PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting Held December 5, 2012

Commissioners Present:

Robert F. Powelson, Chairman
John F. Coleman, Jr., Vice Chairman
Wayne E. Gardner, Dissenting in Part & Concurring in Result Only Statements
James H. Cawley, Dissenting in Part Statement
Pamela A. Witmer

Pennsylvania Public Utility Commission	R-2012-2290597
Office of Consumer Advocate	C-2012-2300266
Office of Small Business Advocate	C-2012-2301063
PP&L Industrial Customer Alliance	C-2012-2306728
William Andrews	C-2012-2300402
Tracey Andrews	C-2012-2328596
Eric Joseph Epstein	C-2012-2313283
Dave A. Kenney	C-2012-2299539
Roberta A. Kurrell	C-2012-2304870
Donald Leventry	C-2012-2304903
John G. Lucas	C-2012-2298593
Helen Schwika	C-2012-2299335

v.

PPL Electric Utilities Corporation

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OPINION AND ORDER

BY THE COMMISSION:

I. Matter Before the Commission

Before the Pennsylvania Public Utility Commission (Commission) for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Susan D. Colwell, issued on October 19, 2012, relative to the above-captioned general rate increase proceeding. Also before the Commission are the Exceptions and Replies to Exceptions filed with respect thereto.

Exceptions to the Recommended Decision were filed on November 8, 2012, by the following Parties: PPL Electric Utilities Corporation (PPL or Company), the Commission's Bureau of Investigation and Enforcement (I&E), the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA), the Commission on Economic Opportunity (CEO), Direct Energy Services LLC (Direct Energy), Dominion Retail, Inc. d/b/a Dominion Energy Solutions (DR), and the PP&L Industrial Customer Alliance (PPLICA). Replies to Exceptions were filed on November 19, 2012, by the following Parties: PPL, the OCA, the OSBA, DR, and PPLICA. I&E filed Replies to Exceptions on November 29, 2012.

II. History of the Proceeding[1]

On March 30, 2012, PPL filed Supplement No. 118 to Tariff – Electric Pa. P.U.C. No. 201, to become effective June 1, 2012, containing proposed changes in rates, rules, and regulations calculated to produce approximately $104.6 million in additional annual revenues. This proposed rate change represents an average increase in the Company's distribution rates of approximately 13%, which equates to an average increase in total rates (distribution, transmission, and generation charges) of approximately 2.9%. The filing was suspended by Commission Order entered on May 24, 2012.

Formal Complaints against this proposed tariff were filed by the following: the OCA, on April 23, 2012; the OSBA, on April 25, 2012; PPLICA, on May 25, 2012; John G. Lucas, on April 9, 2012; Helen Schwika, on April 11, 2012; Dave A. Kenney, on April 16, 2012; William Andrews, on April 19, 2012; Tracey Andrews, on May 1, 2012; Roberta Kurrell, on May 3, 2012; Donald Leventry, on May 15, 2012;[2] and Eric Joseph Epstein, on July 5, 2012. Petitions to intervene were filed by the following: DR, on April 9, 2012; the CEO, on April 30, 2012; the International Brotherhood of Electrical Workers Local 1600, on May 1, 2012; the Sustainable Energy Fund (SEF), on May 3, 2012; Direct Energy, on May 24, 2012; and Granger Energy of Honey Brook LLC and Granger Energy of Morgantown LLC (collectively, Granger), on May 24, 2012. I&E filed a Notice of Appearance on April 10, 2012.

[1] For a full and complete history, as well as information regarding the testimony provided during the Public Input hearings, please refer to the Recommended Decision at 2-10.

[2] By letter received on June 19, 2012, Mr. Leventry indicated that he did not want to be involved in the litigation and asked that he be removed from the service list.

A Prehearing Conference was held on May 31, 2012. On June 1, 2012, ALJ Colwell issued a Scheduling Order which adopted the schedule agreed to by the Parties at the Prehearing Conference.

On June 11, 2012, the Company filed a Motion for a Protective Order. No Party filed a responsive pleading, and the Protective Order was granted on July 3, 2012.

On June 18, 20, and 21, Public Input Hearings were held in Scranton, Wilkes-Barre, Bethlehem, Allentown, and Harrisburg.

On July 13, 2012, Richards Energy Group, Inc. (REG) submitted a late-filed Petition to Intervene. The ALJ granted the intervention by Order issued July 26, 2012.

The evidentiary hearings were held on August 6, 7, 9, and 10, 2012. A hearing was also held on October 11, 2012, to hear the testimony of Tracey Andrews, whose Formal Complaint was filed on May 1, 2012, but was not properly associated with this rate case until October 10, 2012. The record consists of a transcript of 613 pages and numerous statements and exhibits presented by various Parties, as detailed in Appendix A of the Recommended Decision.

On August 29, 2012, the Parties filed Main Briefs and the record was thereupon closed. In addition, PPL filed a Petition to Reopen the Record in order to provide updated information regarding the long-term debt issued on August 24, 2012. As no objections were received, by Order issued September 10, 2012, the ALJ reopened the record for the purpose of accepting the updated information.

On September 14, 2012, the Parties filed Reply Briefs. The record closed upon the receipt of the Reply Briefs.

By way of Recommended Decision, issued on October 19, 2012, ALJ Colwell recommended, *inter alia*, that the company be permitted to file tariffs or tariff supplements containing rates designed to produce a $63,830,000 increase to the Company's present revenues. I.D. at 141. As previously noted, PPL, I&E, the OCA, the OSBA, the CEO, Direct Energy, DR, and PPLICA filed Exceptions. PPL, the OCA, the OSBA, DR, and PPLICA filed Replies to Exceptions. I&E filed Replies to Exceptions on November 29, 2012, as well as a letter requesting that the Commission accept its Replies to Exceptions as timely filed.[3]

[3] In its letter, I&E stated that on November 19, 2012, it electronically served its Replies to Exceptions on all Parties and the Office of Administrative Law Judge and served hard copies upon all internal Commission offices. I&E averred that it did not discover until November 29, 2012, that due to an administrative error, its Replies to Exceptions were inadvertently uploaded for e-filing on November 19, 2012, rather than submitted for e-filing. Under these circumstances, we find it appropriate to consider I&E's Replies to Exceptions in the interest of securing a just, speedy and inexpensive determination in this proceeding. *See*, 52 Pa. Code § 1.2(a). We do not believe that any of the Parties to this proceeding will be prejudiced by our consideration of I&E's Replies to Exceptions, as the Parties and this Commission were timely served with them.

III. Discussion

A. Description of the Company

PPL is a jurisdictional electrical distribution company (EDC) providing electric distribution service to approximately 1.4 million customers in all or portions of twenty-nine counties in eastern and central Pennsylvania. Under its present corporate structure, it is a wholly owned subsidiary of PPL Corporation (PPL Corp.). Another subsidiary of PPL Corporation is PPL Services Corporation, which provides various administrative and general services to the utility, including legal services, human resources, auditing, and community affairs.

B. Legal Standards

In deciding this or any other general rate increase case brought under Section 1308(d) of the Public Utility Code (Code), 66 Pa. C.S. § 1308(d), certain general principles always apply. A public utility is entitled to an opportunity to earn a fair rate of return on the value of the property dedicated to public service. *Pa. PUC v. Pennsylvania Gas and Water Co.* 341 A.2d 239, 251 (Pa. Cmwlth. 1975). In determining a fair rate of return, the Commission is guided by the criteria provided by the United States Supreme Court in the landmark cases of *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In *Bluefield*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or

> anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield, 262 U.S. at 692-693.

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

> **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 proceedings 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.

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

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

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

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

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

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

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

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

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

Additionally, Section 315(a) of the Code, 66 Pa. C.S. § 315(a), cannot reasonably be read to place the burden of proof on the utility with respect to an issue the

utility did not include in its general rate case filing and which, frequently, the utility would oppose. Inasmuch as the Legislature is not presumed to intend an absurd result in interpretation of its enactments,[4] the burden of proof must be on the party who proposes a rate increase beyond that sought by the utility. The mere rejection of evidence contrary to that adduced by the public utility is not an impermissible shifting of the evidentiary burden. *United States Steel Corp. v. Pa. PUC*, 456 A.2d 686 (Pa. Cmwlth. 1983).

In analyzing a proposed general rate increase, the Commission determines a rate of return to be applied to a rate base measured by the aggregate value of all the utility's property used and useful in the public service. The Commission determines a proper rate of return by calculating the utility's capital structure and the cost of the different types of capital during the period in issue. The Commission is granted wide discretion, because of its administrative expertise, in determining the cost of capital. *Equitable Gas Co. v. Pa. PUC*, 405 A.2d 1055, 1059 (Pa. Cmwlth. 1979) (determination of cost of capital is basically a matter of judgment which should be left to the regulatory agency and not disturbed absent an abuse of discretion).

As we proceed in our review of the various positions of the Parties in this proceeding, we are reminded that any issue or Exception that we do not specifically address shall be deemed to have been duly considered and denied without further discussion. The Commission is not required to consider expressly or at length each contention or argument raised by the parties. *Consolidated Rail Corp. v. Pa. PUC,* 625 A.2d 741 (Pa. Cmwlth. 1993); *also see, generally, University of Pennsylvania v. Pa. PUC*, 485 A.2d 1217 (Pa. Cmwlth. 1984).

[4] 1 Pa. C.S. § 1922(1), *PA Financial Responsibility Assigned Claims Plan v. English*, 541 Pa. 424, 430-431, 64 A.2d 84, 87 (1995).

C. Rate Base

1. Depreciation Reserve

a. Positions of the Parties

In its filing, PPL claimed $1.813 billion in its Accumulated Reserve for Depreciation based on plant in service and amortization of net salvage for the test year ending December 31, 2012. PPL Future 1-Revised, Sch. C-1. PPL reflected depreciation accruals of $155.248 million and proposed that the Commission recognize annual depreciation expenses of $168.92 million. PPL Exh. Future 1-Revised, Sch.D-10.

PPL explained that rate base items are not annualized but are the balances projected to be in effect at the end of the test year. PPL also explained that annualization applies only to revenue and expense items, and not to rate base items. PPL M.B. at 22. PPL averred that the OCA's approach of using a non-annualized level of plant in service with an annualized level of depreciation reserve would create a mismatch between plant in service and the accumulated reserve for depreciation, which would result in an overstatement of the accumulated depreciation reserve and an understatement of rate base. PPL further asserted that the OCA's approach is inconsistent with the fundamentals of test year ratemaking, because by including annualized depreciation expense in the calculation of the accumulated depreciation reserve, the OCA's adjustment would add depreciation expense to the reserve that has not and will not be accrued at the end of the future test year (FTY). *Id*. at 23.

The OCA recommended that the Company's proposed level of Accumulated Reserve for Depreciation be increased by $10.417 million to better match the claimed depreciation expense, resulting in a corresponding reduction to PPL's rate base of $10.417 million. OCA M.B. at 12; OCA St. 1-REV. at 11-12; Exh. KC-1-REV. Sched. 2 at 3. The OCA averred that, since ratepayers are being asked to pay for the full

level of depreciation expense, it is appropriate for ratepayers to have the full amount of that expense applied to accumulated depreciation. OCA M.B. at 13; OCA St. 1-SR at 4.

b. ALJ's Recommendation

The ALJ recommended adoption of PPL's position to use the accrued depreciation amount of $155.248 million for calculating the depreciation reserve, rather than the claimed $168.92 million in depreciation expense. R.D. at 17. The ALJ agreed with the Company's reasoning that rate base items are not annualized but are the balances which are projected to be in effect at the end of the year. *Id*. at 16, 17. The ALJ found the Company's following argument persuasive:

> The reserve for depreciation is built up by recording depreciation expense, but the expense recorded is the expense per books for a particular period of time, here calendar year 2012. OCA's proposal to ignore the projected per books depreciation expense and use instead the theoretical, annualized level of expense is not correct. The annualized depreciation expense as of December 31, 2012 will not be recorded on PPL Electric's books during calendar year 2012. Therefore, it is not part of the "build-up" of the depreciation reserve by recording depreciation expense related to plant in service.

