**PENNSYLVANIA**

**PUBLIC UTILITY COMMISSION**

**Harrisburg, PA 17105-3265**

Public Meeting held February 8, 2007

Commissioners Present:

 Wendell F. Holland, Chairman

 James H. Cawley, Vice Chairman, Concurring and Dissenting Statement attached

 Kim Pizzingrilli

 Terrance J. Fitzpatrick

Pennsylvania Public Utility Commission,

Office of Small Business Advocate, Office of R-00061398

Consumer Advocate, Mary Kay Gummo, R-00061398C0001

Michael Blake R-00061398C0002

 R-00061398C0003

 v. R-00061398C0004

PPL Gas Utilities Corporation

**OPINION AND ORDER**

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**BY THE COMMISSION:**

 Before the Commission for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Angela T. Jones issued on December 8, 2006, in the above captioned general rate increase proceeding involving the PPL Gas Utilities Corporation (PPL Gas or the Company). Also before the Commission are the Exceptions and Reply Exceptions filed thereto.

Exceptions to the Recommended Decision were filed on January 3, 2007, by the following Parties: PPL Gas, the Office of Consumer Advocate (OCA), the Office of Trial Staff (OTS) and the Commission on Economic Opportunity (CEO).

The following Parties filed Reply Exceptions on January 12, 2007: PPL Gas, the OCA, the OTS, the Office of Small Business Advocate (OSBA), CEO and the PPL Gas Large Users Group (PGLUG).

**I. HISTORY OF THE PROCEEDING**

On April 27, 2006, PPL Gas filed Supplement No. 11 to Tariff – Gas Pa. P.U.C. No. 3 (Supplement No. 11) with the Pennsylvania Public Utility Commission (Commission) to become effective July 1, 2006. Through Supplement No. 11, PPL Gas proposed increases in rates calculated to produce $12,813,000 (6.2%) in additional annualrevenues. PPL Gas provided twelve volumes of supporting data including eight statements of witnesses’ testimony to comply with the Commission’s rate case filing requirements by natural gas public utility companies.

By Order entered June 22, 2006, the Commission instituted an investigation into the lawfulness, justness and reasonableness of the proposed rate increase. Pursuant to Section 1308(d) of the Public Utility Code (Code), 66 Pa. C.S. § 1308(d), Supplement No. 11 was suspended by operation of law until February 1, 2007, unless otherwise permitted by Commission Order to become effective at an earlier date. In addition, the Commission ordered that the investigation include consideration of the lawfulness, justness and reasonableness of the Company’s existing rates. The matter was assigned to the Office of Administrative Law Judge (OALJ) for hearings to culminate in the issuance of a Recommended Decision. In accordance with the Commission's Order, the matter was assigned to ALJ Angela T. Jones.

The following entities and individuals filed Formal Complaints: the OSBA, the OCA, Ms. Mary Kay Gummo,[[1]](#footnote-1) and Mr. Michael Blake.[[2]](#footnote-2) PPL Gas timely answered all Complaints.

The following entities filed Petitions to Intervene which were granted: the CEO, Transcontinental Gas Pipe Line (Transco), the Hess Corporation (Hess), and PGLUG. PPL Gas objected to the CEO’s Petition to Intervene; however, the ALJ overruled the objection finding CEO’s interest germane to the proceeding to further the public interest. On July 13, 2006, the OTS filed its Notice of Appearance.

A Notice dated June 29, 2006, scheduled an initial telephonic Prehearing Conference for July 18, 2006. By Order issued July 5, 2006, the ALJ set forth requirements for participating in the Prehearing Conference which, among other things, included submitting a prehearing memorandum proposing a procedural schedule. Prior to convening the Prehearing Conference, prehearing memoranda were submitted by the Company, the OSBA, the OCA, Hess, Transco, the CEO, and PGLUG.

A telephonic Prehearing Conference was held as scheduled on July 18, 2006. The following entities participated: the Company, Hess, Transco, the OTS, the OCA, the OSBA, PGLUG, and the CEO. During the Prehearing Conference, the OCA’s modifications to discovery rules were granted. The Parties agreed to one public input hearing and an evidentiary hearing schedule. All of the substantive actions and agreements at the Prehearing Conference were confirmed through the Procedural Scheduling Order issued on July 19, 2006. On July 21, 2006, the ALJ issued special instructions to the Parties regarding Briefs and Exceptions in major rate proceedings.

A public input hearing was held in the Potter County Courthouse in Coudersport, Pennsylvania on August 16, 2006. Approximately forty persons attended, and seven witnesses presented sworn testimony.

Evidentiary hearings were held in this matter in Harrisburg on September 25, and 29, 2006, with PPL Gas, the OTS, the OCA, the OSBA, PGLUG and Transco participating.[[3]](#footnote-3) PPL Gas, the OTS, the OCA and the OSBA, presented witnesses and exhibits. On September 29, 2006, the evidentiary record to the proceeding was closed.

PPL Gas, the OCA, the OTS, the OSBA, PGLUG and Transco filed Main Briefs. Reply Briefs were filed by all of the aforementioned parties except Transco. Both Main and Reply Briefs were filed in accordance with the established schedule.

By Recommended Decision issued December 8, 2006, ALJ Jones rejected the Company’s Supplement No. 11 finding it to be unjust and unreasonable and recommended that PPL Gas file tariffs which produce a revenue increase not in excess of $7,678,000. The ALJ also dismissed the Complaints filed by Ms. Mary Kay Gummo and Mr. Michael Blake.

 On December 13, 2006, PPL Gas filed Supplement No 18 to Tariff-Gas Pa. P.U.C. No. 3, to voluntarily postpone the effective date of Supplement No. 11 from

February 1, 2007, until February 9, 2007.

Exceptions and Reply Exceptions were filed as noted above.

**II. DISCUSSION**

**A. General Principles for a 1308 General Rate Increase**

In deciding this, or any other, general rate increase case brought under Section 1308(d) of the Code, 66 Pa. C.S. § 101 *et seq.*, certain general principles always apply.

 A public utility is entitled to an opportunity to earn a fair rate of return on the value of the property dedicated to public service. *Pennsylvania Gas and Water Co. v. Pa. PUC*, 341 A.2d 239 (Pa. Cmwlth. 1975). In determining a fair rate of return the Commission is guided by the criteria provided by the United States Supreme Court in the landmark cases of *Bluefield Water Works and Improvement Co. v. Public Service Comm’n of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In *Bluefield*, the Court stated:

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

The burden of proof to establish the justness and reasonableness of every element of a public utility’s rate increase request rests solely upon the public utility in all proceedings filed under Section 1308(d) of the Code. The standard to be met by the public utility is set forth at Section 315(a) of the Code, 66 Pa. C.S. § 315(a):

**Reasonableness of rates.** –In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

The Pennsylvania Commonwealth Court, in reviewing Section 315(a) of the Code, interpreted the utility’s burden of proof in a rate proceeding as follows:

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

*Lower Frederick Twp. Water Co. v. Pa. PUC*, 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980) (emphasis added). See also, *Brockway Glass Co. v. Pa. PUC*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

In general rate increase proceedings, it is well established that the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility’s burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one and that burden remains with the public utility throughout the course of the rate proceeding. It has been held that there is no similar burden placed on other parties to justify a proposed adjustment to the Company’s filing. The Pennsylvania Supreme Court has held:

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

*Berner v. Pa. PUC*, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955).

This does not mean, however, that in proving that its proposed rates are just and reasonable, a public utility must affirmatively defend every claim it has made in its filing, even those which no other party has questioned. As the Pennsylvania Commonwealth Court has held:

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

*Allegheny Center Assocs. v. Pa. PUC*, 570 A.2d 149, 153 (Pa. Cmwlth. 1990) (citation omitted). See also*, Pa. PUC v. Equitable Gas Co.*, 73 Pa. P.U.C. 310, 359 – 360 (1990).

Additionally, the provisions of 66 Pa. C.S. § 315(a) cannot reasonably be read to place the burden of proof on the utility with respect to an issue the utility did not include in its general rate case filing and which, frequently, the utility would oppose. Inasmuch as the Legislature is not presumed to intend an absurd result in interpretation of its enactments,[[4]](#footnote-4) the burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility.

The mere rejection of evidence contrary to that adduced by the public utility is not an impermissible shifting of the evidentiary burden. *United States Steel Corp. v. Pa. PUC*, 72 Pa. Cmwlth. 171, 456 A.2d 686 (1983).

In analyzing a proposed general rate increase, the Commission determines a rate of return to be applied to a rate base measured by the aggregate value of all the utility’s property used and useful in the public service. The Commission determines a proper rate of return by calculating the utility’s capital structure and the cost of the different types of capital during the period in issue. The Commission is granted wide discretion, because of its administrative expertise, in determining the cost of capital. *Equitable Gas Co. v. Pa. PUC*, 45 Pa. Cmwlth. 610, 405 A.2d 1055 (1979) (determination of cost of capital is basically a matter of judgment which should be left to the regulatory agency and not disturbed absent an abuse of discretion).

 Any issue or Exception that we do not specifically address has been duly considered and will be denied without further discussion. It is well settled that we are not required to consider, expressly or at length, each contention or argument raised by the Parties. *Consolidated Rail Corporation v. Pennsylvania Public Utility Commission*, 625 A.2d 741 (Pa. Cmwlth. 1993); *see also*, *University of Pennsylvania v. Pennsylvania Public Utility Commission*, 485 A.2d 1217 (Pa. Cmwlth. 1984). “A voluminous record does not create, by its bulk alone, a multitude of real issues demanding individual attention . . . .” *Application of Midwestern Fidelity Corp.*, 26 Pa. Cmwlth. 211, 230 fn.6, 363 A.2d 892, 902, n. 6 (1976). With the foregoing principles in mind, we turn to the rate issues before us.

**B. Rate Base**

 **1. Fair Value**

 **a. Positions of the Parties**

 PPL Gas’ 2006 test year forecasted natural gas inventory claimed amount is $13,912,000 while PPL Gas forecasted natural gas inventory of $11,258,000. ($11,258,000 -13,912,000 = -$2,654,000). PPL Gas has accepted the OCA’s valuation of the Company’s natural gas inventory in storage of $11,194,000. The portion of the claim attributed to the Pennsylvania service territory of PPL Gas is 99.42% (-$2,654,000 x 0.9942 = -$2,638,607 or round to -$2,639,000), thereby reducing the Company’s claim by $2,639,000. (Tr. 129-30; OCA St. 1S. Sch. B-1; R.D. at 8). PPL Gas agreed to this adjustment and it is incorporated in PPL Gas’ calculation of rate base for future test year ending December 31, 2006. (R.D. at 8).

 **b. Disposition**

 There were no exceptions filed to the ALJ’s recommendation in regard to this issue. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OCA's position, and PPL Gas’ concomitant reduction to rate base of $2,639,000.

 **2. Plant in Service**

 **a. Positions of the Parties**

 PPL Gas inadvertently included in its original cost of plant in service $1,862,000 of assets used in non-regulated businesses. The OCA drew this to the attention of PPL Gas and PPL Gas agreed that this amount should be removed from rate base yielding a net reduction as of December 31, 2006 of $1,067,000. ($1,862,000 plant in service - $795,000 depreciation reserve). (PPL Sch. C-2 to Exhibit Future 1-Revised; R.D. at 8 - 9).

 **b. Disposition**

 There were no exceptions filed to the ALJ’s recommendation in regard to this issue. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OCA's position, and PPL Gas’ concomitant reduction to rate base of $1,067,000.

 **3. Net Lag Days**

 **a. Position of the Parties**

 The OTS updated the net lag days for both revenue and expenses from historic to future test year the result of which increased the net lag days from 8.6 days to 10.29 days resulting in an $832,000 increase in PPL Gas’ cash working capital requirement for operation and maintenance expenses from $4,344,000 to $5,176,000. PPL Gas has incorporated this change in its cash working capital (CWC) requirement for operation and maintenance expenses to the future test year level. (PPL Gas Exhibit Future 1-Revised, Sch. C-5, p. 2; R.D. at 9).

 **b. Disposition**

 There were no exceptions filed to the ALJ’s recommendation in regard to this issue. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OTS's position, and PPL Gas’ concomitant increase to CWC of $832,000.

 **4. Unamortized Balance of Environmental Clean Up**

 **a. Position of the Parties**

 The OCA alleged that as of December 31, 2006, PPL Gas will have recovered from insurers and ratepayers $12.917 million more for environmental remediation than it will have spent for environmental remediation. Since the $12.917 million is an over-recovery of ratepayer funds, according to the OCA, it should be adjusted to net out the income taxes of $5.360 million, resulting in an adjustment of $7.558 ($12.917-$5.360 = $7.557) million to rate base.**[[5]](#footnote-5)** (OCA St. 1, Sch. B-3; R.D. at 9).

 PPL Gas opposed the adjustment alleging it is inappropriate because balances that are amortized for ratemaking purposes may not be included in rate base. When an expense is amortized in rates it is improper to reflect the unamortized balance of that expense in rate base. The rationale against including the unamortized expense within rate base is that a utility cannot earn a return on and also receive a return of an expense item. To do so would provide the utility with a double recovery of that expense. The distinguishing factor presented in this proceeding is that instead of unamortized expenses, unamortized revenues, or ratepayer funds collected but not yet spent, are at issue.

 PPL Gas asserted that the Pennsylvania appellate courts have held that utilities may not include unamortized balances of expenses in rate base. Therefore, on the same basis, unamortized revenues should not be deducted from rate base. (PPL Gas MB at 11). Said differently, the distinction of expense versus revenue is of no consequence. (R.D. at 10).

 **b. ALJ’s Recommendation**

 The ALJ found that PPL Gas has shown that the adjustment recommended by the OCA regarding unamortized revenues is not warranted because revenue cannot be simultaneously capitalized in rate base and obtained from ratepayers. Consequently, the ALJ recommended that the OCA’s adjustment regarding the unamortized balance (of ratepayer provided revenues not yet spent) for environmental clean up be rejected. (R.D. at 10).

 **c. Exceptions**

 In its Exceptions the OCA states that the ALJ erred in identifying the OCA proposed deduction to rate base as “unamortized revenues.” (OCA Exc. at 3; R.D. at 9-10). For the following reasons, the OCA believes that the ALJ erred in accepting the Company’s position.

 When a utility incurs an expense and is permitted recovery through an amortization, customers are repaying the utility for an expense incurred in the past. The environmental remediation funds at issue here, however, are not repayment for a past expense. Rather, these represent a prepayment of expenses anticipated under the Consent Agreement. PPL Gas has collected $12.9 million from ratepayers, in addition to recoveries from insurers, in advance of Company expenditures to remediate contaminated sites. (OCA MB at 13-17; OCA RB at 5-6; see OCA St. 1 at 10-12). These ratepayer-supplied funds are being held by PPL Gas just like customer deposits or customer advances. Just as customer deposits or customer advances are deducted from rate base, so too must the pre-collected ratepayer provided environmental remediation expense be deducted from rate base. (OCA St. 1 at 11-12; OCA MB at 14-16); see *Pa. PUC v. West Penn Power Co*., 53 Pa. PUC 410, 429 (1979)(Customer deposits); *Pa. PUC v. Philadelphia Suburban Water Co*., 75 Pa. PUC 391, 402 (1991)(Unexpended customer advances treated as an offset to rate base); *Pa. PUC v. Pennsylvania-American Water Co*., 71 Pa. PUC 210, 241-43 (1989)(Customer advances); see also *Pittsburgh v. Pa. Pub. Util. Comm’n*, 370 Pa. 305, 88 A.2d 59 (1952) (Pittsburgh) (Customer-supplied funds treated as an offset in cash working capital determination). (OCA Exc. at 4; OCA MB at 15-16).

 The OCA states that its recommended adjustment is to prevent the Company from receiving a windfall from the use of customer-supplied funds. (OCA MB at 14-15). The OCA asserts that the ALJ’s recommendation is contrary to the record evidence and sound ratemaking principles recognized by the courts and Commission. Accordingly, the OCA believes that the Company’s rate base should be reduced by $7,558,000, as calculated at OCA Statement No. 1, Schedule B-3. (OCA Exc. at 4).

 In reply PPL Gas states that the only difference between this case and those cited by the OCA in its Exceptions is that those prior cases involved expenses, and in this case, the issue relates to recoveries from ratepayers. PPL Gas believes that the Commission should apply the same ratemaking principle to pre-paid revenue supplied by ratepayers as it has applied to pre-paid expenses. (PPL Gas R.Exc. at 9).

 **d. Disposition**

 The distinguishing factor presented in this proceeding is that instead of unamortized expenses, unamortized revenues, or ratepayer funds, collected but not yet spent, are at issue. PPL Gas asserted that the Pennsylvania appellate courts have held that utilities may not include unamortized balances of expenses in rate base. Therefore, on the same basis, it argues that unamortized revenues should not be deducted from rate base. (PPL Gas MB at 11). Said differently, the distinction of expense versus revenue is of no consequence. (R.D. at 10). Based upon prior Commission decisions, the ALJ recommended rejection of the OCA’s adjustment. We agree, finding the ALJ’s recommendation to be reasonable, appropriate, and in accordance with the record evidence and prior Commission decisions. Our review of the record supports the finding of the ALJ. Accordingly, we shall adopt the ALJ’s recommendation and reject the OCA’s Exceptions.

 In conjunction with our allowance of the Company’s claim, we shall direct the Bureau of Audits to review the activity within this account during the Company’s next Purchased Gas Cost Rate Audit. Specifically, we direct the Bureau of Audits to review the Company’s accounting for the funds collected through rates and those recovered through insurance, that are to be used for environmental clean-up as well as all previous and planned expenditures associated with all projects included within this activity. The findings of the Bureau of Audits shall be included within the Company’s next base rate case filing.

 **5. Adjustment to Depreciation Reserve for Account 330**

 **a. Positions of the Parties**

 The OTS advocated that Account 330, Producing Gas Wells – Well Construction, should be reduced by $397,348 to $270,582 since the net salvage is not being depreciated. The OTS asserted that this adjustment is necessary because the account is fully accrued and there is no annual 2006 accrual. If the adjustment is not made, the OTS stated that the future accrual will be in rate base indefinitely with no offsetting annual accrual. (OTS MB at 12, 15).

 PPL Gas contended that the OTS adjustment is not warranted because future amortization of negative net salvage will reduce future accruals to zero at the end of the five-year amortization period. PPL Gas stated further that the OTS’ adjustment is inconsistent with the Uniform System of Accounts and Pennsylvania precedent regarding ratemaking treatment amortizing negative net salvage as established in *Penn Sheraton Hotel v. Pa. P.U.C.*, 198 Pa. Super. 618, 184 A.2d 324 (1962). (PPL Gas MB at 12). Lastly, PPL Gas asserted that the OTS proposed adjustment unduly harms the Company. (PPL Gas RB at 6-7; R.D. at 11).

 The OTS believes that the Company failed to explain the applicability of *Penn Sheraton* for this account since there are no annual accruals associated with the account and thus, Account 330 is not a typical account being depreciated. Furthermore, according to the OTS, the Company’s assertion that it has followed the Uniform System of Accounts and the requirements under *Penn Sheraton* since 1999, and this past treatment would somehow preclude the Commission from correcting improper treatment once detected is not valid. As OTS states, “all aspects of the Company’s filing are subject to review by the parties and ultimately by the Commission in . . . any . . . rate case.” (OTS RB at 8).

 **b. ALJ’s Recommendation**

 The ALJ found that the record evidence demonstrated that Account 330 is unique in that it has no annual accruals to depreciate, it has fully accrued; that the Company has failed to substantiate its claim regarding Account 330 and the applicability of *Penn Sheraton* to an account that has fully accrued. However, according to the ALJ, the OTS has reasonably substantiated why an adjustment should be made to Account 330, and believes that the adjustment advocated by OTS to Account 330 reducing the future accrual claim is warranted and reasonable. (OTS St. 3 at 12, OTS St. 3-SR at 4-5, and OTS Exh. 3-SR, Sch. 1, line 12). The adjustment to Account 330 suggested by OTS was adopted by the ALJ. (R.D. at 10).

 **c. Exceptions**

 PPL Gas excepted to the ALJ’s recommendation as being erroneous for two principal reasons. First, her concern that PPL Gas would be allowed to earn a return on a negative depreciation reserve of $397,348 in perpetuity is factually unfounded. Second, in any event, the recovery by PPL Gas of its capital investment in plant through depreciation accruals and amortizations of net salvage is under continual review by the Commission, and PPL Gas has done nothing improper to give rise to the substantial rate base disallowance. (PPL Exc. at 11 – 12).

 PPL Gas states that it is undisputed that PPL Gas has followed the Uniform System of Accounts and the rules for recovery of net salvage established in *Penn Sheraton*. (Tr. 185; PPL Gas St. 7-R, at 1-3; PPL Exc. at 12). Contrary to the ALJ’s concern, the amortization of net salvage will fully recover and, thereby, eliminate all actually incurred salvage costs over five-year periods following the year that each salvage cost is actually incurred. (PPL Exc. at 12).

 The ALJ adopted the adjustment to rate base recommended by OTS based on her conclusion that, absent the adjustment, the negative reserve will exist in perpetuity. Such conclusion misunderstands the nature of the accounting of net salvage under *Penn Sheraton*. The ALJ states that the negative depreciation reserved for Account 330 will remain, because there are no future accruals to reduce it. (R.D. at 12; PPL Exc. at 15).

 Although it is correct that, absent future investments in plant under Account 330, there are no future accruals (PPL Gas Exh. JJS-2, p. III-155), that does not mean that the negative reserve will remain indefinitely. Instead, under *Penn Sheraton*, net salvage is amortized (not accrued) over five years commencing with the year after the net salvage was incurred. The fact that no accruals remain does not mean that the balance of net salvage will not be eliminated over a five-year period. (PPL Exc. at 15).

 PPL Gas has consistently distinguished between accruals and amortization. (*See, e.g.,* OTS Exh. 3, Sch. 4). PPL Gas has explained, as set forth above, that the net salvage balance will be eliminated through amortization, regardless of whether any future accruals remain. (PPL Exc. at 15).

 PPL Gas, and its predecessor, North Penn Gas Company, have made Annual Depreciation Reports required by Chapter 73 of the Commission’s regulations. Tr. 187-88. Account 330 has had a substantial negative reserve since at least 1999. Nevertheless, OTS has not challenged any of the entries to that account in any of the Annual Depreciation Reports. (Tr. at 188; PPL Exc. at 14).

 The filing by PPL Gas and its predecessors of Annual Depreciation Reports has special significance under the Commission’s regulations, which provide:

“In subsequent ratemaking proceedings, the most recent annual depreciation report or service life study approved or deemed approved for accounting purposes only under this chapter, constitutes a rebuttable presumption as to the reasonableness of the accrued depreciation claimed for ratemaking purposes, and the burden of proving the unreasonableness of the accrued depreciation shall be on the challenging party.”

52 Pa. Code § 73.9(c). For the reasons stated above, the adjustment to the depreciation reserve for Account 330 proposed in this proceeding is erroneous. (PPL Exc. at 14 – 15).

 Alternatively, if the Commission seeks to make certain that the balance of negative net salvage will be eliminated over five years, as contemplated by the Superior Court in *Penn Sheraton*, the Commission could simply order PPL Gas to amortize all amounts in the depreciation reserve as of December 31, 2006, excluding the portion of the reserve equal to the original cost of plant in service, so that such amounts will be eliminated by the end of 2011. Such an order would not harm PPL Gas, because such amortization would occur in any event. The order, however, would provide assurance to the Commission, the ALJ and the OTS that the negative depreciation reserve, in fact, will be eliminated, as contemplated under *Penn Sheraton*, by the end of 2011. (PPL Exc. at 17).

 In reply, the OTS first asserts that the Company missed the point of the adjustment and again failed to explain how the claimed $667,930 of Future Accruals for Account 330 will be reduced if there is no annual accrual associated with this account. (OTS R. Exc. at 7).

 To defend the level of its original claim, the Company puts forth the argument in its Exception that it followed the “Uniform System of Account” and did “nothing wrong” regarding the account. The OTS believes that the Company failed to point to any provision in the Uniform System of Accounts that allows “Future Accruals” to exist in perpetuity and have no annual accrual. Such failure is due to the fact that no such provision exists. (OTS R.Exc. at 7 – 8).

 **d. Disposition**

 We find the Company’s explanation of this issue to be persuasive. Accordingly, we shall grant PPL Gas’ Exceptions and reverse the ALJ’s recommendation, thereby adopting the Company’s claim. As contemplated by the Superior Court in *Penn Sheraton*, we will order PPL Gas to amortize all amounts in the depreciation reserve as of December 31, 2006, excluding the portion of the reserve equal to the original cost of plant in service, so that such amounts will be eliminated by the end of 2011.

 In conjunction with our allowance of the Company’s claim, we shall direct the Bureau of Audits to review the activity within this account. This review shall be conducted during the Bureau’s next Purchased Gas Cost Rate Audit. The findings of the Bureau of Audits shall be included within the Company’s next base rate case filing.

**6. Cash Working Capital Requirement Regarding Payments of Interest**

 **a. Positions of the Parties**

 PPL Gas included within its calculation of cash working capital (“CWC”) a claim regarding payments of interest. (PPL Gas Exh. Future 1, Sch. C-5 at 5; R.D. at 12). The Company claimed a net lag for interest payments of 7.5 days resulting in an adjustment of $114,000.[[6]](#footnote-6) The OTS proposed disallowance of this portion of the Company’s CWC claim stating that the payments of interest are “below the line” and are not to be considered when establishing rates. Additionally, the OTS stated, “the return dollars provided to utilities in rates compensates them for all debt and related costs [and] the Commission has never allowed a positive interest payment component to CWC.” (OTS MB at 16). Subsequently, the OTS admitted that the Commission has reflected positive interest payments in CWC calculations. (PPL Gas MB at 17-18 citing, OTS St. 2-SR at 18-19 and PPL Gas RB 5).

 PPL Gas stated “below the line” items are those revenues, expenses and investments that are not subject to Commission jurisdiction and consequently are excluded from consideration in establishing rates. (PPL Gas MB at 17 citing *Edison Electric Institute, Glossary of Electric Industry Terms*, at 12 (April 2005)). PPL Gas asserted that interest paid to finance rate base is subject to Commission regulation and is therefore considered in setting rates. PPL Gas stated that it produced an example through PPL Electric Utilities Corp where the CWC calculation for preferred stock produced a positive CWC balance and suggested that the interest payments were not incorrectly calculated or differentiated from the preferred stock. (R.D. at 13).

 **b. ALJ’s Recommendation**

 The ALJ found that even if the PPL Electric Utilities Corp. CWC treatment for preferred stock produced a negative CWC balance, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless of whether it is positive or negative. Accordingly, the ALJ rejected the OTS’ adjustment. (R.D. at 13).

 **c. Exceptions**

 With respect, the OTS contends that the ALJ’s decision is based on a misunderstanding of the history of this adjustment, a lack of understanding of the adjustment, a misinterpretation of the OTS testimony and a misplaced sense of fairness brought about by fundamental misrepresentations put forth by the Company. In fact, Commission acceptance of the ALJ’s recommendation would improperly overturn thirty years of clear-cut precedent regarding this issue.

 To understand the error in the ALJ’s reasoning, it is important to reiterate why there is an interest “offset” to a cash working capital claim in the first place. As stated in OTS Direct Testimony, it is inappropriate to include such an interest payments claim as part of an allowable CWC because the return dollars provided to utilities in rates already compensate them for all debt and related costs. As such, any monies needed for interest payments would be subsumed in the return allowance and should not be part of a CWC allowance. (OTS St. 2, p. 37~~.~~; OTS MB at 16). Stated another way, the rates paid by customers already include a revenue allowance to service debt and preferred obligations. These rates are collected on a continuous basis throughout the year. Debt interest may be paid on a quarterly or semi-annual basis. If revenue collected from ratepayers, but not yet paid to bond holders and preferred stock holders, is not recognized as a source of working capital contributed by the rate payers and correspondingly offset against the CWC allowance, then PPL Gas’ common equity holders will receive a return on capital not supplied by them and will thus receive an inappropriate supplemental return not authorized by any traditional ratemaking standard. The crux of this issue is that such an interest “offset” has no corresponding equitable “flip side” that requires any addition to the CWC calculation as argued by the Company. (OTS Exc. at 4 – 5).

