witness Horsfield recommends the elimination of uncollectible accounts expense from Duquesne's operations and maintenance expense cash working capital calculation. This would reduce the Company's claim by $37,000. In its Main Brief Duquesne states:

> Duquesne submits that uncollectible accounts expense is a recognized expense for rate-making purposes. The uncollectible expense is for service rendered some five to seven months previous thereto. Thus to the extent service is clearly provided to customers prior to collection through rates of the uncollectible expense, a cash working capital requirement is created. The Trial Staff's proposed adjustment should be denied. (Emphasis added).

Main Brief, pp. 35-36. The ALJ recommended rejection of the Staff proposal without discussion.[14/] The Staff and the OCA have excepted. In its exception the Staff states that its proposed adjustment is one which has been repeatedly and routinely adopted by the Commission. The Staff is correct.[15/] We do not perceive any new or novel argument or

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14/ We note that the Staff did not address this subject in its Briefs.

15/ See for example Pa. P.U.C. v. Columbia Gas of Pa., Inc., R-832393 (August 27, 1984); Pa. P.U.C. v. Philadelphia Electric Company, R-832410, (April 27, 1984); Pa. P.U.C. v. The Peoples Natural Gas Co., R-832315, (January 13, 1984); Pa. P.U.C. v. Equitable Gas Co., R-822133 (July 11, 1983); Pa. P.U.C. v. UGI Corp., R-831899 (December 22, 1982).

factual situation offered by Duquesne in support of its claim here. Consequently, we are not dissuaded that the prior conclusions reached on this subject are incorrect. Uncollectible expense is a misnomer. The item normally allowed in a rate proceeding is properly described as a provision for uncollectibles. The collection of this "expense" is reflected in revenues[16/] and the underlying expenses are reflected in the O&M expenses included in the customary lead lag study. We deny the Respondent's claim and, accordingly, the Staff's exception is granted.[17/]

b. Prepayments and Deferred Rentals Under Nuclear Lease

The Company has claimed a cash working capital requirement of $10,483,177 for this item. OCA witness Larkin and the OCA do not oppose the claim as such, but, rather, the amount of the claim. The claim represents the

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16/ The quotation from Duquesne's Brief set forth above, implies that an unpaid bill becomes an uncollectible some 5 to 7 months after service is rendered, and that the associated provision for uncollectibles is only then commenced to be received in customer revenues. We do not understand this view. In our view, the provision for uncollectibles included in the rates established in this proceeding will be collected commencing with the payments received for the first billing cycle. These funds will then be available in the reserve to be written of when uncollectibles are later determined. Only in this way could these be a continuous balance in the reserve account as there is.

17/ The repeated claims by utilities for such an allowance and litigation of the issue is, in light of the repeated adverse decisions on this subject, approaching the level of friviality.

average of 13 month ending balances. OCA witness Larkin suggests that since this balance is declining, the test year end balance is the appropriate figure to use. This amount is $6,822,784, or $3,660,393 less than claimed. Mr. Larkin asserted that the reduced amount was a conservative figure because the balance could be expected to further decline after the end of the test year, during the period that rates to be established in this proceeding would be in effect.

The ALJ agreed with the reasoning offered in support of the proposed adjustment and recommended its adoption. The Respondent has excepted. In its exception Duquesne states that:

> Duquesne's claim for deferred rental under nuclear lease, predicated on a thirteen month average, is in accord with prior Commission orders in Duquesne's rate proceedings and is consistent with working capital principles. To allow a selective use of a year end balance for this one item, ignores all those instances in which the year end balances are higher than the thirteen month averages. The reduction of cash working capital by $3,660,393 is improper and in error and should be rejected.

Exceptions, pp. 5-6. Duquesne's claim of consistency with prior Commission orders without citation thereto is of scant assistance to us in resolving this matter. However, we find noteworthy the absence of a claim that such prior orders involved the same factual situation, i.e. a significantly declining balance. Even were such a factual situation to have existed, in the absence of a similarly proposed adjustment, the prior decision would likely be considered not precedential in value. As for ignoring other items with

higher year-end balances than the 13 month average balances, it is not the responsibility of either the OCA, the ALJ or this Commission to search out, analyze and spontaneously make some adjustment. It is Duquesne's responsibility to pursue these items if it feels that the instant proposal is unfairly selective. We find no merit to the Company's exception.

We adopt the OCA's proposed adjustment as recommended by the ALJ and, accordingly, the Respondent's exception is denied.

c. Deferred Quarto and Warwick Coal Costs

The Company's cash working capital requirement claims for these items are $22,454,294 and $1,976,148, respectively.

The Commission's Opinion and Order in Pa. P.U.C. v. Duquesne Light Co., R-80011069, 54 Pa. P.U.C. 695 (1981), addressed the Warwick mine situation with regard to a claim for rate base inclusion. We believe that a portion of that discussion is relevant to the instant claim for inclusion of deferred Warwick coal costs in the cash working capital allowance. At the risk of boring the reader, we shall quote at some length from that Opinion and Order.

> As a result of our audit of Duquesne's fuel cost adjustment claim for the years 1975 and 1976, we directed the Company at D-76F00017 (later redocketed at D-78M001H0) to retain an outside consulting firm to perform a comprehensive review of the operation of Duquesne's

Warwick No. 3 mine (Warwick). In June 1979, the Commission approved Cecil V. Peake to perform the management audit of Warwick, which has been included in Duquesne's rate base (the original cost measure of value is $36,395,168), and to recommend what steps, if any, could be taken by Duquesne to minimize Warwick's cost of coal. In our Order entered June 11, 1980, in this rate proceeding, we directed the Administrative Law Judge to make specific recommendations with respect to the conclusions and issues raised in the management audit at docket D-78M00140 of Duquesne's operation of its Warwick mine.

On June 12, 1980, Peake submitted his final report which was moved into evidence in this proceeding. The report addressed three major questions, viz.: is the Warwick mine being managed effectively; what are the areas for modification to reduce cost; and should there be a change in the ownership structure? Basically, the Peake report recommends changes in the mining operations and in management, but concludes that Duquesne should continue its operation of the mine. In his Recommended Decision, the ALJ recommended that: the mine remain open; Duquesne be provided an opportunity to remedy any existing deficiencies; and, the Commission monitor the progress of these activities. Further, the ALJ rejected arguments of the trial staff, the OCA, the city of Pittsburgh, and the commercial complainant's that the Warwick mine should be excluded from Duquesne's rate base.

Inefficiencies at Warwick can, and in this case has [sic], significantly decreased production. We agree with the ALJ that Duquesne should be provided an opportunity to review its operations in light of the recommendations and criticisms advanced by the Peake report which indicates that there exist numerous operational areas at Warwick that require modification. Rather than ordering that all of the appropriate modifications be made at this time, or

making adjustments to eliminate unreasonable costs from Duquesne's base rates (and later, from Duquesne's net energy clause, if necessary), we agree with the various complainants that the removal of Warwick from rate base will permit competitive market forces to allocate risk and minimize costs, thereby serving the best interests of ratepayers and Duquesne's investors.

Duquesne, in arguing that it should not bear the risk of the Warwick investment and that the mine should remain in rate base, asserts that in Pennsylvania the test for inclusion of property in a utility's rate base is whether the investment is in that [sic] property is used and useful in the public service, and that risk is irrelevant. See e.g. City of Pittsburgh v. Pennsylvania Public Utility Commission (1952) 171 Pa. Super. Ct. 187, 96 PUR NS 161, 90 A.2d 607. Gas wells, for example, have been included in rate bases of gas utilities, notwithstanding the existence of risk differences between gas exploration and gas distribution. See e.g., City of Erie v. Pennsylvania Public Service Commission, 279 Pa. 512, PUR1924D 89, 123 Atl 471; Pennsylvania Power & Light Co. v. Pennsylvania Public Service Commission (1937) 128 Pa. Super. Ct. 195, 19 PUR NS 433, 193 Atl 427; Re Montana-Dakota Utilities Co. (Mont 1966) 64 PUR3d 266.

Although a coal mine may be used and useful in an indirect sense for the production of electricity, it is not ipso facto included in a utility's rate base, rather, its inclusion therein is a matter within the Commission's discretion. City of Pittsburgh. In the latter case, the court noted (171 Pa. Super. Ct. at p. 187, 96 PUR NS 161, 90 A.2d at p. 614): "There is undoubtedly a limit to which a utility may engage in mining, manufacturing or other enterprises not a necessary part of the utility's business on the ground that is it within the discretion of management.

The incorporation of such enterprises in the rate base of a utility should be carefully scrutinized. The activities of a utility should be confined to utility functions in the rendition of public service. The inclusion of coal land in the rate base is debatable, but on the present record we think the commission's action must be sustained as within the area of its administrative discretion."

Coal mining is not a utility function in the sense that it is not essential for the production of electricity (that is, coal can be purchased on the open market); therefore, the investment should not be included in rate base unless there exist sound record justifications supporting the inclusion therein.

Coal mining, as both parties agree, is an intensely competitive and risky undertaking. As explained below in greater detail, such risks include: (1) market based pricing; (2) vagaries of supply and demand; (3) government regulation; and (4) uncertainties of finding more attractive alternatives.

The primary risk in the coal mining business is arguably market-determined product prices. A Duquesne witness noted that "in an unregulated, competitive situation, the marketplace is usually free to set the price a product or service can command. . . ." (Duquesne statement No. 12, at pp. 3, 4.) As a captive supplier to Duquesne, Warwick does not face the typical risks of the marketplace; rather, the ratepayers must absorb any increases since Warwick's production costs are passed through its net energy clause.

The vagaries of supply and demand also pose a risk in the coal mining industry. Coal prices, like any commodity, have tended to fluctuate (commercial complainant's Exh. No. 1 at p. 1-1). For example, during the Arab oil embargo, coal prices skyrocketed (Tr. 3552) but since then "spot prices for coal have been generally soft ... when compared with the commodity

price index." (Commercial complainants' Exh. 1 at p. 3.) Although the Peake report provides a reasonable basis for anticipating supply-demand equilibrium in coal over the long term (commercial complainants' Exh. 1 at p. 3-5), such equilibrium would not preclude extreme swings in price on occasion (Tr. 3555.)

Government regulation at both the state and federal levels are other risks. One can neither anticipate the form or substance of new laws. Presently, legislation and the regulations promulgated thereunder, require mine operators to change safety and production procedures on a continual basis, purchase new equipment, etc. The impact that these requirements have on productivity and cost is significant. (Duquesne statement No. 26 at p. 4.)

Uncertainty as described by OCA witness Cotton is another risk:

"There is always uncertainty in any natural resource. There is also uncertainty as to whether we will come up with a substitute which will be much more appealing than coal, shortly. There are all sorts of uncertainties that create risk." (Tr. 3045).

Warwick's monopoly status results in additional consequences disadvantageous to the ratepayer. As Mr. Hill testified, "There is little pressure [at Warwick] to increase output ..." (Commercial Complainants' Statement No. 3 at p. 4.) Given Warwick's artificial monopoly status, this reluctance to maximize output is unsurprising. Second, Warwick's production costs exceed the minimum level attainable; thus, the Warwick No. 3 mine is not a competitive and efficient source of supply (commercial complainants' Exh. 1 at p. 1; statement No. 3 at p. 4; OCA statement No. 3 at p. 8; Tr at pp. 3055, 3577, 3578). Third, Warwick's senior management may lack initiative and appears

resistant to change. (Commercial complainants' statement No. 2 at pp. 10, 12; Tr. 3549.) These risks possibly could be significantly decreased, if Warwick were removed from measures of value and the costs arising from its coal production treated as those incurred by purchasing coal on the private market.

In City of Pittsburgh, Duquesne established that its coal land insured its ratepayers of having a reliable and continuous source of coal strengthened [sic] Duquesne's bargaining position in buying coal on the open market. Today, however, Duquesne hardly meets those standards. As explained below, its coal is qualitatively inferior and is supplied at prices in excess of the coal purchased on the spot market or under long-term contracts.

In Pennsylvania Public Utility Commission v. Pennsylvania Power & Light Co. (PP&L), (1981) 54 Pa. PUC 645, we were asked whether coal reserves of PP&L's Arcadia Company, Inc., should be included in PP&L's rate base in view of the fact that PP&L, like Duquesne, bought spot market coal at a cost lower than it could mine Arcadia coal. Rather than including this item in rate base, we treated the coal reserves as a asset of the subsidiary and financed the carrying costs of the reserves through the subsidiary. Carrying costs were to be capitalized and recovered from ratepayers through PP&L's energy clause as the coal is sold to PP&L. In so doing, we stated:

"[W]e are encouraging the acquisition of coal supplies to insure the adequacy of supplies for the production the ratepayers by allowing recovery of the portion of capitalized costs associated with that coal sold to PP&L. An additional safeguard is PP&L's coal purchasing practices and our continued auditing of the PP&L energy clause."

What distinquishes PP&L from the instant case is that Duquesne did not present a precise breakdown of costs. This failure makes monitoring just and reasonable costs difficult if not impossible; similarly this failure renders difficult the determination whether expenses are properly capitalized.

As indicated in the Peake report, there exist numerous operational areas at Warwick that require modification. Most significantly, the cost of Warwick coal is consistently more expensive than Duquesne's long-term contract coal or spot purchased coal (commercial complainants' Exh. 1 at p. 1). Duquesne's Warwick coal is priced above the amount that would be charged ratepayers if bought in the marketplace under by long-term contracts. Duquesne defends the cost of Warwick coal by pointing out that Warwick is an especially deep mine and further, if it is not permitted to recover the cost of Warwick coal, it will have two alternatives: (1) sell the mine and rely on the vagaries of the spot market as to price and reliability, or (2) sell the mine and negotiate a long-term supply with the buyer, Duquesne further argues that Warwick has saved customers in excess of $11 million dollars, and that to abandon Warwick coal now would be poor judgement for its coal costs, will be competitive with the soft coal market, whose prices are bound to increase in view of the pressure being exerted on industry to use coal.

We find that Duquesne's excessive costs are not justified for many reasons. First, as noted by the Commission's Trial Staff, the millions of dollars that ratepayers saved prior to 1974 because of Warwick, were offset by excessive charges from 1974 to date. Since 1976, for example, the average coal costs from Warwick have been 20 per cent higher than the spot price of coal. Also, if Duquesne had a long-term supply contract during the 1974 oil embargo,

the price of coal would not have been changed or maneuvered to market conditions. Second, we are even less sympathetic to Duquesne's position because it buys and sells coal without a middleman. Third, Warwick coal costs are understated for: (1) the costs only include the "cost of production from Warwick for the months and years shown plus transportation to whatever power station it went to on a weighted average basis for the period shown on a cent per million basis" (Tr. 1475, 1754-57); and, (2) unlike market prices, Warwick prices exclude a fully allocated share of indirect costs or any return on capital investment in the mine." Hence, evidence supporting Duquesne's Warwick coal costs compares the cost of Warwick coal versus the total price of the alternatives. All comparisons between Warwick costs (as shown on Duquesne's books) and market prices for coal, including prices paid by Duquesne for non-Warwick coal, understate Warwick's true cost disadvantage; market prices incorporate a pro rata share of fixed costs plus a return on capital, while the Warwick costs provided by Duquesne do not. Results of a study initiated by the OCA further clarifies this point.

Office of Consumer Advocate witness James D. Cotton easily confirmed the Peake report's conclusion. (OCA statement No. 3 at p. 8.) In a study covering the eighteen months from July, 1978, to December, 1979, Mr. Cotton compared the cost Duquesne booked for Warwick coal versus the next highest prices [sic] coal obtained in the market for each of Duquesne's three coal-fired generating stations to which Warwick coal is shipped. Of the 54 observations, only seven showed the Warwick cost to be less than the next highest price coal. (Id., Tr. 3072.) It must be reiterated that this comparison understates Warwick's relative cost disadvantage for the reasons stated above. Further, as Mr. Cotton

testified, there is no statistical basis for of [sic] alternative sources of coal available to Duquesne is [sic] changing over time. (Tr. 3038.)

The analyses by the Peake report and witness Cottor conclusively demonstrate that Warwick's costs are excessive. Given the mine's unnatural monopoly status, with a guaranteed return of costs including a return component, high costs and inefficiencies are inevitable.

In addition to excessive cost, the quality of Warwick coal is somewhat inferior to that of purchased coal. Too much ash is being taken along with coal during mining operations. The high ash content increases inefficiencies of a coal fired plant and, consequently creates additional maintenance and environmental costs. In addition, the quality of coal purchased by a utility has ramifications of a significant nature and increases the cost of fuel at the buss bar. With respect to Warwick, the Peake report at p. 36 states that:

1. Eight per cent moisture limit on Warwick coal causing 12 per cent of the coal to be discarded at the prep plant;
2. Cutting the roof rock in the mine to ease operations and thereby overloading the prep plant with extra ash;
3. Being unable to quantify the cost of fuel utilization so that the prices that are paid for coal reflect its cost at the buss bar instead of at the combustion chamber door.

Clearly, the problems inherent in mining lower quality coal should induce Duquesne Light Company to consider the purchase of better quality coal at lower prices from long-term and spot suppliers. However, lack of market and regulatory pressures or other inducements apparently do not encourage Duquesne to minimize its

coal expenses which are passed through the net energy clause.

The Consumer Advocate and Commercial Complainants argue persuasively that the Peake report provides probative evidence that inefficient and mismanaged operations do exist at Warwick; as already noted, one possible explanation therefor lies in the fact that Duquesne is insulated from competition. As a captive mine, Warwick does not compete with private coal operators in the open market. Furthermore, by setting the rates for Warwick coal, Duquesne can pass the costs thereof to the ratepayers under the net energy clause; consequently, with little economic pressure, there is no incentive for Duquesne to emphasize efficiency.

In view of all of the above findings and discussion, we conclude that Duquesne has failed to demonstrate sound justifications supporting the inclusion of Warwick in rate base. By removing the mining operation from rate base, however, we are not denying Duquesne the opportunity to recover the costs of coal used by the Company, for these costs may be claimed in future energy cost rate proceedings. It is our expectation that such costs claimed will be competitive with market prices of similar quality coal purchased by Pennsylvania utilities in the open market. To the extent that Warwick coal prices exceed competitive prices, the Company can defer such excess cost, which may be charged to the utility's fuel accounts, to the extent that the subsequent unit cost may fall below the competitive market price. In this manner, the Company should be able to recover its costs as indicated by market conditions, which cost includes a return component. The Commission sees no reason why Warwick should not be entitled to earn a reasonable profit on its coal, so long as the prices charged to Duquesne are competitive with prices paid by Pennsylvania utilities for similar quality

> coal. Information on current coal market prices is readily available from monthly fuel cost filings with this Commission, as well as with the Federal Energy Regulatory Commission.

Id at 755-761. Duquesne's comment with regard to this action is as follow:

> [W]hen this Commission ordered the removal of the Warwick mine from rate base and authorized the deferral of any excess in the cost of Warwick coal, <u>it clearly contemplated providing Duquesne the ability to recover its costs</u>. In this respect Duquesne's claim is minimized inasmuch as the Company's deferral reflects only deferred production costs and does not include any allowance for return on the Company's investment in plant and facilities used to produce the Warwick coal. See Duquesne Statement No. 8-2; at 2.

Main Brief, p. 45. We agree that the quoted Opinion and Order contemplated providing Duquesne an opportunity to recover those current coal costs which it permitted to be deferred. In our view there was no regulatory principle which required the granting of permission to defer such costs with a then contemplated future recovery of such costs, if current costs fell below the market price of alternative coal supply sources. Alternatively, simple disapproval of such costs would have been defensible. Be that as it may, the issue here is whether Duquesne should be permitted to earn a return on such costs through rate base inclusion until such time as the market place permits such recovery. The Company argues that these costs and those related to Quarto coal were prudently incurred, and that prudently incurred costs should be included in cash working capital, according, it says, to Staff witness Horsfield and

OCA witness Larkin. We disagree with the witnesses. Prudently incurred costs are not necessarily reasonable costs and reasonableness of costs is the ultimate criteria for cost recovery or other means of cost recognition. This Commission has repeatedly and consistently denied utilities a return on costs whose recovery is deferred over a term of years pending amortization of those costs. This gives rise to the principle of return <u>of</u> capital without return <u>on</u> capital.

We believe that the ALJ's comments on this subject are most apt. He said:

> Ratemaking involves a balancing of consumer and investor interests; it does not provide an insurance policy against unfortunate management decisions, whether prudently made or not, nor even against unfortunate results beyond management control (storms, etc.), incurred with investor-supplied funds.
>
> Even in general business enterprises, unfortunate or inexpedient management expenditures, even if prudently made, may not always be totally recovered from their customers; the market may not so permit as customers may reject the product or service at such cost. Regulation provides a substitute for market influences so as to protect the interest of captive customers of the public utility.
>
> We cannot agree with the Company's argument that a return on the Quarto coal costs must <u>necessarily</u> be permitted by the Commission especially where not found to be imprudently incurred. Where expenditures have been imprudently made, indeed, the Commission may totally refuse recovery. Where unfortunate results have occurred as a result of managements decisions,

> even if not imprudently incurred expenditures, the Commission may exercise its discretion as how to balance the investor-consumer interests. It is not intended that captive utility consumers, who had no part in management decisions, should bear all business risks of the utility; at least the risks should be shared with the investors.
>
> * * * * *
>
> Here, the Commission, in deference to investor interests, provided for the recovery of the deferred ... coal costs from Duquesne's customers upon certain conditions. On balance, we believe that the Commission, in deference to consumer interests, should deny the Company a return on the deferred ... coal costs, found to be excessive and unreasonable, incurred by management.

Recommended Decision, pp. 34-35. The Company has excepted, stating that (1) to deny recovery of a return on its prudently incurred costs is arbitrary and a denial of equal protection of the law; and (2) to disallow Duquesne's claim is not a matter of the balancing of interests, but rather is an arbitrary penalty on Duquesne. Duquesne also states that "case law in this Commonwealth is abundant to the effect that a utility is entitled to recover its prudently incurred costs, including carrying costs." (Emphasis added) (Exceptions, pp. 9-10). We would respond that case law is replete with instances in which the Courts have approved actions by this Commission which in providing for the recovery of costs, has denied a return on such costs pending their recovery. In our view, the effect of denying current recovery of unreasonable costs would largely be defeated by permitting a return on such costs pending such recovery. This would result in shifting the entire burden of the

business risk of unfortunate management decisions to ratepayers while, at the same time, absolving the stockholders from such risk.[18] This risk is a business risk which we believe is reflected in the market cost of equity capital. We conclude that the ALJ's recommended adoption of the OCA's proposed adjustment results in an appropriate sharing of the burden of the risk inherent in the ownership and operation of the Warwick mine. We adopt the OCA's proposed adjustment and deny Duquesne's exception.

The situation with regard to Quarto coal is not distinquishable in any pertinent regard. There, rather than ownership being involved, the arrangement is one of a long term cost plus contract with the mine owner for coal to be furnished to the Mansfield generating stations. The Commission's investigation into the costs of Quarto coal was initiated by Order, dated December 11, 1980 at I-80120343. In our Order of September 14,1984, there was a provision for the deferral of "excessive" Quarto coal costs, similar to that in the Order quoted above with regard to Warwick coal costs. Duquesne has not suggested any basis for any differential treatment of either deferred Quarto coal costs or, therefore, the result to be reached, and neither the ALJ nor any other party has drawn any distinction between the ratemaking treatment to be accorded those two claims. Accordingly, we shall also adopt the OCA's proposed denial

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18/ Were the courts to hold to the contrary on such an issue, it would be necessary for us to reexamine our methods and determinations regarding the market cost of capital for Pennsylvania utilities.

of the deferred Quarto coal cost cash working capital claim, denying Duquesne's exception as to this claim as well.

d. Westinghouse Settlement

The ALJ provided the following factual background.

> Duquesne, Ohio Edison and Pennsylvania Power Company (the Companies) has a contractual agreement with the Westinghouse Corporation that required Westinghouse to provide uranium for two re-load regions [sic] of nuclear fuel at Beaver Valley Unit No. 1. Westinghouse subsequently gave notice to the Companies that it could not honor the contract and deliver the uranium. Because Westinghouse failed to deliver the nuclear fuel at the specified contractural price, the Companies sued for recovery of the higher cost of fuel which had to be purchased from other vendors. After hearings and extensive negotiations, the action was settled with the approval of the Federal District Court of Western Pennsylvania.
>
> The Company received $3,263,767 as the result of the settlement, and recorded this amount of funds as a liability on its balance sheet because this amount is being amortized and flowed back to rate-payers as an offset to nuclear fuel costs.

Recommended Decision, pp. 27-28. OCA witness Larkin proposed a reduction in rate base of $1,577,670, by reason of the unamortized balance of this recovery from Westinghouse. Essentially the OCA's contention is that this deferred liability represents capital available to Duquesne which is cost free.

Duquesne's comment is that:

> Since the Company's ratepayers are receiving a credit against the higher cost fuel and since the ratepayers have not really provided the funds which the OCA would have us deduct from rate base, the proposed adjustment is improper and it is inconsistent with the above accounting treatment and ratemaking principles. In the simplest of terms, the ratepayers have no claim to such settlement funds. Furthermore, the cash received under the settlement has been spent and is not available for working capital purposes. In addition, the equipment and services received from Westinghouse have benefited the customers. The OCA's adjustment for the Westinghouse settlement should be rejected. Finally, we request the Commission to take official notice that on October 19, 1984, the Commission adopted a show cause order at D-83E00391 which removes the Westinghouse settlement from a base rate issue to an ECR issue. (Emphasis added)

Duquesne Main Brief, p. 40.

The ALJ recommended adoption of the OCA's proposed adjustment of $1,577,670. The Company has excepted. In its exception Duquesne states that the money has been spent and is not available for cash working capital. This contention is specious since the funds are recorded in a reserve account. Duquesne also notes again the issuance of the Order to Show Cause and states that it would be inequitable to provide the ratepayer with a double return for this item. Duquesne further states that if we adopt the ALJ's recommendation the show cause order must be rescinded. We disagree. The adoption of the Order to Show Cause did not remove the Westinghouse Settlement as an issue in this proceeding, either by its terms or by fair implication. A current rate base adjustment has only prospective

application. The Order to Show Cause addresses the past as well as the future. Although we tend to be of the view that a rate base adjustment may moot the remedy suggested in the Order to Show Cause prospectively, we need not resolve this issue at this time. However, we are firmly of the opinion that a current rate base adjustment which has only prospective effect does not moot the remedy sought in the Order to Show Cause insofar as any past period is concerned.

We conclude that the unamortized balance of the Westinghouse Settlement represents cost free capital available to Duquesne whose availability should be reflected either in the capital structure as zero cost capital or through a rate base reduction by means of an offset to the Cash Working Capital requirement. We adopt the OCA's proposed adjustment and deny Duquesne's exception.

e. Deferred Income Taxes

The OCA proposed two rate base reductions based upon deferred State and Federal income taxes. The first is a rate base reduction of $1,260,904,[19] representing the income tax deferrals resulting from the deduction of Ohio

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19/ $1,308,284 less $47,380 applicable to Perry Nuclear Plant property, recommended for exclusion from rate base.

property taxes, for income tax purposes, in the year of assessment, rather than the year of payment. This type of income tax deferral has been an annually occurring situation for a number of years.

The second proposed adjustment is one of $1,621,736 which represents deferred taxes resulting from the ten year amortization of the one-time non-recurring revenue acceleration resulting from Duquesne changing from bi-monthly to monthly billing in January 1979.

As to both of these items the OCA argues that the funds represented by these income tax deferrals are cost free funds[20/] and that the ratepayers should receive and enjoy the benefits of those cost free funds. The OCA further states that its proposed rate base adjustment is consistent with the FERC[21/] requirement of 18 CFR §35.25(b)(2) which prescribes a rate base reduction for all deferred tax balances recorded in Account 283.[22/]

Duquesne asserts in its Main Brief, pages 41-42, that the Ohio property taxes "will be paid prior to the customers paying the expense as reflected in rates to be set in this proceeding." (Main Brief, p. 41). Thus, Duquesne

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20/ These tax deferrals appear on Duquesne's balance sheet in Account 283, Accumulated Deferred Income Taxes-Other.

21/ Federal Energy Regulatory Commission.

22/ This is in addition to reductions for the balances in Accounts 281 and 282.

says, the "contention that this tax timing difference should be viewed as ratepayer supplied capital is in error and contrary to the facts".

As we understand the OCA's contention, during calendar year 1984, for example, rates paid by ratepayers are established at levels which, with regard to the income tax component, assume that the 1984 property taxes are not income tax deductible and will not be paid until 1985. This results in higher income tax expense than will be paid, and Duquesne accounts for this by booking deferred taxes. If Duquesne intends to challenge this assumption it does not direct our attention to evidence which would establish that the example given above does not hold true.
or otherwise persuasively argue that such is not the case[23/].

