BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

# Public Meeting held July 18, 2002

Commissioners Present:

 Glen R. Thomas, Chairman

 Robert K. Bloom, Vice Chairman

 Aaron Wilson, Jr., Statement attached

 Terrance J. Fitzpatrick, Statement Concurring and Dissenting in part attached

 Kim Pizzingrilli

### Pennsylvania Public Utility Commission, *et al.*  R-00016750

##  R-00016750C0001-C0091

v.

Philadelphia Suburban Water Company*.*

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) Marlane R. Chestnut issued on June 7, 2002, relative to the above-captioned general rate increase proceedings. Also before the Commission are the various Exceptions and Reply Exceptions filed with respect thereto.

I. HISTORY OF THE PROCEEDING

 On November 9, 2001, the Philadelphia Suburban Water Company (PSWC) filed proposed Supplement Nos. 35 through 39 to Tariff Water-Pa. P.U.C. No. 16 to become effective January 8, 2002. This consolidated filing was made by PSWC on behalf of itself and Consumers Pennsylvania Operating Companies (Roaring Creek, Shenango Valley and Susquehanna), and the Waymart Water Company, Fawn Lake Forest Water Company, Western Utilities, Inc., Northeastern Utilities, Inc. and Hawley Water Company.[[1]](#footnote-1)

 Based upon a historic test year ended June 30, 2001, and a future test year ending June 30, 2002, these tariff supplements proposed changes in rates, rules and regulations calculated to produce $28.0 million in additional annual operating revenues, or an increase of approximately 13.5%.[[2]](#footnote-2)

 By Order entered December 19, 2001, an investigation was instituted into the lawfulness, justness and reasonableness of PSWC’s proposed tariff supplements as well as the Company’s existing rates and service. Consequently, Supplements Nos. 35 through 39 were suspended by operation of law, pursuant to 66 Pa. C.S. §1308(d), for a period not to exceed seven months, or until August 8, 2002. This proceeding was thereafter referred to the Office of Administrative Law Judge (OALJ) for further proceedings.

 More than ninety Complaints were filed against the proposed tariff supplement, including those of the Office of Consumer Advocate (OCA), the Office

of Small Business Advocate (OSBA), Lawrence G. Speivogel, and Charles Mullin. On January 8, 2002, the Commission’s Office of Trial Staff (OTS) filed a Notice of Appearance. A Petition to Intervene, which was unopposed, was filed by the Philadelphia Suburban Water Large Users Group (PSWLUG) on January 22, 2002.[[3]](#footnote-3)

 By Notice dated January 3, 2002, the investigation was assigned to ALJ Chestnut and a Prehearing Conference was scheduled for January 11, 2002. Present, either in person or telephonically, were PSWC, the OTS, the OCA, the OSBA, PSWLUG, Mr. Speilvogel, and Mr. Mullin. At that Prehearing Conference, as set forth in Prehearing Order No. 2 dated January 15, 2002, a number of procedural items were addressed and a litigation and briefing schedule was adopted.

 In order to allow PSWC customers the opportunity to express their concerns or opinions concerning the pending rate increase request, three Public Input Hearings were held in various locations in PSWC’s service territory. These Public Input Hearings were held February 12, 2002, in Hatboro (Bucks County) and February 13, 2002, in Media (Delaware County) and Berwyn (Chester County). Representatives of PSWC, the OTS, the OCA, and the OSBA attended. Testimony was given by twenty-nine individuals and transcribed for the record. A summary of the testimony presented at these sessions is attached to OCA’s Main Brief as Appendix C. (*See also*, PSWC M. B., p. 83).

 On March 22, 2002, the ALJ issued an Order Granting PSWC’s Motion as to Qualifications. Mr. Spielvogel had challenged the qualifications of two of PSWC’s witnesses to sponsor, respectively, the cost of service study and the depreciation study. The ALJ agreed with PSWC that this challenge was completely without merit, and permitted the witnesses to sponsor the studies.

 Evidentiary hearings were held in Philadelphia on April 3, 4, and 5, 2002. The record consists of a transcript of 565 pages, and numerous statements and exhibits. Appendix B to the Recommended Decision lists these statements and exhibits. Pursuant to the schedule adopted at the Prehearing Conference, Main Briefs were filed on April 26, 2002, by PSWC, the OTS, the OCA, the OSBA, PSWLUG and Mr. Spielvogel. Reply Briefs were filed on May 10, 2002, by all Parties except Mr. Spielvogel.

 In their respective Main Briefs, PSWC explained the basis for its requested $28.0 million revenue increase; the OTS recommended a revenue increase of no more than $12,893,915; and, the OCA recommended a decrease in annual revenues of $719,082. Neither the OSBA nor PSWLUG took a position on the amount of revenue relief, but did discuss rate design and revenue allocation issues.

 The Recommended Decision was filed on June 7, 2002. Exceptions to the Recommended Decision were timely filed by the following Parties: Mr. Spielvogel, OTS, PSWC; and the OCA.

 The OSBA and the PSWLUG each filed a Letter, on June 24, 2002, and on June 28, 2002, respectively, indicating that they would not be filing Exceptions to the Recommended Decision.

 The OSBA filed a Letter on July 2, 2002, indicating that it would not be filing Reply Exceptions. On July 3, 2002, PSWLUG filed a Letter in Lieu of Reply Exceptions. The following Parties filed Reply Exceptions on July 3, 2002: the OTS, Mr. Spielvogel, the OCA, and PSWC.

**II. DESCRIPTION OF THE COMPANY**

 PSWC is a regulated Pennsylvania public utility and is a wholly-owned subsidiary of Philadelphia Suburban Corporation (PSC). PSWC furnishes water service to approximately 382,000 customers in a service territory that covers all or a portion of thirteen counties across the Commonwealth. In 1999, PSC acquired Consumers Water Company, including its operating utilities in Pennsylvania (Roaring Creek, Shenango Valley, and Susquehanna) and in 2000, it acquired a group of utilities headquartered in Waymart, Pennsylvania (Waymart Water Company, Fawn Lake Forest Water Company, Western Utilities, Inc., Northeastern Utilities, Inc. and Hawley Water Company). As explained above, our reference to PSWC in this proceeding collectively incorporates all of PSC’s water utility operations in Pennsylvania.

**III. BURDEN OF PROOF**

 It is incumbent upon PSWC to establish rates for its customers which are “just and reasonable” pursuant to Section 1301 of the Public Utility Code (Code), 66 Pa. C.S. §1301. Before addressing the specific elements of the rate filing, it should be noted that the burden of proof is upon PSWC to establish the justness and reason­ableness of every component of the requested rate increase. Specifically Section 315(a) of the Code, states:

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.

66 Pa. C.S. §315(a).

 This section has been interpreted in numerous judicial proceedings. In *Lower Frederick Twp. Water Co. v. Pa. P.U.C.*, 48 Pa. Commw. 22, 226-27, 409 A.2d 505, 507 (Pa. Cmwlth. 1980), the Pennsylvania Commonwealth Court explained:

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. [citations omitted]

*See also, Brockway Glass v. Pa. P.U.C.*, 437 A.2d 1067 (Pa. Cmwlth. 1981). The Pennsylvania Supreme Court also has clearly stated that the party with the burden of proof has a formidable task before its position can be adopted by the Commission. Even where a *prima facie* case has been established, the party with the burden of proof still must establish that “the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.” *Burleson v. Pa. P.U.C.*, 461 A.2d 1234, 1236 (Pa. 1983).

 With specific reference to base rate proceedings, both the Commission and the courts have made it clear that this burden does not shift to intervenors challenging a requested rate increase. While the burden of going forward may shift, the burden of proof remains on the utility, and this burden of establishing the justness and reason­ableness of every component of its rate request is an affirmative one. In contrast, there is no similar burden placed on an intervenor to justify a proposed adjustment to the Company’s filing. The Pennsylvania Supreme Court stated:

[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. P.U.C.*, 116 A.2d 738, 744 (Pa. 1955).

 Similarly, this standard has been recognized by the Commission in its rate determinations:

There is no presumption of reasonableness which attaches to a utility’s claims, at least none which survive the raising of credible issues regarding a utility’s claim. A utility’s burden is to affirmatively establish the reasonableness of its claim. It is not the burden of another party to disprove the reasonableness of a utility’s claim.

*Pa. P.U.C. v. Equitable Gas Co.*, 57 Pa. PUC 423, 444 (1983).

 The utility’s burden of proof must be satisfied by the introduction of substantial evidence, which has been defined by the Commission as “such relevant evidence as reasonable minds might accept to support a conclusion.” *Pa. PUC v. Equitable-Gas Energy Co.*, 68 Pa. PUC 438, 448 (1988). In turn, the Commission’s material findings of fact must be supported by substantial evidence. *See* 2 Pa. C.S. §704.

 The evidentiary standards described above were applied in this case. Where a Party raised a credible question concerning a rate element at issue, the affirmative burden of proving the justness and reasonableness of its claim was upon PSWC.

###### IV. RATE BASE

 PSWC’s claim for rate relief in this proceeding is based upon data for the future test year ending June 30, 2002. PSWC’s claimed rate base of $887,713,655 consisted of its adjusted actual plant balances at June 30, 2001, as set forth in its books of account to reflect those plant additions and retirements and system acquisitions anticipated to occur during the twelve months ending June 30, 2002. PSWC added to that its proposed allowances for materials and supplies, cash working capital and certain other balance sheet items in the process of being amortized, and made normal ratemaking deductions for, *inter alia*, accrued depreciation customer contributions, advances and deposits, deferred income taxes and accrued interest.

1. Recent Water Company Acquisitions

Since the conclusion of PSWC’s last base rate proceeding, the Company has acquired a number of additional municipal and small water systems. As part of its initial rate filing, PSWC submitted original cost studies with respect to the following acquisitions that were completed either prior to or during the historic test year: Fulmer Heights, Chatwood, Waymart, and Geigertown. No Party objected to the proposed measures of value with respect to these acquisitions. (R.D., p. 7).

In addition, PSWC included in its claimed measure of value the amount of $16,787,200 representing the price paid for eight additional systems to be acquired during the future test year. Original cost studies were not provided for those systems with PSWC’s filing. Subsequently, PSWC provided original cost studies for seven of the eight systems cited above. At the same time, PSWC removed the rate base and associated revenues and expenses related to the eighth system because it did not appear that this acquisition would close prior to the end of the future test year. (R.D., p. 8).

1. Positions of the Parties

The OTS recommended that the Commission remove the purchase price from rate base associated with the aforementioned seven acquisitions because it had insufficient time to review the original cost studies. Specifically, the OTS recommended that property and plant associated with the seven acquisitions should not be included in the measure of value ($13,107,200), and that the revenues ($1,496,421) and the expenses ($366,578) relating to the acquisitions should be removed. (R.D., p. 8).

PSWC opposed the OTS’ recommendations. PSWC emphasized that it complied with the OTS’ admonition that the original cost studies pertaining to the acquisitions be supplied prior to the close of the record. Moreover, PSWC asserted that the OTS had nearly two weeks to review the first four studies and a week to review the final three studies before the close of the record on April 5, 2002. PSWC reasoned that the OTS’ proposal, if adopted, would force it either to make separate rate filings for the excluded systems or to wait another two years before recovering on its investment. (R.D., p. 9).

1. The ALJ’s Recommendation

After considering the arguments of the Parties, the ALJ rejected the OTS’ arguments that these systems should be excluded from rate base. The ALJ found that, not only are the water systems used and useful property and, therefore, recognizable in PSWC’s rate base for ratemaking purposes, but also that the OTS had ample time to examine the original cost studies of the water systems. The ALJ emphasized that the OTS had a calendar week, from March 28, 2002, to April 5, 2002, to review the germane set of original cost studies. The ALJ found that a week was sufficient time for the OTS to conduct its review.

The ALJ concluded that it is in the interests of PSWC’s customers for the Commission to recognize these acquisitions for ratemaking purposes. Subject to Commission approval of the relevant applications, the ALJ determined that the acquisitions will occur and be part of PSWC’s operations during the period the rates set in this proceeding will be in effect. Accordingly, the ALJ recommended that the aforementioned acquisitions be recognized for ratemaking purposes, subject to the Commission’s approval of any outstanding application. (R.D., p. 12).

3. Exceptions and Reply Exceptions

 No Party filed Exceptions on this issue.

 4. Disposition

Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with the record evidence, it is adopted.

1. Future Acquisition Applications

 1. Positions of the Parties

The OTS recommended that PSWC be directed to include an original cost study in any future acquisition application so that the Commission will have all relevant information in order to make an informed decision. PSWC has opposed this recommendation as impractical.

2. The ALJ’s Recommendation

The ALJ recommended that the OTS’ proposal be rejected because it is not always possible for a utility to produce an original cost study prior to the filing of an application. The ALJ further observed that the OTS’ proposal may improperly restrict the Commission’s exercise of its jurisdictional authority. The ALJ indicated that presently the Commission can exercise its discretion, in any acquisition application proceeding, to reject an application that is insufficiently supported. (R.D., p. 13).

3. Exceptions and Reply Exceptions

In its Exceptions, the OTS argues that, even if an original cost study may not always be available, such a study will often be available depending on the circum­stances. Specifically, if the utility demonstrates that it has exercised all reasonable options in an attempt to obtain the information necessary for the original cost studies, and still cannot include the studies with the application, only then should the study not be required.

The OTS’ objective in filing its Exception on this issue is to emphasize that it is burdensome, and many times unnecessary, for the Commission to try to analyze an original cost study within the confines of a rate proceeding. The OTS maintains that, if the original cost studies were filed with the acquisition applications, the Commission would have access to this data and have ample time to locate and to review other germane information. Therefore, it is the OTS’ position that the ALJ’s recommendation be rejected. (OTS Exc., pp. 3-5).

In its Reply Exceptions, PSWC rejoins that the ALJ was correct in her recommendation that the Company should not be required to prepare and to submit an original cost study whenever it files a future application to acquire an additional water system. Contrary to the OTS’ Exception, PSWC argues that requiring it to prepare and to include an original cost study as part of its application for a Certificate of Public Convenience, with the holding of associated hearings, will substantially delay the consummation of future acquisitions. PSWC further argues that this will postpone any planned system improvements, to the clear detriment of customers served by troubled water systems. Accordingly, PSWC asserts that the OTS’ Exception must be denied. (PSWC R.Exc., pp. 1-2).

4. Disposition

We agree with the ALJ that it is not always possible for a utility to produce an original cost study prior to filing an application to acquire an additional water system. Presently, we have the discretion to reject any acquisition application that is insufficiently supported. By ordering a utility always to include an original cost study with its filing, we would restrict the exercise of our jurisdictional authority to grant or reject an application irrespective of the filing of a concomitant original cost study. Furthermore, we agree with PSWC that requiring it to prepare and include an original cost study, as part of its application, may delay the consummation of future acquisitions. We nevertheless reserve the right to require an original cost study, if appropriate, in the context of a specific application proceeding. Therefore, we will deny the Exceptions of the OTS on this issue, and adopt the ALJ’s recommendation.

# **V. REVENUES**

 In this proceeding, PSWC submitted extensive financial and accounting data depicting the results of its operations during the historic test year ended June 30, 2001, and as projected for the future test year ending June 30, 2002. (PSWC Exh. 1‑A(a)). A summary statement of income, together with its revenue and expense claims, was attached to PSWC’s Main Brief as Appendix A. That statement shows pro forma revenue at the end of the test year in the amount of $197,270,372, pro forma revenue at the end of the future test year at current rates of $208,338,392 and pro forma revenue at the end of the future test year at proposed rates of $236,338,392.

 To develop its claimed pro forma future test year revenue level, PSWC began with the level of revenue experienced during the historic test year. The historic data were then adjusted to: (1) annualize revenues associated with each of the acquisitions that occurred during the historic test year and will occur during the future test year; (2) annualize the effect of actual and anticipated changes in the number of customers during the historic and future test years; and (3) reflect known and measurable changes affecting the consumption levels of specific customers. (PSWC Exh. 1‑A(a), pp. 6-17).

 According to PSWC, the appropriate amount of pro forma revenue associated with future test year acquisitions is $1,496,421. The ALJ recommended that, since the future test year acquisitions are to be recognized for ratemaking purposes, the revenues associated with those various acquisitions also should be recognized in this proceeding.

 The only outstanding issue to be addressed is the appropriate level of revenue to be imputed from the Chalfont and White Haven Divisions.

**A. Imputed Revenue from Chalfont and White Haven Divisions**

**1. Positions of the Parties**

 The OTS asserted that PSWC’s proposed rate increases for the Chalfont and White Haven Divisions are understated. The OTS recommended, therefore, that $32,802 be added to the proposed revenue for the Chalfont Division and $26,182 be added to the proposed revenue for the White Haven Division, based on a hypothetical 30% rate increase for those customers. According to the OTS, this adjustment would result in rate parity for those divisions with PSWC’s Main Division in nine years, rather than twelve years as provided for by PSWC.

 In supporting its claim, PSWC notes that the agreement it entered into with the Borough of Chalfont to acquire the Chalfont Water System provided that, in order to gradually equalize rates, PSWC would raise rates by 50% over a series of four annual rate increases beginning November 1, 2002. (PSWC M.B., pp. 10-11). In accordance with this contract, PSWC filed with the Commission a series of tariff supplements to increase rates annually through November 2005. The Commission approved that agreement, at Docket No. A‑212370F066 by Order entered October 25, 2002.

 In arriving at its pro forma revenue claim relating to Chalfont, PSWC included existing revenue of $481,163, additional revenue of $54,590 relating to the November 1, 2002 increase, and an additional $49,082, which represents the present value of revenues resulting from the November 1, 2002 increase. (PSWC Exh. 1‑A(a), p. 11; PSWC Supp. Exh. 2, p. 3). This represents an approximate 22.8% increase in metered rates for the Chalfont Division.