 Turning to the Company’s claim, the OTS argues that since the interest payment lag is less than the CWC revenue lag, an additional component to the CWC calculation is thereby created that must be reflected in the calculation. This argument improperly seeks to make the inclusion of interest a necessary part of a lead/lag study when it constitutes nothing more than a potential offset to the results of a lead/lag study. (OTS Exc. at 6).

 In response, the OTS asserts that it is well established in prior Commission and Commonwealth Court decisions that the timing and payment of interest may create an offset to the CWC claim, but is not part of the actual CWC calculation. (OTS Exc. at 6 – 7).

 The OTS states that the timing of revenue receipts and interest payments has long been recognized as an appropriate “offset” to the CWC requirement. In fact, Webster’s Dictionary defines offset as “to place over against something or to serve as a counterbalance for.” The point being that interest has long been recognized as an offset and that an offset by definition works in the opposite direction of the claim. An offset by regulatory practice or by definition has not constituted, nor should it constitute, an increase or enhancement to the Company’s claim. (OTS Exc. at 7).

 However, at page 13 of the Recommended Decision, the ALJ states that:

Even if the PPL Electric CWC treatment for preferred stock produces a negative CWC balance, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless if it is positive or negative.

(R.D. at 13).

 The Company’s Main Brief at page 18 cites a Commonwealth Court decision for People’s Natural Gas wherein People’s challenged a $550,000 offset reduction based on the fact that revenue lagged the actual payment of interest. The Court agreed and rejected the offset. *Peoples Natural Gas Co. v. Pennsylvania Public Utility Commission*, 52 Pa. Cmwlth. 201, 205-206, 415 A.2d 937, 939 (1980). However, the Company’s Main Brief fails to point out that a full reading of the Court’s opinion discloses that the offset was reduced to zero. The facts in that case are identical to the instant situation, yet the Court did not recognize or authorize a negative offset even though interest payments occurred prior to receipt of revenue. (OTS Exc. at 8).

 Again at page 13 of the Recommended Decision, the ALJ states:

Additionally, PPL Gas points to clarification made by OTS to admit that the Commission has reflected positive interest payments in CWC calculations. (PPL Gas MB at 17-18 citing, OTS St. 2-SR at 18-19 and PPL Gas RB at 5).

(R.D. at 13; OTS Exc. at 8).

 Simply put, the ALJ has misinterpreted the OTS testimony. The OTS reference was to the fact that the Commission has always required an offset to the CWC and should not be construed to mean that the Commission recognized a negative offset. The Commission either reflected a positive offset or reflected zero, nothing else.

 Also at page 13 of the Recommended Decision, the ALJ provides that:

PPL Gas states that it produced for the record an example through PPL Electric Utilities where CWC calculation for preferred stock produced a positive CWC balance.

(R.D. at 13).

 Here, the ALJ has relied upon an incorrect Company representation. The offset to CWC is for interest and preferred dividends. The net of the two is what is reflected as the offset. They do not stand alone. In the cited PPL Electric case, the interest offset was negative by an amount greater than the positive claim for preferred dividends. The net of the two was an offset reduction to CWC. The OTS asserts that the Company is simply incorrect when it claims the Commission has previously accepted positive balance for preferred dividends. (OTS Exc. at 9).

 Finally, the fundamental point to consider is that CWC measures the amount of cash outlay that the Company must have available to cover expenses from the rendition of service to payment for these services. The expenses reflected in a lead/lag study are those above-the-line cost of service O&M expenses. As pointed out above, the Company already recovers its interest cost through the return component of rates. It is therefore no more appropriate to include interest in the CWC calculation than it is to reflect a return component in a CWC calculation. (OTS Exc. at 9).

 For the foregoing reasons, the OTS believes that the Commission should reject the ALJ’s recommendation and adopt the OTS-recommended reduction of $114,000 to the Company’s CWC claim to properly exclude interest payments. (OTS Exc. at 10).

 In reply the Company describes the OTS’ proposal as a “one-way” calculation in that the OTS contends that interest payments cannot increase CWC ‘because return dollars provided to utilities in rates already compensate them for all debt and related costs.’ (PPL R. Exc. at 10). The Company also states that the OTS’ reliance upon *Pa. PUC v. West Penn Power Co.,* 1981 WL 178838 and *Peoples Natural Gas Co.,* *Pa. PUC,* 52 Pa. Cmwlth. 201, 415 A.2d. 937 (1980), is misplaced. PPL states that these cases do not address the issue of whether interest payments could increase the CWC requirement, because the issue was not presented. (PPL R.Exc. at 11).

 **d. Disposition**

We agree with the ALJ, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless of whether it is positive or negative. Accordingly, we shall adopt the Company’s position on this issue and deny the Exceptions of the OTS. We do not find the OTS’ reasoning to be persuasive.

 **7. Accumulated Deferred Income Taxes Related to Contributions in Aid of Construction**

 **a. Positions of the Parties**

 The balance of accumulated deferred income taxes (“ADIT”) consists of two components: 1) deferred taxes related to accelerated depreciation on plant in service; and 2) deferred taxes related to contributions in aid of construction (“CIAC”). The CIAC portion is a debit balance that reduces the balance of ADIT deducted from plant in service. (OCA M.B. at 10 – 11). More simply stated, plant in service is increased by number one above and reduced by number two, above. Thus, if the amount of ADIT on CIAC, number 2 above, is reduced, the plant in service is lower and fewer return dollars are allowed.

PPL Gas recorded ADIT on CIAC in compliance with Commission procedures and the Tax Reform Act of 1986. Under that Act, CIAC are treated as taxable income. The Commission allows jurisdictional utilities to select a method for treatment of income taxes on those contributions. *See, Re Contribution in Aid of Construction and Customer Advances,* 70 Pa. PUC 44 (1989). PPL Gas opted to pay income taxes on CIAC which results in a reduction to deferred taxes. (PPL Gas MB at 20).

 PPL Gas projected $5,909,000 of ADIT on CIAC for the future test year. (PPL Gas Exh. Future 1, Sch. C-1). The OCA stated that the Company’s proposed future test year claim for ADIT on CIAC is a 31% increase from the historic test year level[[7]](#footnote-7) and recommended that the future test year balance be reduced by $1,294,000**[[8]](#footnote-8)** to a projected balance of $4,615,000. (OCA MB at 11). The OCA stated that while ADIT on CIAC for 2004 and 2005 was roughly the magnitude of that forecasted by the Company for 2006, the ADIT on CIAC averaged only $70,000 per year for 2001 through 2003. The OCA looked at the Company’s actual experience for the five months of the future test year ending May 2006 and found that the CIAC growth rate was closer to that in the years 2001 – 2003. (OCA M.B. at 11). During this period the average monthly growth in CIAC was $9,000. This is the monthly, annual growth allowed by the OCA in its proposed future test year CIAC of $4,615,000. (OCA St. 1S, Schedule B-2).

 According to the Company, the OCA’s proposal does not consider that the increases in ADIT on CIAC do not occur uniformly throughout the year. For example, for the five-month period ending December 2005, the balance in accumulated deferred income taxes increased by over $1 million. (PPL M.B. at 21). The OCA admits that the magnitude of the 2004 and 2005 ADIT on CIAC is the approximately same of that being forecasted by the Company for 2006 confirming that the more recent level of CIAC is significantly higher than that acquired in 2001 through 2003. Further, according to PPL, the facts confirm that the actual ADIT for CIAC are not uniform per month through the year and thus, the level collected in the first five to seven months of 2006, cannot be concluded to be at the same level of CIAC as assumed for the latter portion of the year. (R.D. at 14 – 15).

 **b. ALJ’s Recommendation**

 The ALJ found that evidence supports the projection of ADIT on CIAC proposed by PPL Gas. PPL Gas substantiated its proposal for ADIT on CIAC based on the facts presented and its $5,909,000 figure for ADIT on CIAC shall be implemented in full. The OCA’s proposed reduction of $1,294,000 ($1,286,000 jurisdictional) to the future test year ADIT on CIAC figure is not supported by the facts on the record and thus, the ALJ deemed the OCA adjustment to be unwarranted. (R.D. at 15).

 **c. Exceptions**

 In its Exceptions, the OCA stated that the ALJ’s recommendation is contrary to the record evidence in this proceeding. Also, the OCA contends that its recommended end of future test year ADIT on CIAC balance of $4,615,000 should be adopted. Additionally, in support of its adjustment, the OCA points out that the balance of ADIT on CIAC at August 2006 was $4,551,000 or $64,000 below the future test year claim. Accordingly, the OCA believes the Company’s claim is overstated and speculative. (OCA Exc. at 5).

 In reply, PPL Gas states that the actual balance at August 2006, is insignificant and that the allowance in this proceeding should be based upon the most recent experience from 2004 and 2005. (PPL R.Exc. at 12).

 **d. Disposition**

 Based upon our review of the record evidence, as well as the post record submissions of the Parties, we agree with the ALJ on this matter. We agree with PPL Gas in that the additions to CIAC do not occur ratably during the year and therefore, the OCA’s use of a six-month average to represent an annual growth rate CIAC is unrealistic. Additionally, we find that the more recent years’ experience to be germane to this account as being more reflective of current economic activity within the PPL Gas service territory. Accordingly, we shall adopt the recommendation of the ALJ and deny the Exceptions of the OCA in this matter.

**C. Revenues**

 **1. Off-System Sales**

 **a. Positions of the Parties**

 PPL Gas proposed an adjustment removing $150,000 in net margins from off-system sales in the future test year revenues. This adjustment would have the effect of removing off-system sales revenues as an item in this base rate proceeding. PPL Gas explained that it retains a portion of the net revenues from off-system sales as an incentive to encourage the Company to obtain as much off-system sales as practical. The remaining portion of net revenues is then flowed through to ratepayers in annual Section 1307(f), 66 Pa. C.S. § 1307(f), proceedings. PPL Gas averred that because these revenues result from a sharing program implemented through annual Section 1307(f) proceedings, it would be inappropriate to reflect these revenues in this proceeding for determining rates as it would defeat the purpose of the sharing mechanism. (PPL Gas MB at 22, PPL Gas St. 4-R at 6-7, PPL Gas Exh. Future 1-Revised, Sch. D-2 Rev. 9-1-06).

 This adjustment was unopposed by any of the Parties. (R.D. at 16).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the Company’s adjustment removing $150,000 in net margins from off-system sales be approved. (R.D. at 16).

 **c. Disposition**

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

 **2. Storage Service Contracts**

 **a. Positions of the Parties**

 The OCA recommended using more updated information regarding the storage service contracts. Specifically, the OCA recommended that three cost of service allocators be modified to reflect increased contracted storage service capacity and storage service maximum daily demand. (OCA MB at 22-23; OCA St. 3 at 4).

 PPL Gas agreed that more updated information for storage service contracts should be used and added that the revenue from storage customers should also reflect a change in volume. The end result was a proposed increase of $169,000 to the Company’s initial claim for storage service revenue of $7,209,172. The Company acknowledged that this adjustment was appropriate. (PPL Gas St. 8-R at 6, PPL Gas MB at 22, Tr. 213-16).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the Company’s adjustment, which increased the claim for storage service revenue to $7,378,172, be approved. (R.D. at 16; PPL Gas Exh. PRH-1R, Sch. A and A1).

 **c. Disposition**

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

 **3. Weather Normalization Adjustment**

 **a. Positions of the Parties**

 PPL Gas adjusted actual test year revenue levels to reflect “normal” weather conditions based upon degree day data obtained from the National Oceanic and Atmospheric Association. PPL Gas performed four calculations: (1) for residential customers in the southern region (old PFG); (2) for the residential customers in the northern region (old NPG); (3) for commercial customers in the northern region; and (4) for the commercial customers in the southern region. PPL Gas used calendar month degree days and revenue month revenues where the revenue months are based upon revenues billed on a billing cycle basis throughout a month. Revenues during a revenue month can be related to a customer usage during the prior calendar month. (PPL Gas MB at 23; R.D. at 17).

 The OCA found anomalies based on the methods used by PPL Gas in making calculations. The OCA stated the primary factor for the anomalies is due to the Company’s calculation on a month by month basis which caused an extra element of randomness to the calculation; that is, the billed sales for a month included bills sent out the prior calendar month while degree days were recorded on a calendar month. Furthermore, the OCA criticized the Company’s methodology because there may be differences in the weather as a whole for the year that is not apparent when comparing weather on a month-to-month basis or *vice-versa*. (OCA MB at 19-20; R.D. at 17).

 The OCA proposed an alternative method, using the heat-sensitive load per degree day for the entire year rather than for each individual month to mitigate the randomness and the effect of mismatch between calendar month and revenue month. The OCA further refined its alternative by weighting the sales adjustment on the distribution of sales in February 2005, the month of sales most heavily weighted toward the tail block evidencing high volume of usage. The result yields an adjustment increase of $401,245 to the Company’s *pro forma* test year revenues under present rates. (OCA MB at 21-22, OCA Sch. C-1 Revised Appendix A; R.D. at 17).

 **b. ALJ’s Recommendation**

 The ALJ stated that this adjustment is founded upon the use of different weather normalization methodology. She found it disconcerting that under PPL Gas’ method of weather normalization, a colder than normal month in a warmer than normal year, would result in a reduction to *pro forma* sales. (OCA MB at 20). However, the ALJ noted that the Company explained that this result happens in the non-heating months which do not substantially effect the weather normalization calculation. Furthermore, according to the ALJ, the OCA does not refute the Company’s criticism that the OCA’s methodology assumes usage per degree day is uniform throughout the year. The ALJ concluded that OCA Cross Exam. Exh. No. 8 shows that usage per degree day increases exponentially in proportion to colder weather. (R.D. at 18).

 The ALJ concluded that the methodology employed by the Company, while not perfect, is substantiated by the record and is reasonable. She found the OCA alternative method to be flawed and not reasonable. The ALJ recommended that the adjustment proposed by the OCA for weather normalization should be rejected. (R.D. at 18).

 **c. Exceptions**

 In its Exceptions, the OCA states that the ALJ erred in adopting the weather normalization presented by the Company even though the calculation used a mismatch of billing revenue to monthly degree day data. The OCA also states that the Company’s method did not produce reasonable, normalized results. (OCA Exc. at 8).

 The Company supports the ALJ’s recommendation adopting its weather normalization calculation. PPL Gas states that its methodology is superior to that of the OCA for two principal reasons. First, its method demonstrates that usage per degree day increases exponentially as heating degree days increase and second, that the OCA’s conversion of usage to revenue, as originally proposed and as revised, is computed incorrectly. (PPL R.Exc. at 13).

 **d. Disposition**

 We agree with the ALJ’s finding on this issue. While the Company’s weather normalization computation is not perfect, it is supported by record evidence and is reasonable. The adjustment proposed by the OCA and its revised calculation, are not reasonable and are substantially flawed. Accordingly, we shall deny the Exceptions of the OCA and adopt the recommendation of the ALJ.

**D. Expenses**

 **1. Undisputed Expense Adjustments**

 PPL Gas’ *pro forma* annual operations and maintenance (O&M) expense claim for the future test year ended December 31, 2006, is $186,926,000.[[9]](#footnote-9) During the course of this proceeding, PPL Gas accepted, in whole or in part, certain adjustments proposed by other parties. These uncontested adjustments are described briefly in this section.

 **a. Company-use Gas**

 PPL Gas’ O&M expense claim included $1,289,000 for the costs of gas used by the Company. The OTS originally proposed to eliminate the recovery of the costs of all company-use gas from base rates, based on its concern that PPL Gas was recovering these costs entirely through rates for recovery of purchased gas costs (“PGC”) established under Section 1307(f) of the Pennsylvania Public Utility Code, 66 Pa. C.S.

§ 1307(f).

 Upon review, PPL Gas determined that, of the total amount of company-use gas of $1,289,000, it does recover $618,000 through PGC rates. The remaining $671,000 of gas is used to operate storage facilities. The cost of gas used to operate storage facilities traditionally has been recovered through base rates because PPL Gas has storage customers who do not pay PGC rates. PPL Gas reasoned that it is proper to recover the cost of gas used to operate storage facilities through base rates so that storage customers would pay their fair share of the costs. (PPL Gas MB at 27, PPL Gas St. 4-R at 1-3).

 The OTS accepted the reduced adjustment in the amount of $618,000 for company-use gas. (OTS MB at 30-31; OTS St. 2-SR at 7-8), and the ALJ’s Recommended Decision incorporated this adjustment. (R.D. at 18).[[10]](#footnote-10) No Exceptions were filed to the ALJ’s recommendation on this issue, which we will adopt.

 **b. Universal Services Hardship Company Matching Funds**

 PPL Gas’ O&M expense claim included $50,000 for the Universal Services Hardship Fund (Fund). The OTS asserted that the claim should be denied because the Fund is financed by voluntary contributions from the Company’s customers, whose contributions are matched by the Company’s shareholders. The OTS contended that it would be inappropriate to recover the shareholders’ matching funds from ratepayers, but agreed that the Company should be entitled to recover the portion of the expenses used to administer the Fund. (OTS St. 2 at 15-16).

 On rebuttal, PPL Gas stated that ten percent, or $5,000, of the Fund’s expense was used for administration and accepted an adjustment of $45,000. (PPL Gas St. 1-R at 9). The OTS accepted the modified adjustment of $45,000. (OTS MB at 29-30; OTS St. 2-SR at 6-7).

 The Company’s revised O&M claim reflects the reduction of $45,000. (PPL Gas Exh. Future 1- Revised, Sch. D-2.) The ALJ’s Recommended Decision incorporated this adjustment. (R.D. at 19). No Exceptions were filed to the ALJ’s recommendation on this issue, which we will adopt.

 **c. Lobbying Expense**

 PPL Gas’ O&M expense claim included $89,000 for “governmental relations and lobbying service and various Corporate Communications activities,” which the OCA initially proposed to eliminate in its entirety. (OCA St. 1 at 26). PPL Gas acknowledged that $26,000 of the $89,000 expense claim related to lobbying activities. (PPL Gas St. 2R at 4-5). The OCA subsequently amended its adjustment to eliminate only the portion of the expense related to lobbying expenses. (OCA St. 1S at 4).

 PPL Gas agreed to the $26,000 expense adjustment, which the ALJ’s Recommended Decision incorporated. (PPL Gas MB at 28; PPL MB Table II, line 3; R.D. at 19-20, Table I). No Exceptions were filed to the ALJ’s recommendation on this issue, which we will adopt.

 **2. Variable Pay Expense**

 **a. Positions of the Parties**

 PPL Gas’ O&M expense claim included a variable pay expense claim of $279,085 for the future test year. Both the OTS and the OCA advocated that a portion of the variable pay expense claim be disallowed. The OTS proposed to disallow fifty percent of the variable pay claim; the OCA proposed to disallow thirty percent of the claim.

 PPL Gas’ compensation package for all non-union employees includes a market-based salary with two components – base pay and variable pay. The base pay component compensates an employee for the accountabilities and competencies related to the position. The variable pay component compensates an employee for achievements related to various financial, operational and safety-related objectives. (PPL Gas MB at 28, PPL Gas St. 5-R at 5). Under this salary structure, ten percent of a non-union employee’s compensation is placed at risk based on the achievements of the established objectives. (PPL Gas RB at 11).

 The OTS argued that fifty percent of the variable pay expense, or $139,543, should be disallowed, based on the rationale that both shareholders and ratepayers benefit from the variable pay award program and should share the costs. (OTS St. 2 at 2, 21). The OTS argued that, through division earnings targets, the variable pay award emphasizes the financial performance of the Company. The OTS stated that shareholders benefit from the Company’s improved financial performance through increased dividends and/or stock prices, and ratepayers may benefit from improved financial performance if rates are maintained at existing levels or future rate increase are minimized. (OTS St. 2 at 22). The OTS reasoned that, since both shareholders and ratepayers benefit from the variable pay program, both should share in the expense. (OTS MB at 32). In surrebuttal, the OTS raised an additional issue, arguing that to the extent that the goals are not achieved and employees do not receive variable compensation, ratepayers will be paying more than PPL Gas’ actual expenses. (OTS St. 2-SR at 3).

 The OCA contended that thirty percent of the variable pay program expense, or $83,000, should be disallowed as related to the achievement of the Company’s financial goals. Specifically, ten percent of the program expense is related to net income goals set by the Company, and twenty percent is related to the achievement of rate case goals. The OCA characterized the claim as requiring ratepayers to reward management for getting them to pay higher rates. (OCA St. 1 at 18-19). The OCA argued that ratepayers should not be required to pay for that portion of the incentive compensation related to the achievement of financial or profitability goals, citing *Pa. PUC v. Roaring Creek Water Co.*, 81 Pa. PUC 285, 299 (1994); *Pa. PUC v. UGI Utilities – Electric Div.*, 82 Pa. PUC 488, 508 (1994). (OCA St. 2 at 19; OCA MB at 26-27).

 PPL Gas argued that the adjustment advocated by the OTS was contrary to the law; that the adjustment advocated by the OCA was contrary to the facts; and that both adjustments therefore should be rejected.

 PPL Gas stated that the OTS adjustment was flawed because the concept of sharing expenses between ratepayers and shareholders on the theory that the expenses are incurred for the mutual benefit of both has been rejected by Pennsylvania’s appellate courts. In *Butler Township Water Co. v. Pa. PUC*, 473 A.2d 219 (Pa. Cmwlth. 1984), the Commonwealth Court reversed the Commission’s disallowance of one-half of a rate case expense claim based on the shared benefit theory. The Court held that a utility generally is entitled to recover expenses reasonably necessary to provide service, and that operating expenses include prudently incurred rate case expenses. The Court held that there must be evidence in the record that a rate case expense is unreasonable, imprudently incurred or excessive to support its disallowance. PPL Gas stated that the Court’s rationale is equally applicable to variable pay expense, and that the OTS made no claim that the variable pay expense was unreasonable, imprudent or excessive. Further, the arbitrary disallowance proposed by the OTS would reduce incentives to achieve goals that are beneficial to ratepayers. (PPL Gas MB at 29-31).

 With regard to the issue that the OTS raised on surrebuttal, PPL Gas stated that the OTS misunderstood the mechanics of the variable pay program; that when certain employees do not receive all of their variable pay, such funds are available to compensate other employees who receive more than 100 percent of their variable pay budget; and that in the last four years, variable pay expenses exceeded the variable pay budget in all but one year, and that shareholders bore such amounts in excess of budget. (PPL Gas MB at 32).

 PPL Gas stated that the adjustment proposed by the OCA also was flawed, but for different reasons. PPL Gas acknowledged that a portion of variable pay is tied to financial goals, but argued that PPL Gas must operate its system efficiently to achieve these goals; that operational efficiency leads to lower rates; and that rewarding employees for efficient operation of the system therefore is beneficial to ratepayers. PPL Gas also acknowledged that twenty percent of the total variable pay expense, or $55,817, was related to this rate case, but argued that the rate case goals also were in the interest of ratepayers. The Company’s rate case goals are to achieve a quality and user-friendly filing, and to restore the Company’s financial health through the recovery of prudently incurred costs. PPL Gas asserted that achieving these goals will allow it to continue to provide safe, adequate, reasonable and reliable service to customers. (PPL Gas MB at 31).

 The OTS argued in reply that the *Butler* case cited by the Company was limited to necessary expenses, such as rate case expense, but that its holding did not extend to the variable pay program expense. The OTS also disagreed with the Company’s assertion that the OTS had not claimed that the expense was unreasonable, imprudent or excessive. The OTS argued that recovering the full amount of the claim from ratepayers would be unreasonable and excessive in this or any other case. The OTS also asserted that, since the record supports a conclusion that the program is not necessary to providing service, the entire program expense could be disallowed, rather than half of the expense proposed by the OTS as a compromise position.

 The OCA argued in reply that rate case expense and incentive compensation are not analogous. According to the OCA, rate case expense is reasonably necessary to provide service and, therefore, recoverable from ratepayers, unlike incentive pay tied to net income and rate case goals. The OCA concluded that the holding of the Commonwealth Court in *Butler* does not apply.

 PPL Gas argued in reply that its variable pay program is distinguishable from the programs at issue in *Roaring Creek* and *UGI*, *supra*., cited by the OCA. In both of these cases, the programs focused on the utility’s parent company. The Commission stated in *UGI* that, at a minimum, the utility must show that the program has a “direct bearing on cost reduction and rate control efforts.” PPL Gas argued that its program is not based on holding company performance; that its program has balanced objectives that promote efficient operations; and that even its rate case objectives promote the interests of customers.

 **b. ALJ’s Recommendation**

 The ALJ recommended that the OTS adjustment be adopted and that half of the variable pay expense claim, or $139,543, be disallowed. (R.D. at 22). The ALJ reasoned that the variable pay expense is not analogous to rate case expense as argued by PPL Gas, since rates and rate cases are necessary to provide service. Incentive pay to reward employees for meeting shareholders’ net income goals and rate case goals are not reasonably necessary expenses related to service to customers.

 The ALJ found that the Company’s reliance on *Butler* was misplaced, and that the Commission has held that ratepayers have no duty to pay for incentive compensation related to achievement of financial or profitability goals, citing *Roaring Creek*. The ALJ found that “[b]ecause it is determined that the Company is incorrect on the applicable law, PPL Gas’ rebuttal to the adjustment proposed by OTS must fail. PPL has not sustained its burden to show the full claimed variable pay expense of $279,085 is reasonable.” (R.D. at 22). The ALJ concluded that the OTS adjustment appropriately models the shared benefit of the expense by ratepayers and shareholders.

 **c. Exceptions**

 PPL Gas excepts to the ALJ’s recommendation. PPL Gas states that the sum of base pay and variable pay equals the market rate for each position; that its program is *not* a bonus program; and that the program permits employees to earn the market compensation rate for their position only if they achieve various objectives. PPL Gas states that the ALJ factually was mistaken that variable pay expenses are not necessary. “As explained previously, the sum of base pay and variable pay equals the market-based compensation rate for particular positions. It is necessary for PPL Gas to compensate employees at market rates.” (PPL Gas Exc. at 20). PPL Gas distinguishes *Roaring Creek* as a case that addressed a bonus program tied to the financial goals of the corporate parent. PPL Gas reiterates that the goals of its program are balanced and unrelated to the financial performance of any corporate affiliate. PPL Gas also repeats its argument that the rate case goals in its program, achieving a quality filing and achieving the best possible outcome for the Company, are beneficial to ratepayers. PPL Gas states that it is in the best interests of ratepayers for there to be as few rate cases as practical, since rate cases are expensive and inefficient. “Achieving a good result in a rate case will permit PPL Gas to file fewer rate cases in the future, thereby, controlling rate case expense, which is properly borne by customers.” (PPL Gas Exc. at 22-23).

 PPL Gas also reiterates its position that the rationale for disallowing one-half of the variable pay expense is contrary to law. “Indeed, it cannot be the law that ratepayers and shareholders should share expenses that are for their mutual benefit, because the result could be a financial disaster for utilities.” (PPL Gas Exc. at 18-19). PPL Gas points out that many expenses could be said to benefit both ratepayers and shareholders, such as purchasing gas supplies. PPL Gas, citing *Butler*, states that a public utility is entitled to recover fully its reasonable expenses incurred in providing service, and that there is no basis in the record for a finding that any portion of the variable pay expense is unreasonable, imprudent or excessive.