Duquesne also asserts that a rate base deduction for this item is not sound ratemaking, but does not further elaborate upon this statement.

As to the subject of deferred income taxes resulting from the billing change, Duquesne's Main Brief quotes from the testimony of its witness Ellenberger regarding changes to the historic test year income statement. We find this testimony irrelevant to the subject

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23/ We are unaware of any evidence that the 1984 (test year) income tax calculation reflects 1984 Ohio property taxes as a tax deduction. If such be the case we would expect Duquesne to demonstrate that fact for us. Even this however might not be sufficient to warrant rejection of the OCA proposal.

of proper ratemaking treatment to be accorded to the deferred taxes in Account 283.

In its Reply Brief, pages 32-33, Duquesne makes several statements regarding when it first commenced paying Ohio property taxes and when (2 years later) it first began recovering these taxes in rates, claiming, therefore, that ratepayers did not pay the expenses initially giving rise to the tax deduction. How relevant this fact might be to ratemaking treatment of the deferred taxes remains to be seen. However, we need not resolve this question because Duquesne has not drawn our attention to any record evidence supporting these assertions in its Brief.

Duquesne also reiterates an argument touched upon in its Main Brief, which is that Ohio property taxes are included in its cash working capital lead-lag study, thereby giving ratepayers credit for the delay in payment of such taxes. The ALJ addressed this subject and cited the FERC decision regarding Ohio Edison[24/] in which, in the face of an apparently similar contention, the Commission rejected this argument that a lead-lag study would recognize deferred taxes. In this proceeding we note that the Company's lead-lag study, Exhibit 1B, page F4, sets forth $2,500,000 in Ohio property taxes, with a column heading of "expenses per income statement". It is self evident to us that these are taxes assessed in 1983, paid in 1984 and do not

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24/ 24 FERC §63,068 at 65,110 (August 1983).

represent deferred 1984 taxes reflected in Account 283. Thus, Duquesne's statement is at the minimum both misleading and incorrect.25/

Duquesne was totally silent upon the subject of the FERC rule mentioned by the OCA.

The ALJ recommended the adoption of both OCA proposed adjustments, finding them to be appropriate upon the basis that the deferred taxes involved are a source of cost free capital, not otherwise recognized in the Company's showing. In its exceptions Duquesne asserts, with regard to the property tax issue, that the ALJ ignored the fact that historically payment of taxes has been made prior to ratepayers providing funds.26/ Duquesne also asserts that the lead-lag study provides ratepayers the benefit of any payment lag within the test year. We agree that such seems to be the case, but this is not the issue. The issue is the deferred taxes.

With regard to the billing practice change, Duquesne offers the fact that in 1979, the year of the change, it earned only $1.81 with a dividend of $1.76 per

25/ We also note that Duquesne has made an additional very confusing and seemingly contradictory statement, which is that "similarly, the deferred income tax resulting from Duquesne's change in billing practices has consistently been excluded from Duquesne's cash working capital calculation." (Emphasis added) (Reply Brief, p. 33).

26/ We have previously noted that Duquesne has failed to direct our attention to record evidence of this fact.

common share. Then Duquesne states that "[c]learly, Duquesne did not earn its return and the subject monies are thus obviously investor rather than customer provided funds.[27] We disagree with both of Duquesne's stated conclusions. Ratepayers provided rates which included an element of income tax expense. Taxes associated with the accelerated rate collection revenues were deferred. Duquesne's failure to earn its authorized rate of return does not convert ratepayer (or Treasury) supplied funds to investor supplied funds.[28]

We deny Duquesne's exception as being without a scintilla of merit, and adopt the OCA's proposed adjustments.

f. Accumulated Interest and Preferred Dividends

Duquesne reduced its cash working capital claim by $13,931,510 by reason of Bond Interest-Preferred and Preference Dividends.[29] The ALJ reduced this offset by $256,000 to reflect his recommended rate base adjustments.[30] Since the offset is rate base dependent, we

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27/ There is no record evidence of this fact. Even if there were such evidence, calculated on a ratemaking, not a financial accounting basis, such evidence would not lead to the conclusion subsequently stated.

28/ As we have stated previously, profit is not earned in advance of the recovery of expenses.

29/ Exhibit 1B, page F3.

30/ Recommended Decision, Table I.

shall reduce the offset by $248,175 to reflect the adjustments adopted herein.

3. Other Working Capital

a. Fuel Inventory-Eastlake

Duquesne's claim for the coal inventory at the Eastlake station of $4,083,916 involves a 60 day inventory of 77,582 tons at an average price of $52.64. Staff proposed a ceiling price to be allowed for this inventory of $41.31 per ton. Staff witness Prowell challenged the reasonableness of the Company's claimed price, claiming that the high price of this coal was unexplained,[31/] other than by a claimed rail transportation cost of $7.29 per ton. Mr. Prowell's proposed allowable price of $41.31 per ton, represents the simple average of the inventory prices of coal at the remaining six power station.[32/] This results in a proposed reduction in the claim of $879,004 or an allowance of $3,204,912.

Duquesne opposes the Staff proposal by stating that the coal in question involves rail transportation at an additional cost of $7.29 per ton over the costs involved for

31/ The next highest price was for Mansfield at $46.95, which is addressed infra, followed by Elrama at $42.21 per ton.

32/ This average includes the claimed inventory for Mansfield which is addressed and reduced in the discussion to follow.

large delivered coal. Duquesne also asserted that the Staff's proposal fails to attempt to price deep mined coal provided under a long term contract, but, rather, the Staff's average price simply aggregates deep mined and strip mined, and spot purchase and long term contract coal.

The ALJ concluded that while the Company's objection regarding the Staff averaging methodology might have some merit, it failed to demonstrate the reasonableness (carry its burden of proof) of its claimed inventory price or the merit and, therefore, reasonableness of some alternative pricing methodology.

The ALJ did conclude however that the incremental cost of rail transportation should be recognized. Accordingly, he reduced the proposed adjustment to one of $313,431.[33]

Both the Staff and the Company have excepted. The Staff first states that cross-examination of Company witness Irvin revealed that the other coal inventories also represented deep mine coal, procured under long-term contract. Additionally the Staff asserts that the ALJ ignored the fact that other inventories contain some rail transported coal. Consequently, Staff urges, the more equitable resolution would be to disallow the said rail

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33/ This figure is correct. The ALJ's figure of $323,431 is incorrect.

transportation increment of $7.29. Based upon the Staff's statement regarding other inventories containing some rail transported coal, a more precise calculation may be possible. However, on balance we believe that the ALJ's conclusion is a reasonable resolution of this issue and consequently a reasonable allowance for the Company. Accordingly, the Staff exception is denied.

The Company's exception first complains that the Staff's figure of $41.31 is a simple arithmetic average, not a weighted average, which would be $41.77.[34/] While this may be true the Company suggests no reason why a weighted average is a better method of arriving at a reasonable allowable cost, even though it characterizes a weighted average as "more proper". Duquesne then challenges the Staff's failure to exclude surface mine coal, and proceeds to present an average of $42.35 which allegedly excludes coal at the Sammis plant, which in June 1984 had no deep mine coal.[35/] The Company's conclusion is that the Staff's figure is flawed and understates the cost of deep mined coal. Impliedly, Duquesne proposes that the Staff's flawed figure, even with the ALJ's addition of incremental rail transportation costs must be rejected and its claim accepted. We do not view the matter in such light. We view it as Duquesne failing in its burden of proof as to the reasonableness of its claim for this inventory. We have

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34/ We would also point out that if Mansfield coal, which we shall later conclude is not reasonably priced, were excluded the simple average would be $40.18.

35/ This type of material is more properly presented through cross-examination or direct rebuttal testimony rather than by way of Brief.

little doubt that if the record were reopened as to this matter a more precise figure could be developed. However, based upon the record before us we believe that the allowance proposed by the ALJ is reasonable and fair to both the Company and the ratepayers. We shall disallow $313,431 of Duquesne's claim and deny its exception.

b. Fuel Inventory-Mansfield

The Company's claim for the coal inventory at Mansfield is for 113,263 tons at an average price of $46.95 for a total of $5,317,698. The price of $46.95 represents the projected "capped" price of Quarto mine coal using the pricing methodology extant at the time of filing the instant application. Staff proposed a price of $39.49 which it stated was the ceiling price permitted to be included in the Energy Cost Rate (ECR) under our recent September 11, 1984 Order in the proceeding at I-80120343. The Staff's rationale is that the coal inventory should be priced at the same price which is permitted to be charged to ratepayers through the ECR.

The ALJ notes in his Recommended Decision that the Company has claimed (Main Brief, pp. 50-51) that the Staff has misinterpreted the Commission's Order of September 11, 1984, and that the Staff's calculations are incorrect. In this regard a review of Duquesne's Main Brief (pp. 50-51) reveals the assertion that the Staff's calculation utilized data from FERC Form 423 and did not exclude spot coal purchases of coal. Duquesne also asserts that the Staff's average price calculation used January-June 1984 price data and then escalated that average to December 1984, as if it

were a June price rather than an average price reflecting March 30, 1984 pricing. Duquesne also asserted that the Boyd escalator was not used as allegedly required. Duquesne further states that the publication Coal Marketronix, relied upon by the Staff, reveals that many companies were passing through costs higher than Duquesne claims. (Duquesne recites several alleged examples).36/ What we find missing from Duquesne's Brief is a claimed correct figure to be utilized. Duquesne neither claims that its figure is in accord with our September 11, 1984 Order, nor does it supply a correct figure as an alternative to the allegedly infirm Staff figure. Duquesne concludes with the assertion that we must accept its total fuel inventory claim of some $38 million plus.

The ALJ did not directly address the subject of the deficiencies in the Staff calculation claimed by Duquesne. The ALJ merely states that the Company has not adjusted its claim to conform to our Order of September 11, 1984, and then adopts the Staff's proposal.37/

36/ Duquesne does not state the relevance if any of this fact, if it be one, to the Staff's calculation, but, rather, states that it is unfair to allow other companies to pass through higher costs and deny Duquesne recovery of its costs. This appears to be a collateral attack upon the concept of the Quarto coal cap, rather than a deficiency in Staff's calculation and, consequently, it is not germane here.

37/ We infer that the ALJ concluded that the Company had failed to meet its burden of proof.

We find that Duquesne's exception is virtually a verbatim recitation of the language of its Main Brief. We find missing any assertion by Duquesne that its claim is in conformity with the September 11,1984 Order. Duquesne's position seems to be that although its figure is not correct, the Staff's figure is infirm, therefore, this Commission must accept its claim. We conclude to the contrary, and find that Duquesne has not sustained its burden of proof. If Duquesne is unsatisfied with the Staff's calculation it is incumbent upon Duquesne to do more than take pot shots at the Staff's calculations; it must supply a correct calculation supported by an appropriate evidentiary showing. We deny Duquesne's exception and adopt the Staff's proposed adjustment of $844,942.

E. Conclusion

As a result of our adoption and rejection of the various proposed adjustments discussed above, we adopt as a fair value rate base determination in this proceeding, the figure of $1,783,550,928.

IV. REVENUES

Duquesne's claim with regard to estimated future test year total operating revenues, net of State Tax Adjustment Surcharge, Energy Cost Rate and Gross Receipts Tax revenues for Pennsylvania jurisdictional operations, is $779,559,000.[38/] Various parties proposed a number of adjustments to this claim. These will be addressed individually below.

A. Adjustment to Year End Level of Operation

Duquesne adjusted its estimated level of revenues to reflect the annualization of test-year end levels of usage. This adjustment resulted in an increase in budgeted revenues of $1,044,385. OCA witness Larkin proposed an adjustment which would increase budgeted revenues by an additional $170,488 (OCA Statement No. 2, Schedule 9). The substance of Mr. Larkin's proposed adjustment is that the changes in sales under rate schedules RH, GM, GMH and GLH should be priced at the tail block rates rather than at a rate weighted on the basis of the distribution of sales among rate blocks as reflected in the bill frequency analysis of the various rate schedules. The totality of Mr. Larkin's direct testimony in support of his proposal consists of the following conclusory statement:

38/ Revenues derived from sales under the jurisdiction of the FERC have been excluded.

> If additional consumption or curtailment of consumption is to occur for customers currently taking service, it is more likely that the change in consumption would occur in the tail block of the rate rather than occurring in both the initial block and the tail block.

OCA Statement No. 2, p. 15. This statement serves to state no more than that the majority of the increase or decrease in sales on each rate schedule will occur in the tail blocks. However, in his adjustment, Mr. Larkin priced all changes in consumption at the terminal block rate, which is the equivalent of stating that all consumptive change in usage will occur in the terminal blocks.

The ALJ states in his recommended Decision that: "from the record evidence, we find the assumption proposed by the Consumer Advocate to be faulty in that all relevant factors have not been considered in such assumption."39/ We agree. The subject of where in a blocked rate schedule a utility will experience growth or conservation by existing customers is an infinitely more complex subject than Mr. Larkin suggests. While we might agree that temperature sensitive changes in consumption have a likelihood of occurring in the terminal block, depending upon block sizes, normal growth or conservation is another matter, and experience would indicate that growth changes may have a different pattern than conservation changes. That is, the

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39/ The assumption to which reference is made is Mr. Larkin's conclusory statement quoted above.

largest share of growth may result from the smaller customers (usage saturation by larger customers) while the largest share of conservation may be achieved by the larger customers. We conclude that Mr. Larkin's proposal is simplistic and therefore infirm; we find no major flaw in the Company's methodology.

The ALJ recommended that the OCA's adjustment be rejected. The OCA has excepted. In its exception the OCA states that it finds support for its proposal in the testimony of Company witness Maxwell, which was to the effect that changes in usage by schedule RH customers is more likely to occur in the tail block (Tr. 207).[40/] We do not find support in this statement for pricing all such decrease in consumption at the terminal rate as was done by Mr. Larkin. We deny the OCA's exception and reject its proposed adjustment.

B. Annualization for New Customers

The ALJ's discussion and resolution of this matter was as follows:

> The Consumer Advocate proposes an additional upward adjustment of $3,044,331 in revenues to reflect the change in customers and changes in use as of December 31, 1984.

40/ The OCA makes no claim that this fact was not reflected in Duquesne's weighted price factor.

> Duquesne has utilized a one-half factor both in the change of customer usage and change in the number of customers to recognize uniform growth throughout the future test year. This develops reasonable results in the annualization process.
>
> The Consumer Advocate's proposed adjustment fails to recognize the fact that a portion of the growth is already reflected in the Company's budgeted figure and, for example, a new customer who went on the Company's service on January 1, 1984 would already have a full year's usage reflected. The Consumer Advocate presumes all changes in customers and usage occurred on December 31, 1984. Such a presumption is unfounded.
>
> We reject the proposed upward adjustment of the Consumer Advocate in the amount of $3,044,331, and find that the procedures utilized by the Company are reasonable and consistent with prior orders of the Commission.

Recommended Decision, p. 60. The OCA has not excepted to the ALJ's recommendation. We concur with the ALJ's recommendation and reject the OCA's proposal.

C. Late Payment Charges

Duquesne's income statement as adjusted reflects late payment revenues of $2,169,000. OCA witness Larkin proposed an upward adjustment $145,691. In calculating his revenue adjustment Mr. Larkin states that he utilized: (1) total revenues billed, i.e. including the STAS and the ECR elements of bills; and, (2) factors representing the rates of 1983 late payment charges to 1983 revenues. The ALJ found fault with this proposal by reason of the

inclusion of STAS and ECR revenues and recommended that the adjustment be rejected. The OCA has excepted.

In its exception the OCA urges that the ALJ's rejection of the adjustment was in error, citing the Commission's Opinions and Orders in two prior proceedings.41/ Although in those Opinions and Orders the Commission adopted a proposed OCA adjustment to late payment charge revenues, the Commission decisions do not indicate that the same issue was involved there, as here.

In this instance the Company takes issue with Mr. Larkin's utilization of only the 1983 ratio of late payments to revenues, rather than the longer period which it employed in its "historic" relationship. We conclude that Mr. Larkin's adjustment is faulted by his sole reliance upon the experienced 1983 ratios in making his proposed adjustment,42/ and that we should reject it for this reason. Accordingly, the OCA's exception is denied.

41/ Pa. P.U.C. v. Peoples Natural Gas Co., R-832315, (January 1984) (incorrectly cited by OCA as R-832115, (January 13, 1983)), and Pa. P.U.C. v. Equitable Gas Co., R-822133 (July 1983).

42/ As to Mr. Larkin's inclusion of STAS and ECR revenues, we are inclined to agree that they should be included in the calculation unless the historic relationship utilized was developed upon a different base. In any event we need not resolve this matter here. The resolution of this matter can await a proceeding in which the issue is dispositive of the dispute between the parties.

D. Unbilled Revenues

The OCA has proposed an upward adjustment to revenues of $2,777,137 to reflect unbilled revenues at the end of the future test year, December 31, 1984. The rationale underlying the proposal is that the test year reflects expenses invoiced and booked during the test year and revenues billed during the test year. OCA witness Larkin states that because of the lag between rendering service and billing, estimated at 15.2 days, there is a mismatch between booked expenses and booked revenues (OCA Statement No. 2, pp. 41-43). The witness points out that because usage, numbers of customers and base rate change over time, typically upward, the amount of unbilled revenue typically increases.43/ Since 1984 expenses are above those of 1983, the failure to include in sales and revenue figures the service provided in the latter part of December 1984 revenues, billed in January 1985 (excluding similar revenues for January 1984), results in understating 1984 test year revenues vis a vis expenses. At this point the theory seems fine. However, the mechanics of Mr. Larkin's proposed adjustment creates problems. He has compared one-half of January 1983 revenues with one-half of January 1984 revenues (temperature and base rate increase adjusted) and offers the calculated difference of $2,777,137 as a surrogate for the increase of unbilled revenues for December 1984 over December 1983. This was done because estimated revenues for

43/ Consequently, we suppose, the December 1983 service billed in January 1984 is not simply an offset.

January 1985 were not available.44/ In order to accept Mr. Larkin's calculation as a surrogate, one must implicitly accept the assumption that the growth of revenues (sales) experienced in January 1984 over January 1983 is a reasonable quantification of what should be expected as the growth of January 1985 over January 1984.45/

The Company has raised several issues with regard to the reasonableness or accuracy of Mr. Larkin's calculation in its Main Brief, pp. 99-101. These are:

1. Mr. Larkin's calculation fails to take into consideration the Company's annualization adjustments.
2. Mr. Larkin's calculation fails to take into account his own proposed annualization adjustments.
3. Mr. Larkin is using a dissimilar time period to calculate the proposed adjustment.46/

To our dismay the OCA's Reply Brief is silent with regard to this proposed adjustment and the objections to Mr. Larkin's calculation raised in Duquesne's Main Brief.

44/ The proper measure of the difference would be January 1985 over January 1984.

45/ In light of the unusual economic conditions in recent years in Duquesne's service territory, we are extremely hesitant to accept such an assumption without evidence bearing upon the reasonableness of such an assumption.

46/ The thrust of this objection is that changes in revenues from January 1983 to January 1984 are not representative of the changes to be experienced from January 1984 to January 1985.

The ALJ stated that it appeared to him that Mr. Larkin's calculation was duplicative of those made by the Company by way of annualization and he recommended that the proposed adjustment be rejected. The OCA has not excepted. In light of those questions raised by the Company with regard to Mr. Larkin's calculation we are unable to conclude that the proposed adjustment is properly calculated and reasonably based. Accordingly, we reject the proposed adjustment.

E. Minimum Bill Revenues

LTV witness Bloom proposed an upward adjustment to Rate L minimum bill revenues in the amount of $2,169,887. The essence of witness Bloom's testimony is that Duquesne's calculation of Rate L revenues failed to account for the difference between what billing would be under the "demand ratchet" in that rate schedule and under the minimum bill provisions.

The ALJ recommended that the proposed adjustment endorsed by both the Staff and the OCA be rejected. The Staff, OCA and LTV have all excepted.

We find merit in the exceptions filed and in Dr. Bloom's proposed adjustment. However, Staff witness Rosenthal has proposed a change in the minimum bill provision of Rate L, which effectively moots this proposed adjustment prospectively, that is, under the rates to be established in this proceeding. Consequently, we shall not adopt the proposed adjustment.

V. EXPENSES

Duquesne's claimed estimated expenses for the future test year, as adjusted, at present rates, are $482,174,000, exclusive of income taxes. This figure is comprised of: (1) Operating Expenses-$368,306,000; (2) Depreciation, Amortization and related expenses-$79,803,000; and; (3) Taxes Other than Income-$34,065,000. Income Tax Expense claimed is $99,892,000. Adjustments to Duquesne's claims are addressed below.

A. CAPCO Cancellation Costs

The Company has claimed $3,444,000 as amortization of those costs associated with cancelled nuclear generating units Davis Besse Units 2 and 3, and Erie Units 1 and 2. In our Opinion and Order of January 28, 1983 at R-831945[47/], we authorized the amortization of $34,697,389 over a 10 year period at the rate of $3,469,739.[48/]

47/ 57 Pa. PUC 1, (January 1983).

48/ We note here that Duquesne has revised its total cost figure to $34,456,006 or a reduction of $241,383. We also note that Duquesne claims the recovery during the period January 28, 1983 through January 27, 1985 of the amount of $6,905,566 rather than the amount of $6,939,478 which we would expect based upon the expense authorized above. Our action here is not to be interpreted as approval of Duquesne's claimed prior recovery of only $6,905,566.

Duquesne's claim here differs from the amount authorized in that proceeding to reflect an 8 year amortization of its claimed unrecovered balance.49/

The OCA opposes the instant claim. In its Petition for Reconsideration of our Opinion and Order in the proceeding at R-831945, the OCA raised the matter of the recent amendment of the Public Utility Code adding Section 1315 (66 Pa. C.S. §1315). The OCA asserted that this Code amendment barred our action allowing the amortization of the costs associated with these cancelled plants.

In our Opinion and Order Upon Reconsideration (57 Pa. P.U.C. 177 (April 1983)), we fully discussed the issue regarding Section 1315 and concluded "that the OCA's objection is not well taken our approval of the amortization of the investment in the four cancelled generating plants does not controvene the Act [Section 1315]...." (57 Pa. P.U.C. 177, 185).

The OCA now advises us that its appeal to Commonwealth Court on this issue (docketed at No. 553 C.D. 1983) was argued *en banc* on September 11, 1984, and that a decision pending. The OCA also states that although

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49/ Our approval of Duquesne's claim does not constitute approval of Duquesne's claimed unrecovered balance but is approved as being within the amortization approved in the proceeding at R-831945. We expect that past amortization and the unamortized balance will be reconciled in a proceeding near the end of the 10 year amortization period.

the Court will rule on this matter within the reasonably near future, we are "free at this time to reverse what the OCA contends is [our] previous error...." We have reviewed the arguments presented by the OCA again here, and find no allegation or argument of substance, which was not considered in our Opinion and Order Upon Reconsideration.

The OCA excepted to the ALJ's recommendation that we reject the OCA's proposed disallowance. That exception is one of form rather than substance. Accordingly, we deny the OCA's exception and approve the Company's claim.50/

B. EEOC Settlement

The ALJ provided the following background regarding this claim in his Recommended Decision:

> On September 4, 1975, the United States Department of Justice filed a complaint in the United States District Court for the Western District of Pennsylvania, alleging that the Company's assignment and pre-employment criteria violated Executive Order No. 11246, [sic] sought both injunctive relief and the payment of compensation to persons allegedly harmed as a result of Duquesne's alleged wrongful conduct. The complaint was amended on March 1, 1976 to name the national and local unions representing the Company's employees as additional defendants.

50/ We note that the doctrine of res judicata applies as to this issue, under the criteria approved by the Court in PECO v. Pa. P.U.C., 61 Pa. Commonwealth Ct. 325, 433 A.2d 620 (1981).

On December 29, 1976, the Federal Equal Employment Opportunity Commission filed suit against the Company and the national and local unions representing the Company's employees in the said Federal District Court, alleging that the Company's employment practices, including assignment and pre-employment selection criteria, by discriminating against minorities and females, violate Title VII of the Civil Rights Act of 1964. The complaint sought both injunctive relief and the payment of compensation to persons allegedly harmed as a result of the Company's alleged wrongful conduct.

By Order dated March 7, 1977, the court consolidated the two cases for trial purposes only. By Order dated March 27, 1980, the Court dismissed all claims against the Company concerning the acts or practices at its Warwick Mine facilities.

On April 26, 1983 the Court signed a Consent Decree which provided for payment by the Company of $900,000 for settlement of the two cases.

Duquesne has claimed a three-year amortization of its EEOC settlement costs of $900,000, and one-third thereof as expenses in this proceeding.

Recommended Decision, p. 67.

The Staff and the OCA contest this claim contending: (1) that the Commission has previously rejected this claim; (2) that discrimination constitutes imprudent conduct; and (3) that these costs are properly to be borne by stockholders either as non-recurring extraordinary costs or on the basis of equitable sharing.

As noted by the ALJ, the Commission Opinion and Order in Pa. P.U.C. v. Duquesne Light Co., 57 Pa. PUC 1, at

27-28 (January 1983) considered a claim arising from this litigation. At that time the claim was for $183,333 which represented 3 year amortization of a then pending settlement amount for this litigation. In rejecting that claim, which was urged upon the Commission as a normal cost of doing business, it was stated that:

> Having considered the evidence and the contentions of the parties, we find that, while the expense claimed is one which is incurred in the business world from time to time, Duquesne has not satisfied its burden of proof that the claimed expense is <u>a reasonable and necessary expense incurred to provide utility service</u>. (Emphasis added).

57 Pa. PUC 1, 28 (January 1983).

The only difference between the claim in that proceeding and the claim here is that the settlement has been finalized at $900,000 and the amortization claim has increased to $300,000. Duquesne again argues that this expense is a legitimate operating expense and should be allowed. Duquesne has not attempted to establish that this expense is, in the language of the Commission's prior Opinion and Order "a reasonable and necessary expense incurred to provide utility service."

However, we find that we need not discuss this matter at length yet another time because, although not mentioned by any party, the doctrine of <u>res judicata</u> is applicable, under the criteria iterated by the Court in <u>PECO v. Pa. P.U.C.</u>, 61 Pa. Commonwealth Ct. 325, 433 A.2d 620 (1981). Accordingly, the claim is denied, as is the Company's exception to the ALJ's recommendation against the claim.

C. Rate Case Expense

Duquesne's original claim for current rate case expense of $518,841 represents the arithmetic average of its four most recent rate proceedings.[51] In addition to current rate case expense Duquesne has claimed continued amortization of past rate case expense ($42,460), the amortization of which was authorized in the proceeding at R-821945 (57 Pa. PUC 1, at 19 (January 1983)), for a total of $561,301.[52] The Staff and the OCA both urged a 50/50 sharing of this expense between ratepayers and stockholders. It is true, as parties have urged upon us, that in past proceedings we have disapproved 50% of claimed current rate case expense based upon a 50/50 sharing concept and did so with regard to Duquesne in the proceeding at R-821945 (57 Pa. PUC 1 (January 1983)). However, as noted by the ALJ, the Commonwealth Court, in Butler Township Water Co. v. Pa. P.U.C., ___ Pa. Commonwealth Ct. ___, 473 A.2d 219 (1984), rejected a similar 50/50 sharing of current rate case expense saying:

51/ R-80011069, R-811470, R-821945, R-832337. In Duquesne Exhibit I-B, p. Ill. Although Duquesne updated its claim for current expense to $475,000 in Exhibit 2H, we have excluded that exhibit and, accordingly will not consider the revised claim.

52/ Duquesne proposed normalization of estimated current rate case expense utilizing a one year period to arrive at the normalized expense.

The general rule is that a public utility is entitled to recover in rates those expenses reasonably necessary to provide service to its customers and to earn a fair rate of return on the investment in plant used and useful in providing service. [Citations omitted]. Operating expenses include prudently incurred rate case expenses. [Citations omitted]. Obviously, the refusal to allow the recovery of a proper expense diminishes to the same extent the utility's return on investment. There is no evidence in the record that the rate case expenses claimed here were unreasonable, imprudently incurred or excessive in amount.