 With respect to the White Haven Division, the Commission approved PSWC’s Application to purchase the assets of the White Haven Municipal Water Authority by Order docketed at No. A‑212600F0007 and entered January 28, 2002. The contract with White Haven provides for a twelve-year rate equalization plan and a rate freeze until January 1, 2004. Although White Haven’s rates will not change, PSWC has imputed $30,901 of additional revenue at present rates. (PSWC Exh. 1A(a), p. 11‑1). This is equivalent to a 16.2% increase above current revenues. (PSWC St. 1-R, p. 41).

 PSWC noted that, at 14,000 gallons per quarter, a White Haven residential customer’s bill at present rates is $93.56, while a similarly situated Main Division customer would pay $90.28. (PSWC St. 1-R, p. 41).

 The only reason advanced by the OTS for proposing to impute revenues associated with a 30% increase for each division is that “OTS believes that if the rate freeze were not in effect, these customers would have received an increase of 30% in this proceeding.” (OTS R.B., p. 16). The OTS also argued that this adjustment “will facilitate the more timely movement of these divisions to Main Division rates.” (OTS R.B., p. 17).

**2. The ALJ’s Recommendation**

 The ALJ recommended that the OTS’ proposal be rejected. The ALJ noted that PSWC’s proposed rate equalization plans were each approved by the Commission in the respective application proceedings. The ALJ concluded that, therefore, there was no basis in this proceeding to reject or to modify the Commission’s conclusions concerning the appropriateness of the proposed schedule for rate equalization with the Main Division.

 The ALJ also noted that, as explained by PSWC, the average overall percentage increase to all of the rate divisions other than the Main Division is approximately 13%. (PSWC M.B., pp. 10‑11). Excluding the newest divisions with minimal increases or net decreases, the average increase to the rate divisions other than the Main Division is approximately 22%. (PSWC Exh. 50-A, Schedule 1, p. 2 and Schedule 1A, p. 2). Therefore, the ALJ concluded that PSWC’s proposed revenue imputations, representing an increase of 22.8% in metered rates to the Chalfont customers and 16.2% to the White Haven customers, were appropriate.

**3. Exceptions and Reply Exceptions**

The OTS excepts to the ALJ’s recommendation on this issue. The OTS contends that the ALJ’s characterization of a rate equalization plan, or rate freeze, that was included in prior Application Dockets as binding in a rate case is misguided. The OTS asserts that when a utility acquires another system and agrees to a rate freeze as a condition of sale, the utility should reflect the revenue of the acquired system as if the rate freeze did not exist. (OTS St. No. 2, p. 51).

The OTS argues that the ALJ has misinterpreted the conclusions of the Application Dockets from the Chalfont and White Haven divisions (Docket numbers cited above), and has inappropriately infused them into the instant proceeding. Additionally, PSWC has explicitly recognized the need to impute some revenues pertaining to those divisions. The error occurred in the ALJ’s characterization of what was sufficient. Despite Commission precedent indicating that a theoretical increase of 33% was reasonable,[[4]](#footnote-4) the ALJ determined that the theoretical increase of 30% proposed by the OTS in the case of the Chalfont and White Haven divisions is not appropriate. (R.D., p. 16). The OTS maintains that an additional $26,182 needs to be imputed in White Haven and an additional $32,802 is necessary for Chalfont. (OTS Exc., pp. 15‑18).

PSWC rejoins that the ALJ properly rejected the OTS’ attempt to impute an additional $58,984 in revenues for Chalfont and White Haven customers, based upon a hypothetical 30% rate increase for those divisions. PSWC contends that the OTS has provided no reason why an assumed 30% increase for these divisions is more appropriate than the 22.8% increase that PSWC has imputed for Chalfont, or the 16.2% increase that PSWC has imputed for White Haven. These increases are greater than the increases proposed for the Main Division, and thus represent reasonable movement toward single tariff pricing. PSWC Asserts that the OTS’ proposal to impute additional revenues for the Chalfont and White Haven Divisions is unsupported by the record, and was properly rejected by the ALJ. (PSWC R.Exc., pp. 2-3).

**4. Disposition**

On review of this issue, we conclude that the ALJ properly rejected the OTS’ proposal to impute an additional $58,984 in revenues for Chalfont and White Haven customers, based upon a hypothetical 30% rate increase for those divisions. PSWC’s proposed rate equalization plans for those divisions were each approved in the respective application proceeding. Accordingly, there is no basis in this proceeding to reject or to modify our prior conclusions regarding the appropriateness of the proposed schedule for rate equalization of those divisions with the Main Division.

 Given PSWC’s acquisition history, it is not surprising that the various rate divisions are subject to varying degrees of percentage increases. There is no fixed percentage which is applied across the board. While the OTS pointed out divisions with proposed substantial increases in rates, there are other divisions with little or no increase proposed.

 Finally, we note that the OTS provided no rationale as to why its proposed 30% increase for the two pertinent divisions is more appropriate than the 22.8% increase PSWC imputed for Chalfont, or the 16.2% increase that PSWC imputed for White Haven. Those increases are greater than the increases proposed for the Main Division, and thus represent reasonable movement toward single tariff pricing.

Accordingly, for the above reasons, the OTS’ Exception on this issue is denied.

**VI. EXPENSES**

**A. Operating and Maintenance Expense**

 In developing its future test year claim, PSWC adjusted the expenses incurred throughout the historic test year ended June 31, 2001, to arrive at a projected future test year pro forma operating and maintenance claim. Both the OTS and the OCA recommended adjustments to PSWC’s claim. Throughout the course of the proceeding, the Parties were able to reach agreement on a number of issues, because PSWC was able to update certain claims as actual data became available.

 PSWC’s pro forma operating and maintenance expense for the future test year is $76,391,178. (PSWC M.B., Appendix A).

 **1. Payroll Expenses**

PSWC’s claim for payroll expense is found at PSWC Exhs. 2-A and 2‑A(a). A number of issues raised by the OTS and the OCA were resolved. The unresolved issues relating to payroll expense are the post-future test year increase, the incentive compensation claim and overtime normalization.

**a. Post-future Test Year Increase**

**i. Positions of the Parties**

 Both the OTS and the OCA recommended that the Commission reject that portion of PSWC’s claim relating to a wage increase that was projected to be granted to the unionized Shenango District employees in October 2002. Two reasons were presented for the rejection of the claim: (1) it will fall outside the end of the future test year; and (2) the amount of the increase is not now known, therefore, the claim is speculative. (R.D., p. 18).

 PSWC argued that the OTS and OCA proposals were without merit. Two primary reasons were cited: (1) the Commission previously approved post-future test year salary and wage increases; and (2) PSWC’s claim for post-test year payroll increases were extremely conservative. (PSWC M.B., pp. 13-14; PSWC R.B., pp. 6-7).

**ii. The ALJ’s Recommendation**

 The ALJ noted that the Commission routinely has accepted payroll adjustments that are projected to occur within six months of the end of the future test year, when such adjustments are known or anticipated with reasonable certainty. The existence of a collective bargaining agreement or other contractual obligation has been determined to constitute the requisite certainty. *See Dauphin Consolidated Water Supply Co. v. Pa. P.U.C.*, 423 A.2d 1357, 1360, 1980 Pa. Commw. LEXIS 1958; *Pa. P.U.C. v. Pennsylvania American Water Co.*, 85 Pa. PUC 13, 27-28 (*PAWC 1995*).

 The ALJ also noted that she had found no cases that support the position, taken by the OCA and the OTS herein, that the absence of a contractual obligation renders future wage increases so speculative as to be uncertain. On the other hand, there are cases in which the Commission has found that post-future test year wages are appropriate in the absence of a collective bargaining agreement or other contractual obligation. *See Pa. P.U.C. v. Pennsylvania American Water Co.*, Docket No. R‑00016339 (Opinion and Order entered January 25, 2002) (*PAWC 2002*).

 Additionally, the ALJ cited *Pa. P.U.C. v. UGI Corp. (Gas Division)*, 58 Pa. PUC 155, 207-209 (1984). In that case, the Commission did allow a 4% increase, based on current economic conditions, in lieu of a proposed 7% increase, stating “[w]e specifically note that the Company is not under any obligation to provide a 7% increase to its union.”

 Upon consideration, the ALJ concluded that the proposed payroll increase is sufficiently definite to be accepted for ratemaking purposes. In doing so, she noted that the unionized Shenango employees have received a wage increase in each of the last ten years. Furthermore, given the prior history of increases, the 2.1% increase appeared reasonable. Weighing all the relevant factors, the ALJ concluded that PSWC’s claim is consistent with Commission precedent and should be approved. (R.D., pp. 18-19).

**iii. Exceptions and Reply Exceptions**

The OTS objects to the ALJ’s recommendation on this issue, arguing that, since PSWC claimed that it expects a new contract for the Shenango employees in October 2002, it increased the future test year salaries by 2.1% to account for the annualization of the expected increase. (PSWC St. 2, p. 3). The OTS opposed this increase on the grounds that it is not known and measurable. (OTS St. 4, p. 13).

The OTS asserts that the Commonwealth Court, in *Lower Frederick Township v. Pa. PUC*, 409 A.2d 505 (Pa. Cmwlth. 1980), determined that in order to recover an expense claim, the amount of evidence adduced must be substantial. Additionally, such evidence must be supported with a minimum amount of specificity. The OTS argues that since the 2.1% increase proposed by PSWC is not supported by a signed contract, it is clearly speculative and uncertain, and should, therefore, be rejected. (OTS Exc., pp. 5-6).

 PSWC rejoins that the OTS has not identified a single case in which the Commission held that an executed collective bargaining agreement was a prerequisite to rate recovery. The Commission and the Commonwealth Court have frequently authorized utilities to recover projected post-test year wage and salary increases so long as the estimated increases are anticipated to occur within a relatively short period following the end of the test year, and are reasonable in amount. (PSWC R.Exc., pp. 3‑4).

**iv. Disposition**

On review of this issue, we conclude that the ALJ correctly determined that the proposed payroll increase is sufficiently definite to be accepted for ratemaking purposes. The Commission has routinely accepted payroll adjustments which are projected to occur within six months of the end of the future test year, when such adjustments are known or anticipated with reasonable certainty. Based on our review of the record evidence, we find that there is a sufficient basis for concluding that the projected payroll increase is sufficiently definite to be accepted for ratemaking purposes. Accordingly, the OTS’ Exception on this issue is denied.

**b. Incentive Compensation Program**

**i. Positions of the Parties**

 The OCA recommended an adjustment of $631,068, to completely eliminate PSWC’s claim for incentive compensation. PSWC’s incentive compensation plan consists of a Management Incentive Program and an Employee Recognition Program. (OCA Sch. LKM-7 (final)). The reasons advanced for the OCA’s recom­mendation are that payments pursuant to the plan are uncertain and that this type of plan should be rejected as a matter of policy. (OCA M. B., pp. 58-62).

 In addition, the OCA recommended that PSWC’s proposed wage increase should not be applied to that portion of employee compensation. The OCA contends that the incentive compensation program should be reflected in rates at the historic test year level, not adjusted to reflect increases in wages and salaries for non-union employees. This argument results in a proposed adjustment of $37,864, found at Sch. LKM-6. (OCA St. 1, p. 11).

 PSWC’s response was that this proposal is flawed because the compen­sation plan payments are based on a percentage of the employee’s salary. (PSWC R.B., p. 9).

**ii. The ALJ’s Recommendation**

 In her disposition of this issue, the ALJ noted that the Commission carefully examines each incentive compensation plan on a case-by-case basis to determine if it is appropriately recognized for ratemaking purposes. The ALJ emphasized that the Commission has never demanded a quantification or demonstration of improved customer performance, but rather has rejected those plans that are based entirely on the achievement of financial goals. However, incentive plans that are linked to “operational effectiveness” have been permitted.

 The ALJ opined that, in this case, the OCA either intentionally or unintentionally misrepresented the incentive plan as implemented by PSWC. Contrary to the unambiguous testimony presented by PSWC, the OCA asserted that “[t]he primary objective of the incentive compensation plan is profitability.” (OCA M.B., p. 61). The ALJ concluded that that statement was untrue. In the ALJ’s opinion, the OCA attempted to mischaracterize PSWC’s incentive compensation plan as being solely or primarily intended to improve PSWC’s financial condition. Thus, that plan would be analogized to plans previously rejected by the Commission.

 The ALJ found that the instant plan was not designed to address “profitability,” but rather was intended to address a number of corporate objectives. (PSWC R.B., pp. 7-8, citing PSWC St. 2-R, pp. 7-8). Additionally, the ALJ noted that PSWC’s incentive plan, implemented in response to a 1988 Commission management audit recommendation, was more than just a plan that gives bonuses to certain employees. Rather, every non-union employee has a percentage of his or her compensation put at risk. (PSWC St. 2-R, p. 7).

 The ALJ concluded that PSWC has sustained its burden of establishing that its incentive compensation plan is focused on improving operational effectiveness, including customer service, and, therefore, should be recognized for ratemaking purposes. Accordingly, the ALJ rejected the OCA’s recommendation that all expenses associated with this program should be disallowed. (R.D., pp. 22-23).

**iii. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

**iv. Disposition**

Since no Party filed Exceptions to the ALJ’s recommendation on this issue, and finding the ALJ’s recommendation to be otherwise reasonable, and in accord with the record evidence, it is adopted. As noted by the ALJ, the Commission has previously recognized that incentive compen­sation plans which are designed to improve the level of customer service by achieving “operational effectiveness” obviously are in the best interest of the company’s ratepayers, and should be supported through rates.

 We find that PSWC has sustained its burden of establishing that its incentive compensation plan is focused on improving operational effectiveness, including customer service, and, therefore, should be recognized for ratemaking purposes. It is a reasonable incentive program that conditions a portion of an employee’s compensation on the achievement of appropriate performance standards.

**c. Overtime Normalization**

**i. Positions of the Parties**

 The OCA recommended that PSWC’s overtime claim be normalized. Implementation of that recommendation would result in a decrease to expenses of $193,712. (Schedule LKM-23). The OCA explained that “[t]he adjustment [Mr. Morgan] proposed is based upon the use of average overtime hours for a three‑year period and composite overtime pay rates for the test year.” (OCA M. B., p. 63). Additionally, the OCA stated that:

In response to Mr. Smeltzer’s suggestion in rebuttal that the 2001 overtime should be included in the average, Mr. Morgan testified that he would incorporate the 2001 overtime data for union employees into his normalization adjustment. Tr. 405-406; PSW St. 2-R at 11. In addition, Mr. Morgan incorporated the 51.6% capitalization ratio for 2001 in response to Mr. Smeltzer’s rebuttal statement about the appropriate capitalization ratio for overtime. PSW St. 2‑R at 12. This adjustment is shown on Schedule LKM-23 and would reduce operating expenses by $101,678, thus increasing net income by $64,039. Sch. LKM-3 (Final).

(OCA M.B., p. 64).

 The basis for the recommendation was the OCA’s observation that the level of overtime payroll for non-union employees was significantly higher than in previous years, which seems to be in conflict with the PSWC stated objective of reducing overtime.

 In its Reply Brief, PSWC explained the derivation of the proposed adjustment for unionized employees:

In his direct testimony (OCA St. 1, Sch. LKM-23), Mr. Morgan developed a “normalized” level of overtime for unionized employees by calculating a three-year average (1998, 1999 and twelve months ending June 30, 2001) of overtime hours and multiplying the result by the average hourly overtime rate during the historic test year. In the final schedule (LKM-23 Final) attached to the OCA’s Main Brief, Mr. Morgan takes a different approach and simply calculates a four-year average (1998, 1999, twelve months ending June 30, 2001 and calendar 2001) of overtime dollars equaling $2,673,000. Because that amount is less than unionized overtime expense incurred during the historic test year ($2,748,346), Mr. Morgan concludes that PSW’s claim is overstated.

(PSWC R.B., p. 9).

PSWC further explained:

Although Schedule LKM-23 (Final) continues to refer to union overtime “payroll hours,” the $2.673 million figure obviously represents overtime dollars. It apparently was derived as follows: $2,180,573 (1998) + $2,563,082 (1999) + $2,748,346 (historic test year) + $3,200,000 (2001) = $10,692,011 ÷ 4 = $2,673,000. The 1998, 1999 and historic test year figures were provided in response to OTS Inter­rogatory RE-67 (*see* OTS Ex. 4, Sch. 1, p. 6); the year 2001 figure was supplied by Mr. Smeltzer in his rebuttal testimony (PSWC St. 2-R, p. 11).

(PSWC R.B., p. 9, n. 3).

**ii. The ALJ’s Recommendation**

 The ALJ noted that, since PSWC addressed only the unionized portion of the adjustment, she assumed that it accepted the OCA’s proposal relating to the non-unionized overtime. Therefore, the ALJ also accepted the OCA’s proposed adjustment to the non-unionized payroll overtime claim. (R.D., pp. 25-26).

 With respect to the unionized portion of the claim, the ALJ noted that the OCA had switched methodologies in calculating the appropriate claim. In doing so, she relied on PSWC’s contention that by using a four-year average based on total dollars, the OCA “fails to fully account for wage rate increases granted between 1998 and June 30, 2002. In other words, even if PSWC were to incur the same number of hours as it did in 1998, the Company would still have to pay more today than it did then.” (R.D., p. 26 (quoting PSWC R.B., p. 10)).

 The ALJ recommended that the OCA’s proposed adjustment be adopted, despite some reservations she expressed regarding the appropriateness of the methodology used to derive the proposed adjustment. (R.D., pp. 25-26).

**iii. Exceptions and Reply Exceptions**

 PSWC excepts to the ALJ’s recommendation on this issue, contending that the ALJ’s proposed disallowance of union payroll expenses, as to which even the ALJ herself expressed doubt, is unsupported and should be rejected.

 PSWC observes that the OCA developed a “normalized” level of overtime for union employees by calculating a three-year average (1998, 1999 and twelve months ending June 30, 2001) of overtime hours and multiplying the result by the average hourly overtime rate during the historic test year. (OCA St.1, Sch. LKM-23). In the final schedule, LKM-23 attached to its Main Brief, the OCA took a different approach and simply calculated an unadjusted four-year average (1998, 1999, twelve months ending June 30, 2001 and calendar 2001) of overtime dollars equaling $2,673,000. Because that amount is less than unionized overtime expense incurred during the historic test year ($2,748,346), the OCA concluded that PSWC’s claim was overstated by $75,346, which, when allocated between capital and operating expense, yielded a proposed disallowance of $38,869. (OCA Sch. LKM‑23 Final).