 The OTS’ Reply Exceptions state that the Company has not responded to the possibility that ratepayers could pay more than the Company’s actual variable pay expenses if employees do not achieve program goals and receive payments. The OTS also argues that the Company’s reliance on *Butler* as controlling precedent is misplaced, since unlike rate case expense, variable pay expense is discretionary. (OTS R.Exc. at 11-13).

 The OCA’s Reply Exceptions state that, while the OCA continues to support its recommendation for a disallowance of thirty percent based on the percentage of variable pay tied to the Company’s net income and rate case goals, the fifty percent disallowance recommended by the ALJ is supported by the record and consistent with Commission precedent. (OCA R.Exc. at 11). The OCA responds to PPL Gas’ argument that its variable pay program is not a bonus program as ignoring the fact that variable pay is “at risk” and is the very type of bonus or incentive program that was the subject of prior Commission disallowances. Second, the OCA responds to PPL Gas’ argument concerning the 50/50 sharing reversed by the Commonwealth Court in *Butler* as involving rate case expense, which factually is distinguishable from the variable pay expense at issue here. As the ALJ explained, rate case expense is non-discretionary, whereas the Company has discretion when establishing goals for the variable pay component of employee compensation.

 **d. Disposition**

 On review, we will grant the Company’s Exception. Although we do not agree with the Company that the adjustment urged by the OTS would be prohibited as a matter of law under *Butler*, we find that, under the facts of this case, the Company has demonstrated that its variable expense claim is reasonable and should be approved.

 Several considerations lead us to this conclusion. First, the compensation program’s variable component is tied to balanced operational and financial objectives. Only thirty percent of variable compensation is related to net income and rate case goals while fully seventy percent is related to operational and safety goals. Second, only ten percent of an employee’s salary is categorized as variable, or at-risk. Base pay constitutes ninety percent of compensation. Third, the program extends to *all* non-union employees, as opposed to a bonus program that is limited to the very top echelon of management. Fourth, variable pay is unrelated to the performance of a PPL Gas holding company or affiliate. All of these factors support a determination that the Company’s broad-based compensation program provides for market-based compensation rates for its non-union employees. Since we conclude that the Company’s compensation program provides for market-based rates for its non-union employees, we conclude that both its fixed and variable components are reasonable and hence recoverable in rates.

 The Company’s variable pay component of its employee compensation program does not constitute a bonus program of the type disallowed in *Roaring Creek* and *UGI*. In *Roaring Creek*, we disallowed a claim for a bonus program that was limited to management employees, where fully one-third of the program expense was earmarked for one employee. In addition, the bonus program was tied largely to income and earnings targets for the parent company, which were unrelated to improvements in service to ratepayers. We disallowed the claim because the bonus program was not aimed at enhancing the productivity and efficiency of the utility. In *UGI*, we disallowed a claim for a bonus plan and a stock option plan where most of the eligible persons were holding company employees and the plans again were aimed at the parent company’s financial performance. We stated that “[i]ncentive compensation plans are a good idea and they should be utilized to stimulate innovative operational improvements to create a better performing company. In order to be passed on to ratepayers, however, there must be an adequate factual basis for the Commission to conclude that the Company seeks to maximize more than just shareholder value. Even if no specific cost savings can be shown to result from the incentive compensation plan, at a minimum the plan must be shown to have a direct bearing on cost reduction and rate control efforts.” 82 Pa. PUC at 508. In the instant case, PPL Gas has demonstrated that the variable pay component of its compensation program is related to the Company’s operational performance and efficiency objectives.

 We reject the argument of the OTS that its proposed disallowance is supported by the fact that there is a possibility that the Company’s actual variable pay expense could be less than its ratemaking allowance if employees do not achieve program goals and receive all of their variable pay. The Company stated that, in three of the last four years, actual variable pay expense exceeded its variable pay budget, and that shareholders bore the amounts in excess of budget. In addition, a similar argument could be made concerning nearly all expense items. Expenses that are allowed for ratemaking purposes nearly always will be either greater or lesser than actual expenses incurred when the rates are in effect. Such is the inherent nature of budgets and projections used in establishing rates.

 **3. Affiliates Charges**

 **a. Positions of the Parties**

 Within the PPL corporate system, certain services are provided to all members from a common pool of resources. When the user of services can be identified specifically, expenses are charged directly to that user. General administrative support costs are allocated among the member companies. In this case, PPL Gas claimed total charges of $9,453,000 from several affiliates for the future test year. Included in this amount was $8,705,000 in charges from PPL Services Corporation (PPL Services). (PPL St. 2-R at 3).

 PPL Gas stated that indirect costs are allocated among the members of the PPL corporate system based on a three-factor formula that was recommended in a Commission-sponsored management audit. The three factors include a payroll factor, an investment factor, and an O&M expense factor.

 The OTS proposed an adjustment to total direct and indirect charges based on a four-year (2003-2006) average of charges from affiliates. The OTS proposed an adjustment of $844,000. (OTS MB at 28-29; OTS St. 2; OTS Exh. 2, Sch. 6).

 The OCA proposed an adjustment of $238,000, which would disallow the increase in indirect support expenses over the level of such expenses in 2005.[[11]](#footnote-11) The OCA noted that PPL Gas had forecast an increase of approximately seven percent in its indirect support expense, from actual 2005 expense of $3,386,000, to projected 2006 expense of $3,624,000. The OCA argued that, when asked to explain this increase, PPL Gas cited two factors: (1) a “modest” increase in the percentage of total indirect support provided by PPL Services; and (2) a “minor” increase in the costs being allocated. (OCA MB at 37; OCA St. 1 at 27). The OCA submitted that this explanation does not demonstrate how these factors translate into an increase of seven percent. Because the increase had not been adequately justified, the OCA recommended that the forecasted increase of $238,000 be disallowed. (OCA St. 1 at 28, Sch. C-2).

 PPL Gas argued that the increases in costs from support groups within the PPL corporate system are reasonable. PPL Gas noted that its total support charges between 2003 and 2006 increased only five percent annually on average. Charges to PPL Gas for direct and indirect support services increased by $672,000 and $238,000, respectively, from 2005 to 2006. Over the four-year period, indirect support charges increased by approximately eight percent annually, while direct support charges increased by approximately 3.1 percent annually. PPL Gas argued that, through the first six months of 2006, PPL Gas was charged an annualized amount of $8,738,000 for direct and indirect costs, which was slightly more than its budget of $8,705,000, the basis for the claimed affiliate charge expense in this proceeding. The fact that PPL Gas actually is incurring the claimed level of expenses demonstrates the reasonableness of its claim. (PPL Gas MB at 35, PPL Gas St. 2-R at 3).

 In reply, the OCA stated that the fact that the Company’s claim for indirect service charges resulted from allocation factors recommended in a Commission management audit does not relieve the Company from its burden of proof. The OCA argued that its adjustment of $238,000 should be adopted because PPL Gas did not meet this burden of proof. (OCA RB at 17).

 In reply, PPL Gas contended that both the OTS and the OCA seek to arbitrarily limit expenses to historic levels based only on their subjective feelings that the increases to the charges are too great. PPL Gas stated that neither party was clear on the basis for its proposed adjustment. Presumably the basis for the proposed adjustments was that PPL Gas’ projections either were not accurate or were excessive. PPL Gas reiterated that its actual charges for the first six months of 2006 demonstrate that its projections are reasonably accurate and, indeed, slightly conservative. PPL Gas also reiterated that the increase in affiliate charges is justified by the increased level of services provided by affiliates, citing the cost to comply with increased regulatory requirements imposed following the collapse of Enron in 2001. Finally, PPL Gas stated that the OTS adjustment particularly is unreasonable because it would allow only an annual increase of 1.5 percent over the four-year period from 2003-2006. (PPL Gas RB at 12-14).

 **b. ALJ’s Recommendation**

 The ALJ recommended that both the OTS and the OCA adjustments be rejected, and found that PPL Gas had substantiated its affiliated expense claim. The ALJ stated that “[t]he arguments relayed by OCA and OTS fail to show that the magnitude of the increase in the 2006 future year expense claim is unreasonable, inappropriate, inaccurate or unsupported. The claimed 2006 affiliated expense of PPL Gas at $8,705,000 in charges from PPL Services Corporation should be approved.” (R.D. at 24).

 **c. Disposition**

 Neither the OTS nor the OCA excepted to the ALJ’s recommendation on this issue. Based on our review of the record, we shall adopt the recommendation of the ALJ and allow the Company’s claim for $9,453,000 in charges from several affiliates, including $8,705,000 in charges from PPL Services Corporation. The record demonstrates that, through the first six months of 2006, PPL Gas was charged an annualized amount greater than its budget, and that its budget was reasonably accurate. We also accept PPL Gas’ contention that the increased regulatory requirements imposed on publicly-held companies following the collapse of Enron, including the Sarbanes-Oxley Act of 2002, reasonably explains and justifies the increased level of expense.

**4. Environmental Remediation Expenses**

 **a. Positions of the Parties**

 PPL Gas’ claim for environmental remediation expense of $987,000 is based on the methodology previously accepted by the Commission through the approval of the settlement of PPL Gas’ prior base rate case at Docket No. R-00005277. (PPL Gas Exh. Future 1 - Revised, Sch. D-2 at 1, PPL Gas MB at 36). The Company first forecast spending on environmental remediation projects in excess of insurance recoveries through the end of 2011. The Company then determined that this amount exceeds the environmental remediation expenses recovered in rates through December 31, 2006, by $4,935,000. The Company then normalized this difference over the five-year period 2007-2011, resulting in the *pro forma* annual expense claim of $987,000. (OCA MB at 38).

 The OTS proposed two adjustments that together would reduce the Company’s claim by $882,000 and provide an annual allowance of $105,000: (1) the elimination of the three percent (3.0 %) annual escalation used by the Company to project environmental remediation expenses after 2006; and (2) the elimination of remediation expenses at sites that the Company has not yet identified. The OTS then netted the total amount of expected costs through 2011 against the amount already recovered. (OTS St. 3 at 9-12; OTS MB at 24-27). First, the OTS argued that the three percent escalation factor is not supported historically. (OTS St. 2 at 11). Second, the OTS proposed to eliminate $510,299 in remediation expenses attributable to “Unknown Utility MGP [Manufactured Gas Plant] & Mercury Sites.” (OTS St. 2 at 10; OTS Exh. 2, Sch. 4 at 2). The OTS opined that test year expenses claimed for ratemaking purposes must be known and measurable, and that remediation expenses for unknown sites were neither. The revenue impact of the two adjustments recommended by the OTS is a reduction of $882,000 to the annual environmental remediation expense claimed by the Company of $987,000. (OTS St. 2 at 11-12; OTS MB at 24-27).

 PPL Gas argued that a modest allowance for inflation for the five year period ending December 31, 2011, would be appropriate. The remediation of MGP sites and mercury is labor-intensive, and costs are escalating as the price for labor, equipment rentals, fuel costs, disposal costs and property acquisitions continue to rise. The OTS adjustment to disallow inflation is contrary to the experience of PPL Gas and without foundation. (PPL Gas St. 3-R at 11; PPL Gas MB at 38-39).

 PPL Gas also argued that it was appropriate to include remediation costs for unknown MGP and mercury sites, as the prospect of having to remediate presently unknown sites is a serious concern. PPL Gas currently is remediating and/or monitoring four previously unidentified MGP sites. PPL Gas stated that its inclusion of $3,061,794 for unknown sites through 2011 is reasonable, given the fact that the average cost of fully remediating an MGP site is about $2 million. (PPL Gas St. 3-R at 11; PPL Gas MB at 38).

 The OTS replied that the Company’s general arguments are not sufficient to deviate from the standard ratemaking requirement that expenses be known and measurable as a prerequisite to being recoverable. (OTS RB at 13).

 The OCA proposed that the Company’s expense claim be rejected in its entirety and set at zero until its next base rate case. The OCA objected to the Company’s forecasting its expense level through 2011 on the basis of its estimate of remediation expenses of $2,879,000 in 2006. Through the first five months of 2006, the Company has spent only $329,000, an annualized expenditure of only $790,000. (OCA St. 1 at 23; OCA MB at 39). In the three-year period 2003 through 2005, the highest annual expenditure by the Company was only $1,507,000, not much more than half of the forecasted 2006 level of $2,879,000 used to determine the expense claim in this proceeding. The OCA stated that the Company already has recovered $12,621,000 more than its actual expenditures through the rate recovery mechanism approved by the Commission. If this over-recovered amount were used to fund expenditures between now and the end of 2011, the Company would have $2,524,000 available each year for environmental expenditures. Between 1989 and 2005, the Company never has reached a spending level of $2,524.000. (OCA St. 1 at 23-24; OCA MB at 39).

 PPL Gas stated that the OCA’s adjustment would decrease the Company’s 2006 test year environmental remediation expense by $2,089,000, to $790,000, and require that all projected expenses be charged against amounts previously recovered from ratepayers and insurance companies. PPL Gas argued that the “OCA ignores the fact that environmental remediation expenses are expected to increase during the later years of the DEP [Department of Environmental Protection] Consent Order, when remediation expenditures typically reach their highest levels.” (PPL Gas MB at 39). PPL Gas contended that it would be inappropriate to eliminate recovery of environmental remediation costs when they are expected to escalate. (PPL MB at 39, PPL Gas St. 3-R at 12).

 The OCA replied that the Company had not rebutted the OCA’s calculation of a future test year level of expense of only $790,000, or otherwise provided updated information to support the Company’s 2006 expense claim of $2,879,000:

Thus, Mr. Kleha’s “first step” of calculating expenditures and recoveries through the end of the future test year, which PPL Gas relies upon in its Main Brief, is not supported by record evidence. Further, OCA witness Effron found the Company’s forecast annual environmental remediation expenditures of $2,879,000 overstated, compared to the Company’s future test year level of spending and historic levels. The Company’s theory of a net deficiency at the end of 2011 of $4.935 million is based on supposition and assumptions which are without support in the record.

(OCA MB at 10 (citations omitted)). The OCA argued that the Company’s theory that the OCA would not provide the Company with funds to pay for environmental remediation expenses was incorrect and ignored the OCA’s testimony that the Company already has $12,621,000 on hand, the amount of the net over-recovery through the end of the historic test year. This amount is sufficient to provide an annual expenditure of $2,524,000 for 2007 through 2011, a level in excess of historic levels. (OCA RB at 10).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the OTS adjustment of $882,000 to the Company claim of $987,000 for annual environmental remediation expense be granted.[[12]](#footnote-12) (R.D. at 28).

 With respect to the $510,000 adjustment for unknown sites, the ALJ found that the Company had not refuted the OTS assertion that test year expenses should be known and measurable, and had affirmed that the MGP and mercury sites are unknown. (R.D. at 27).

 With respect to the adjustment to eliminate the three percent escalation factor, the ALJ found that nothing in the record demonstrates that inflation will reach levels of three percent per year over the next five years, and that PPL Gas simply had not supported through record evidence an inflation factor of that magnitude. (R.D. at 28).

 The ALJ concluded that the OCA adjustment to disallow all projected environmental remediation expenses was over zealous, drastic and unreasonable, and should be rejected on that basis.

 **c. Exceptions**

 The Company’s Exceptions to the ALJ’s recommendation argue that the inclusion of projected expenses for unknown sites is appropriate, given that it currently is in the process of remediating four MGP sites that were unidentified when it entered into the Consent Order with DEP. The Company contends that it is reasonable to expect that additional sites will be identified during the remaining five years of the Consent Agreement and that its projected costs of approximately $3 million for these unknown sites is reasonable. With respect to the elimination of its 3.0 percent inflation factor, the Company concedes that it did not specifically introduce evidence of inflation for environmental remediation costs, but states that there is evidence in the record regarding prospective inflation. The Company refers to evidence introduced by the OTS that inflation for the period 2007 through 2011 is expected to range between 2.4 and 2.8 percent (OTS Exh. 1, Sch. 3), and states that its projection of 3.0 percent is consistent therewith, rounded to the nearest whole number. (PPL Gas Exc. at 23-26). PPL Gas concludes that it would be inappropriate for the Commission to reduce recovery of environmental remediation expenses at the time when they are expected to increase, and that the elimination of expenses for unknown sites would be inconsistent with the “matching” principles established in the settlement of PPL Gas’ last base rate case.

 The OTS’ Reply Exceptions state that the Company simply had not met its burden of proving the legitimacy of its claim and that the ALJ properly applied the reasonable, known and measurable standard set forth at *Pa. PUC v. West Penn Power*, 73 Pa. PUC 454 (1990). (OTS R.Exc. at 14).

 The OCA’s Reply Exceptions state that, while it had recommended that the Company’s entire expense claim be eliminated because the Company was not spending on a pace that would utilize the $12.6 million it previously collected by the end of 2011, the adjustments proposed by the OTS are well supported and necessary. The OCA states that, insofar as the Company’s claim is related to unknown sites, it does not meet the requirement that expenses allowed in a rate case must be reasonable, known and measurable, citing *West Penn*. The OCA also states that the ALJ correctly found that the Company had not supported its three percent allowance for inflation to environmental remediation expenses. Contrary to the Company’s argument that the ALJ’s recommendation denies the Company any financial resources, the OCA submits that it simply provides for the recovery of a reasonable level of expenses from ratepayers based on the record in this case. (OCA R.Exc. at 12-14).

 **d. Disposition**

 We will adopt the recommendation of the ALJ regarding disallowance of the expenses associated with unknown sites, and will deny the Company’s Exceptions on this point. We will, however, grant, in part, the Company’s Exceptions regarding an inflation factor. However, rather than an inflation factor of 3.0 percent sought by the Company, we will utilize an inflation factor of 2.4 percent to calculate the Company’s annual expense allowance.

 The Company’s claim for expenses associated with the remediation of unknown sites is speculative, and fails the basic ratemaking tenet that expenses must be known and measurable in order to be recoverable. PPL Gas’ argument that expenses to remediate sites that it has not yet discovered should be recoverable from ratepayers is based solely on the fact that it discovered four sites since its consent order with DEP was signed. It essentially then extrapolates this information as proof that additional sites will be discovered in the future. Without additional support and explanation, the Company’s claim for expenses to remediate undiscovered sites must be denied.

 The Company’s claim for a 3.0 percent inflation factor similarly is not supported on the record. The Company did not provide any evidentiary support for its claim that environmental remediation expenses will increase by 3.0 percent per year. In lieu of providing evidence of its own, the Company relied on evidence introduced by the OTS’ witness on rate of return regarding forecasted changes to the general rate of inflation, specifically the Consumer Price Index (CPI). The OTS witness forecast increases to the CPI ranging from 2.4 percent to 2.8 percent for the years 2007 through 2011. (OTS St. 1 at 14; OTS Exh. 1, Sch. 3). As a matter of common sense, PPL Gas’ argument that environmental expenses will be subject to inflation is convincing. PPL Gas argued that the remediation of MGP sites and mercury is labor-intensive, and costs are escalating as the price for labor, equipment rentals, fuel costs, disposal costs and property acquisitions continue to rise. However, because there is no evidence on the record to support the Company’s claimed inflation rate of 3.0 percent, we will utilize an inflation rate of 2.4 percent, the low end of the range of forecasted increases to the CPI introduced into the record by the OTS.

 The disallowance of the claimed expenses for unknown sites, and the inclusion of an inflation factor of 2.4 percent, results in an adjustment of $705,000 to the Company’s claim, as opposed to the adjustment of $882,000 as recommended by the ALJ. *See* Table VII attached to this Opinion and Order.

**5. Rate Case Expense**

 **a. Positions of the Parties**

 PPL Gas proposed to normalize its rate case expense claim of $1,125,000 over two years, resulting in an annualized claim of $563,000. (PPL Gas Exh. Future 1, Sch. D-5). No Party disputed the total amount of the rate case expense, but both the OTS and the OCA recommended that, based on the past ten-year history of PPL Gas’ base rate case filings, the expense should be normalized over five years. (OTS St. 2 at 2-6; OTS MB at 18-21; OCA St. 1 at 16-17; OCA MB at 25-26).

 PPL Gas argued that both Parties failed to recognize that events that precluded more frequent filings in the past are not expected to recur in the future. These events include the acquisition of Penn Fuel Gas, Inc. (Penn Fuel) by the PPL corporate system in 1998, and the required applications of Penn Fuel’s regulated subsidiaries for approval of their restructuring plans under the Natural Gas Choice and Competition Act, 66 Pa. C.S. §§ 2201 *et seq*. (Competition Act). PPL Gas averred that potential rate cases were disrupted by rate caps under the Competition Act, and that base rate increases generally were banned for eighteen months, from July 1, 1999, until January 1, 2001. Both Penn Fuel subsidiaries underwent a detailed review of their existing rates and a rate cap period during the last ten years, which is not consistent with future circumstances.

 PPL Gas further argued that it is experiencing reductions in the average annual usage of natural gas by residential customers, which declined almost nine percent between 2000 and 2005. In addition, PPL Gas averred that there are increasingly stringent requirements for replacement of aging infrastructure and safety regulations, which will require an increased level of pipeline replacements and other maintenance, and that all of the related changes will increase expenses. (PPL MB at 40-42). PPL Gas implies that all of these pressures will lead to more frequent rate case filings in the future.

 The OTS argued that the normalization period should be determined based on a utility’s actual, historical rate filings, not upon the utility’s intentions, citing *Popowsky v. Pa. PUC*, 674 A.2d 1149, 1154 (Pa. Cmwlth. 1996). The OTS recommended that the Company’s rate case expense be normalized over five years, which would result in an annual allowance of $225,000 and a reduction in rate case expense of $338,000. The sixty-month normalization period recommended by the OTS is the average interval between the 1996 and 2000 filings, and the 2000 and 2006 filings. (OTS St. 2 at 2-6; OTS MB at 18-21). The OTS further argued that the Company’s assertions of future events lacked documentation and specificity. (OTS RB at 11-12).

 The OCA recommended the same normalization period of five years for the same reasons as the OTS. In addition, the OCA responded to the Company’s argument concerning changed circumstances, and argued that requirements such as those cited by the Company have existed for many years. “These requirements have certainly existed at least since the time of the Company’s last two rate cases, which were in 1996 and 2000.” (OCA St. 1-S at 5; OCA MB at 25-26).

 In reply, the Company argued that “if OTS and OCA were simply to acknowledge that the restructuring proceeding is the equivalent of a full investigation of rates and the fact that PPL Gas (and its predecessors) were barred from increasing rates for the eighteen-month rate cap period, their adjustments would be reduced substantially.” (PPL Gas RB at 16). The Company argued that, by subtracting the eighteen-month rate cap period, and recognizing the restructuring proceeding as a rate case, the resulting interval was 34.7 months, less than three years, and far less than the five years proposed by the OTS and the OCA. PPL Gas then argued that its two-year normalization period should be adopted, but that in no event should the rate case normalization period exceed three years. (PPL Gas RB at 17).

 **b. ALJ’s Recommendation**

 The ALJ recommended that rate case expense be normalized over a three- year period, based on the Company’s argument in its Reply Brief that the restructuring period should be considered as the equivalent of a base rate case, and that the eighteen-month rate cap period should be subtracted from the calculation. Normalizing the rate expense claim of $1,125,000 over three years results in an annual rate case allowance of $375,000 ($1,125,000/3 = $375,000), thereby reducing PPL Gas’ claim by $188,000. (R.D. at 29).

 **c. Exceptions**

 The OCA argues that the ALJ erred by adopting the alternative normalization period of three years that was proposed for the first time in the Company’s Reply Brief. The OCA argues that no Company witness testified in support of a three-year normalization period or the specific calculation made by the Company in its Reply Brief. The OCA argues that deducting the eighteen-month rate cap period is without merit, noting that the Company was allowed to increase its base rates when the rate cap period expired on January 1, 2001, and filed a base rate case in June 2000 to accomplish this. The OCA states that the five-year normalization period is less than the 72-month interval between the June 2000 filing and the April 2006 filing in the present case. The OCA further argues that the inclusion of a “non-Section 1308(d) regulatory filing in the calculation of historic interval between base rate cases is unprecedented and unrelated to the normalization of base rate expense to be recovered in base rates.” (OCA Exc. at 11).

 The OTS did not file a specific Exception to the ALJ’s recommendation on this issue. The OTS, however, reaffirms its support for all of the OTS recommendations in this proceeding, and requests that the Commission review and adopt each OTS recommendation rejected by the ALJ, whether or not OTS filed a specific Exception. The OTS cited rate case expense as an example of a recommendation that it is not withdrawing by virtue of not filing a specific Exception on the issue. (OTS Exc. at 2).

 The Company’s Reply Exceptions state that the OCA’s criticism of its proposed compromise of a three-year normalization is unwarranted, and that looking at the average span between rate cases over the last ten years simplistically ignores many factors that influence past and future filings. Following a recital of several of these factors, the Company states that its proposal for a three-year amortization of rate case expense is reasonable. (PPL Gas R.Exc. at 14-16).

 **d. Disposition**

 We shall adopt the ALJ’s recommendation on this issue and adopt a three-year normalization period, which reduces the Company’s initial rate case expense claim by $188,000. (R.D. at 28-29, Table II). Although we agree with the OTS and the OCA that a normalization period for rate case expense should be based on a utility’s actual, historic rate filings, the OTS and the OCA have taken an overly prescriptive view of the Company’s filing history. The Company’s calculation of an interval of 34.7 months between cases, after recognizing the restructuring proceedings of its subsidiaries as equivalent to rate cases and subtracting the eighteen-month rate cap period, is persuasive. Similar to base rate cases, the Company’s restructuring proceedings entailed the equivalent of a full investigation of existing rates. It would be unrealistic to disregard these restructuring proceedings when determining a reasonable rate case normalization period simply because the cases were not filed under a particular section of the Public Utility Code. We also agree with the Company that subtracting the eighteen-month rate cap period is reasonable when assessing the frequency with which the Company likely will file base rate cases in the future.

 We accordingly deny the Exception of the OCA on this issue. Although it is correct that the Company did not propose a three-year normalization period until the filing of its Reply Brief, its calculation of a 34.7 month interval was simply an arithmetic result based on evidence already in the record. The three-year normalization period was proposed by the Company as a compromise between its proposed two-year and the OTS/OCA proposed five-year normalization periods. Compromise proposals generally are welcome, and should be encouraged. We conclude that the three-year period is reasonable, and that it is supported by the Company’s filing history, including its restructuring proceedings and rate cap periods.

**6. Payroll Expense and Appropriate Budgeted Employee Complement**

 **a. Positions of the Parties**

 PPL Gas’ annual payroll expense claim of $12,633,000 is based on a complement of 321 employees. (PPL Gas Exh. Future 1, Sch. D-6). Both the OTS and the OCA proposed adjustments based on a lower complement of employees. The OTS recommended an adjustment of $274,176 based on seven unfilled positions as of August, 2006, and an employee complement of 314. (OTS St. 2 at 12; OTS errata sheet). The OCA proposed an adjustment of $316,000 based on an employee complement of 315. (OCA St. 1 at 17-18).

 The Company argued that its detailed information comparing budgeted employee complement with the actual number of employees over a three-year period showed that its employee complement has been very close to its budgeted complement. The Company asserted that, on average, its employee complement was seven thirty-sixths (less than 1/5) of one position below budget over the three-year period. (PPL Gas MB at 43; PPL Gas RB at 17). The Company also asserted that it was in the process of hiring four new employees in September 2006 alone, and that only three additional employees would restore the employee complement to the full budget level. (PPL Gas RB at 17-18).

 The OTS argued that the Company’s claim was based on a complement of 321 employees at the end of 2006, but as of August, 2006, seven positions remained unfilled. The OTS noted that there were no guarantees that the positions ever would be filled, and recommended an adjustment of $274,176 based on the Company’s average wages for seven positions. (OTS St. 2 at 12-13; OTS MB at 27-28).