Id. at 17-18 (citing PPL R.B. at 9-10). Accordingly, the ALJ recommended that the OCA's proposed $10.417 million adjustment be rejected. *Id*. at 18.

c. Exceptions

In its Exceptions, the OCA avers that the ALJ erred by rejecting the OCA's accumulated reserve for depreciation adjustment. The OCA states that it recommended an adjustment to PPL's accumulated reserve for depreciation to match PPL's claimed depreciation expense. OCA Exc. at 2; OCA St. 1-REV. at 11-12; Exh. KC-1-REV.

Sched. 2 at 3. The OCA explains its position that the depreciation expense included in the cost of service and the additions to the depreciation reserve, which are deducted from rate base, should be based on the level of plant the Company claims will be in service at the end of the FTY and the depreciation expense claimed for the FTY that is related to that plant. OCA Exc. at 2-3. The OCA asserts that ratepayers should receive the full benefit of the depreciation expense for which they are being charged by receiving the corresponding full benefit of accumulated depreciation reserve. *Id*. at 3.

In its Replies to Exceptions, PPL states that the ALJ properly rejected the OCA's proposal. PPL R.Exc. at 11. PPL submits that the accumulated reserve for depreciation, plant in service, and retirements as of December 31, 2012, are determined by bringing forward the book balances as of December 31, 2011, by reflecting the projected plant additions, annual depreciation expense per books, projected retirements per books, and projected net salvage per books. *Id*. at 11; PPL Exh. JJS-2 at III-6-III-7; PPL Exh. 1, Part V-A-3 at 1-3. PPL also submits that the OCA is proposing to change only one of these elements in determining net plant in service – the projected depreciation expense per books for 2012. PPL avers that the OCA's proposed adjustment is flawed, because the use of the annualized depreciation expense would be a mismatch with every other component of net plant in service, as those components are based on projected transactions per books. PPL asserts that there is not an annualized level of plant in service as of December 31, nor are there annualized retirements or annualized net salvage. PPL R.Exc. at 11. PPL further avers that its method of determining the accumulated reserve for depreciation was approved in its prior rate proceeding and has been accepted by the Commission for all major electric, gas, and water public utilities. *Id*.; PPL St. 13-R at 4.

d. Disposition

Based on our review of the record, the Parties' positions, and the Recommended Decision, we find that the ALJ properly adopted PPL's claim and rejected the OCA's proposal to use an annualized level of depreciation. PPL has met its burden of proof by showing that its method of determining the accumulated reserve for depreciation is reasonable, is consistent with the fundamentals of test year ratemaking, and is consistent with the methods used by other major public utilities. We agree with PPL that rate base items are not annualized but are balances to be in effect at the end of the test year. PPL is correct that the OCA's proposed adjustment to use a non-annualized level of plant in service with an annualized level of depreciation reserve would create a mismatch between plant in service and the accumulated reserve for depreciation, which would result in an overstatement of the accumulated depreciation reserve and an understatement of rate base. For these reasons, we shall deny the OCA's Exceptions and adopt the ALJ's decision on this issue.

2. Cash Working Capital – Lag Days for Payments to Affiliates

a. Positions of the Parties

PPL explained that its expense lag days for payments to its affiliate for support services is thirty-five days, consisting of the sum of fifteen days, which is the midpoint of the monthly service period, and twenty days, which is a standard accounting transaction for the preceding month. PPL M.B. at 24. PPL stated that it treats its payments to affiliates in the same manner that it treats its payments to non-affiliated vendors, and that it should not discriminate in favor of, or against, its affiliates. PPL also stated that a payment lag of thirty days is commercially reasonable and typical of the terms required by PPL's vendors. PPL asserted that it has consistently incorporated a thirty-five day payment lag for its affiliates in previous rate cases, and the Commission and the other parties to those proceedings have accepted the thirty-five day payment lag

for affiliated services in calculating cash working capital (CWC) requirements. *Id*. at 25; PPL St. 7-R at 3.

I&E recommended a reduction in the CWC operation and maintenance (O&M) claims based on its position that PPL unnecessarily pays its affiliate substantially in advance of the required due date under the Company's service agreement with its affiliate. I&E submitted that, under the service agreement, PPL is billed monthly and has sixty days to pay its affiliate. Therefore, I&E argued that PPL has an allowable payment lag of seventy-five days pursuant to contract. I&E M.B. at 12. I&E proposed changing the payment date to the affiliate which, when weighted with the other expense groups, would result in an overall average expense lag payment of approximately forty-eight days, compared to PPL's claimed average expense payment lag of approximately thirty-five days. *Id*.; I&E St. 2 at 56. Application of I&E's recommendation would result in a $13,021,000 reduction to the Company's CWC claim to rate base. I&E M.B. at 11; I&E St. 2 at 56. I&E further argued that PPL did not provide any evidence that it has consistently incorporated a thirty-five day affiliate payment lag in its prior rates cases. I&E R.B. at 10. According to I&E, no prior litigated case addressed CWC generally or this O&M expense lag specifically, and there are no prior applicable Commission Orders providing the Company with Commission approval for this expense lag. *Id*. at 10-11.

b. ALJ's Recommendation

The ALJ adopted I&E's recommendation for a $13.021 million reduction to O&M in the CWC component of the Company's claimed rate base. The ALJ found persuasive I&E's argument that PPL did not have to pay its affiliate for services within the time period that the Company claimed but had the discretion to take advantage of a longer payment period of up to sixty days under the terms of the contract with its affiliate. The ALJ did not believe that PPL met its burden of proving its claim was reasonable, because the Company was causing the ratepayers a substantial amount of

money due to a practice it could not otherwise justify except by saying that it has always been done that way. R.D. at 20.

c. Exceptions

In its Exceptions, PPL avers that the Recommended Decision's proposed adjustment to its lag days for payments to its affiliate should be rejected. PPL Exc. at 35. PPL submits that it uses a computerized system to pay all of its invoices from PPL Services and non-affiliated vendors. The Company notes that it pays its affiliates on the twentieth day of the month after services are received, which results in a thirty-five day payment lag for services it receives from its affiliates. PPL asserts that the ALJ's reliance on the payment terms in the agreement with its affiliate is not an adequate basis for the adjustment, because the agreement does not require a sixty-day payment period and clearly authorizes a twenty-day payment period. The Company explains that the agreement was entered into seventeen years ago when computers were not used to the extent they are currently and a longer time period for invoice payment was more common. *Id*. at 36.

I&E rejoins that the ALJ properly rejected PPL's calculation of its expense lag days based on the evidence presented by I&E, which demonstrated that the Company paid its affiliate well in advance of the due date, thereby resulting in a significantly shorter expense payment lag and an unnecessary annual ratepayer CWC contribution of $1.1 million. I&E R.Exc. at 3; I&E St. 2-SR at 62. I&E believes that PPL should be required to save its ratepayers $1.1 million annually by paying its affiliate as permitted under the agreement. I&E asserts that the manner in which PPL pays its affiliate disadvantages ratepayers and benefits its affiliate. I&E submits that, as a regulated monopoly with captive ratepayers, PPL should be held to a strict standard regarding the manner in which it handles payments to affiliates. I&E R.Exc. at 4.

d. Disposition

We agree with the ALJ's decision to adopt I&E's recommended $13.021 million O&M reduction to the CWC component of the Company's claimed rate base. PPL did not meet its burden of proving that its expense lag days for payments to its affiliate are reasonable. Since PPL has up to sixty days to pay its affiliate under the agreement, it would have been reasonable for PPL to take advantage of the longer payment period and, by doing so, to minimize the rate impact on its customers. PPL has control over when it pays its affiliate and can alter its computerized system to change the date on which it pays its affiliate. The evidence presented by I&E demonstrated that PPL's choice to pay its affiliate forty days early resulted in an annual ratepayer CWC contribution of $1.1 million. I&E St. 2-SR at 62. PPL's customers should not be burdened with this expense when it can be avoided. For these reasons, we shall deny PPL's Exception and adopt the ALJ's decision on this matter.

3. Cash Working Capital – Prepayment of Postage Expense

a. Positions of the Parties

PPL averred that it is proper for postage expense to be reflected in both the operation and maintenance expense component of working capital and prepayments, because each component addresses the expense during separate and distinct time periods. PPL M.B. at 26. PPL explained that the first time period related to postage expense is the prepayment, which begins when it makes prepayments to the United States Postal Service for postage to be used by the postage meter and ends when the postage meter adds postage to an envelope. According to PPL, the second time period is the payment lag, which begins when the postage is used. During the second time period, the expense appears in the working capital requirement as an O&M expense to reflect the period between when the postage meter adds postage to an envelope and when customers pay PPL. PPL's position was that there is no double recovery, because the inclusion of

postage expense as a prepayment is separate from its treatment as an O&M expense in the working capital calculation. *Id*. at 27; PPL St. 7-R at 6-7. In its Reply Brief, PPL stated that its position that there is no double recovery was consistent with controlling Commission precedent, particularly the Commission's decision in the Company's 2004 rate case. PPL R.B. at 14 (citing *Pa. PUC v. PPL Electric Utilities Corp*., Docket No. R-00049255, at 11-12 (Order entered December 22, 2004)).

I&E did not recommend a specific adjustment to the Company's treatment of postage expense, but stated that the Company should be ordered to discontinue this practice in future proceedings because it is an improper CWC calculation that overstates the Company's CWC needs. I&E M.B. at 18. I&E averred that PPL includes a full twelve-month expense dollar amount claim for postage in its total CWC O&M expense, and also includes a twelve-month average prepayment dollar amount for postage in the Prepayment CWC component. *Id*. at 17. I&E's position was that this practice overstates the actual CWC requirement for postage, because the inclusion of two different CWC components results in a funding claim that is greater than what is incurred on an annual basis. *Id*. at 17-18.

b. ALJ's Recommendation

ALJ Colwell agreed with I&E's position. The ALJ found that PPL should discontinue its practice of including the same CWC need for postage in both the O&M expense and prepayment components of the CWC calculation, because this practice improperly inflates the CWC calculation. R.D. at 22. The ALJ distinguished this case from PPL's 2004 rate case. The ALJ stated that, in the 2004 case, the Commission accepted ALJ Turner's finding that the evidence did not support a conclusion that the Company prepaid its postage, which ALJ Turner admitted would have changed her recommendation. In this case, ALJ Colwell noted that PPL admitted to prepaying for postage and using the prepaid postage in its postage meter. R.D. at 21.

c. Exceptions

In its Exceptions, PPL avers that it should be permitted to continue to calculate the postage expense component of working capital as it has been calculating it. PPL states that it has fully explained its treatment of postage expense in rate base in its briefs. PPL also states that the Commission previously approved its treatment of postage expense and that nothing has changed since the Commission's previous approval. PPL Exc. at 37 (citing *Pa. PUC v. PPL Electric Utilities Corp*., Docket No. R-00049255, at 11-12 (Order entered December 22, 2004)).

In its Replies to Exceptions, I&E states that the ALJ correctly found that the Company overstated postage and that the Company should correctly calculate its postage expense in future proceedings. I&E avers that PPL improperly included postage expense as both an O&M expense and a prepayment, which resulted in a funding claim greater than the Company incurred. I&E believes that PPL's 2004 rate case is distinguishable from this case because, in that case, the OCA did not provide evidence that the Company included a prepayment and an expense for the same item, whereas, the Company admitted that it did in this case. I&E submits that PPL's CWC claim for postage is overstated, because, whether loaded into a meter or directly expensed, postage is paid only once. I&E R.Exc. at 5.

d. Disposition

Based on our review of the record, the Parties' positions, and the ALJ's decision, we find that PPL improperly included the same postage expense in two CWC components by listing it as both an O&M expense and a prepayment, resulting in an overstatement of that expenditure. We do not find merit in PPL's reliance on our Order in the Company's 2004 rate case. We agree with the ALJ and I&E that this case is

distinguishable from the 2004 rate case. In the 2004 case, PPL included a claim for the net lag in recovery of operating expenses based upon a lead/lag study and a separate claim for average prepayments. In that case, PPL stated that the time period captured in its lead/lag study was from the date the bills were mailed to the date payment was received from customers, thus, excluding the time period from when the postage was paid to when it was expensed. *Pa. PUC v. PPL Electric Utilities Corp*., Docket No. R-00049255, at 11 (Order entered December 22, 2004). In the 2004 case, we concluded that the Company's position refuted the OCA's argument of double counting, because the time period from when the postage was paid to when it was expensed was excluded. *Id*. at 12. In the present case, PPL is expressly claiming that it properly included a prepayment and an expense for the same postage item. Accordingly, we shall adopt the ALJ's recommendation that PPL discontinue its practice of including the same CWC need for postage in both the O&M expense and prepayment components of the CWC calculation and deny PPL's Exception.