Id. at 221. The parties have offered no evidence or argument to distinquish the holding in that case. Accordingly, we feel constrained to follow the Court's decision here.53/

With regard to the Staff's alternative proposal that an 18 month period be utilized in determining a normalized allowance, the ALJ, noting that Duquesne has been filing annually, recommended against normalization over any period greater than one year. The Staff has excepted to this recommendation. The Staff states that the anticipated life of rates to be established in any proceeding is to be established on a case by case basis. We agree that the frequency of past filings is not the sole determinant of the question of a proper normalization period, as impliedly urged by the ALJ. Staff offers for our consideration the

53/ That portion of the Staff's exception and the OCA's exception addressing the ALJ's recommendation against a disallowance of a portion of Duquesne's current rate case expense, based upon the Court's decision in the Butler Township case, is denied.

fact that it will be in excess of 16 months between the entry of our Opinion and Order in this proceeding and the Opinion and Order at R-832337 (entered September 17, 1983). Additionally, we find relevant to the Company's claim, our allowances and disallowances in this proceeding, the level of return on common equity which we adopt, the general state of the economy, and the prospective wage and price escalation reasonably to be expected over the next one to two years. Considering these and other matters in addition to past experience with regard to Duquesne, and other electric utilities reasonably comparable to Duquesne, we believe that it is reasonable to expect the rates established in this proceeding to remain reasonable for a period of 18 months. Consistent therewith, we adopt an 18 month period over which to normalize the Company's current rate case expense claim.[54/] This results in a normalized allowance of $345,894. This together with continued amortization of past expense of $42,460, results in a total of $388,354.

D. Management Audit Expense

Duquesne has claimed an expense of $634,067 for this item, which represents three year amortization of $1,902,197. The underlying gross amounts are itemized in Duquesne Exhibit 22B, as follows:

54/ The Staff's exception is, accordingly, granted in part.

1984	$780,000
1983	592,387
1982	218,326
1981	311,484
Total	$1,902,197

The three year amortization claim is premised upon the three year amortization of what were the 1981 and 1982 expenses in the proceeding at R-821945 (57 Pa. PUC 1, 27 (January 1983)).[55/] Of the capital expenses claimed, we have established in the footnote below that the unrecovered balance of these expenses as of the date of the establishment of new rates in this proceeding is $1,283,942. Since the amortization of the 1981, 1982, 1983 expenses presumed to be included in current rates is $374,057[56/] the Company's current claim represents an increase in annual expense for this item of $260,010 ($634,067-$374,057).

55/ Since the 3 year amortization authorized at that time is presumed to have continued until such time as it may be changed, as of the date of the establishment of new rates in this proceeding on January 26, 1985, almost precisely 2 years (67%) of the 1981 and 1982 expenses will have been recovered. Similarly something over 16 months (44%) of the 1983 expenses must be presumed to have been recovered in the rates established in the proceeding at R-832337 (entered September 17, 1983). Consequently, the unrecovered balance of these expenses as of that time will be:

1984	$780,000
1983	325,813
1982	72,775
1981	103,830
Total	$1,282,418

56/ 1981-$103,834; 1982-$72,775; 1983-$197,462 (Duquesne Exhibit 22B).

The Staff proposed that Duquesne's unamortized balance[57/] of these expenses be amortized as follows: (1) remaining unamortized 1981 expenses - continue 3 year amortization for remaining 1 year; (2) remaining unamortized 1982 expenses - cont'nue 3 year amortization for remaining 1 year; (3) remaining unamortized 1983 expenses - adopted 5 year amortization and continue for remaining 4 years; and, (4) unamortized 1984 expenses - adopted 5 year amortization.[58/]

The Staff's rationale is to continue the amortization of the 1981 and 1982 expenses as established in R-821945 (57 Pa. PUC 1 (January 1983)), but to establish a longer five year period for the 1983 and 1984 implementation expenses which will have long range benefits.

OCA witness Larkin's proposal for some reason did not include 1981 expenses. He then made an adjustment to 1983 expenses for a minor item and proposed a 10 year amortization period.

57/ In arriving at its unamortized balance the Staff has assumed certain recovery in the settlement rates established in the proceeding at R-832337 (September 17, 1983). We prefer our method of arriving at the unamortized balance as set forth in footnote 54 above.

58/ The Staffs unamortized balances are:

1981	$103,830
1982	72,775
1983	174,054
1984	780,000

The ALJ recommended rejection of the Staff's and OCA's proposals on the basis that the longer periods were unreasonable.[59/] The Staff and the OCA have excepted.

We reject the OCA's proposed 10 year amortization period as unreasonable.[60/]

As to the 1981 and 1982 expenses, we will adopt the Staff's figures of 1981-$103,830, and 1982-$72,775. As to the 1983 expenses we disagree with the Staff's assumption that $418,333 of expense, as claimed, was included in settlement rates leaving an unrecovered balance of $174,054 ($592,387-$418,333). We believe that it is much more reasonable to conclude that the three year amortization method established in the proceeding at R-821945 (57 Pa. PUC 1 (January 1983)) continued and that during the period September 18, 1983 when settlement rates were established and January 26 1985 where rates will be established in this proceeding (1.35 years), some $266,544[61/] was amortized, leaving an unamortized balance of $325,813. The addition of the 1984 expense of $780,000 results in a total unamortized expense of $1,282,418. Prospective five year amortization of this balance would result in an annual allowance of $256,484, which if applied to the oldest expenses first,

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59/ The ALJ also found no justification for the Staff's distinction between the study and implementation expense categories.

60/ In the proceeding at R-821945 the Commission concluded that the Company's proposed three year period was more reasonable than the Staff's proposed 5 year period.

61/ $592,387 ÷ 3 x 1.35 = $266,574.

would more than amortize the current unamortized balance of 1981 and 1982 expense within one year. Additionally, all expense would be amortized over five years and this expense would be level for the 5 year period, rather than be reduced in the next rate proceeding. Additionally, we have determined during our discussion of rate case expense that the reasonable expected life of the rates to be established here is 18 months. If this proves correct, and we were to establish essentially three amortization schedules for three vintages of expense, we have no difficulty in hypothesizing the arguments in the next rate proceeding regarding the over recovery of 1981 and 1982 expenses which should be credited to 1983, etc. Therefore, we conclude that it is appropriate to establish a prospective 5 year amortization of the current (January 26, 1985) unamortized balance of $1,282,418 and direct that the Company, for ratemaking purposes, first apply this amortization to the oldest expense, rather then on some pro rata basis through multiple amortization schedules.

Our action then is to approve a prospective expense allowance of $256,484 or a disallowance of $377,583. Accordingly, the Staff's exception is granted in part.

E. Uncollectible Accounts Expense (Provision for Uncollectibles)

Duquesne's claim for this item is $4,900,000. The Staff proposed a reduction of $392,000, or an allowance of $4,508,000.[62] The basis for the Staff's adjustment is

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62/ The ALJ's figure of $4,672,756 is incorrect.

that the Company's actual 1983 expense was 8% below the 1983 rate case claim and applying that factor ($4,900,000 x .08) arrived at a proposed disallowance of $392,000. The ALJ commented: (1) that 1983 sales were 7.6% below budget; (2) that no recognition was given to the fact that a revised estimate based upon increased 1984 sales led to an estimate of $5,263,895 (not claimed); (3) that 1983 write offs are in large part related to 1982 revenues; and (4) that experience for the first 18 months of 1984 was an average $404,373 per month, and simple extension of that figure would indicate an annual figure of $4,852,476.

The ALJ recommended against the Staff's proposed adjustment. The Staff has excepted, urging that at a minimum the Commission adopt the $57,000 variance resulting from the ALJ's extension of the 8 month average to 12 months. Beyond this comment there is nothing in the Staff's exception which is not addressed in its Briefs.

We find nothing to suggest that the past errors in Duquesne's estimates of uncollectibles, which the Staff castigates, are consistent or necessarily present to the same degree in the instant estimate.63/ Accordingly, we find little merit in the Staff's methodology, and are unpersuaded that the results would have validity. We, therefore, deny

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63/ We suggest that an analysis of uncollectibles as a percentage of electric revenues might provide more meaningful data and persuasive results than does this analysis of historic estimating errors.

Staff's exception and reject its proposed adjustment.[64/]

F. Tree Trimming

The Company's claim for this item was $5,471,106, further itemized as $5,317,000 for outside contractors and the balance of $154,106 as in-house expense. Staff witness Laudenslager proposed a downward adjustment of $261,000. Mr. Laudenslager analyzed 1982 and 1983 actual expenses together with the test year 1984 claim. After adjusting the average cost for each year by an inflation factor, a three year average of $6,319 was developed, which when applied to the 1984 estimated of 800 miles produced an outside contractor cost of $5,055,200 or $261,800 less than the claim.

In it Main Brief (pp. 121-122), Duquesne challenges Mr. Laudenslager's use of the GNP Price Deflator for his inflation adjustment, asserting that it is not relevant to the expense under consideration. Duquesne also faults Mr. Laudenslager for failure to utilize 3 years of historic data, which they state is his own preferred methodology. Duquesne also demonstrated by its witness Irvin[65/] that the average of 1981, 1982 and 1983 expenses,

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64/ We view the ALJ's calculation as merely an interesting example regarding 8 months experience, not a reliable indicator of expected results, nor do we believe it was intended to be.

65/ Schedule 1, Duquesne Statement No. 19-1.

adjusted for wage increases,[66] was $6,721 contrasted with the $6... reflected in its claim.

The ALJ agreed with the Company's points regarding the Staff presentation. The Staff has excepted. The Staff's exception consists of a reiteration of the matters set forth in its Main Brief, which was an explanation of Mr. Laudenslager's methodology. We are unpersuaded that the Staff's methodology is more meritorious than that of the Company. We conclude that the Company has met its burden of proof as to this item. Accordingly, we deny the Staff's exception and reject its proposed adjustment.

G. Net Negative Salvage

Duquesne's claim for this item is $2,798,000 (Exhibit 1B, p. I2). This represents the Pennsylvania jurisdictional portion of the 5 year amortization of the net negative salvage accumulated (experienced) during the five years ending December 31, 1984.

66/ The wage increases used were those granted to its own IBEW employees since contractor employees are also represented by the IBEW.

Both the OCA and the Staff challenge the Company's calculation methodology in that it excludes third party reimbursements,[67] i.e. insurance or other payments by tort-feasers and other forms of reimbursement.[68]

The ALJ provided the following comments in his Recommended Decision:

> The contentions of Trial Staff and the Consumer Advocate arise from a lack of understanding of the circumstances attendant to Duqueshe's reimbursements. <u>In the Company's case, it is clear that its insurance reimbursements were received upon the premature retirements of major facilities which occurred years in advance of the estimated retirement dates in the life span procedure</u>.
>
> The cases cited by Trial Staff and the Consumer Advocate are not in point, since those cases related to mass plant accounts depreciated by average service life group depreciation procedures.
>
> The issue in Duquesne does not relate to the sale of plant and does not involve sales figures. It relates to the <u>premature</u> failure of specific plant items for which Duquesne receive insurance reimbursements.

<u>67</u>/ Neither party questioned the exclusion of material reused, i.e., returned to inventory, which was questioned by the Commission in its Opinion and Order in the proceeding at R-80011069, 54 Pa. P.U.C. 695 (1981).

<u>68</u>/ The Staff proposed a reduction of $984,438. The OCA proposed a reduction of $767,838.

premature retirement a matter of law, as is contended by Trial Staff; it depends upon the facts and circumstances of the premature retirement and the reimbursement.

Recovery of amounts of original cost, which had not been recovered previously through depreciation accruals established in the ratemaking process, should not reduce provisions for negative net salvage. If the reimbursements, in such case, are passed through to ratepayers, it would then become necessary to subsequently recoup the unrecouped original cost from ratepayers.

As Mr. Waddington, witness for Duquesne explained:

The excluded reimbursements represented payments received for damages associated with plant retirement occurrences which were not incidental to the service life estimates used as the basis for depreciation accruals claimed by Duquesne for ratemaking purposes. In these cases a retirement occurred prematurely due to damage by external parties, due to requests for relocations by external parties, or due to premature failure or accidental damage. The service life of the property would not have ended if it had not been for the occurrence leading to the reimbursement.

The reimbursement represents unrecovered future service value that had not been and will not be recovered from the ratepayer. It is not salvage in the sense that a recovery for the sale of scrap or trade-in of used equipment is salvage received after the end of normal service life of a facility. It is appropriate to deduct normal salvage from the basis for the amortization of net salvage [in the latter case], inasmuch as receipts were received after the end of service life of a facility for which the Company had the opportunity to full reimbursement through depreciation accruals.
[Duquesne St. No. 9-1 at 12]

As Mr. Waddington further explained:

> . . . When service life estimates do not incorporate cause of premature retirements for which reimbursement is received, as in Duquesne's case, a proposal to pass the reimbursement through to ratepayers merely increases the amount of cost recovery that must be recouped from those same ratepayers in the future.
>
> Consider, for example, the nonsensical situation that would exist for the Shippingport Nuclear Power Station if the Commission were to accept Mr. Larkin's recommendation. One of the 1980 insurance recoveries, in the amount of $607,667, which Mr. Larkin would pass through to ratepayers relates to the Shippingport turbine that prematurely failed. Inasmuch as Duquesne was able to recover $607,667 from an insurance carrier, its total unrecovered cost is reduced by that amount, and the claim for the amortization of unrecovered costs associated with the retirement of Shippingport exclude that $607,667 back into the unrecovered cost base, and Duquesne would be in a nonsensical position of passing the $607,667 insurance recovery through to its ratepayers via the negative net salvage item on one hand, while on the other hand simultaneously recovering that same $607,667 from the same ratepayers via the Shippingport amortization item.
>
> Although the timing is not as dramatically nonsensical for the other major reimbursements, the principle remains the same. Any reimbursements for future unrealized depreciation accruals that are passed through to the ratepayers by excluding them from the amortization of negative net salvage must eventually be recovered back from ratepayers in the future.
> [Duquesne St. No. 9-1 at 16, 17]

Recommended Decision, pp. 75-77. Apparently finding Mr. Waddington's explanation persuasive, the ALJ recommended

Only the OCA has excepted.

The OCA asserts in its exception that the ALJ's distinction as to whether "life span" or "average service life group" methods of depreciation is used is immaterial. The OCA then outlines and reviews past Commission decisions and proceeds to argue against the Company's position in this matter. Also cited and argued is a provision in the _NARUC Public Utility Depreciation Practices Handbook_ (1974 Ed.).

While we follow the OCA's argument, argument is not a substitute for appropriate testimony. This is obviously a complicated matter involving ratemaking theory. We would invite such a dialogue by depreciation experts in a future Duquesne proceeding, since there seems to be a fair risk that our past actions may have been inconsistent; but we are not prepared to resolve this matter in favor of the OCA's position based on arguments in briefs and exceptions alone. In the posture of this matter, we conclude that the Company has satisfied its burden of proof in _this_ proceeding.69/ Accordingly, we deny the OCA's exception and reject its proposed adjustment.

H. Split Pin Replacement

Duquesne claims 1983 costs of $1,258,928 for replacement of split guide pins which hold guide tubes

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69/ In any future proceeding we would invite any dialogue on this subject to include the subject of property returned to inventory.

inside the reactor vessel (Beaver Valley No. 1). The estimated 1984 cost claim is $755,574. Duquesne seeks 3 year amortization of these costs, or $604,834 annually. This results in a downward adjustment for test year 1984 of $151,000.70/

Staff opposes this claim and recommends 25 year amortization, while the OCA recommends 10 year amortization, if recovery of the costs are to be permitted at all (opposing recovery as a non-recurring costs).

The ALJ characterized the Company's claim as reasonable and recommended that it be approved, characterizing the Staff's and OCA's amortization periods as nearly the equivalent of capitalization of the costs.

Both the Staff and the OCA have excepted. The Staff argues that since split pins are designed to last the life of the plant itself (the instant replacement being the result of a defective design), it is logical and equitable to amortize the replacement cost over the plant life. Alternatively, Staff argues that if it could be demonstrated that the costs of the original pins have been deleted from rate base, the replacement cost should be capitalized.

The OCA first urges that this is a non-recurring expense which should not be recovered, since they were costs incurred in 1983 (although paid, or to be paid, in part in

70/ $755,574 - $604,834 = $150,740 rounded to $151,000. See Exhibit 1B, p. I1 and note 30 thereto.

1984). The OCA also cites to us certain language from a prior Opinion and Order in the Duquesne proceeding at 54 Pa. P.U.C. 695, 718 (1981) and the Recommended Decision in the pending proceeding of Pa. P.U.C. v. PECO, R-842590. We are not satisfied that the instant split pin replacement is totally analogous to the repairs involving PECO's plant at Peach Bottom. Further, the language cited from the prior Duquesne decision was a generalized comment which did not result in a total disallowance of the Company's claim; to the contrary, in the face of the particular statement cited, a normalized allowance was granted.

The OCA urges again its proposed 10 year amortization to reflect a normalized level of reactor maintenance expense. We have reviewed the OCA's Main Brief in this subject most carefully, together of course with the briefs of other parties. We find the OCA's discussion of past Commission decisions and comments most helpful. The question of whether recovery of these expenses should be allowed is a difficult decision. On balance, we are of the view, at least this time, that recovery should be permitted, but that a lengthy period is appropriate. We can find many similarities between the expense claimed here, and one involving storm damage (except perhaps the degree of certainty regarding a future equivalent occurrence). Accordingly, we shall grant the OCA's exception, in part, and adopt 10 year amortization. This results in an allowance of $181,450 or a reduction in Duquesne's claim of $423,384.71/

71/ $604,834 - $181,450 = $423,384. This action does not preclude this issue being again raised in future proceedings.

I. Computer Costs

Duquesne's initial cost claim for the lease of an IBM 3083-B computer was $420,000 per year.72/ During the cross and redirect examination of Company witness Cook (Tr. 595 et seq.), it was revealed that in fact the computer leased was an IBM 3083-JX with a cost of $62,300 per month. He also stated that 10-15 per cent of its use would be for construction. This claim was definitized in Exhibit 2H as an annual expense of $738,000.73/ This claim was reduced for the 15% use for construction, or by $110,700, for a net claim of $627,300.

In its Main Brief, pages 93-95, the OCA proposed a construction use reduction of 25% of the initial cost claim of $420,000, or $105,000.

The ALJ recommended against the OCA's proposed adjustment. The OCA has excepted. This exception consists of a reiteration of the argument in the briefs. We are satisfied that Duquesne's revised claim as set forth in Exhibit 2H is a proper expense and that the 15% allocation to construction is appropriate and reasonable. Therefore,

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72/ $210,000 included in 1984 budget plus an annualization allowance of $210,000 appearing at note 31 to Exhibit 1B, p. I1. See also revised note 30 to Exhibit 2H.

73/ Although the OCA has objected to the updates in Exhibit 2H, we conclude that the OCA was put on notice of a change, at an early date, which was larger than the definitized claim. Accordingly, this portion of Exhibit 2H was properly admitted.

we approve an additional Company adjustment (increase) for this item of $207,000 for a total expense of $627,000.[74]

J. Leasehold Improvements

Duquesne has claimed $351,453 for the amortization of the unamortized leasehold improvements[75] associated with the Company's former corporate headquarters, vacated in early 1983. These improvements had been depreciated since 1954 over the life of the lease, scheduled to expire in 1988. The Company states that it claimed such costs in its filing in the proceeding at R-832337 (terminating in settlement rates) and has continued to amortize these costs. The Company asserts that these improvements provided a benefit to the Company and its customers during the occupancy of the premises and that the subsequent move in 1983 was in the best interest of its customers. The OCA proposed the total disallowance of this claim. The ALJ, without discussion, recommended approval of the claim and rejection of the OCA's proposal disallowance. The OCA has excepted.

74/ (1) $210,000 included in 1984 budget; (2) $210,000 upward adjustment in Exhibit 1B, p. I1 (note 31); (3) $207,000 upward adjustment in Exhibit 2H, page 1 (note 31).

75/ Totalling $1,553,673 as of the date of the move and $1,171,163 as of the present time. (See Exhibit 1B, p. I57-I58)

The Company stated, with regard to the amortization of these costs, that they "appeared to the Company to have been accepted in the Joint Petition for Settlement" (at R-832337). The OCA challenged this conclusion. We agree with the OCA's challenge. In the prior proceeding at R-80011069, 54 Pa. PUC 695 (1981), Duquesne claimed 5 year amortization of the rate case expense incurred in a prior settled proceeding at R-79010740. The Commission said there that "[w]e do not believe that it is appropriate to read into the settlement, and the Order approving it, something that is not set forth therein" (Id. at 726). Applying the same standard here we cannot read into the settlement at R-832337, approval of the amortization of these costs. Unless, an item is singled out and specifically approved in the settlement Order, or unless the claim constitutes the continuation of an existing regulatory practice with regard to that specific cost item or category, such as the management audit expense in this proceeding, an approved settlement cannot be considered to do more than establish reasonable rates. Consequently, the fact that this category of costs was claimed in the proceeding at R-832337, does not constitute Commission of approval of these costs, or approval of their amortization over a term of years.

The OCA also challenges the Company's claim that the move to Oxford Centre was of benefit to ratepayers, as a basis for approval of the amortization of the unamortized leasehold costs at the old headquarters building. In support of that challenge the OCA has argued that since under the Court's decision in Philadelphia Suburban Water Co. v. Pa. P.U.C., 58 Pa. Commonwealth Ct. 272, 427 A.2d 1244 (1981) ratepayers are not to receive the benefit of the

gain experienced upon the sale of land, because they would not bear the burden of any loss, the same logic would indicate that ratepayers should not bear the burden of an loss occasioned by the vacation of leasehold premises.

Again in the Commission's Opinion and Order at R-80011069, 54 Pa. PUC 695 (1981) it was said:

> Our objective as regulators is to arrive at a normal level of operational expenses, which will be representative of a future period of operations, an objective with which the respondent's counsel agrees. Mere assertions in the respondent's brief that these nonrecurring expenses will be replaced by others of a similar type, rendering the test year representative of the future does not satisfy its burden of proof. If not the first, the most widely accepted maxim of regulation is that it is prospective rather than retrospective looking. There have only been two areas in which the commission has traditionally permitted the amortization of unusual recorded expenses: (1) flood and storm damage; and (2) rate case expenses, both of which upon the basis that they are recurring in nature, although at significantly separated intervals. ... In our view, the recorded results of operations, whether they be within or without a test year, are to be looked to for the purpose of providing guidance for the future, not for the purpose of correcting the ills of the past. To adopt amortization for these nonrecurring expenses in this case would not only smack of retroactive ratemaking, but would be tantamount to an open invitation to all parties to examine past results of operations with the template of past decisional allowances in a search for all manner of revenue and expense items to be amortized in the future. We believe that the Pandora's box of the past is best left unopened, and we will not permit amortization of these expenses.

Id. at 718. In our view, a utility seeking amortization of past expenses bears an unusually heavy burden. In addition to the burden of establishing that the expenses were if fact incurred and that they were reasonable, it must establish that all or some part of the expenses exceeds the normal expense level for that or similar expenses and most pertinently, cogent and persuasive reasons why the particular expense from the past should be singled out and be accorded the exceptional ratemaking treatment of future amortization, as distinquished from either a reduction to a normalized level or disallowed as non-recurring extraordinary expense. Since no hard and fast or even generally accepted ratemaking principle is involved, the matter of granting or denying amortization is essentially one of sound discretion on our part. The only argument offered by Duquesne as to this amortization claim is that the cost was incurred and ratepayers benefited in the past by reason of the improvements and also by reason of the move. This does not persuade us that amortization is warranted. This is an expense incurred in 1983 and we see no reason why ratepayers should be required to pay for the abandoned improvements.

We grant the OCA's exception and reject Duquesne's claim for $351,453.

K. Deferred Oxford Centre Costs

Duquesne proposed an upward adjustment of $29,771 which represents the amortization of deferred engineering and consulting costs incurred in an evaluation and study which was necessary in conjunction with upgrading the

facilities and accouterments (furniture, lighting, partitions, etc.) at the Company's new headquarters building. These expenses have not been capitalized.

The Company notes that in the proceeding at R-821945 (57 Pa. PUC 1 (January 1983)), the Commission approved an allowance of $9,712 representing 20 year amortization[76/] of then known costs.[77/] The Company advises that the costs claimed here are essentially a update of these costs, reflecting all costs, to include those not known at the time of the close of the record at R-821945.

The OCA opposes this claim on the basis that this is retroactive ratemaking and the allowance of a non-recurring expense. Alternatively, the OCA opposes recognition of any expenses over and above those recognized in R-821945.

Relying upon the Commission's action in R-821945, and concluding that additional costs of the same nature should be recognized, the ALJ recommended denial of the

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76/ The Respondent's claim there was for 5 year amortization. The Commission adopted 20 year amortization, coincident with the life of the lease. We are pleased to see that Duquesne has acceded to the Commission's decision there and has not chosen to relitigate the matter of the proper amortization period.

77/ The Company did not occupy the building until after the record closed in that proceeding.

OCA's objection and approval of this claim. The OCA has not excepted. Finding this claim otherwise reasonable, it is approved.

L. Reed, Smith, Shaw & McClay Legal Fees

The OCA proposed that $1,042,000 of legal expenses for professional services rendered by this firm be disallowed. There is no dispute as to the reasonableness of the expenses claimed. The basis for the OCA's objection is that Mr. John M. Demmler a partner in the firm is a member of the Board of Directors of Duquesne and, accordingly an affiliated interest under the provisions of 66 Pa. C.S. 2101. The OCA argues that since no contract or "arrangement" has been filed by Duquesne and approved by the Commission, the contract or arrangement is not valid or effective under the provisions of 66 Pa. C.S. §2102(a), and payment thereunder should be denied as a matter of law.

In its Main Brief the OCA cites the Commission's Opinion and Order in the proceeding at Pa. P.U.C. v. Kane Gas Light and Heat, R-832438 (July 24, 1984). The ALJ concluded that case was distinquishable on the basis that the attorney involved was a co-owner, officer and employee of Kane. We agree that factual situation is distinquishable from one involving a director.

The OCA also quotes the following passage from the Commission's Opinion and Order in R-80011069:

> Regardless of the legalities involved, we believe that a transaction between a utility and the law firm of which a director is a partner is subject to an appearance of possible conflict, and that it is within our prerogative to require evidence of the underlying cost, as described in §2106 even absent a legal conclusion of the applicability of that section. We hereby place Duquesne on notice that in its next proceeding a failure on the part of Duquesne to supply underlying cost data, will risk disapproval of such legal expenses.

54 Pa. PUC 695, 734. The OCA then continues and states that the Company was placed on notice during the course of the proceeding that the matter of this affiliated interest was in question, but made no attempt to introduce the affiliated interest contract and "in this respect they have failed in their burden of proof...." (Main Brief, pp. 125-126).

In this regard we note that in Exhibit 2C (consisting of over 150 pages) the legal services performed by the firm are explained in detail. It appears that in the face of this exhibit no question was raised regarding the reasonableness of the fees charged and paid.78/

78/ We assume that the scope and extent of this exhibit was a response to our injunction to Duquesne that it supply underlying cost data. We commend Duquesne for this response. However, we do find missing a general explanation of the basis for billing, such as hourly rates etc. We expect that such information will be forthcoming in future proceedings, because in the absence of hours and rates we are somewhat at a loss as to the basis of review of these invoices by Duquesne, and even the manner in which bills are developed. Bills for legal fees without data as to hourly rates and hours of work shall be subject to disallowance as being unsubstantiated.

The instant contention by the OCA is not new. It was also raised in the proceeding at Pa. P.U.C. v. PG&W, R-80071265 (April 24, 1981). Upon appeal by the OCA of the Commission's rejection of its position, the Court said:

> Finally, the OCA contends that $82,901 of PG&W's legal expense ought to have been disallowed because the law firm engaged by PG&W is, in the OCA's view, an "affiliated interest" the contracts of which are required to be but are not the subject of written approval by the Commission.
>
> The definition of affiliated interest is found at 66 Pa. C.S. §2101. Of the seven subparts of this definitional provision, the OCA argues for the applicability of only one:
>
> (a) General Rule.--As used in this part "affiliated interest" with a public utility means and includes the following:
>
> (4) Every person who is an officer or director of such public utility or of any corporation in a chain of successive ownership of 5% or more of voting securities.
>
> The pertinent facts are at Charles Thomas, Esquire is a member of the board of directors of PG&W and its corporate parent, Pennsylvania Enterprises Incorporated, and is a partner of the law firm of Thomas and Thomas which law firm is engaged by PG&W with respect to litigation before the Commission.
>
> [7] On this issue the Commission first determined that the contested expenses were reasonable. The Commission then declined to address the issue of whether a law firm is included within the meaning of "every person who is an officer or director of such public utility" if a member

M. Edison Electric Institute Dues, Media Communications Dues; and Local Institutional Advertising

1. General Edison Electric Institute Dues

Duquesne's claim for this item is $213,377. The OCA has proposed a disallowance of 25% (or $53,344). The ALJ provides the following discussion of this item:

> EEI is the association of the nation's investor-owned electric utility companies. EEI provides the principal forum where electric utility people exchange information on the development of their business. The Company states that one of EEI's basic objectives is the "advancement in the public service of the art of producing, transmitting and distributing electricity and the promotion of scientific research in such field." (Duquesne Exhibit No. 31A-10 Supplement).
>
> In addition, Duquesne asserts that EEI ascertains factual information, data and statistics relating to the electric industry and makes them available to member companies and the public. Further, it states that EEI has functioning committees on virtually every aspect of the electric utility industry, and that the Company has some 42 employees who are members of these committees.
>
> The Consumer Advocate recommends that the EEI dues claim should be reduced by $53,344, or one-fourth thereof. It bases such adjustment primarily on a subcommittee preliminary report of the National Association of Regulatory Utility Commissions (NARUC) of October 12, 1983, and reissued on March 23, 1984. It asserts that the report generally finds that EEI engages in many activities of benefit to ratepayers, but that it also engages in political and lobbying activities, the precise extent of which is difficult to measure. The Consumer Advocate, however states that since the report suggested a

disallowance of 1/3 to 1/4 of such dues in ratemaking, it was recommending a reduction of the smaller amount.