 The OCA argued that the last time that the Company had 321 employees was in March 2004; that the increase to 321 employees in July 2006 was due to the summer hiring of temporary employees; and that by August 2006 the number of employees had dropped again to 314. The OCA therefore recommended an adjustment of $316,000 based on a total complement of 315 permanent employees (314 permanent employees plus two temporary employees equivalent to one permanent employee). (OCA St. 1 at 17-18; OCA St. 1S at 3-4; OCA MB at 34-35).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the Company’s claim of $12,633,000 in annual payroll expense based on a complement of 321 employees be approved, finding that it was reasonable and supported by record evidence. The ALJ found that over a three-year period, the average employee complement has been less than one-fifth of one position below the budgeted amount, and that at times the Company’s complement of employees has been greater than budgeted. (R.D. at 30-31).

 The ALJ found that the adjustments proposed by the OCA and the OTS were based on employee complement numbers that were not supported by historic data, and that it would be inappropriate and inaccurate to establish an employee complement based upon one month in time. (R.D. at 30).

 **c. Exceptions**

 The OCA’s Exceptions contend that the ALJ erred when the record clearly demonstrates that the number of Company employees consistently ranged between 313 and 315. The OCA argues that the Company based its claim on the peak number of employees that was achieved in only two months, March 2004 and July 2006. The OCA notes that the July 2006 complement of 321 employees included six temporary employees.

 The Company’s Reply Exceptions state that its number of employees compared to budget varies over time, and that on average its actual employee complement is less than one-fifth of one position below budget. The Company argues that the OCA did not specifically address its contentions, and that the OCA focused on the employee complement from December 31, 2005 through August 2006, rather than considering the relationship of employee complement to budget over time. (PPL Gas R.Exc. at 16-17).

 **d. Disposition**

 We will adopt the ALJ’s recommendation on this issue. We agree that the Company adequately demonstrated that its budgeted employee complement is reasonably accurate and supported by historic data. As demonstrated, its actual employee complement was less than one-fifth of one position below budget over a three-year period. Although in the one-month snapshot taken in August 2006 there were seven unfilled positions, over time the difference between employee complement and budget has been insignificant. The relative insignificance of the employee complement in one individual month is confirmed by the Company’s averment that in the next month it was in the process of hiring four additional employees. The OCA’s Exception on this issue is denied.

**7. Amortization of Storage Field Gas Losses**

 **a. Positions of the Parties**

 PPL Gas claimed $282,000 for gas losses from two storage fields, based on a total loss of 482,336 Dth valued at $2,820,000, from 2002 through 2005, and a proposal to amortize this amount over ten years. (PPL Gas St. 3-R at 19). The OCA proposed to eliminate the claim entirely on the basis that its approval would constitute retroactive ratemaking.

 PPL Gas argued that the OCA’s proposal should be rejected because its method of recovering storage field gas losses has been approved by the Commission in prior rate proceedings over the OCA’s objections. PPL Gas averred that its long-standing practice has been to determine periodically the amount of lost gas during a prior period from the Meeker and Tioga storage fields, and then to amortize the losses for ratemaking purposes. *Pa. PUC v. North Penn Gas Co*., 65 Pa. PUC 215 (1987). PPL Gas stated that the OCA ignored the ratemaking treatment history of this issue and that its proposal should be rejected on this basis. (PPL Gas MB at 43-45).

 The OCA characterized the Company’s claim as a request for the recovery of past losses in future rates, or retroactive ratemaking. (OCA St. 1 at 20, OCA MB at 28). The OCA disputed the ratemaking history relied upon by the Company, noting that the last base rate case was resolved through a settlement and cannot be relied upon as precedent. Additionally, in this case PPL Gas proposed a change in practice. To comply with new accounting practices under the Sarbanes-Oxley Act of 2002, the Company now is expensing the cost of gas lost from storage when it occurs. To match the timing of revenue and expense, the Company proposed an annual expense for future gas losses of $507,420, which the OCA has not opposed. The OCA is opposed, however, to the recovery of gas lost from storage from 2002 through 2005, and argued that prior expenses cannot be recovered unless the expense is unanticipated, extraordinary and non-recurring. *Philadelphia Electric v. Pa. PUC*, 502 A.2d 722, 728 (Pa. Cmwlth. 1985). According to the OCA, PPL Gas did not allege that the lost gas expense fits within these exceptions to the rule against retroactive ratemaking. The OCA pointed to a Commission decision that denied a claim for recovery of past sludge removal expense, but allowed the recovery on a going-forward basis. The Commission found that “[t]he existence of the unchallenged ongoing expense, however, is proof positive that the cost for removal of the sludge … is not extraordinary, non-recurring expense which should be amortized in current rates.” *Pa. PUC v. Mechanicsburg Water Co.*, 80 Pa. PUC 212, 232 (1993). The OCA concluded that its proposal to deny the claim for recovery of past storage losses was supported by the record and by the law.

 PPL Gas replied that it properly referenced the inclusion of storage field gas losses in the settlement of its 2000 rate case, because the purpose of the reference was to establish the fact of an existing practice, as opposed to legal precedent. More importantly, the Commission approved the recovery of storage field gas losses in the Company’s litigated proceeding in the 1987 *North Penn* case. PPL Gas argued that these two cases demonstrate that the Commission in the past allowed the Company to amortize past storage field gas losses, and that the OCA’s proposal is inconsistent with prior Commission orders.

 **b. ALJ’s Recommendation**

 The ALJ recommended that PPL Gas’ annual expense claim of $282,000 for amortization of storage field gas losses be approved. The ALJ concluded that the OCA failed to show how the 1987 Commission decision in *North Penn* does not apply in this proceeding. (R.D. at 32).

 **c. Exceptions**

 The OCA’s Exceptions argue that the ALJ’s finding that it had not distinguished this case from the 1987 *North Penn* case is erroneous. The OCA states that the Company itself departed from past practice by claiming an expense for current storage field gas losses, which the OCA did not oppose. In the past, the Company deferred the recovery of losses, but the Company has since changed its accounting practices to comply with the Sarbanes-Oxley Act of 2002. Since the Company now expenses gas losses, the OCA argues that it no longer can defer such amounts for future recovery. The OCA argues that the Company no longer uses the accounting practices upon which the *North Penn* decision was based, and that the recovery of gas lost between 2002 and 2005 would be improperly retroactive where the Company also has proposed to recover lost gas expense on a normalized, recurring basis.

 The Company’s Reply Exceptions argue that the OCA proposes to depart from well-established practice and allow PPL Gas to recover losses only prospectively. The Company states that, while it is willing to recover losses on a current basis prospectively, as part of a transition to current recovery it is necessary to recover losses for the period 2002 through 2005. The Company distinguishes its claim from the disallowed sludge removal expenses at issue in *Mechanicsburg Water*. According to the Company, in *Mechanicsburg Water* there had been no prior approval of amortization of past expenses, and the Commission found that the expenses were routine, normal and ongoing and did not qualify for amortization. In contrast, in this case the Commission previously concluded that the Company’s storage field losses qualify for amortization. Here, one last amortization is necessary to complete the transition from amortization of past expenses to current recovery of such expenses. (PPL Gas R.Exc. at 17-19).

 **d. Disposition**

 We shall adopt the ALJ’s recommendation and deny the OCA’s Exception on this issue. While it is true that the Company now is expensing its storage field gas losses on a current basis, it would be unfair to depart abruptly from past practice and prevent the Company from recovering the losses it incurred from 2002 through 2005. It is important to note that the gas losses from 2002 through 2005 will not be expensed on a going-forward basis, and that there is no double recovery issue, as the OCA’s Exceptions seem to imply. We agree with the Company that one last amortization is necessary to complete the transition from amortization of past expenses to current recovery of expenses going forward.

**8. Right-of-Way Maintenance Expense**

 **a. Positions of the Parties**

 PPL Gas claimed an expense of $678,000 for its right-of-way (ROW) maintenance program. (PPL Exh. Future 1 – Revised, Sch. B-4 at 3). PPL Gas also provided testimony that its projected ROW maintenance expense for the 2006 future test year was $765,000. (PPL Gas St. 1-R at 10). PPL Gas and the OCA describe this issue in terms of a claimed expense of $765,000; the OTS and the ALJ describe the issue in terms of a claimed expense of $678,000. The discrepancy between the two amounts is not explained.

 PPL Gas averred that the increase over prior years’ expense results from changes in legal requirements. Specifically, the ROW maintenance program has expanded to accommodate testing under the Company’s Integrity Management Plan, which is a result of the Company’s response to federal regulations. The ROW maintenance program now must incorporate a wider clear path over and along the Company’s pipelines, and an open tree canopy above the pipelines, to accommodate global positioning system (GPS) tools. PPL Gas further argued that it now expects that its actual expense in 2006 will be approximately $855,000, significantly more than its 2006 budget of $765,000. (Tr. at 121-23). PPL Gas argued that the Commission should encourage natural gas distribution companies to maintain their system in a safe and adequate manner, in compliance with all legal requirements.

 The OTS argued that the Company’s claim of $678,000 should be adjusted downward by $202,000 to $476,000, which is the Company’s projected average expense level for the five-year period 2006 - 2010. (OTS St. 2 at 20; OTS Exh. 2, Sch. 12). [[13]](#footnote-13)

 The OCA argued that the Company’s claim of $765,000 represents a significant increase to actual ROW expenditures in recent years, and should be adjusted downward by $440,000 to $325,000, the Company’s actual expense in 2005. The OCA noted that, from 2001 through 2004, the annual ROW program costs never exceeded $284,000. (OCA MB at 30). The OCA also noted that the Company recorded $120,000 in payments for work performed in late 2005 as 2006 expenses. The OCA argued that, while some level of increased expense would be reasonable, the Company’s claim was abnormally high and inconsistent with the Company’s recent experience. The OCA stated that, given the Company’s projected average expense of $476,000 for 2006 through 2010, even the Company does not consider its claim for $765,000 to be normal. In addition, the OCA argued that the Company’s spending in 2006 was not on pace to support its claim, and that exclusive of the payment of $120,000 for work performed in 2005, the actual expenses during the first six months of 2006 were only $82,000.

 Based on the Company’s actual costs and its own projected level of on-going expense, the OCA recommended that the claim be adjusted downward by $440,000 to reflect an annual expense allowance of $325,000, equal to the Company’s actual expenditure in 2005 of $205,000, adjusted upward for the $120,000 for work performed in 2005 but recorded in 2006. (OCA St. 1S, Sch. C-2 Revised; OCA MB, Table II). This would represent an increase of 75 percent over 2004 costs and 146 percent over 2003 costs.

 PPL Gas replied that the OCA’s proposed adjustment should be rejected because it is based on 2005 expenditures and does not provide for any expense increase. PPL Gas averred that it provided unrebutted evidence that 2006 expenses will be $855,148, an amount that exceeds the budgeted expense. PPL Gas claimed that the OCA ignored its explanation of the increased work that was required to meet the requirements of federal regulations, and that even the OCA admitted that it was reasonable to expect some level of increased expense. PPL Gas’ Reply Brief did not address the OTS’ proposed adjustment.

 The OTS replied that the Company’s argument seems to be that expense levels from previous years should be ignored in favor of the disproportionately higher level of expense in 2006, the future test year. The OTS rejected the Company’s argument that changes in legal requirements will cause expenses to increase as too vague, stating that the Company failed to quantify any such alleged increase or address such legal requirements with sufficient specificity to render the increase known and measurable for ratemaking purposes. The OTS also stated that the Company presented no evidence that its increased 2006 expenditures were not scheduled to coincide with the future test year and will be typical for the post-2006 years that these rates will be in effect. The OTS argued that the sharp escalation in the 2006 expense level justifies the reliance on the Company’s own projection of an annual normalized expense level of $476,000 as a better representative of the normal level of expense. (OTS RB at 19-21).

 The OCA replied that PPL Gas improperly mixed the question of how much the Company will spend in 2006 with the question of a reasonable, normal level of ROW expense for the purpose of establishing just and reasonable rates. The OCA stated that, even if the Company spends $765,000 in 2006, there is nothing in the record that supports this amount as a normal level of expense, noting that the average of the Company’s own forecasted expense for the five years 2006 through 2011 was less than the Company’s rate case claim. The OCA also noted that, as of the close of the record in September 2006, the Company incurred only $239,318 in ROW expense.

 **b. ALJ’s Recommendation**

 The ALJ recommended that PPL Gas’ claim be approved. The ALJ found that the Company’s claim was supported by the record; that PPL Gas presented evidence that the actual cost of the ROW maintenance will exceed the amount budgeted for the 2006 test year; and that this supportive evidence was not refuted by either the OTS or the OCA. The ALJ concluded that the arguments presented by the OTS and the OCA and OTS were not persuasive. (R.D. at 32-34).

 **c. Exceptions**

 The OCA argues in its Exceptions that the ALJ erred in concluding that the record evidence supports the Company’s budgeted claim for ROW clearing costs of $678,000.[[14]](#footnote-14) The Company’s actual expenditures for the first six months of 2006 were only $82,000; the actual expenditures at the end of August 2006 were only $119,000; and the record does not support a conclusion that the Company will spend the budgeted amount of $765,000, either in 2006 or in the future. “Based on the Company’s actual expenditures and the Company’s own expectations of a normal level of on-going ROW maintenance expense, the ALJ erred in accepting the Company’s abnormally high ROW program expense claim in this case.” (OCA Exc. at 16). The OCA submits that the Commission should adopt *either* the OCA’s proposed allowance of $325,000 based on 2005 expenses, *or* the OTS proposed allowance of $476,000 based on the Company’s forecasted expenses from 2006 through 2010.

 The Company’s Reply Exceptions state that, contrary to the OCA’s argument that the Company did not prove its claimed level of expense in the future test year, the Company demonstrated that the increased level of expense results from changes in legal requirements, and that its actual costs for ROW maintenance will exceed its 2006 budget. (PPL Gas R.Exc. at 19-20).

 **d. Disposition**

 We will adopt the ALJ’s recommendation on this issue. The Company has demonstrated that its ROW maintenance program is expanding significantly to accommodate GPS tools and testing required by the Company’s Integrity Management Plan. Although the Company’s claim is based on its 2006 budget of $765,000, it presented testimony that its actual expense in 2006 will be approximately $855,000. The OTS and the OCA adjustments both are based on the Company’s past level of expenditures, and make no allowance for higher costs from the increased maintenance required to maintain a wider clear path and open tree canopy along the Company’s pipeline ROWs. The OCA’s Exception is denied.

**9. Customer Records Expense**

 **a. Positions of the Parties**

 PPL Gas claimed $2,284,000 in customer records expense for the future test year. The Company’s expense in the historic test year was $1,774,000. (PPL Gas Exh. Historic 1, Sch. B-4 at 4; PPL Gas Exh. Future 1, Sch. B-4 at 4). The OCA proposed an adjustment of $100,000 based on the expenditure for a new telephone system, which the OCA maintained was a non-recurring expense.

 The Company argued that, while viewed in isolation the installation of a new telephone system, appears to be a non-recurring charge, similar projects are done routinely every year. Similar projects in recent years included radio coverage studies and enhancements, electronic dispatching equipment set-up, consultant support for enhancements to software, and distribution system alarm programming. (PPL Gas MB at 47-48).

 The OCA argued that the inclusion of the one-time cost of installing the new telephone system would mean that ratepayers would be charged for this cost every year. The OCA submitted that the Company did not meet its burden of proof that the customer records expense claim should include $100,000 for the new telephone system, noting that the Company’s claim increased from $1,774,000 in the historic test year to $2,284,000 in the future test year. (OCA St. 1 at 29; OCA Sch. C-2 Revised; OCA MB at 35-36).

 The OCA argued in reply that the Company attempted to shift the burden of proof and has asked the Commission to accept that the Company will spend $100,000 per year for different projects chargeable to different accounts. Such expenditures imply a deduction to customer records expense and a corresponding increase to some other account. However, the Company’s claims in rebuttal can not substitute for the substantial evidence that is required to support its claim. (OCA RB at 18).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the OCA’s proposed adjustment be adopted, finding that PPL Gas failed to meet is burden of proof on its inclusion of the expense for the new telephone system. “PPL Gas attacks the logic of the OCA’s reasoning stating that the conclusion is flawed because the expenditure is viewed in isolation. However, PPL Gas does not present any credible rationale for why the expenses should be viewed as recurring annually and thus, justifiably applied to rates for recovery each year the rates are in effect.” (R.D. at 34). The ALJ recommended that the jurisdictional expense of $99,000 for the new telephone system should be rejected, and that the OCA’s adjustment should be adopted.[[15]](#footnote-15) (R.D. at 34-35).

 **c. Disposition**

 No party filed an Exception to the ALJ’s recommendation on this issue. On review, we agree with the ALJ’s reasoning and will adjust the Company’s claim downward by $99,000 on a jurisdictional basis. The Company claimed that the expenditure for the new telephone system was representative of a recurring expense, but did not present adequate evidence to support its claim.

**10. Uncollectible Accounts Expense**

**a. Positions of the Parties**

 PPL Gas claimed $2,916,000 in uncollectible accounts expense, which it calculated by multiplying a projected uncollectible accounts of 1.5 percent by the budgeted future test year revenues, then adding $200,000 for anticipated arrearage forgiveness under its Customer Assistance Program (CAP). The OTS and the OCA proposed adjustments of $179,621 and $343,000, respectively.

 PPL Gas argued that its uncollectible accounts of 1.5 percent is based on judgment and historical experience. Excluding CAP arrearage forgiveness, over the last four years uncollectible accounts expense ranged from 1.07 percent in 200,5 to 1.41 percent in 2002.[[16]](#footnote-16) PPL Gas submitted that the lower percentage in 2005 was due to unusual circumstances, including the publicity surrounding the implementation of Chapter 14, increased LIHEAP funding, the Governor’s *Stay Warm Pennsylvania* initiative and the increase in the Company’s CAP enrollment. More significantly, gas cost increases in the latter part of 2005 increased 2005 revenues significantly without affecting uncollectible accounts expense for that year. Uncollectible accounts expense related to the higher level of purchased gas costs will not materialize until several months after the service is provided. (PPL Gas St. 1-R at 5). PPL Gas submitted that the combination of suppressed uncollectible accounts expense and increased revenues in 2005 produced an extraordinarily low ratio of expense to revenue. PPL Gas selected 1.5 percent as the ratio for its filing because certain of the 2005 factors will have no effect in 2006, and others will have the opposite effect and increase uncollectible accounts expense. Most importantly, the continuation of high purchased gas costs will result in an increased number of customers being unable to pay their bills.

 PPL Gas’ inclusion of an additional $200,000 to reflect arrearage forgiveness under its CAP reflects the expansion of its CAP and the historically increasing trend of CAP arrearage forgiveness, which steadily has increased from $73,091 in 2002 to $164,463 in 2005. (PPL Gas St. 1 at 12). PPL Gas stated that it had completed the expansion of its CAP from 2,200 to 2,500 customers, and that no further increase in the CAP population is anticipated. (PPL Gas RB at 22). PPL Gas criticized the adjustments proposed by the OTS and the OCA, both of which were based on an average of multiple years’ write-offs, as failing to recognize that changes have occurred and that historical experience is not a reliable indicator of uncollectible accounts expense in 2006 and beyond.

 The OTS proposed an adjustment based on the write-off ratio over four years, which would lower the 1.5 percent ratio proposed by the Company to 1.27 percent. The OTS also opposed the inclusion of an additional $200,000 in CAP arrearage forgiveness in the calculation of the Company’s claim. The OTS methodology excluded arrearage forgiveness write-offs from net write-offs in its calculation, and then added back the Company’s projected CAP arrearage of $200,000 to the uncollectible allowance. The calculation produced an OTS-recommended adjustment of $179,621. The OTS argued that the Company improperly included CAP arrearages in the development of its proposed write-off ratio because these amounts are fixed and do not vary with revenue. According to the OTS, the Company improperly included CAP arrearage amounts twice in its calculation – first as part of the calculation of the ratio, and second as an add-on to arrive at the Company’s total claim. The OTS criticized the Company’s methodology as “double dipping.” (OTS MB at 21-24).

 PPL Gas argued that the OTS failed to recognize that there is an annual thirty percent turnover among CAP customers, and that the CAP population is increasing, both of which will increase the level of CAP arrearage forgiveness. In reply, PPL Gas also contested the OTS’ argument that PPL Gas included the CAP arrearage forgiveness amount twice in its calculation, and flatly asserted that arrearage forgiveness amounts were not included in the 1.5 percent ratio used to calculate uncollectible accounts expense. PPL Gas pointed out that the OTS witness on this issue made no such criticism of PPL Gas’ calculation, and the OTS provided no record citation in support of its argument. PPL Gas reiterated that the only difference between its and the OTS’ methodology was that the OTS used a write-off ratio of 1.27 percent based on an average of historical write-offs, while PPL Gas used a judgmental ratio of 1.5 percent.

 The OCA recommended three adjustments to the Company’s calculation: (1) a reduction in the write-off ratio from 1.5 percent to 1.33 percent based on the Company’s actual experience from 2001 through 2005; (2) a weather normalization adjustment; and (3) an update to reflect the recent settlement of the Company’s Section 1307(f) case under which the purchased gas cost rate is $12.4738 per Mcf. The OCA observed that its recommended write-off ratio of 1.33 percent, which was based on the five-year period 2001 through 2005, was not materially different than the 1.35 percent average for the three-year period 2002 through 2004. The total adjustment recommended by the OCA was $343,000. (OCA MB at 32-33).

 PPL Gas criticized the OCA’s use of a lower level of revenues to calculate the expense. PPL Gas states that changes in purchased gas cost rates that took effect on December 31, 2006, will not affect uncollectible account expense until late in 2007, and argues that the OCA should not be allowed to reach beyond the future test year to reduce uncollectible accounts expense. Further, PPL Gas argued that, because purchased gas cost rates are adjusted quarterly, there is no reason to believe that the rates established by the settlement of its Section 1307(f) proceeding will be maintained on an ongoing basis. Finally, PPL Gas averred that its uncollectible accounts expense clearly is on the rise, and that as of July 31, 2006, it had 410 more accounts shut off for nonpayment than at the same time in 2005, an increase of thirty-six percent, and that the amounts owed by customers terminated for nonpayment was ninety-five percent higher. (PPL Gas MB at 48-52).

 In reply, the OCA argued that the Company’s write-off ratio of 1.5 percent is in excess of any level experienced in the last five years, and that the Company’s claim that 2005 was atypical was addressed by the OCA’s use of a five-year average. Second, the OCA applied its recommended ratio of 1.33 percent to the Company’s *pro forma* future test year revenues, updated to reflect known and measurable rates, while the Company did not offer a substitute or better rate. Third, the OCA stated that its recommended expense level included an allowance of $196,000 for CAP arrearage forgiveness. (OCA RB at 15-16).

 **b. ALJ’s Recommendation**

 The ALJ recommended that the Company’s uncollectible accounts expense claim be adjusted to reflect the OCA’s recommended write-off percentage of 1.33 percent. The ALJ recommended, however, that the OCA’s recommended adjustment to revenues be rejected. The ALJ recommended that the uncollectible accounts expense claim be adjusted to $2,861,609, a reduction of $54,391 to the Company’s claim.[[17]](#footnote-17) (R.D. at 36-37).

 The ALJ found that a write-off ratio of 1.33 percent was supported by record evidence, and that the Company’s argument that 2005 data should be disregarded as abnormal was unconvincing. The ALJ concluded that the use of an average ameliorates variations in the magnitudes of uncollectibles. “Simply put, PPL Gas’ assertion that the historical experience cannot be relied upon to provide an accurate estimate of uncollectible accounts for the future is not persuasive since PPL Gas to some extent reflects historical experience in its presentation of the proposed claim.” (R.D. at 36-37).

 The ALJ rejected the OCA’s recommended adjustment to revenues to reflect rates established by the settlement of the Company’s Section 1307(f) proceeding because these rates are subject to quarterly adjustment and will not remain constant on a going forward basis. (R.D. at 37).

 **c. Exceptions**

 The OCA’s Exceptions argue that, while the ALJ correctly adopted a write-off ratio of 1.33 percent, she applied the ratio to the wrong revenue amount when calculating uncollectible accounts expense. The OCA avers that the ALJ applied the write-off ratio to a revenue amount of $200,121,000, whereas the Company used $181,321,000 to calculate its uncollectible accounts expense. The OCA suggests that the ALJ erroneously used a revenue figure from OTS Exhibit No. 2, Schedule 2, which included transportation revenues that should not be included in the calculation of uncollectible accounts expense. The OCA submits that the ALJ’s recommendation should be corrected to reflect a *pro forma* uncollectible accounts expense of $2,612,000.[[18]](#footnote-18) (OCA Exc. at 16-17).

 The Company’s Reply Exceptions state that the OCA’s criticism of the ALJ’s calculation is erroneous because the ALJ’s use of future test year billed revenues, as proposed by the OTS, was not criticized in the record, is supported by substantial evidence in the testimony of the OTS, and is consistent with past Commission practice. The Company cites *Pa. PUC v. National Fuel Gas Distribution Corp.*, Docket No. R-901670, p. 5 (December 24, 1990) and *Pa. PUC v. National Fuel Gas Distribution Corp.*, Docket No. R-891218 (December 29, 1989). As to the OCA’s contention that the ALJ did not intend to use the level of revenues proposed by the OTS, the Company states that there is no such indication in the Recommended Decision. Finally, the Company disputes the OCA’s contention that it is improper to include transportation revenues in the calculation because a portion of transportation revenues become uncollectible. (PPL Gas R.Exc. at 20-21).

 The Company did not except to the ALJ’s determination that a write-off ratio of 1.33 percent as proposed by the OCA is appropriate.

 **d. Disposition**

 No party excepted to the ALJ’s recommendation to adopt the OCA’s proposed write-off ratio of 1.33 percent, which we shall adopt. This ratio comports with the Company’s actual experience for the five-year period from 2001 through 2005. It also is not materially different than the Company’s 1.35 percent average for the three-year period 2002 through 2004, which excludes the year 2005 that the Company claims was abnormal.

 With regard to the level of revenues against which the write-off ratio will be applied to determine the Company’s uncollectible accounts expense, we agree with the OCA’s argument that the most recent purchased gas cost rate should be used to calculate the Company’s revenues. Although, as the Company points out, the rate is subject to quarterly adjustment going forward, the more recent rate is a more reliable indicator of the Company’s future revenues than is a rate that already has been rescinded. The Company’s argument against using the more recent rate because it may change really is an argument against using any rate at all. We know for a fact that the rate preferred by the Company is no longer operative; we can only assume that the current rate will not be in effect for the duration of the base rates established in this proceeding. Such is the nature of the rate setting process. In order to calculate a revenue amount against which the write-off ratio will be applied, we must select a rate certain, knowing in advance that the rate is subject to change. We believe that the more recent rate is a better predictor of future revenue than is a past rate no longer in effect. Accordingly, we adopt the OCA’s revised adjustment in this regard. After multiplying the adjusted present rate revenue by the write-off ratio of 1.33 percent, we will add $200,000 for CAP arrearage forgiveness to determine the total uncollectible accounts expense allowance. This results in an uncollectible accounts expense of $2,695,615, and a downward adjustment of $220,385 to the Company’s claim.[[19]](#footnote-19)

**11. LIURP Initiative**

 **a. Positions of the Parties**

 The issue in this proceeding is whether or not the Company should be required to implement a low income usage reduction program (LIURP). The settlement of the Company’s restructuring proceeding in 2000 at Docket No. R-00994788 provided that the Company would not be required to implement a LIURP through the end of its four-year ramp up of its CAP. After this four-year period, any party was free to recommend that a LIURP be implemented. In this proceeding, the Commission on Economic Opportunity (CEO) has advocated that the Company be required to implement a LIURP. The CEO is a non-profit corporation whose clients are the low-income population in Luzerne County. (CEO MB at 1).