 PSWC posits that there are several problems with the OCA’s analysis. For one thing, the four-year average unquestionably masks the upward trend in overtime expense as PSWC grows and expands its operations. For another thing, the OCA’s recommended four-year average fails to account for wage rate increases granted between 1998 and June 30, 2002. Finally, PSWC’s claim of $2,748,346 is substantially less than the amount of union overtime expense incurred during the most recent (2001) calendar year, *i.e.*, $3,200,000. PSWC contends that, for all of these reasons, the OCA’s proposed disallowance should be denied. (PSWC Exc., pp. 16-17).

 The OCA rejoins that the ALJ correctly recommended a normalization of union overtime costs. The OCA maintains that PSWC’s overtime claim is overstated and its arguments are unpersuasive. Furthermore, the OCA contends that PSWC’s Schedule 2 attached to its Exceptions should not be considered at all but, if it is, the inherent flaws should be recognized. The OCA concludes by urging this Commission to adopt the proposed adjustment to PSWC’s union overtime claim. (OCA R.Exc., pp. 6‑10).

**iv. Disposition**

On review of this issue, we conclude that the ALJ correctly recommended a normalization of union overtime costs. Normalization has been used historically as an appropriate ratemaking tool, to ensure that the level of expenses recognized for rate­making purposes will be representative of the period rates will be in effect.

Here, there is no question that that future test year level of overtime was significantly higher than for previous years. While the trend in overtime definitely is upward, there is no assurance that the corporate objective of reducing the amount of overtime will not be achieved. Additionally, we agree with the OCA that PSWC’s overtime claim appeared to be overstated, and that its arguments in support of that claim were unpersuasive.

Accordingly, PSWC’s Exception on this issue is denied.

 **2. Liability Insurance**

**a. Positions of the Parties**

 PSWC’s proposed liability insurance expense claim of $3,921,728 (PSWC M.B., Appendix A, p. 42) was a substantial increase over the historic test year expense of $2.9 million. That claim was based on the final 2001/2002 renewal policy received in October 2001, and projected increases for the 2002/2003 policy year. Both the OTS and the OCA recommended that this claim be reduced because the increase was not supported by an invoice or signed contract. The OTS also noted that the renewal falls outside the end of the future test year. The OTS proposed an adjustment of $1,171,154. (OTS M.B., p. 50). The OCA proposed an adjustment of $978,500. (OCA M.B., pp. 54-58).

 The OTS also suggested that the record should remain open until the issuance of the Recommended Decision, so that if PSWC received an invoice or policy it could be admitted into the record and considered in this proceeding. (OTS M.B., p. 50, n. 31). The ALJ opined that that was an excellent suggestion, and should be extended perhaps to the period after the issuance of the Recommended Decision. The ALJ pointed out that the Commission’s regulations recognize and permit the introduction of additional evidence after the record is closed in appropriate circumstances. (*See* 52 Pa. Code §5.431).

 The OCA’s proposed adjustment was summarized as follows:

In rebuttal, PSW tried to buttress the claim by presenting the testimony of Roger C. Fell, its insurance broker. While this step added some information to the record, the long and short is that PSW’s claimed increase to liability insurance is still based purely on estimates and opinions expressed by a witness who was not qualified as an expert by the Presiding Officer. Moreover, those estimates are based on hearsay statements by others not present in the hearing room and not even identified by the witness in most instances.

(OCA R.B., p. 17).

 The OCA’s second procedural contention was that the information relied on by PSWC in compiling its estimates is hearsay and, as it was objected to, cannot form the sole basis for the Commission’s decision. *See* *Re: Duquesne Light Co.*, 57 Pa. PUC 313, 317 (1983).

 On the issue of whether PSWC sustained its burden of proof with respect to the general liability insurance claim, PSWC presented the expert testimony of Mr. Fell, who described his firm as “able to secure insurance for our clients at the lower prices and on better terms than they could secure on their own.” (PSWC St. 8-R, p. 3). He explained that the estimates he provided were developed “following direct discussions with insurers and our observation of the insurance costs of similar operations.” (*Id*., p. 7). He also provided a chart showing actual premiums paid by various businesses. (PSWC St. 8‑R, Sch. 1, Tr. 372).

 Mr. Fell further explained that the cost of property insurance is expected to rise because of, among other factors, the terrorist attacks on September 11, 2001, which resulted in losses now estimated at $60 billion. (PSWC St. 8-R, p. 5).

 No evidence was presented by either the OCA or the OTS to rebut Mr. Fell’s expert testimony that the cost of insurance was expected to increase substantially. The OCA cited a number of cases where it asserted that the Commission rejected claims based on oral estimates. In none of those cases, however, was an expert presented to support the reasonableness of the utility’s claims.

**b. The ALJ’s Recommendation**

 The first issue to be discussed under this heading is the qualification of PSWC’s witness Roger C. Fell as an expert. The OCA contended that he was not qualified as an expert. The ALJ concluded that the witness was properly qualified and that the OCA’s contention was misplaced. The ALJ determined that substantial record evidence attested that Mr. Fell was amply qualified, by virtue of education, knowledge and experience, to testify as an expert in insurance matters. (PSWC St. 8‑R, p. 1; R.D., pp. 27-28). The ALJ further concluded that Mr. Fell was the only insurance expert presented in this case. (R.D., pp. 28-29).

The OCA’s next issue was that the information relied on by Mr. Fell in compiling his estimates was hearsay and, as it was objected to, it cannot form the sole basis for the Commission’s decision.

The ALJ observed that, while this assertion is generally correct, it does not apply here because the information Mr. Fell relied upon (quotes from various insurance companies) is that type of information used by him as a broker. (PSWC R.B., p. 14; R.D., pp. 29-30).

 The next question to be resolved is whether PSWC sustained its burden of proof with respect to the general liability insurance claim. The ALJ concluded that it had. The ALJ noted that the OCA cited a number of cases wherein it was claimed that the Commission rejected claims based on oral estimates. However, in none of those cases was an expert presented to support the reasonableness of the utility’s claims. (R.D., p. 31).

 The ALJ noted that Mr. Fell was not simply passing along quotes and estimates. He knew the people from the various insurance companies from whom he received estimates, and, based on his knowledge and experience, as well as the actual costs shown on his schedule for other clients, was well able to evaluate the reason­ableness of those estimates by applying his expert judgment. (R.D., pp. 31-32). The ALJ further noted that the OCA’s citation to *Pa. P.U.C. v. Philadelphia Suburban Water Co*., 71 Pa. P.U.C. 593 (1989) was misplaced.

 The ALJ concluded that, as PSWC’s claim for liability insurance was supported by the unrebutted testimony of its expert witness, that claim should be approved. The ALJ added that the claim should be adjusted to reflect any actual invoices received by PSWC prior to the issuance of the Commission’s Opinion and Order herein. (R.D., p. 33).

**c. Exceptions and Reply Exceptions**

In its Exceptions, the OTS again raises the issue of the qualifications of Mr. Fell. The OTS contends that the ALJ gave too much weight to the credentials of PSWC’s witness Mr. Fell. The OTS furthermore complains that the ALJ failed to discuss all of the cases it cited in support of its claim that PSWC had not sustained its burden of proof.

 PSWC rejoins that the OTS’s criticism of the ALJ is unwarranted, and should be disregarded. First, the ALJ noted that Mr. Fell’s testimony was unrebutted. Second, the OTS did not cite a single case in support of its proposed adjustment in the Main Brief. Additionally, PSWC notes that the ALJ not only recommended that PSWC’s liability insurance expense claim be approved, but also that it submit for the record any actual invoices that become available to it prior to final Commission action herein. (R.D., pp. 27‑33).

**d. Disposition**

In general, we adopt the ALJ’s recommendation on this issue. As noted by the ALJ, PSWC’s liability insurance expense claim is supported by the unrebutted testimony of PSWC’s expert witness. Further, there is no question that Mr. Fell qualifies as an expert in the insurance field. (R.D., p. 33). The ALJ noted that this claim should be adjusted to reflect any actual invoices received by PSWC prior to the Commission’s decision. (R.D., p. 33). However, she also explained that PSWC should make a request to reopen the record and that the invoices should be “subject to the parties’ ability to review the late-filed exhibit.” (R.D., p. 27).

On July 15, 2002, PSWC filed an affidavit signed by PSWC’s Manager of Regulatory Accounting, along with copies of PSWC’s liability insurance invoices. The affidavit states that PSWC’s liability insurance expense is slightly higher than the amount supported by the testimony of PSWC’s expert witness. To the extent that the affidavit constitutes a request to reopen the record, such request is hereby denied. The affidavit and supporting invoices were not submitted in sufficient time for the other Parties to have a fair opportunity for review and challenge. We note that the invoices are dated July 2, 2002, and that PSWC did not file them until July 15, 2002. As such, the affidavit and the invoices are rejected and will not be admitted into the record.

 Accordingly, the OTS’ Exception on this issue is denied. PSWC’s claim for liability insurance, as supported by the unrebutted testimony of its expert witness, is approved.

 **3. Inflation Adjustment**

**a. Positions of the Parties**

 As part of its filing, PSWC included an adjustment for General Price Level (inflation) increases applicable to various historic test year operating expenses for which specific future test year adjustments were not made. PSWC utilized a projected inflation rate of 2.35% to develop an inflation adjustment of $279,500. (PSWC St. 1, p. 8).

 In response to testimony from the OTS and the OCA, PSWC removed certain expenses as not being properly subject to the inflation adjustment. PSWC also updated the inflation factor, as recommended by the OTS, to 1.7%, based on the March 1, 2002 Blue Chip Forecast for the Gross Domestic Product Chained Price Index (GDP-PI). This reduced the claim to $192,600. (PSWC St. 1-R, p. 5).

 The OTS also recommended that the claim be adjusted by removing approximately $6.6 million of expenses whose costs have not increased during the period June 30, 2000 to June 30, 2001, thereby reducing the claim for inflation expense by $113,266 to $79,334. (OTS M.B., p. 44). The basis for this adjustment is that it removes those expenses that are not subject to inflationary pressures.

 The OCA had alternative recommendations. First, it proposed that the adjustment be adjusted to remove inappropriate expenses.[[5]](#footnote-5) Alternatively, it proposed that the claim should be eliminated entirely “because to apply an inflation factor just to accounts not otherwise adjusted results in an overstatement of the effect of inflation and is not a ‘sufficiently known and certain’ expense.” (OCA M.B., p. 50).

 PSWC asserted that the OTS’ recommendation should be rejected because, while a single year comparison may show that some expenses have declined, the “longer term view” demonstrates that its overall level of expenses has increased at a pace much greater than the level of inflation claimed in this case. PSWC contends that the OTS’ adjustment creates a serious mismatch between the inflation factor and the expense base because, as the OTS acknowledged (Tr. 381), the inflation factor is, by definition, a composite of both increases and decreases. PSWC contended that, by applying the inflation factor only to expenses that have increased, the effect of inflation is understated. (PSWC M.B., pp. 18-19).

 In response to the OCA’s recommendation that general inflation adjust­ments should be rejected as not meeting the standard of “known and measurable,” PSWC retorted that that argument has been rejected by the Commission. Additionally, PSWC noted that the inflation factor is properly applied to expenses that were not separately adjusted. (*Id.*).

1. **The ALJ’s Recommendation**

 The first issue addressed by the ALJ was whether the OCA’s proposal that the inflation adjustment be rejected in its entirety should be adopted. On this issue, the ALJ stated that there is no question but that the OCA’s proposal must be rejected. (R.D., p. 37).

 The ALJ noted that there are numerous cases in which the Commission has accepted this type of adjustment. The ALJ further noted that the Commission’s practice of accepting inflation adjustments was the basis of the Commonwealth Court’s reversal and remand of a proceeding in which the Commission had rejected a utility’s proposed inflation adjustment. *See National Fuel Gas Distribution Corp. v. Pa. PUC*, 677 A.2d 861, 1996 Pa. Commw. LEXIS 210; *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, 88 Pa. PUC 363 (1998) (*NFG Remand*). (R.D., p. 35).

 The ALJ also stated that she had not been able to find any support for the OCA’s assertion that “[h]owever, recent decisions indicate that the Commission has held utilities to a higher standard than in prior years before accepting such an adjustment to test year expense.” (OCA M.B., p. 52). The ALJ noted that a utility’s burden of proof has not changed. Rather, over time there has been an increasing body of Commission decisions discussing each rate case element.

 The next issue was whether the specific adjustments recommended by the OTS and the OCA should be adopted. The OTS suggested that the Commission should remove those items that did not increase during the historic test year, and also should apply the inflation factor to the remaining expense items.

 The ALJ opined that the OTS’ recommendation was inappropriate and should not be adopted in this proceeding. The ALJ pointed to the fact that PSWC’s actual expenses for the year ended June 30, 2001, increased approximately 6.3% over the previous year, ended June 30, 2000. If the same comparison is made excluding those accounts identified as having declined, the increase for the remaining accounts is approximately 9.7%. (PSWC M.B., p. 19). Obviously, concluded the ALJ, the OTS’ methodology understates the effect of inflation.

 The ALJ also noted that the Commission has never accepted the proposed methodology in any proceeding, and, in fact, that methodology may be inconsistent with the Commission’s position that the expenses, to which general inflation adjustments are properly applied, need not be individually examined. (R.D., pp. 37-38).

 Similarly, concluded the ALJ, there is no basis for applying the adjustment suggested by the OCA. As PSWC explained, the inflation adjustment was applied only to those miscellaneous employee expenses not otherwise specifically adjusted. While such expenses as employee picnics, lunches etc. vary with the number of employees participating, the ALJ concluded that it was reasonable to assume that the costs of putting on such events are also subject to inflationary pressure.

 Accordingly, the ALJ concluded that PSWC met its burden of proof on the relevant issues, and that its general inflation adjustment should be adopted. In this regard, PSWC presented a study showing that the expenses to which it applied the adjustment have increased over the past five years at a rate in excess of the claimed inflation factor. (PSWC St. 1-R, Schs. 2A and 2B). Additionally, the Commission has previously accepted this type of historic data. *NFG Remand*, *supra*, 88 Pa. PUC, pp. 367‑68 (1998).

 Additionally, the ALJ concluded that the inflation index used in this proceeding (the GDP-PI) has previously been accepted by the Commission. The Commission has characterized it as “relatively conservative.” Therefore, the ALJ concluded that PSWC’s general inflation adjustment, as modified and revised, should be accepted herein. (R.D., pp. 37-38).

1. **Exceptions and Reply Exceptions**

The OTS objects to the ALJ’s recommendation, noting that PSWC applied an inflation adjustment of $192,600 by multiplying a 1.7% inflation rate by the total expenses not specifically adjusted, including expenses that both increased and decreased during the period. (PSWC Exh. 1-A, p. 23). The OTS accepted PSWC’s proposed inflation rate of 1.7%, but recommends that the rate be multiplied only by the expenses that have been shown to be sensitive to inflation. Also, only expenses that have increased during the test period should be included in the calculation. The OTS concludes that both the evidentiary record and the case law indicate that the ALJ’s recommendation should be rejected. (OTS Exc., pp. 10‑12).

 The OCA also objects to the ALJ’s recommendation, arguing that the ALJ misinterpreted both the facts and the applicable law in rejecting the OCA’s proposed inflation adjustment. The OCA also contends that the Commission has accepted its position on the inflation adjustment in other cases for many of the same reasons expressed herein. Furthermore, the OCA argues that the ALJ gave more weight to PSWC’s evidence on this issue than was appropriate and wrongly interpreted applicable precedent. Accordingly, the Commission should reject the ALJ’s recom­mendation to accept PSWC’s inflation adjustment and instead accept the OCA’s position. (OCA Exc., pp. 16‑19).

 PSWC responds to the Exceptions of the OTS and the OCA on this issue, arguing that the Commission’s acceptance of those Exceptions would be contrary to logic and to Commission precedent. Namely, PSWC argues that the OTS and OCA approach would mismatch the inflation rate and the expense base. (PSWC R.Exc., pp. 6-7).

1. **Disposition**

On review, we conclude that the ALJ correctly determined that PSWC’s general inflation adjustment, as modified and revised, should be accepted herein. We find that adjustment to be reasonable, supported by the applicable record evidence, and consistent with applicable precedent.

 The OTS contends that PSWC’s inflation factor should be applied only to those accounts that showed increases for the year ended June 30, 2001, from the year ended June 30, 2000. However, PSWC has demonstrated to our satisfaction that, over the past five years, its expenses, specifically adjusted for customer additions and exclusive of expenses have increased at a rate in excess of the 1.7% inflation factor accepted by the ALJ. (PSWC R.Exc., pp. 6-7). We conclude that adoption of the OTS-proposed methodology herein would result in an understatement of the effect of inflation.

 The OCA argues that an inflation adjustment is an issue in flux before the Commission. That is not accurate. Since the Commonwealth Court’s decision in *National Fuel Gas Distribution Corporation v. Pa. PUC*, 677 A.2d 861 (Pa. Cmwlth. 1986), we have consistently accepted inflation adjustments where supported by historic data demon­strating that the utility has experienced cost increases that exceed the claimed inflation increases.

 Accordingly, the Exceptions of the OTS and the OCA on this issue are denied.

 **4. Depreciation Expense**

 PSWC’s annual depreciation accrual applicable to plant in service at June 30, 2002, the end of the future test year, is $32,269,254. (PSWC Exh. 6-A, Part II, page II‑8). The OTS and the OCA recommended reducing the depreciation accrual by extending the service lives of various groups of property. In addition, the OCA recommended that in future proceedings, PSWC be required to provide actuarial retirement analyses to “corroborate” the direct-weighted average service life resulting when PSWC uses the life span method for calculating depreciation for accounts for which it has no specific retirement plans.

 Each of these issues is discussed below.