4. Cash Working Capital – Prepayment of Regulatory Assessments

a. Positions of the Parties

PPL stated that, consistent with Commission precedent, it included the Commission assessment in the prepayment component of its working capital requirement. PPL M.B. at 28 (citing *Pa. PUC v. National Fuel Gas Distribution Corp*., 1994 Pa. PUC Lexis 134). PPL stated that, while the Commission's assessment is calculated based on a utility's jurisdictional revenue for the prior calendar year, the assessment applies for the forthcoming fiscal year as provided in the Commission's June 21, 2012 invoice. PPL quoted the language in the Commission's invoice as follows:

> The Commission is submitting a request for **pre-payment** of PPL Electric's estimated Public Utility Commission assessment for the fiscal year 2012-2013. The requested pre-payment amount is an estimate based on the revenues shown

> on your Company's GAO-11 submission and the Commission's **fiscal year 2012-2013 budget** request. When the assessment invoices are issued in August for the **fiscal year 2012-2013** your invoice will be adjusted to reflect the payment made in response to this letter.

PPL M.B. at 29; PPL Exh. BLJ-1 (emphasis added).

PPL averred that its position that the assessment is for the fiscal year beginning on the following July 1 is also supported by the language in Section 510 of the Code, 66 Pa.C.S. § 510. PPL explained that, under Section 510, the Commission budget is proposed to the Governor and the General Assembly the preceding November 1, and the General Assembly is expected to approve a Commission budget for the upcoming fiscal year by the preceding March 30. PPL stated that, based on the approved budget, the Commission allocates the assessment among public utilities according to each utility's jurisdictional revenues for the preceding calendar year. PPL stated that, once the Commission makes the calculations, it prepares payment requests that the utilities receive in June prior to the fiscal year for which the assessment is made. PPL M.B. at 29.

I&E recommended removing the Company's claimed Commission assessments from the prepayments component of its CWC claim, which would result in an allowable working capital prepayment of $394,000, a reduction of $2.78 million to the Company's working capital prepayment claim. I&E averred that the Commission assessment is not a prepayment. I&E explained that the assessment is calculated as a proportion of Commission, OCA, and OSBA services that have been provided to PPL's utility type in the prior year, and it is billed as a percentage assessed on PPL's prior calendar year jurisdictional revenue and payable to the Commission, the OCA, and the OSBA in the subsequent calendar year. I&E M.B. at 15. I&E opined that the assessment is akin to a tax and, thus, should be treated as an expense with an associated lag. I&E argued that the assessment should be matched against the revenue generation time period

on which the expense was based, namely, the prior year's jurisdictional revenue. *Id*. at 16.

b. ALJ's Recommendation

The ALJ recommended that I&E's proposal to remove PPL's Commission assessment expense as a prepayment under its CWC calculation be denied. The ALJ stated that several large utilities, including PPL, pay their assessments, or a portion of them, early in order to assure continued funding of the Commission's activities for the first quarter of the fiscal year. The ALJ found that it was clear that the assessment is based on a prior year's revenues, but the application period is the following fiscal year. R.D. at 23.

c. Exceptions

In its Exceptions, I&E avers that the ALJ erred by recommending rejection of I&E's adjustment to remove PPL's claimed regulatory assessments from the prepayments component of its CWC claim. I&E Exc. at 4. I&E states that the ALJ's finding that the regulatory assessment is a prepayment due to the time period in which the actual funds are spent is erroneous. I&E Exc. at 5. I&E contends that, under Section 510(b) of the Code, 66 Pa. C.S. § 510(b), although the assessment is paid in the subsequent fiscal year, the assessment covers the regulatory expenses incurred in the prior year. As such, I&E asserts that the assessment is not a prepayment for the next year's expenses, and it should be treated as an expense with an associated lag. *Id*. at 6.

I&E also distinguishes assessments from prepayments because prepayments are paid in advance of a service and may be refunded if the service is terminated before the end of the service period, whereas a utility's assessments are representative of the proportion of agency services rendered to the utility in the prior year

and are not subject to a refund if the utility ceases operations the following year. *Id*. I&E believes that for ratemaking purposes, the assessment, which is a billed expense, must be matched against the revenue generation time period on which the expense was based, which is the prior year's jurisdictional revenue. I&E avers that this practice is consistent with the manner in which the assessment is made and with the accrual accounting concept of matching expenses with the revenue earning period that manifested the expenses, or matching revenues with the expenses that result from the production of those revenues. *Id*. at 7; I&E St. 2-SR at 63.

I&E further submits that the Commission's June assessment letter does not support the ALJ's recommendation. I&E describes the assessment process and states that the assessment is based upon the utilities' prior calendar year revenues, which must be reported by March of the following calendar year. I&E Exc. at 7. While assessments are made in August of a fiscal year, the Commission issues letters in June, such as the one issued to PPL, asking certain larger utilities to submit an early payment of the fiscal year's assessment based on a preliminary early assessment provided by the Commission. *Id*. at 7-8; PPL Exh. BLJ-1. Thus, I&E avers that the Commission's use of the word "prepayment" in the June assessment letter is merely a request for an early payment to assure the continuous funding of regulatory agencies, and is not determinative of the status of the assessment payment for purposes of the proper calculation of PPL's CWC requirements. *Id*. at 8.

In its Replies to Exceptions, PPL avers that the ALJ properly included regulatory assessments as a prepayment in the working capital calculation. PPL states that I&E's proposed adjustment is inconsistent with the Commission's invoice for assessments, the relevant law, and the manner in which the Commission operates. According to PPL, the language in the Commission's invoice supports its position that regulatory assessments are a prepayment. PPL R.Exc. at 14. PPL states that Section

511(b) of the Code, 66 Pa. C.S. § 511(b), also supports its position. *Id*. at 14-15.[5] PPL asserts that I&E's position suggests that regulatory assessments are paid after the fact and, if this were true, the Commission would have to borrow money to fund operations while collections of assessments were pending. PPL believes that I&E's position ignores reality and the way the Commission operates. *Id*. at 15.

d. Disposition

We find that PPL properly included the Commission assessment in the prepayment component of its working capital requirement. PPL presented evidence to show that, based on the language in the Commission's June 21, 2012 invoice, the assessment applies for the forthcoming fiscal year, July 1 through June 30. *See,* PPL St. 7-R at 3-4; PPL Exh. BLJ-1. PPL also presented evidence demonstrating that, pursuant to the assessment process set forth in Section 510 of the Code, 66 Pa. C.S. § 510, the assessment payment qualifies as a prepayment. PPL St. 7-R at 4. While it is clear under Section 510 that the assessment is calculated based on operating revenues for the preceding calendar year, the assessment that a utility pays is for the upcoming fiscal year. Moreover, PPL paid its assessment early, as requested in the Commission's invoice, and based its prepayment calculation on the manner in which it handles its assessment payments. *Id*. PPL's inclusion of the assessment as a prepayment is consistent with our prior decisions. *See, Pa. PUC v. National Fuel Gas Distribution Corp*., 1994 Pa. PUC Lexis 134, *29-30 (permitting the public utility to include in rate base a prepayment

[5] PPL quotes Section 511(b) of the Code, which provides the following:

> All such assessments and fees, having been **advanced** by public utilities for the purpose of defraying the cost of administering this part, shall be held in trust solely for that purpose, and shall be earmarked for the use of, and annually appropriated to, the commission for disbursement solely for that purpose.

PPL R.Exc. at 15 (quoting 66 Pa. C.S. § 511(b) (emphasis added)).

balance that included the Commission's assessment). For these reasons, we shall deny I&E's Exceptions and adopt the ALJ's decision on this issue.

D. Expenses

1. Incentive Compensation

a. Positions of the Parties

PPL provides three types of compensation to its employees: base pay, benefits, and eligibility for incentive compensation. PPL makes incentive compensation payments to its own employees and reimburses PPL Services for its share of PPL Services' incentive compensation, which enables PPL Services to make incentive payments to its eligible employees. PPL St. 3-R at 15-26; PPL M.B. at 33.

The OCA recommended disallowing half of the incentive compensation expense, thereby requiring the shareholders to share equally in the cost of the compensation plans. The OCA recommendation is to adjust the expenses of $4.468 million for the Company's incentive compensation plan and $4.902 million related to the PPL Services' incentive compensation plan downward. OCA Exh. KC-1-SR, Sch. 4 at 4; Sch. 1 at 2.

I&E recommended an equal sharing of the claimed incentive compensation expenses between shareholders and ratepayers, resulting in a jurisdictional allowance of $4.459 million and a reduction of the same amount from PPL's claim. I&E asserted that PPL has provided no evidence that the incurrence of this cost is necessary for the provision of safe and reliable service at just and reasonable rates. I&E M.B. at 28-29.

PPL argued that the incentive compensation payments are a part of the total compensation package that was developed and is maintained based, at least in part, on a

comparison with those of other employers for comparable positions. PPL stated that, if the incentive compensation payments to employees were eliminated, the fixed compensation would have to be raised in order to remain competitive with other employers, and "[t]here would be no savings to ratepayers." PPL St. 3-R at 16-17; PPL M.B. at 34.

Further, PPL stated that the Commission has approved incentive compensation programs in numerous prior rate cases. PPL M.B. at 36-37 (citing *Pa. PUC v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, at 20-21 (Order entered July 31, 2008); *Pa. PUC v. PPL Gas Utilities Corporation*, Docket No. R-00061398, at 40 (Order entered February 8, 2007)).

b. ALJ's Recommendation

The ALJ stated that, because the Parties have not challenged the reasonableness of the total compensation expense, the overall amount was not at issue; rather, only the method of recovery was at issue. While the two public advocates rely on the inherent fairness of having shareholders fund half of the incentive program, since they too receive a benefit, the ALJ found that the law does not support that concept. Rather, the ALJ found that a utility is entitled to recover in rates all expenses reasonably necessary to provide service to its customers and to earn a fair return on its investment in plant used and useful in providing service. The ALJ stated that to require a sharing of expense is to deny that portion in a rate case, which is simply not permitted under case law. R.D. at 28 (citing *Butler Township Water Co. v. Pa. PUC,* 473 A.2d 219, 221, 222 (Pa. Cmwlth. 1984); *T.W. Phillips Gas and Oil Co. v. Pa. PUC*, 474 A.2d 355 (Pa. Cmwlth. 1984)). Based upon the above rationale, the ALJ recommended that PPL be permitted full recovery of its incentive compensation plan. R.D. at 27-28.

c. Exceptions

The OCA and I&E excepted to the ALJ's recommended full recovery of PPL's incentive compensation plan. As presented in its Main and Reply Briefs and in its Exceptions, the OCA asserted that there is ample case law to support the OCA's position that shareholders should fund a portion of the incentive compensation plan. OCA Exc. at 3 (citing *Pa. PUC v. Philadelphia Gas Works*, 2007 Pa. PUC Lexis 45; *Pa. PUC v. UGI Utilities, Inc. - Electric Division*, 82 Pa. P.U.C. 488, 508 (1994); *Pa. PUC v. Roaring Creek Water Co*., 1994 Pa. PUC Lexis 41 (1994)). The OCA believes that the ALJ erred in failing to recommend a sharing of PPL's incentive compensation plans. *Id.*

In its Exceptions, I&E contends that neither the evidence nor the case relied upon by the ALJ supports the recommendation that PPL be permitted to recover the entire incentive compensation program expense from ratepayers. I&E Exc. at 9. I&E argues that while PPL is entitled to recover all reasonably incurred expenses, necessary for the provision of safe, reliable and adequate utility service, it must first satisfy its burden of proof. *Id.* I&E contends that PPL did not meet this burden. I&E opines that, absent sufficient data to determine the relative ratepayer and shareholder values, its proposed equal sharing of the expense is fair because the Company's earnings per share performance and other financial measures directly impact shareholder value, I&E's. *Id.* at 10. I&E also contends that the ALJ erroneously concluded that *Butler Township Water Co. v. Pa. PUC*, 473 A.2d 219 (Pa. Cmwlth. 1984), prohibited, as a matter of law adoption of I&E's proposal to disallow half of PPL's incentive compensation program. *Id.* at 11.