 The CEO averred that it has a particular expertise in weatherization programs, having weatherized more than 25,000 homes under the U.S. Department of Energy Weatherization Assistance Program. The CEO serves as a subcontractor for the LIURPs operated by PPL Electric, UGI Gas, and PG Energy. The CEO argued that PPL Gas should be required to establish a LIURP because the Commission found that LIURPs have been one of the most successful programs for assisting low-income customers. The CEO also argued that PPL Gas is required by law to implement a LIURP with minimum annual funding equal to 0.2 percent of jurisdictional revenues, citing 52 Pa. Code § 58.4. The CEO argued that, while 52 Pa. Code § 58.18 authorizes exemptions from the requirement for special circumstances, a covered utility is required to petition the Commission for an exemption. PPL Gas did not file such a petition; rather, it simply has operated without a LIURP. Finally, the CEO argued that the Competition Act requires that the Commission ensure that universal service programs are available and appropriately funded; that universal service programs include LIURPs; and, therefore, that the Act mandates that PPL Gas have a LIURP. (CEO MB at 3).

 The CEO proposed that PPL Gas be directed to establish a LIURP at the regulatory minimum level of 0.2 percent of jurisdictional revenues, or $300,000. The CEO averred that this funding level would provide services to 107 customers per year, out of the total 66,000 plus residential customers served by PPL Gas. (CEO MB at 4-5).

 PPL Gas argued that there are valid reasons why it is inappropriate for PPL Gas to implement a LIURP. First, PPL Gas argued that a LIURP would not be practical because it is a small gas distribution company with a service territory geographically disbursed throughout the Commonwealth. As of December 31, 2005, PPL Gas served 66,537 residential customers in thirty-four different counties. PPL Gas’ service territory extends from the New York state line to northern Maryland, and from the Delaware River to forty-five miles from the Ohio state line. (PPL RB at 23). To implement a LIURP to serve thirty-four counties, PPL Gas would be required to use services from eighteen different community-based organizations (CBOs).

 PPL Gas argued that the fifteen percent regulatory cap on administrative costs at 52 Pa. Code § 58.5 would not be feasible, given the large number of CBOs with which it would be required to work. All of the reporting and monetary requirements would be the same as those for large utilities, and PPL Gas would be required to obtain and consolidate required information from each of the eighteen CBOs that would be involved. The fifteen percent cap on administrative costs would equate to $45,000, which would not be sufficient to pay the wages and benefits of even one full-time employee, or the other requisite costs such as travel, office space and computer systems. (PPL MB at 53). PPL Gas argued that, if it were required to implement a LIURP, it would need relief from the cap on administrative expenses. (PPL Gas RB at 24).

 PPL Gas further argued that, even assuming none of the LIURP costs of $300,000 were used for administration, only 107 residences could be weatherized per year, on average only three customers per county. Each CBO would be able to weatherize only six residences per year. A CBO could not be expected to maintain a program under which only one residence could be weatherized every two months. PPL Gas noted that these already low numbers would be reduced to even lower levels to accommodate administrative costs. PPL Gas argued that the CEO simply ignores the practical difficulties in implementing a LIURP in PPL Gas’ service territory, and that it would not be in the best interests of customers to implement such an inefficient program.

 PPL Gas also contested the CEO’s interpretation of the Commission’s regulatory requirements. The Commission’s LIURP regulations took effect on January 16, 1993, and therefore were in effect in 2000 when PPL Gas specifically was exempted from the requirement to implement a LIURP. (PPL Gas MB at 54).

 Although PPL Gas argued that it would not be appropriate for the Commission to require it to implement a LIURP, it stated that is willing to develop a program tailored to its specific circumstances, which would provide less aggressive usage reduction measures to more customers. Such an alternative program would have significantly reduced analysis and reporting requirements so that the administrative costs would not be disproportionate to the program’s costs. PPL Gas stated that it would be willing to work with the CEO and other CBOs to develop such a program, and noted that the program’s size would be commensurate with the revenue allowance, if any, approved by the Commission. (PPL Gas MB 52-55).

 In reply, the CEO argued that, although PPL Gas should be compelled to implement a LIURP, at a minimum it should be directed to implement its alternative proposal. The CEO argued that, regardless of whether a traditional LIURP or an alternative program is established, the funding level should be $300,000 annually.

**b. ALJ’s Recommendation**

 The ALJ concluded that PPL Gas should not be required to implement a traditional LIURP, and that the Commission had provided a specific exemption from the regulatory LIURP requirement to PPL Gas. The ALJ concluded that the fact that the Commission provided this exemption after Chapter 58 of the Commission regulations became effective in January 1993 was compelling. (R.D. at 39).

 The ALJ determined that an alternative program as suggested by PPL Gas would satisfy 66 Pa. C.S. § 2203(8), and recommended that: (1) PPL Gas be required to file a program proposal within a time certain; (2) PPL Gas be directed to work with the CEO in implementing its program; (3) PPL Gas and the CEO be required to propose analysis and reporting requirements to the Commission’s Bureau of Consumer Services at least three months prior to implementation of the program similar to the provision in the settlement at Docket No. R-00991488; and (4) PPL Gas should not commence the program without Commission approval. (R.D. at 39).

 **c. Exceptions**

 PPL Gas’ Exceptions object to the ALJ’s failure to include any rate recovery provision for the costs of an alternative program. Although PPL Gas does not object to undertaking a design of a scaled-back usage reduction program, it strongly objects to any requirement to implement such a program without a cost recovery provision. In order to address this problem, PPL Gas states that it is willing to submit to the Commission a program that would address funding in addition to program design. In the alternative, PPL is willing to propose a program in conjunction with its next base rate case, when funding could be addressed. (PPL Exc. at 26-27).

 The CEO’s Exceptions object to the ALJ’s failure to require that the funding for the Company’s program be established at $300,000 annually. Although the CEO does not object to the type of program recommended by the ALJ, it objects to the lack of a required funding level of $300,000 for the program.

 PPL Gas’ Reply Exceptions do not respond to the CEO’s Exceptions on a specific funding level. The CEO’s Reply Exceptions, however, object to the alternative proposed by the Company of waiting until its next base rate case to address the design and funding of a program. The CEO submits that, because the Company’s low income residential customers have been without a LIURP for years, funding should be established as part of the current rate case. The CEO points out that the Company did not argue that program funding should be scaled back, but rather that the usage reduction measures provided to customers be less than those in a traditional LIURP so that more customers could be reached in the Company’s dispersed service territory. Although the CEO has no objection to scaled-back program measures and reporting requirements if it means more customers would be served, the CEO does object to funding at less than $300,000 annually. The CEO requests that funding be established at $300,000 and that this amount be recoverable through rates.

 The OCA’s Reply Exceptions state that funding should be addressed in conjunction with a filing by the Company on program design. The OCA refers to the Commission’s recent Order regarding CAPs where the Commission expressed its intent to more closely link the review of CAP program design and funding. *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051923 (December 18, 2006). The OCA states that the same approach for a scaled-back low income weatherization program is appropriate.

**d. Disposition**

 We agree with and will adopt the ALJ’s recommendation that the Company be required to implement an alternative to a traditional LIURP program. The ALJ recommended that the Company be required to file a proposed program with the Commission for approval within a date certain. We shall require that the Company file a program proposal within six months of the date of this Order, or with the filing of its next base rate proceeding, whichever comes first.

 With regard to the Exceptions filed by the Company and by the CEO, we believe that the Company should propose a funding level and a funding mechanism at the time that it files its program proposal. Establishing a funding level in advance for a program that has not been proposed or approved seems to us to be ill advised. Waiting to establish a funding level will enable the Company to tailor its requested funding level to the program that it develops and proposes. If the proposed program measures are revised in the forthcoming Commission proceeding, the funding level can be adjusted accordingly. If, however, we were to establish a fixed and immutable funding level in a vacuum, the Company would have to design its program to fit the funding, rather than the other way around.

 We also do not believe that the funding level for the Company’s program is or should be dictated by our regulation at 52 Pa. Code § 58.4. First, the funding level of 0.2 percent of jurisdictional revenues is described as a general guideline subject to revision when the Commission reviews the need for program services and addresses the recovery of program costs in utility rates. Program services and program costs will be reviewed in the Company’s filing that we are requiring in this Order. Second, the Commission previously has exempted the Company from the requirement that it establish a low income usage reduction program. Today we are requiring that the Company begin the process of establishing such a program and file a proposal within six months. We will establish the appropriate funding level in that proceeding. Until that time, the Company’s current exemption shall continue in effect.

**E. Taxes**

 **1. Federal Income Tax & Consolidated Tax Savings**

 **a. Positions of the Parties**

 PPL Gas originally filed a calculated federal income tax liability on a stand-alone, separate company basis although the Company filed with the Internal Revenue Service as part of a consolidated group under parent corporation PPL Corporation. (PPL Gas Exh. 1-A at 66). Although PPL Gas asserted that it is inappropriate to adjust the federal income tax expense to reflect its participation as a member of the PPL Corporate System in a consolidated tax return, the Company acknowledged that the Commission makes adjustments in rate cases where a utility participates in a consolidated federal income tax return and unregulated affiliates experience losses for the purposes of calculating federal income taxes. Consequently, PPL Gas concurred with the methodology regarding federal income tax advocated by the OTS in using three years of data for computing an adjustment reflecting consolidated savings. (PPL Gas MB at 56-57). In addition, PPL Gas also suggested removal of certain non-recurring items: non-recurring bonus tax depreciation which expired at the end of 2004; one-time losses associated with sale of specific assets or business units; losses from discontinued operations and now divested assets; and losses from Synfuel operations as the operations are being shut-down and thus will not recur. (PPL Gas MB at 57, PPL St. 3-R at 15-16). The result of these adjustments yields a reduction to income tax expense of $59,715. (See PPL Exh. JMK-2 Sch. 2, PPL Gas Exh. Future-1 Revised Sch. D-12). The OTS accepted this adjustment. (OTS MB at 40).

 The OCA recommended a reduction of $411,000 (on a jurisdictional basis) to the federal income tax expense claim. (OCA MB at 42, Appendix A Sch. C-4 and C-4.1 corrected 9/22/06). The difference between the Company’s claim and the position of the OCA hinges upon the use or disregard of a three-year average of taxable income for PPL Gas. The OCA did not use a three-year average of PPL Gas’ taxable income but used the *pro forma* federal taxable income under present rates. (See PPL Gas Exh. Future-1 Revised Sch. D-12). The OCA essentially contended that, because of the quantities of the historic three years, two years with zero amounts and one with a positive amount, it is unsound to base consolidated tax savings on these data. The OCA chose instead to base its recommendation on the best available record data, the Company’s normalized three-year average of affiliates’ tax losses. (OCA RB at 20).

 PPL Gas refuted the OCA’s assertion that using the three-year average of taxable income for PPL Gas is unsound. According to PPL Gas, the OCA’s calculations contain several inconsistencies because of mismatched data. PPL Gas noted that the OCA mismatched data from different time periods, 2003 – 2005 for affiliates, and 2006 for PPL Gas, and mismatched per books federal taxable income for the affiliates with normalized future test year federal taxable income, as adjusted for ratemaking purposes, for PPL Gas. PPL Gas asserted that this mismatching is inconsistent and inappropriate. Additionally, PPL Gas asserted that the OCA’s method is inconsistent with Commission practice of using the Modified Effective Tax Rate method. PPL Gas cited *Pa. PUC v. Pa. American Water Co.*, 2002 Pa. PUC LEXIS 1, 93 for the contention that the Commission’s practice is to use multiple year averages to smooth out year-to-year fluctuations in taxable income. (PPL Gas RB at 24-27).

 **b. ALJ’s Recommendation**

 The ALJ concluded that the adjustment presented by the OCA was unreasonable and not objective and should be rejected. Conversely, the ALJ recommended that the adjustment as presented by PPL Gas in its Main Brief, yielding a $59,175 reduction in its income tax expense claim consistent with PPL Gas Future-1 Revised Sch. D-12, was reasonable and should be accepted. (R.D. at 41).

 **c. Exceptions**

In its Exceptions, the OCA submits that the ALJ erred in accepting the Company’s adjustment rather than its recommended adjustment for consolidated tax savings. The OCA avers that the Company’s adjustment understates the consolidated tax savings due to its selective “normalization” adjustments and should not be used in this proceeding. The OCA notes that the ALJ appeared to suggest that the OCA disregarded unfavorable data in its calculations but opines that the Company’s method does exactly what the ALJ finds to be unreasonable. The OCA avers that the Company does not take the data as it exists but makes numerous “normalization” adjustments to the taxable income of the tax loss affiliates, but makes no such normalization adjustment to the taxable income of PPL Gas. According to the OCA, the Company’s selective adjustments to the data had the effect of reducing the magnitude of the consolidated tax savings adjustment. (OCA Exc. at 17-18).

 In reply, PPL Gas reiterates its position that the OCA’s calculation is replete with inconsistencies, and is contrary to the Commission’s Modified Effective Tax Rate method. PPL Gas rejoins that its consolidated federal income tax savings calculation is consistent with the calculation presented by the OTS, which was based on three years of data, from 2003 to 2005, for the PPL Corporate System. PPL Gas avers that the only difference between the OTS calculation and its calculation is that PPL Gas made certain adjustments to remove the effects of non-recurring items from the calculation. PPL Gas cites to *Pa. PUC v. Pennsylvania Water Co. – Sayre Division,* Docket No. R-00891473, at 6-8, 70-71 (Aug. 31, 1990) and to *Pa. PUC v. Philadelphia Suburban Water Co.,* 75 Pa. PUC 391, 420 – 424 (Oct. 18, 1991) as support for its position that the elimination of non-recurring items has been consistently approved by the Commission. PPL Gas also notes that the OTS did not object to its consolidated tax calculations. (PPL Gas R.Exc. at 21-22).

 **d. Disposition**

 The OTS has employed the Modified Effective Tax Rate method utilizing a three-year average of the most recent available tax years to compute its consolidated tax adjustment. Upon review of the OTS calculation, PPL Gas concurred with this methodology, but recalculated the proposed consolidated income tax savings by excluding certain non-recurring items. Both the OTS and the ALJ accepted the PPL Gas recommended $59,715 amount as the appropriate adjustment to the Company’s federal income tax liability in this proceeding. Based on the evidence of record, we are in agreement with the ALJ and find the OCA’s arguments against the removal of non-recurring items to be unreasonable and inconsistent with Commission precedent.

 Accordingly, we deny the Exceptions of the OCA and shall adopt the recommendation of the ALJ.

 **2. Payroll Taxes**

**a. Positions of the Parties**

The OCA advocated that the payroll tax should be adjusted commensurate with the appropriate complement of employees on payroll. (OCA MB at 40).

**b. ALJ’s Recommendation**

The ALJ did not recommend adjusting the Company’s claim for payroll expense and complement of employees. (R.D. at 30-31). Consequently, the ALJ did not recommend adjusting payroll taxes corresponding to the payroll expense position of the OCA. (R.D. at 41).

**c. Disposition**

In its Exceptions filed in regard to PPL Gas’ annual payroll expense, the OCA noted that a corresponding adjustment to payroll taxes also should be adopted. (OCA Exc. at 13). Consistent with our discussion on the Company’s payroll expense claim, we shall deny the OCA’s Exception.

 **3. Capital Stock Taxes (“CST”)**

 **a. Positions of the Parties**

 PPL Gas calculated a CST of $382,000. (PPL Gas Exh. Future 1 Sch. D-11 at 2). PPL Gas used a 4.99 mills tax rate because it was currently in effect. The OTS opposed the use of the 4.99 mills and advocated use of 3.99 mills which becomes effective January 1, 2007, and will be in effect on the proposed effective date of the rate change from this proceeding, February 1, 2007.[[20]](#footnote-20) The change in the tax rate advocated by the OTS yields a reduction in the capital stock tax claim of $76,000. The OTS also recommended disallowance of the Company’s attempt to iterate the CST under proposed rates as inappropriate and unnecessary. (OTS MB at 35).

 **b. ALJ’s Recommendation**

 The ALJ concluded that PPL Gas’ use of the 4.99 mills tax rate instead of the 3.99 mills tax rate that will be in effect when this rate change takes place was not reasonable. The ALJ found that the adjustment to the capital stock tax of $76,000 reflecting the appropriate tax rate in 2007 is appropriate and supported by record evidence. The ALJ recommended the adjustment of $76,000 to the capital stock tax be approved as recommended by the OTS. Furthermore, the ALJ recommended that PPL Gas be required to make a second STAS filing on February 1, 2007, that will increase the Company’s STAS charge because the CST rate will have decreased from that effective January 1, 2007. (R.D. at 42).

The ALJ also noted that the Commission rejected the CST iteration claimed by PPL Electric Utilities Corporation in *Pa. PUC v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (December 22, 2004). The ALJ concluded that PPL Gas did not provide any persuasive record evidence to distinguish this case from Commission precedent. Therefore, in addition to the OTS adjustment of $76,000 to reduce the Company’s claim for Capital Stock Tax, the ALJ recommended that the Company’s claim for an additional $37,000 in CST based on PPL Gas’ requested increase should be rejected. (R.D. at 42).

**c. Exceptions**

In its Exceptions, PPL Gas first notes that it is not excepting to the ALJ’s first recommendation concerning capital stock tax, which adopted the OTS position to use a tax rate of 3.99 mills. PPL Gas avers that the difference between the tax rate effective in 2006 and the rate effective in 2007 can be addressed through proper use of the State Tax Adjustment Surcharge.

However, PPL Gas does except to the ALJ’s recommendation that the value of the capital stock of PPL Gas be based upon historical data instead of net income calculated on a *pro forma* basis, at rates established by the Commission in this proceeding. PPL Gas opines that the OTS’ characterization of the valuation of PPL Gas for tax purposes is correct, but it is not appropriate for ratemaking purposes. PPL Gas notes that the OTS valuation assumes that the capital stock tax for ratemaking purposes will be an exact repetition of historical net income for the five-year period from 2002 through 2006, during which time the rates of PPL Gas were deficient. PPL Gas avers that instead, capital stock tax, like all other taxes for ratemaking purposes, should be calculated based upon the level of net income allowed by the Commission in the Final Order. PPL Gas acknowledges that the Commission, in *PPL Electric,* accepted the approach of the OTS, but requests the Commission reconsider that conclusion and reject the OTS’ proposed adjustment. (PPL Gas Exc. at 27-28).

In reply, the OTS reiterates its position that capital stock tax should be excluded from the iteration process because it does not increase in direct proportion with an increase in revenues as does gross receipts tax and federal and state income taxes. The OTS responds that the Company is correct that the Commission has rejected the same CST iteration claimed By PPL Electric Utilities Corporation in *PPL Electric* and claims there is nothing in the instant record to successfully distinguish this present claim from the Commission’s determination there. The OTS requests that the Commission follow its own precedent and disallow the iteration of the claim and adopt the additional $37,000 recommended reduction to PPL Gas’ CST claim. (OTS R.Exc. at 15-16).

**d. Disposition**

We are in agreement with the OTS that PPL Gas has failed to distinguish its CST claim in this proceeding from our determination in *PPL Electric.* Consistent with this precedent, we adopt the OTS recommendation to disallow the iteration claimed by the Company because capital stock tax does not increase in direct proportion with an increase in revenues.

Accordingly, we shall adopt the recommendation of the ALJ and deny PPL Gas’ Exception concerning this matter.

**F. Rate of Return**

 The following table summarizes the Company’s position as to its required fair rate of return in this proceeding. The capital structure ratios and cost of long-term debt are the estimated levels at December 31, 2006, the end of the future test year in this case. PPL Gas’ claimed cost of common equity is 11.75 percent.

**Rate of Return[[21]](#footnote-21)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Capital** | **Capital Structure Ratio** | **Cost Rate** | **Weighted Cost** |
| Long-Term Debt | 26.90% | 6.30% | 1.69% |
| Short-Term Debt | 17.42% | 6.44% | 1.12% |
| Common Equity | 55.68% | 11.75% | 6.54% |
| Overall Rate | 100% |  | 9.35% |

Both the OCA and the OTS challenged the capital structure proposed by the Company. The capital structures proposed by the OCA and the OTS are hypothetical capital structures. The capital structures and cost rates proposed by the OCA and the OTS are shown in the table below:

 **OCA**[[22]](#footnote-22) **OTS**[[23]](#footnote-23)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Capital | Capital Ratio | Cost Rate | Weighted Cost | Capital Ratio | Cost Rate | WeightedCost |
| Long-Term Debt | 55% | 6.35% | 3.49% | 37.16% | 6.30% | 2.34% |
| Short-Term Debt |  |  |  | 17.42% | 6.44% | 1.12% |
| Common Equity | 45% | 9.625% | 4.33% | 45.42% | 9.00% | 4.09% |
| Total | 100% |  | 7.82% | 100% |  | 7.55% |

**1. Capital Structure (Actual vs. Hypothetical)**

 **a. Positions of the Parties**

PPL Gas proposed an actual capital structure of 55.68 percent common equity and 44.32 percent debt. This capital structure proposed by PPL Gas was based upon the actual capital to be employed at December 31, 2006, with a 13-month average of short-term debt to reflect the variations in the amount of stored gas to be financed during different months of the year. (PPL Gas St. 6 at 17-20). PPL Gas asserted that it has no plans to issue additional debt or equity in 2006. (PPL Gas MB at 68, note 8 citing PPL Gas St. 6 at 17).

PPL Gas stated that in reviewing the barometer gas group common equity ratios based upon permanent capital for 2004, the average was 53.2 percent with that average reduced to 47.2 percent if short-term debt is included. PPL Gas averred that it is only about 1/10th the size of the average barometer group company and investors view small size as creating greater risk for the investor. PPL Gas reasoned that, because of its smaller size, investors would expect to be compensated for greater risk with a higher equity ratio. Furthermore, PPL Gas cited Commission decisions where common equity ratios greater than 55 percent were adopted. *Pa. PUC v. Peoples Natural Gas Co.*, 63 Pa. PUC 6, 28-31 (1986) (61.2%); *Pa. PUC v. Peoples Natural Gas Co.*, 69 Pa. PUC 138, 164 (1989) (59.5%). (PPL Gas MB at 68).

The OTS rejected the Company’s capital structure and instead recommended a hypothetical capital structure of 37.16 percent long-term debt, 17.42 percent short-term debt, and 45.42 percent common equity. The OTS posited that the Company’s proposed permanent capital structure, that does not include short-term debt, is not representative of the industry norm. The OTS asserted that the projected actual equity ratio for PPL Gas is 67.43 percent compared to the nine gas distribution companies making up the gas barometer group’s average equity ratio of 54.47 percent.[[24]](#footnote-24) Based on these industry averages, the OTS proposed a hypothetical capital structure based upon permanent capital of fifty-five percent (55%) equity and forty-five percent (45%) long-term debt. (OTS MB at 43-44).

The OTS then made a further adjustment to its recommended capital structure due to the inclusion of PPL Gas’ gas storage in its rate base. The OTS opined that since gas storage is included in rate base and is financed by short-term debt, it is appropriate to include short-term debt in the company’s capital structure for ratemaking purposes. The OTS calculated the short-term debt using PPL Gas’ thirteen month average for the future test year of $38,819,000 as appropriate, and arrived at the same figure advocated by PPL Gas at 17.42 percent for short-term debt. Using this short-term debt quantity, the OTS hypothetical capital structure was recalculated to 37.16 percent long-term debt, 17.42 percent short-term debt and 45.42 percent equity. (OTS MB at 44).

The OCA also opposed the Company’s proposed capital structure and recommended a hypothetical capital structure of 55 percent debt and 45 percent equity. The OCA found PPL Gas’ proposed capital structure problematic because the amount of equity is excessive and inappropriate for ratemaking and inconsistent with the common equity ratios of other gas distribution companies and PPL Gas’ sister company, PPL Electric, and its parent PPL Corporation. (OCA MB at 49, OCA St. 2 at 3). The OCA found PPL Gas’ level of short-term debt “unusually high” compared with the capital structure of PPL Corporation. The OCA found that PPL Corporation maintained more consistent and lower common equity ratios of 43.3 percent, including short-term debt, and 44.1 percent, excluding short-term debt, in the parent capital structure. (OCA MB at 47-49).

PPL Gas criticized the capital structure presented by the OTS as flawed because it calculated short-term debt by including $25.8 million which financed non-storage gas. Therefore, according to PPL Gas, the short-term debt was overstated by the OTS and should be reduced to $13 million.[[25]](#footnote-25) PPL Gas averred that the correction to the calculations presented by the OTS using the $13 million for short-term debt yields a common equity ratio of 51.79 percent and total debt of 48.21 percent. (PPL Gas RB at 29-30, PPL Gas MB at 69, PPL Gas St. 6R at 9). The OTS did not dispute the rationale for executing this correction to its calculation of common equity. (OTS RB at 28).

**b. ALJ’s Recommendation**

The ALJ concluded that the OTS presentation, with the Company’s correction to short-term debt, was supported by the record evidence. Therefore, the ALJ recommended that a common equity ratio of 51.79 percent and a total debt ratio of 48.21 percent be used to adjust PPL Gas’ capital structure. According to the ALJ, both the OTS and the OCA, by implication, found the actual capital structure unreasonable. The ALJ concluded that the record evidence supported the conclusion that the actual capital structure proposed by PPL Gas was unreasonable. (R.D. at 50).

**c. Exceptions**

In its Exceptions, PPL Gas opines that its higher equity ratio is reasonable given that PPL Gas is much smaller than the average barometer group company and, therefore, faces greater risk, but does not except to the ALJ’s capital structure recommendation. However, PPL Gas noted that it does except to the ALJ’s failure to reflect its greater risk in the determination of the cost of equity. (PPL Gas Exc. at 4).

The OCA states in its Exceptions that the ALJ erred in rejecting the OCA recommended hypothetical capital structure of 55 percent debt and 45 percent equity. The OCA avers that, while the ALJ correctly recognized that the Company’s actual capital structure was unreasonable, the capital structure recommended by the ALJ of 48.21 percent debt and 51.79 percent equity should not be adopted for determining a fair rate of return in this proceeding. The OCA opines that this capital structure is still out of line with the industry average, whether compared to the 47.2 percent common equity ratio for PPL Gas’ proxy group in 2004 or the 45 percent common equity ratio supported by capital structures of the Value Line companies examined by the OCA. The OCA maintains that adoption of the ALJ recommended capital structure will impose unfair costs on ratepayers through use of an atypical capital structure. The OCA requests that the Commission adopt a capital structure comprised of 55 percent debt and 45 percent equity. (OCA Exc. at 19-20).

In reply, PPL Gas explains that the capital structure recommended by the ALJ aligns the hypothetical long-term debt and common equity used on average by the much larger barometer group with the short-term debt used to finance stored gas employed by the Company. PPL Gas avers that the OCA’s calculations do not properly reflect PPL Gas’ short-term debt. PPL Gas maintains that the ALJ properly adopted the hypothetical capital structure ratios developed by the OTS after consideration of all of the evidence. (PPL Gas R.Exc. at 1-2).

**d. Disposition**

Our review of the record evidence leads us to adopt the hypothetical capital structure recommended by the OTS, as adjusted by PPL Gas to correct the short-term debt amount. We do not find the arguments of the OCA convincing or persuasive, and agree with PPL Gas that this calculation aligns the hypothetical long-term debt and common equity used on average by the larger barometer group with the short-term debt used to finance stored gas employed by PPL Gas. The OCA’s calculations do not properly reflect this short-term debt. Therefore, we shall adopt the recommendation of the ALJ that a common equity ratio of 51.79 percent and a total debt ratio of 48.21 percent are reasonable and should reflect the capital structure of PPL Gas in this proceeding.

Accordingly, the Exceptions of the OCA are denied.