1. **Remote Meters (Account 334.02)**
2. **Positions of the Parties**

 PSWC’s claim for accrued depreciation for Account 334.02 was $4,545,254, based on its use of an Iowa 18-R4 survivor curve (18‑R4 curve). PSWC presented testimony that its selection of the 18-R4 curve for this account was based on a number of factors, including a retirement analysis, discussions with PSWC management, the testing cycle of meters and the estimated lives for meters of other utilities. (PSWC St. 6, p. 12). This was based in part on the expected replacement of these meters at twenty years, based on its mistaken belief that this was required by the Commission’s Regulations at Section 65.8(b) which reads, in pertinent part, as follows:

No public utility furnishing public water service may allow a water meter of 1 inch or less nor a water meter of more than one inch to remain in service for a period longer than twenty years respectively without testing it for accuracy and readjusting it if it is found to be incorrect beyond the limits established in subsection (a).

52 Pa. Code §65.8(b).

 PSWC’s position was that, despite the cost differential, its replacement policy is reasonable and cost-effective. In this regard, PSWC points out that most utilities would replace rather than rebuild when the cost differential is close and that a rebuilt meter would not last as long as a new meter. (Tr., pp. 443-444).

 PSWC contended that its policy is that meters which are tested at twenty years are returned to inventory. If they were automatically retired at twenty years, then the average service life would be much shorter than eighteen years. (Tr., p. 460).

 The OCA noted that PSWC maintains continuing property records (CPR) from which it can identify the date of installations and retirements of most of its assets. (OCA M.B., pp. 37-38). The CPRs are incorporated into a database, which can be used to produce retirement-rate studies (statistical analyses of actual investment exposures and retirement experience) which result in an Original Life Table (OLT). This data can be used to provide an analysis of the experienced average service life and retirement characteristics of the plant account. The plotted OLT is the “original survivor curve.”[[6]](#footnote-6)

 The OTS recommended that an Iowa 21-R4 survivor curve (21‑R4 curve) be used instead of the 18-R4 curve, reducing PSWC’s claim by $1,028,494. The OTS argued that the 21‑R4 curve is a better fit than the 18-R4 curve because “the 21-R4 curve bisects the actual data curve closer to the most recent data points.” (OTS St. 3, pp. 8-9). In addition, the OTS did a mathematical “best fit” analysis by comparing the percent surviving from actual data to the percent surviving under selected Iowa curves for each interval year. (OTS St. 3, pp. 9-10; OTS Exh. 3, Schedule 4).

 In response to criticism of its original recommendation, the OCA, in surrebuttal testimony, adopted the OLT developed by PSWC. The OCA also recommended use of a 21-R4 curve. As a result, all three Parties used PSWC’s OLT and the 1968-1998 experience band for this account. (OCA St. 4S, p. 13; OTS St. 3, p. 8; PSWC St. 6, pp. 11-12; PSWC Exh. 6-A, Part II, p. I-3).

 Both the OCA and the OTS opposed PSWC’s policy of replacing the small meters at twenty years of age, based on two factors. First, they argue, most meters will survive past twenty years. Second, a rebuilt meter costs approximately 83% of the cost of a new meter, a saving of approximately $7.90 per meter.

1. **The ALJ’s Recommendation**

 The ALJ concluded that the evidentiary record demonstrates that PSWC’s meter replacement policy is proper and cost-effective. She pointed in this regard to the fact that a rebuilt meter is less expensive than a purchased meter by $7.90.

 Additionally, the ALJ concluded that the 21-R4 curve should be used to calculate the annual depreciation accrual claim in this proceeding. However, she stated that she reached this conclusion somewhat reluctantly, because she did not feel that the record has established that PSWC’s 20‑year meter replacement is imprudent or not cost-effective.

 However, the ALJ stated that she was ultimately persuaded by the OCA’s argument that excessive depreciation expense raises the revenue requirement, resulting in higher rates. The ALJ reasoned that if depreciation expense is too low (as the result of the adoption of longer service lives), PSWC is not at risk as it ultimately recovers all of its capital investment. (R.D., pp. 39-44).

1. **Exceptions and Reply Exceptions**

The OTS filed an Exception to the ALJ’s recommendation arguing that the ALJ reached the correct conclusion for the wrong reason. The OTS does not object to the ALJ’s ultimate recommendation that the Commission adopt the 21-R4 survivor curve for remote meters. That adoption was recommended by the OTS.

 In determining that the OTS-recommended 21-R4 survivor curve is the best fit, the ALJ stated as follows:

There is no question that [the PSWC proposed 18-R4 curve] was based in part on the expected replacement of these meters at 20 years, based on the company’s mistaken belief that this was required by the Commission at 52 Pa. Code §65.8(b).

(R.D., p. 41). The OTS contends that the ALJ later “inexplicably” states that PSWC’s mistaken belief on this issue does not by itself invalidate PSWC’s recommendation. (R.D., p. 44).

It is the OTS’ position that the ALJ did not accord proper weight to the determination that PSWC misinterpreted the Commission’s regulation. PSWC’s adherence to the 20-year meter replacement policy is not surprising since it provides significant financial benefits to PSWC. The OTS argues that the correct reason for the ALJ’s recommendation is that PSWC’s proposed 18-R4 curve for remote meters is not supported by the best fit analysis. Additionally, PSWC has inappropriately pursued a 20‑year replacement policy. (OTS Exc., pp. 13-15).

PSWC also excepts to the ALJ’s recommendation, pointing out that although that recommendation at first seems quite modest, it actually has a very significant revenue requirement effect, reducing PSWC’s claimed depreciation expense by $1,028,494. PSWC reiterates that its recommended survivor curve is reasonable and should be approved. PSWC outlines several factors leading to the conclusion that it is more cost effective for it to replace, rather than rebuild, meters that fail the Commission-mandated testing. (Tr., pp. 443-44). PSWC contends that the record fully supports its recommended 18 year average service life for remote meters. (PSWC Exc., pp. 8‑12).

In response, the OTS notes that although PSWC maintains that very few meters will survive beyond the 20-year replacement/testing cycle, PSWC’s own graph of survivor percentages indicates that the actual survivors have reached approximately twenty-three years. In other words, the data indicate that, as of June 30, 2002, approximately 50% of the remote meters have survived at least twenty-three years. (PSWC Exh. 6-A, Part II, PP. 108-109). Additionally, the OTS reiterates that PSWC misinterpreted the Commission regulation when it adopted a corporate policy to replace, rather than test, remote meters after twenty years of service. (Tr., pp. 448-49). Therefore, it is argued that the ALJ’s recommendation of a 21-year service life for remote meters should be adopted by the Commission. (OTS R. Exc., pp. 3-7).

1. **Disposition**

On review of this issue, we conclude that the ALJ properly determined that PSWC’s meter replacement policy is proper and cost-effective. Additionally, the ALJ properly determined that the OTS-recommended 21-R4 curve should be used to calculate the annual depreciation accrual claim in this proceeding.

We note that depreciation rates for PSWC’s remote meters account have been calculated using a 24-R2 curve since our approval of the settlement of PSWC’s last base rate case. This account has grown by $11 million dollars, or almost twenty percent, during that period. (OCA St. 4, p. 26).

In the instant proceeding, PSWC proposed to reduce the service life for this account to eighteen years. The ALJ agreed with the OCA and with the OTS that a 21‑year service life should be applied to this account. (R.D., p. 44). Our adoption of the ALJ’s recommendation results in an adjustment that reduces PSWC’s $4.5 million depreciation expense claim for the account by $1,028,494. (R.D., p. 39; OTS St. 3, p. 12).

 We also agree with the ALJ that the 21-R4 curve recommended by the OCA and the OTS is the appropriate life for purposes of calculating depreciation rates for the remote meters account. A 21-year service life is more reasonable than PSWC’s proposed eighteen years, is supported by the recent retirement data, and furthermore protects PSWC’s customers from paying excessive depreciation rates.

 In our determination herein, we note with approval the OCA’s argument that excessive depreciation expense raises the revenue requirement, resulting in higher rates. If depreciation expense is too low (as the result of the adoption of longer service lives), however, PSWC is not at risk as it ultimately recovers all of its capital investment.

Accordingly, PSWC’s Exception on this issue is denied.

1. **Electric Pumping Equipment (Account 311)**
2. **Positions of the Parties**

 The OCA proposed extending the service life of Account 311 (Electric Pumping Equipment) from 35 years to 50 years by use of a 50-S1 survivor curve, rather than the 35-R2.5 survivor curve used by PSWC. The OCA based this recommendation on a “full retirement rate study,” which it conceded in surrebuttal testimony was flawed. (OCA St. 4S, p. 6). Despite this, the OCA continued to support its recommendation, based on the assertion that PSWC’s analysis does not reflect a significant portion of its own OLT data. (OCA St. 4S, p. 9, OCA Redirect Exh. 1, p. 1).

 PSWC opposed this for a number of reasons. First, it notes that the OCA failed to consider the type of investment recorded to this account. As explained by PSWC witness Spanos:

My use of a 35-R2.5 average survivor curve for pumping equipment is based on experience during the period 1983-1998. The plant exposed to retirement decreases significantly beyond age 40. The retirement data for ages subsequent to 40 are not sufficient to use as a basis for developing historical indications or forecasting future service lives. In addition, judgment must be used in interpreting the statistically signifi­cant data. As compared to the significant portion of the historical experience, the 35-R2.5 anticipates increased levels of retirement beyond age 25, inasmuch as more recently installed equipment includes a greater investment in controls such as variable speed equipment. Such equipment enables the Company to maintain consistent pressure levels in the system. This type of equipment has a shorter service life than the pumps and motors that previously constituted the large majority of the investment in this group. Therefore, I anticipate a shorter service life for the group.

The 50-S1 estimate of Mr. Majoros is based on an incorrect life analysis, does not incorporate consideration of the changing nature of this account, and should be rejected.

(PSWC St. 6-R, p. 15). On cross-examination, the OCA conceded that it was doubtful that any investment in electric pumping equipment, over 40 years of age, would represent variable speed equipment. (Tr., p. 466).

 Additionally, PSWC noted that, as a policy matter, this account (as well as the others that are the basis for some OCA-proposed recommendations) is Distribution System Improvement Charge (DSIC) eligible. Any lengthening of the service lives for these accounts will reduce the allowed depreciation in the DSIC calculation, thus reducing DSIC revenues available between rate cases to be used for infrastructure replacements.

 This would frustrate the Commission’s decision to have that revenue available to promote infrastructure rehabilitation, citing the “daunting challenge of rehabilitating their existing distribution infrastructure before the property reaches the end of its service life to avoid serious public health and safety risks.” *Re: Petition of Philadelphia Suburban Water Co. for Approval to Implement a DSIC*, Docket No. P‑00961036 (Order entered August 26, 1996), pp. 7-8 (cited in PSWC M.B. (p. 30).

1. **The ALJ’s Recommendation**

The ALJ stated that she agreed with PSWC that the OCA’s proposal on this account should be rejected. The ALJ noted that the nature of the equipment included in this account has changed from pumps and motors to variable speed controls, which has a shorter service life. Pursuant to *Pa. P.U.C. v. Philadelphia Electric Co.*, 48 Pa. PUC 183, 191 (1974), retirement rates are to be representative of present and future service conditions. (R.D., pp. 44-46).

1. **Exceptions and Reply Exceptions**

The OCA excepts to the ALJ’s recommendation, reiterating that for Account 311, its witness recommended a 50-year service life. The OCA complains that the ALJ’s recommendation does not consider that the OCA developed its recommended service life using a 1983 to 1998 experience band. The OCA contends that PSWC has not supported its argument that the average service life for this account should be shortened by fifteen years. Therefore, the OCA submits that the depreciation rate for this account should be calculated using a 50‑year survivor life, and that the ALJ’s recommendation should be rejected. (OCA Exc., pp. 4-6).

PSWC rejoins that the OCA’s proposed 50 year average service life for electric pumping equipment is not supported by the evidentiary record. (PSWC R.Exc., pp. 8-9).

1. **Disposition**

 On review of this issue, we agree with the ALJ that the OCA’s proposal should be rejected. The nature of the equipment included in this account has changed from pumps and motors to variable speed controls, which evidence a shorter service life. Retirement rates are, ideally, to be representative of present and future service conditions.

 Additionally, the OCA’s proposal was based solely upon its analysis of historical data for Account 311. The error in this approach is that it fails to recognize the changing nature of this account. Specifically, as above noted, more recently installed equipment includes substantial investment in variable speed controls, which have a shorter life than the pumps and motors that traditionally made up the bulk of the investment. (PSWC St. 6-R, p. 15).

 Accordingly, the OCA’s Exception on this issue is denied.

1. **Mains and Accessories (Account 331)**
2. **Positions of the Parties**

 Prior to 1972, PSWC used one average survivor curve to describe the service life for its Mains account. The Commission, however, in *Pa. P.U.C. v. Philadelphia Suburban Water Co.*, 46 Pa. PUC 288, 299 (1972), concluded that this approach was inappropriate. In response, PSWC disaggregated Account 331 into fourteen subaccounts, each with its own average service life. (PSWC M.B., p. 31).

 The OCA proposed to increase the lives of 5 of these subaccounts, by from 5 to 20 years, so as to move these subaccounts to a 110-year average life. The basis for this is a retirement study, which the OCA abandoned in its surrebuttal testimony. Despite this, the OCA continued to adhere to its recommendation. The OCA argued that a 110-year life is reasonable because the OLT data support a much longer life and it is the life that PSWC has proposed for the 12” and over mains. Additionally, it is supported by the simple average of PSWC’s “life defining retirements” of 108 years. (OCA M.B., p. 40).

 PSWC opposed this adjustment, explaining that adoption of the OCA’s proposal is equivalent to the longest service life for any of the Mains subaccounts and would substantially undo the disaggregation directed by the Commission. PSWC noted that similar proposals of the OCA to extend the service lives of mass property accounts have previously been rejected by the Commission.

 PSWC also asserted that, as in the above-cited case, the OCA’s proposal to extend the service lives is based upon insufficient retirement data.

1. **The ALJ’s Recommendation**

The ALJ recommended that the OCA’s proposal for this item be rejected. First, she stated, it would essentially undo the disaggregation of the subaccounts. Second, there simply is no basis for its adoption. In the ALJ’s opinion, the fact that 108 years is an average is meaningless except as a mathematical exercise -- as acknowledged by the OCA on cross-examination:

“Q: So a simple average does not present anything but two points averaged?

A: You are absolutely correct.”

(R.D., pp. 46-48 (quoting Tr. 460-71)).

1. **Exceptions and Reply Exceptions**

The OCA excepts to the ALJ’s recommendation on this issue, reiterating that its witness had recommended a service life of 110 years for each account to mitigate the impact that a much longer service life would have on the overall depreciation rate. (OCA St. 4, p. 24). With regard to disaggregation, the OCA proposes to extend the average service lives of only five out of fourteen subaccounts. (OCA R.B., p. 9). The OCA contends that while a 110-year life may still be too short, it is closer to the service life indicated by the retirement data and thus more supportable than PSWC’s proposed service lives. (OCA Exc., pp. 6-10).

 PSWC rejoins that, in 1972, the Commission directed PSWC to cease using a single survivor curve for all mains. In response, PSWC separated its mains account into fourteen subaccounts, and established separate average service lives. The OCA now seeks to undo that disaggregation by increasing the service lives of five subaccounts to 110 years. (PSWC R.Exc., pp. 9-10).

1. **Disposition**

On review of this issue, we agree with the ALJ that the OCA’s proposal should be rejected. To accept that proposal would undo the policy behind the dis­aggregation of the subaccounts. Additionally, the OCA’s proposal in this regard is founded upon insufficient retirement data, as recognized by the ALJ. (R.D., pp. 47‑48). The main investment exposed to retirement reflects significant data only through approximately ages 75‑90. (PSWC St. 6-R, pp. 16-17).

 In its Exceptions, the OCA presents a table showing the “best fit” survivor curves if all retirement data were used. (OCA Exc., p. 7). We assume this table was developed in an effort to bolster the OCA’s contention that its proposals are “reasonable.” In fact, what this table demonstrates is that it is unreasonable to base depreciation lives upon data that is not significant in the life-defining ages.

Accordingly, the OCA’s Exception on this issue is denied.

1. **Services (Account 313)**
2. **Positions of the Parties**

 The OCA proposed to add twenty years (from 65 to 85) to the average service life for this account. PSWC used sixty-five years, based on its judgement, because the statistical analysis of the account was “inconclusive.” The OCA’s proposal is based on a “best fit” Iowa curve of 94‑L2 resulting from the adoption in surrebuttal testimony of PSWC’s OLT, which it asserts would support a longer average service life than eighty-five years.

 PSWC opposed this, noting that the OCA’s analysis relies upon retirement data for exposures older than seventy-eight years, even though the available exposures are less than $10,000, and that other Pennsylvania water utilities use service life estimates of 60 to 63 years.

1. **The ALJ’s Recommendation**

 The ALJ stated that the OCA’s proposal on this item should be rejected. First, she asserted that insignificant data should not be the basis for such a substantial increase in the service life. The OCA’s inclusion of thirty years worth of exposures under $10,000 to derive its recommendation for this account, with more than $113 million in investment, is not consistent with Commission precedent. Also, the reasonableness of the 65-year average service life used by PSWC is demonstrated by other water utilities’ practice. (R.D., pp. 48-49).

1. **Exceptions and Reply Exceptions**

The OCA excepts to the ALJ’s recommendation on this issue, reiterating that, for Account 313, the service life be moved closer to the statistical indication of 94 years, to 85 years, based on a “best fit” analysis of PSWC’s OLT data for this account. (OCA St. 4S, p. 12; OCA Exh. MJM-7S). PSWC had argued that a 65-year life was appropriate. The OCA also reiterates that its recommendation for Account 313 reflects PSWC’s most recent retirement experience as well as its actual retirement data since 1983. Accordingly, the OCA contends that the Commission should reject the ALJ’s recommendation on this issue on the basis that PSWC failed to consider all available retirement data. (OCA Exc., pp. 10-13).