Mr. Douglas Bauer, vice-president of the Institute, witness of the Company, agreed that the following percentages of EEI dues were disallowed in recent cases in which he had testified: California, 25%; Colorado, 35%; Florida, 33%; Texas, 100%, Massachusetts, 20%. He stated that 20% of EEI's activities were devoted to "legislative advocacy, broadly defined." (Duquesne St. 25 at 15).

We believe that the record establishes that a substantial portion of EEI's activities are of no benefit to ratepayers. While the Company states that NARUC has not adopted the report of the subcommittee, nevertheless, the committee's findings, together with the admission of Mr. Bauer that about 20% of the Institute's activities are related to "legislative advocacy," indicates that the recommendation of the Consumer Advocate is reasonable and should be adopted.

At the outset of its exception, Duquesne states that "EEI and its activities are a substantial benefit to Duquesne's ratepayers." (Exceptions, p. 21). Duquesne then continues and provides extensive quotations (pages in length) from the testimony of its witness Bauer. Also provided is a summarization of EEI activities from its annual report (1983-1984). Duquesne then says it has "thus clearly set forth examples of the benefits to its customers from EEI activities." (Exceptions, p. 27). To our knowledge no one contests that the activities of EEI provide benefits to Duquesne's customers. The question is 100%, 75%, 50%? Duquesne's conclusion that since "this evidence

is not contested[79], the 25% disallowance in the Recommended Decision is unsupported." (Exceptions, p. 27). Duquesne's premise does not lead to its stated conclusion.

In our view Duquesne's showing that EEI activities provide <u>some</u> benefits to ratepayers does not establish that the entirety of Duquesne's claim is reasonable and appropriate for recovery from ratepayers. On balance, in light of Mr. Bauer's concessions and the persuasive example of other Commissions, we conclude that the ALJ's recommended disallowance of $53,444 is modest. Finding that Duquesne has failed to meet its burden of proof as to the entirety of its claim we will adopt the ALJ's modest recommended disallowance and, accordingly, we deny Duquesne's exception.

2. <u>EEI Media Communications Dues</u>

Duquesne's claim for this item is $35,000. The ALJ stated that he is not satisfied that the activities funded by these dues provide customer benefits.

This claim was opposed by both the Staff and the OCA, both claiming in essence that there has been no demonstration of customer benefits.

The testimony provided by Duquesne regarding this subject was the rebuttal testimony of its witness

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79/ Referring to its examples, etc.

Laudenslager (Statement No. 25). We shall quote this testimony in its entirety:

> 5. Q. What is the Media Communications program and why does Duquesne participate in the program?
>
> A. Duquesne Light supports the national Media Communications Program through payment of $35,000. In addition to energy conservation messages, this program is designed to provide valuable information that the consumer is unlikely to receive from any other source. Energy management, acid rain, residential energy conservation, alternate energy sources, electrical safety, understanding your electric bills, and other energy-related issues are frequently "hot" media items. Unfortunately in most instances, because of a lack of time or expertise, the news reports regarding issues facing our industry are either shallow or one-sided. We believe the public can best be served when they hear all sides of any issue.
>
> EEI's Media Communications Program serves the public by providing important information regarding a number of energy-associated issues facing our nations' electric energy industry. An informed public is essential to the rational decision making process that will ultimately affect our continued ability to provide reliable, safe electric energy at the most reasonable cost.
>
> The Company receives a number of benefits from the EEI Media Communications program. The two primary benefits are:
>
> 1. In advertising terms, the Company realizes a very good frequency/reach/cost ratio. In other words, because the program is supported by a number of utilities on a national basis, the

> impact is greater per utility than if each invested the same amount of dollars on a local basis.
>
> 2. The national media program runs in certain high readership media such as Time Magazine and the Wall Street Journal that would otherwise be beyond the area served and budgets of any single utility.
>
> The Company believes the entire amount of the Media Communications Program dues are justified expenditures. All of Duquesne Light's communications programs provide valuable information to the public.
>
> We believe we have an obligation to make that information available to the public so that they can properly evaluate the issues.

Duquesne Statement No. 23, pp. 2-3.

While we have Mr. Laudenslager's opinion that this program provides ratepayer benefits, there is nothing from which we can derive our own conclusion. Stated differently, we have a witness' conclusion, based upon his viewpoint and particular bias, not objective evidence. We are not bound to accept the opinion of any witness, and we reject Mr. Laudenslager's opinion testimony regarding a matter which is not the subject of expertise (i.e. the subject of ratepayer benefit).

Accordingly, Duquesne not having sustained its burden of proof, we deny this claim[80/] and Duquesne's exception.

3. Institutional Advertising

Duquesne's claim for this item is $345,430. The ALJ's Recommended Decision appears to have omitted a recommendation as to this item. The OCA's exceptions note this apparent omission and it pursues its opposition to this claim.

The OCA's Main Brief sets forth some selected examples of local advertising from Duquesne Exhibit 31-P-1. The Company's Reply Brief addresses the matter at some length. We have examined Duquesne Exhibit 31-P-1 in its entirety and while we conclude that the advertising may result in some image building, which the OCA derides, we believe that the vast majority of the ads are of benefit to the ratepayers in that they provide information which is of value to them, and any image building is merely incidental.[81/]

80/ This is consistent with the Commission's action with regard to a prior claim for this expense item in R-821945 (57 Pa. PUC 1 (January 1983)).

81/ We drawn a distinction as to the value to ratepayers of local advertising regarding "their" utility and national advertising which may have only theoretical interest.

Accordingly, we shall approve Duquesne's claim and reject the OCA's proposed disallowance.

N. Steam Power Maintenance

Duquesne's claim for this item is $34,278,000. The ALJ provided the following discussion of this subject:

> Trial Staff proposes a $2,380,564 decrease, based on an averaging [sic] actual 1982, 1983 and budgeted 1984 figures. It argues that in 1983 though the Company budgeted $39,159,000 for steam power expenses, actual expenditures were only $28,881,948. It maintains that since the Company has admitted that there is no identifiable "normal cyclical expense" for steam power maintenance, because of the number of stations and the number of units, "normalization" of such expenses is the logical way to proceed for prospective recovery through ratemaking.
>
> Duquesne maintains that the level of maintenance expenses should be considered on a total system basis, including nuclear and oil-fired units as well as coal-fired (i.e. steam). It urges that it is inappropriate to determine steam power maintenance expense simply by averaging the actual 1982, 1983 and budget 1984 figures. Its witness Shirer testified that:
>
> > ... my testimony has indicated that all areas of Production Maintenance are interrelated from the initial maintenance scheduling to the recording of actual costs and that any determination of a level of maintenance expense should be done on a Company wide basis.
> > [Duquesne St. No. 20-1 at 5-6]

As the Company points out, there are at least two major flaws in Trial Staff's position. First, the averaging process of Trial Staff witness Kalbarczyk used historical figures for 1982 and 1983. If he had used the expenditures for the last three years of 1981, 1982 and 1983, in 1984 dollars and then averaged the same, the Company's 1984 budgeted claim is approximately 4% less than the average.

Secondly, Trial Staff fails to recognize the fact that while steam expenses (for coal-fired plants) were budgeted higher than expended in 1983, there was a corresponding reduction in the expenses budgeted in 1984 for nuclear power maintenance expense.

The Company explained that unprecedented reductions in consumer requirements for electricity resulted in reduced system loads during the last half of 1982 and the first half of 1983. As a result the Company made appropriate changes in maintenance procedures and scheduling where applicable.

Duquesne further states that actual 1984 steam power maintenance expenses for the first eight months are more than $2,400,000 over budget, and that although certain products have been accelerated, Duquesne expects its actual expenses to exceed budgeted figures.

In our opinion, the record evidence shows that the budgeted steam power maintenance expenses of the Company are reasonable. Trial Staff's attempt to fragment total system maintenance expenses, and look only at the steam power generation, does not present a true picture.

Recommended Decision, pp. 86-88. The ALJ recommended against the proposed Staff adjustment. The Staff has excepted. In its exception the Staff generally reargues its

case but does not address what to us is the most interesting question, which is the divergence of results from the use of 2 years historical data and the use of 3 years of historic data. The Staff does not suggest any reason why the result derived from 2 years of historic data is more appropriately used than the result of 3 year historic data. Additionally, Duquesne has provided a plausible explanation for the deviation of 1983 recorded, from 1983 estimated.

Based upon our evaluation of the evidence we conclude that Duquesne has sustained its burden of proof as to this item. Accordingly, we deny Staff's exception and reject its proposed adjustment.

O. Wage Increase

Included within the pro forma test year adjustment made by Duquesne is an adjustment to reflect: (1) annualization of a 6% wage increase effective October 1, 1984; (2) annualization of the increase in pension and other employee benefits accompanying the October 1, 1984 wage increase; and (3) annualization of charges by the operators of jointly owned plants for increases in wages and fringe benefits for those operating employees.

The October 1, 1984 increase is the second year of an IBEW 2 year contract signed in October 1983.[82/]

82/ Duquesne customarily increases non-union employee wages by the same amount as union employees.

Both the Staff and the OCA proposed a disallowance of a portion of this increase. The Staff proposes allowance of only a 3.9% increase resulting in proposed reductions for union employees of $771,992 and for non-union employees of $573,176 or a total of $1,345,168.

The OCA proposes the allowance of a 2.5% increase for union employees and a 5.05% increase for non-union employees or disallowances of $919,039 and $1,378,353, respectively, for a total of $2,297,392.83/

The ALJ's comments on this subject are:

> Both Trial Staff and the Consumer Advocate arbitrarily ignore the wage increase contained in Duquesne's negotiated contract with the International Brotherhood of Electrical Workers (IBEW). Duquesne has replied by contending that this increase for union workers is provided by contract, which the Company would be required to break if the adjustment suggested by Staff and the Consumer Advocate were made.
>
> The Company further states that for the 6% increase in wages, the employees contracted to work a 40 hour week or a 6.6% increase over the 37.5 hours under the prior contract.
>
> The Blue Chip Economic Indicators edition from which the Trial Staff obtained its 3.9%, forecasted change in the GNP Implicit Price Deflator shows forecasted changes in the Consumer Price Index of 3.6% for 1984 and 5.77% for 1985 (T. 3585).

83/ The ALJ's figure of $3,543,025 is incorrect and is applicable to another OCA proposed wage expense adjustment related to numbers of employees.

> The latter figure for the period when the rates to be set in this proceeding and Duquesne's contracted increase will be in effect is more appropriate than Trial Staff's 3.9% figure, since the 5.77% figure is virtually the same as the Company's contract figure of 6%.
>
> In view of the Company's contract with the IBEW, concessions by the union, particularly increasing the work week, and other record evidence, we find Duquesne's wage claim to be reasonable....

Recommended Decision, pp. 89-90. The ALJ recommended rejection of the proposed adjustments. Both the Staff and the OCA have excepted.

The Staff first takes issue with the ALJ's comments with regard to predicted inflation. Second, it speaks of incentives to Duquesne to bargain aggressively, and give-backs and reductions by other unions. Third, the Staff states that the Company will not be required to break the contract if a reduced allowance is granted, but can internally reprogram funds from excesses or economies in other areas. Fourth, the Staff proposes the 3.9% increase as a signal and an incentive for consideration in future bargaining sessions. The Staff also makes reference to Commission adoption of a proposed reduction regarding another utility, which was adopted as a more reasonable approximation of a likely wage increase.

In its exceptions the OCA characterizes the wage increase granted October 1, 1984 as excessive, given comparable increases in the Pittsburgh area. It also asserts that Duquesne has done little to contain the growth in wage and salary expense. The OCA generally takes issue

with the other comments by the ALJ and ends by stating that the non-union employee's wage increase was not a matter of union contract.[84/]

First, let us state that the Commission's prior Opinions and Orders cited by the parties are distinquishable in that in those proceedings, estimated future wage increases were involved, not contractually set wage increases. Second, as to the matter of an equal wage increase for non-union employee, it has generally been the Commission's practice to approve equal increases for non-union employees, based upon arguments regarding employee morale considerations. Third, as to incentives to bargain effectively and efficiently we believe that the customary regulatory tool of imprudency determinations, is about as efficatious a tool as we have available to us, with which to review past actions.[85/] In this instance no party suggests that Duquesne was imprudent during its 1983 wage negotiations. If we were to conclude that, in retrospect, Duquesne's bargain was a bad bargain no party has suggested any method whereby the consequences of such a bad bargain could be shared between ratepayers and stockholders.

84/ In its Main Brief the OCA had cited several recent Commission Opinions nd Orders, ostensibly as precedent for its proposed adjustment, wherein the Commission had adopted proposed adjustments to claimed wage in-ceases.

85/ It should go without saying that in light of the modest collective bargaining agreements reached in many industries in the last year or so, the contract which will be bargained for commencement in October 1985, will be most carefully scrutinized for prudency on the part of Duquesne management.

All things considered we believe that Duquesne has sustained its burden of proof as to this item and, accordingly, the Staff's and OCA's exceptions are denied.

P. Early Retirement and Levels of Employees

Two Duquesne actions have been addressed together by the parties and addressed together by the ALJ. As to the first, a corporate reorganization, the ALJ advised that:

> In conjunction with the recommendations of the 1982 Commission mandated management audit, Duquesne instituted an examination of its organizational plan for the future. The new organization was designed to insure appropriate direction for future corporate needs and to further increase efficiency, effectiveness and responsiveness to changing market conditions in the Company's service area. As part of the reorganization, the Company has reduced the number of departments from 44 to 25, and anticipates a reduction of approximately 100 management and management support positions. The reorganization is scheduled to be completed by April 1985.
>
> * * * * *
>
> In conjunction with the reorganization, Duquesne has reflected a decrease in O&M expenses for 1984 of $3.4 million as its estimate of the savings resulting from the reorganization and the estimated 100 employee reduction.

Recommended Decision, pp. 90-91.

The second action by Duquesne is an early retirement program. As to this program the ALJ reports:

> The purpose of the Company's voluntary early retirement program was to create a method of providing an incentive for employees to retire early so as to create openings and new opportunities in the Company. Of the 450 employees eligible for early retirement, 324[86/] employees chose early retirement. As part of the incentive to accept the early retirement offer, lump sum payments were made to each employee based on the individual's salary and the remaining months until normal retirement. Duquesne has proposed that the total lump sum payments of $5,083,467 be amortized for ratemaking purposes over a three-year period, or $1,694,489 per year.[87/]

Recommended Decision, p. 90.

The OCA questioned the benefit of this early retirement program insofar as union employees are concerned if, as Duquesne states, all 210 employees will be replaced.[88/] OCA witness Larkin determined, based upon data supplied by Duquesne, that the level of employees at July 30, 1984 was 178 below that of the December 31, 1983 level. He then assumed that this would hold true at December 31, 1984 and based upon average employee wages

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86/ These 324 employees consisted of 210 union employees with a lump sum payments of $2,913,583, and 114 non-union employees with lump sum payments of $2,169,884.

87/ Duquesne witness Beck stated that this program and the management reorganization were not directly related.

88/ On this record it is unclear if they will all be replaced; however, if they are it certainly does call into question the benefit to Duquesne of this part of the early retirement program.

as of December 31, 1983 calculated a savings attributable to these 178 employees of $3,543,025. However, as the OCA notes, Duquesne was unable to supply any figure with regard to the number of employees provided for in its budget estimate (Main Brief, p. 79) and, consequently, the 178 employee decline cannot be attributed to either unreplaced early retirees or any other particular cause. Consequently, the employee level noted on July 30, 1984 does not indicate that 1984 will be below budget, an assumption implicit in the OCA's calculation. Alternatively, the OCA proposes disallowance of the claimed amortization of lump sum payments of $1,694,489.89/

The Staff went through a somewhat similar analysis of the Duquesne exhibit and concluded that, none of the early retirees would be replaced by the end of the test year because of hiring delays, and, consequently, its witness recommended a salary and wage adjustment of $6,546,504. Alternatively, the Staff proposes elimination of the lump sum amortization claim for $1,694,489.

The ALJ recommended against the adoption of the proposed adjustments with the exception of the disallowance of the lump sum payment amortization. The Staff and the

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89/ This lump sum amortization claim relates to all 324 early retirees. The OCA finds no benefit to Duquesne of the union employee portion of this program if all 210 union employees are replaced. Assuming that we were to agree, disallowance of amortization of lump sum payments for these employees would result in a disallowance of $971,194 ($2,913,583 ÷ 3 = $971,194) (See footnote 85 above).

Company have excepted. We have reviewed these exceptions and find nothing new. The Staff's proposed adjustment is based upon conjecture and surmise regarding a reduced level of employees. Duquesne has of course contributed to the need for such conjecture by its inability to advise anyone as to the number of employees which are included within its wage and salary budget.[90/] However, we do not find a sound basis for adopting this adjustment.

In its exception to the ALJ's recommendation to adopt the Staff's and OCA's proposed lump sum payment amortization, the Company states that the two adjustments, which it proposed as a consequence of the reorganization and early retirement programs, are a $3.4 million reduction of annual wage expense (as a result of the 100 employee reorganization program) and a $1,694,489 expense, representing three year amortization of lump sum payments to early retirees. Duquesne has stated that these programs are not directly related (Duquesne Reply Brief, p. 85) but are in fact two separate programs, adopted for different reasons and to achieve different objectives, which, it seems by happenstance, were somewhat concident in time. However, Duquesne argues that the benefit of one should be considered as an offset to the cost of the other, or at least that they should be considered together.

90/ We find little excuse for such lack of information. A repetition of such inability to provide the assumption as to number of employees in a budget will not be looked upon with favor and may have unpleasant consequences for Duquesne in future proceedings.

If we were to view these two programs as directly related and interdependent, the overall result would be a ratepayer benefit. However, based upon the facts presented, we agree with Duquesne that they are not interrelated. The reorganization with the attendant reduction of 100 personnel spares was a result of the 1982 management audit, which in addition to increased efficiency, effectiveness and responsiveness to changing market conditions, provides a ratepayer benefit in the form of reduced salary expense. We believe that ratepayers are entitled to this benefit.

As to the early retirement program, Duquesne states that it was adopted for the purpose of "providing an incentive for employees to retire early so as to create openings and new opportunities in the Company." (Main Brief, p. 112). When we look for the ratepayer benefit from this program we find that 210 union employees, of the 324 early retirement employees, are to be replaced. The OCA asserted that as to these employees there was no discernable benefits. We are inclined to agree. We have rejected the OCA's proposed adjustment for reduced union employees, based, in part, upon Duquesne's representation they are to be replaced. As to the 114 non-union employees who retired early, we conclude that the reorganization plan would have achieved a 100 employee reduction without it. Thus, we are at a loss to find any ratepayer benefit experienced or to be experienced as a result of the early retirment program for the non-union employees.

We conclude that the Company's exception, insofar as it joins the two actions and claims that the benefit of the reorganization offsets the cost of the early retirement program, is without merit. The Company's argument or

position is tantamount to seeking to avoid the consequence of an inefficiency, an imprudent action, or its larçesse by pointing to efficiencies which it has achieved in other areas. We shall not countenance the Company's attempt to escape an examination of the reasonableness of its early retirement program, by obfuscation of the issue by focusing upon the benefits of another separate and independent management action.

We find that Duquesne has not met its burden of proof as to the reasonableness and necessity for incurring the early retirement lump sum payment costs and we disallow such costs and deny Duquesne's claim for amortization. Accordingly, we adopt the Staff's and OCA's proposed adjustment and deny the Company's exception.

The OCA proposed one additional adjustment. This adjustment deals with Duquesne's calculation of the savings applicable to the reorganization and reduction of the work force by 100 employees. The Company calculated a savings of $3.4 million (Duquesne Ex. 1B, p. I14). The OCA calculated savings of $3,597,000 (OCA Statement 23, Schedule 13). We have reviewed these calculations and find that the difference is that the OCA witness used the average actual wages of the 114 non-union early retirees rather than an average wage figure for non-union employees as did Duquesne and adjusted for a portion of the 1983 wage increase, as well as the 1984 wage increase adjusted for by Duquesne. Implicit in the OCA's calculation is the assumption that the 114 early retirees held the jobs to be eliminated or will be the employees actually reduced, as a result of this reorganization. The OCA has excepted to the ALJ's failure to recommend its adjustment. We find nothing new in the

OCA's exception. While, as the OCA stated, there is no basis to assume that the eliminated positions will be at the average salary, there is no basis to assume that they will be above average and, in fact, we would be inclined to believe that they may well be below the average salary. We deny the OCA's exception.

Q. Warwick A&G Expenses

The ALJ provides the following comments regarding this item:

> The Consumer Advocate contends that $149,019 of the Company's expenses (Accounts 920, 921 and 923) should be disallowed [sic] to the Company's mining operations. The Company states that all costs directly related to the Warwick Mine, including supervisory costs, depreciation and depletion, labor fringes, insurance, vacation time and utilities are included in the cost of coal production. It further allocates a limited number of costs including (1) purchasing, warehousing, accounting and computer costs associated with material purchased or withdrawn from stock; (2) headquarters copying costs; (3) central mail costs; and (4) headquarters occupancy costs. The Company does not allocate any costs for management time, legal services and accounting and data processing service, which it estimated as follows:

Management Time	$ 3,700
Legal Services	77,524
Accounting and Data Processing Services	67,795
	$149,019

> We agree with the Consumer Advocate that given the size of the mine, it is hardly conceivable that only $3,700 worth of Duquesne's senior officer's time is devoted to this operation.
>
> We also agree with the Consumer Advocate, however, that at least the $149,000 estimated by the Company itself as additional administrative and general expense attributable to Warwick should be transferred to that account.

Recommended Decision, p. 94.

The Company has excepted and argues that "there is no basis to assume that if there were no Warwick Mine tht Duquesne's costs would be $149,019 less." We don't find this statement to have any relevance at all to the subject under consideration.91/ The question is not whether Duquesne's costs would be the same with or without the mine but whether time spent on non-utility operations are properly allocable to such operations.92/ Clearly, such an allocation is both a customary accounting and regulatory practice, and we shall follow it. The exception is denied and we adopt the OCA's proposed adjustment.

91/ The obverse of this argument would be to allocate more costs because the mine could not obtain the same services as cheaply elsewhere.

92/ Allocations to Warwick operations should not be limited to Duquesne's avoidable costs and if they are, a different method should be used which shares between Duquesne and Warwick the efficiency of joint operation.

R. Depreciation Expense

OCA witness Larkin proposed four depreciation expense adjustments which net to an expense reduction of $282,811. The details of these adjustments are:

a.	Environmental Control Projects	($233,267)
b.	Nuclear Regulatory Commission Mandated Projects	(70,551)
c.	Retirements Associated with CWIP	6,260
d.	Customer Advances	14,747
	Total[93/]	($282,811)

As to the first two OCA proposed adjustments the OCA states that the environmental control projects and the Nuclear Regulatory Commission Mandated Projects are not yet in service and will not be in service until various dates in 1985, and that therefore depreciation expense is not a legitmate expense. In support of this proposition the OCA argues the provisions of the Uniform System of Accounts, Accounts 107 and 405. The ALJ found no merit in this proposal and recommended against the adjustment. The OCA has excepted. The OCA generally reargues its proposal. It also states that approval of this claim would create a mismatch between Duquesne's books and the ratemaking treatment to be accorded this property, as well as violate the provisions of the Uniform System of Accounts.

93/ We rely upon the OCA's Main Brief for the dollar detail of these adjustments since they do no appear in Mr. Larkin's testimony or accompanying schedules, or if they do, the OCA has not identified their location and we have been unable to locate these details. The Staff took no position on this proposed adjustment.

As to the matter of a deviation from the Uniform System of Accounts, the inclusion of this CWIP in rate base is a deviation. The termination of AFUDC at that time may also create a mismatch between its financial books and the Company's ratemaking accounts or between its ratemaking accounts for Pennsylvania and before the FERC. This is something which this Commission and other parties must and frequently do live with. This proposed adjustment by the OCA raises what appears to be a matter of first impression. As such the OCA has not persuaded us that we should change our past practice of permitting depreciation expense with regard to CWIP included in rate base. Accordingly, its exception is denied and we reject the proposed adjustment.

The third adjustment is to remove or reverse the depreciation expense of retirements associated with CWIP. It appears that this is the other side of the coin as it were; that is, if CWIP is not in service there can be no retirements. The effect of this OCA proposed adjustment is to decrease depreciation expense.

The last proposed adjustment is described as the removal of "the depreciation expense effect of customers advances for construction, which offset the Company's claimed depreciation expense...." (OCA Main Brief, p. 129).

Since these two latter adjustments are linked to and/or dependent upon the first two adjustments we disapprove them as well.

S. Transmission Line Rentals

The Staff describes this matter as follows:

Budgeted 1984 transmission line payments of $6,036,578 and rentals of $3,554,883 (Duq. St. 19, p. 24) were revised, respectively, to $6,048,258 and $3,671,593 in response to Staff interrogatories. Duq. Ex. 30P, PUC RE-65; Duq. Ex. 30P-3; PUC RE-64; Tr. 975-979, 1000-1015.

Duquesne's responses, at Duq. Ex. 30P-3, PUC RE-64 and Duq. Ex. 30P, PUC RE-2, describe in detail the adjustments composing these revisions. The $11,680 budgeted increase in line rental payments is intended to normalize over twelve months the $35,040 budgeted for nine months use of lines relating to the Harding-Mansfield lighting facilities (scheduling in service April 1984 but actually placed in service on June 1, 1984). The $116,760 net budgeted increase in line rental receipts is the difference between a $252,502 reduction in receipts (attributable to a revised in service date from February 8, 1984 to the summer of 1985 of BV 2 for which the Hanna Loop line is required) and a $369,262 increase in receipts (due to an understatement in the budget projection for the Beaver Valley-Collier transmission line rental receipts). Tr. 975-976.

Staff witness Kalbarczyk has recommended that net transmission line rental claims submitted in utility witness Irvin's direct testimony, Duq. St. 19, p. 24, be reduced to reflect Duquesne's revisions in further direct testimony by Mr. Irvin and his response to Staff interrogatories. The net reduction in the cost of Respondent's transmission line transactions is $105,080 ($11,680 increase in line rental payments <u>minus</u>

$116,760 net increase in line rental receipts). TS St. DMK-1, p. 10; TS Ex. DMK-1, Sch. 6. This $105,080 net reduction was subsequently reflected in Duquesne's revised statement of income. Duq. Ex. 2H, pp. 3, 8.

Main Brief, pp. 67-68. Since the Company has acceded to the appropriateness of this proposal there is no contest with regard to this item. However, since we have rejected Duquesne's updated Exhibit 2H as a point of beginning, it is necessary that we make an expense adjustment for this item.

T. Inflation Adjustment

The Staff has proposed the use of a 3.9% inflation rate in lieu of the 5% rate allegedly used by Duquesne. In its Main Brief Duquesne stated:

> In the preparation of the Company's 1984 operating budget the Company's budget department suggested the use of a 5% inflation rate if the individual departments did not have a specific increase to reflect (Duquesne Ex. No. 30I-2 and 30L-2). As indicated in Duquesne Exhibit No. 30Q-3, most departments applied more than one inflation rate depending on the expenses involved, with some being above 5% and some below 5%. In certain instances where the increase was 5% or greater it was not necessarily the result of an inflation factor but rather the result of changes in the scope of work etc. A review of Duquesne Exhibit No. 30Q-3 shows that almost every department had areas where less than a 5% increase was used and where a greater than 5%

> increase was used an explanation for
> the increase is set forth in the
> exhibit. (Footnote omitted)
> (Emphasis added).

Main Brief, pp. 145-146.