**2. Cost of Debt**

 **a. Positions of the Parties**

Both the OCA and the OTS accepted PPL Gas’ cost of debt in determining a reasonable rate of return. (OCA St. 2 at 14; OTS St. 1 at 9). PPL Gas proposed a 6.35 percent overall embedded cost of debt for rate of return purposes. The Company’s 6.35 percent future test year cost of debt was based on the Company’s long-term debt (6.30 percent) and its short-term debt (6.44 percent) cost rates. (PPL Gas Exh. PRM-1 Sch. 1 and Sch. 6 at 2). However, PPL Gas stated that the cost of debt should be adjusted if either the proposals of the OTS or the OCA for capital structure were adopted. (PPL Gas St. 6R at 6). PPL Gas asserted that the ratio of debt and the cost of debt would be mismatched if this adjustment were not made. (PPL Gas St. 6R at 1). Additionally, PPL Gas argued that an adjustment should be made because the Company’s capital structure was actual and the OCA’s and the OTS’ capital structures were hypothetical. Consequently, according to the Company, the actual cost of debt would be mismatched with a hypothetical capital structure. (R.D. at 50).

The OCA disagreed that PPL Gas’ adjustment was necessary because it concluded that the cost of debt was supported by the record and is reasonable. According to the OCA, the Company valued the short-term debt based on three months of actual interest rates and nine months of projected London Interbank Offered Rates (LIBOR) interest, adjusted to reflect PPL Gas’ short-term borrowing rate. (PPL Gas St. 6 at 21). The OCA cited precedent where a hypothetical capital structure has been used by the Commission. (*Pa. PUC v. Citizens Utilities Water Co. of Pa.*, 86 Pa. PUC 51 (1996) (where the Commission approved a hypothetical capital structure but found it inappropriate to adjust the cost of debt absent strong, specific evidence to do so). The OCA averred that PPL Gas failed to distinguish this proceeding from *Citizens.* (OCA MB at 53-55).

**b. ALJ’s Recommendation**

The ALJ concluded that the record lacked strong, specific evidence to adjust the cost of debt. The ALJ stated that Commission precedent requires strong, specific evidence to make such an adjustment and found that the Company’s request to adjust the cost of debt if a hypothetical capital structure is adopted was without merit. The ALJ recommended that the Commission use 6.35 percent as the overall cost of debt as proposed by PPL Gas and as agreed to by the OTS and the OCA. (R.D. at 51).

**c. Disposition**

No Party filed Exceptions to the ALJ’s recommendation on this issue. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

**3. Cost of Equity**

Although there are various models used to estimate the cost of equity, the Commission favors the Discounted Cash Flow (DCF) Model. The DCF analysis theory is based upon finding the present value of an expected future stream of net cash flows during the investment holding period discounted at the cost of capital or capitalization rate. The capitalization rate is the total return rate anticipated and commonly is expressed in terms of the sum of a representative dividend yield plus a growth rate to capture investors’ expectations of future increases in cash dividends.

The following table summarizes the cost of equity claims made, and methodologies used, by the Parties in this proceeding.

|  |  |  |  |
| --- | --- | --- | --- |
| **Methodology** | **PPL Gas (1)****(%)** | **OCA (2)****(%)** | **OTS (3)****(%)** |
| DCF | 10.4 (4) | 9.0-9.5 | 9.0 |
| CAPM | 12.49 | 10.25 | n/a |
| CE | 14.45 | 10.00 | n/a |
| RP | 11.5 | n/a | n/a |
| Range Recommendation | 11.25 to 11.75 | 9.0 to 10.25 | 8.75 to 9.25 |
| Point Recommendation | 11.75 | 9.625 | 9.0 |

(1) PPL Gas St. 6 at 1,5.

(2) OCA St. 2 at 4.

(3) OTS St. 1 at 21.

(4) This includes a 0.70% leverage adjustment and a 0.31% size adjustment.

 **a. Positions of the Parties**

PPL Gas employed four separate methodologies to determine the range of the cost of equity: DCF, Risk Premium (RP), Capital Asset Pricing Model (CAPM) and Comparable Earnings (CE). PPL Gas averred that it is appropriate to use multiple methods because investors use multiple methods and because each method has deficiencies. (PPL Gas MB at 71). The Company stated that its adjusted DCF cost of equity result was 10.4 percent. The remaining methods used by PPL Gas resulted in costs of equity of 11.5 percent for RP, 11.54 percent for CAPM and 14.45 percent for CE. From these results, PPL Gas selected a cost rate range of 11.25 percent to 11.75 percent. PPL Gas requested that the Commission select the high end of the range, or 11.75 percent, based upon the Company’s exemplary management performance.[[26]](#footnote-26) (PPL Gas MB at 82).

PPL Gas relied on analysts’ projections of growth rates in the DCF analysis because analysts consider all historical and projected information, and analyst projections affect the price used in the dividend yield component in the DCF analysis. PPL Gas used a DCF growth rate of 5.0 percent, although its updated growth rates supported a growth rate of 4.9 percent. (PPL Gas St. 6R at 22) (PPL Gas MB at 73).

Within PPL Gas’ DCF analysis, the Company included a 70 basis point leverage adjustment designed to reflect the fact that the DCF cost of equity reflects the investor expected return on market price. PPL Gas claimed that because the DCF cost rate reflects the percentage of debt based on capital structure including equity at market prices, the cost rate understates the cost of equity based upon capital structure calculated with book value. PPL Gas averred that the Commission repeatedly has approved and accepted this financial risk adjustment, citing *Pa. PUC v. Aqua Pennsylvania, Inc.*, 99 Pa. PUC 204, 234 (2004) and *Pa. PUC v. PPL Electric Utilities Corp.*, 99 Pa. PUC 389, 426 (2004). (PPL Gas MB at 74).

PPL Gas also made an adjustment of 31 basis points to its DCF analysis to reflect the greater risk it faces, relative to the barometer group, because it is a much smaller company. PPL Gas stated that a smaller company faces greater risk and that the size adjustment is calculated based upon the difference in bond yields between A-rated and Baa-rated debt to estimate the increased risk to the investor in equity due to increased risk. According to the Company, the barometer group cost rate does not account for risk associated with a smaller company. (PPL Gas MB at 76).

The following table summarizes PPL Gas’ DCF results.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Dividend Yield** | **Growth Rate** | **Leverage Adjustment** | **Size Adjustment** | **DCF Cost Rate** |
| 4.39 | 5.00 | .70 | .31 | 10.4 |

In addition to the DCF analysis, PPL Gas performed a CAPM analysis. According to PPL Gas, the CAPM identifies a risk free rate and an equity premium in excess of the risk free rate that is proportional to the systematic risk of a stock or portfolio of stocks. PPL Gas stated that the risk premium of the market is adjusted by the “beta” of the barometer group to reflect differences in risk. (PPL Gas MB at 78).

PPL Gas used a risk free rate of 5.5 percent, based upon the prospective yield on U.S. Treasury Bonds. (PPL Gas St. 6 at 47). The Company determined the market premium by averaging the historic market performance of Treasury Bonds (6.5 percent) and the projected market performance of Treasury Bonds (5.95 percent) which resulted in a premium of 6.23 percent. PPL Gas used adjusted betas to reflect the leverage adjustment. The Company’s CAPM analysis produced a CAPM result of 11.54 percent. PPL Gas noted that financial literature also supports an additional adjustment for the size of the average gas group relative to the average size of the companies in the general market. The size adjustment would require an additional 0.95 percent. With the size adjustment, the final result of PPL Gas’ CAPM analysis is 12.49 percent. (PPL Gas MB at 78-79).

PPL Gas also performed a CE analysis. According to PPL Gas, the CE method reviews the earnings of non-regulated, similar risk entities to determine cost of capital. Critical to the CE analysis is the choice of those entities identified with similar risk. PPL Gas selected companies from the Value Line Index to reflect the overall investment risk of the gas group. PPL Gas asserted that non-regulated companies generally have higher business risk but generally have less debt, thereby producing similar total investment risk. PPL Gas determined the cost of equity of 14.45 percent based upon an average of the historical returns in equity of comparable group (14.40 percent) and the projected return (14.50 percent) on book equity. (PPL Gas MB at 80-81).

Additionally, PPL Gas performed a RP analysis. According to the Company, the RP analysis is based upon the conclusion that equity investors require a premium over the expected cost of debt to provide equity capital because investors do not receive any return until debt holders receive their full return. PPL Gas explained that RP is the sum of a prospective bond yield and the premium of the bond yield expected by investors. PPL Gas concluded that the RP cost rate was the sum of 6.50 percent (expected yield) plus 5.00 percent (premium yield) or 11.50 percent. PPL Gas contended this result is likely understated because PPL Gas would not have an A bond rating (the 6.50 percent is based on A-rate utility bonds), and thus that percentage would be higher reflecting the lower bond rating and higher risk of PPL Gas. (PPL Gas MB at 77-78).

The OCA utilized the DCF, CAPM and CE methods. The OCA submitted that the Company’s request for an 11.75 percent cost of equity is excessive, unjust and unreasonable. The OCA position is that, due to low capital costs, stable economic factors and the Company’s lower risk profile, a cost of common equity of 9.625 percent is just and reasonable. The OCA developed this market-based cost of common equity recommendation using the DCF model, claiming that this is the method relied upon by the Commission. (OCA MB at 55-56).

The OCA applied the DCF methodology to two proxy groups of natural gas utilities: (1) a group of fifteen gas distribution companies followed by Value Line, excluding those that did not pay cash dividends; and (2) a group of nine distribution utilities used by PPL Gas in its analysis. (OCA St. 2 at 15, Exh. DCP-1 Sch. 5). This DCF analysis of the two proxy groups showed a DCF indicated range of 9.0 percent to 9.5 percent. The OCA also conducted a cost of equity analysis using the CAPM, which found a cost of equity of 10.25 percent, and using a CE approach, resulting in a cost of equity of 10.0 percent. As a result, the OCA recommended a range of 9.0 percent to 10.25 percent for cost of equity and selected the midpoint, 9.625 percent, as the cost of equity for PPL Gas, giving more weight to results of the DCF method and recognition of the slightly higher cost of equity indicated by the other two methodologies. (OCA MB at 58, 61).

In its CAPM analysis, the OCA stated that U.S. Treasury securities customarily are used to represent a risk-free investment rate as they are guaranteed by the government and are default free. The OCA used the three month average yield (April – June 2006) for 20 year U.S. Treasury bonds, with an average yield of 5.29%. In calculating the measure of risk or beta, Mr. Parcell used the Value Line betas for each company in his Value Line Group and the Company’s Group. Based on these inputs, the OCA concluded that the CAPM cost of equity for the proxy groups was 10.25 percent. (OCA MB at 66).

The OCA stated that the CE analysis is viewed more or less as a reasonableness check on the result of the DCF analysis citing, *Aqua Pennsylvania.* The OCA claimed that it examined realized equity returns and evaluated investors’ acceptance of those returns for several groups of companies and used market data as part of its CE analysis. The OCA used equity returns of several groups of companies covering the period of 1992 through 2005 and a risk comparison of utilities versus unregulated entities. The OCA used its Value Line Gas group, PPL Gas’ nine company barometer group and the S&P 500 Composite group for the level of return to be expected and realized in the regulated and competitive sectors of the economy. (OCA St. 2 at 25). The OCA concluded, after comparing risk levels, that the S&P 500 group is more risky than the Value Line proxy group and PPL Gas’ nine company barometer group. The OCA concluded that the CE method of the two groups yielded a result of no more than 10 percent for the cost of equity. (OCA MB at 67-68).

The OCA opposed the Company’s 70 basis point leverage adjustment, the Company’s 31 basis point adjustment for size and the Company’s request for a higher cost of equity in recognition of management performance. (OCA MB at 74, 77-79).

The OTS employed a DCF analysis to determine its recommended cost of equity for PPL Gas. The OTS submitted that the 11.75 percent return on common equity recommended by PPL Gas is excessive. The OTS used the DCF method applied to the Company’s barometer group of nine gas companies to determine its recommended 9.00 percent cost rate of common equity. Based on the DCF results for the nine company barometer group, the OTS concluded that the appropriate cost rate of common equity for the LDC industry on average is in the range of 8.75 percent to 9.25 percent. The OTS recommended 9.00 percent as the common equity rate for PPL Gas, finding that this figure is supported by its analysis. Additionally, the OTS pointed out that, since the hypothetical capital structure for ratemaking purposes was based on the barometer group average, a financial risk adjustment is not necessary and that the selection of a cost rate of common equity at the midpoint of its range is appropriate. (OTS MB at 45-52).

**b. ALJ’s Recommendation**

Based on her review, evaluation and analysis of the evidentiary record, the ALJ recommended adoption of a cost of equity rate of 10.26 percent as reasonable and adequately supported. The ALJ noted that in this proceeding she considered the DCF analysis and considered the analysis and critiques of the other methods for checking the reasonableness of the results of the DCF analysis. The ALJ based her recommendation on the DCF analysis of PPL Gas including the 31 basis point size adjustment, but only a 56 basis point leverage adjustment. The ALJ found the 70 basis point leverage adjustment proposed by the Company to be excessive and concluded that 56 basis points equated to a more reasonable adjustment. The ALJ concluded that the analysis of the record supports a DCF cost of equity of 10.26 percent (4.39 percent + 5.00 percent + 0.56 percent = 9.95 percent + 0.31 percent (size adjustment) = 10.26 percent). (R.D. at 61-65).

 The ALJ stated that the OTS and the OCA are correct that the Commission favors the DCF method to determine the cost of equity. However, the ALJ concluded, based on recent precedent, that the Commission consistently has adopted a leverage adjustment to compensate for the difference between market prices and book value (used in ratemaking). (See, *Aqua Pennsylvania*, 204, 234 (2004); *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-00049255, at 70-71 (2004); *Pa. PUC v. Pennsylvania American Water Co.*, 2002 Pa. PUC LEXIS 1; *Pa. PUC v. Phila. Suburban Water Co.*, 219 PUR 4th 272 (2002); *Pa. PUC v. Pennsylvania American Water Co.*, 231 PUR 4th 277 (2004)). According to the ALJ, these cases are persuasive that a leverage adjustment should be employed with the DCF analysis. (R.D. at 62-63).

Additionally, the ALJ concluded that the argument to increase the equity return in recognition of management performance as presented by PPL Gas is without merit. The ALJ noted that noticeably absent in PPL Gas’ presentation is any precedent for this adjustment. The ALJ recommended that the adjustment advocated by PPL Gas to recognize its management performance should be rejected. (R.D. at 65).

Based upon the testimony and evidence of record, the ALJ recommended the following overall rate of return for PPL Gas based upon her conclusions regarding the capital structure ratio and the cost rate for the debt and common equity capital:

|  |  |  |  |
| --- | --- | --- | --- |
| **Capital** | **Capital Structure Ratio** | **Cost Rate** | **Weighted Cost** |
| Debt | 48.21% | 6.35% | 3.06% |
| Common Equity | 51.79% | 10.26% | 5.31% |
| Overall Rate | 100% |  | 8.37% |

(R.D. at 65-66).

 **c. Exceptions**

PPL Gas excepts to the ALJ’s recommendation because she: (1) improperly adjusted the DCF analysis by reducing PPL Gas’ leverage adjustment from 70 to 56 basis points; (2) did not give any weight to the other equity cost rate methods; and (3) incorrectly rejected consideration of management performance. First, PPL Gas notes that the ALJ accepted PPL Gas’ DCF analysis, except that she reduced its leverage adjustment from 0.70 percent to 0.56 percent. PPL Gas maintains that this is incorrect because the ALJ calculated the adjustment based on PPL Gas’ actual debt ratio instead of the hypothetical ratio she recommended. The Company maintains that, if the leverage adjustment is to be modified, it should be synchronized with the hypothetical capital structure and would result in a 0.80 percent leverage adjustment. According to PPL Gas, this would result in a DCF cost rate of 10.5 percent. (PPL Gas Exc. at 4-7).

 Next, PPL Gas contends that the ALJ erred in not giving any weight to other equity cost rate models. PPL Gas noted that in reviewing the other methods, the ALJ criticized the CAPM analysis performed by the Company for its use of adjusted betas and for employing an adjustment for PPL Gas’ size relative to the barometer group. The Company notes that the ALJ arrived at a CAPM result of 10.61 percent using unadjusted beta and no size adjustment, yet she gives absolutely no weight to this revised CAPM by simply adopting her DCF result of 10.26 percent. PPL Gas then points out that the ALJ rejected its RP and CE analysis because they are market-based and yield results that are questionable due to more risk being included than what exists in regulated industry. PPL Gas avers that the reasons offered by the ALJ provide no basis for rejection of the Company’s RP analysis because it was based on public utility bond yields and returns. (PPL Gas Exc. at 8-10).

 Finally, PPL Gas complains that the ALJ incorrectly rejected consideration of management performance because it did not cite authority for this adjustment. The Company states that it cited *Pa. PUC v. West Penn Power Co.,* 83 Pa. PUC 628, 675 (1994) and *Pa. PUC v. Aqua Pennsylvania Inc.,* 263 PUR 4th 218, 247 (2004), both of which affirmed the authority and policy of the Commission to exercise its discretion in selecting a cost of equity within the range of reasonableness to reward or penalize a company based on the quality of its service. PPL Gas requests the Commission to consider management performance and adopt an equity cost rate at the high end of the equity cost rate range. (PPL Gas Exc. at 10-11).

 In its Exceptions, the OCA avers that the ALJ erred in recommending adjustments for leverage and size to the DCF-based cost of equity. The OCA notes that if these adjustments are eliminated, the ALJ’s DCF analysis results in a 9.39 percent cost of equity which is within the range the OCA recommended as appropriate. The OCA notes that, while it recognizes that the Commission has made leverage adjustments in other cases, it is within the Commission’s discretion whether to make such an adjustment or not. The OCA opines that use of the higher end of the DCF-only results would adequately account for the effect of current financial conditions on the DCF calculation. Additionally, the OCA submits that the 31 basis point adjustment for size is unwarranted as PPL Gas’ source of capital comes from PPL Corporation and affiliates, not from the much smaller gas subsidiary. The OCA reiterates its position that a cost of common equity for PPL Gas of no more than 9.625 percent should be adopted by the Commission. (OCA Exc. at 20-24).

 The OTS also excepted to the ALJ’s recommended adoption of a 10.26 percent return on equity for several reasons. First, the OTS states that the ALJ mistakenly rejected the OTS’ dividend yield of 4.26 percent in favor of the Company’s 4.39 percent dividend yield. The OTS opines that the Company’s claim contains a 13 basis point adjustment for an ex-dividend adjustment to dividend yields that should not be adopted by the Commission. Next, the OTS states that the ALJ erroneously used PPL Gas’ 5.0 percent growth rate and provided no rationale for disregarding the OTS recommended growth rate of 4.65 percent. Additionally, the OTS excepts to any leverage adjustment. The OTS opines that the leverage adjustment is unsupported and inconsistent with the proper determination of an appropriate rate of return for PPL Gas or any other public utility. (OTS Exc. at 12-16).

 In reply, PPL Gas avers that the Exceptions of the OCA and the OTS do not comport with prior Commission decisions or investor expectations. PPL Gas states that the OCA and the OTS arguments against the leverage adjustment specifically were rejected in *PPL Electric* and both argue incorrectly that the leverage adjustment maintains a certain market price to book value ratio. PPL Gas notes, as the Commission has recognized, that the leverage adjustment reflects the greater risk caused by the greater level of debt as a percentage of total capital with equity and debt at book value when compared to the percentage of debt of total capital with equity at market prices. Because the DCF estimates the investor-required return at market prices, an adjustment is necessary to determine the investor-required return on equity at book value, according to PPL Gas. (PPL Gas R. Exc. at 4-5).

 Concerning the OCA’s Exception on the size adjustment, PPL Gas notes that the OCA did not dispute that size affects risk, but contends size should not be considered here because PPL Gas is a subsidiary of the much larger PPL Corporation. PPL Gas rejoins that the Commission is determining the cost of equity for PPL Gas, not PPL Corporation. PPL Gas maintains that the Commission has concluded that cost of equity is to be determined based upon the risks of the operating utility. *Pa. PUC v. West Penn Power Co.*, 1993 LEXIS 62, 172-173 (1993). The Company requests that the Commission reaffirm that the cost of equity is to be determined for the utility, particularly in the post-restructuring environment. (PPL Gas R.Exc. at 5-7).

 Concerning the OTS’ Exceptions regarding the dividend yield, PPL Gas avers its adjustment is appropriate because the stock prices change on the ex-dividend dates and that such data are widely reported and understood by investors. In regard to the OTS exception on PPL Gas’ growth rate, the Company notes that several analysts’ growth rates reported by the OTS resulted from a double count of the same analyst’s estimate. PPL Gas avers that the ALJ properly rejected the OTS’ dividend yield and growth rate. (PPL Gas R.Exc. at 7).

 In its reply to PPL Gas’ Exceptions, the OCA rejoins that the Company’s position that an 80 basis point adjustment is appropriate to “synchronize” the equity return in its leverage adjustment calculation with the capital structure equity ratio recommended by the ALJ is flawed and without support. The OCA points out that no Company witness testified in support of an 80 basis point adjustment and did not propose a leverage adjustment based upon the Company’s actual, less leveraged, capital structure. The OCA opines that under the Company’s scenario the savings to customers that would result from adoption of a hypothetical capital structure with less equity should be offset by an increase to the common equity cost for increased financial risk. The OCA maintains that the ALJ correctly rejected the Company’s proposal to increase the cost of debt for ratemaking if a hypothetical capital structure were adopted. The OCA reiterates its position that no leverage adjustment should be adopted in this case. (OCA R.Exc. at 2-4).

 Next, the OCA rejoins that the ALJ did not err in rejecting the Company’s 11.75 percent cost of equity claim, which was based heavily on the results of the Company’s non-DCF costing methods. The OCA opines that the ALJ properly rejected PPL Gas’ RP analysis and CE analysis as conceptually flawed and not persuasive, and properly relied on the DCF methodology and informed judgment, as supported by Commission precedent. (OCA R.Exc. at 6-8).

 Concerning PPL Gas’ Exception regarding a cost of equity adjustment for management performance, the OCA submits that the ALJ correctly determined that the Company’s request unreasonably would require ratepayers to pay twice, once through operating and maintenance expense and again through rate of return. The OCA avers that management performance adjustments requested by the utilities in *PPL Electric* and *Pa. PUC v. Pennsylvania-American Water Co.*, 99 Pa. PUC 4, 40, 43 (2004) were not granted. (OCA R.Exc. at 8).

 In its reply to PPL Gas’ Exceptions, the OTS contends that the issue of the proper calculation of any leverage adjustment is immaterial because, in its opinion, no such adjustment should be applied in the first place. The OTS next avers that the credibility of the CAPM model is questionable, while the CE and RP methods should not be given equal weight with the DCF method. None of these methods should be considered by the Commission for ratemaking purposes, in the opinion of the OTS. Concerning the size adjustment, the OTS points out that the Company failed to note any prior ruling by this Commission where a specific adjustment to the allowed rate of return was made due to the size of the utility. In regard to the management performance adjustment, the OTS maintains that the Company did not provide any conclusive evidence to support its position that PPL Gas is more efficiently and economically operated in comparison to the companies in PPL Gas’ barometer group and, absent such evidence, any claimed adjustment must be rejected. (OTS R. Exc. at 3-7).

**d. Disposition**

 As noted previously, we have relied primarily upon the DCF methodology in arriving at our determination of the proper cost of common equity. However, we agree with the ALJ’s statement that other methodologies can be used as a check on the reasonableness of the results of the DCF method, tempered by informed judgment. We note that both PPL Gas and the OCA have done so in the instant proceeding. We also will use the results of the CAPM, CE and RP methodologies as a check of the reasonableness of our DCF-derived equity return calculation.

 Based upon our analysis and review of the record evidence, the Recommended Decision and the Exceptions and Replies thereto, we reject the ALJ’s recommendation to adopt 10.26 percent as the appropriate cost of equity in this proceeding. We note that the ALJ recommended the adoption of PPL Gas’ DCF calculations, except for the reflection of a lower leverage adjustment, 56 basis points in lieu of 70 basis points. We agree with the ALJ that PPL Gas’ unadjusted DCF proposal of 9.39 percent is reasonable in comparison to the results of the OCA (range of 9.0 to 9.5 percent) and the OTS (9.0 percent). We further agree with the ALJ that the 11.75 percent request of PPL Gas is excessive and unreasonable.

We note that the Company has proposed the addition of three separate adjustments in determining the allowable return on equity in this proceeding. PPL Gas has requested the adoption of a 70 basis point leverage adjustment, a 31 basis point size adjustment and a 25 basis point management performance adjustment. We are in agreement with the ALJ that the size adjustment is appropriate and that the additional adjustment for management performance is unsupported and should be denied. In regard to the ALJ’s recommended reduction of the leverage adjustment, we find that the Company’s original requested 70 basis point adjustment is reasonable and should be adopted. We are persuaded by the Company’s argument that the ALJ was incorrect because she calculated the adjustment based on PPL Gas’ actual debt ratio instead of the hypothetical ratio she recommended and we have accepted. Therefore, the ALJ’s recommended reduction to the leverage adjustment requested by PPL Gas is rejected.

Based upon these findings, we are of the opinion that an equity return of 10.4 percent is reasonable and will be adopted. This amount is comprised of the PPL Gas DCF result of 9.39 percent, a 0.70 percent adjustment for leverage and a 0.31 percent size adjustment. Accordingly, the Exceptions of PPL Gas are granted in part and denied in part to the extent consistent with the foregoing discussion. The Exceptions of the OCA and the OTS are denied.

The following table summarizes our determination concerning the Company’s capital structure, cost of debt and cost of common equity, as well as the resulting weighted costs and overall rate of return:

|  |  |  |  |
| --- | --- | --- | --- |
| **Capital Structure** | **Ratio****(%)** | **Cost Rate****(%)** | **Weighted Cost****(%)** |
| **Debt** | 48.21 | 6.35 | 3.06 |
| **Common Equity** | 51.79 | 10.40 | 5.39 |
|  |  |  |  |
| **Overall Rate** | 100.00 |  | 8.45 |

**G. Rate Structure and Rate Design**

 **1. Cost of Service**

 PPL Gas submitted a fully allocated cost of service study (COSS) to determine the cost of providing gas service to each rate class based on the future test year ending December 31, 2006. (PPL Gas Exh. PRH-1 at I-2). The study also determined the customer cost per month by service allocation. (PPL Gas Exh. PRH-1R, Sch. J). PPL Gas used the Average and Extra Demand Method for allocating costs to each class. (PPL Gas MB at 84). The three basic cost responsibility categories in the allocation study are: (1) commodity; (2) capacity; and, (3) customer. (Id.). In the Average and Extra Demand Method of allocation, capacity costs are allocated among service classes based on average use and use above average at periods of peak demand. (PPL Gas Exh. PRH-1 at I-2 to I-3). PPL Gas accepted some of the modifications proposed by opposing Parties and submitted Exh. PRH-1R as its revised COSS. (PPL Gas MB at 85).

 **a. Modifications to COSS Accepted by PPL Gas**

The OSBA proposed that uncollectible accounts expense and forfeited discounts be allocated based upon the actual experience of PPL Gas for each rate class. (OSBA St. 1 at 21-23). The OCA also proposed that the uncollectible accounts expense be based upon actual experienced write-offs over the last two years. (OCA St. 3 at 8). PPL Gas accepted this modification and incorporated it in its revised allocation. (PPL Gas MB at 86, 88; PPL Gas Exh. PRH-1R).

The OCA proposed an adjustment to update certain allocation factors to reflect more recent information concerning storage service. (OCA St. 3 at 4). PPL Gas accepted this adjustment and reflected the update corresponding to storage service in its revised allocation. (PPL Gas MB at 87, PPL Gas Exh. PRH-1R). The OCA further proposed amending the allocation of taxable income to reflect additional deductions from income. (OCA St. 3 at 4). Noting the small effect upon the returns of each class, PPL Gas agreed to change the allocation as suggested by the OCA. (PPL Gas MB at 87, PPL Gas St. 8-R at 6).