 PSWC rejoins that the flaw in this argument is that it reflects the OCA’s continued rejection of expert analysis in favor of raw statistics. For example, the OCA includes thirty years worth of exposures amounting to less than $10,000 to derive its recommendation for PSWC’s $113 million investment in services. Accordingly, PSWC contends that the OCA’s Exception on this issue should be denied. (PSWC R.Exc., pp. 10-11).

1. **Disposition**

 Again, we agree with the ALJ’s analysis and recommendation on this issue. We conclude that insignificant data should not be the basis for such a substantial increase in the service life. The OCA’s inclusion of thirty years worth of exposures under $10,000 to derive its recommendation for this account with more than $113 million in investment, is not consistent with Commission precedent. (R.D., pp. 48-49).

 Accordingly, the OCA’s Exception on this issue is denied.

1. **Fire Hydrants (Account 335)**
2. **Positions of the Parties**

 PSWC used an average service life of seventy years for this account. It based this on a “good fit of the correct original survivor curve through ages 40-45 years, the most significant portion of the data.” (PSWC St. 6-R, p. 18).

 The OCA originally recommended a 92-year service life, based on its flawed retirement analysis. Using PSWC’s OLT, the OCA recommended use of a 85‑S1.5 survivor curve, using its best fit analysis. (OCA St. 4S, p. 13). The OCA noted that PSWC excluded almost all of what it considers to be “life defining data,” those retirements that cause the original survivor curve to decrease from between 80 and 20 percent.

 As explained by PSWC, “[t]he OCA proposes a 21% extension to the service life for Fire Hydrants, from 70 to 85 years. The OCA offers this proposal even though the only exposure data available beyond the approximately 50% survival age of eighty-five years are annual exposures ranging from $285 to $17,500. Such data are not significant and were given no weight by Mr. Spanos in exercising his expert judgement.” (PSWC R.B., p. 22). PSWC stated that the OCA agreed that “20 years’ worth of exposures under $10,000 were used to derive the statistical ‘best fit’ for the $26.8 mil­lion investment in hydrants.” (PSWC M.B., p. 33) (Tr., pp. 471-472).

1. **The ALJ’s Recommendation**

 The ALJ recommended that the OCA’s proposal on this item should be rejected. First, the ALJ noted that the Commission, in a number of cases, has rejected similar OCA proposals that rest upon insignificant data, even when supported by a retirement rate analysis. The Commission has previously recognized that there is a weight to be placed on the exercise of professional judgement, and it has never stated that the calculation of the appropriate survivor curves is a purely mechanical exercise based simply on a statistical analysis of unadjusted data.

 The ALJ observed that adoption of the OCA’s recommended 85‑year service life necessarily implies that some hydrants will remain in service for 160 years. This is patently unreasonable, and is not cured by the OCA’s statement that “[M]ass property depreciation is based on dollars rather than units. Also the proportion associated with the maximum life is a very small proportion.” (OCA St. 4S, p. 14, cited in OCA M.B., p. 46). (R.D., pp. 49-50).

1. **Exceptions and Reply Exceptions**

The OCA excepts to the ALJ’s recommendation on this issue. For Account 335, the OCA recommended an 85-year life, which is the life indicated by the retirement data. (OCA St. 4S, p. 13; OCA Exh. MJM-9S). PSWC opposed this proposal, and argued that a 70-year average service life is a good fit to the most significant portion of the retirement data. (PSWC St. 6-R, p. 18). The OCA reiterates that its recommenda­tion for Account 335 reflects PSWC’s most recent retirement experience as well as its actual retirement data since 1983. Accordingly, the OCA contends that the Commission should reject the ALJ’s recommendation on this issue. (OCA Exc., pp. 10‑13).

The OCA argues that PSWC failed to consider all available retirement data. PSWC rejoins that the flaw in this argument is that it reflects the OCA’s continued rejection of expert analysis in favor of raw statistics. For example, the OCA gives consideration to as little as $285 in annual exposures to develop its proposed 15‑year extension to the service life for hydrants. (PSWC R. Exc., pp. 10‑11).

1. **Disposition**

 We agree with the ALJ that the OCA’s proposal on this issue should be rejected. (R.D., p. 50). We have previously, in a number of cases, rejected similar OCA proposals which are based on insignificant data, even when supported by a retirement rate analysis. We have never viewed the calculation of the appropriate survivor curves as a purely mechanical exercise, based simply on a statistical analysis of unadjusted data. In this case, PSWC properly exercised its expert judgment in rejecting insignificant data.

 Additionally, we note that to accept the OCA’s proposed 85-year average service life for hydrants would mean that some investment in hydrants was expected to remain in service for 160 years. That prospect is not realistic.

 Accordingly, the OCA’s Exception on this issue is denied.

1. **Retirement Rate Analysis Requirement**
2. **Positions of the Parties**

 The OCA recommended that, in future proceedings PSWC should be required to provide actuarial retirement rate analyses to corroborate the direct-weighted average service life resulting from PSWC’s life span calculations. The retirement rate analyses should incorporate all past interim and final retirements and should be required to support PSWC’s estimated retirement dates. (OCA M. B., p. 33).

 In rebuttal, PSWC demonstrated four errors in the OCA’s calculations, thereby rendering useless the OCA’s analysis. In surrebuttal, the OCA conceded its errors and withdrew its adjustments. In its Main Brief, the OCA suggested that its failed analysis forced PSWC to undertake a proper statistical analysis. The OCA further asserted that, in future proceedings, PSWC should be required to submit further “analytical support” for its probable retirement year estimates for life span property.

 PSWC opposed this, stating that the “analytical analysis” requested by the OCA seeks to remove expert judgment from the determination of depreciation, and replace judgment with mathematical exercises.

1. **The ALJ’s Recommendation**

 The ALJ concluded that this OCA proposal should be rejected. The ALJ reasoned that the result of the Commission’s adopting this proposal would be to subject PSWC to more rigorous filing requirements than any other utility. The ALJ also stated that, if the OCA wishes the Commission to consider changing its filing requirements, then it should file a petition requesting that the Commission consider this issue on a generic basis. It is for the utility to determine what, if anything, it feels appropriate to file in excess of the Commission’s requirements. (R.D., pp. 50‑51).

1. **Exceptions and Reply Exceptions**

 The OCA excepts to the ALJ’s recommendation on this issue, contending that PSWC had the burden of making a convincing showing that its depreciation rates are not excessive. The OCA argues that in this case PSWC did not make any such showing in its case-in-chief.

 Additionally, the OCA points to the ALJ’s assertion that the OCA’s proposal would result in PSWC “[being] subject to more rigorous filing requirements than any other utility.” (R.D., p. 51). The OCA rejoins that all utilities using the life span method for accounts for which there are no specific retirement plans, have an obligation to show that their depreciation rates are not excessive. Accordingly, the OCA submits that the Commission should direct PSWC to prepare analytical analyses to support its chosen life spans in the circumstances above described. (OCA Exc., pp. 13‑15).

 PSWC responds to this issue, in particular noting the ALJ’s observation that this OCA proposal, if adopted, would subject PSWC to different filing requirements than are imposed on any other utility. (R.D., p. 51). (PSWC R.Exc., p. 11).

1. **Disposition**

 We agree with the ALJ that the OCA’s proposal should be rejected. As noted by the ALJ, if the OCA desires that the Commission consider changing its filing requirements, then it should file a petition requesting that we consider that issue on a generic basis.

 Additionally, as noted by the ALJ, if we were to adopt the OCA proposal on this issue, the result would be to subject PSWC to different filing requirements than are imposed on any other utility. (R.D., p. 51). This is yet another situation where the OCA seeks to replace expert judgment with mathematical exercises. In the recent *Pa. PUC v. Pennsylvania-American Water* Co, Docket No. R‑00016339 (Order entered January 25, 2002) (*PAWC 2002*), the OCA sought to ban the use of the life span method unless the utility presented a definitive plan for retirement. We therein rejected that effort.

 Accordingly, the OCA’s Exception on this issue is denied.

 **5. Wind Energy Project**

**a. Positions of the Parties**

 PSWC included as an expense item, $68,000 representing its investment in the Pennsylvania Wind Energy Project, a 1.5 MW wind turbine. PSWC claimed that its sponsorship of this project was “part of its ongoing research and development efforts to provide quality water service at the lowest cost and least impact upon the environment.” PSWC furthermore claimed that its customers immediately benefitted from this project through pollution reductions and resource savings. (PSWC St. 2‑R, p. 18).

 The OTS opposed this claim as being in the nature of a forced contribution by ratepayers. (OTS M. B., pp. 45-47; OTS St. 4, p. 22). The OTS cited *Pa. P.U.C. v. National Fuel Gas Distribution Corp.*, 88 Pa. PUC 363, 366 (1998), where the Commission disallowed a claim for advertising expenses associated with a conservation program, stating that the “advertising lacked a proper nexus to directly benefiting the ratepayer.”

1. **The ALJ’s Recommendation**

 The ALJ recommended that this claim should be disallowed. The ALJ reasoned that, while the project could serve to improve the environment and also could serve as an alternative energy source, she discerned no direct benefit to PSWC’s ratepayers. (R.D., p. 52).

1. **Exceptions and Reply Exceptions**

PSWC objects to the ALJ’s recommendation on this issue, and submits that the ALJ applied an incorrect standard in analyzing the rate treatment of this item. Recently, the Commission considered the criteria to be used in assessing research and development projects. In *PAWC 2002*, cited *supra*, the Commission rejected an OCA proposal to disallow costs for research and development projects on the basis that the projects did not provide current benefits to customers. In that case, the Commission stated as follows:

We note that the types of studies here at issue could only serve to benefit customers in the future....Furthermore, we are persuaded that this expense item has important and significant public health and safety implications.

(*PAWC 2002*, 2002 Pa. PUC LEXIS 1, \*56).

 PSWC argues that its participation in the Pennsylvania Wind Energy Project satisfies the foregoing standards. PSWC’s position is that investment in the development of wind energy has important public health benefits, including reductions in carbon dioxide, sulfur dioxide, and nitrogen oxide emissions. (PSWC St. 2-R, pp. 18‑19). Those emission reductions will improve the quality of both air and surface water supplies. According to PSWC, wind energy is proven viable, it has the potential for reducing PSWC’s future energy costs. Improving the environment and developing alternative energy supplies are appropriate research and development objects. Accordingly, PSWC states that its claim for this item should be accepted. (PSWC Exc., pp. 17-18).

In response, the OTS posits that the Commission’s decision in *PAWC 2002* is not dispositive of the instant issue. In allowing the expenses there at issue, the Commission stated that the relevant studies would provide a direct benefit to customers, albeit in the future, and that combining resources at the Service Company level could serve to address the most pressing concerns in a more efficient manner. In contrast, the OTS states that in the instant proceeding the ALJ properly found that although the expenditure of funds might have an indirect benefit to the environment and perhaps assist in the development of alternative energy sources, the expenditures did not provide a direct benefit to ratepayers. The OTS concludes that in this proceeding, PSWC has in a similar fashion failed to demonstrate a nexus between the proposed expense and a direct benefit to ratepayers. (OTS R. Exc., pp. 10‑12).

1. **Disposition**

On this issue, we agree with PSWC that its claimed expense of $68,000 in future test year expenses attributable to its investment in the Pennsylvania Wind Energy Project should be allowed.

The ALJ recommended the disallowance of that expense, reasoning that “there is no direct benefit to PSWC’s ratepayers”. (R.D., p. 52). We would note, however, that while wind energy is still in its infancy, its potential benefits are tremendous. As correctly noted by PSWC in its Initial Brief and Exceptions, wind energy has important public health benefits. “The wind turbine [sponsored by PSWC] will reduce carbon dioxide emissions by 4.7 million pounds, sulfur dioxide emissions by 36,000 pounds, and nitrogen oxide emissions by 11,000 pounds. Moreover, the project will reduce coal usage by 1.3 million pounds (PSWC St. 2-R, pp. 18‑19).” (PSWC M.B., p. 22; *see also* PSWC Exc., p. 18).

 We conclude that these reductions clearly improve the quality of the ratepayers’ air and water. Furthermore, wind is a reliable source of renewable energy and, one day, may be one of the cheaper sources of energy. Because PSWC’s investment in the Pennsylvania Wind Energy Project is reasonable and prudent in this instance and directly benefits ratepayers through a cleaner environment, PSWC’s Exception on this issue is granted.

**6. NARUC Conversion**

1. **Positions of the Parties**

 Prior to January 1, 2000, PSWC maintained its accounting system in conformity with the Commission’s 1948 Chart of Accounts as required by the Commission. Effective February 14, 1998, the Commission revised 52 Pa. Code §65.15 and directed water utilities to convert to the most recent uniform system of accounts prescribed by the National Association of Regulatory Utility Commissioners (NARUC). The conversion was to be completed no later than January 1, 2000.

 On January 1, 2000, PSWC completed the required conversion. As of November 2000, the total cost of the conversion project was known and determined to be $178,958. (PSWC St. 3-R, pp. 3-4). PSWC claimed a five-year amortization of this cost, resulting in an annual expense allowance of $35,800. (PSWC St. 3, p. 3).

 The OCA opposed this claim as being incurred prior to the test year and because PSWC was not granted approval to defer these costs.

1. **The ALJ’s Recommendation**

 The ALJ noted that amortization has long been accepted as the appropriate ratemaking treatment for unusual and non-recurring expenses. *Pa. P.U.C. v. Western Utilities, Inc.*, 88 Pa. PUC 124, 144-45 (1998). Deferred approval is not necessary. The ALJ furthermore noted that this is the first opportunity PSWC has had to request permission to recover these costs, and, therefore, amortization of the instant expense would be appropriate. *See* *Columbia Gas of Pa., Inc. v. Pa. P.U.C.*, 613 A.2d 74, 80 (Pa. Cmwlth. 1992); *Popowsky v. Pa. P.U.C.*, 695 A.2d 448, 452 (Pa. Cmwlth. 1997).

 The ALJ recommended that the OCA’s proposal on this issue be rejected. She posited that the NARUC conversion cost represents an unusual and non-recurring expense that is appropriately amortized. (R.D., p. 53).

1. **Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

1. **Disposition**

Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with the record evidence, it is adopted.

As noted by the ALJ, amortization has long been accepted as the appropriate ratemaking treatment for unusual and non-recurring expenses. Deferred approval is not necessary.

**7. Uncollectible Expense**

**a. Positions of the Parties**

 PSWC originally claimed $1,293,666 in uncollectible accounts expense for the future test year ending June 30, 2002. PSWC developed that claim by multiplying the total present rate revenues of $204,171,080 by a write-off ratio of .58464. (PSWC Exh. 1‑A, p. 36).

 The OTS’ witness Keim testified that the write-off ratio was overstated and that PSWC should have multiplied the proper ratio (.49700, based on four years of historic data) by the future test year total present rate sales to general customers. (OTS St. 4, p. 29).

 In rebuttal, PSWC agreed to use a three-year average of uncollectible accounts expense ratio in determining an appropriate write-off ratio. (PSWC St. 1‑R, p. 23). This reduced PSWC’s claim to $1,104,510, based on a write‑off ratio of .0052961. (PSWC Exh. 1-A(a), p. 36 (revised)). The OTS accepted this adjustment. (OTS St. 4-SR, pp. 8-9).

 The OCA also agreed to the use of a three-year average for calculating uncollectible accounts expense. However, the OCA recommended that the reserve accrual should be included in the normalization in order to ensure consistency in accounting.

 PSWC asserted that the write-off ratio should not be applied to the reserve accrual. (*See* PSWC St. 1-R, pp. 22-23).

**b. The ALJ’s Recommendation**

 The ALJ recommended that the OCA’s proposal to adjust the reserve accrual should be rejected. (R.D., p. 54).

**c. Exceptions and Reply Exceptions**

No Party filed Exceptions to the ALJ’s recommendation on this issue.

 **d. Disposition**

Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted.

VII. TAXES

**A.** **Consolidated Tax Savings**

 **1. Positions of the Parties**

 PSWC’s Federal Income Tax Expense claim in this proceeding is based upon that of a separate entity standing alone. PSWC makes this claim despite the fact that it participates in the Federal Income Tax return of its corporate parent, PSC. PSWC recognized that the Commission has consistently made adjustments to Federal Income Tax claims based upon a computed Consolidated Tax Savings. This is referred to as the “Actual Taxes Paid” doctrine.

 The OTS and the OCA propose downward adjustments to PSWC’s Federal Income Tax claim based upon a Consolidated Tax Saving. The OTS defined Consoli­dated Tax Savings as the difference between the income taxes calculated by a corporation on a stand-alone basis in a rate proceeding, and the tax obligation actually incurred in filing as part of a consolidated group with its corporate parent and its other subsidiaries. (OTS St. 4, pp. 33-34).

 The OTS proposed an adjustment that resulted from the use of a three-year average consisting of company-provided income tax data for the tax years ending December 31, 1998, 1999 and 2000. The OTS’ calculation resulted in a proposed downward adjustment of $525,430 to PSWC’s claimed Federal Income Tax Expense.

 The OCA used a similar methodology to derive its recommended Consolidated Tax Savings Adjustment. It calculated the difference between the aggregate taxes which the members of the PSC would have paid on a separate return compared to the taxes paid on a consolidated basis. Next, the OCA determined PSWC’s share of the savings based on its taxable income compared to the taxable income of all members of PSC with positive taxable income, based upon a three-year average. Initially, this calculation resulted in a decrease to federal taxes of $525,430.

 The OCA, subsequently accepted PSWC’s adjustment to remove high interest expense, merger costs and expenses that were erroneously booked. The OCA did not incorporate the unrecognized gain on marketable securities that PSWC included, on the ground that it was speculative. The OCA’s final revised adjustment would reduce federal taxes by $120,573.

 **2. The ALJ’s Recommendation**

 The ALJ recommended that a Consolidated Tax Savings Adjustment be made in the instant proceeding. (R.D., p. 56). The ALJ cited *Barasch v. Pa. P.U.C.,* 493 A.2d 653, 656 (Pa. 1985) (*Barasch I*), and also cited *Barasch v. Pa. P.U.C.,* 548 A.2d 1310 (Pa. Cmwlth. 1988) (*Barasch II*) in support of a Consolidated Tax Savings Adjustment. (*Id.*).