We should note before proceeding that, at Transcript pages 573 et seq., Staff counsel, during the cross examination of Company witness Taylor as to the budget preparation process, indicated that he wished to know what inflation factors might have been used for or within each department, when they were used, and if more than one factor was used what they were. Counsel for Duquesne indicated that what counsel sought was almost impossible to provide, but that he would go to the Company and determine what could be obtained. Staff counsel then made his inquiry a formal discovery request, requiring a response within five days if there were an objection. No objection appears to have been lodged.

Duquesne Exhibit 30Q-3 contains the following introductory statement:

> Given the Company's reorganization and limited time frame, it is not possible to list all of the inflation factors used by each department for each FERC account number. However, as examples of the way in which inflation was considered in the budgeting process, the Company has selected certain departments which utilized factors greater than 5% and/or reflected increases greater than 5% and attempted to provide additional detail as to these departments budgeting process. Information with respect to these departments is set forth on pages 3 and 4 hereof. (Emphasis added).

Following this introduction data was provided, of which the follow is an example:

Inflation Factors used in the 1984 Operating Budget For Expenses Other Than Fuel and Labor

	1984 Budget Inflation Factors		
	Less Than 5%	5%	Greater Than 5%
Customer Services Division			
Industrial and Governmental Services Dept.	x		x
Commercial Services Dept.	x		x
Technical, Research and Planning Services Dept.	x		x
Rate Dept.	x		x
Residential Services Dept.	x		x
Customer Service Dept.	x		x
Area Development Dept.	x		x
Fiscal Division			
Secretary's Dept.	x	x	x
Budget Coordination Dept.	x	x	
Internal Audit Dept.	x		
Treasury Dept.		x	
Accounting Dept.	x	x	
Systems and Procedures Dept.			x
Vice President's Office		x	
Legal & Corporate Communications			
Governmental Relations	x		
Legal		x	
Corporate Communications	x		

This exhibit, such as it is, appears to have been the Company's response to the Staff's discovery request. As can readily be seen, the exhibit provides no more definitive information than that inflation factors of 5%, or greater or lesser than 5%, were employed to an undisclosed degree in the budget process, for the selected departments for which Duquesne chose (or was able) to provide information.

In the absence of definitive information from Duquesne regarding the inflation factors employed in the budget process (when a specific budgeting basis was not utilized), it is understandable that the Staff was not able to approach the subject of a proper or reasonable inflation factor on an item by item basis. Laboring under the disability of a lack of information, Staff witness Kalbarczyk (Staff Statement DMK-1) testified as follows:

> Q. Mr. Kalbarczyk, what is your understanding of the company's filing with regard to inflation?
>
> A. The company, in response to Interrogatory RE-36, indicated that in preparing the 1984 Operating Budget a 5% inflation factor (for items other than payroll) was suggested to be used by its departments for purposes in this rate case proceeding. During cross-examination it was learned that some departments may have used a lesser or greater amount than 5%. It is my understanding that only if cost exceeded a 10% level in the budget year when compared to the prior year actual would top level management conduct a detailed review of the individual department's request. As of this date, the company and its individual departments have not been able to identify the exact inflation percentage rate used, operating dollars it was applied to, and the actual dollars representing inflation in this filing.

Q. What is your recommendation regarding the 5% inflation rate suggested by Duquesne Management?

A. Based on in-house data shown on Schedule 7, p. 2 of 3, which has been provided to me, by the Commission's Bureau of Rates, it is my opinion, the appropriate inflation rate for 1984 is 3.9%.

Q. Please explain your adjustment of $1,354,000 which you are proposing on Schedule 7.

A. Yes, if we look at Schedule 7, the position that I have taken is the company claim, exclusive of fuel and wages, includes a 5% inflation factor. In my opinion, the net amount of Operating Expense, exclusive of fuel, wages, and Staff Adjustments, as shown on Schedule 7, is in the amount of $129,219,000 which includes a 5% inflation factor. Applying my proposed 3.9% level of inflation would allow an operating expense level of $127,865,000. Thus, an adjustment of $1,354,000 is appropriate.

Staff Statement DMK-1, pp. 10-11.

As to the assumption that all expenses other than essentially fuel and wages includes a 5% inflation factor, we would respond to the obvious challenge that there is no basis for such an assumption, that it is a matter of record that all departments were told by the budget department to use a 5% inflation factor unless they had some basis for employing some other methodolgy, and Duquesne has not indicated the extent to which the 5% factor was used or not used, either through design or an honest inability to do so. We do not believe that a utility should be able to prevent a review of its budget process, which is the foundation of its test year claim, by its inability or failure to respond to requests for information. Consequently, in such instances

where the utility does not respond, the only alternative is to make the most reasonable assumption possible under the circumstances. Here we believe, that under these circumstances the assumption that there is a 5% inflation factor in all expenses, other than those enumerated categories excluded, is reasonable.[94/] We also conclude that the 3.9% inflation adjustment utilized by Mr. Kalbarczyk is reasonable. We therefore conclude that the adjustment is reasonable and that it should be made.[95/]

U. New Customer Expenses

The Company has claimed an increase in operating expenses of $96,424 related to new customers. This amount was derived from a factor of 4.18% applied to the increase in revenues from new customers of $2,306,786. Duquesne states that the factor was derived from "the formula adopted by this Commission at R-80011069" (Main Brief, p. 147.) Duquesne apparently has reference to mimeo page 44 of the Commission's Opinion and Order therein, at which the Commission adopted a Staff proposed adjustment (reduction), to Duquesne's claim therein for additional administrative

94/ In this instance we are dealing with only 35% of the operating expense claim. Total expenses claimed were $368,647,000. Excluded were: (1) fuel $145,370,000; (2) wages and salaries $90,274,000; and, (3) expenses for which specific Staff adjustments were recommended $3,784,000. The remaining expenses subject to this Staff adjustment are only $129,219,000.

95/ The ALJ recommended against the Staff's proposed adjustment. The Staff has excepted. We grant that exception.

and general expenses associated with an increase in the number of customers. The Commission stated there that the "foundation of Staff's adjustment is that these expenses do not increase in direct proportion to the increase in number of customers." Duquesne characterizes its methodology as a "formula, which was originally developed by the Commission Staff...." (Reply Brief, p. 148). When we review Duquesne's Reply to Exceptions we see that it now characterizes its methodology as "consistent with prior Commission directives in prior Duquesne proceedings," (Reply Exceptions, p. 32). Thus, Duquesne has changed its characterization of its methodology from "a formula adopted by the Commission" to a "Commission directive". We find that it is neither of these. In the proceeding at R-80011069 the Staff chose to challenge only a portion of Duquesne's claim. In doing so it used a methodology to quantify the maximum allowance which could be considered reasonable. The Commission accepted the Staff's proposal and stated that "the Respondent has failed in its burden of proof as to an adjustment in excess of $129,049." (Mimeo, p. 44). We would characterize the Commission's action there, at the very most, as merely establishing a limitation upon Duquesne's claim, not establishing a right on the part of Duquesne to anything up to that limit. The fact that Duquesne received any allowance there at all is primarily a result of the fact that the Staff did not choose to challenge the claim in its entirety. Thus, Duquesne's methodology here is not an established, Commission adopted and approved methodology as Duquesne urges.

Turning to the methodology we find (Exhibit III, Item III-D26) that Duquesne has performed the following calculation:

Estimated Additional Other Operating Expense
(000 Omitted)

	Operating Expenses Exclusive of Production Expenses & Administrative & General Expenses			
	Total Per Books	Labor	Excluding Labor	Revenues
Revenues - Per Books				$ 887,210
Revenue Adjustments				(107,215)
Adjusted Revenues				$ 779,995
Other Expenses:				
Transmission	$ 5,667	$ 1,104	$ 4,563	
Distribution	34,939	18,477	16,462	
Customer Accounts	22,189	11,819	10,370	
Customer Service	2,599	1,633	966	
Sales Expense	499	266	233	
Total	$ 65,893	$ 33,299	$ 32,594	$ 779,995
Other Expenses (Less Labor)			$ 32,594	
Adjusted Revenues			$ 779,995	4.18%
Revenues From Increase in Number of Customers				$ 2,306,786
Percent				4.18%
Estimated Increase in Other Operating Expenses				$ 96,424

Based upon our review, we conclude that the methodology utilized implies or assumes that transmission, distribution, customer accounts, customer service and sales expenses increase in direct proportion to increased revenue. We find no rational direct relationship between these expenses and operating revenues.[96/]

The OCA proposed a disallowance of this claim. The ALJ recommended against the OCA's proposal with little discussion. The OCA has excepted. We have reviewed the OCA's exception and Duquesne's response thereto as well as the pertinent portions of the record and find ourselves unsatisfied in two important regards. First, it is difficult to believe that there was not some customer growth assumption used by various departments in preparing their budget for the test year if the department's expenses are number of customers sensitive. Duquesne's proposed adjustment presumes that the budgeted test year does not contain such assumptions, which we do not find to be established fact. Second, assuming that the budget assumption was no customer growth, and assuming that these categories of expenses are sensitive to the number of customers, we find no rational direct relationship between the categories of expenses with which we are concerned and an increase in revenues. Accordingly, we conclude that Duquesne has failed to meet its burden of proof as to this proposed adjustment and we will adjust its claim accordingly. The OCA's exception is granted.

96/ We could possibly accept a more or less direct relationship between expenses and number of customers, but not with kwh sales and certainly not a direct relationship with revenues.

V. Additional Claims

As to these matters the ALJ reported:

> There are two additional but related claims which Duquesne wished to make in this proceeding and which it seeks to be allowed even though not reflected in Duquesne Exhibit No. 2H. They are related to costs imposed on the Company by government action. In July 1984 Senate Bill 987 became an enacted law. This Act is called the Radiation Protection Act, and as a result of this Act, Duquesne is required to pay $142,500 to the Commonwealth of Pennsylvania. A similar act, i.e., the Ohio Disaster Agency Act, requires payment of $33,250 to the State of Ohio. (Duquesne St. No. 31N-1).

Recommended Decision, pp. 97-98. The ALJ recommended approval of these claims. The OCA has excepted.

The matter of these claims was first mentioned in the Respondent's Main Brief, pages 163-164. They were not included in Duquesne's update income statement, Exhibit 2H, which we have rejected. There is no evidence in the record with regard to these items. As such we find no basis for the allowance of these late claims. Since these claims are not reflected in Duquesne's income statement we need not make any adjustment. The OCA's exception is granted.

W. CAPCO Displacement Training Costs

With regard to this matter the ALJ reports:

> In the course of constructing Beaver Valley Nuclear Unit II, (BV2) a CAPCO power station operated by Duquesne, certain employees

from the Duquesne's existing power stations were eligible to bid and accept positions at BV2 through the internal bidding procedures of Duquesne. This created job openings in Duquesne's existing power stations which will be filled by new employees. In partial recognition for the reduced level of productivity in Duquesne's existing stations caused by replacing experienced workers with new employees requiring on-the-job training, the CAPCO companies reimbursed Duquesne in the amount of $481,220.

Duquesne initially credited Account 557.101 (Other Power Supply Expenses) against the expense which it incurred as a result of the loss in productivity. However, the credit was removed for purposes of this case under the rationale that the training costs are non-recurring.

Recommended Decision, p. 62.

Both the Staff and the OCA opposed the Company's ratemaking adjustment to this account. Staff witness Kalbarczyk testified as follows:

In my opinion, the revenue received from these CAPCO companies in the amount of $481,200 should be included. Although the Company during cross-examination implied that the loss of productivity can not accurately be traced, the fact remains that CAPCO as a group has noted and recognized this problem. Moreover, the CAPCO companies devised a method to allow the operating company some monetary compensation to cover the loss associated with the loss in productivity. This loss in productivity effects [sic] Duquesne's fully owned and operating plants. These costs are being recovered from Duquesne's customer. Thus, the appropriate method is to include these revenues in the amount of $481,200 in

> this rate case proceedings as a partial offset to these costs.

Staff Statement DMK-1, p. 8. The ALJ agreed and recommended an adjustment. The Company has excepted. In its exception Duquesne states:

> Duquesne excepts to the Recommended Decision's $481,200 adjustment increasing net operating income for C. PCO displacement training costs.97/ In disallowing the Company's adjustment, the Recommended Decision refers to reduced levels of productivity. There is no evidence of any actual reductions in productivity.98/ The theoretical concept of CAPCO displacement training costs has existed for approximately 10 years. During many of those years Duquesne was paying such costs and not claiming them for recovery in rates. To now reflect the monies received for these costs in their entirety is inequitable, especially considering the fact that over the last ten years Duquesne expended $1,045,393 for CAPCO Displacement Training (Duquesne Ex. 30Q-2) which were not recovered. If revenues relating to CAPCO displacement training are now to be reflected, then

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97/ To the extent that this comment is read as the ALJ having made a net operating income adjustment of $481,000 it is incorrect. The ALJ made a revenue adjustment in this amount, which should have been an expense adjustment.

98/ Whether there is or is not, the reimbursement assumes that there is and the assumption appears to be reasonable. If we are wrong Duquesne stockholders lose a windfall. If on the other hand we were to assume that there was no reduction in efficiency and are wrong, ratepayers loose the benefit of a reimbursement to which they have a legitimate claim.

> the related expenses which Duquesne itself has incurred should be allowed to be recovered via an appropriate amortization.

Exceptions, pp. 17-18.

Most of what Duquesne argues in this exception are matters which allegedly occured years in the past. Matters regarding what Duquesne has or has not claimed in past years is, in our view irrelevant. We specifically reject Duquesne's argument regarding equity, based upon its decision not to make claims in past proceedings. Finding no merit in Duquesne's exception, it is denied. We shall adopt the ALJ's recommendation and make the adjustment.

VI. TAXES

A. Excess State Tax Adjustment Surcharge Revenues

The State Tax Adjustment Surcharge (STAS) was authorized by the Commission by Order dated 1970, in order to provide utilities with a method to recover promptly, increases in the Capital Stock Tax, the Corporate Net Income Tax, The Gross Receipts Tax and the then new Public Utility Realty Tax. Utilities are required to file a recalculated STAS factor annually and are also customarily required to file a recalculation in conjunction with the filing of new tariffs at the conclusion of each rate increase proceeding. The Commission's Order establishing the STAS procedure states that the surcharge was established "so as to prevent over compensation for the increased [tax] cost... and to later review each public utility situation to enable us to require refunds or other remedies to customers in any appropriate case." (Order, p. 2)

The OCA asserts through its witness Larkin that, during the historic test year, Duquesne had an overcollection of $490,570. The OCA states that "this matter should not be ignored in the establishment of base rates in this case." (Main Brief, p. 154) The OCA proposes in the alternative that "if the Commission believes that it is not appropriate to reflect this overrecovery in the current proceeding, then it should establish that this $490,570 shall be deducted from Duquesne's State Tax Adjustment Surcharge when this rate is reestablished for the period beginning April 10, 1985" (Id).

Duquesne has not challenged Mr. Larkin's calculation. Duquesne has responded to this issue in its Main Brief, as follows:

> The STAS is subject to both over and under recoveries. Taxes like other expenses are not generally monitored to assure a dollar for dollar recovery of what has been allowed. In fact, to do so for just taxes is punitive and absurd. If revenues go down or expenses go up then net operating income declines and so do taxes. The effect of Mr. Larkin's theory is the lower a company's net operating income, the lower income taxes it will pay and the more STAS collections it will have to refund to its customers. Id. See also Duquesne Exhibit No. 31L.
>
> The OCA's adjustment which is based upon a single year's experience and a single expense account is arbitrary, unconstitutional and unsupported in this record. Until the Commission is prepared to monitor both revenues and expenses in respect to each individual revenue and expense account and make adjustments for over and under collections, the OCA's contention is arbitrary and unreasonable. Furthermore, the OCA's proposal would result in a flow back being built into base rates without any evidence of future and continuous overcollections.[99] (Emphasis addition).

Main Brief, p. 166. As to the Company's assertion that such an adjustment is arbitrary and unreasonable, until this Commission is prepared to monitor both revenues and expenses with respect to each individual revenue and expense account

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99/ Duquesne does not either explain or argue its assertion of arbitrariness and unconstitutionality. As to the assertion of lack of support in the record, we find support in Mr. Larkin's testimony.

and make adjustments for over and under collections, we disagree. The energy cost rate of electric utilities has singled out fuel expenses for just this finite type of accounting treatment, and we have heard few complaints from utilities about this procedure. Additionally, when utilities initially filed for recovery of the then new tax expenses, that act, in our view, constituted their consent to a reconciliation type accounting procedure. We reject Duquesne's objections.

In addition to taking the position that there should be no refund at all, the Company has also taken the position that STAS matters should be kept separate from base rates. We are inclined to agree.

The ALJ's discussion and resolution of this matter is as follows:

> We must not be chained by procedural niceties in this matter so as to prevent us from rendering substantial justice. Our goal is to make a fair rendition. The Company here seeks an increase in the rates it seeks from its customers. The Commission's Order of June 1, 1984, which initiated this investigation, stated "That this investigation shall include consideration of the lawfulness, justness, and reasonableness of Respondent's existing rates, rules and regulations." It is not denied by Duquesne that it overcollected $490,570 under STAS from its ratepayers in 1983. We cannot ignore this matter in the establishment of base rates in the case. Fairness requires that this over-collection be refunded to ratepayers by whatever means. We recommend that the over-collection should be a reduction to the allowable revenues allowed, as a simple solution. If the

> Commission should determine that it is not appropriate to reflect this over-recovery in the current proceeding, then we recommend, as advocated by the Consumer Advocate in the alternative, that this $490,570 shall be deducted from Duquesne's State Tax Adjustment Surcharge when this rate is reestablished for the period beginning April 10, 1985. (Emphasis omitted).

Recommended Decision, pp. 101-102.

The Company has excepted. The substance of its exception is a follow:

> Duquesne submits that this adjustment is inconsistent with the STAS procedure and with treatment afforded other expenses in base rate proceedings.
>
> The STAS is subject to both over and under recoveries, without any provision for reconciliation similar to the adjustment factor found in the ECR. Taxes like other expenses are not generally monitored to assure a dollar for dollar recovery. The 1983 calculation which was the OCA's sole basis for imputing an annual overrecovery of $490,570 represents only approximately 1% of Duquesne's total STAS expenses. This adjustment ignores the fact that there was a more than 10% shortfall in Duquesne's 1983 return which obviously affects certain of the taxes Duquesne pays. The STAS is in part dependent on net operating income which decreases as costs increase resulting in a reduced income tax expense. The more expenses exceed those recovered in rates and the greater the earnings deficiency, the more income taxes are overcollected through the STAS. If Duquesne had no income, it would have no income taxes and obviously the STAS would overcollect. It is this very phenomenon which frequently results in Duquesne paying less income taxes than

> it otherwise would have, had it earned the return to which the Commission said it was entitled. (Footnote omitted).

Exceptions, p. 36. While it is not free from all doubt, the thrust of the Company's exception seems to be directed toward the ALJ's proposed base rate reduction, rather than his alternative proposal. This conclusion is bolstered by the Company's citation of the Commission's decision in Pa. P.U.C. v. Mid-Penn Telephone Corp., 52 Pa. P.U.C. 405, 419 (1978) wherein the Commission rejected a Staff proposed reduction to revenue requirement, in a base rate proceeding, on the basis that there was no evidence of future and continuous overcollection.100/.

As to the contention that this adjustment ignores the fact that there was a shortfall of 10% in Duquesne's 1983 return, we suppose that this is a way of renewing the Company's contention in its Reply Brief that the ultimate test is whether the Company earned its authorized rate of return. This type of argument is frequently offered by utilities, that is that no refund can properly be required, under any circumstances, if the utility has not earned its authorized rate of return. This contention has been generally rejected by the Commission, especially in recent years. We do not find such an argument persuasive here. In different circumstances, we might devote more attention to a response, but here in our view, Duquesne, when it first availed itself of the STAS procedure, consented to be bound by all the terms and conditions of that Order, and as has

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100/ We believe that the concern there was that if such a refund was reflected in base rates, an overcollection refund could easily become an overrefund.

been said we have concluded that Order clearly envisoned the possibility of a refund such as proposed here.

We deny the Company's exception. Left for our consideration is the method to accomplish such refund. As we indicated above, we agree with the Company that it is inappropriate to incorporate this adjustment in base rates, and we have concluded that a refund through the STAS procedure is an inherently more accurate method. We shall so order.

B. Deferred Income Tax

The Pennsylvania Corporate Net Income Tax rate was reduced from 10.5% to 9.5% effective January 1, 1985. Consequently, deferred income taxes collected and deferred at the then extant rate of 10.5% will eventually be paid at the rate of 9.5% (assuming no change in the rate). Based upon this assumption there is an excess of deferred State income tax in the amount of $664,764.101/ The OCA has proposed that this amount be refunded to ratepayers through the mechanism of a 3 year amortization.102/

In its Main Brief Duquesne argues:

101/ The ALJ's figure of $644,764 is incorrect.

102/ This proposal is similar to the action adopted by the Commission with regard to excess deferred Federal Income Taxes at Pa. P.U.C. v. Duquesne Light Co., R-821945, 57 Pa. PUC 1, 33-34 (January 1983), in which instance a three year period was adopted.

> The change in this accounting treatment proposed by the OCA is contrary to Accounting Principles Board Opinion No. 11 and FPC Accounting Release AR-2 dated August 31, 1965, which dictates that when a change in tax rates takes place, the deferred amounts accumulated shall be returned at the same rate as was originally used to defer the amount in the account (Duquesne Ex. No. 32L-2).
>
> Another important point is that given the in service dates of significant recent past plant additions prior to their reflection in rates, what Duquesne would be required to flow back to the ratepayers under this proposal would be deferrals which the ratepayers never paid for.
>
> The OCA's adjustment is arbitrary and unreasonable and should be rejected.

Main Brief, p. 165.

As to the Accounting Principles Board Opinion No. 11 and the FPC Accounting Release AR-2, we have chosen not to follow them in the past and we do so again. As to the matter of ratepayers not funding certain deferrals, Duquesne has not referred us to evidence of record on this subject and we are aware of none. We cannot accept Duquesne's bare assertion that the adoption of the OCA's proposal would require that it flow back to ratepayers "deferrals which the ratepayers never paid for," and we reject this argument.103/

103/ Duquesne must understand that we are limited to the matters of record in this proceeding. As such, we cannot decide issues based upon purported assertions of fact regarding matters not before us in the record.

The ALJ recommended adoption of the OCA's proposed adjustment. The Company has excepted. That exception consists solely of a repetition of the two arguments propounded by Duquesne, quoted above. The exception is denied. Consistent with the Commission's decision in Pa. P.U.C. v. Duquesne Light Co., R-821945, 57 Pa. PUC 1 (January 1983), regarding Federal Income Taxes, we adopt the OCA's proposed adjustment and reduce expenses by $221,588.

C. Ohio State Property Taxes

The ALJ did not address the subject of the OCA's proposed disallowance of $103,313 representing Ohio State Property Taxes related to Perry Units 1 and 2, and the OCA has excepted to such omission.

The position of OCA witness Larkin was that since these units were not yet in service the taxes applicable to the properties should be capitalized rather than expensed. The OCA relies, in part, upon the provisions of the Uniform System of Accounts, Electric Plant Instructions 4A (Overhead Construction Costs).104/ (18 CFR Part 101)

In its Main Brief, page 163, Duquesne states that Ohio property taxes are current expenses and, similar to

104/ See also Instruction 3 "Components of Construction Cost", (16) as follows: "'Taxes' includes taxes on physical property (including land) during the period of construction and other taxes properly includible in construction costs before the facilities became available for service."

property held for future use, "should be included in the ratemaking determination."

The OCA's exception merely asserts that this expense associated with this CWIP project should not be charged to customers as current expenses. The Company's Reply Exception reiterates the statements in its briefs that this expense should be allowed.

We see no reason to deviate from the guidance provided in the provisions of the Electric Plant Instructions, of the Uniform System of Accounts, quoted in the footnote above. Accordingly, we adopt the OCA's proposed adjustment, grant its exception, and shall reduce expenses by $103,313.

D. Normalization vs. Flow Through

With possibly the sole exception of rate of return, the subject of normalization vs. flow through of income taxes, has produced more testimony, prompted more briefing, engendered more argument, created more controversy, raised more passions and consumed more time than any other subject in ratemaking. It is with no great enthusiasm that we embark yet again upon a discussion of this subject.

Perhaps the best point at which to begin is to provide an overview of the legislative provisions regarding liberalized depreciation and its progeny, deferred income taxes.

The Internal Revenue Code has always permitted an allowance for depreciation on business or investment property to be used in determining a business' taxable income. Prior to 1954, the only permissible basis of depreciation was straight line depreciation under which the cost of the depreciable property was written off in equal installments over its useful life.

The Internal Revenue Code of 1954 provided that businesses, including utilities, could accelerate this depreciation allowance by taking larger amounts in early years with offsetting lesser amounts in later years. There are several accelerated depreciation methods, the most common of which are the Double Declining Balance and Sum of the Years Digits methods.[105/]

In 1969, Congress enacted the Tax Reform Act of 1969, Section 441 of which placed certain restrictions on the use by utilities of liberalized depreciation for tax purposes. They were:

1. If a utility had been using straight-line depreciation for tax purposes, it was not permitted to switch to a liberalized method for property installed prior to 1969, and for post-1969 property it could employ a liberalized method only if it normalized the deferred taxes.

2. If a utility had been using a liberalized method and normalizing the tax difference it was required to continue to do so and could not switch to flow-through.

105/ The intricacies and advantages of the various methods are not germane to our discussion and will not be addressed.

3. If a utility had been using a liberalized method and flowing through rather than normalizing they were permitted to continue to do so.

In 1981 Congress enacted the Economic Recovery Tax Act. This enactment provided that for post 1980 additions, an accelerated form of depreciation could be utilized for the purpose of calculating income taxes, only if the tax effect thereof is normalized for ratemaking purposes.

No claim is made by Duquesne that any of these Congressional enactments control or concern in any manner the ratemaking treatment to be accorded deferred State income tax.

Neither the OCA nor any other party has advocated flow-through of the tax deferral effect of the ACRS[106/] method for post 1980 plant additions. Thus the test year taxes involved in the normalization vs. flow-through issue, as quantified by OCA witness Larkin, are:

106/ The Accelerated Cost Recovery System was a provision of the Economic Recovery Tax Act of 1981.

Duquesne Light Company
Deferred State & Federal Income
taxes not included in Cost of Service
For the Year Ended December 31, 1984

Line No.		Deferred Federal Income Tax (1)	Deferred State Income Tax (2)
1	Account 282 ADR	$2,620,800	$668,400
2	Account 282 Post 1969 Property	3,554,200	906,500
3	Account 282 Accelerated Cost Recovery System	-	3,102,900
4	Total	$6,175,000	$4,677,800 107/

OCA Statement 2, Schedule 22.

The Staff has advocated the flow through of only the deferred State Income taxes, in accord with our action in Pa. P.U.C. v. Columbia Gas of PA, Inc., R-832393 (August 27, 1984). The OCA has proposed flow through of State and Federal Income Taxes to the full extent which, it concludes, is permitted by law. That includes all deferred Federal Income taxes except those under the ACRS method regarding post 1980 additions, as reflected in the table above. The Company advocates full normalization of both Federal and State income taxes.

The briefs of the parties are filled with the customary arguments which have been propounded for over a

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107/ The Staff has provided the slightly different State income tax figure of $4,579,607.

decade. There are arguments as to whether there is merely a deferral of taxes or an actual tax savings. All manner of customer benefits and customer detriments are argued. The Commission commented on these benefits and detriments in the decision at R-80011069, February 1981, and summarized them as follows:

> Normalization has its advantages and disadvantages. As pointed out by the ALJ, normalization produces the following tax benefits:
>
> 1. it increases the level of internal funds and reduces the need to go into the capital markets;
>
> 2. it does improve before income tax interest coverage which experienced over time may increase a firm's first mortgage bond rating, resulting in a lower debt and common equity cost rate;
>
> 3. it benefits ratepayers where accumulated deferred taxes are deducted from the measures of values; and
>
> 4. it spreads the tax depreciation benefit evenly over the period the property will be used while avoiding discriminating between current and future ratepayers.
>
> On the other hand, normalization
>
> 1. forces ratepayers to become involuntary investors;
>
> 2. forces the ratepayer to provide an additional dollar to pay the resulting increase in current federal and state taxes for every deferred tax dollar provided by ratepayers;

3. produces an inequity since the ratepayer who pays in the first part of an asset life may not be the one who bears [sic] the benefit of underpaying in the latter part of the assets life, and,

4. threatens to deny ratepayers a chance to reap its (normalization's) benefit for a minimum payback period of 22 years, and possibly never if inflation surpasses 10%.

Mimeo, pp. 76-77.