**b. Modification to Allocation of Cash Working Capital**

 **1. Positions of Parties**

The OSBA advocated allocating 100% of the Company’s cash working capital requirement to the residential class. According to the OSBA, working capital costs are incurred because PPL Gas must pay its bills before its supplier bills before it gets paid by its ratepayers. (OSBA MB at 10). However, the OSBA opined that business customers do not contribute to the need for working cash because the revenue lag for all business customers is less than the cost payment lag. (*Id.*). In contrast, the OSBA stated that residential customers’ revenue lag is greater than the cost payment lag; resulting in the Company’s working cash cost. (OSBA St. 1 at 22, Tr. at 254-55).

PPL Gas stated that cash working capital requirement is determined on a total company basis rather than by rate class. (PPL Gas MB at 86, PPL Gas St. 8R at 5). PPL Gas opined that an allocation exclusively to the residential class would be inappropriate. (R.D. at 68).

 **2. ALJ’s Recommendation**

The ALJ recommended that the OSBA’s modification to the cash working capital allocation should be rejected as unreasonable and inappropriate. (R.D. at 68). The ALJ found that the OSBA did not demonstrate that business customer revenues for gas services routinely come to the Company before the Company’s payments to suppliers are due. The ALJ found PPL Gas’ statement that cash working capital is determined on a total company basis, implying that all customers contribute to the Company’s need for cash working capital, to be reasonable. As such, the ALJ recommended that PPL Gas’ allocation for cash working capital should be accepted. (*Id.*).

 **3. Disposition**

 No exceptions have been filed to this determination. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

 **c.** **Modification to Allocation of Distribution Mains Costs on Minimum or Zero-Intercept System**

 **1. Positions of Parties**

The OSBA’s witness, Mr. Knecht, recommended that the distribution mains be classified on a minimum or zero-intercept system as 28% customer-related and 72% demand-related since the mains are built to connect customers and sized to meet peak demands. (OSBA MB at 7-8, OSBA St. 1 at 13-17). The OSBA posited that it is more costly to construct gas distribution networks to serve many smaller customers than to install capacity for a few larger customers. The OSBA stated that because PPL Gas’ COSS fails to reflect this fact, it, “over-assigns mains costs to business customers and under-assigns mains costs to residential customers.” (OSBA MB at 8, OSBA St. 1 at 4).

PPL Gas classified the distribution mains cost as 100% demand costs based on growth in demand. (R.D. at 69). PPL Gas argued that the OSBA proposal to modify the allocation based on 28% customer-related and 72% demand-related be rejected. According to PPL Gas, quantifying the cost of the minimum or zero-intercept system is extremely difficult and imprecise. (PPL Gas M.B. at 85; PPL Gas St. 8-R at 2-3).

The OCA argued that the Commission has in the past rejected the zero-intercept and minimum system methods as inconsistent with cost causation. (OCA MB at 105, OCA St. 3R at 4). According to OCA witness, Mr. Watkins, the OSBA’s method of determining the demand/customer related allocation ignores the fact that while peak demands are a major design consideration for main extension or construction, the fact remains that mains are joint costs serving many groups of customers throughout the year. (OCA M.B. at 104; OCA St. 3R at 2). Mr. Watkins also found that the OSBA’s zero-intercept analysis violates statistical foundations and principles which render the linear regression analysis, the technique used in the zero-intercept method, an invalid model and its results illogical. (OCA MB at 105, OCA St. 3R at 5).

 **2. ALJ’s Recommendation**

The ALJ recommended that the modification to allocate the mains distribution costs on a 28% customer-related and 72% demand-related basis should be rejected and that the allocation based on 100% demand should be approved. (R.D. at 71). ALJ Jones noted that the Commission has rejected minimum and zero-intercept system methods as inconsistent with causation. (*Id.*). The ALJ noted that while the concept of main costs derived from both distance and capacity factors is persuasive, the model and calculations provided present misgivings to implement the concept as proposed. (*Id.*). As such, the ALJ rejected the OSBA’s alternative allocation.

 **3. Disposition**

 No exceptions have been filed to this determination. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

**d. Modification to Allocation of Demand Costs**

 **1. Positions of the Parties**

PPL Gas used and average and excess (A&E) method to allocate demand costs. The Company allocated 40% of demand costs based upon commodity usage and 60% based on excess demand (demand in excess of average demand). (PPL Gas MB at 85). PPL Gas stated that the 40% for commodity was based upon system average load factors for 2004 and 2005 of 39.1% and 39.8% respectively. (PPL Gas St. 8-R at 4). The excess demand was allocated using non-coincidental peak factors for each classification. (PPL Gas MB at 86). The factors were based upon the experienced class factors over the last three years. (*Id.*).

The OSBA argued that the demand related costs should be allocated in proportion to each class’ share of peak demand rather than the A&E allocator used by PPL Gas. (OSBA MB at 8-9). According to the OSBA, while the A&E allocator would produce the same results as a peak demand allocator, the Company’s COSS incorrectly calculates the A&E allocator, and, therefore, incorrectly assigns more costs to higher load customers and less to lower load customers. (OSBA MB at 8). The OSBA opined that because peak day demands for PPL Gas’ smaller customers are not directly metered, the Company had to estimate when developing the demand allocators. (OSBA MB at 9, OSBA St. 1 at 17-20).

The OCA identified three areas of concern with regard to the OSBA’s demand allocator: (1) The OSBA’s method has a timing mismatch in that it considers each class’ total monthly booked consumption with calendar monthly heating degree days as a means of measuring weather sensitivity. Meanwhile, the Company has twenty different billing cycles and consumption measured over the course of the cycle often includes usage registered in two different calendar months. (OCA St. 3R at 7); (2) the OSBA’s monthly analysis was done on a total class basis rather than a per customer basis and failed to consider either customer growth/attrition or declining usage per customer over a six-year period in which gas prices increased dramatically. (OCA St. 3R at 8); and, (3) the OSBA’s method for estimating class peak demands did not employ any statistical analyses to estimate or test the reasonableness of results. (*Id.*).

 **2. ALJ’s Recommendation**

The ALJ found that the OSBA never corrected or provided guidance as to what corrections need to be made to the A&E allocator. (R.D. at 72; OSBA RB at 7). The ALJ determined that the record does not demonstrate that the A&E allocator as calculated by PPL Gas is incorrect and that the OSBA failed to support its conclusion by explaining or demonstrating how the definition of the A&E methodology used by the Company is wrong. Finding that the A&E allocator is supported by the evidence, and that the OSBA modification to replace the A&E allocator with a peak demand allocator is not supported by the evidence, the ALJ recommended approval of the Company’s A&E allocator. (R.D. at 72).

 **3. Disposition**

 No exceptions have been filed to this determination. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

**e. Modification to Allocate CAP Costs Among All Rate Classes**

The OCA proposed allocating CAP costs among all non-storage customer classes instead of assigning 100% of the CAP costs to the residential customer class. (OCA St. 3 at 5). The OCA excluded the storage class because that class’ service is not natural gas delivery service. (OCA MB at 89, n. 16). The OCA argued that CAP is a social program that benefits all ratepayers in that “low income [CAP customers] have virtually zero propensity to save. Therefore, the additional income available to CAP participants [as a result of lower natural gas bills] is spent in the local economy and benefits local businesses.” (R.D. at 73; OCA MB at 90; OCA St. 3 at 5-6).

The OSBA, PPL Gas, and PGLUG opposed the OCA’s proposed amendment to allocate CAP costs to all customer classes. (OSBA MB at 11-12; PPL Gas MB at 87; PGLUG MB at 8-10).

**1. ALJ’s Recommendation**

The ALJ noted that CAPs are narrowly tailored to the residential class and determined that overwhelming Commission precedent supported 100% allocation of CAP costs to the residential customer class. (R.D. at 74-75). Finding that the OCA presented no persuasive argument to change this Commission policy, the ALJ recommended that the OCA’s proposed modification to allocate CAP costs to all non-storage customers be denied. (*Id*.).

**2. Exceptions**

The OCA submits that the Commission’s policy of allocating CAP costs only to residential customers does not properly reflect the recent decision in *Lloyd v. Pa*. PUC, 904 A.2d 1010 (Pa. Cmwlth. Ct. 2006) which found that Section 2804(9) of the Code regarding certain conservation programs – according to the OCA, a parallel provision to Section 2203(6) at issue here – did not require that a customer class receive a direct benefit as a condition of accepting cost responsibility for the program. (OCA Exc. at 31). OCA witness Watkins opined that CAP programs do provide benefits to all customer classes, both as social benefits accruing to society as a whole, and as direct benefit to PPL Gas’ local economy. (OCA Exc. at 32; OCA St. 3 at 5-6).

PPL Gas rejoins that even if *Lloyd* were interpreted to permit the PUC to allocate CAP costs to all rate classes, it does not mandate that result. (PPL Gas R. Exc. at 23). PPL Gas continues that the Commission was well aware of *Lloyd* when it entered its Order in Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms, Docket No. M-00051932 (December 18, 2006), where it rejected the OCA’s contention again. (Id.).

The OSBA replied that the ALJ was correct when she concluded that the overwhelming Commission precedent, which requires 100% allocation of CAP costs to the residential class, is consistent with sound regulatory practice and that the OCA’s proposed modification should be rejected. (OSBA R. Exc. at 7).

**3. Disposition**

The ALJ properly denied the OCA’s proposal to amend the Company’s COSS to allocate CAP costs to all customer classes with the exception of the storage class. Contrary to the OCA’s reading, the Commonwealth Court in *Lloyd* did not address how universal service costs were to be allocated, it simply rejected PPLICA’s argument that conservation program funding should come (if at all) through generation rates and not through distribution rates. Therefore, *Lloyd* is not precedent for the OCA’s argument that universal service costs are to be allocated to all customer classes. We concur with the ALJ who correctly limited recovery of the CAP costs to residential customers. This recommendation is consistent with cost causation and the Commission’s Order on Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms, Docket No. M-00051923 (December   18, 2006). As such, the OCA’s Exception on this issue is denied.

 **f. Modification to Allocation of Off System Sales**

 **1. Positions of the Parties**

PPL Gas explained that Off Systems Sales were reflected in the COSS as the result of an oversight. (PPL RB at 43). PPL stated that these sales are a “below the line” revenue stream because they are the subject of a sharing mechanism established in the Company’s annual Section 1307(f) proceedings. (*Id.*). To include these proceeds in base rates would flow the revenues through to customers disregarding PPL Gas’ sharing mechanism where parties agreed PPL Gas is entitled to some proceeds as an incentives to obtain sales. (PPL Gas RB at 43; PPL Gas St. 4R at 6-7).

The OCA proposed assigning Off System Sales margin revenue on retail sales volumes. The OCA opined that Off System Sales margins “represent opportunity sales of gas obtained and reserved for PPL [Gas’] retail gas sales customers. As such, it is inappropriate to provide Off System Sales credit to transportation and storage classes.” (R.D. at 75; OCA St. 3 at 7).

 **2. ALJ’s Recommendation**

The ALJ determined that the record evidence does not support the OCA’s proposal. The ALJ stated that the OCA ignored the nuance of the sharing mechanism developed in the Company’s Section 1307(f) proceedings which established the sharing mechanism to provide the Company an incentive to achieve large volumes in these sales. (R.D. at 75-76). As such, the ALJ recommended denial of the OCA’s modification on Off Systems Sales. (R.D. at 76).

1. **Exceptions**

The OCA excepts to the ALJ’s determination arguing that the sharing mechanism addresses only the amount of off-system sales revenue that is flowed back to customers and has no impact on how the revenues are derived or how the revenues are reflected in rates. (OCA Exc. at 26). The OCA argues that the fact that the revenues are used to reduce the total cost of service does not reflect the reason that the off-system revenue exists. (OCA Exc. at 26-27). According to the OCA, its allocation properly matches these revenues to the class of customers providing the benefit, the NGDC sales customers, for cost of service purposes. (OCA Exc. at 27; OCA St. 3S at 3).

PPL Gas rejoins that the OCA is erroneous in its claim that the sharing mechanism addresses only the amount of off-system sales to be flowed back to customers and that the mechanism has no impact on how revenues are derived or how revenues are reflected in rates. (PPL Gas R. Exc. at 23). The Company states that the sharing mechanism specifically contains a formula for determining the amount of revenues from off-system sales to be flowed back to customers, and the mechanism requires that such revenues be reflected as a reduction to purchased gas costs. (*Id.*; PPL Gas Exh. CPW-1 at 8.1).

**4. Disposition**

Based on our review of the record evidence, we will deny the OCA’s Exception on this issue. The sharing mechanism has no impact on distribution rates and as such, should not be reflected in a distribution rate COSS.

**g. Modification to Allocation of Timber Sales Based on Land and Land Rights**

 **1. Positions of the Parties**

PPL Gas provided that Timber Sales offset the need to recover revenues from all rate classes. As such, PPL Gas stated that it is appropriate to allocate Timber Sales among the rate classes proportionately based on the total cost of service allocated to each rate class. (PPL Gas MB at 87-88, PPL Gas St. 8R at 7).

The OCA opined that since Timber Sales are a function of PPL Gas’ land, the sales should be allocated based on Land and Land Rights. (OCA MB at 94, OCA St. 3 at 7).

**2. ALJ’s Recommendation**

The ALJ found that the rationale offered to support the OCA’s modification for allocation of Timber Sales was not persuasive and the method of allocation for Timber Sales provided by PPL Gas was reasonable and supported by the evidence. (R.D. at 75).

**3. Exceptions**

The OCA submits that as with off-system sales revenue, the allocation should reflect the reasons for the sales, in this instance the land and land rights of PPL Gas. (PPL Exc. at 27). The OCA argues that the ALJ erred in rejecting the OCA’s modification to allocate these revenues on the same basis as Land and Land Rights are allocated in the COSS. (*Id.*).

**4. Disposition**

Based on our review of the record evidence, we will deny the OCA’s Exception on this issue. The OCA has not persuaded us that its modification is in the public interest. Furthermore, the OCA failed to rebut the Company’s evidence that timber sales offset the need to recover revenues from all rate classes. As such, we agree with the Company that it is appropriate to allocate timber sales among the rate classes proportionately based upon the total cost of service allocated to each rate class.

**h. Modification to Allocation of Outside Service Based on Rate Base**

 **1. Positions of Parties**

PPL Gas would allocate Outside Service Expenses (Account 923) based upon rate base. (PPL Gas MB at 88). PPL Gas claimed that the expenses for this account represent administrative and general functions not performed by PPL Gas employees. The Company stated that because these expenses are typical administrative and general expenses they should be allocated using the factor for allocating other administrative and general costs. (PPL Gas MB at 88, PPL Gas St. 8R at 7).

The OCA opined that because over 90% of the outside services costs are from affiliates to provide a wide range of service to support PPL Gas operations, it is more appropriate to allocate this account in rate base. (OCA St. 3S at 2).

**2. ALJ’s Recommendation**

ALJ Jones determined that the OCA’s proposal was not supported by the record evidence and recommended denial of the OCA’s modification to allocate the Outside Service Expenses based on rate base. (R.D. at 77).

**3. Exceptions**

 The OCA argues that since 90% of these expenses are attributable to affiliate transactions to provide a wide range of services to support all of PPL Gas operations, OCA witness Watkins proposed to allocate this account based on the Company’s investment in rate base was more reasonable. (OCA Exc. at 28; OCA St. 3 at 7-8; OCA St. 3S at 2). The OCA contends that given the wide range of services included in the expenses recorded in Account 923, its proposed allocation more properly reflects cost causation. (OCA Exc. at 28).

 OSBA witness Knecht rejoined that absent a detailed study of the individual components of outside services costs, “it is not unreasonable to assume that these services are related to either overall O&M costs or to PPL’s direct labor-related costs. As the labor allocator is much more similar to PPL’s proposed O&M allocator than to Mr. Watkins’ rate base allocator, I see no reason to change PPL’s proposed approach.” (OSBA St. 2 at 13; OSBA R.Exc. at 10).

**4. Disposition**

The OCA failed to prove that Account 923 Outside Service Expenses are any different from the general administrative functions. As such, we will deny the OCA’s Exception on this issue.

 **i. Modification to Allocation of General Plant**

 **1. Positions of Parties**

The Company proposed allocating General Plant based on O&M expense (excluding administrative and general expense, credit for gas used for other utility operations, storage gas losses, and compressor station fuel expense). PPL Gas stated that general plant includes office buildings, office furniture, office equipment, *etc.*, all of which are used to provide administrative and general services. (PPL Gas MB at 88). According to PPL Gas witness, Mr. Herbert, “the general plant and the associated maintenance and depreciation [accounts], support the employees who work primarily in the administrative, customer accounting and distribution functions.” (OCA MB at 96 quoting PPL St. 8R at 7-8).

The OCA proposed allocating General Plant based production, transmission and distribution plant in service and claimed that this allocation is the preferred industry method. (OCA St. 3S at 2).

The OSBA opined that there is no reason to change the Company’s approach without a thorough study of cost causation factors. (OSBA St. 2 at 14).

 **2**. **ALJ’s Recommendation**

The ALJ was not persuaded by the OCA’s argument to modify the allocation of general plant and recommended denial of the modification. The ALJ noted that the OCA did not claim that the Company’s position was either incorrect or unreasonable, only that it was not the typical method used in the industry. (R.D. at 78).

 **3. Exceptions**

 The OCA argues that while not totally unreasonable, PPL’s method still does not accurately reflect cost causation, as generally accepted in the industry. (OCA Exc. at 28; OCA St. 3S at 5). The OCA contends that it is important that the most accurate allocation be used for cost of service study purposes, particularly as the ALJ recommends an allocation of the revenue requirement in this case based largely on the results of the cost of service study. (OCA Exc. at 28).

 OSBA witness Knecht testified that General Plant rate base is comprised primarily of buildings, garages, shops, and tools, and that such facilities are more related to providing support for both the O&M and A&G activities of the Company than they are to distribution rate base. (OSBA R.Exc. at 8-9). The OSBA cautioned against rejecting the Company’s judgment and substituting some other arbitrary allocation method for General Plant. (OSBA R.Exc. at 9).

 **4. Disposition**

We note that the OCA conceded that PPL’s methodology is not unreasonable. Moreover, the OCA has not presented evidence to demonstrate that its methodology is more consistent with cost causation. The allocation of general plant based on administrative and general expenses as presented by PPL Gas is supported by the evidence. As such, the OCA’s Exception on this issue is denied.

 **j.** **Modification to Allocation of Costs Record in Account 903, Customer Records & Collections**

 **1. Positions of Parties**

OCA proposed allocation of the Customer Records & Collections based on a 50/50 split between throughput and the quantity of customers. (OCA M.B. at 99; OCA St. 3 at 9). OCA’s Mr. Watkins explained that small volume customers require no contracts and are billed monthly based on a single meter read. In contrast, storage and transportation customers require written contracts, daily usage metering, balancing and more complex billing information. (*Id.*). The OCA posited that because large customers impose higher record and collection cost, customer size should be considered in the allocation. (OCA MB at 99).

The result of the allocation proposed by OCA yields 35 percent of the costs to 1½ percent of the customers and 65 percent of the costs to 99.45 percent of the customers. (PPL Gas MB at 88-89). Both the OSBA and PPL Gas disagreed with the OCA’s proposed 50/50 split based allocation because the result of the allocation is not supported by the record evidence as reasonable or appropriate or sound. (PPL Gas MB at 89). PPL Gas stated that in recognition of the cost differential between the small and large customers, it used a factor number 10 to allocate expenses in Account 903. (PPL Gas MB at 89; PPL Gas Exh. PRH-1R). The Company explained that this factor is based on the “number [of] meters measuring and regulation equipment for each rate class weighted by equivalent factors and therefore it recognizes a higher weighting for larger customers.” (PPL Gas MB at 89; PPL Gas St. 8-R at 8-9). The Company stated that the OCA’s argument is flawed in that the employees that carry out daily nominations, usage metering, daily balancing, etc., for large customers are the same ones that provide balancing for the entire system. (PPL Gas RB at 44). PPL Gas claimed that such expenses are charged to Account 851, not to account 903. (PPL Gas RB at 44-45).

1. **ALJ’s Recommendation**

The ALJ found that the record does not support the OCA’s allocation for the Customer Records and Collections expenses and recommended that the Commission reject the modification. The ALJ further found PPL Gas’ proposal to be reasonable noting that it incorporates the contrasts in customer size that the OCA emphasized. (R.D. at 80).

1. **Exceptions**

The OCA submits that its allocation is far more reasonable that the Company’s allocation on the basis of the number of customers which significantly understates the cost responsibility of the large volume users. (OCA Exc. at 29). According to the OCA, this account includes significant expense associated with services provided to large volume users, including the costs of customer applications, contracts and credit investigations. (OCA Exc. at 29-30). The OCA opines posits that since the costs are incurred in support of services provided to a particular class, the cost of service study should reflect this fact. (OCA Exc. at 30).

The OSBA rejoins that the OCA did not offer any explanation or basis for why the allocation factor should be based 50 percent on throughput. (OSBA R.Exc. at 9). The OSBA argues that the OCA methodology erroneously implies that records and collections costs are 58 percent higher per GS-Small customer than per Residential customer. (*Id.*). The OSBA counters that both of those classes include only sales customers for whom PPL faces the same billing arrangements and the collections costs for GS-Small customers are likely to be lower than those for residential customers. (*Id.*; OSBA St. No. 2 at 14).

1. **Disposition**

We agree with the ALJ’s determination that the OCA did not prove that its modification to the allocation of Customer Records and Collections expenses is reasonable or in the public interest. As noted by the ALJ, PPL Gas’ proposal is reasonable and took into consideration the contrasts in customer size that the OCA emphasized. We will, therefore, deny the OCA’s Exception.

 **k. Modification to LVS Class’ Rate Discount** **ts**

 **1. Positions of the Parties**

PPL Gas offers a discounted rate to some LVS (large volume service) customers as a result of negotiated contracts between the Company and the customer. The contracts have at least one of the following characteristics: (1) high energy consumption with alternate fuels as a threat; (2) usage levels such that bypassing the local distribution company is advantageous; (3) significant impact on the local economy; and (4) multiple locations to vie competitive service providers. (R.D. at 80; PPL St. 5R at 3). These factors and the potential loss of any one customer leaving large fixed costs to be distributed to the remaining customer base results in PPL Gas offering discount rates for the customer’s remaining with PPL Gas. (R.D. at 80). PPL Gas reflected the difference between the actual revenues from Rate L (rate for LVS customers) and the revenue required to produce the system average rate of return. The purpose is to allocate among the other rate classes the discounted revenue received by the Company that is less than the system average rate of return. (PPL Gas RB at 45). The Company, the OSBA, and the OCA agree that under-recovery of costs that results from the rate discounts provided to Rate LVS customers should be shared among the customer classes. However, the OCA disagrees with PPL and the OSBA on the amount to be re-allocated to the classes other than LVS.

For COSS purposes, OCA witness Watkins proposed that the cost of the rate discounts provided to Rate LVS customers should be shared equitably among the customer classes since all ratepayers are better off with some revenue contribution to fixed costs by these customers. (OCA St. 3 at 10). This amount is proposed to be allocated across all customer classes, except storage, on the basis of class throughput. The OCA proposed to quantify rate discounts allocated among the rate classes based upon the difference between the discounted rates and the revenue produced from full tariff rates for the large volume class. Mr. Watkins determined that the cost of the Rate L discount is $5.6 million. (OCA St. 3S at 5).

PGLUG interpreted the OCA’s proposal as effectively abolishing the negotiated contracts between the Rate L customers and the Company and requiring those customers to pay full tariff rates. (PGLUG RB at 2, PGLUG MB at 2-5). PGLUG opined that the result would be to nullify the benefits of keeping these targeted characteristic Rate L customers in that remaining customers will be saddled with a greater share of fixed cost when the customer ceases to be a PPL Gas customer. (PGLUG RB at 2).

 **2. ALJ’s Recommendation**

The ALJ determined that to propose allocation based on a rate that is beyond what the utility is entitled would necessarily overstate the cost of retaining these identified customers. (R.D. at 81). The OCA’s proposal would unnecessarily overstate the cost of retaining the discount Rate L customers and should be rejected. (R.D. at 81).

 **3. Exceptions**

The OCA argues that while the Company may only be entitled to rates to produce the system average rate of return on an overall basis, the rate of return by class will vary. (OCA Exc. at 30). At full tariff rates, the Rate LVS class produces a greater than system average rate of return, but without a discount, it is the full tariff rate that would be paid, not a lower rate based on the system average rate of return. As such, the OCA opines that the amount of Rate LVS discount allocated to other customer classes should be the $5.6 million. (OCA Exc. at 31).

PPLUG responds that the OCA’s approach would overstate the cost of retaining the discounted Rate L customers because the full tariff rate is significantly above the system average rate of return. (PPLUG R.Exc. at 3). According to PPLUG, acceptance of the OCA’s proposal would improperly base the calculation on a rate in excess of what the utility is permitted to recover and must be rejected. (*Id.*).

The OSBA rejoins that since the LVS class is over-recovering its costs at present rates, the cost of the discounts to be re-allocated to the other classes are significantly less than the $5.6 million recommended by the OCA. (OSBA R.Exc at 8).

 **4. Disposition**

PPL Gas’ allocation reasonably and appropriately calculates the difference between the system average rate and the amount of discounted revenues. ALJ Jones correctly concluded that, “[t]o propose allocation based on a rate that is beyond what the utility is entitled to would necessarily overstate the cost of retaining these identified customers. The OCA’s proposal would thus, unnecessarily overstate the cost of retaining the discount Rate L customers which is not appropriate.” (R.D. at 81-82). The OCA’s Exception on this issue is denied.

**l. Modification to Reflect Uncollectible Accounts Expense as a Volumetric Cost Instead of a Customer Cost**

 **1. Positions of the Parties**

PPL Gas allocated 100 percent of the uncollectible accounts expense claim to the customer cost function stating that the expense is more closely related to the number of customers rather than the volume of sales. (See PPL Gas Exh. PRH-1 Sch. E at II-8).

The OTS proposed that the uncollectible accounts expense be allocated as a commodity cost based on the volume of sales rather than a customer cost. (OTS St. 3 at 2-6; OTS MB at 55-59; OTS RB at 40-42). The OTS posited that because the Company receives over 91 percent of its revenue from volumetric sales, it is appropriate to allocate over 91 percent of the uncollectible accounts expense to the volumetric cost function. (*Id.*).

**2. ALJ’s Recommendation**

The ALJ found PPL Gas’ argument supporting the allocation of 100 percent of the uncollectible accounts expense claim to the customer cost function to be reasonable. (R.D. at 82-83). The ALJ determined that the OTS’ modification to amend the uncollectible accounts expense to a volumetric cost to be unreasonable and recommended that it be denied.

**3. Exceptions**

The OTS excepts to the ALJ’s recommendation and argues that its proposal addresses the proper allocation of the expense within a class rather than between transportation and usage customers. (OTS Exc. at 11). According to the OTS, the ALJ erroneously accepted the Company’s mischaracterization of the issue as a comparison of received revenues between transportation and sales customers. (*Id.*). The OTS states that the adjustment is not dependent upon whether the customer is a sales or transportation customer, it simply allocates uncollectible expense to the function or “cause” of the uncollectible expense. (*Id.*).

PPL Gas rejoins that there is no direct relationship between volumes and uncollectible accounts. (PPL Gas R.Exc. at 24). The Company argues that a volumetric allocation ignores the fact that there are different levels of revenues for different classes of service. For example, revenues from a sales customer for 100 Dth of natural gas are much greater than revenues from a transportation customer for 100 Dth of gas, because a transportation customer is not paying for the cost of gas purchased by PPL Gas to meet its customers’ requirements. (PPL R.Exc. at 24; OSBA St. 1 at 21). The Company acknowledges that uncollectible accounts, clearly, are affected by customer failures to pay their bills and notes that it modified its COSS in a manner that treats a portion of the expense as volumetric in nature. (PPL Gas R.Exc. at 24; PPL Gas St. 8-R at 5).