 The ALJ noted that both the OTS and OCA proposed Consolidated Tax Savings Adjustments based upon the use of the Modified Effective Tax Rate Method. The ALJ commented that under the Modified Effective Tax Rate Method, which was approved in *Barasch II, supra,* the consolidated tax savings generated by the non-regulated companies of a corporate group are allocated to the regulated, and non-regulated members of the group having positive taxable incomes.

 The ALJ recommended rejection of the adjustment for declining interest rates in light of the testimony of PSWC’s Rate of Return witness that interest rates are expected to rise in the latter half of 2002 and the first quarter of 2003. (R.D., p. 58). The ALJ agreed with PSWC that merger expenses of $515,948 should be removed from the calculation as being non-recurring. The ALJ reasoned as follows:

I agree with the company that these adjustments should be made, as the merger has been completed. Future mergers or acquisitions are too speculative to support the conclusion asserted by OTS that “merger expenses will continue to be part of PSW’s financial future.” OTS Reply Brief, pp. 35-36. Nor is there any evidence to rebut PSW’s assertion that the officers’ salaries will not be paid in the future.

(*Id.*).

Finally, the ALJ recommended rejection of PSWC’s adjustment concerning an unrecognized gain on the projected sale of marketable securities. The ALJ adopted the position of the OTS and the OCA that the proposed adjustment was clearly speculative.

 Based upon the foregoing discussion, the ALJ recommended the adoption of a downward adjustment to Federal Income Tax expense of $294,448. (R.D., p. 59).

 **3. Exceptions and Reply Exceptions**

 In its Exceptions, PSWC maintains its disagreement with the principle underlying the Consolidated Tax Savings Adjustment, but concedes that Pennsylvania Appellate Court decisions have circumscribed the Commission’s discretion in this area to a considerable extent.

 PSWC argues further that even if the Commission were to reject its interest expense normalization, the Consolidated Tax Savings Adjustment is substantially over­stated and in the alternative, should be reduced from $294,448 to $180,547. This is to eliminate merger costs of $966,306 incurred by Consumers Water Company in the merger with PSWC. (PSWC Exc., p. 15).

 In response, the OTS first asserts that the ALJ was correct in rejecting the interest expense adjustment since PSWC’s witness, was predicting higher interest rates while another witness, Mr. Jerdon, was predicting lower interest rates for the same 2002‑2003 period. The OTS argues that although PSWC claims that its witness was referring to a more modest upward movement in utility bonds alone, this narrow view is not apparent from the testimony.

 The OTS posits that, if the ALJ properly eliminated all costs associated with the adjustments that were apparently approved in her Recommended Decision, it appears that PSWC is correct that the appropriate Consolidated Tax Savings Adjustment should be $180,547. The OTS points out that this number results from the three year average of the PSWC normalized tax loss without Interest Normalization of $648,050 (*See* PSWC Exceptions, Sch. 1) x the 79.6% ratio of Pennsylvania taxable income of all companies x the 35% tax rate. (OTS R.Exc., p. 10).

#  **4. Disposition**

 The Parties to this proceeding are in agreement that the Federal Income Tax Expense allowance for PSWC in this proceeding should be based upon the Actual Taxes Paid doctrine. Accordingly, we will adopt the ALJ’s recommendation to make a Consolidated Tax Savings Adjustment based upon the Pennsylvania Supreme Court’s finding in *Barasch I* without further comment. The remaining controversy on this issue is the amount of the Consolidated Tax Adjustment to be made.

 For computation of the adjustment, we will use the Modified Effective Tax Rate Method described, *supra.* With regard to the various components of the tax calcu­lation, we adopt the ALJ’s recommendation to reject PSWC’s proposed interest rate adjustments and its adjustment to include an unrecognized gain on marketable securities planned to be sold.

 We adopt the ALJ’s recommendation to reject the interest rate reduction because we find that PSWC did not provide persuasive evidence in support of this adjustment. We are convinced by the argument advanced in the OTS’ Reply Exceptions that PSWC’s presentation was internally inconsistent. Specifically, as discussed previously herein, two PSWC witnesses provided contradictory interest rate projections. Moreover, we note that the rate of return witnesses of PSWC and the OTS project rising interest rates for the 2002-2003 period.

 We agree with the ALJ’s recommendation to reject PSWC’s adjustment to include the unrecognized gain on marketable securities. The proposed adjustment is speculative and cannot be considered for ratemaking purposes. We observe that PSWC did not except to the ALJ’s recommendation on this specific issue. Accordingly, we adopt the ALJ’s recommendation without further comment.

 The OTS is in agreement with PSWC that if the ALJ properly eliminated all costs associated with the adjustments that were apparently approved in her Recommended Decision, the appropriate Consolidated Tax Savings Adjustment should be $180,547. We find the OTS’ Reply Exceptions to be well-articulated on this point. Accordingly, we shall grant the Exceptions of PSWC to limit the Consolidated Tax Savings Adjustment to $180,547. The Exception of PSWC on this issue is otherwise denied.

**VIII. RATE OF RETURN**

 Commonwealth case law clearly states that a public utility is entitled to an opportunity to earn a fair rate of return on the value of its property which is dedicated to public service. *Pennsylvania Gas & Water Company v.* *Pennsylvania Public Utility Commission*, 341 A.2d 239 (Pa. Cmwlth. 1975). This is consistent with longstanding decisions by the United States Supreme Court, including *Bluefield Water Works and Improvement Company v. Public Service* *Commission of West Virginia*, 262 U.S. 679, 690-93 (1923), and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

 A utility’s rate of return has been defined as follows:

[t]he *rate of return* is the amount of money a utility earns, over and above operating expenses, depreciation expense and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the ‘return’ is interest on long-term debt, dividends on preferred stock, and earnings on common stock equity. In other words, the return is that money earned from operations which is available for distribution among the capital. In the case of common stockholders, part of their share may be retained as surplus. The rate-of-return concept merely converts the dollars earned on the rate base into a percentage figure, thus making the item more easily comparable with that in other companies or industries.

(P. Garfield and W. Lovejoy, *Public Utility Economics*, (1964), p. 116).

 In determining what is a fair rate of return, we have traditionally considered the utility’s capital structure in conjunction with its costs of debt, preferred stock, and common equity, as will be discussed below.

#### A. Capital Structure

The following is a summary of the Parties’ positions regarding PSWC’s capital structure:

|  |  |  |  |
| --- | --- | --- | --- |
| Capital Structure | PSWC(1) | OTS(2) | OCA(3) |
|  | % | % | % |
| Long-term Debt | 52.26 | 52.26 | 46.3 |
| Short-term Debt |  |  | 9.00 |
| Common Equity | 47.74 | 47.74 | 44.7 |
| Total Capital | 100.00 | 100.00 | 100.0 |

(1) PSWC Main Brief, p. 42

(2) OTS Main Brief, p. 34

(3) OCA Main Brief, p. 77

 **1. Positions of the Parties**

PSWC’s position is based on the use of a capital structure at the end of the future test year, June 30, 2002. PSWC chose the capitalization ratios tabulated above because these ratios are indicative of those that PSWC will maintain to finance its claimed rate base during the period that new rates will be in effect. The OTS accepts the capital structure proposed by PSWC because, according to OTS, it protects the interests of all Parties to the instant proceeding and is, therefore, acceptable for ratemaking purposes.

 The OCA alleges that PSWC’s proposed capital structure does not accurately represent the source of its capital. Specifically, the OCA maintains that the evidence of the instant proceeding shows a consistent and ongoing pattern of short-term debt usage by PSWC to finance projects other than construction work in progress (CWIP), so that short-term debt must comprise a portion of PSWC’s capital structure. (R.D., p. 63).

 **2. The ALJ’s Recommendation**

 The ALJ, noting that the Commission in numerous prior cases rejected the exact same arguments raised by the OCA, recommended the adoption of PSWC’s proposed capital structure anticipated at the end of the future test year. Specifically, the ALJ indicated that, although PSWC utilizes short-term debt on an on-going basis, it has used, and will continue to use, short-term debt to support construction activities (CWIP as well as plant placed in service between rate cases), the acquisition of other water and wastewater systems, and other short-term borrowing needs (*e.g.*, tax and interest payments). (R.D., p. 66).

 **3. Exceptions and Reply Exceptions**

 In its Exceptions the OCA states that it is well settled that if short-term debt primarily finances CWIP and non-CWIP short-term debt is insignificant, such short-term debt should not be included in rate base. *Pa. P.U.C. v. Philadelphia Suburban Water Co.,* 67 Pa. PUC 752, 96 PUR4th 158 (1988) *(PSWC 1988).* The OCA maintains, however, that it has demonstrated that an average of fifty percent and as much as 87.7 percent of all PSWC short-term debt funds are non-CWIP, and that short-term debt is a significant amount of PSW’s non-CWIP funds. Moreover, the OCA argues that PSWC consistently carries short-term debt, without replacing it with permanent financing, evidencing that short-term debt contributes to financing PSWC’s rate base. Therefore, the OCA concludes that under *PSWC 1988*, *supra,* the Commission should include short-term debt in PSWC’s capital structure. (OCA Exc., pp. 21-22).

 The OCA maintains that the ALJ erred in characterizing its short-term debt amount as far exceeding PSWC’s credit lines. The OCA indicates that between December 1999 and February 2002, records show that that PSWC’s short-term debt approximated the $79 million of short-term debt that PSWC disputes. The OCA further maintains that the ALJ erred by disregarding the fact that PSWC has relied upon rating services, such as Standard and Poor’s, including a short-term debt component to achieve its credit rating, while excluding that same short-term debt component for ratemaking purposes. Since PSWC’s credit ratings reflect the inclusion of short-term debt in its capital structure, the OCA argues that it is erroneous to exclude the short-term debt component for ratemaking purposes. (OCA Exc., pp. 23-24).

 PSWC argues that, contrary to the OCA’s Exceptions, its ongoing short-term debt balance does not finance today’s rate base nor support CWIP. PSWC maintains that it utilizes short-term debt to support plant placed in service between rate cases (plant that is no longer in CWIP but has yet to be included in rates), to finance the acquisition of other water and wastewater systems and to meet other short-term borrowing needs. Alternatively, PSWC maintains that, consistent with past practice, it will employ a combination of long-term debt and common equity to finance its proposed rate base. PSWC, therefore, concludes that we should deny the OCA’s Exception that its short-term debt be included in its capital structure. (PSWC. R.Exc., pp. 12-13).

 **4. Disposition**

We are persuaded that PSWC has properly shown that it uses its non-CWIP short-term debt for a number of purposes other than to finance its rate base, such as the support of plant placed in service between rate cases, to finance the acquisition of other water and wastewater systems and to meet other short-term borrowing needs. The record shows that PSWC has had anywhere from $20 to $40 million of short-term debt outstanding related to acquisition activity alone. We, therefore, adopt the position of the ALJ set forth above and deny the Exceptions of the OCA regarding capital structure.

#### B. Cost of Debt

 **1. Positions of the Parties**

 Regarding its cost of debt, PSWC’s claimed cost of debt for this proceeding is 7.01 percent. (PSWC Exh. No. 4-A, updated p. 14). No Party contested this cost rate. (OTS M.B., p. 17; OCA M.B., p. 83).

 **2. The ALJ’s Recommendation**

 The ALJ recommended adoption of a cost rate for long-term debt of 7.01%. (R.D., p. 67).

 **3. Exceptions and Reply Exceptions**

 No parties filed Exceptions on this issue.

 **4. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted.

#### C. Cost of Common Equity

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Methodology |  | PSWC(1)% |  | OTS(2)% |  | OCA(3)% |
| Discounted Cash Flow Range (DCF) |  | 10.29-13.16 |  | 9.92-10.37 |  | 8.9 |
|  |  |  |  |  |  |  |
| Risk Premium Model (RPM) |  | 12.50-13.00 |  |  |  | 8.84 |
|  |  |  |  |  |  |  |
| Capital Asset Pricing Model (CAPM) |  | 11.64-12.06 |  |  |  |  |
|  |  |  |  |  |  |  |
| Comparable Earnings Method (CEM) |  | 13.55 |  |  |  |  |
|  |  |  |  |  |  |  |
| Recommendation |  | 11.75 |  | 9.90 |  | 9.00 |
| (1) PSWC St. No. 4, p. 49(2) OTS St. 1-SR, p. 8  (3) OCA St. 2, p. 26 |  |  |  |  |  |  |

####  1. Positions of the Parties

 PSWC, after applying four of the above cited and widely recognized market-based models to market data for its barometer group of water utilities, arrived at an 11.75 percent cost of common equity recommendation. Because all of PSWC’s common stock is owned by its parent PSC and, therefore, is not publicly traded, it analyzed data for PSC as well as a barometer group consisting of four water utilities with actively traded common stock. These water utilities appear in the *Water Utility Industry Category* of the *Value Line Investment Survey*. (PSWC Exhibit No. 4-A, Schedule 3, Page 5). PSWC also employed a barometer group of eleven natural gas local distribution companies. PSWC argued that it is essential that a variety of techniques are employed to measure its cost of equity because of the limitations/infirmities that are inherent in each method.

According to PSWC, informed judgment must be used to take into con­sideration the relative risk traits of the firm. It is for this reason that PSWC uses more than one method to measure its cost of equity. (PSWC Statement No. 4, p. 24). It should be noted that PSWC’s DCF computed range of common equity cost rates (9.82-12.15 percent) has been increased to 10.29-13.16 percent, which is tabulated above, in order to adjust for the financial risk associated with the book value of the capitalization. (PSWC Statement 4, pp. 35-36).

 Specifically, PSWC calculated a recent six-month average dividend yield of 2.48 percent for PSC, 3.46 percent for the Water Company Group, and 4.72 percent for the LDC Group which it basically increased to reflect the prospective nature of dividend payments to include higher expected dividends for the future. The adjusted dividend yields that are calculated in Appendix E of Statement No. 4 are 2.58 percent for PSC, 3.57 percent for the Water Group, and 4.90 percent for the LDC Group.

 PSWC utilizes an 8.00 percent growth rate for PSC, a 6.25 percent growth rate for the Water Group and a 7.25 Percent growth rate for the LDC Group. These growth rates are based on its opinion that a blend of historical performance and published forecasts are appropriate to estimate the DCF growth rates listed above. Thus, PSWC proposes a DCF result of 10.58 percent (2.58 percent plus 8.00 percent) for PSC, 9.82 percent (3.57 percent plus 6.25 percent) for the Water Group, and 12.15 percent (4.90 percent plus 7.25 percent) for the LDC Group, before making its aforementioned financial risk adjustment which raises its proposed DCF results to 11.69 percent, 10.29 percent, and 13.16 percent, respectively.

 Although PSWC utilized four other cost of common equity estimating techniques enumerated above, the ALJ emphasized that the RP, CAPM, and Comparable Earnings methods of analysis are inappropriate for use in rate-making because they are based on historic data, and do not measure the current rate of return on common equity. (R.D., p. 71). In any case, PSWC chose 11.75 percent as representative of the four cost rates of common equity results enumerated above. Moreover, according to PSWC, it is entitled to an 11.75 percent rate of return on common equity so that it can compete in the capital markets and maintain a reasonable credit quality. (PSWC Statement 4, p. 49).

 The OTS relied solely on the DCF method to arrive at its 9.90 percent recommended cost rate of common equity. The OTS applied the DCF method to both the market data of PSC and to its barometer group of water utilities’ stock which is actively traded. The OTS’ barometer group consists of five publicly traded water utilities that have at least two sources of analysts’ forecasts of earnings growth, and are not the announced subject of an acquisition.

 Specifically, the OTS averaged the spot dividend yield and the 52‑week average dividend yield of its barometer group to reach a 3.68 percent composite dividend yield. The OTS then added its 5.90 percent growth rate recommendation to the 3.68 percent dividend yield to reach a 9.58 percent DCF recommendation for its barometer group.

 Next, the OTS averaged the spot dividend yield and the 52‑week average dividend yield of PSC to reach a 2.41 percent composite dividend yield. The OTS then added its 7.80 percent growth rate recommendation to the 2.41 percent dividend yield to reach a 10.21 percent DCF recommendation for PSWC. The OTS proceeded to average the aforementioned 9.58 percent and 10.21 percent results to reach a 9.90 percent overall DCF recommendation which became OTS’ updated common equity cost rate recommendation. (OTS Exhibit No. 1-S, Schedule 2).

 The OCA relied primarily upon the DCF method to produce a common equity cost rate of 8.9 percent. The OCA afforded lesser weight to its RP result of 8.84 percent. The OCA then chose 9.0 percent as its common equity cost rate recommendation.

In its DCF analysis, the OCA averaged the 12-month composite dividend yield of 3.6 percent and the latest one-month average dividend yield of 3.5 percent to develop the DCF dividend yield of 3.55 percent for its barometer group. The OCA proceeded to employ the midpoint of its range of prospective Comparison Group growth rates of 5.00 percent to 5.50 percent. The resultant 5.25 percent is chosen by the OCA as a representative DCF growth rate. Next, in order to account for dividend growth in the period in which rates will be in effect, the OCA adjusted the 3.55 percent dividend yield by one‑half the expected dividend growth rate of 5.25 percent or 2.63 percent. The OCA’s DCF result is thereby 8.9 percent (3.55 percent\*1.0263 +5.25 percent). (OCA Statement No. 2, p. 21).

In its RP analysis, the OCA used the risk-free Treasury securities over a 24‑month period to arrive at a rate of 5.5 percent as the risk-free rate. The OCA then derived a risk premium range from data for its barometer group, which ranged from 2.8 percent to 4.4 percent. Using the average of 3.34 percent, the OCA concluded that the indicated rate of return was 8.84 percent (5.50% + 3.34%).

The OCA subsequently recommended a 9.0 percent common equity rate of return based primarily upon the DCF method and, to a lesser extent, the RP method.