As we view the matter of the matter of flow through vs. normalization, there is (as much as the protagonists might wish it otherwise), no "right" side of, or "correct" resolution of the issue. A resolution of the issue is essentially one of judgment. While regulators and appellate courts have waxed eloquently and at great length in an effort to convince the reader that their instant resolution in a particular case is the "correct" decision, it is "correct" only in the eye of the author and those disposed to resolve the issue in the same way. But upon sifting through the rhetoric, the impartial reader, if there be one, is dismayed to discover that the decision is not based upon an indisputable factual truth or immutable legal principle. The bottom line is that the decision maker has exercised the best judgment available and has rendered a decision which reflects a pure and simple judgment.

As noted in the briefs of the parties, the decisions regarding flow-through vs. normalization in prior Duquesne proceedings (as well as those involving other utilities) have a decidedly checkered history. The OCA has provided the following history:

> Mr. James Ellenberger, Controller of Duquesne, has described the history of Duquesne's tax normalization in Statement 8-2. Duquesne first began normalizing upon its books of accounts the tax benefits produced by using ADR lives beginning January 1, 1971. Duquesne has also normalized the effect of using the double declining balance method. Duq. St. 8-2 at 10-14. More recently, Duquesne has begun using the ACRS tax depreciation system as required by law. Duq. St. 8-2 at 15.
>
> * * * * *
>
> Duquesne first sought to "normalize" its deferred tax expense in rates at R.I.D. No. 89 as filed April 30, 1973. In that case the PUC decided that, even though Duquesne had failed to elect normalization, Duquesne would be allowed to normalize for tax purposes its use of ADR lives and double declining balance accelerated depreciation. Order at 68-69. In a later Order entered February 20, 1981 at Pa. P.U.C. v. Duquesne, R-80011069, the Commission reversed its normalization policy and flowed through to ratepayers the tax advantages of using accelerated depreciation and reduced Duquesne's federal and state income tax expense. Order at 73-81. Subsequently, in an Order entered January 28, 1983 at Pa. P.U.C. v. Duquesne, R-821945, over the dissents of Commissioners Shanaman and Johnson, the PUC rejected any flow through of accelerated depreciation tax benefits in that case. Order at 38-41.

OCA Main Brief, pp. 134-136. There is probably no satisfactory explanation for these conflicting decisions. We would offer no explanation other than that they represent the judgment of the majority the Commissioners then

comprising the Commission, in the context of the facts and circumstances of the particular proceeding.

Our decision at this time is to follow our most recent decision on this subject in Pa. P.U.C. v. Columbia Gas of PA, Inc, R-832393 (August 27, 1984) and to flow through deferred State Income Taxes and to permit the normalization of all Federal Income Taxes. We do not believe that we need extend this discussion and comment upon each point addressed by both the Company and the OCA. We agree that there is considerable merit in their arguments on their respective sides. On behalf of our decision in this matter, we state that it represents our judgment as to the best balance between the claimed benefits and detriments from both sides.

With regard to the adjustments which we shall make, we adopt the figures proposed by the Staff. We shall reduce expenses by income tax expense of $2,472,988 ($4,579,607-$2,106,619 increase in Federal Income Tax expense). Since the reduction in deferred State Income Tax adjustment affects the calculation of deferred Federal Income Tax, the adjustment to the deferred tax reserve is in a like amount. This results in a reduction of the deferred income tax reserve and an increase in rate base of the same amount, that is $2,472,988.

The exceptions of the Company and the OCA to the ALJ's recommendation that we dispose of this matter in the manner which we have, are denied.

VII. RATE OF RETURN

A public utility, is entitled to an opportunity to earn a fair rate of return on the fair value of its property. Pennsylvania Gas & Water Co. v. Pa. P.U.C., 19 Pa. Commonwealth Ct. 214, 341 A.2d 239 (1975); Keystone Water Company White Deer District v. Pa. P.U.C., 19 Pa Commonwealth Ct. 293, 302, 330 A.2d 873, 877 (1975); Riverton Consolidated Water Co. v. Pa. P.U.C., 186 Pa. Superior Ct. 1, 140 A.2d 114 (1958). Rate of return can be defined as:

> ...the amount of money a utility earns, over and above operating expenses, depreciation expense, and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the 'return' are interest on long-term debt, dividends on preferred stock, and earnings on common equity. In other words, the return is the money earned from operations which is available for distribution among the various classes of contributions of money capital.

Public Utility Economics, Paul J. Garfield and Wallace F. Lovejoy (1964), at 116. The return authorized must not be confiscatory, and must be based upon the evidence presented. Pittsburgh v. Pa. P.U.C., 165 Pa. Superior Ct. 519, 69 A.2d 844 (1949).

Although it is acknowledged that the fair rate of return and cost of capital are not always synonymous, we consider the "cost of capital" approach to be one of the important bases upon which a fair rate of return is determined. Lower Paxton Twp. v. Pa. P.U.C., 13 Pa. Commonwealth Ct. 135, 317 A.2d 917 (1974); Pa. P.U.C. v.

Duquesne Light Company, 54 Pa. PUC 695 (1981). In availing ourselves of this generally accepted method of arriving at a fair rate of return, we, the ratemaking authority, first examine the utility's capital structure to identify the sources of the utility's capital and accompanying ratios. We then ascertain the cost of each component; namely, the cost of debt, determined essentially by the annual interest requirement of the utility's bonds, the cost of preferred stock, and, the cost of common stock (common equity), determined by the return required to sell such stock upon reasonable terms in the market. Pa. P.U.C. v. The Bell Telephone Company of Pennsylvania, 57 Pa. P.U.C. 639 (1983); Pa. P.U.C. v. Pennsylvania Power Company, 55 Pa. P.U.C. 552 (1982).

Regardless of the procedure employed in determining fair rate of return, we must exercise "informed judgement". As we stated in Pennsylvania Power:

> The return finding should consider the financial costs being incurred, so that the utility has the opportunity to recover its present cost of capital or to attract needed capital at reasonable cost. A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. It requires the exercise of informed judgment based upon an evaluation of the particular facts presented in each proceeding. There is no one precise answer to the question as to what constitutes a proper rate of return. The interests of the company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at least cost, while at

> the same time maintaining the financial integrity of the utility involved. (Emphasis added).

Moreover, we must adhere to the legal constraints which guide our decision.

In the landmark case of Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), the United States Supreme Court addressed the issue of fair rate of return for a public utility. In Bluefield, the Court stated:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgement, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country in investments in other business undertakings which are attended by corresponding risk and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or

> too low by changes affecting opportunities for investment, the money market, and business generally.

Id. at 692-693.

In establishing the standards to be applied in implementing the Federal Natural Gas Act, the United States Supreme Court, in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944), said:

> The rate-making process, under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interest .... "[R]egulation does not insure that the business shall produce net revenues." (Citations omitted)
>
> But such considerations aside, the investor interest has legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include services on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. at 603.

As noted in these cases, we are required to approve as just and reasonable, rates which will produce

revenues sufficient to enable the utility to recover all reasonable operating and maintenance expenses, depreciation and taxes. Additionally, the utility is entitled to have an opportunity to earn an fair rate of return on the capital invested in the enterprise. Pa. P.U.C. v. North Penn Gas Company, 55 Pa. P.U.C. 425 (1981). We stated in Pa. P.U.C. v. Philadelphia Electric Co., 52 Pa. P.U.C. 772 (1978):

> Among the factors to be considered in determining a fair return are (1) the earnings which are necessary to assure confidence in the financial integrity of the utility and to maintain its credit standing; (2) the payment of dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development and operation.

Finally, we must engage in an appropriate balancing of the rates charged to the customers, for the service provided, with the return to which investors in the enterprise are entitled to have an opportunity to earn.

A. Capital Structure

In view of the absence of any controversy concerning the accuracy of the Company's proposed capital structure ratios, the ALJ adopted these ratios for use in this proceeding. For the future test year ending December 31, 1984, Duquesne employed capital structure ratios of 51.3% long-term debt, 10.5% preferred stock, and 38.2% common

equity. We accept the accuracy of these ratios and shall employ them in this proceeding.

B. Cost of Debt

Duquesne proposes a long-term embedded debt cost of 10.24%.108/ Although Staff accepted this cost rate, the OCA proposed a downward adjustment from 10.24% to 10.19% in the Company's proposed debt cost in order to include an extraordinary gain upon the reacquisition of debt in the calculation of the embedded cost of debt (OCA St. 1, p. 15, Sch. 5)

According to Duquesne witness Brennan, the Company's composite debt cost excluded the effect of a $9.6 million extraordinary gain on a debt/equity exchange in December 1982 when Duquesne traded approximately 1.4 million newly issued shares of common stock for various outstanding First Mortgage Bonds with a face value of about $29.8 million. Company witness Brennan explained the reason for the exchange (Duquesne Statement 12, p. 12):

> ...The Company, as shown by its Securities Certificate and the Commission's Order at S-824862, entered into the exchange of common stock for debt for the sole purpose of creating a gain so as to be able to offset the loss incurred in connection with the disposition of the assets of Allegheny

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108/ No short-term debt was included in the Company's capital structure (Duq. Exh. 12-A, Sch. 2).

> County Steam Heating Company (ACSH) so as to minimize the financial impact and possible resultant increased cost of money to the Company....

Duquesne is of the opinion that offsetting the loss by means of the debt/equity exchange gain reflects good business judgment. As support for its assertion, Duquesne emphasizes that without the $9,600,000 gain, its reported average earnings per share for 1982 would have been $.21 lower or $1.75. Furthermore, in the absence of the debt/equity exchange, the dividend might have had to have been reduced, causing a downward pressure on the stock price, thereby resulting in a higher cost of capital. Finally, Duquesne contends that the debt/equity exchange increased its common equity ratio and decreased its debt ratio, resulting in a improved cash flow.

The OCA, however, maintains that the fact the Company incurred a loss on a totally unrelated transaction does not justify deviation from accepted rules of Commission ratemaking practice. According to the OCA, if the Company wanted to recognize this 1982 loss, it should have proposed an amortization adjustment in its 1983 rate case.

The ALJ rejected the OCA's recommendation and provided the following rationale in support:

> In our opinion, the Consumer Advocate places an inordinate emphasis upon <u>form</u> as against the <u>substantive merits</u> of the procedure utilized by the Company in its treatment of the debt/equity exchange in relation to its debt cost. In our view, the Commission should not reject good business practices and prudent

> management practices, where such activity is reasonable and appropriate under the circumstances, solely upon the basis that the utility has utilized novel or unusual procedures. The Commission must place primary consideration on the end result in establishing just and reasonable rates, rather than being constrained in reaching such goal by undue emphasis and application of procedural niceties. For the reasons stated by the Company, we find its application of the debt/equity exchange in relation to its debt cost to be reasonable.

The OCA filed an exception and emphasizes that the practice of including gains on reacquired debt in the computation of the embedded cost of debt is well established. The OCA submits that this debt/equity exchange results in a higher debt cost than Duquesne actually pays and a higher equity cost due to the changed capital structure.

We agree entirely with the ALJ's resolution of this issue. Therefore, for the reasons set forth by the ALJ, we shall adopt his recommended debt cost rate of 10.24% for use in this proceeding. The OCA's exception is denied.

C. Cost of Preferred Stock

Duquesne claimed a preferred stock cost of 7.69%. No party took issue with this claim and the ALJ recommended our adoption of this cost figure. Accordingly we adopt a preferred stock cost of 7.69% for use in this proceeding.

D. Common Equity

When addressing the issue of equity returns, we have come to expect a wide range of cost estimates. Therefore, the controversy which surrounds the determination of the cost of common equity in this proceeding is to be expected. Due to the extensive record developed on this issue, we shall not be able to note or comment on every supporting argument or criticism presented by the various parties. However, this does not mean that we have not considered the positions which are not specifically addressed in the discussion below.

Before commencing our analysis of the various allowances urged by the parties, it is worthwhile to reiterate our goal, which is to be fair to the stockholders, fair to the ratepayers, and achieve a proper balance between these two conflicting interests.

Presented below are the common equity cost rate methodologies and claims of the parties offering rate of return testimony in this proceeding.

1. Duquesne

Company witness Brennan recommended a 17.0% return on Duquesne's common equity capital, based primarily on the Discounted Cash Flow (DCF) and risk spread analyses. Witness Brennan also considered earnings/price ratios and, as a check on his primary methodologies, performed a Capital Asset Pricing Model (CAPM) analysis.

Witness Brennan gave primary weight to market data for Duquesne, but also considered market data for the Moody's 24 Public Utilities, a Barometer Group of Six A Rated Electric Companies, and a Barometer Group of Five Baa Rated Electric Companies. Rather than solely using a spot dividend yield, witness Brennan also used an average dividend yield in his DCF computations. Mr. Brennan used the following market factors: the spot yield on April 18, 1984 (15.5%); the average yield for the twelve months ended March 31, 1984 (12.8%); the spot yield reflective of the next period growth in dividends (15.8%); and the average yield reflective of the next period growth in dividend (13.1%). The average of these various inputs is 14.3%, which is the dividend yield component utilized by Mr. Brennan in his DCF calculation.

Mr. Brennan's growth factor was based on Value Line's historical and projected dividend and earnings growth rates for Duquesne, as of April 1984, which are as follows:

Historic earnings growth rate - (3.0%)
Projected earnings growth rate - 3.0%
Historic dividend growth rate - 1.0%
Projected dividend growth rate - 3.5%

Mr. Brennan contends that negative growth is not representative of the future nor consistent with the DCF concept which is forward looking. However, Mr. Brennan did calculate two average growth rates, one excluding negative historic earnings growth rate, which is 2.5%, and one including the negative growth rate which is 1.1%. (Duq. Exh. 12A, Sch. 1, p. 3). Combining the average dividend yield of 14.3% with the average growth rate of 2.5% yields an indicated common equity cost rate of 16.8%. The DCF

calculation which includes the negative historic earnings growth rate, produces an equity cost rate of 15.4% (14.3% + 1.1%). Both of these results do not reflect market pressure and selling and issuance expenses.

Utilizing the very same DCF methodology, the DCF indicated cost rate for common equity capital for the Barometer Group of Six A Rated Companies and the Barometer Group of Five Baa Rated Companies, would be, respectively, 16.4% and 18.2% excluding negative historic growth rates, and 16.4% and 17.6% including negative historic growth rates (Duq. Ex. 12A, Sch. 1 p. 3).

Under witness Brennan's two-stage DCF approach, Duquesne's "transitional" growth rate for the next five years would be the average of the 5.5% earnings growth rate and the 1.8% dividend growth rate or 3.6% (Duq. St. 12, p. 42). According to witness Brennan, at the end of five years when a 15.5% earnings/book ratio and a 75% dividend payment ratio are achieved, the "sustainable" rate will be 3.9% for earnings, dividends and book value (Duq. St. 12, p. 41). The average of the 3.6% transitional growth rate and the 3.9% sustainable growth rate is Duquesne's "two stage" growth of 3.8% (Duq. St. 12, p. 42). Adding this growth rate figure to the average dividend yield of 14.3% yields a DCF indicated equity cost rate of 18.1%, before recognizing market pressure and selling and issuance expenses (Duq. St. 12, p. 43).

Giving equal weight to his DCF indicated equity cost rates of 16.8%, 15.4% and 18.1% respectively, witness Brennan submits that a DCF indicated cost rate for common

equity capital is 16.8%, before recognizing market pressure and selling and issuance expenses, which he states is reasonable.

In applying the risk spread analysis to Duquesne data, witness Brennan utilized as a starting point a cost rate of 13.5% for Duquesne's Baa long-term debt (Duq. St. 12, p. 53). According to Mr. Brennan, a 13.5% cost rate for Baa long-term debt is .125 percentage points higher than the 13.375% rate paid by Duquesne in March 1984 (Duq. St. 12, p. 25), but is less than the current interest rate forecast of 14.5% for Baa rated bonds (T. 2781), and less than the interest rate forecast of Blue Chip Financial Forecasts for Aa utility bonds (T. 2927-2929).

To the prospective long-term interest rate of 13.5% Mr. Brennan added a risk premium of 2.5% to 3.5% (Duquesne St. No. 12 at 53). Mr. Brennan explained the calculation of his risk premium as follows:

> By referring to page 1 of Schedule 18, please observe that for companies whose bonds are rated A within a 50 electric company study group experienced a risk spread of 4.0% at the 13.25% interest rate level. Also, it can be seen that for companies whose bonds were rated Baa when interest rates were at the 13.86% level, the risk spread was 3.7%. For Duquesne, the interest rate nearest the 13.5% forecasted rate is an interest rate of 13.09% and the risk spread was 2.6 percentage points. On page 2 of Schedule 18 I have shown similar calculations, but pertaining to the Barometer Group of Six A Rated Electric Companies and the Barometer Group of Five Baa Rated Electric Companies, or

> the same companies I employed in my DCF calculation, as previously described. Please observe that the interest rate nearest the rate forecasted for each group, namely, 13.14% for the A rated electrics and 13.43% for the Baa rated electrics, suggests a risk spread of 4.6% and 2.9%, respectively.
>
> In my judgment, these data suggest that the spread should not be less than 2.5% nor higher than 4.6%. To avoid needless controversy, I have adopted a range of 2.5% to 3.5%. This technique may result in a slightly understated cost rate using the risk spread analysis approach. (Duquesne St. No. 12 at 53-54).

By combining a 13.5% estimated cost rate for Baa rated bonds and a 2.5%-3.5% estimated risk spread (premium) range, Duquesne submits that the indicated cost rate for common equity capital under a risk spread analysis is 16.0% to 17.0%, or a mid-point of 16.5%, before recognition of market pressure and selling and issuance expenses.

In determining his final cost of common equity recommendation, witness Brennan combined his DCF indicated cost rate of 16.8% with his 16.5% risk spread calculation which results in an unadjusted cost of common equity of approximately 16.6%. According to Duquesne, the achieved earnings rate should result in a stock price of approximately 103.% of book value in recognition of selling and issuance expense which suggests a need for an earnings rate at a level of 17.1%. After referring to the results of similar calculations for his barometer groups, and results using more recent data, Duquesne submits that a cost rate for common equity capital of 17.0% is reasonable, conservative, and appropriate for use in this proceeding.

As a point of departure, witness Brennan utilized the earnings/price ratio methodology in estimating Duquesne's equity cost rate. According to Mr. Brennan, the current earnings/price ratio of 16.6% for Duquesne understates the Company's cost of capital. Finally, Mr. Brennan performed a CAPM calculation, only as a check on his final recommendation. This method indicated a 17.2% equity cost rate without any recognition of market pressure, selling and issuance costs.

Staff criticized witness Brennan's use of a spot dividend yield at September 10, 1984, for the reason that the market data could be distorted and the approach is not forward looking. With respect to witness Brennan's risk spread analysis, the Staff considers it improper to base the risk premium solely on data for the calendar year 1980 since the prospective period will not be similar to market conditions in 1980.

The OCA objects to witness Brennan's exclusion, to any degree, of zero and negative historical growth data in his one-stage DCF computation. With respect to Mr. Brennan's two-stage model, OCA witness Merchant made the following comments (OCA St. 1, p. 16):

> Mr. Brennan made the following assumptions:
>
> a. That investors believe that <u>five</u> years from now, the Company will earn 15.50% on book common equity, and that such return will be the 15.50% equity rate calculated by the Commission Staff more than one year ago.

b. That the payout ratio will fall from over 90% currently to 75% by 1988, and will remain there.

c. That new stock will not be sold at net proceeds less than book value.

While these assumptions might be appropriate for certain specific companies, there is no reason to believe that they necessarily represent the reasonable expectations of investors toward Duquesne or the barometer group of companies. In fact, the history of Duquesne's earned return on equity combined with the Company's relatively slowly growing service territory and its financial commitment to new generation, make it very unlikely that investors would make these assumptions in their evaluation of Duquesne's stock.

2. Staff

Staff witness Deardorff recommends a determination of Duquesne's cost of common equity within the range of 15.75%-16.00% with the midpoint, 15.875%, being his final recommendation for cost of service purposes.

In arriving at his final recommendation, Staff witness Deardorff employed a DCF analysis and a risk spread analysis of a barometer group of five independent electric utilities, and also Duquesne-specific market data. According to the Staff, the barometer group is similar to Duquesne in size, financial risk, fuel mix and reserve margin.

For the dividend yield component of Staff's DCF analyses, employing both Duquesne and barometer group market data, equal emphasis was placed on the average dividend

yield for the 1983 calendar year (12.34% and 11.62% respectively) and the twelve months ending June 1984 (13.96% and 12.75% respectively). According to witness Deardorff, the representative nature of these yields was confirmed through a comparative check with a smoothed average yield for the five-year period ending 1983 (Staff St. KLD-1, p. 11; Staff Exh. KLD-1, Sch. 6, pp. 1, 2, 7, 8). For the growth component, witness Deardorff estimated dividend growth rates, representative of the test periods referred to above, derived by weighing equally a five-year historical average and forecasts of Value Line, Salomon Brothers and Staff (Staff Ex. KLD-1, Sch. 6 p. 11). According to Mr. Deardorff, investors could reasonably expect to achieve prospective dividend growth rates of 2.75% and 3.25% for Duquesne and the barometer group (Staff St. KLD-1, p. 12).

Completing the DCF analyses, the addition of dividend yield to growth rate, yields an indicated DCF equity cost rate range of 15.26%-16.90% (and a mean of 16.08%) for Duquesne (Staff Ex. KLD-1, Sch. 6, p. 1). The barometer group's indicated DCF equity cost range is 15.06%-16.21% (with a mean of 15.64%) (Staff St. KLD-1, p. 10; Staff Ex. KLD-1, Sch. 6, p. 2).

For his risk spread analysis, Staff witness Deardorff established average historical risk premiums of 3.80% for Duquesne and 5.07% for his barometer group (Staff Exh. KLD-1, Sch. 7, pp. 1, 2, 3). The risk premium estimates were developed by subtracting forecasted 1985 three-month treasury bill yields from expected DCF equity returns for Duquesne and the barometer group, during the period 1978 through 1983. These estimates were then

combined with the forecasted 1985 three-month treasury bill yields, provided by Standard and Poor's, Chase Econometrics, Blue Chip Indicators, and WSJ Futures Market. According to the Staff, the indicted common equity return rates under the risk spread methodology were 14.93% for Duquesne (with a range of 14.10%-15.50%), and 16.20% for the barometer group (with a range of 15.27%-16.77%) (Staff St. KLD-1, p. 14; Staff Exh. KLD-1, Sch. 7, pp. 3-4).

As indicated by Staff Exh. KLD-1, Schedule 9, Staff witness Deardorff's range of results for Duquesne and the barometer group, based on his DCF and risk spread analyses, is 15.75% to 16.00%, with the midpoint, 15.875%, being his final recommendation. Finally, Staff contends that the earnings/price ratio methodology corroborates witness Deardorff's primary equity costing methodologies (Staff St. KLD-1, pp. 14-15; Staff Exh. KLD-1, Sch. 8).

In addressing Staff witness Deardorff's DCF methodology, the Company first criticizes witness Deardorff's use of average dividend yields for the calendar year 1983 and the 52 weeks ending June 30, 1984. After comparing the upward trend of yields on public utility bonds rated Baa, Duquesne contends that the money market environment for these periods, is not indicative of the period when rates set here will be in effect. With respect to the growth rate component of Mr. Deardorff's analyses, the Company contends that the growth rate is understated as it includes consideration of a totally subjective Staff Estimate, which, it states, is inconsistent with the witness' remaining growth rate inputs. Further, Duquesne

argues that the growth rate estimate also fails to consider earnings growth.

The risk spread analysis of witness Deardorff was also criticized for using forecasts of treasury bill rates as the estimate of a risk free rate. In addition, Duquesne considered it improper to rely on expected DCF returns on equity, which are significantly less than the expected rates of return allowed by this Commission, in prior Duquesne rate proceedings.

3. <u>OCA</u>

According to OCA witness Merchant, Duquesne should be given the opportunity to earn 15.82% on its common equity. Mr. Merchant arrived at his final recommendation by using the DCF methodology to obtain a Duquesne-specific estimate, and then checked the result against similarly derived DCF estimates for a barometer group of 13 companies. As his barometer group, Witness Merchant selected 13 eastern United States electric companies, with characteristics similar to Duquesne in bond rating, risk associated with uncompleted nuclear construction projects, and other financial indicators (OCA St. 1, Sch. 3).

The dividend yield component of Mr. Merchant's DCF formula was derived as follows (OCA St. 1, p. 11):

> For the divisor of the yield calculation, I have averaged the monthly high and low stock prices for each of the last 12 months (July 1983 through June 1984), using data from the S&P Monthly Stock Guides. The dividend, or "D" term of the DCF model,

> is determined by annualizing the current quarterly dividend for each company and adjusting this annual dividend rate by the growth rate, "g" [to be described below]. This procedure essentially forecasts the dividend for one full year. The adjusted dividend is then divided by the average price to produce the adjusted yield.

Witness Merchant calculated an adjusted dividend yield of 14.19% for Duquesne, and 12.28% for the barometer group (OCA St. 1, Sch. 2).

Mr. Merchant described his computation of the growth rate as follows (OCA St. 1, pp. 10-11):

> I have elected to estimate "g" in two ways. One estimate of "g" is based on the historical trend of "g". The other estimate of "g" is based on a set of analysts' forecasts of "g". I believe that the "g" most likely to represent the consensus view of investors can be expected to fall within these limits. ...
>
> I have employed the Value Line "86-88" forecasts of EPS and DPS growth (averaged) as the forecast estimates of "g" for Duquesne and each of the sample companies. These forecasts are widely disseminated and are available quarterly for most electric utilities. ...
>
> The choice of data for developing an historical growth rate is a choice among a large number of possibilities.... The 10 year compound growth rates for DPS and EPS have been averaged to derive the historical estimate of "g".

For Duquesne, Mr. Merchant calculated a growth rate of 1.63%, and a 3.85% growth rate was calculated for the

barometer group. Witness Merchant explained the difference (OCA St. 1, pp. 14):

> Q. Duquesne's estimated growth rate of 1.63% is significantly lower than the sample average. Is this estimate reasonable, compared to the sample?
>
> A. Yes, I believe it is reasonable in light of Duquesne's yield. The fact that Duquesne's yield is over 160 basis points higher than the sample yield indicates that investors do not view Duquesne as having the growth potential of the sample utilities. This is partly due, in my opinion, to Duquesne's very low retention ratio, relative to that of the sample. In 1984, for example, Duquesne's estimated retention ratio is about 12.3%, while the sample average retention ratio is about 28.5%. No company in the sample has a retention ratio lower than 21%. (Calculated from Value Line data.) If investors actually expected higher growth in earnings and dividends for Duquesne than 1.63%, the yield on the stock would be much closer to the average yield of the sample.

Combining the respective dividend yields with the respective growth rates results in a DCF estimated equity rate for the group of 16.13%, compared with 15.82% for Duquesne which is the OCA's final recommendation.

Because of the subjectivity associated with the use of the DCF methodology, the Company considers it imperative to utilize more then one methodology in arriving at an appropriate cost rate for common equity. Furthermore, the Company objects to witness Merchant's exclusive use of a 12-month average dividend yield ending June 30, 1984. Duquesne argues that exclusive use of this period

understates its current and anticipated prospective dividend yield.

With respect to witness Merchant's growth estimate, Duquesne criticizes his inclusion of a negative 1%, ten-year historic annual earnings growth rate, as being inappropriate as it is the product of an out-of-date, substandard earnings rate.

4. ALJ's Recommendation and Exceptions

The ALJ's dividend yield recommendation of 13.5% (rounded) is based upon the average of the three dividend yield recommendations and the spot dividend yield of 13% at November 12,1984. Taking into consideration the OCA's recommended growth rate, without the negative growth portion, the ALJ recommended a growth rate of 2.5% for a recommended DCF common equity cost rate of 16.0% (13.5% + 2.5% = 16.0%). Similarly, the ALJ recommended a 16.0% risk spread common equity cost rate based on Company witness Brennan's forecasted bond yield of 13.5% and the risk premium of 2.5%. Based on the DCF and risk spread analyses, the ALJ recommended a 16.0% common equity cost rate for Duquesne. Exceptions to the ALJ's recommendation were filed by the Company, Staff, and the OCA.

5. Discussion and Conclusion

For reasons which will be discussed below, we consider the ALJ's recommended return on common equity to be

slightly overstated in view of our determination that a cost rate for common equity of 15.82% is fair and reasonable. The primary methodologies advanced by the witnesses were the DCF and risk spread analyses.

The DCF analysis is a market-based technique, which is founded upon the principle that the present value of stock is a discounted value reflecting the future anticipated payments, which are comprised of cash flows in the form of anticipated future dividends and capital gains upon the sale of the investment. Pa. P.U.C. v. Metropolitan Edison Company, R-822249 (October 19, 1983); Pa. P.U.C. v. Duquesne Light Company, R-821945 (January 28, 1983); Pa. P.U.C. v. Pennsylvania Power Company, R-811510 (January 22, 1982); Pa. P.U.C. v. Dauphin Consolidated Water Supply Company, R-80061242 (April 3, 1981). In order to calculate the cost of equity as a percentage, the following formula is utilized: Cost of Equity = dividend yield (dividend/market price of stock) + future growth.