**4. Disposition**

We are persuaded by the Company’s argument that there is not a direct relationship between sales volumes and uncollectible accounts being cognizant of the different revenue levels earned from different customer classes. The OTS, in arriving at its proposal that uncollectible accounts expense should be allocated to the volumetric cost function failed to provide evidence of record showing that it considered and applied factors such as differing class revenue levels to arrive at its 91 percent figure. We will, therefore, deny the OTS’ Exception on this issue.

 **2. Allocation of Revenue Requirement**

The tables presented below summarize PPL Gas’ present and proposed rates. (PPL Gas Exh. PRH-1R Schs. B (present rates) & C (proposed rates)).[[27]](#footnote-27)

Present Rates

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Rate | System | Res. | GS-S | GS-L | LVS | Storage |
| Actual | 5.63% | 4.03% | 8.09% | 5.85% | 6.23% | 6.57% |
| Relative | 100% | 72% | 144% | 104% | 111% | 117% |

Proposed Rates

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Rate | System | Res. | GS-S | GS-L | LVS | Storage |
| Actual | 9.35% | 9.33% | 11.85% | 8.47% | 7.76% | 9.06% |
| Relative | 100% | 99% | 125% | 90% | 82% | 96% |

As discussed in our COSS discussion above, the OCA and the OSBA each proffered their own COSS alternatives and allocation modifications which we have denied as being unreasonable and not in the public interest. The revenue requirement allocations presented by PPL Gas are based upon its COSS which we shall approve as being reasonable and appropriate. The relative return for the proposed rates comports with the Commission’s policy of gradualism and provides the magnitude of change in the correct direction for the appropriate rate classes. (R.D. at 85). The margins between the proposed rate of return for each rate class relative to the system average proposed by PPL Gas are getting smaller; thus showing that all rate classes are approaching the system average rate of return. (*Id.*).

The discussion below considers the proposals by the OSBA and the OTS if the Company’s COSS is recommended. These proposals are based on the potential of rejecting the full increase proposed by PPL Gas in additional annual revenues.[[28]](#footnote-28)

 **a. OSBA’s Proposed First Dollar Relief for Small Business Customers**

 **1. Positions of the Parties**

Premised upon the approval of PPL Gas’ COSS, the OSBA proposed that a first-dollar relief (FDR) approach be used to reduce the subsidy provided by the GS-S class. OSBA explained how it formulated its FDR proposal:

Mr. Knecht calculated the first dollar relief for the GSSmall class so that the subsidy provided by that class is reduced and the class is on a par with the other classes. Specifically, Mr. Knecht reduced the subsidy from the GS-Small class to the level of the subsidy provided to the class with the second highest revenue cost ratio under PPL proposed rates. In this case, that class is the residential class. To bring the GS-Small class in line with the residential class requires assigning the first $1.49 million which the Commission trims from PPL’s proposed rate increase as an offset to PPL’s proposed increase to the GS-Small class.

 (OSBA MB at 23; Exh. RDK-R1; OSBA St. 2 at 4; Exh. RDK-R1).

The OTS also proposed using the FDR method for allocating revenue. The OTS recommended that the first $882,415 of any Commission decrease from the full requested amount be used to reduce the three Small Service – General Service, and Resale class usage rates and that any further required scale back be in proportion to the ratios in the Company’s filing. (OTS RB at 36; OTS MB at 54; OTS St. 3 at 12-13). OTS opined that its recommendation is a more balanced approach to moving the rate of return for the GS class closer, but not immediately, to the system average rate of return under PPL Gas’ COSS. (OTS RB at 38-39).

 **2. ALJ’s Recommendation**

The ALJ determined that PPL Gas’ revenue requirement allocation is unreasonable because it results in discriminatory rates. The ALJ rejected the Company’s argument that the allocation was justified by the principle of gradualism. (R.D. at 88). The ALJ further determined that neither the OTS’ proposed allocation for revenue requirement if the revenue increase is less than $11.9 million, nor PPL Gas’ allocation of revenue requirement comply with the mandates directed by the Commonwealth Court in *Lloyd*. The ALJ found that the sole proposed revenue requirement allocation supported by the record and conforming to the applicable case law is the FDR of $1.49 million proposed by the OSBA. (*Id.*).

 **3. Exceptions**

The OCA submits that the ALJ erred in concluding that *Lloyd* dictates that gradualism cannot be considered in establishing rates. (OCA Exc. at 34). The OCA argues the Commonwealth Court decision in *Lloyd* does not require that rates be set precisely so that all customer classes provide the system average rate of return as shown by one cost of service study. (*Id.*). The OCA further argues that a proportional scale back is a more reasonable method to reflect any reduction in the claimed revenue requirement and it ensures that all customer classes are provided some relief from the Company’s full request if the Commission determines that less than the full request should be awarded. (OCA Exc. at 35).[[29]](#footnote-29)

PPLUG approves of the ALJ’s adoption of the Company’s COSS but argues that Commission precedent supports the proportional scale back methodology proposed by the OCA. (PPLUG R.Exc. at 6).

The OSBA replies that the OCA fails to recognize that, at present rates, the GS-Small class exhibits the highest rate of return of any rate class, meaning that the GS-Small class is subsidizing the other rate classes. (OSBA R.Exc. at 13). The OSBA posits that, here, as in *Lloyd*, it is wrong to assert that assigning an above average increase to a rate class that is already a net provider of a subsidy will achieve cost-based rates. *(Id.*).

PPL Gas submits that by adopting the OSBA’s proposal for the First Dollar Relief method of allocating PPL Gas’ overall revenue requirement, the ALJ moved all rate classes, particularly the General Service – Small class, toward their cost of service provided. (PPL Gas R.Exc at 25). The Company opines that the ALJ properly recognized the cost of providing service, in a manner consistent with *Lloyd*. (*Id.*; OSBA Exh. RDK-R1; OSBA St. 2 at 2-8).

 **4. Disposition**

With regard to the OCA’s claim that the ALJ concluded that *Lloyd* dictates that gradualism cannot be considered in establishing rates, we must clarify that the ALJ did not make this statement. The ALJ stated that, “[t]he contentions presented by OSBA to reject the Company’s rationale of gradualism as progress toward the cost of service relative to the GS-S class are inconsistent with the holding in *Lloyd,* violates the Commission statute in discriminatory rates because the Company gives no other justification for the difference in rates.” (R.D. at 88). This statement is in accord with the Commonwealth Court’s holding that the cost of providing service is the polestar of ratemaking which trumps other concerns such as gradualism or rate shock. *Lloyd v. Pa. PUC*, 904 A.2d 1010, 1020.

We disagree with the OCA’s argument that there is no sound basis to deviate from a proportional scale back if the rate increase is less than the Company has requested. GS-Small is the only class with a rate of return above the system average at both present and proposed rates. A straight scale back, as proposed by the OCA, would perpetuate the problem of over-recovery from GS-Small customers and would actually move the GS-Small class farther away from its cost of service, since that was the result of PPL’s original proposal. It is important to note that application of the FDR does not mean that GS-Small will avoid a rate increase entirely. GS-Small will still experience an increase; however, it will concurrently move closer to its cost of service. It is also important to note that the FDR method cannot cause rates for any customer class to be higher than those proposed by the utility. (R.D. at 86-87; OSBA St. 2 at 3). We find that the FDR proposed by the OSBA is supported by the record evidence and is a reasonable method of progressing toward cost-based rates. Accordingly, the OCA’s Exception on this issue is denied.

 **3. Residential Customer Charge**

 **a. Positions of the Parties**

PPL Gas proposed a 23.8% increase in its residential customer charge from the current $10.50 per month to $13.00 per month. (PPL Gas Exh. CPW-4 at 3). The Company provides a calculation demonstrating the residential customer costs to provide service is $19.73 per month, more than the $13.00 requested. (PPL Gas Exh. PRH-1R, Sch. J).

The OCA argued that the Commission precedent has stated that the residential customer charge is to be limited to those costs which directly relate to the meter and service drop and customer service expenses associated with meter reading and billing. (OCA MB at 120). The OCA argued for a customer charge of $12.00, based on the customer cost analysis performed by its witness Mr. Watkins, which was based on direct customer costs, i.e., those that vary directly with customer connections. (OCA MB at 121-122; OCA RB at 48). The OCA stated that if the Company receives a revenue increase less than its full claim, the customer charge increase should be scaled back proportionately. (OCA RB at 50).

 **b. ALJ’s Recommendation**

The ALJ determined that the evidence presented by the OCA was persuasive and recommended approval of the OCA’s modification to implement a residential customer charge of $12.00. (R.D. at 91).

 **c. Exceptions**

PPL Gas states that its proposal is based upon an analysis of customer cost which is consistent with recent prior orders of the Commission and that residential customer costs per month are $19.73. (PPL Gas Exc. at 30). The Company argues that its proposal that the residential customer charge be increased to $13.00 per month encompasses the principle of gradualism, while also recognizing the cost of service. (*Id.*). PPL Gas claims that the OCA attempted to justify its residential customer cost analysis based upon Commission precedent that is outdated. (PPL Gas Exc. at 29).

The OCA submits that the $12.00 customer charge it has proposed serves the interests of both energy conservation and gradualism, as well as being cost based. (OCA R.Exc. at 15-19). The OCA opined that that a smaller increase in the current customer charge is appropriate because high fixed monthly charges such as the Customer Charge are inconsistent with the Commission’s general goal of fostering energy conservation in that the more money collected in high fixed charges, the lower the volumetric (per ccf or mcf) charge, thus affecting the conservation decision. (OCA R.Exc. at 19).

PPL Gas rejoins that the OCA is erroneous in its claim that the sharing mechanism addresses only the amount of off-system sales to be flowed back to customers and that the mechanism has no impact on how revenues are derived or how revenues are reflected in rates. (PPL Gas R. Exc. at 23). The Company states that the sharing mechanism specifically contains a formula for determining the amount of revenues from off-system sales to be flowed back to customers, and the mechanism requires that such revenues be reflected as a reduction to purchased gas costs. (*Id.*; PPL Gas Exh. CPW-1 at 8.1).

 **d. Disposition**

OCA witness, Mr. Watkins, performed a residential customer cost analysis based only on direct customer costs (those costs that vary directly with customer connections). Based on his analysis, Mr. Watkins determined that the direct customer cost revenue requirement is $12.12 per month. (OCA MB at 121; OCA St. 3 at 21; Sch. GAW-7). After conducting his analysis, Mr. Watkins recommended a customer charge increase from $10.50 to $12.00. (OCA St. 3 at 22). We find that the OCA’s proposal is supported by record evidence, supports the public policy of gradualism, and is less likely to erode conservation by customers. As such, we will deny PPL Gas’ Exception on this issue.

**4. Declining Rate Blocks for Residential Service**

**a. Positions of the Parties**

The structure of the distribution charge for Residential customers of PPL Gas is a declining rate block structure (the first block applying to the first 5 Dth of gas use and the second block applying to greater than 5 Dth of gas use). (R.D. at 91; PPL Gas Exh. CPW-2 at 17). PPL Gas proposed increasing the commodity charges in each block by 25.2%. (PPL Gas Exh. CPW-4 at 3).

The OCA proposed narrowing the differential in this declining block structure over time contending: “(1) the rate structure shifts an appropriate level of risk to ratepayers and away from shareholders, as the majority of residential revenue is collected in the customer charges and [the] first usage block; (2) the rate structure promotes additional consumption of gas and is at odds with conservation efforts; and (3) PPL [Gas’] declining block distribution usage charge is at odds with cost causation and sends a price signal to consumers to use more gas at all times, including peak periods.” (R.D. at 91; OCA MB at 122 citing OCA St. 3 at 22-23).

The OCA recommended starting a transition to gradually reduce the differential in the declining block beginning with this proceeding. (R.D. at 91). The OCA specifically recommended that the difference between the first and second usage rate blocks should be reduced from 40 percent to 25 percent with further reductions made in PPL Gas’ next base rate case. (OCA MB at 122; OCA St. 3 at 24). Stated differently, the first 5 Dth usage rate would be increased to just 10.8 percent while the usage rate for greater than 5 Dth (the second usage rate block) would be increased to 38.8 percent. (OCA RB at 50-51). The non-uniformity in the rate increases proposed by the OCA reduces the difference in the usage rates of the two rate blocks from 40 percent to 25 percent. This alters the Company’s proposal which was to increase both blocks uniformly by 25.2 percent. (R.D. at 92).

**b. ALJ’s Recommendation**

The ALJ recommended that OCA’s rate design regarding the declining rate blocks for customer usage of gas should be rejected as unreasonable. ALJ Jones stated that the reasons provided by the OCA for changing PPL Gas’ proposed 25.2 percent increase for each rate block were based in conservation. (R.D. at 92). The ALJ accepted PPL Gas’ argument that costs are to be the basis of rate design not conservation. (*Id.*). The ALJ determined that PPL Gas’ suggestion that conservation of the gas commodity procedures can be evaluated at a 66 Pa. C.S. § 1307(f) proceeding was reasonable. As such, the ALJ found that PPL Gas’ proposal of a 25.5 percent increase uniformly to both rate blocks for customer usage is supported by the evidence and reasonable. (R.D. at 93).

**c. Disposition**

No exceptions have been filed to this determination. Finding the ALJ’s recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

**H. Miscellaneous**

**1. PPL Gas Changes to Tariff**

**a. Positions of the Parties**

PPL Gas proposed several changes to the rules and regulations sections of its tariff, and their witness, Mr. Charles P. Weekes, summarized these changes as follows:

The proposed changes [to the Description of the Company’s Territory] were made to correct spelling mistakes and to remove “Unincorporated Communities” that are not defined political boundaries. Townships and Boroughs were not changed and those designations fully define the Company’s territory. These changes in the Description of Territory did not affect, in any way, the territory actually served by the Company.

Rule 2.6 was changed to include Rate Schedules CAP 1 and CAP 2.

Rule 2.9 was changed to include Rate Schedules CAP 1 and CAP 2.

Rule 3.8 was changed to remove the paragraph that defines how deposit interest is calculated for residential customers. Chapter 14 of the Public Utility Code now mandates the method of calculating deposit interest for residential customers. In addition, deposits by non-residential customers was changed from “customers” to “accounts” because a single customer may have multiple accounts that could have different refund dates established for a refund of their deposit and deposit interest.

Rule 4.2 was changed to clarify the wording of the Rule. Specifically, the word “put in” was replaced with “installed” regarding the reference to installation of meter connections.

Rule 4.3 was changed to clarify that a customer may not install barriers that inhibit access to Company equipment.

Rule 9.1 was changed to state that billing will begin once the meter is set.

Rule 9.3 was changed to differentiate the calculation for a single residential construction from the calculation for a residential development. Also, a change was made in the calculation of the Company’s funding for new facilities in residential developments and for non-residential customers.

Rule 9.6 was changed to clarify when a customer may receive a refund for all or a portion of an advance for construction. Also, the refund period was changed from 5 years to 3 years.

Rule 11.1 was changed to include the use of procedures set forth in Chapter 14 of the Public Utility Code when pursuing collections of outstanding residential delinquent accounts.

Rule 15.1 was changed to add “Chapter 14” to the list of Common Natural Gas Competition Terms.

(Citing PPL Gas St. 4 at 10-13; PPL Gas Exhs. CPW-1 and CPW-2).

No Party opposed or disputed these tariff changes as unreasonable or inappropriate. (R.D. at 93).

**b. ALJ’s Recommendation**

The ALJ recommended that the Commission approve the proposed changes to the PPL Gas tariff rules and regulations section as they were uncontested by any of the Parties in this proceeding. (R.D. at 93).

**c. Disposition**

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

**2. OCA Proposed Maintenance of Records for Discounted Rates**

**a. Positions of the Parties**

PPL Gas provides discounted rates to LVS customers based on the customer’s (1) potential to bypass; (2) threat of switching to an alternative supplier; (3) significance to the local economy; and (4) multiple sites to vie for competitive suppliers. (PPL Gas St. 5R at 3). During this proceeding, it was revealed that the Company could not provide documentation to support the discounted rates it had awarded. The OCA’s witness, Mr. Watkins, contended that without supportive documentation for the discounts it is impossible to analyze and evaluate whether the discounts are appropriate and effective at the levels awarded to retain customer or whether the levels can be adjusted. (OCA St. 3 at 14-15). As such, the OCA submitted that the following recommendation by Mr. Watkins be adopted:

PPL [Gas] should be required to maintain current records supporting any discounted rate. Moreover, these records should include a detailed analysis of not only alternative burner tip fuel prices but any storage capacity, or emissions constraints imposed on the customer. For those customers that claim to have the ability to bypass the PPL [Gas] system a cost analysis supporting this claim should be required. Finally, PPL [Gas] should be required to update these studies and records at least annually.

(OCA MB at 124 citing OCA St. 3 at 17).

The OCA reasoned that the recommendation provides the Company and the Commission with the appropriate documentation to affirm and ensure the rates and discounts for LVS customers are reasonable. (OCA MB at 124).

No Party opposed or disputed the OCA recommendation regarding documenting LVS customer discounts. (R.D. at 94).

**b. ALJ’s Recommendation**

The ALJ found the OCA’s recommendation regarding maintenance of records documenting support for LVS customer discounts to be reasonable. Noting that it was uncontested by any Party, the ALJ recommended that the Commission direct PPL Gas to keep and maintain records supporting the discounts to LVS customers, consistent with the OCA’s recommendation, and that the records associated with the documentation be updated on an annual basis. (R.D. at 94).

**c. Disposition**

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

# **III. CONCLUSION**

 For the reasons discussed above, we will adopt the Recommended Decision of Administrative Law Judge Angela T. Jones as modified by, and consistent with the foregoing Opinion and Order; **THEREFORE,**

 **IT IS ORDERED:**

 1. That the Exceptions of the Parties are granted or denied, consistent with this Opinion and Order.

 2. That PPL Gas Utilities Corporation shall not place into effect the rates contained in Supplement No. 11 to Tariff – Gas Pa. P.U.C. No. 3, which have been found to be unjust and unreasonable and therefore, unlawful.

 3. That PPL Gas Utilities Corporation is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing proposed rates, rules and regulations, consistent with the findings herein, to produce a revenue increase not in excess of $8,142,000.

 4. That PPL Gas Utilities Corporation’s tariffs, tariff supplements, or tariff revisions described in Ordering Paragraph No. 3 may be filed upon less than statutory notice, pursuant to the provisions of 52 Pa. Code §§ 53.31 and 53.101, and may be filed to be effective for service rendered on and after the date of entry of this Opinion and Order.

 5. That PPL Gas Utilities Corporation shall file detailed calculations with its compliance filings, which shall demonstrate to this Commission’s satisfaction that the filed tariffs and adjustments comply with the provisions of this Opinion and Order. The filing shall include a redlined version of the tariff indicating where changes have been made.

 6. That PPL Gas Utilities Corporation shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class pursuant to and in the manner set forth in this Opinion and Order.

 7. That the Commission’s Bureau of Audits is directed to review, in conjunction with PPL Gas’ next Purchased Gas Cost Rate audit, PPL Gas’ accounting for the funds collected through rates and those recovered through insurance, that are to be used for environmental clean-up as well as all previous and planned expenditures associated with all projects included within this activity. The findings of the Bureau of Audits shall be included within PPL Gas’ next base rate case filing.

 8. That the Commission’s Bureau of Audits is directed to review, in conjunction with PPL Gas’ next Purchased Gas Cost Rate audit, the activity within Account 330, Producing Gas Wells – Well Construction. The findings of the Bureau of Audits shall be included within PPL Gas’ next base rate case filing.

 9. That within 6 months from the entry date of this Opinion and Order, or with the filing of its next base rate proceeding, whichever occurs first, PPL Gas Utilities Corporation shall file a proposed low income usage reduction program, including a mechanism for funding, with the Commission for review and approval, and shall serve a copy of the filing upon the Parties to this proceeding.

 10. That upon entry of this Opinion and Order, PPL Gas Utilities Corporation is directed to keep and maintain records supporting the discounted rates to Rate LVS customers consistent with the recommendation of the Office of Consumer Advocate and to update any studies and records associated with this documentation on an annual basis.

 11. That PPL Gas Utilities Corporation shall comply with all directives, conclusions and recommendations contained in the body of this Opinion and Order, which are not the subject of any individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering paragraph.

 12. That the formal Complaints filed by Ms. Mary Gummo at Docket No. R-00061398C0003 and Mr. Michael Blake at Docket No. R-00061398C0004 are dismissed consistent with this Opinion and Order.

 13. That the Complaints filed by the Office of Small Business Advocate at Docket No. R-00061398C0001 and the Office of Consumer Advocate at Docket No. R-00061398C0002 are sustained in part and dismissed in part, consistent with this Opinion and Order.

 14. That after acceptance and approval by the Commission of the tariff revisions filed by PPL Gas Utilities Corporation, the investigation at Docket No. R‑00061398 shall be terminated and the record shall be marked closed.

 **BY THE COMMISSION,**

James J. McNulty

 Secretary

(SEAL)

ORDER ADOPTED: February 8, 2007

ORDER ENTERED: February 8, 2007

**TABLES**

1. Although Ms. Gummo filed a Formal Complaint, she did not participate in any stage of the proceeding. [↑](#footnote-ref-1)
2. Mr. Blake complained that the rates charged by PPL Gas are higher than the current wholesale price of natural gas. On October 17, 2006, PPL Gas filed an Answer to the Complaint requesting that the Complaint be denied because the purchased gas costs are recovered pursuant to Section 1307(f) of the Code, 66 Pa. C.S. § 1307(f), in a separate proceeding. [↑](#footnote-ref-2)
3. Due to agreements between the Parties, the evidentiary hearing scheduled for September 28, 2006 was canceled. [↑](#footnote-ref-3)
4. 1 Pa. C.S. § 1922(1), *PA Financial Responsibility Assigned Claims Plan v. English*, 541 Pa. 424, 64 A.2d 84 (1995). [↑](#footnote-ref-4)
5. Actual figures rounded result in $7.558 million. [↑](#footnote-ref-5)
6. The components of this adjustment are the measure of value at December 31, 2006; the Company’s claimed debt ratio of 44.32% which is comprised of short-term and long-term debt; the Company’s claimed embedded cost of debt of 6.35%. (PPL Exh. Future 1 Sch. B7, B8 and C5). [↑](#footnote-ref-6)
7. For the historic test year the calculated balance of ADIT ~~for~~ on CIAC was $4,507,000. (($5,909,000 - $4,507,000 = $1,402,000) / $4,507,000 = 31.1%) (PPL Gas Exh. Historic 1, Sch. C-6). [↑](#footnote-ref-7)
8. PPL Gas has a portion of service territory in Maryland which is outside of the jurisdiction of the Commission. Acknowledging this portion outside of the jurisdiction of the Commission, the OCA reduces its adjustment to $1,286,000 in proportion to that portion of the Company’s service territory that is within the Commonwealth of Pennsylvania. [↑](#footnote-ref-8)
9. The Company’s final claim of $186,926,000 reflects the three uncontested adjustments discussed in this section. The Company’s revised claim on rebuttal of $186,952,000 did not include the $26,000 adjustment for lobbying expenses, *infra.* (PPL Gas. Exh. Future 1 – Revised, Sch. D-1). [↑](#footnote-ref-9)
10. PPL Gas St. 4-R at 2 indicates that $618,000 is reflected as a cost of purchased gas and recovered through the PGC filing. PPL Gas Exh. Future 1 - Revised at Sch. D-2, however, reflects a larger reduction of $854,000 in company-use gas, which in turn is reflected in the total O&M claim of $186,926,000. The discrepancy of $236,000 is not explained. Because all Parties and the ALJ accepted the Company’s adjustment, we will assume that it is correct. [↑](#footnote-ref-10)
11. As noted, the OCA also proposed an adjustment to eliminate $26,000 in lobbying expenses, which PPL Gas accepted. *See* Section D(1)(c) of this Opinion and Order. [↑](#footnote-ref-11)
12. The text of the ALJ’s Recommended Decision reversed the OTS recommended allowance of $105,000, and the OTS recommended downward adjustment of $882,000. (R.D. at 27). Table II to the Recommended Decision, however, correctly reflects a downward adjustment of $882,000. [↑](#footnote-ref-12)
13. To add further confusion, the Company stated that the OTS proposed an adjustment of $289,000 to the Company’s ROW “program cost” of $765,000, and an allowance of $476,000. (PPL Gas MB at 45). [↑](#footnote-ref-13)
14. The OCA also states that its adjustment is directed at the Company’s “broader claim for ROW related expenses of $765,000.” (OCA Exc. at 15). [↑](#footnote-ref-14)
15. The OCA’s proposed adjustment deducted $100,000 from O&M Expense before applying a jurisdictional allocation factor of 99.41 percent. (OCA St. 1, Sch. C-2). [↑](#footnote-ref-15)
16. The actual percentages from 2002 through 2005 were 1.41, 1.32, 1.32, and 1.07 percent, respectively. (PPL Gas MB at 48). [↑](#footnote-ref-16)
17. $200,121,000 (future test year billed revenues) x 0.0133 = $2,661,609 + $200,000 (CAP arrearage forgiveness) = $2,861,609. $2,916,000 (PPL Gas expense claim) - $2,861,609 = $54,391. [↑](#footnote-ref-17)
18. ($181,321,000 x 1.33 percent) + $200,000 = $2,611,569, rounded up to $2,612,000. (OCA St. 1, Sch. C-2.2). [↑](#footnote-ref-18)
19. $187,672,000 (Rate Revenue) + $12,449,000 (Transportation Revenue) - $13,070,750 (GCR Reduction) = $187,050,250 x 1.33% = $2,495,615 + $200,000 = $2,965,615 - $2,916,000 (Company Claim) = ($220,385). [↑](#footnote-ref-19)
20. Note that the effective date was voluntarily extended by the Company until February 9, 2007. [↑](#footnote-ref-20)
21. PPL Gas Exh. PRM-1 Schs. 1, 5 and 6. [↑](#footnote-ref-21)
22. OCA St. 2 at 3, Exh. DCP-1 Sch. 11. [↑](#footnote-ref-22)
23. OTS St. 1 at 9, Exh. 1 Sch. 1. [↑](#footnote-ref-23)
24. The OTS accepted PPL Gas’ barometer group of nine gas distribution companies. [↑](#footnote-ref-24)
25. $38.8 million (short-term debt) - $25.8 million = $13 million. [↑](#footnote-ref-25)
26. PPL Gas used the midpoint of the range, or 11.50%, plus 25 basis points for management performance to equal 11.75%. (PPL Gas St. 6 at 2). [↑](#footnote-ref-26)
27. Under PPL Gas’ proposed rates allocation the only class that has not moved closer to the system average is LVS because that class is subject to competitive restraints. (PPL Gas MB at 91). [↑](#footnote-ref-27)
28. The proposed revenue allocations of the OCA and of the OSBA are rejected because they are based on the modifications to the Company’s COSS advocated by these Parties which we have denied. The alternative revenue requirement allocation proposed by the OTS providing the first $882,415 be used to reduce usage rates for the GS-S customer class, where that class includes Resale customers is contingent upon a grant of the full rate increase requested and, therefore, is rejected. [↑](#footnote-ref-28)
29. The OCA states that the ALJ appears to have adopted the Company’s allocation at the full rate increase amount since it forms the basis of the OSBA FDR proposal. (OCA Exc. at 36). The ALJ clearly states that it does not adopt the full increase as proposed by PPL Gas. (R.D. at 85). [↑](#footnote-ref-29)