In its Replies to Exceptions, PPL averred that this adjustment would ignore the fact that almost everything PPL does will provide a benefit to both shareholders and ratepayers. PPL R.Exc. at 12. Further, PPL argues that this adjustment is unlawful because a public utility is entitled to recover expenses reasonably necessary to provide

service to customers and to earn a fair rate of return. *Id.* A public utility is also entitled to recover operating expenses that are prudently incurred to provide service to customers. *Id.* In *PGW*, *UGI*, and *Roaring Creek*, as cited by the OCA and I&E, incentive compensation was disallowed in total because the utilities could not demonstrate that the program would provide a benefit to ratepayers. *Id.*at 13. In further support of its incentive compensation plan, PPL notes the plan's three overarching objectives: to achieve operational excellence; to optimize workforce readiness and engagement and to increase shareholder value. *Id.*

d. Disposition

We agree with the ALJ's interpretation of *Butler.* We find that, because PPL's incentive compensation plan is reasonable, prudently incurred, and is not excessive in amount, PPL is permitted full recovery of this expense. *See*, *Butler*, 473 A.2d at 221. PPL correctly notes that many of the cases the OCA and I&E rely on are distinguishable from this case because, in those cases there was not adequate evidence that the incentive compensation expense was reasonable or that there was a benefit to ratepayers. *See, Pa. PUC v. Philadelphia Gas Works*, 2007 Pa. PUC Lexis at *73-75; *Pa. PUC v. Roaring Creek Water Co*., 1994 Pa. PUC Lexis at *37-38. Our decision to allow this incentive compensation expense is consistent with our prior decisions approving incentive compensation programs that are focused on improving operational effectiveness. *See, e.g., Pa. PUC v. Aqua Pennsylvania, Inc*., 2008 Pa. PUC Lexis 50 at *24; *Pa. PUC v. Duquesne Light Co*., 1987 Pa. PUC Lexis 342 at *99-100. Accordingly, the exceptions of the OCA and I&E on this issue are denied.

2. PPL Services

a. Environmental Management

i. Positions of the Parties

PPL's FTY claim of $467,000 is based upon the adoption of new federal, state and local environmental regulations that require PPL to undertake greater levels of environmental management activities. More specifically, federal and state environmental rules mandate that routine inspection of storm water and erosion, and sedimentation control measures continue beyond project completion. PPL further asserted that its budgeted increase in construction carries with it an increased need for environmental management services. For these reasons, PPL asserted that the past years' variability of this expense does not support the use of an historic average because, in this instance, the past is not representative of the future. PPL St. 3-R at 2-5; PPL M.B. at 41, 42.

I&E recommended a four-year average of actual annual jurisdictional direct support fees from 2009 through 2011, and the 2012 budget amount, resulting in a ratemaking allowance of $364,000, or a reduction of $103,000 from PPL's FTY claim. It is I&E's position that PPL's claimed level of expense is unsubstantiated. I&E's analysis includes PPL's FTY claim, which I&E believes recognizes an increase over PPL's historic level by giving consideration to the equivalent of 1.5 new full time employees. I&E is also of the opinion that PPL failed to substantiate how new environmental regulations may impact the expenses of operating PPL's distribution system. I&E M.B. at 25-26. I&E further contended that PPL ignored the fact that costs for the implementation of a new software system will not recur, and should not be included within the FTY claim. I&E M.B. at 34.

PPL asserted that I&E's rationale for its proposed disallowance, which relies upon the variability of the expense, the nonrecurring nature of the cost of the new

computer system and that PPL does not expect its FTY level of expense to be sustained in subsequent years, was either incorrect or irrelevant, or both. PPL explained that while its expenses for the new software will not extend beyond the FTY, PPL will require additional licenses for employees using the software and additional environmental management support as more employees become authorized to use the software. PPL M.B. at 42. Further, as indicated in the data provided to I&E in response to discovery, PPL's business plan anticipates an increase in environmental management expense as follows: $485,000 for 2013; $494,000 for 2014; $508,000 for 2015; and $549,000 for 2016 and 2017. *Id.* at 43.

ii. ALJ's Recommendation

The ALJ concluded that PPL did not provide citations to the new regulations, nor any specific cost estimates for specific requirements to support its claim that there will be additional costs for environmental compliance. Further, the ALJ found that PPL did not sustain its burden of proving entitlement to the level of support fees sought. In the absence of record evidence to support its claim, the ALJ recommended adoption of I&E's proposal to reduce PPL's FTY claim by $103,000. R.D. at 29-30.

iii. Exceptions

In its Exception, PPL argues that the ALJ's recommendation is in error. PPL claims that, due to the adoption of new regulations, it will be required to undertake greater levels of environmental management activities due to the increase in construction activity throughout its system. This increase in construction activity elevates PPL's expenses related to environmental permitting and the need for additional employees. PPL Exc. at 32.

I&E rejoins that the ALJ correctly rejected PPL's claim for payment to its affiliate for environmental management services and recommended adoption of I&E's $103,000 reduction. I&E argues that PPL's claim contained costs that were irregular, erratic, and unsupported in the FTY. I&E R.Exc. at 9. I&E submits that despite PPL's claims that environmental compliance costs will increase substantially, PPL Corp. contended otherwise in its reports to investors, stating there will be no environmental downside for its distribution system, noting no significant exposure to currently proposed environmental regulations. *Id.* at 10.

iv. Disposition

We agree with I&E and the ALJ on this issue and shall grant the $103,000 expense reduction proposed by I&E. We find that PPL failed to carry its burden of proof that adoption of new regulations will require PPL to undertake greater levels of environmental management activities due to the increase in construction throughout its system. PPL did not refer to any newly adopted environmental regulations to which it is, or will become subject to, in the FTY. Absent this type of support we find the position of I&E to be reasonable. Accordingly, we shall deny PPL's Exception on this issue.

b. External Affairs

i. Positions of the Parties

PPL's budget for 2012 includes $2.602 million for direct services from the External Affairs[6] Department of PPL Services, which is an increase of $1.17 million, or 81% above the $1.432 million 2011 expense. PPL St. 3-R at 6; PPL M.B. at 43. The indirect expenses from this department totaled $1.252 million for the Historical Test Year

[6] External Affairs provides, in part, for the coordination of government relations activities, corporate communications, such as media and public relations services, as well as community and economic development activities. PPL St. 2 at 21-22.

(HTY) and are budgeted at $1.368 million for the FTY. I&E St. 2-SR at 17. The total charges to PPL represent 25% of the annual corporate budget for the HTY and 36% for the FTY. *Id.*

PPL explained that the reason for the increase from 25% to 36% of the annual corporate budget is two-fold. First, a review of the day-to-day activities of the regional community relations directors, who are part of the External Affairs Department, revealed that their activities center around reliability, connections and disconnections, billing and payment, street lighting and requests related to economic development. All of these activities directly benefit PPL, not other members of the PPL corporate system. Therefore, these expenses now are being directly charged to PPL instead of being allocated as indirect charges among all members of the PPL corporate system. Second, PPL stated that increases in line siting and upgrading work, tree trimming and enhanced storm damage communication protocols have also added to the responsibilities of this department. PPL St. 3-R at 6-7; PPL R.B. at 36-37.

I&E contended that the proposed percentage increase would shift an inordinate portion to the rate-regulated entity, PPL, without express consideration of the broader nature of the function of the External Affairs Department. I&E RB at 27. I&E stated that while External Affairs may become involved in billing and connection issues on occasion, PPL has other divisions specifically designed to address these functions on a daily basis. *Id.* at 27-28. In further support of its position, I&E explained that there is very little nexus, if any, between community development activities and the safe and reliable provision of utility service. *Id.* at 28. At a minimum, I&E contended that PPL's efforts with respect to community development enhance the corporate brand at least as much as they affect the provision of electric distribution service. *Id.*

I&E's original recommendation was to allow only the HTY level of directly assigned costs, or $1.432 million representing an expense adjustment of $1.170

million. However, upon review of PPL's explanation of the increase in this cost element from the HTY to the FTY, I&E revised its original expense adjustment. I&E R.B. at 27. I&E's revised expense allowance is based upon an average of the HTY percentage of 25% and the FTY proposed percentage of 36%, for an average of 30.5%. This average percentage, as developed in the table above, was then applied to the total FTY External Affairs Division budget of $10.982 million, providing a recommended allowance of $3.350 million. I&E's revised adjustment, therefore, is $3.970 million - $3.350 million, or $620,000. I&E St. 2-SR at 18.

ii. ALJ's Recommendation

The ALJ found that PPL did not adequately support the proposed increase in its allocated share of the External Affairs Division's FTY budget. The ALJ also found that PPL's only reference was to a schedule attached to its rebuttal testimony. The ALJ recommended that I&E's revised adjustment of $620,000, be adopted based upon I&E's rationale to support its calculated disallowance. R.D. at 31.

iii. Exceptions

In its Exceptions, PPL argues that the Commission should reverse the ALJ and allow the total claim of $2.6 million. PPL Exc. at 33. PPL explains that the increased costs for external affairs is driven primarily by refinements to the process of identifying the affiliates who benefit from the services provided, rather than a dollar increase in the overall costs of those services, which was only 0.8% from 2011 to 2012. *Id*. PPL explains that starting with the FTY, more of the costs for external affairs are directly assigned rather than being allocated as an indirect cost. *Id.* at 34.

In reply, I&E states that PPL provided no evidence to connect monies spent on community and economic development ($865,000 for 2011 and $1.7 million for 2012)

and government relations ($463,000 for 2011 and $727,000 for 2012) to the provision of safe and reliable utility service. I&E R.Exc. at 10; I&E Exh. No. 2, Schedule 13, at 2. I&E also states that while logic dictated that as the allocation of direct costs rose, the allocation of indirect costs should have decreased, because overall expenses of PPL Services for this account increased by only 0.8% I&E R.Exc. at 11.

iv. Disposition

Based upon our review of the record evidence, we shall reverse the ALJ's recommendation on this issue. I&E's position is based upon its opinion that this expense lacks any nexus to PPL's provision of safe and reliable utility service and that the proposed percentage increase would shift an inordinate portion to the rate-regulated entity, PPL, without express consideration of the broader nature of the function of the External Affairs Department. I&E has also taken the position that since there was a very small increase in the total expense, the significant rise in direct expenses should have caused the indirect expense allocation to shrink. As shown in the table above, the allocated indirect costs increased from 2011 to the FTY by 9.2%, or $116,000, while the total indirect and other expenses to be allocated increased by 75.0%, or $21.951 million.

PPL Exhibit DAC-1, Schedule 4, page 2, indicates that the indirect and other costs to be allocated increased from $29.241 million to $51.192 million from 2011 to the FTY. The $29.241 includes a Storm Insurance recovery of $15.501 million. Without this significant insurance recovery, the increase in this account would be only 14% or $6.45 million. I&E did not present any issue regarding the amount of indirect and other costs to be allocated until after it adopted PPL's explanation for the increase in direct assignment of costs relative to this account.

I&E's final position is to 'split the baby' by taking an average percentage of the jurisdictional expense level for 2011 and the FTY, as they are compared with the

total amount of expense as shown in the table above. We believe that this mathematical adjustment is not supported by I&E's contentions of an insufficient nexus or that the percentage increase in the direct assignment portion represents an excessive shift of expense to PPL, the regulated entity. Accordingly, we shall grant PPL's Exception and reverse the ALJ's recommendation on this issue.

c. Office of General Counsel

i. Positions of the Parties

Legal services to PPL Electric are provided by PPL Corporation's Office of General Counsel (OGC), and PPL's jurisdictional FTY claim for OGC is $6.083 million. I&E Exh. 2, Sch. 17 p. 2. According to I&E, PPL's claim is based on its HTY expense increased by $1.2 million in estimated costs for outside counsel fees related to this proceeding. Because of this, I&E recommended a ratemaking allowance of $4.833 million for OGC expense, which is a $1.2 million reduction to PPL's claim. The basis for I&E's adjustment is to eliminate the additional expense associated with outside counsel for this proceeding since the Company also includes a claim for rate case expense in its pro forma adjustments. I&E M.B. at 38.