In arriving at his unadjusted DCF indicated equity cost rate of 16.8%, Company witness Brennan averaged the results of his two-stage DCF approach which indicated a cost rate of 18.1%. The OCA pointed out that witness Brennan's two-stage growth methodology is based on the validity of certain assumptions, i.e., at the end of five years a 15.5% earnings/book ratio and a 75% dividend payment ratio will be achieved. In other words, it is Mr. Brennan's assumption that investors believe that five years from now the 15.50% return on equity will be earned for the first time (Tr. 241). However, there are a variety of reasons why Duquesne, or any utility, may not earn its Commission

authorized rate of return including a downturn in the local economy, a burdensome construction program, or inefficient management. Therefore, we are not, at this time, prepared to accept the assumptions upon which the two-stage DCF approach is based.

Consistent with the Company's approach, the OCA utilized Duquesne-specific market data in its DCF methodology. The OCA calculated a dividend yield of 14.19% by averaging the monthly high and low stock prices for July 1983, through June 1984, and annualizing the current quarterly dividend, adjusted by the growth rate (OCA St. 1, p. 11). We believe that use of this 12-month average will mitigate any abnormalities in the price of stock over this period. Pa. P.U.C. v. PG&W, R-80071265 (April 24, 1981). The OCA's recommended dividend yield of 14.19%, which we find reasonable, is only 11 basis points below the Company's recommendation of 14.3% and 119 basis points above the spot dividend yield calculated by the ALJ at November 12, 1984.

Furthermore, in view of this relatively high yield, compared to the 12.28% dividend yield for the OCA's barometer group, we do not believe that investors expect a high growth rate (OCA St. 1, p. 14). OCA witness Merchant explained that "Duquesne's estimated retention ratio is about 12.3%, while the sample average retention ratio is about 28.5%". Therefore, we shall settle upon 1.63% as the growth rate component in our DCF analysis.[109/] Although the

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109/ As further support of its growth rate estimate, the OCA notes the 1.5% normalized five year estimate of Duquesne's earnings per share by Dean Witter Reynolds (Statistical Review, May 1984) (Tr. 1672).

OCA witness uses 10-year historical earnings and dividend growth rates to arrive at his recommendation, we have relied on 10-year historical growth data in the past, when the record warranted such reliance. Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc., R-832393 (August 27, 1984). Finally, we recognize that Mr. Merchant's grow rate calculation includes a negative 1% ten-year historic annual earnings growth rate. However, we note that Company witness Brennan includes negative historical growth data in his one-stage DCF analysis. Since witness Merchant's growth rate recommendation does not rely solely on this data, we believe, given Duquesne's extremely low retention ratio, that an investor's perception of this data should not be ignored.

Combining a dividend yield of 14.19% with a 1.63 growth rate results in a DCF indicated common equity cost rate for Duquesne of 15.82%. For purposes of comparison, a DCF indicated common equity cost rate of 15.82% is within the range of Staff witness Deardorff's DCF equity cost rate recommendation of 15.26%-16.90% for Duquesne and 15.06%-16.21% for his barometer group. Witness Deardorff placed emphasis on the average dividend yield for the 1983 calendar year and the twelve months ending June 1984. We consider this near-term and historic data to be representative of reasonable investor expectations. See e.g. Pa. P.U.C. v. UGI Corporation-Gas Division, R-832331 (January 27, 1984). Furthermore, Staff witness Deardorff's DCF growth rate for Duquesne of 2.75% is comparable to Company witness Brennan's one-stage DCF growth rate of 2.5%, which excludes the negative historic earnings growth rate.

In the risk spread analyses presented here, the cost rate for common equity was determined by the cost of prospective long-term debt, plus a risk premium to reflect the fact that common equity generally is perceived as being riskier than debt.

The cost associated with a prospective long-term investment is comprised of a "bare rent" for the use of the capital, and an inflation protection component. In his risk spread analysis, Company witness Brennan utilized a cost rate of 13.5% for Duquesne's Baa long-term debt as the risk free rate of return. The Company criticized Staff witness Deardorff's calculation of the risk free return stating that only the Wall Street Journal treasury bill futures rate, is the product of actual investor decision, i.e. 11.7% is the treasury bill rate expected by investors for 1985 (Tr. 1736). However, a comparison of the two cost rates, 13.5% and 11.7%, indicates that Duquesne's long-term debt cost is substantially higher than treasury bill futures. We believe that this difference reflects risk factors, both financial and business, which renders witness Brennan risk spread analysis suspect.

In conclusion, we consider the OCA's common equity cost rate recommendation of 15.82% to be reasonable, as it represents the most accurate prospective cost rate for Duquesne's common equity capital. We recognize again, with particular emphasis, that the OCA's recommendation of 15.82% is within Staff witness Deardorff's recommended range of

15.75% to 16.00%.110/ Finally, we again find it unnecessary to make any adjustment for market pressure issuance and selling expenses. See e.g. Pa. P.U.C. v. UGI Corporation-Gas Utility Division, R-832331 (January 27, 1984).

Based on the foregoing, we shall utilize 15.82% as our cost rate for common equity, which, combined with our findings with respect to capital structure, cost of debt and cost of preferred stock yields an overall return of 12.10%, as shown below:

Summary of Recommendation

Type of Capital	Ratio %	Cost Rate %	Weighted Cost %
Debt	51.30	10.24	5.25
Preferred Stock	10.50	7.69	.81
Common Equity	38.20	15.82	6.04
	100.00		12.10

110/ For this reason, we have not found it necessary to extensively address Staff's recommendations.

VIII. RATE STRUCTURE

ALJ Matuschak, in the Recommended Decision, describes the methodology used and cites the applicable provisions contained in the Public Utility Code with which we are concerned in determining just and reasonable rates for Duquesne in this proceeding, to wit:

> Public utility rates must enable the utility to recover its costs of service, including allowed return, and to spread such cost among its customers in a just, reasonable and nondiscriminatory manner. The Public Utility Code, 66 Pa. C.S. [§1301], provides, in part:
>
> Every rate made, demanded, or received by any public utility, or by two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the commission...

And in Section 1304, it is further provided, in part:

> No public utility shall, as to rates, make or grant any unreasonable preference or advantage to any person, corporation, or municipal corporation, or subject any person, corporation, or municipal corporation to any unreasonable prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates, either as between localities or as between classes of service....

Generally, there are two basic determinations to be made in a rate proceeding: (1) how much of an increase (or decrease) is required by the utility (revenue requirement), and (2) how should the increase (or decrease) be spread among the different customer classes (rate

structure). Rate structure can be further divided into two sub-issues: (1) the appropriate distribution of the increase (or decrease) among the various customer classes, and (2) the appropriate rate design within each class to provide the previously mentioned revenue requirement. (R.D., p. 108)

A. Cost of Service Study

The ALJ stated the reasons for utilizing a cost of service study, the method used in developing such a cost of service, and the factors, other than cost of service, which are considered in determining just and reasonable rates, to wit:

> A cost of service study is a procedure for the allocation of plant investment, revenues and expenses to classes of service and serves as a foundation or beginning point in the determination of just and reasonable rates. Pa. P.U.C. v. Duquesne Light Company, R-821945 (1983).
>
> A cost of service study consists of three steps: functionalization, classification and allocation. Functionalization is the separation of plant and costs into the major functions such as power production, transmission or distribution. The second step, classification, is the separation of plant or costs into groups which recognize service characteristics such as demand, energy consumption or number of customers. The third and final step, allocation, is the assignment of the functionalized and classified plant or cost to particular rate classes.
>
> It must be remembered, however, that the cost of service studies are not perfect or

> precise. Even if the cost of service studies are done in a craftsmanlike manner, this does not mean that they can be relied upon exclusively. It is not the only consideration in the allocation of revenue; while cost is important, other factors must also be considered, such as avoidance of discrimination between customers, maximization of efficient use of facilities, establishment of rates that have a reasonable relationship to each other, social costs, and considerations of changing conditions. Rate structure, which is an essential, integral component of ratemaking, is not merely a mathematical exercise applying theoretical principles. Rate structure must be based on the hard economic facts of life and a complete and thorough knowledge and understanding of all the facts and circumstances which affect rates and service; and the rates must be designed to furnish the most efficient and satisfactory price for the greatest number of customers in a fair manner. (R.D. pp. 109-110).

A cost of service study utilizing the 12 months ended December 31, 1983 (1983 Cost of Service Study) was presented in the instant proceeding and supported by the testimony of William M. Hayduk, Director of Cost and Load Research for Duquesne. Mr. Hayduk testified that Duquesne monitors its cost allocation procedure on an on-going basis and takes all steps necessary to insure that all changes in Duquesne's operations and all changes in the customers' use of the system are reflected in the Company's cost of service allocation. Duquesne's 1983 Cost of Service Study follows the same allocation procedures as previous studies accepted by the Commission. (Duquesne's St. No. 16-2 at 1-2).

The Company's proposed revenue/increase allocation is as follows:

Rate Schedule*/	Base Revenue ($)	Increase (%)
RS	12,623,224	5.55
RS-WW	899,438	8.23
RH	479,307	5.41
RH-WW	535,837	7.19
Total Residential	14,537,806	5.71
GS	531,525	5.99
GM	8,608,390	5.56
GL	6,685,896	5.24
GMH	680,490	5.48
GLH	740,065	5.02
L	9,018,128	4.97
Total General Service	26,264,494	5.26
Total Street Lighting	846,593	6.07
Total Retail	41,648,893	5.42

(Duquesne Exhibit Ib-J-2)

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*/ RS designates Residential Service, RH designates Residential Heating, and WW designates Electric Water Heating. GS, GM and GL designates Small, Medium and Large General Service Customers, respectively. H signifies General Service Heating customers.

1. Allocation of Demand Related Production Plant and Expenses

Given Duquesne's high daily and annual load factors, its relatively small summer-winter peak differential and its customer mix, the Company allocated demand related production plant and expenses using the

average and excess methodology. (Duquesne Exhibit No. IV, Item IV-C-15 at 19). The average and excess demand cost allocation distributes a portion of total demand responsibility according to the average demand of each class of service. The average and excess demand method and purported advantages are described in Duquesne Exhibit No. IV, as follows:

> The Average and Excess Demand Method allocates demand costs in a two-part formula. A portion of demand costs is allocated based on the average demand of the classes. The remaining demand costs are allocated based on the excess of class maximum demands over class average demand. This method has the advantage of recognizing the impact on costs of both energy consumption and maximum demand. By considering both energy and demand, the importance of class load factor, or relative use of facilities, is incorporated into the study. Diversity is also considered with the benefit of diversity allocated on the basis of load factor. The low load factor customers receive a greater proportion of the benefits of diversity. One of the most important advantages of this method is that stable results are produced. This is particularly critical on a system such as Duquesne's, where one or more customers with extremely large loads can drastically affect the system peak at any time. In the Average and Excess Method the loads composing the system peak are not considered, but class peaks, which are generally more stable, are used. It is Duquesne's opinion that the Average and Excess Demand Method meets more of the selection criteria than other available methods and, therefore, is the method most appropriate for Duquesne's system for power production and transmission

plant. (Duquesne Exhibit No. IV, Item IV-C-15 at 20-21)

OCA witness Oliver criticized the Company's allocation of demand related production and transmission plant and expenses using the average and excess methodology, urging instead that this Commission employ a coincident peak allocation in recognition, in his view, of the fact that the Company's investments in bulk power supply facilities are reflective of a joint consideration of energy and demand requirements.[111/] (OCA St. 3, p. 19). Mr. Oliver presented the following testimony in support of his views as to the proper allocation of power production and transmission plant and expenses for Duquesne:

> The incurrence of demand-related production and transmission capacity oosts is driven by coincident system load requirements. Both the planning and operation of the Company's bulk power supply system are based on the system's coincident load requirements. The diversified peaks of individual customers or classes of customers are not important to these activities. The planning and dispatch of generation and transmission facilities focus primarily on actual and anticipated coincident system requirements, and these activities are essentially unconcerned with whether those demands emanate from residential, commercial, industrial or street lighting customers. I note that the testimony and exhibits of Duquesne witness Bartosh, the Company's

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111/ Essentially, Mr. Oliver is proposing that Duquesne's average and excess methodology be adjusted to as to use the peak demand method to allocate the excess demand, as contrasted with the non-coincident demand method used by Duquesne.

> Director, Bulk Power Section, System Planning Department, provide no discussion of, or reference to, class non-coincident peak demands. In his assessments of bulk power system capacity requirements, he relies exclusively on measures, or estimates, related to coincident system peak demands and system energy requirements. Likewise, the dispatch of Duquesne's generating equipment is solely a function of coincident customer requirements. The aggregation of non-coincident class demands has no role in Duquesne's dispatch operations. Thus, an allocation of bulk power capacity costs which relies on measures of class non-coincident peaks is a clear distortion of the manner in which Duquesne incurs those costs.

(OCA St. 3 at 18-19).

Trial Staff has accepted the Company's average and excess methodology of allocating demand-related production plant and expenses.

Hospital Council of Western Pennsylvania and United States Steel Corporation oppose the peak and average demand method proposed by the Consumer Advocate.

LTV states that for purposes of this case, the coincident peak cost of service study should be used because it is based upon actual, unadjusted data. It further claims that the studies using non-coincident peak data cannot be used because they are based upon imaginary data and do not portray actual costs incurred.

Armco submits that the Commission should distribute the rate increase to rate schedules based on the

results of the coincident peak cost of service method to achieve the Company's goal of uniform rates of return.

The matter of a proper allocation for production and transmission plant and expenses was at issue in the proceedings at Docket No. R-80011069. We therein discussed the rationality behind and the benefits flowing from the average and excess methodology, thus.

> In its cost of service study Duquesne adopted the Average and Excess Demand Method ("AED") to allocate demand costs to rate schedules. Excess demand was allocated on the Non-Coincident Demand ("DCD") basis (rather than the Peak Responsibility, or Average of Significant Peak Demand methods), all three of which methods are generally recognized and accepted. Average demand was allocated on the basis of energy, as is customary.
>
> * * *
>
> ...The essence of this method...is to classify a portion of what would otherwise be classified as demand costs as energy related costs, to be allocated to rate classes on that basis. The balance of demand classified costs are allocated on a variety of methods... In this instance maximum demand costs are allocated by Duquesne on the Non-Coincident Demand basis... Cost allocation methods have been debated by rate engineers most vigorously since the early 1920's. Those same debates, with little change in substance, are heard today. The method employed by Duquesne is one of four methods, (among almost dozens proposed from time to time) described and discussed in The Electric Utility Cost Allocation Manual, published by the National Association

> of Regulatory Utility Commissioners (1973) as those most frequently employed... we find no evidence which indicates that Duquesne's method should be rejected in favor of some alternative method....

The ALJ concluded here that the Company's average and excess methodology was a fair and equitable method of allocating costs; that unlike exclusive or even partial reliance on a coincident peak allocator, average and excess prevents customers operating off-peak or customers having large fluctuating loads, from benefitting from plant paid for by others. He also concluded that by considering both energy and non-coincident demand, the importance of class load factor, or relative use of facilities, is incorporated into the study.

The Consumer Advocate's proposal involves measurement of peak responsibility on the average of three months -- July, August and December. The value of the Consumer Advocate's peak demand allocation factor depends on whether or not a customer group is making demands on the system during the three monthly peaks. The result for customer classes not peaking at these three peak hours is a reduced peak component in the peak and average methodology which enables these classes to enjoy the benefit of plant paid by others. With a large industrial class, such a result could be significant upon Duquesne.

The testimony of Dr. Melvin P. Bloom, on behalf of LTV, recommends that we reject the average and excess methodology and apply a coincident peak methodology to set the rates in this proceeding. Dr. Bloom's recommendation is based on his belief that Duquesne's determination of non-coincidental peak data is deficient. Our view

concerning this recommendation was explained in Pa. P.U.C. v. West Penn Power Company, R-80021082 (1981);

> The single peak demand allocation method used by West Penn fails to recognize that bulk power supply costs are caused by peak demand requirements as well as by average demands. West Penn's method benefits large customers at the expense of the small user because the large users are not paying their share of the additional cost of generating units which are constructed to provide the lower cost base-load generation. (Mimeo, pp. 38-39)

The record shows that large fluctuating loads exist on Duquesne's system at several large electric steel making electric furnace customers, and impose substance demands on the system during a number of months of the year. However, because of economic conditions, production schedules, or other factors, these customers may have a small demand at the hour of the system peak. Contract provisions guarantee that a large amount of capacity is available for such a customer's use at all times. As a consequence of the contract provisions, such a customer imposes a constraint on the system capacity. The coincident peak methodology disregards these considerations.

We concur with the ALJ that Dr. Bloom's coincident peak methodology recommendation is not appropriate for use in this proceeding.

Because non-coincident peaks are generally more stable than other peak measurements, more stable cost allocation results from Duquesne's application of average and excess. This is particularly critical on a system such

as Duquesne's, where one or more customers with extremely large loads can drastically affect the system peak at any time.

We find the Company's allocated demand related production plant and expenses, using the average and excess methodology, to be acceptable for the purpose of this rate proceeding.

2. Allocation of Distribution Plant

Duquesne's cost of service study allocated distribution plant on a demand/customer basis. The Company contends that this allocation methodology is consistent with and based on the same theory accepted by this Commission in the proceedings at Docket No. R-821945, and with the position set forth in the Electric Utility Cost Allocation Manual published by the National Association of Regulatory Utility Commissioners (Duquesne St. No. 16-2 at 31-33). Duquesne thus described its rationale regarding a determination of the customer component of distribution plant:

> The customer component of distribution plant is a theoretical minimum size system that is required to serve a customer with an infinitely small load and represents the costs of just being a customer. This system can be represented as wet thread supported by long tooth picks to serve a Christmas tree light. Basically, it is a cost that measures customer density. If two customers are served from a pole, each customer would share the customer component of the pole.

> If only one customer were served from the pole, his customer component of poles would be twice that of the previous example.
>
> The customer component concept is recognized throughout the United States. The existence of this cost has been demonstrated in the past by the comparison of costs of a privately owned utility and those of the REA served by a privately [sic] [sic] owned utility. Rigorous regulation by State and Federal regulatory authorities maintain approximately equal demand and energy costs at the production level for Retail and Resale customers. Thus, demand and energy costs to the input of both distribution systems are approximately equal. The REA, however, will generally have higher rates for service than does the privately owned utility. Bearing in mind the REA and the utility have equally efficient distribution systems, i.e., they can both move a KW over the same distance at equal cost, the difference in costs is due to the fact that most REA's have less customer density than the corresponding privately owned utility. A utility may have 2 customers served from a pole whereas the REA may have 5 poles per customer. This is a result of customer density and is definitely a customer component of cost.

(Duquesne Ex. No. 31B, Item 129, pp. 5-6).

In the Duquesne allocation methodology used for distribution plant, the customer component is based on the labor cost of installing the minimum distribution system. This approach assumes that each component of the distribution system is replaced by the minimum sized component which Duquesne normally installs. This cost of labor to install this minimum sized component becomes the customer component. The difference between the minimum

system labor and the actual book labor is classified as demand related.

The OCA contests the Company's customer component methodology,[112] urging instead that it is more reasonable to assume the use of class non-coincident peak demands for the allocation of distribution Account Nos. 364-368.[113] (OCA St. 3, p. 29). OCA witness Oliver contends that the OCA's recommendation is consistent with how this plant serves customers; that is, by providing the ability to meet peak demand for each customer. The OCA therefore requests that we functionalize Account Nos. 364-368 on the basis of non-coincident demand and customer basis.

Although we recognize that there may be substantial differences of opinion as to the proper methodology to be followed for allocating distribution plant costs, we continue to be of the view, expressed in Pa. P.U.C. v. Duquesne Light Company, R-821945 (1983), mimeo at p. 70, that costs must be incurred in planning, constructing and operating a distribution system which have no relationship to capacity required to deliver maximum and lesser demands for electricity. Similarly, we stated in Pa. P.U.C. v. Duquesne Light Company, R-811470 (1982):

112/ The OCA also contends Duquesne has provided no basis for assuming that it expended $141.4 million simply to serve those customers in a minimum or skeletal distribution system.

113/ The OCA only accepts a customer component for Account No. 369, Services.

> Mr. Miller argues that distribution facilities are sized to serve peak demands not to serve numbers of customers since lines must run up and down each street regardless of the number of customers located thereon. We find this argument unpersuasive. While strictly speaking distribution facilities are sized to serve peak demand, the utility investment in distribution facilities is the result of both size and length and generally the greater the number of customers the greater the length. We have considered all of Mr. Miller's arguments that investment in distribution facilities is in no way a function of number of customers and we are unpersuaded that such is the case. Therefore, we reject Mr. Miller's position. (Mimeo at 21)

We concur with the ALJ that Duquesne has properly supported the use of a customer component in the allocation of distribution plant costs in this proceeding.

3. Allocation of General Plant-Account No. 397.4

In Duquesne's cost of service study used in this proceeding, the investment in General Plant was analyzed by separating the items into sub-accounts based on the characteristics of the items included in the account, and then each item was functionalized based on the primary function found appropriate for each item.

The telephone system in Account No. 397.4 is functionalized and classified as customer related on the basis that the primary function of the telephone system is the processing and coordination of customer inquiries,

requests, new business activities, and other customer service activities (Duquesne St. No. 16-2 at 40).

The OCA disagreed with the Company's use of the number of customers as a basis for allocating telephone equipment costs, and recommended that the allocation be based upon labor costs for the reason that the need for telephone equipment is closely related to the number of employees. (OCA St. 3, p. 33-34). Until such time as an investigation of the factors contributing to the incurrence of these costs can be completed by the Company - at a cost, contends Duquesne, which could not be justified by the minor increase in accuracies achieved -, the OCA urges that these costs be allocated on the basis of labor costs.

We will accept Duquesne's allocation factor for this account. Although the OCA has raised an issue regarding the propriety of allocating this account by the number of customers, it has not presented any substantial evidence which would persuade us to change this allocation method.

We hereby accept Duquesne's cost of service study in this proceeding as a reasonable guide to our determination of the revenue allocations in this proceeding.

B. Rate Structure

1. Rate L Contract Terms

Duquesne's present Rate L Schedule requires an initial five year contract term for contract demands of

100,000 Kw or less, and an initial ten year contract term for Rate L loads with contract demands exceeding 100,000 Kw. A three year written cancellation notice is required in both cases; as a consequence, the contracts have a "rolling three year term" following their initial term in situations where no cancellation notice has been given. No changes were proposed by Duquesne in these provisions which have been in effect for more than 25 years and were not challenged in the ten Duquesne rate cases going back to 1969 (Duquesne St. No. 4-1 at 7). Trial Staff witness Rosenthal and LTV witness Bloom proposed revisions in these provisions.

Mr. Rosenthal proposes to reduce the existing three year cancellation period in Rate L to 60 days in the case of customers with contract demands of 100,000 Kw or less, and to one year in the case of customers with contract demands exceeding 100,000 Kw. Mr. Rosenthal proposes that this change be implemented on the effective date of the new tariff filing for all existing contracts with existing customers. Although he did not indicate that he was advocating a change in the initial five to ten year terms, Mr. Rosenthal is proposing that following the initial term, all contracts be only one year in duration for customers with demands of 100,00 Kw or less, and of only a two year duration with customers with demands above 100,000 Kw.

LTV witness Bloom recommends that the Commission require Duquesne to permit all contract reductions desired by its large customers.

If Mr. Rosenthal's proposed changes were implemented on the effective date of the new tariff filing

resulting from this rate case, twelve of fifteen Rate L customers which have already given Duquesne the three year notice to cancel their respective contracts could cancel or renegotiate their contracts immediately since the initial terms of their contracts have expired. The total contract demand of these twelve customers is 510,000 Kw, and the Company's total 1983 annual revenues from these customers was about $90,000,000. Duquesne estimated the actual impact of Mr. Rosenthal's proposal under present conditions to be a reduction in contract demands of about 250,000 Kw, with an annual revenue reduction of approximately $20,000,000 to $30,000,000. This reduction is equivalent to about 50% to 75% of the revenue increase being sought in this proceeding. If Dr. Bloom's recommendation that the Commission require Duquesne to permit all contract reductions desired by its large customers were implemented, in addition to the 250,000 Kw reduction associated with Mr. Rosenthal's proposal, Duquesne estimates an additional 100,000 to 125,000 Kw and $5,000,000 to $10,000,000 of annual revenue could be lost.

The ALJ recommended that the Rate L revisions proposed by Trial Staff witness Rosenthal and by LTV witness Bloom be rejected because the existing contract terms which Trial Staff and LTV propose to eliminate, provide Duquesne with revenue stability and protect other classes of customers.[114] (R.D., pp. 124-125).

114/ We agree with the ALJ that the burden of proof on this issue clearly rests with Duquesne. We do not, however, agree with the ALJ that Duquesne has met this burden of proof. See Section 315(a) of the Public Utility Code, 66 Pa. C.S. §315(a).

In its exceptions, Trial Staff urges adoption of its recommendations as being imperative to maintaining and developing industrial customer load in the Duquesne service territory. Trial Staff further contends that Duquesne's existing Rate L requires a three year cancellation notice from customers (TS St. RAR-1, p. 7), the longest notice required of any jurisdictional electric utility. (TS St. RAR-1, p. 6, TS Ex. RAR-1A, Sch. 6). Trial Staff also contends such provisions can negatively impact the customer's production modifications, conservation and load management efforts. Trial Staff witness Rosenthal testified that inasmuch as many investments in load management and conservation techniques are premised on a payback of less than five years, a three year cancellation period can be a significant roadblock to achievable savings in a reasonable time period. Trial Staff therefore recommends, that for customers with contract demands below 100,000 Kw, the contract terms be reduced from five years to one year after the initial terms, with a sixty day cancellation notice prior to the end of the contract. Trial Staff further recommends that contracts, for customers in excess of 100,000 Kw, be reduced from a ten year to a two year term after the initial term, with a one year cancellation period prior to the end of the contract. TS St. RAR-1, p. 6.

Since Duquesne has already received cancellation notices from twelve customers, Trial Staff contends that present tariff provisions (cancellation provisions) for Rate L do not in fact provide a level of revenue stability.

Trial Staff therefore urges that its recommendations concerning Rate L be adopted in order that Duquesne be required to provide incentives to its customers

to maintain existing loads and to attract new industrial loads. Trial Staff further contends that Duquesne's inflexibility regarding its industrial customer contract terms has caused significant industrial load loss.

LTV also excepted to the recommendation of the ALJ that the proposed Rate L contract term modifications recommended by Trial Staff be rejected.

LTV contends that a shorter cancellation notice will enable Duquesne better to evaluate its future requirements; and that if the contract terms are shorter, there will of necessity be a closer liaison between Duquesne and its customers, resulting in more accurate load forecasting. (Tr. 2632-2633; 2655-2656). LTV also argues that Trial Staff's proposal would give customers a better opportunity to enjoy the fruits of their conservation investments, since the long termination notice currently in effect under Rate L discourages conservation by unduly prolonging the commencement of the pay-back period.

LTV argues that the long contract term provisions are not required at the present time when Duquesne has excess capacity on its system, and that shorter contract terms will encourage customers to enter into contracts without the fear of being locked into long-term burdensome contracts.

We have carefully considered the arguments of Duquesne, Trial Staff and LTV on the issue of the reasonableness of the contract terms under Duquesne's currently effective Rate L and conclude that a shorter cancellation period clearly would be in the public interest,

beneficial both to Duquesne's customers, existing and potential, and to Duquesne's retention of existing industrial loads. We agree with Trial Staff and LTV that the present cancellation notice periods negatively impact customers' production modifications, and conservation and load management efforts, since many customer investments in load management and conservation measures have a pay-back period considerably less than five years. We do conclude that Duquesne's adherence to existing contract terms under Rate L has been a contributing factor to industrial load loss.

We conclude that the contract termination notice required under Rate L should be revised by providing for a one year contract termination notice under all Rate L contracts, and Duquesne is directed to appropriately so modify its present Rate L tariff provisions. Our conclusion in this regard derives from our judgment that existing contract termination provisions discourage a closer liason between Duquesne and its customers, discourage the implementation of load management and conservation measures by Duquesne's customers, and discourage the maintenance of existing industrial loads and the attraction of new loads. Reduction of contract termination periods should contribute to a more vigorous, healthy and productive industrial base in Duquesne's service territory.