####  2. The ALJ’s Recommendation

 After considering the arguments of the Parties regarding the cost of common equity, the ALJ recommended that we permit PSWC the opportunity to earn a rate of return on common equity of 9.9 percent as recommended by the OTS. It is the ALJ’s position that a 9.9 percent rate of return on common equity is amply supported by the record. Moreover, the ALJ maintains that the OTS’ DCF analysis was conducted in accordance with Commission precedent and appears reasonable. As such, the ALJ finds that in numerous cases we have recognized that while investors use many analytic methodologies such as RP, CAPM and CE, these types of analyses are inappropriate for use in rate-making because they are based on historic data, and do not directly measure the current rate of return on common equity. (R.D., p. 71).

 Finally, the ALJ rejected PSWC’s use of a leverage adjustment of 111 basis points for its DCF PSC analysis and 47 basis points for its DCF Water Group analysis. The ALJ reasoned that, although we accepted a 60 basis point adjustment in *Pa P.U.C. v. Pennsylvania-American Water Co.,* Docket No. R-00016339 (Opinion and Order entered January 25, 2002) (*PAWC 2002*), pp. 71-72, high financial risk is not a factor in this case. Moreover, the ALJ submitted that the financial risk adjustment of 60 basis points that we made in *PAWC 2002, supra* was far smaller than the 111 and 47 basis point adjustments that PSWC made for PSC and the Water Group, respectively. (R.D., p. 72).

####  3. Exceptions and Reply Exceptions

 PSWC excepts to the ALJ’s 9.9 percent common equity cost rate recommendation arguing that it falls midway between the 9.58 percent to 10.21 percent range of unadjusted DCF values developed by the OTS. In its Exceptions, PSWC avers that the DCF method should not be relied upon exclusively, to the exclusion of other generally accepted methods, to form a cost of common equity recommendation. PSWC argues that no one cost of equity model is so inherently precise that it can be relied upon to the exclusion of all other methods. PSWC supports the utilization of several common equity cost rate methodologies in rate case proceedings by reminding us that the Commission reviews the results of more than one method in evaluating the quarterly earnings reports submitted by Pennsylvania’s jurisdictional utilities and in establishing the cost of equity for Distribution System Improvement (DSIC) purposes. (Co. Exc., pp. 3‑4).

 PSWC further argues that extensive reliance on the DCF method is inappropriate because: (1) PSWC’s stock is not publicly traded and, therefore, the DCF method provides no direct evidence as to PSWC’s cost of equity capital; (2) due to the recent spate of mergers, the universe of comparable companies has shrunk to the point where the usefulness of any particular group must be questioned; and (3) PSWC alleges that when the DCF results are applied to an original cost rate base, its cost of equity capital will be understated when the market prices of the stocks used in the analysis substantially exceed book values.

PSWC notes that, in *PAWC 2002*, we adopted a financial risk adjustment virtually identical to the adjustment made in the instant proceeding. PSWC, therefore, excepts to the ALJ’s rejection of the financial risk adjustment that it made in this rate case. PSWC alleges that it sought to correct the “mismatch” of market and book values by making a 47 basis point adjustment for its barometer group and a 111 basis point adjustment for PSC. PSWC indicates that the midpoint of this range (47 to 111 basis points) approximates 80 basis points that when added to the ALJ’s unadjusted DCF findings of 9.9 percent would suggest an equity allowance of 10.7 percent. In *PAWC 2002, supra*, PSWC indicates that we adopted a 60 basis point financial risk adjustment to reconcile the greater financial risk inherent in PAWC’s book value-derived capital structure ratios.(PSWC Exc., p. 6).

 In their Reply Exceptions, both the OTS and the OCA rejoin that the Commission has relied upon the DCF analysis and informed judgment as the appropriate means of measuring the cost of common equity.*See, e.g., PAWC 2002*; *Pa. P.U.C. v. City of Lancaster,* 197 P.U.R.4th 156 (1999); *Pa. P.U.C. v. Consumers Pennsylvania Water Company-Roaring Creek Division (Roaring Creek),* 87 Pa. P.U.C. 826 (1997); *Pa. P.U.C. PECO Energy Company,* 87 Pa. P.U.C. 184, 212-213 (1997). (OTS R.Exc., pp. 15‑16). The OTS indicates that PSWC’s Exception stating that because the Commission reviews the results of more than one method in establishing the cost of equity for the DSIC, it is, therefore, necessary in a base rate case to do the same thing, is entirely without merit. It is the OTS’ position that rate of return analysis in DSIC reports was never intended to be used as a substitute for the rate of return analysis in a base rate proceeding. According to the OTS, rate of return analysis in DSIC reports was developed to facilitate interim rate of return allowances on infrastructure improvements up to 5% of net plant between base rate proceedings. (OTS R.Exc., p. 16; OTS St. 1‑SR, pp. 3‑4).

 In their Reply Exceptions, both the OTS and the OCA rejoin that the ALJ correctly rejected any proposed risk adjustment to PSWC’s Cost of Common Equity. The OCA argues that PSWC’s reliance on a single case, *PAWC 2002,* that is inapplicable to this issue, is unjustified. The OCA reasons that any inequity between market and book values is not necessarily significant. It is the OCA’s position that a company with market value that exceeds book value and results in a market/book ratio of over 1.0, such as the case of PSWC, simply means that such a company is earning a return on equity in excess of its cost of equity. The OCA explains that a market/book ratio of 1.0 indicates that investors return requirements are being met. A market/book ratio greater than one, as is the case with PSC and its barometer group, indicates that PSWC’s returns are more than sufficient to meet its investors’ requirements. (OTS R.Exc., pp.17-18; OCA R.Exc., pp. 12‑14.).

Therefore, the OTS and the OCA conclude that, not only should the DCF method be relied upon exclusively in the current base rate case, but also that no financial risk adjustment is necessary based on the market/book ratio of both PSC and its barometer group being greater than 1.0. The OTS and the OCA recommend that the associated Exceptions of PSWC be denied.

#### 4. Disposition

 Historically, we have primarily relied on the DCF methodology in arriving at our determination of the proper cost of common equity. We have, in many recent decisions, determined the cost of common equity primarily based upon the DCF method and informed judgment. *See Pa. PU C  v. Philadelphia Suburban Water Co.,* 71 Pa. PUC 593, 623-32 (1989); *Pa. PU C  v. Western Water Co.*, 67 Pa. PUC 529, 559-70 (1988); *Pa.* *PUC v. Roaring Creek Water Co.*, 150 PUR4th 449, 483-88 (1994); *Pa. PUC  v. York Water Co.,* 75 Pa. PUC 134, 153-67 (1991); *Pa. PUC  v. Equitable Gas Co.*, 73 Pa. PUC 345-46 (1990); *PAWC 2002*, p. 70. After a thorough examination of the record in this proceeding, we continue to find that the DCF method is the preferred method of analysis to determine a market based common equity cost rate.

 We note that, in *Lower Paxton Township* *v. Pennsylvania Public Utility Commission,* 317 A.2d 917 (Pa. Cmwlth. 1974) (*Lower Paxton Township),* the Common­wealth Court recognized that this Commission may consider such factors that affect the cost of capital such as the utility’s financial structure, credit standing, dividends, risks, regulatory lag, wasting assets and any peculiar features of the utility involved.

PSWC argues that a preliminary DCF calculation, which is computed using the market price of PSC’s common stock and the average of the barometer group’s market prices, should be adjusted to reconcile the divergence between market and book values. The indicated cost of common equity of 9.90 percent recommended by the ALJ, therefore, reflects the barometer group’s average *market* capitalization, which includes a common equity ratio of 69.74 percent as opposed to its common equity ratio of 52.85 percent which reflects the group’s book capitalization and significantly more financial risk. The corresponding common equity figures for PSC were 72.89 percent market and 46.95 percent book. PSWC properly determined that a financial risk adjustment ranging from 47 basis points for the barometer group and 111 basis points for PSC is in order. The midpoint of this range approximates 80 basis points.

 We find that a financial risk adjustment is indeed necessary to reconcile the divergence between PSWC’s market and book values. This is particularly true in light of the significant turbulence currently being experienced by the stock market. We find merit to the alternative proposal presented in PSWC’s Exceptions cited above. Specifically, an 80 basis point adjustment to the 9.90 percent recommendation of ALJ Chestnut is appropriate. We, accordingly, find that a 10.70 percent common equity cost rate assures the continued financial stability of PSWC and takes into account PSWC’s efficiency, effectiveness, and adequacy of service. *See* 66 Pa. C.S. §523 (a).

Moreover, we find that even in the absence of a financial risk adjustment applied to the unadjusted DCF results, the record in this proceeding still supports a cost of common equity allowance of 10.70 percent. For example, the RP, CAPM and CE analyses performed by PSWC’s rate of return witness all yielded results in excess of 10.70 percent for the cost of common equity. While the Commission does not rely primarily on these alternative methods of determining the company’s cost of common equity, this testimony further supports the reasonableness of the 10.70 percent cost of common equity we have allowed in this proceeding.

 Based on our analysis of the record, we conclude that PSWC’s cost of common equity of 10.70 percent is reasonable and appropriate under the circumstances in this proceeding. The following table summarizes our determinations concerning PSWC’s capital structure, cost of debt, cost of preferred stock, 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 |  | 52.26% |  |  7.01% |  |  3.66% |
| Common Equity |  | 47.74% |  | 10.70% |  |  5.11% |
|  |  | 100.00% |  |  |  |  8.77% |

IX. RATE STRUCTURE

A. Overview

 In *Pa. P.U.C. v. West Penn Power*, the Commission described its view of cost recovery through rates as follows:

Public utility rates should enable the utility to recover its cost of providing service and should allocate this cost among the utility’s customers in a just, reasonable and nondiscriminatory manner.

73 Pa. P.U.C. 454, 510, 199 PUR 4th 110 (1990) (*West Penn Power*). The determination of the proper amount of the total cost of service to be allocated to each customer class is accomplished through the use of a cost of service study. The allocation is determined based upon the relative cost responsibilities of each customer class.

 The ALJ observed that, due to acquisitions of several water utilities, PSWC customers are currently served under twenty-five separate rate zones. Over the long term, it is PSWC’s stated intent to serve all of its customers under a uniform set of rates, imple­menting Commission approved Single Tariff Pricing. Thus, PSWC’s different rate divisions receive varying rate increases as the company continues the rate equalization process.

 The ALJ observed further that this process is complicated by several factors. First, the need for gradualism, to avoid rate shock; and second, the fact that many of the systems acquired by PSWC were served by rates substantially different from those of PSWC, as well as those served by flat rates or rates which contain a water allowance in the customer charge. (R.D., pp. 73-74).

**B.** **Cost of Service Study**

 **1. Positions of the Parties**

 PSWC prepared a cost of service study using the Base-Extra Capacity Method for allocating costs to customer classifications. PSWC revised its original cost of service study to change certain cost allocations. No Party objected to the use of the revised cost of service study submitted by PSWC.

 The OCA recommended that, in future proceedings, PSWC be directed to: (1) undertake further demand studies to refine its estimates of class non-coincident peak demands; and (2) make changes to the allocation of storage facilities to the public fire protection class. PSWC objected to the OCA’s proposal arguing that PSWC should determine how to conduct the cost of service study that it presents.

 **2. The ALJ’s Recommendation**

 The ALJ recommended rejection of the OCA’s proposal. The ALJ found that any party to a proceeding should have the right to prepare its cost of service study in the manner supported and recommended by its expert. (R.D., p. 77). The method proposed by PSWC has been accepted by this Commission as the appropriate methodology for determining class costs of service. The ALJ proffered a description of this method, which is incorporated herein by reference. (R.D., p. 75-77).

 **3. Exceptions and Reply Exceptions**

 In its Exceptions, the OCA argues that it provided evidence to show that PSWC does not use the appropriate measurement for customer demand in its load study and, as a result, PSWC’s Cost of Service study may overstate the relative hourly and daily demands of residential customers. The OCA continues that the information used by PSWC to determine class cost of service could be made more accurate by continuing PSWC’s load research to develop a method to estimate class non-coincident peak day and hour demands

 The OCA wants PSWC to develop a method to estimate non-coincident peak demands. The OCA argues that despite the foregoing definition, PSWC applies the Base-Extra Capacity method without a measure of the non-coincident peak (NCP) demands on its system. The OCA maintains that NCP demands are used to assign cost responsibility because they avoid potential biases against particularly low load factor customers by capturing the diversity of their usage. According to the OCA, the residential class tends to be more diversified than other classes, thus resulting in a particular difference in the measurement of demand if this diversity is not reflected. (OCA Exc., pp. 29‑30).

 PSWC rejoins that it measures residential demand within residential load control areas that contain from 22 to 105 residential customers. PSWC argues that the resulting data captures the coincident peak usage of the customers on the distribution system, and presents a more accurate measurement of peak usage of distribution facilities than the OCA’s proposal, which PSWC contends would understate the peak by looking at coincident usage across the system.

 PSWC further argues that the OCA’s proposal also is flawed in that it fails to consider the technological difficulties, and resulting costs, that would be encountered in trying to develop more, but not necessarily more accurate, data.

 According to PSWC, the difficulty is in measuring commercial and industrial demand data for customers that are not served in discrete systems, but are instead spread throughout the service territory. PSWC asserts that to adopt the OCA proposal, it would have to establish a system to record and compile data for an unspecified number of commercial and industrial customers 24 hours/day, 365 days/year, since it is impossible to know, in advance, when each of these classes will experience a peak hour or a peak day. PSWC posits that, even if this could be accomplished, there is no basis to conclude that the relative demands of each class will vary from those already determined. (PSWC R.Exc., pp. 30-31).

 **4. Disposition**

 After careful consideration of the positions of the Parties, we shall adopt the recommendation of the ALJ. First, we agree with the ALJ that any party to a proceeding should have the right to prepare its cost of service study in the manner supported and recommended by its expert, and that PSWC should not be constrained as to the evidence it presents in future cases. We are persuaded by the argument advanced by PSWC in its Reply Exceptions that the OCA’s proposal does not consider the technological difficulties and resultant costs that would be encountered in imposing the proposed requirement upon PSWC. We find that the OCA has not demonstrated that its proposal would produce more accurate data.

 We further conclude that implementation of the OCA proposal would not result in more accurate data than is currently being developed. Since we are mindful that the cost of a rate proceeding is ultimately borne by the ratepayers of a utility seeking rate relief, we are unwilling to create a further evidentiary requirement which may not result in more accurate data than is currently being produced. Accordingly, we will deny the Exceptions of the OCA, and adopt the recommendation of the ALJ on this issue.

**C.** **Rate Design Proposals**

 **1. Customer Charge - Main Division**

 **a. Positions of the Parties**

PSWC proposed to raise its customer charge for customers in the Main Division with 5/8 inch meters from $7.50 per month exclusive of the DSIC, or $7.7875 inclusive of the DSIC. PSWC proposed comparable increases in customer charges for those customers with other meter sizes.

 The OCA recommended no increase in the customer charge in the Main Division because its witness contended that there were indirect costs included in the proposed charge. Specifically the OCA argued that employee benefits and payroll taxes related to employees who operate and maintain meters and services, prepare bills and collections and read meters and computer costs, should not be recovered through the customer charge. The OCA also argued that as a matter of policy, customer charges should be kept low to encourage conservation.

 PSWC responded that the OCA’s calculations were flawed. Specifically, PSWC pointed out that although a significant number of its customers are billed on a quarterly basis, the OCA divided quarterly billing costs by monthly billing units. This, according to PSWC, creates a substantial mismatch.

 **b. The ALJ’s Recommendation**

 The ALJ recommended adoption of the PSWC recommendation reasoning as follows:

In light of this [error], it is not necessary to address the further criticism of OCA’s customer cost analysis. I do agree with PSW that OCA’s methodology is deficient and should not be used to reject the company’s proposal to increase the customer charge.

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In addition, as discussed in detail in PSWLUG’s Reply Brief, pp. 5-7, those other cases cited by OCA do not support its assertion that the Commission has ever recognized the promotion of conservation as a policy matter in the setting of a customer charge. For example, in Pa. P.U.C. v. City of Bethlehem, 160 PUR4th 375, 428 (1995), the Commission’s discussion was in the context of minimum usage charges which contained water allowances. It was the consumption allowance – not the customer charge – that was eliminated to favor conservation.

In conclusion, I recommend that the Main Division 5/8-inch meter customer charge be increased as proposed by the company.

(R.D., pp. 88-89).

 **c. Exceptions and Reply Exceptions**

 In its Exceptions, the OCA argues that PSWC’s costing analysis is at odds with previous Commission decisions regarding the development of customer charges and gradualism. The OCA argues further that a customer charge that is greater than the direct customer costs – which is improper in itself – will also have the effect of discouraging water conservation.

 In its Reply Exceptions, PSWC maintains that the OCA erred in its calculation of customer costs by dividing meter reading, collecting and billing costs by meter equivalents. PSWC argues that this is wrong because these costs are driven principally by the frequency of billing, and thus should be divided by billing units.

 According to PSWC, the OCA concedes that if these costs are divided by billing units, its own customer cost analysis produces a $9.07 customer charge for a 5/8” meter. PSWC submits that this is more than sufficient to support the ALJ’s recommended $8.75 customer charge. Moreover, PSWC contends that the $9.07 charge understates PSWC’s true customer costs because it fails to include such items as employee benefits and payroll taxes related to those employees who perform meter services, billing and collection functions. PSWC argues that the OCA’s suggestion would also exclude PSWC’s investment in billing computer equipment, even though without computers additional employees would be needed to prepare bills by hand. PSWC cites *Pa. P.U.C. v. Citizens Utilities Water Company of Pennsylvania*, 86 Pa. P.U.C. 51 (1996) (*Citizens Utilities*) for the proposition that such costs have been recognized as direct customer costs. (PSWC R.Exc., pp. 21-22).