PPL agreed with the adjustment but argued that it was more appropriate to eliminate the duplication from O&M expenses because the expense in question will be incurred by the OGC and then charged directly to PPL. PPL St. 8-R, at 41-42. PPL M.B. at 47.

I&E acknowledged PPL's acceptance of the expense reduction, but contended that it is appropriate to reflect the reduction as a part of the affiliate support allocation, and not as a rate case expense reduction. I&E M.B. at 39. I&E explained that keeping the expense as a part of PPL's affiliate support allocation will overstate the level of OGC affiliate support dedicated to the provision of electric distribution service in

years when there is no rate case. *Id.* In other words, ratepayers will be allocated an inflated portion of OGC expenses based upon rate proceeding expenses that are not provided annually or regularly by OGC. *Id.* Further, the overstated level of OGC affiliate support allocated to PPL in this proceeding will then be used in future proceedings to support similarly overstated OGC allocations. *Id.*

ii. ALJ's Recommendation

The ALJ found merit in I&E's rationale and recommended that in order to prevent the overstatement of legal expenses in non-rate case years, this reduction should be to the Affiliate Support (Direct) – Office of General Counsel expense claim. R.D. at 32.

iii. Exceptions

Exceptions were not filed by the Parties on this issue.

iv. Disposition

Finding it otherwise reasonable, we will adopt the recommendation of the ALJ. However**,** some accounting clarification is in order.

In PPL's Exhibit Future 1-Revised, Sch. D-6, an adjustment was made to O&M expenses to reflect its revision to rate case expense. In rebuttal testimony, PPL explained its adjustment. The original rate case expense claim of $2.025 million was normalized over a two-year period, providing for an annual expense of $1.013 million. Based upon opposing testimony, PPL revised this claim by removing the remaining $674,000, representing its 2010 rate case expense, and by $1.2 million, representing a duplicate entry. The $1.2 million was budgeted by the OGC for this proceeding. PPL St. 8-R at 42. With these two adjustments, PPL's original O&M expense claim of $1.687 million was revised to be a reduction to FTY O&M of $0.861 million. Based upon these

two adjustments, which include rate case expense and a direct assignment of cost from the OGC, PPL's reduction to its collective O&M expenses for the FTY would appear to be properly reflected in Exhibit Future 1-Revised.[7]

The adjustment proposed by I&E and recommended by the ALJ to reduce the OGC allocated expense and to leave the $1.2 million in rate case expense will not change the outcome of the revenue allowance in this proceeding. This proposed change would effectively reverse the decrease in rate case expense already included by PPL in its Future 1-Revised by $1.2 million and reduce the OGC expense by that same amount. The impact would be an increase in rate case expense of $1.2 million and a decrease in OGC expense of $1.2 million.

Accordingly, we shall adopt the recommendation of the ALJ on this issue.

3. Storm Damage Expense Recovery

i. Positions of the Parties

PPL revised its total storm damage expense recovery claim due to the unavailability of insurance beyond the FTY. PPL Exc. at 20-26. PPL stated that without storm damage insurance, PPL's initial FTY expense claim as it related to insurance is moot. PPL's revised FTY storm damage expense of $23.199 million includes the following: $17.875 million for annual storm damage expenses and a proposal to amortize over five years the extraordinary storm expenses in excess of insurance recoveries of $26.620 million incurred during major storms in August 2011, Hurricane Irene, and October 2011 at $5.324 million per year for five years. PPL Exc. at 24-25; PPL Exh. GLB-9.

[7] *See*, Exhibit Future 1-Revised, Schedule D-6.

PPL stated that among the details to be agreed upon before a rider may become effective are (1) provisions for interest on under and over collections; (2) timing of reconciliation; (3) reporting of storm damage expenses and revenue for their recovery; (4) methods for adjusting the annual level of the expense in rates; and (5) exact categories of storm damage expense that would be subject to the reconciliation. PPL M.B. at 71.

I&E recommended a simple five year average of total storm damage expenses, which would account for yearly fluctuations to determine an appropriate level of expense for ratemaking purposes. I&E's calculated five-year average of PPL's storm expenses from 2009 to 2011 inclusive is $23.785 million. I&E St. 2 at 35. I&E also recommended that PPL establish either a reserve account or a rider to recover storm damage expenses. I&E St. 2-SSR at 4-5.

ii. ALJ's Recommendation

The ALJ recommended that PPL be directed to establish a storm damage reserve account, as proposed by I&E, to be submitted to the Commission for approval. R.D. at 39. If approved by the Commission, the ALJ found that the reserve account should be implemented when the insurance coverage provided by PPL's present provider expires. The ALJ also recommended that the statutory advocates be included in the development of this storm damage reserve account. R.D. at 39. The ALJ also approved PPL's original storm damage expense claim of $26.699 million, which includes $12.625 million for annual storm damage expenses not covered by insurance, $8.75 million for insurance premiums and a five-year $5.324 million amortization of PPL's 2011 extraordinary storm damage expense claim.

iii. Exceptions

In its Exceptions, PPL supports the ALJ's recommendation to establish a reserve/tracker mechanism with reconciliation for over and under collections. PPL states that it intends to propose such a mechanism in a filing to be made as soon after the Commission decision in this proceeding as practicable. PPL will request that the proposal be given expedited consideration so that it can become effective at the earliest possible date. PPL Exc. at 23. PPL also revised its expense claim because it will be unable to purchase insurance beyond 2012. PPL Exc. at 24-26. PPL's revised claim is comprised of $12.625 million for expected storm damage not covered by current insurance; $5.25 million for the normal ongoing level of storm damage previously covered by insurance beyond 2012; and a five-year amortization of $5.324 million for the extraordinary loss incurred in 2011, for a total revised expense claim of $23.199 million.

In reply, I&E encourages the Commission to require PPL to meet with the statutory advocates to develop a rider within ninety days of Order entry. I&E R.Exc. at 13.

iv. Disposition

Based upon our review of the record and the Parties' Exceptions and Replies to this issue, we agree with the ALJ's recommendation to adopt I&E's proposal for PPL to propose a Storm Damage Expense Rider for Commission review. R.D. at 39. The issues to be discussed between PPL and the public advocates shall include, but not be limited to, the following: (1) provisions for interest on under and over collections; (2) timing of reconciliation; (3) reporting of storm damage expenses and revenue for their recovery; (4) methods for adjusting the annual level of the expense in rates; and (5) exact categories of storm damage expense that would be subject to the reconciliation. Additionally, we approve I&E's recommendation, and so direct, that PPL file a rider for

storm damage expense recovery within ninety days of the date of entry of this Opinion and Order. PPL has stated its intention to file as soon as practicable after the Commission's entry of a final decision in this proceeding.

Recovery of PPL's revised FTY storm damage expenses of $23.199 million shall be through base rates. Any recovery through a Storm Damage Rider shall be permitted only to the extent that such expense exceeds the amount included within base rates.

4. Payroll - Employee Complement

i. Positions of the Parties

PPL has proposed a budget for payroll based upon an employee complement of 2,002, which it states is necessary for the management and maintenance of the Company's transmission and distribution systems in order to meet the needs of customers. PPL St. 2-R at 8-9; PPL M.B. at 71.

The OCA has proposed reducing the payroll budget to allow for an employee complement of 1,943, which is PPL's average number of employees over the sixteen-month period prior to March 2012. OCA M.B at 18. The OCA's proposal would reduce PPL's FTY wages, payroll taxes and benefits by $3.740 million. OCA St. 1-REV at 17. In response, PPL asserted that it is in the process of filling 106 positions. PPL St. 2-R at 8; PPL M.B. at 72.

The OCA argued that the budgeted staff levels should be reasonably based on historic data. *See e.g., Pa. PUC v. PPL Gas Utilities Corporation,* 255 P.U.R. 4th 209, 242 (Pa. PUC 2007) (utility's complement claim was reasonable and supported by the record where at times the actual number of employees was greater than budgeted, because the number was supported by historic data). OCA M.B. at 18. The OCA also

noted that PPL's employee complement had declined from 1,974 in December 2010, to 1,943 in June 2012. OCA M.B. at 19. Thus, it is the OCA's opinion that since PPL had neither claimed nor proven that the lower complement had resulted in inadequate service, there is no evidence of record to support a need for the higher number of employees. OCA M.B. at 19.

ii. ALJ's Recommendation

The ALJ took notice that PPL's actual employee complement for the first three months of the FTY was, on average, seventy-one employees less than budgeted and that, as of June 2012, the Company's complement was 1,942, which was still one person lower than the OCA recommendation. OCA R.B. at 6. However, the ALJ found that PPL is most familiar with its own needs in terms of staffing, and that PPL's historical payroll supports a finding that the Company's claim is reasonable. R.D. at 41. Accordingly, the ALJ rejected the OCA's adjustment and recommended adoption of PPL's employee complement. *Id.*

iii. Exceptions

In its Exceptions, the OCA states that the ALJ erred in granting PPL's employee complement of 2,002 because, according to the OCA, it is not supported by the record. OCA Exc. at 9. The OCA further asserts that it is unlikely that PPL's complement will increase by three percent to achieve the budgeted 2,002 employee level by December 31, 2012. *Id.*at 11.

PPL replies that the OCA failed to recognize the appropriate level of staffing needed to maintain and manage PPL's system and instead relied upon a sixteen-month average complement ending March 2012 as the basis for its adjustment. PPL R.Exc. at 15.

iv. Disposition

We agree with the ALJ that PPL is most familiar with its needs in terms of staffing, and that PPL's historical payroll supports a finding that the Company's claim is reasonable. Further, we believe that the basis for the OCA's adjustment, while mathematically accurate, does not envision an appropriate level of staff needed to maintain and manage PPL's system. Accordingly, we shall deny the OCA's Exception on this issue.

5. Uncollectible Expenses

i. Positions of the Parties

PPL's total FTY uncollectible accounts percentage is 2.23%, representing an expense of $42.099 million. This amount includes expected write-offs plus any change in the reserve for doubtful accounts due to increased accounts receivable, which are subject to write-off. PPL M.B. at 72.

I&E's position is that PPL's proposed reserve allowance for uncollectible accounts expense should be rejected because that methodology is subject to manipulation and does not reflect PPL's actual expense or historic percentage write-off factor. I&E St. 2 at 5-6. Further, I&E stated that the Commission has no authority to permit recovery of hypothetical expenses not actually incurred by PPL, pursuant to *Barasch v. Pa. PUC,* 493 A.2d 653, 655 (Pa. 1985):

> Although the Commission is vested with broad discretion in determining what expenses incurred by a utility may be charged to the ratepayers, the Commission has no authority to permit, in the rate-making process, the inclusion of hypothetical expenses not actually incurred. When it does so,

as it did in this case, it is an error of law subject to reversal on appeal.

I&E's analysis presents PPL's actual net write-off uncollectible percentages from 2007 to 2011, which is based upon the following data supplied by PPL in response to interrogatory I&E-RE-10:

Actual Net Write-Off Uncollectible Percent				
2007	↑ 2008	↓ 2009	↓ 2010	↑ 2011
1.57%	1.72%	1.63%	1.49%	1.97%

I&E Exh. No. 2, Sch. 1 and 2; I&E MB at 22. Additionally, I&E stated that its analysis clearly showed that PPL's proposed 2.23% write-off factor is unsupported by record evidence. I&E notes that in determining the Purchase of Receivables program administrative factor percentage in PPL's 2010 base rate case, the ALJ found that use of a five-year average, as proposed by I&E here, is appropriate. *Id.* at 23 (citing *Pa. PUC v. PPL Electric Utilities Corporation,* Docket No. R-2010-2161694 (Order entered December 16, 2010)).

ii. ALJ's Recommendation

The ALJ concluded that PPL's use of a FTY permits forecasting in terms of using real data to forecast the final uncollectibles for 2012, which is sufficient to ensure that the Company's uncollectibles will be covered. Doubtful accounts, however, present an unmeasurable, and unsupported, factor which the ALJ disallowed. R.D. at 42.