2. Minimum Charge Provision

Duquesne's rate schedules L, I, GL, GM and the commercial heating schedules currently contain minimum bill provisions. These provisions, with the exception of

Rate GM, provide that the minimum shall be the product of $5.24 and the maximum Kw demand during the life of the contract. As to Rate GM, the minimum charge is the product of $5.24 and the Kw of demand in excess of 5 for either the current month or 50% of the highest demand during the preceding eleven months.

Duquesne proposes to increase the applicable charge to $5.70. LTV, a rate schedule L customer, proposes the elimination of the minimum charge provision in its entirety, because, it says, the charge "serves no legitimate purpose, and Duquesne Light has not justified its continuation" (Main Brief, p. 25). LTV further states that:

> There is no support, no study, and no explanation for this increase offered. The cost of service witness, Mr. Hayduk, professed no knowledge at all of this rate component which according to Mr. Maxwell accounted for more than $8 million of revenue from Rate L alone during the historic test year. It is not known how much revenue came from this provision under Rate GL which presumably had 120 bills calculated thereunder. There is no quantification in the record to show the units billed or the dollars produced.
>
> Further, Dr. Bloom observed that there is no justification for increasing the minimum charge. If its purpose is to recover costs already incurred to provide service, there is no justification for increasing it further, especially when it applies only when service is not taken. In this respect, the minimum charge is like the untransformed service credit which Duquesne Light does not increase on the theory that it recovers "sunk" costs.

> Over a period of recent rate cases the minimum charge has increased at a much greater rate than the demand charge. The result is to change the terms of the contract entered into by customers at a time when the relationship between the minimum charge and the demand charge was lower. This appears from a consideration of the LTV situation at its Southside works as described by Dr. Bloom in his surrebuttal testimony at Tr. 3724-3726. In the 1978 tariff which was attached as a then current rider to the service agreement entered into in 1979, the ratio of the minimum charge to the demand charge was 2.35/3.42 = 68.71%. At present rates the ratio is 5.24/6.87 = 76.27%. At proposed rates the ratio is 5.70/7.33 = 77.76%. The point is that the minimum charge would not have been operative so long as it was below 70% if the customer estimated its demand accurately. The reason is the 70% demand ratchet would apply instead. The minimum charge would apply only if the customer underestimated its demand and then ran considerably over. Now, however, the effect is much different because the minimum charge is greater than the demand ratchet. This is a basic change in the terms of the business arrangement entered into at the time.

LTV Main Brief, pp. 26-27.

Staff witness Rosenthal opposed the proposed increase as unsupported. In conjunction with his testimony he prepared tables which compared the charges resulting from the minimum bill provisions with the applicable demand rate. The table reflecting the comparison at proposed rates is set forth below:

Proportions of $5.70 Minimum Rate to KW Rate

Schedule/Block	Tariff Rate $	Minimum $	Proportion %
Rate L - First 5000	9.84	5.70	57.9
Additional	7.33	5.70	77.8
Rate GL - First 300	12.26	5.70	46.5
Excess	9.68	5.70	58.9
Rate GM - Over 5 KW	12.10	5.70	47.1
Rate I - First 10000	5.70	5.70	100.
Excess	5.33	5.70	100.9

Staff Statement RAR-1A, Schedule 8. A portion of Mr. Rosenthal's testimony and his recommendation, is as follows:

Q. What is the purpose of the minimum charge?

A. The minimum charge provision is to provide a measure of revenue towards the expenses and fixed charges of the company. One may relate the minimum charge as an attempt to maintain some coverage of the fixed charges related to specific facilities associated with service to the customer. It is for this reason that minimum provisions normally involve the use of demand measures in their calculation.

Q. Do you believe a uniform rate should be stated and applied as it is in the company Tariff?

A. No. the statement of a uniform rate applicable to a multitude of rate schedules makes little sense when the schedules vary significantly in the applicability and character of service. As each rate schedule or class has a specific cost of service based upon their cost causative characteristics, it is unlikely that a uniform charge is fair to all customers.

Q. **Is there a better means to developing the minimum?**

A. Yes, that is to base it strictly on a portion of contract demand or rolling ratchet demand and apply the rate schedule charges.

Q. What do you recommend as a minimum provision?

A. For Pate L & I would use "70% of contract demand" as a billing demand minimum to replace the standard charge mechanism. I would use "50% of contract demand" as a billing demand minimum for Rate GL. For Rate GM the applicable tariff would be applied to 50% of the highest demand of the preceding eleven months. These changes aid understanding, ease administration and result in specific rate schedule minimums based upon their own cost of service.

Staff Statement RAR-1A, pp. 9-10.

The ALJ recommended that the LTV and Staff proposals be rejected as not in the "public interest." The Staff and LTV have excepted.

The Staff states that while it agrees with the concept of minimum bills, and favor their contribution to revenue stability, it asserts that it has been demonstrated that the minimum bill provisions of the various schedules are neither equitable in their calculation nor are they relied upon by the utility for revenue stability. Further, states the Staff, the provisions have a significant negative bearing upon Duquesne's ability to attract new industrial load to its system.

The Company's Reply to the Staff's Exception consists primarily of the statement that the increase in the minimum charge is necessary to move in the direction of

restoring the proper relationship between the minimum bill and the excess demand charge of Rate L.

Our review of this matter leads us to the conclusion expressed by Staff witness Rosenthal that there is an inequity in using a uniform minimum demand charge in calculating the minimum bill, when the normal demand charge varies as widely as it does. We are persuaded that the minimum bill provisions of the various rate schedules should be modified as suggested by Mr. Rosenthal, with some modification, and, accordingly we grant Staff's exception, in part.

We informally understand that as to Rate GL that the billing data base does not contain contract demand data and, consequently, a period of time is necessary in order to gather and enter that data. Accordingly, we direct, as to Rate GL, that the Respondent revise its tariff to provide that the minimum charge is the product of the demand charge and 50% of the contract demand. Additionally, the Respondent may provide in such revised tariff that the new minimum bill provision shall not be effective until the fourth billing cycle after the effective date of the revised tariff.115/

As to the Rate GM, we informally understand that the institution of Mr. Rosenthal's proposed minimum bill provision would result in drastic increases in minimum bills

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115/ This delay should be sufficient time for the Respondent to make the necessary preparations to bill the new minimum charge provisions.

for some customers. Accordingly, we shall not now direct a change in the minimum bill provision for this rate, and, alternatively, we direct that the Respondent propose a phase in of Staff's proposal regarding the minimum provision, in its next general rate increase proceeding.

As to rate schedules for which we have adopted the Staff's proposal, it is not our intent that any alternative minimum bill provision such as, a minimum dollar amount or a minimum Kw of demand, existing in current rate schedules, be eliminated.

3. Customer Class Risk Differential

The OCA alleged that a risk differential exists between customer classes which warrants a targeted rate of return for the industrial customer groups somewhat above the system average. The targeted rates of return for residential and street light classes as proposed by the OCA are somewhat below the system average rate of return, while the targeted rate of return for the commercial customer group is somewhat above those for residential and street lighting classes but below the targeted rate of return for industrial customers. The OCA bases its recommendation upon an alleged historical significant instability in industrial customers' requirements as shown by variations in Duquesne's megawatt-hour sales to industrial customers.

The ALJ found that instability in megawatt-hour sales, however, is not the same as instability in revenue, and that for industrial customers taking service under

Rate L, stability in revenue is maintained, at least in part, by minimum demand and ratchet demand contract provisions.

The ALJ also found that Duquesne's tariffs are not based on customer classes, but rather on the size of customer demands, and that as a consequence, hospitals and schools, for example, are in the same class as large industrials. There would be no way to segregate industrial customers in order to assign them a higher return, even if warranted.

The ALJ rejected this recommendation of the OCA. We concur with this recommendation. We find insufficient evidence in this proceeding which would permit us meaningfully to address this recommendation of the OCA.

4. Essential Usage - Inverted Residential Rate

The Consumer Advocate proposes that initial rate blocks be established within the RS and RH rate schedules reflecting essential electric energy use requirements for residential customers. This proposal would result in an inverted rate structure for the residential class. An inverted rate is a rate where the charge per Kwh in the front end of the rate is less than the charge per Kwh at the back end of the rate beyond a certain fixed point.

In our Generic Rate Structure Investigation, 76 P.R.M.D. 7, the Commission studied inverted rates; in our report to the Legislature we did not support inverted rates.

There is nothing in this record which would justify a departure from our former rejection of inverted rates.

An essential usage inverted residential or life-line rate must be carefully targeted to the beneficiary group; otherwise, relief for low income customers could also provide relief to high income customers as well.

In our view, the adoption of inverted rates for the purpose of easing the pressure of higher electric costs for low income customers could actually benefit high income customers and conceivably discourage energy conservation. We concur with the recommendation of the ALJ.

5. Rider No. 18

Rider 18 of Duquesne's presently effective tariff sets forth the terms and conditions by which the Company will purchase electricity from cogenerational small power producers. Rider 18 presently reads in pertinent part:

> The Company will purchase electric energy from customer-owned generating facilities (1) that are "qualifying small power production facilities" as defined in Subpart B-Qualifying Cogeneration and Small Power Production Facilities, of Part 292 of Subchapter K of Chapter I, Title 18, Code of Federal Regulations ("facility"), (2) which are located in the Company's service area, and (3) that use as the energy source renewable resources such as small scale hydro facilities of 5 megawatts or less, biomass, waste, solar or wind.

The Company proposes to limit the applicability of Rider 18 by removing the renewable resource category of "waste", and inserting the specific resources of "waste paper" and "garbage". The Respondent testified that the change is sought to more accurately reflect the intended scope of the Rider's applicability. (Duq. St. 5, p. 6, Tr. 1337).

The Staff, as well as the OCA and LTV Steel Corporation, presented testimony criticizing the proposed change.116/ The Staff's testimony on this and other rate structure matters was presented by Robert A. Rosenthal. (TS St. RAR-1, p. 1).

As presently existing, Duquesne will purchase electric energy under Rider 18 at 6¢/Kwh from customer-owned generating facilities that: (1) are qualifying small power production facilities; (2) are located in the Company's service territory; and (3) use as the energy source renewable resources such as small scale hydro facilities of five megawatts or less, biomass, waste, solar or wind. To qualify for Rider 18, the facility must meet all three criteria. Rider 18 was initially filed with the Commission on August 10, 1981, and became effective October 9, 1981.

Rider 18's stated purpose is to "encourage the development of facilities utilizing renewable resources for generating electricity." (Duquesne Exhibit No. 1B at A 25). Duquesne asserts that it established Rider 18 as a community

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116/ See Direct Testimony of OCA witness Oliver (OCA St. 3, p. 67) and LTV Steel Corporation witness Bloom (LTV St. 2, p. 14-18).

benefit to support a project to burn garbage from the City of Pittsburgh and other municipalities. The 6¢/Kwh purchase price was higher than Duquesne's avoided cost at that time.

Duquesne proposes replacing the word "waste" presently in Rider 18 with "waste paper," since it states that the word "waste" could be defined to include certain energy sources which are non-renewable and which were never intended by the Company for inclusion in Rider 18.

Duquesne maintains that to the extent there are facilities which qualify under PURPA 210 but are excluded from Rider 18, a rate can be established for such facilities under conditions set forth by the Commission's Order adopted September 17, 1982 at Docket No. L-810060, subject to disposition of the appeal at No. 87 C.D. 1983.

The Company states that within the intent of Rider 18, "waste" was and is garbage, and that an industrial waste gas produced from coal, which cannot be replaced, and supplemented with natural gas, is not a renewable resource and was never intended to qualify for Rider 18.

Duquesne contends that if the word "waste" is retained, it would work to the economic benefit of companies such as LTV and to the detriment of the Company's ratepayers as a whole.

Trial Staff witness Rosenthal testified that the drastic impact such a seemingly minor word change would have on the applicability of Rider 18 can best be demonstrated by reviewing the accepted definitions of the renewable resource

category of "waste" as compared to the specific items of "waste paper" and "garbage". Mr. Rosenthal first cited the federal definition of "waste" as set forth in the Federal Regulations implementing Section 201 of PURTA. Said regulation was published on March 20, 1980, at Subchapter B, Section 292.202. The regulations defines "waste" as "by-product material other than biomass," The same regulation also defines biomass as "any organic material not derived from fossil fuels," (TS St. RAR-1, p. 2).

As further evidence supporting the definition of "waste", Mr. Rosenthal referred to the Statement of Managers, The Joint Explanatory Note Of The Senate-House Conference Committee wherein it was stated that "waste as used in the definition of small power production facilities includes wood and liquid or solid waste." (TS st. RAR-1, p. 2).

Trial Staff argues that should the limitation proposed by Duquesne be approved, certain waste-fired small power producers would be unable to sell power to Duquesne under Rider 18, despite the fact they are recognized as "qualified facilities" for federal purposes. By way of example, Mr. Rosenthal referred to the situation of LTV Steel Corporation, Pittsburgh Works. LTV was granted "qualified facility" status by the FERC on September 16, 1983. The facility is capable of producing 27 MW utilizing coke oven gas. It was classified as a "waste by-product unit" on April 6, 1984. (TS St. RAR-1, p. 3).

LTV has been negotiating with Duquesne, inter alia, to become eligible for power sales to Duquesne under Rider 18. (Tr. 1340). LTV, as a waste-fired cogenerator, would not be eligible under the proposed Rider 18 revision.

Trial Staff observes that Rider 18 is designed to be similar to PP&L's Pioneer Rate, which rate also designates "waste" rather than "wastepaper" and"garbage" as a qualified renewable resource. (TS St. RAR-1, p. 3).

It is Trial Staff's position that the intent of the Company regarding the word "waste" has little probative value since it differs substantially from the commonly accepted meaning of the word. Trial Staff further contends that the customers of Duquesne have a right to rely on the wording of the Rider without inquiry into the Utility's intent, and that LTV, as well as other customers, will be seriously prejudiced should the Rider be altered at this juncture without any compelling reason.

LTV strenuously opposes the Duquesne proposal on the grounds that Rider No. 18 is being used by the Company to avoid its obligations under PURPA, and that the proposed changes constitute an inappropriate attempt to change the rules of the game when it became apparent that LTV could take advantage of the rate. LTV claims Duquesne has failed to carry its burden of proof to sh[illegible] that the changes would be appropriate, and that the evidence of record shows that Duquesne's proposal is not in the public interest, and that Rider No. 18 should be expanded to cover all generation produced by "Qualifying Facilities" as defined under PURPA

unless and until Duquesne Light offers a viable PURPA 210 rate. This approach is also supported by Staff and the OCA.

LTV contends that this Commission adopted regulations to implement the PURPA provisions which are now applicable to utilities operating in this state; that the state PURPA regulations (52 Pa. Code §§57.31-57.39) incorporate the federal definitional criteria for "qualifying facilities"; that this definition was adopted by Commission Order (12 Pa. Bulletin pp. 4237-4249) where the Commission said its action was necessary and proper and in the public interest, and that under Title 12, §292.202(b) of the Code of Federal Regulations, it appears that an acceptable energy source would be biomass, waste, renewable resources, geothermal resources, or any combination thereof with 75% or more of the total energy input being from these sources. LTV further argues that in §292.202, the term "waste" is defined as "by-product materials other than biomass", and the term "biomass" is defined as "any organic material not derived from fossil fuels".

Specific to its own position, LTV contends that it has a generator that runs on waste, namely coke oven gas, and LTV wants to sell electricity to Duquesne Light under Rider No. 18; that Duquesne knows this and also knows that the Federal Energy Regulatory Commission has determined that the LTV generator is a "qualifying facility" within the meaning of PURPA (Tr. 1334; 1340) and that only the fear of having to buy LTV's electricity under Rider No. 18 could have prompted Duquesne's claim that the transaction would be unfavorable. LTV also observes that there was no discussion of Duquesne's "intent" when Rider No. 18 was originally

filed. (Tr. 2607) In summary, LTV contends that Duquesne's proposal should be rejected and that Rider No. 18 should be expanded to cover all PURPA 210 purchases unless and until Duquesne presents a different PURPA 210 rate which complies with our regulations.

The ALJ recommended that Duquesne's proposed revision to Rider No. 18 be approved for the reasons that in his opinion, given the voluntary nature of Rider No. 18, it should be Duquesne which should determine its terms and availability, that the Company should not be penalized for offering such a rate by being required to substantially increase, in effect, the purchase price as set forth in Section 210 of PURPA, and that it is not for the Commission to define under what conditions such a voluntary rate should be established by Duquesne, absent a generic ruling applicable to all jurisdictional utilities. We disagree with the recommendation of the ALJ on this issue.

We agree with Trial Staff that the customers of Duquesne have the right to rely on the wording of Rider No. 18 without inquiring into Duquesne's intent. The term "waste", is defined under Section 292,202 of PURPA, as "by-product material other than biomass." "Biomass" is defined thereunder as "any organic material not derived from fossil fuels." (TS St. RAR-1). Duquesne's proposal to modify Rider No. 18 is accordingly denied.

Rider No. 18 presently provides that in order for this Rider to be available, the capacity of small hydro facilities may not exceed five megawatts. Trial Staff witness Rosenthal has opposed this limitation, and

recommends that it be increased to 30 megawatts. The Company is not opposed to such revision. Accordingly, we direct Duquesne to revise Rider No. 18 to make it available to small hydro facilities, not exceeding 30 megawatts.

6. Rate L Service Voltage Level Adjustment

LTV witness Dr. Bloom proposed that a service voltage level adjustment should be added to Rate L in order to better track the cost of service. He proposed an adjustment in the form of a voltage level discount which he states is supported by the fact that it costs less to serve customers at higher voltages; and he would make Rate L a more cost based rate, to be consistent with the Commission's decision in the last Penn Power case at Docket No. R-832409. He further testified that many other utilities in the state offer rates of this kind.

Duquesne opposes this proposal, explaining that the additional equipment utilized to reduce voltage to lower levels, such as step-down transformers, distribution lines, and voltage regulating equipment are adequately addressed in the demand allocation development and the cost allocation process of the cost of service study by proper recognition of voltage level by rate schedule. It further maintains that these areas have always been recognized in the resulting return by rate schedules produced by the cost of service study, and that no additional adjustment for service voltage is justified.

The ALJ rejected the recommendation of LTV, and would deny such voltage level adjustment for Rate L. We concur with the recommendation of the ALJ.

7. Bill Format

In the last settlement, Duquesne agreed to revise its billing format in order that customers will be able to identify charges and each commodity consumption block and rate, to enable customers to recognize that if consumption is reduced to an essential usage level, the rate charged may be reduced. The OCA observes that Duquesne has not yet modified its billing format to reflect our prior directive. Duquesne is hereby directed to implement this prior directive effective with the billing cycle commencing after March 31, 1985.

IX. CONCLUSION

We have concluded herein that Duquesne is entitled to an opportunity to earn income available for return of $215,809,662 based upon its Pennsylvania jurisdictional operations. This constitutes an increase in operating revenues of approximately $31,367,810 or approximately 74.7% of the $41,999,934 increase requested and approximately 48.4% of the $64,758,951 increase which Duquesne claims to be justified by its evidentiary presentation.

In furtherance of such an objective Duquesne is authorized to establish rates which will produce $810,926,810, annually, in total Pennsylvania jurisdictional operating revenues (combined electric service and other electric revenues), in such a manner as is more fully described in the appropriate ordering paragraphs; THEREFORE,

IT IS ORDERED:

1. That Duquesne Light Company shall not place in effect the rates, rules and regulations contained in Supplement No. 11 to Tariff Electric Pa. P.U.C. No. 15, the same having been found to be unjust, unreasonable, and therefore, unlawful.

2. That Duquesne Light Company is hereby authorized to file tariffs or tariff supplements containing rates, consistent with our findings herein, which are designed to produce Pennsylvania operating revenues, exclusive of revenue to be derived from the State Tax Adjustment Surcharge, not in excess of $810,926,810.

3. That in support of such tariffs or tariff supplements, there shall accompany such filing a proof of revenues for each rate schedule, reflecting the estimated normalized level of operations at the year end of the future test year ending December 31, 1984, as adopted and/or modified in this proceeding, in the foremat and detail as provided in the original filing at Duquesne Exhibit IV-C-3.

4. That Duquesne Light Company may file the necessary tariffs or tariff supplements upon less than statutory notice, and, pursuant to the provisions of 52 Pa. Code §3.321(b), the tariffs or tariff supplements may be filed to become effective for service rendered on and after January 26, 1985.

5. That Duquesne Light Company and the Commission Staff shall file a written report with the Commission Secretary (joint or individual as the parties desire), not later than March 15, 1985, and every 45 days thereafter, advising the Commission as to the discussions and progress toward agreement regarding the utilization of a book depreciation reserve, in future general rate increase proceedings. The initial report(s) shall include, but not be limited to (1) the matters upon which agreement has been reached; (2) any matters then outstanding upon which the parties have not agreed; (3) the nature of the disagreement between the parties; and (4) the estimated date of final resolution of each outstanding issue. The subsequent reports at 45 days intervals shall update the information previously furnished.

6. That Duquesne Light Company shall recompute its State Tax Adjustment Surcharge in accordance with the Commission's Order of March 10, 1970, as revised.

7. That Duquesne Light Company shall include and reflect the overcollection of $490,570, as discussed in the body of the Opinion, at the time of its annual revision (filing) of its State Tax Adjustment Surcharge factor, on March 31, 1985.

8. That Duquesne Light Company shall, at the time of its next general rate increase application, propose a phased or multistep average to the minimum charge provision currently contained in Rate Schedule GM. The minimum charge provision is to ultimately provide that it is the sum of the Customer Charge plus the Capacity Charge based upon 50% of the current month Billing Demand or 50% of the highest Billing Demand during the preceding eleven months, which ever is greater.

9. That Duquesne Light Company shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class on the ratio of increases shown in Duquesne Exhibit 1-B, Section J. That is to say, the the relative percentage increase relationships are to remain the same as proposed, at the reduced level of revenues authorized herein.

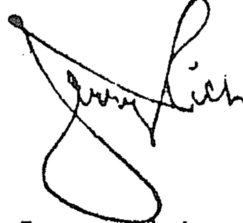
10. That except to the extent specifically granted herein, the exceptions of all parties, to the Recommended Decision of the Administrative Law Judge, are denied.

11. That Duquesne Light Company shall comply with all other directives in the body of this Opinion and Order, which are not the subject of an individual directive in the preceding Ordering Paragraphs, as fully as if they were the subject of a specific Ordering Paragraph.

12. That except as modified herein, the Recommended Decision of the Administrative Law Judge is adopted as the decision of this Commission.

13. That upon Commission approval of the tariffs or tariff supplements authorized to be filed herein, the investigation at Docket No. R-842583 shall be terminated and the file marked closed.

BY THE COMMISSION,



Jerry Rich
Secretary

(SEAL)

ORDER ADOPTED: January 24, 1985

ORDER ENTERED: January 25, 1985

TABLE I
Duquesne Light Company
Income Summary

	Pro forma Present Rates[a] $	Commission Adjustments[b] $	Adjusted Present Rates $	Revenue Increase $	Total Allowable Revenues $
Operating Revenues	779,559,000	-	779,559,000	31,367,810	810,926,810
Deductions					
O&M Expense	368,306,000	(4,927,393)	363,378,607	-	363,378,607
Depreciation	79,803,000	-	79,803,000	-	79,803,000
Taxes - Other	34,065,000	(103,313)	33,961,687	627,356[d]	34,589,043
Income Taxes	99,892,000	2,172,793	102,064,793	15,281,705[e]	117,346,498
Total Deductions	582,066,000	(2,857,913)	579,208,087	15,909,061	595,117,148
Operating Income	197,493,000	2,857,913	200,350,913	15,458,749[f]	215 809,662[g]
Rate Base					$1,783,550,[illegible]28[h]
Rate of Return					12.[illegible]%[i]

Notes
(a) Respondent's Exhibit I, 1-4
(b) See following page, Table II
(c) $15,458,749 ÷ .49282206[j]
(d) $31,367,810 x 2% gross receipts tax
(e) Tax factor based on Company's revenue factor
(f) $215,809,662 - 200,350,913
(g) 12.10% x $1,783,550,928
(h) See Table II, Commission Rate Base
(i) Rate of Return

Capital Structure %	Cost %	Weighted Cost %
51.3	10.24	.0525
10.5	7.69	.0081
38.2	15.82	.0604
100.0		12.10%

(j) This revenue (return) factor is the Company's based on the inclusion of West Virginia taxes.

(k) 2% gross receipt tax
(l) Composite state and federal tax rate - see Table VI footnote a/

TABLE II
Duquesne Light Company
Summary of Adjustments

	Rate Base $1,815,899,916 $	Revenues $	Expense $	Depreciation $	Taxes Other $	Income Taxes $	Return $
Deloitte Haskins & Sells Study	(1,365,119)						
Unrecorded Retired Line Transformers	(615,603)						
Cash Working Capital							
Uncollectible Expense	(37,000)						
Operating Expense	(657,494)						
Accrued Interest	(248,175)						
Deferred Rentals Under Nuclear Lease	(3,660,393)						
Westinghouse Settlement	(1,577,670)						
Deferred Quarto and Warwick Coal Costs	(22,454,294)						
Return on Warwick Costs	(1,976,148)						
Fuel Inventory							
Eastlake	(313,431)						
Mansfield	(844,942)						
Land Held for Future Use	(201,832) 1/						
Deferred Taxes Associated with Ohio Property Taxes	(1,260,904)						
Deferred Taxes Associated with Change in Billing Practice	(1,621,736)						
Deferred State Taxes - Flow-Through	2,472,988						
Tax Calculation Error (Duq. St. 8-1)	178,864					1,490,000	(1,490,000)
CAPCO Displacement Training Costs			(481,200) 2/			239,480	241,720
EEOC Settlement Claim			(300,000)			149,302	150,698
Rate Case Expense			(172,947) 3/			86,071	86,876
Management Audit Expense			(377,583) 4/			187,913	189,670
Split Pan Replacement			(423,384)			210,707	[illegible]

TABLE II
(Continued)

	Rate Base $1,815,899,916 $	Revenues $	Expense $	Depreciation $	Taxes Other $	Income Taxes $	Return $
Transmission Line Transactions			(105,080)			52,296	52,784
Leasehold Improvements			(351,453)			174,909	176,544
EEI Dues			(53,344)			26,548	26,796
Media Communciations			(35,000)			17,419	17,581
Early Retirement Program			(1,694,489)			843,361	851,183
Warwick A&G Expense			(149,000)			74,153	74,847
Computer Costs			207,000			(103,019)	(103,981)
Inflation			(1,354,000)			673,851	680,149
Expenses Required for Additional Customers			(96,424)			47,988	48,436
Deferred Deloitte Haskins & Sells Study			455,038			(226,461)	(228,577)
Deferred State Tax-Flow Through						(4,579,607)	4,579,607
Deferred State Tax (10.5-9.5)						(221,588)	221,588
Increase in FIT Associated Deferred State Flow-Through						2,106,619	(2,106,619)
Ohio Property Tax					(103,313)	51,416	51,897
Interest Expense[5/]						873,407	(873,407)
Total Adjustment	(33,371,551)		(4,931,866)		(103,313)	2,174,765	2,857,913

TABLE II
(Continued)

	Rate Base $	Revenues $	Expense $	Depreciation $	Taxes Other $	Income Taxes $	Return $
	$1,815,899,916						
Jurisdictional Adj. 6/							
(x.000697)							
(x.000907)	(22,563)						
Total Adjustment	(32,348,988)		4,473		94		
Commission Rate Base	1,783,550,928		$4,927,393)		(103,219)	2,172,793	2,857,913

1/ Text P. 19

2/ Text P. 130

3/ Text P. 72

4/ Text P. 74

5/ Interest Expense:

Commission Rate Base	$1,783,550,928
Weighted Debt Cost	x.0525
Commission Interest	93,636,424
Company Claim	95,391,402
Reduction	(1,754,978)
Tax Factor	x.497674
Tax Increase	(873,407)

6/ Jurisdictional factor taken from Respondent's Table - attached to their exceptions.

TABLE III
Duquesne Light Company

Adjustment to Cash Working Capital Requirement for Lag in Bond Interest And Preferred Dividend Payments

Interest Claimed (Ex. 1B, p. F-3)	$13,931,510
Per Commission Rate Base	13,683,335*
Adjustment	$ 248,175

	Debt Interest	Preferred Dividends
Rate Base	$1,783,550,928	$1,783,550,928
Capitalization Ratio	.513	.105
	914,961,626	187,272,847
Weighted Cost	.1024	.0769
	93,692,071	14,401,282
Per Day	÷365	÷365
	256,691	39,456
Mid-Point Revenue Lag Days	(90.00-37.8÷52.2)	(45.00-37.8 = 7.2)
	$ 13,399,255	$ 284,080

Total	$13,399,255
	284,080
	$13,683,335*