 **d. Disposition**

 Upon consideration of the positions of the Parties we shall adopt the recommendation of the ALJ. We arrive at this conclusion for several reasons. First, we find, as did the ALJ, that the OCA calculations were flawed. As noted in PSWC’s Reply Exceptions, the OCA concedes that if these costs are divided by billing units, its own customer cost analysis produces a $9.07 customer charge for a 5/8” meter, which is more than sufficient to support the $8.75 customer charge.

 Next, it appears that even the $9.07 charge may be understated because it fails to include such items as employee benefits and payroll taxes related to those employees who perform meter services, billing and collection functions.

 Finally, we also reject the argument that a customer charge would influence consumption. We find that consumption would be far more affected by an allowance included within a customer charge. Since PSWC has eliminated the water allowance from its customer charge, such an argument is rendered moot.

 Based upon the foregoing discussion we adopt the ALJ’s recommendation. The Exception of the OCA relative to this issue is denied.

1. **Fawn Lake and Paupack Divisions**

 The Fawn Lake and Paupack Divisions primarily serve vacation rental properties in the Pocono Mountain area. PSWC proposed a $17.22 per month customer charge for customers of the Paupack Division who are served by a 5/8 or ¾ inch meter. Included in the monthly customer charge is an allow­ance of 2,300 gallons. For customers of the Fawn Lake Division who are served by the 5/8 or ¾ inch meters, the monthly charge is $17.22, which includes an allowance of 2,000 gallons.

 **a. Position of the Parties**

 The OTS and the OCA proposed the same per month customer charge as the Main Division with no water allowance for customers of Fawn Lake Division. For both the Fawn Lake and Paupack Divisions, the OTS and the OCA accepted PSWC’s proposal to charge the same consumption rates as in the Main Division.

 **b. The ALJ’s Recommendation**

 The ALJ recommended as follows:

Therefore, it is recommended that the 5/8-inch minimum charge in the Fawn Lake Division be set at $8.75, and the ¾‑inch meter minimum charge be set at $13.80, with no water allowance, consistent with the Main Division charges. It is further recommended that the 5/8-inch meter minimum charge in the Paupack Division be set at $10.00 with no allowance and that the ¾-inch meter minimum charge be set at $13.80 per month with no water allowance. (Footnote omitted.)

(R.D., p. 91).

 **c. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted. As such, we adopt the minimum charges for the Fawn Lake Division consistent with our approval of the Main Division charges. We also adopt the ALJ’s recommended charges for the Paupack Division as reasonable since the charges implement (1) a move toward single tariff pricing; and (2) a substantial decrease from the rates currently charged to the Paupack Division customers.

 **3. Western Division**

 **a. Positions of the Parties**

 PSWC proposed to increase customer charges for customers served by 5/8‑inch and ¾-inch meters from $35.01 to $44.00 per month with an allowance of 5,000 gallons per month.

 The OTS recommended a $15 per month customer charge for customers served by 5/8 and ¾ inch meters with no minimum allowance. The OCA recommended a $12.50 per month customer charge with no minimum allowance for customers served by 5/8 inch meters.

 **b. The ALJ’s Recommendation**

 The ALJ found as follows:

As explained in PSW’s Main Brief, p. 79, at present rates, pro forma revenue from Western Division metered sales service is $266,094. PSW’s proposed rates would produce pro forma revenues of $294,163. PSW St. 1-R, p. 35. OTS’ proposal would reduce metered revenue to $228,028, a 14% reduction. PSW St. 1-R, p. 35, PSW St. 1-R, Sch. 7, p. 3. OCA’s proposal would reduce metered revenue even further to $213,251, a $52,843, or 20%, reduction from current revenues. PSW St. 1-R, Sch. 7, p. 4.

It is recommended that the OTS proposal be adopted. For the reasons stated above, no water allowance should be included. A customer charge of $15.00 with no allowance will move current rates closer to the Main Division rates. It is certainly possible that the anticipated revenue shortfall will be offset by

reductions in expenses, given the economies of scale that will now be available.

(R.D., p. 92).

 **c. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted. Specifically, we find that the imposition of the rates recommended by the OTS are a move toward single tariff pricing.

**4. Woodloch Springs Division**

 **a. Positions of the Parties**

 The Woodloch Springs Division was recently acquired by PSWC. Customers of the Woodloch Springs Division are currently charged a flat rate of $32.85 per month. PSWC proposed to establish a $32.50 per month customer charge including a 5,000 gallon allowance. PSWC proposed that all other rates would be the same as the Main Division rates. The OTS proposed a $15 per month customer charge for customers with 5/8 and ¾ inch meters with no minimum allowance.

 **b. The ALJ’s Recommendation**

 The ALJ recommended as follows:

I recommend that the company’s proposal be accepted. I agree that the OTS recommendation fails to give due regard to principles of gradualism. Because Woodloch Springs customers are presently flat rate customers, it would be more appropriate, in the transition to metered service, to charge these customers higher customer charges with a usage allowance. The application of PSW Main Division commodity charges to these customers is adequate move­ment toward Single Tariff Pricing in this case. OTS’ proposal for Woodloch Springs presents too great a change in rate design with an inappropriate reduction in revenues.

(R.D., pp. 92-93).

 **c. Exceptions and Reply Exceptions**

 In its Exceptions, the OTS argues that, in the case of Woodloch Springs, the ALJ favors the creation of a water allowance under the guise of supporting gradualism. The OTS contends that the recom­mended proposal does not move the average consumer's bill toward an appropriate rate in any manner. (OTS Exc., p. 21).

 PSWC rejoins that the OTS’ proposal represents too dramatic a change in rate design for these customers and “fails to give due regard to principles of gradualism”. PSWC argues that the OTS-proposed Woodloch Springs rates would produce a 26% decrease in revenues from existing rates, at the same time that the average increase to other non-Main Division customers is approximately 13%. PSWC opines that the OTS proposal was properly rejected by the ALJ. (PSWC R.Exc., p. 23).

 **d. Disposition**

 Upon consideration, we agree with the ALJ that the OTS recom­mendation is not consistent with the principles of gradualism. We also agree with the ALJ’s finding that PSWC’s recommendation represents a more gradual transition to metered service and to eventual single tariff pricing.

 We are mindful that the customers of the Woodloch Springs Division are presently flat rate customers and must be transitioned to metered service. We find that the OTS’ Exceptions do not rise to the level that would cause us to modify or reject the ALJ’s recommendation. Moreover, we take cognizance of the fact that under the OTS’ proposal, the Woodloch Springs Division would receive a 26% decrease, while the remainder of the non-Main Division customers would receive an increase of approximately 13%.

 Based upon the foregoing discussion we deny the Exception of the OTS on this issue, and adopt the recommendation of the ALJ.

**5. Bristol Division**

 **a. Positions of the Parties**

 For customers of the Bristol Division, PSWC proposed to maintain the monthly minimum charge of $8.00 per month including an allowance of 1,600 gallons for customers served by 5/8 and ¾ inch meters. PSWC agreed to OTS’ proposal to maintain the minimum charge at $8.00 per month, but reduce the monthly allowance to 1,400 gallons. (R.D., p. 93).

 The OCA recommended that the monthly minimum charge be reduced to $7.50 including an allowance of 1,000 gallons.

 **b. The ALJ’s Recommendation**

 The ALJ recommended rejection of the OCA’s position, reasoning as follows:

The OCA’s recommendations should be rejected because (1) its customer charge analysis has already been rejected in connection with the Main Division; and (2) the allowance recommended by OTS is appropriate, given the company’s intention to completely eliminate the minimum allowance by 2007. OTS St. 2, p.10.

(*Id.*).

 **c. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted. Consistent with our rejection of the OCA’s proposal to adopt $7.50 as a customer charge for the Main Division, we reject the OCA’s proposal.

**6. West Chester Division**

 **a. Positions of the Parties**

 PSWC proposed to increase monthly customer charge for customers served through a 5/8-inch meter from $8.33 to $8.75. The OCA recommended that the monthly customer charge for the 5/8-inch metered customers be reduced to $7.50 from the current level of $8.33.

 **b. The ALJ’s Recommendation**

 The ALJ recommended adoption of PSWC’s proposal and rejection of the OCA’s proposal, consistent with the previous proposals.

 **c. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted.

 **7.** **Flying Hills Division**

 **a. Positions of the Parties**

 PSWC proposed no change to the $9.65 monthly customer charge for customers served through 5/8 inch meters. PSWC proposed lowering the monthly water allowance from 2,300 to 1,800 gallons for these customers. The current customer charges for all other meter sizes would be retained. The OCA did not oppose this proposal.

 The OCA proposed reducing the monthly customer charge for customers served through 5/8 inch meters from $9.95 to $8.75. PSWC opposed the OCA’s proposal reasoning that PSWC’s proposed rate includes 1,800 gallons and thus warrants a customer charge higher than $8.50 per month in the Main Division where there is no water allowance.

 **b. The ALJ’s Recommendation**

 The ALJ recommended adoption of the OCA proposal, as follows:

I recommend that the OCA’s proposal be adopted for this Division. As it points out, currently, the customer charge is higher than the Main Division customer charge with a higher allowance. The reduction to the monthly allowance will help to offset the reduction to the customer charge, while moving these customers toward Main Division rates.

(R.D., p. 94).

 **(c) Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d.** **Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted. We find that the ALJ’s recommendation to adopt the OCA’s recommended rate is consistent with the principle of gradualism. As the ALJ pointed out, the customer charge is higher than that of the Main Division, with an allowance that is not contained in the Main Division customer charge.

**8. Main Division-Consumption Charges**

 **a. Positions of the Parties**

 PSWC proposed increasing the first consumption block (the first 10,000 gallons) by a greater percentage than any other consumption block. The ALJ noted that the first consumption block is also the flat rate for the Residential and Sales to Other Utilities classes.

 The OCA argued that PSWC’s cost of service study shows that the Residential Class is over-contributing to PSWC’s rate of return at current rates. Thus, the OCA proposed that PSWC increase each consumption block by the same percentage. PSWC responded that the OCA proposal is based upon its original cost of service study. PSWC submitted that its revised cost of service study shows that the Residential Class is at the system average rate of return.

 PSWLUG opposed the OCA’s recommendation. PSWLUG argued that while the OCA proposal may promote the interests of the Residential Class, it has not shown that its proposal would result in just, reasonable and fair rates for the other classes.

 **b. The ALJ’s Recommendation**

 The ALJ recommended adoption of the PSWC proposal based upon the revised cost of service study.

 **c. Exceptions and Reply Exceptions**

 In its Exceptions, the OCA submits that the ALJ erred in determining, based on the results of the revised cost of service study, that a disproportionate increase is appropriate for the Residential Class. According to the OCA , PSWC proposed a disproportionate increase for residential customers who are paying "at the system average." The OCA argues that PSWC had not proposed a disproportionate increase for any of the other classes that are paying the average rate of return. The OCA contends that it is restoring reason and proportion to the cost allocation by proposing elimination of the disproportionate increase. (OCA Exc., pp. 36-38).

 PSWC rejoins that the fallacy of the OCA proposal is that PSWC’s revised cost of service study shows that the Residential Class rate of return is at system average under PSWC’sproposed rates. According to PSWC, the OCA’s proposal, rather than restoring proportionality, will instead perpetuate below system-average rates for the Residential Class. PSWC opines that the OCA has offered no compelling justification for such a result. (PSWC R.Exc., p. 24)

 **d. Disposition**

 Upon our careful consideration of the positions of the Parties in this proceeding, we shall adopt the recommendation of the ALJ. We observe that the resolution of this issue turned on a determination of whether the Residential Class over contributed to the system average rate of return. We agree with the ALJ’s determination that the Residential Class’ rate of return was at the system average.

 We find that the Exceptions of the OCA do not refute the ALJ’s findings that (1) the Residential Class is not over contributing to the overall system rate of return; and (2) PSWC’s Cost of Service Study indicates that the Residential Class contribution is at the system average.

 Based upon the foregoing discussion, we will deny the Exception of the OCA and adopt the recommendation of the ALJ.

**9. Scaleback of Revenue Increase**

 **a. Positions of the Parties**

 All Parties presented recommendations as to how the revenue increase, if any, should be allocated in the event the Commission determines that PSWC is entitled to a lower revenue requirement than it requested.

 PSWC proposed to that consumption charges in the Main Division be scaled back proportionally before any scale back to customer charges, because the customer charges are “substantially” below cost. PSWC recommended that, in order to facilitate the move to single tariff pricing, any rate in another division that was moved to the proposed rates in its Main Division should be scaled back equal to the scaled back Main Division rates.

 PSWC contended that any proposed rates in other divisions that would still be lower than the scaled back Main Division rates should remain as proposed and not be scaled back. PSWC pointed out that these scaleback proposals represent its acceptance of the recommendations of the OTS. PSWLUG supported PSWC’s position.

 The OSBA recommended that: (1) the customer charge and the first consumption block should be scaled back proportionally; (2) the second and third blocks should receive a greater than proportionate scale back; and (3) the fourth and fifth blocks should be given a less than proportionate scale back. The OSBA’s proposal was based on the fact that the Industrial Class’s relative rate of return is .87% under the proposed rates.

 **b. The ALJ’s Recommendation**

 The ALJ recommended as follows:

In the event the Commission allows a lower level of revenue than that requested by the company, I recommend that the PSW/OTS/PSWLUG proposal should be adopted. While the testimony of OSBA witness Kalcic concerning the effect of the interclass subsides (Public Fire Protection, Riders DIS and DRS) is persuasive, the revised cost of service study addresses some of his concerns. There is no question that, even under the revised class cost-of-service study, the industrial class’s relative rate of return is less than system average; whether or to what extent the class return is under­stated due to any overlap with the private fire protection class.

(R.D., p. 97).

 **c. Exceptions and Reply Exceptions**

 No Party filed Exceptions on this issue.

 **d. Disposition**

 Since no Party excepts to the ALJ’s recommendation on this issue, and finding that recommendation to be otherwise reasonable and in accord with record evidence, it is adopted. We find PSWC’s proposal to be reasonable. We are of the opinion that PSWC’s proposal represents a fair and equitable first step toward single tariff pricing for PSWC. Additionally, we find that the provision that there be no scaleback to any proposed rates in other divisions that would still be lower than the scaled back Main Division rates, to be consistent with the principle of gradualism.

**X. CONCLUSION**

 We have carefully reviewed the record as developed in this proceeding, including the ALJ’s Recommended Decision and the Exceptions filed thereto. The ALJ recommended an allowable revenue increase in the amount of $15,118,564. This amount is approximately 53.99% of the original request of $28,000,000, and represents a 7.26% overall increase in revenues at current rates. (R.D., p. 99). We will permit PSWC to increase its annual revenues by $21,225,941 or 10.19%. The increase that we will permit is 75.81% of the amount requested. As noted above, we conclude that a cost of common equity of 10.70 percent is appropriate.

 As such, we hereby grant and/or deny the Exceptions filed by the various Parties hereto, as discussed *supra*. Accordingly, the ALJ’s Recommended Decision is adopted, as modified by this Opinion and Order; **THEREFORE,**

 **IT IS ORDERED:**

 1. That the Exceptions of the various Parties to the Recommended Decision of Administrative Law Judge Marlane R. Chestnut herein, are granted or denied, consistent with this Opinion and Order.

 2. That the Recommended Decision of Administrative Law Judge Marlane R. Chestnut, issued on June 7, 2002, is adopted as modified by this Opinion and Order.

 3. The Philadelphia Suburban Water Company shall not place into effect the rates contained in Supplements Nos. 35 through 39 to Tariff Water–Pa. P.U.C. No. 16, which have been found to be unjust, unreasonable and, therefore, unlawful.

 4. The Philadelphia Suburban Water Company is hereby authorized to file tariffs or tariff supplements containing rates, provisions, rules and regulations, consistent with the findings here, to produce revenues not in excess of $229,564,333.

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

 6. That Philadelphia Suburban Water Company shall file detailed calculations with its tariff filing, which shall demonstrate to this Commission’s satisfaction that the filed rates comply with the instant Opinion and Order.

 7. That Appendix A of the Main Brief of Philadelphia Suburban Water Company and Appendix A of the Main Brief of the Office of Consumer Advocate are admitted into the record.

 8. That Philadelphia Suburban Water Company shall comply with all directives contained in the body of the instant Opinion and Order which are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

 9. That the Complaints filed by the various Parties at Docket No. R‑00016750C001 through R-00016750C0091 are granted or denied to the extent consistent with the instant Opinion and Order.

 10. That upon Commission approval of the tariffs filed in response to the instant Opinion and Order, the proceeding at Docket No. R‑00016750, including R‑00016750C0001 through R-00016750C0091, shall be marked closed.

 **BY THE COMMISSION,**

 James J. McNulty

 Secretary

(SEAL)

ORDER ADOPTED: July 18, 2002

ORDER ENTERED: August 1, 2002

1. *See* Commission Order entered December 7, 2001 at Docket No. A‑210104 *et al*., which permitted the consolidation of these entities for corporate purposes. [↑](#footnote-ref-1)
2. As the result of a number of mergers and acquisitions, rates for service vary among PSWC’s operating divisions. Therefore, the percentage change for each division will vary. [↑](#footnote-ref-2)
3. *See*, Prehearing Order No. 3, dated January 31, 2002. PSWLUG is an ad hoc association of large-volume end-users who receive water service from PSWC. The members in this proceeding are the Apartment Association of Greater Philadelphia, Building Owners’ and Managers’ Association of Philadelphia and GlaxoSmithKline. [↑](#footnote-ref-3)
4. *Pa. P.U.C. v. Pennsylvania American Water Company*, Docket No. R‑00016339, Order entered January 25, 2002 (PAWC 2002). [↑](#footnote-ref-4)
5. Specifically, the OCA objected to the miscellaneous employee expenses contained in Account 6048. The other two categories of employee expenses in that account - active employee health costs and post-retirement benefits - were separately adjusted and are not included in this general inflation claim. (PSW St. 1-R, p. 16, PSW M.B., p. 20). [↑](#footnote-ref-5)
6. Survivor curves are data points determined by models and are widely used to simplify life estimation procedures and forecasting concerning utility property. (OCA St. 3, p. 11). [↑](#footnote-ref-6)