I&E used five years of data in its calculation, which includes four years of recession and two years post-rate cap. The final I&E recommendation is based on the 2009-2011 three-year average, which is confirmed by I&E's five-year average, each yielding a 1.70% uncollectible rate. The ALJ stated that it is evident that the highest

historic percentage of uncollectible accounts between 2007 and 2011 is below PPL's requested 2.23% recovery rate. Further, the ALJ found that PPL's proposed increase in the uncollectible rate is unjustified. Accordingly, the ALJ found that the methodology and result proposed by I&E is reasonable and should be adopted by the Commission.

iii. Exceptions

In its Exceptions, PPL states that an historic three-year average, as proposed by I&E and recommended for approval by the ALJ, is not appropriate because it is inconsistent with the ongoing increase in write-offs over the last three years and because the three-year average is inconsistent with actual, current data. PPL Exc. at 30. PPL explains that the goal in this proceeding should be to set rates which reasonably reflect future conditions. The three-year average relied upon by the ALJ included 2009, when PPL's generation supply rates were capped. Since then, PPL's electric supply rates for provider-of-last-resort service have increased significantly, when compared to prior periods where the generation supply rate cap was in effect. Not surprisingly, PPL experienced increases in the number and dollar amounts of uncollectible accounts since the generation rate cap has ended. *Id.* In addition, PPL and its customers continue to experience the effects of the recession. *Id.* PPL, therefore, asserts that the unfavorable economic conditions adversely affect uncollectible accounts expense and the use of a three-year average where uncollectible accounts expenses are increasing will, by definition, understate current costs. Accordingly, PPL believes that there is no basis for using a three-year history to calculate PPL's FTY uncollectible accounts allowance. *Id.* Lastly, PPL excepts to the ALJ's disallowance of its proposed increase in bad debt reserve. PPL states that elimination of this adjustment would be improper because the reserve includes charges for the increase in accounts receivable that are subject to eventual write-off. *Id.* at 31.

In reply, I&E contends that PPL ignores the facts, cited by the ALJ, that the five-year average, commencing in 2007 and extending through 2011, includes not only two years of data following removal of the generation rate cap (2010 and 2011), but also four years of data from the continuing recession (2008, 2009, 2010, and 2011). I&E R.Exc. at 6-7. I&E believes that while citing an increase in the number of accounts and uncollectible dollars from 2009 through 2011, PPL has misconstrued those facts to claim there is an ongoing increase over the last three years. I&E R.Exc. at 7.

I&E also contends that the facts do not support PPL's claimed 2.23% uncollectible accounts expense rate unless the Commission looks at only a snapshot of six months of experience in the first part of the FTY and then extrapolates that to an assumed level. I&E R.Exc. at 7. However, I&E notes that this Commission has never calculated an allowed uncollectibles expense rate on this basis. *Id.* Further, I&E claims that its calculation comports with the Commission's Regulations, the Company's own calculation of other claims, and PPL's calculation of its uncollectibles expense in both its 1985 and 2010 rate cases. *Id.* I&E submits that PPL's claims that the ALJ's allowance understates PPL's experience and that a three-year average fails to reflect ongoing increases is inaccurate. *Id.*

iv. Disposition

Based upon our review of the record evidence, the ALJ's recommendation and the Exceptions and Replies filed thereto, we shall adopt PPL's position on this issue as it reflects the level of uncollectible accounts on a going forward basis. In this proceeding, a FTY is the basis for ongoing utility expenses. We believe that I&E's historic analysis, although used by the Commission in prior decisions, is not warranted in this instance as it will not reasonably reflect future conditions. Accordingly, we shall deny I&E's Exception on this issue.

6. Revised Rate Case Expense and Normalization Period

i. Positions of the Parties

PPL's original rate case expense of $1.687 million for the FTY was comprised of $2.025 million for the instant proceeding and $674,000 as an amortization recovery of its 2010 base rate case expense. PPL proposed to recover the $2.025 million over a two-year period, or $1.013 million per year. This two-year normalized amount of $1.013 million plus the amortization portion of $674,000, totaled $1.687 million. Subsequently, PPL revised its rate case expense claim to remove its proposed amortization expense of $674,000 and $1.2 million, which PPL inadvertently included in both rate case expense and PPL Services-Office of General Counsel. These two adjustments have been reflected in PPL Exhibit Future 1-Revised, Schedule D-6, and result in a reduction to O&M expense of $861,000.

PPL proposed a two-year normalization period to recover the rate case expense associated with the instant proceeding and argued that a two-year recovery period was appropriate given the pressure that its capital spending program will place on earnings. PPL's planned rate base capital expenditures of approximately $1.7 billion over the next two calendar years represent an increase in PPL's total net measure of value as of December 31, 2012, exceeding fifty percent. PPL MB at 76. PPL asserted that with such a significant capital investment over the next two years, it seems more likely than not that its next base rate case could be filed during or before 2014. Further, PPL stated that even though it may request a distribution system improvement charge (DSIC), that mechanism is capped at five percent of revenue, which would do little to offset the incremental revenue requirement associated with the significant investment in rate base projected over the next two years. For these reasons, PPL believes that a two-year normalization of rate case expense is appropriate. *Id.*

The OCA advocates using a three-year period because PPL's last three rate cases filed in 2004, 2007, and 2010, were held exactly three years apart. The OCA's position is that it is the historical filings, not the actual intentions of the utility, which will guide the determination of the normalization period. OCA M.B. at 26. (citing *Pa. PUC v. City of Lancaster,* Docket No. R-2010-2179103 (Order entered July 14, 2011); *Pa. PUC v. Metropolitan Edison Company,* Docket No. R-00061366 (Order entered January 4, 2007)).

I&E agreed that the normalization period should be determined by the historical filings and, accordingly, recommended a thirty-two month normalization period based upon PPL's last four base rate filings.

Thus, I&E's recommended allowance for expenses associated with the instant rate proceeding is $759,375. This is calculated by dividing PPL's $2.025 million rate case expense claim by thirty-two months and then multiplying the result by twelve months to arrive at a normalized level of expense. [$2,025,000 / 32 months = $63,281.25; $63,281.25 x 12 months = $759,375] This reduces PPL's FTY claim by $253,625. ($1,013,000 - $759,375 = $253,625).

ii. ALJ's Recommendation

PPL has agreed to two adjustments regarding its claimed rate case expense. First, PPL has removed the prior base rate expense claim of $647,000 from its FTY total. Second, PPL has removed from total FTY expenses the $1.2 million double count of rate case expense as described above.

As discussed above,[8] the ALJ recommended the double count of $1.2 million of legal fees included by PPL in both its rate case expense claim and its PPL Services-OGC, be removed from the PPL Services expense and not the rate case expense as requested by PPL.

Regarding the normalized recovery period for allowable rate case expense, the ALJ found that the OCA and I&E used the appropriate historic analysis methodology. The ALJ found I&E's analysis to be more accurate because it used the filing date of each of the last four base rate cases to develop a normalized period reflective of PPL's actual base rate filing frequency. Therefore, the ALJ recommended adoption of I&E's thirty-two month recovery period.

iii. Exceptions

In its Exceptions, PPL notes that in late 2008, it conducted a comprehensive study to assess the age, condition and performance of plant in order to develop a strategy for capital replacements in order to avoid the cost and reliability of service effects of aging infrastructure. Based on this study, PPL embarked on a ten-year capital plan to replace, maintain and improve plant and anticipates adding $1.6 billion in plant from 2012 through 2016. Rate case history prior to 2010 does not reflect this construction program. PPL believes that plant expenditures of this magnitude will necessitate a base rate case within two years, if not sooner. Based upon PPL's capital improvement plan, PPL also believes it is unreasonable to rely on an historic pattern of rate cases that extends back eight years to 2004 to determine the appropriate period for normalization of rate case expenses. PPL Exc. at 35.

In reply, I&E states that citing no error by the ALJ, PPL repeats the same argument rejected by the ALJ, namely, that because of infrastructure plans, rate case

[8] See discussion in the Office of General Counsel section above.

history prior to 2010 is not an accurate reflection of the Company's future rate case plans. I&E R.Exc. at 8.

I&E explains that the law is well-settled that, absent exceptional circumstances, rate case expense is normalized based upon a party's filing history and not its presently stated intentions, no matter how unequivocally declared. *Id.* (citing *Popowsky v. Pa. PUC*, 674 A.2d 1149, 1154 (Pa. Cmwlth. 1996); *Pa. P.U.C. v. Borough of Media Water Works*, 72 Pa. P.U.C. 144 (1990)). I&E believes that there are no exceptional circumstances here. Conversely, I&E asserts that there are mitigating circumstances in the form of the effect of the DSIC. *Id.*

I&E contends that PPL has been finely attuned to its infrastructure needs since 2004 when it began regularly filing rate cases and, contrary to PPL's characterization, the current infrastructure improvement plan is not a sudden development that renders its recent rate case history irrelevant. *Id.* I&E notes that, recently, the Commission rejected a similar argument in which the Borough of Quakertown disputed a seven-year normalization based on filing history because anticipated intensive capital construction was under contract and had broken ground with an estimated 2013 completion date. *Id.* In affirming the ALJ, the Commission found that if the Borough filed sooner it "may be appropriate to consider a shorter normalization period going forward." *Id.* (citing *Pa. PUC v. Borough of Quakertown*, Docket No. R-2011-2251181 (Order entered September 13, 2012)).

iv. Disposition

Based upon our review of the record established in this proceeding, the ALJ's recommendation, the Exceptions and the Replies filed thereto, we shall reverse the ALJ and grant the Exception of PPL on this issue. As previously discussed, this proceeding is premised upon a FTY and, based upon that criterion, certain expenses may

now be based upon future expectations. We believe that the normalization period for rate case expense is one of those expenses. We fully support PPL's capital expenditure program and expect that it will proceed into the future as explained by PPL. Further, we can reasonably expect that PPL will file its next base rate case much closer to a twenty-four month interval than to a thirty-two month interval as proposed by I&E and the OCA. Accordingly, we shall grant the exceptions of PPL on this issue.

7. CEO's Proposed Increase in LIURP Funding

i. Positions of the Parties

PPL has proposed no changes in its universal service programs (USPs) nor to the funding for them, as these are subject to separate proceedings. *PPL Electric Utilities Corporation Universal Service and Energy Conservation Plan for 2011-2013,* Docket No. M-2010-2179796 (Order entered May 5, 2011). This was a litigated proceeding, with the participation of interested parties.

PPL's USPs include OnTrack (PPL's customer assistance program), WRAP (PPL's free weatherization program or Low Income Usage Reduction Program), Operation Help (PPL's hardship fund for customers with incomes at or below 200 percent of the federal poverty level, and CARES (PPL's Customer Assistance and Referral Evaluation Services, which connects customers with local community based organizations offering short-term help to customers at or below 200 percent of the federal poverty level). PPL St. 9 at 3-4.

PPL's currently effective USPs were approved by Commission Order entered May 5, 2011, at Docket No. M-2010-2179796, and run through December 2013. In June 2013, PPL will submit to the Commission for review and approval its USP plan for years 2014 through 2016, and will include therein proposals for any necessary or

appropriate changes to the current programs and services available to low-income customers. PPL M.B. at 77.

CEO argued that PPL's last increase of $250,000 in the 2011-2013 USP case was inadequate to serve the needs of the low-income customer base and suggests that funding increase from $8.0 million to $9.5 million for PPL's WRAP Program. CEO disagreed with PPL's position that a base rate case is not the proper place for this argument, citing former rate cases that have evaluated the low-income plan budgets.

CEO pointed out that the funding for WRAP increased only 3% in the USP case, which translates into an additional 106 customers per year at the average cost of $2,349, an increase not consistent with the increased number of low income customers in PPL Electric's territory, which CEO argues is 44% based on the 2008 census. CEO M.B. at 5; CEO St. 1 at 7. CEO continues that the usefulness of a well-funded LIURP program has long been recognized by the Commission as a tool for lowering heating bills, thus creating a heating bill that the customer is more likely to pay. CEO M.B. at 5-6. In addition, CEO states that the higher prices resulting from this proceeding will be effective January 1, 2013, a full year prior to the end of the effective period from the current USP case. CEO R.B. at 2. It is CEO's opinion that refraining from addressing this issue now will deprive low-income customers of timely relief from a rate increase. CEO R.B. at 3.

PPL countered that the increase in low-income customers in its service territory should not be viewed in isolation. Rather, consideration needs to be given to the cost impact on other residential customers, the ability of the community based organizations (CBOs), which administer the programs, to deliver additional services, and the availability of funding from other sources. PPL advocated for the consideration of all of these issues within the triennial filings for approval of the plans themselves, where all entities involved may participate. PPL St. 9-R at 6; PPL M.B. at 79.

I&E opposed CEO's proposal because it fails to consider the total increase in the funding of universal service benefits in recent years. Since 2004, over three base rate cases, the funding for the OnTrack program increased from $9.5 million to $41.2 million, and from 2000 to 2008, weatherization funding grew from $5.7 million to $8 million. I&E M.B. at 66-67. I&E stated the following:

> Through 2012 PPL ratepayers will be compelled to contribute $75.35 million annually to the funding of PPL's USP benefits. That mandatory ratepayer funding is projected to increase to $78 million by 2014. The trajectory of mandatory ratepayer funding of PPL's universal service benefits has skyrocketed upward, increasing 122% from 2008 to 2011 and projected to increase by 145% through 2014. I&E submits that PPL's ratepayers are contributing sufficiently towards relief for their low-income neighbors. PPL's LIURP funding should remain at its current $8 million.

I&E M.B. at 68.

ii. ALJ's Recommendation

The ALJ found that base rate cases are the traditional forum for budgets of low-income plans, but in recent years, the Commission has required companies to file separate cases to address the USP budgets. R.D. at 44-45. PPL has a Commission-approved plan in place, including a budget. R.D. at 45.

The ALJ continued by observing that the USPs for EDCs, including PPL, are filed every three years and concentrate on the programs included in the customer assistance portfolio. After noting that, in a base rate case, any part of the Company's tariff may be brought into question, the ALJ stated that as an issue raised by another party, the burden of proving that the universal service issues deserve additional funding belongs to the party raising it – here, CEO. *Id.*

The ALJ concluded that the Commission's institution of separate proceedings for these plans is indicative of a preference to address the issues within those proceedings. Therefore, the ALJ recommended that CEO's proposed increase in funding be denied. However, the ALJ encouraged CEO to participate in the triennial plan reviews. *Id.* at 46.

iii. Exceptions

In its Exceptions, CEO submits that the Commission has a statutory duty to ensure that a company's USPs are appropriately funded and available. Further, CEO contends that a proceeding that results in a rate increase to low-income customers would require the Commission to determine the effect of the rate increase on whether those USPSs are, or remain, appropriately funded and available. CEO Exc. at 6. CEO alleges that to postpone consideration of universal service funding to a time after a rate increase takes effect, and to a non-adversarial proceeding, is contrary to the Commission's past practice and its statutory duty. *Id.*

PPL responds that the ALJ properly rejected CEO's proposal because the USP costs are no longer recovered through base rates. PPL R.Exc. at 22-23. I&E also supports the ALJ's recommendation on this issue. I&E R.Exc. at 14-15.

iv. Disposition

We agree with the ALJ, PPL and I&E on this issue. Recent Commission practice is to address all aspects of USPs through the triennial filing process and to collect all revenues through a rider to base rates. We believe this process has provided, and will continue to provide, the customers who rely upon USPs with appropriate funding levels on a timely basis. Accordingly, we deny the Exceptions of CEO on this issue.

8. Consumer Education Expenses

i. Positions of the Parties

PPL's consumer education program was mandated and authorized by the Commission's Final Order in *PPL Electric Utilities Corporation Consumer Education Plan for 2008-2012,* Docket No. M-2008-2032279 (Order entered July 18, 2008), which was designed to communicate Energy Education Standards to customers. The goal was to educate consumers in each EDC's service territory regarding (1) the expiration of rate caps; (2) ways to reduce energy consumption and, thereby, lower bills; and (3) the availability of retail competition.

PPL's FTY consumer education expense claim of $7.976 million is comprised of $5.482 million associated with the final year of PPL's Commission-approved Consumer Education Plan (CEP), plus $2.494 million for three Retail Markets Investigation (RMI) mailings and customer protections regarding the Eligible Customer List (ECL), which PPL proposed to collect through a CER. PPL St. 5-R at 28-29.

I&E and the OCA opposed portions of PPL's proposal. I&E pointed out that PPL's proposed CER is designed to recover costs of the RMI initiatives, and that any costs related to education regarding those initiatives should be recovered through that rider and not included in base rates. While I&E does not object to recovery of the Commission mandated RMI costs and costs related to the ECL mailings, it notes that these should be recovered under the CER, if it is approved, and removed from base rates. I&E points out that the Commission and its EDCs are moving into the next phase of retail competition and that shopping and energy efficiency are more effectively addressed by the Act 129 Energy Efficiency and Conservation (EE&C) Plan and the RMI mandates. These are funded through the Act 129 Rider and the proposed CER. I&E St. 2 at 44; I&E M.B. at 62-63.

The OCA recommends that the Company's consumer education funding be set at $5,400,000, annually, based on the budget amount approved in the 2008-2012 Consumer Education Plan. OCA MB at 29.

ii. ALJ's Recommendation

The ALJ found that the Commission's mandates must be funded, and the issue here is the best method of funding. While PPL must be reimbursed fully for its prudent expense, there must be a limit to the amount that should be spent. The ALJ concluded that the I&E proposal to recover the costs through a CER is the best choice, as it fully funds the Commission's mandates but does not waste ratepayer money on duplication.

Accordingly, the ALJ recommended that funding for PPL's CEP lapse at the end of the FTY and that the education costs of $2.494 million incurred in carrying out the RMI mandates be recovered using the CER and, thus, removed from the allowed increase in base rates associated with this proceeding. R.D. at 49.

iii. Exceptions

In its Exception, PPL explains that the ALJ would disallow complete recovery of costs associated with PPL's Commission-approved Consumer Education Plan, which promotes and encourages the competitive retail market for electric generation in PPL's service territory and encourages conservation, beyond 2012. PPL Exc. at 26. The issue presented here, as viewed by PPL, is whether the Commission recognizes the need for the Energy Education Standards established in the Commission's Final Order on *Policies to Mitigate Potential Electricity Price Increases*, at Docket No. M-00061957, and wants the Consumer Education Plan to continue. According to PPL, if the Plan is to continue, the Commission should approve PPL's claim of $5.482 million for that Plan, in

addition to other consumer education expenses. If not, PPL states that the ALJ's recommendation should be adopted on this issue, and PPL will discontinue the program. *Id.*

I&E rejoins that despite PPL's assertion otherwise, the Act 129 Plan provides both financial incentives as well as education about energy efficiency, rendering the CEP duplicative. *See* I&E St. 2-SR at 47-48, citing PPL's *Final Report for Year 2 of PPL Electric Utilities Corporation's Act 129 Plan,* at Docket No. M-2009-2093216. I&E R.Exc. at 14. In addition, I&E states that while the specific activities and programs may differ, the goals under all of these programs are the same: (1) to educate customers about shopping and efficiency; and (2) to provide financial incentives to modify behavior. Accordingly, I&E continues to urge that PPL's five-year plan and its $5.4 million annual cost should be allowed to lapse naturally at the end of year 2012. *Id.*

iv. Disposition

As discussed above, we agree that Commission mandates must be funded. With regard to the recovery of Act 129 costs, we believe that it is proper to recover these costs through a rider to base rates. It is unknown whether the Act 129 expenses discussed in this section will be in place for many years or for only a few years, which supports recovery through a rider to base rates. Accordingly, we shall approve the education costs incurred in carrying out RMI mandates as expenses to be recovered through the CER Rider.

Regarding continued recovery of PPL's CEP costs of $5.482 million, we find that the record supports allowing these pre-Act 129 expenses to lapse at the end of the FTY. Accordingly, we shall deny the Exceptions of PPL on this issue and reduce PPL's O&M expenses by $5.482 million.

9. CAP (Customer Assistance Program) Outreach

i. Positions of the Parties

In its Exceptions, the OCA states that the ALJ did not address its recommendations regarding CAP outreach initiatives. OCA Exc. at 12-13. The OCA proposed three specific outreach initiatives: (1) that PPL engage in a direct-contact outreach program aimed at a population of customers that are both confirmed low-income and 120 days or more in arrears; (2) that all shut-off notices to confirmed low-income customers be modified so that they also contain a notice of CAP availability and the means of accessing CAP; and (3) that PPL engage in a direct-contact outreach program focused on customers 120 days or more in arrears whether or not those customers are confirmed low-income customers. OCA St. 4 at 33-34; OCB M.B. at 115.

PPL noted that it is not opposed to modifying its termination notice to include information about CAP so long as it does not add another page to the termination notice because that would increase the cost. PPL St. 9-R at 22. Further, PPL would not consider a requirement to have two separate termination notices, one for confirmed low-income customers and one all other residential customers. *Id.* at 23. PPL further stated that it is willing to propose the content and format of the new information on the termination notice and review it with Commission staff and interested Parties. *Id.*

Regarding the OCA's first and third recommendations, PPL states that these should not be adopted. PPL asserts that its current outreach programs are sufficient and that the OCA has not provided evidence that more outreach is needed to contact confirmed low-income customers who are 120 days or more in arrears. PPL St. 9-R at 22. Further, most residential customers with overdue balances or terminated accounts call PPL to address their concerns. *Id.* at 23. Depending on a customers' status in the collection process, PPL has concerns about sending them a mixed messages regarding the

requirements stated in the collection notices versus the content of the targeted outreach. *Id.* at 23-24.

ii. ALJ's Recommendation

As noted by the OCA, the ALJ's Recommended Decision did not address this issue.

iii. Disposition

Based upon the testimony of the Parties, we shall grant the OCA's Exception, in part, with regard to its second recommendation that shut off notices to confirmed low income customers include information about CAP. However, we expressly acknowledge and accept PPL's willingness to propose the content and format of the new information on the termination notice and review it with Commission Staff and interested Parties. We encourage PPL to proceed in a timely manner, in this regard. Further, PPL should submit its proposed content and format of the new notice to the OCA and the Commission's Bureau of Consumer Services for review. Lastly, we agree with PPL that their current outreach programs, as discussed in testimony, are well designed and that the OCA has not provided sufficient evidence to support its first and third recommendations. Accordingly, we shall grant the OCA's exception in part, as discussed above.

E. Rate of Return

1. Introduction

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

PPL

Capital Type	Percent of Total %	Cost Rate %	Weighted Cost %
Debt	48.98	5.58	2.73
Common Equity	51.02	11.25	5.74
Total	100		8.47

PPL St. 11, Exh. PRM-1, Sch. 1.

PPL modified its overall return to reflect the actual issuance of $250 million of long-term debt on August 24, 2012, at an interest rate of 2.61%. This update resulted in the following revised rate of return position of PPL:

PPL Revised

Capital Type	Percent of Total %	Cost Rate %	Weighted Cost %
Debt	49.22	5.50	2.71
Common Equity	50.78	11.25	5.71
Total	100		8.42

PPL M.B. at 91.

OCA

Capital Type	Percent of Total %	Cost Rate %	Weighted Cost %
Debt	52.84	5.58	2.95
Common Equity	47.16	9.00	4.24
Total	100		7.19

OCA St. 2, Exh. SGH-1, Sch. 11 at 1.

I&E

Capital Type	Percent of Total %	Cost Rate %	Weighted Cost %
Debt	54.89	5.58	3.07
Common Equity	45.11	8.38	3.77
Total	100		6.84

I&E St. 1 at 12.

The Company argued that the public advocates' recommendations relied on historically low interest rates instituted during the recent recession in an attempt to justify returns on common equity that are far below any allowed by this Commission in decades. Even in these difficult financial times, allowed ROEs have ranged between 9.75% and 10.99%. PPL M.B. at 87-88; PPL St. 12-R at 3-5. The Company averred that if either of these is adopted, Pennsylvania utilities will be placed at a disadvantage compared to other utilities in the country in terms of raising capital during what it terms to be a critical infrastructure replacement phase, PPL St. 12-R at 3-5, as well as at risk for another downgrade in its credit rating.[9] Of course, accompanying this would be higher debt costs and potential limits to access to capital in difficult markets. PPL M.B. at 87-88.

2. Capital Structure

Capital structure involves a determination of the appropriate proportions of debt and equity used to finance the rate base. This is crucial to developing the weighted cost of capital, which, in turn, determines the overall rate of return in the revenue requirement equation.

[9] Note that in presenting its 2004 rate case, PPL had an A minus rating, which it sought to retain at that time. *See,* Docket No. R-00049255, Recommended Decision of Administrative Law Judge Allison K. Turner, at 94.

a. Positions of the Parties

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

Capital Type	**PPL (1)**	**I&E (2)**	**OCA (3)**
	(%)	**(%)**	**(%)**
Debt	49.22	54.89	52.84
Common Equity	50.78	45.11	47.16
Total	100.00	100.00	100.00

(1) PPL M.B. at 91 fn. 16
(2) I&E St. 1 at 12
(3) OCA St. 2 at 25

As noted above, PPL proposed the use of its actual capital structure of 49.22% long-term debt and 50.78% common equity. According to the Company, the legal standard in Pennsylvania for deciding whether to use a hypothetical capital structure in setting rates is that if a utility's actual capital structure is within the range of a similarly situated barometer group of companies, rates are set based on the utility's actual capital structure. PPL stated that only if the capital structure is atypical, outside of the range of the barometer group, should a hypothetical capital structure be used to set rates for a utility. PPL R.B. at 41 (citing *Pa. PUC v. City of Lancaster – Water,* 1999 Pa. PUC Lexis 37 at *17; *Pa. PUC v. City of Bethlehem,* 84 Pa. P.U.C. 275, 304 (1995); *Carnegie Natural Gas Co. v. Pa. PUC,* 433 A.2d 938, 940 (Pa. Cmwlth. 1981) (where a utility's actual capital structure is too heavily weighted on either the debt or equity side, the Commission must make adjustments)).

Both I&E and the OCA sought to utilize a hypothetical capital structure in this proceeding. I&E stated that a capital structure should be representative of the

industry norm and be an efficient use of capital. According to I&E, the use of a capital structure that is significantly outside the range of the industry's capital structure may result in an overstated overall rate of return. I&E advocated for the use of a hypothetical capital structure based upon an industry average for ratemaking purposes if the use of the utility's actual capital structure has the potential to overstate the overall cost of capital. I&E M.B. at 82.

The OCA submitted that the Commission should adopt a hypothetical capital structure for PPL as the Company's proposed capital structure is unnecessary to attract capital and would create an unreasonable cost burden for ratepayers. The OCA averred that its proposed capital structure of 47.16% equity and 52.84% debt is reasonable, consistent with how PPL has been capitalized over the last few years prior to this current rate filing, and similar to the manner in which the electric industry is capitalized. The OCA noted that of particular concern in this case is the percentage of common equity in the capital structure, since common equity commands a higher return than debt financing. OCA M.B. at 32-42

The I&E and the OCA recommendations to utilize a hypothetical capital structure are based upon use of a barometer group of companies with characteristics similar to PPL. The three Parties' barometer groups all contain comparison companies which are higher and lower than PPL's capital structure in this case.Error! Bookmark not defined. A barometer (or proxy) group is a group of companies that act as a benchmark for determining the utility's rate of return. I&E M.B. at 79. I&E noted that a barometer group is necessary because PPL is a private wholly owned subsidiary of PPL Corp. and is not publicly traded. According to I&E, using data from a group of companies is more reliable than data from a single company in that it smooths short-term anomalies and the use of a barometer group satisfies the long-established principle of utility regulation that seeks to provide the utility the opportunity to earn a return equal to that of similar companies with corresponding risks. I&E M.B. at 79 – 80.

PPL selected two barometer groups, an Electric Distribution Group (EDG) and an Integrated Electric Group (IEG). PPL's EDG group was based upon the following criteria:

1. Their stock is traded on the New York Stock Exchange;

2. They are listed in the Electric Utility (East) section of *The Value Line Investment Survey*;

3. They are not currently the target of a publicly-announced merger or acquisition; and

4. They do not have a significant amount of electric generation.

PPL's criteria for its IEG are identical except for criterion four, which requires that at least 75% of the companies' identifiable assets are subject to public regulation. PPL St. 11 at 4-5.

I&E used a barometer group comprised of Consolidated Edison, Dominion Resources, Nextera Energy, TECO Energy, PEPCO Holdings, and UIL Holdings. I&E St. 1 at 9-11. These were chosen by I&E based on the following criteria:

1. 50% or more of the company's revenue were generated from the electric distribution industry;

2. The company's stock was publicly traded;

3. Investment information for the company was available from more than one source;

4. The company was not currently involved/targeted in an announced merger or acquisition; and

5. The company had six consecutive years of historic earnings data.

I&E M.B. at 80.

The equity ratios for I&E's barometer group for 2011 range from 39.34% equity to 52.47% equity. I&E Exh. 1, Sch. 1 at 2. I&E then averaged the companies in its barometer group and developed a hypothetical capital structure based upon the average of 54.89% long-term debt and 45.11% equity for the FTY, or 55% debt/45% equity. I&E M.B. at 82.

The OCA used sixteen companies that had at least 70% of revenues from electric operations, did not have a pending merger, did not have a recent dividend cut, had stable book values and a senior bond rating between "A" and "BBB-". The OCA used "wires" companies as well as those with generation, and all were listed in *Value Line*. OCA St. 2 at 29-30. OCA M.B. at 52.

I&E argued that PPL's selected EDG and IEG barometer groups are flawed. According to I&E, Northeast Utilities must be excluded from PPL's EDG and Duke must be excluded from its IEG because their inclusion violates the Company's own presumably objective criteria number three in that Northeast is the subject of an announced merger with NSTAR and Duke is the subject of an announced merger with Progress Energy. I&E M.B. at 81. Also, I&E maintained that TECO Energy and Dominion Resources should be excluded from the Company's IEG and, instead, included in its EDG, because they derive more than 50% of their revenues from their regulated electric distribution sector. I&E further contended that the Company's IEG group should be disregarded in its entirety, because the group is too dissimilar in terms of business lines to be comparable to PPL in this proceeding. Specifically, I&E stated that PPL does not have regulated generation or gas distribution, properties common to SCANA Corp.

and Southern Co. included in the IEG, and neither company's revenues are derived more than 50% from electric distribution only. I&E St. 1 at 11-12. I&E M.B. at 80-82.

I&E asserted that PPL's claimed capital structure, if left unadjusted, overstated its capital needs by $15 million. I&E M.B. at 83. According to the OCA, the Company's equity-rich common equity ratio would cost its ratepayers an additional $10.6 million annually compared to the more economically efficient capital structure it has employed in recent years. OCA M.B. at 41.

b. ALJ's Recommendation

The ALJ concluded that the appropriate capital structure is the Company's actual capital structure of 49.22% long-term debt and 50.78% common equity. R.D. at 60.

c. Exceptions

In its Exceptions, the OCA states that PPL's proposed capital structure is unnecessarily burdensome to ratepayers, contains more common equity capital than the electric industry on average and is inconsistent with how PPL has been capitalized over the last several years prior to this rate case being filed. The OCA avers that its proposed capital structure of 47.16% equity/52.4% debt is reasonable, consistent with how PPL has been capitalized over the last few years and similar to the manner in which the electric utility industry is capitalized. The OCA notes that PPL's proposed capital structure is not really an "actual" capital structure, but rather a projection based on 2012 year-end data. OCA Exc. at 12-13.

Next, the OCA avers that the ALJ erred by finding that PPL's capital structure is not atypical, as the Company's proposed capital structure contains

significantly more equity than comparable utilities. According to the OCA, the average common equity ratio for publicly-traded electric and combination gas and electric utilities is 45.9% as reported by AUS Utility Reports in its May 2012 publication. Also, the OCA submits that the average common equity ratio of PPL's IEG sample group, and the S&P Public Utilities was 44.4% and 45% in 2010, respectively. The OCA opines that these ratios are far below the 50.78% common equity ratio requested by PPL. According to the OCA, the Company's own barometer group shows that a 45% common equity ratio is common in the industry for publicly traded companies. OCA Exc. at 13-14.

The OCA submits that Pennsylvania courts have upheld the use of a hypothetical capital structure where the utility's management adopts an actual capital structure that imposes an unfair cost burden on ratepayers. The OCA refers to *T.W. Phillips Gas and Oil Co. v. Pa. PUC,* 474 A.2d 355, 362 (Pa. Cmwlth.1984) and *Carnegie Natural Gas Co. v. Pa. PUC*, 433 A.2d 938 (Pa. Cmwlth. 1981) as support for its assertion. OCA Exc. at 14.

Next, the OCA reiterates that PPL's average common equity ratio from 2006 through 2010 was 43.7% of permanent capital per PPL's Exhibit PRM 1, Schedule 2. According to the OCA, PPL's requested ratemaking capital structure contains considerably more common equity than that with which it has been successfully capitalized historically. The OCA states that PPL plans to reduce its reliance on preferred stock and increase its reliance on more expensive common equity by means of a $150 million capital contribution to PPL by its parent company, which is a management decision at PPL Corporation that changes the regulated capital structure of PPL. The OCA avers that this new test year capitalization will cost the Company's ratepayers approximately $10.6 million more every year than the capital structure the Company has relied on for many years. The OCA submits that ratepayers should not bear this unnecessary and unfair burden and that the ALJ's recommendation should be rejected. OCA Exc. at 14-15.

I&E also excepts to the ALJ's recommendation on capital structure, stating that the ALJ erred in not applying a more cost-efficient capital structure for PPL, using I&E's calculated industry average, particularly because PPL's more expensive equity ratio is assigned by its affiliate. I&E avers that a hypothetical capital structure based upon an industry average should be used for ratemaking purposes if use of the utility's actual capital structure has the potential to overstate the overall cost of capital. I&E recommends a hypothetical capital structure based upon its industry average of 54.89% long-term debt and 45.11% equity for the FTY. According to I&E, PPL's proposed capital structure is neither representative of the industry norm nor an efficient use of capital. I&E Exc. at 15-16.

I&E submits that while the differences between PPL's and I&E's proposed capital structures are nuanced, PPL's actual capital structure includes sufficiently more expensive equity than less expensive debt, such that I&E's proposed adjustment is appropriate. According to I&E, imposing the industry average capital structure upon PPL saves ratepayers an annual $15 million while still providing the Company competitive and effective means to finance its capital needs. This is particularly true, alleges I&E, given today's economic environment where debt rates have been and remain at all-time lows, and where PPL's capitalization is controlled by its affiliate, which is financially accountable to PPL's corporate parent and not PPL's ratepayers. I&E offers that if the corporate family is unwilling to take advantage of historically low interest rates to benefit its affiliated rate-regulated entity's ratepayers, then it is incumbent upon this Commission to do so. I&E Exc. at 17.

Next, I&E avers that contrary to PPL's characterization, the legal standard for employment of a hypothetical capital structure is not that the actual capital structure is "atypical." Rather, I&E maintains that use of a capital structure that is representative of the industry average presents a better option for PPL's efficient capitalization than the

capital structure assigned to PPL by its corporate family. According to I&E, use of a barometer group average is more reliable than comparing data from individual companies as individual company data may be subject to short-term anomalies that distort its return on equity. I&E notes that its industry average, as well as the common equity ratio averages from PPL's own barometer groups (44.8% for EDG, 45.1% for IEG and 45.3% for the S&P Public Utilities) more closely support I&E's recommended capital structure of 45% equity and 55% debt. I&E Exc. at 18.

In conclusion, I&E submits that while it agrees that PPL's actual capital structure does not deviate substantially from the industry range, the applicable legal standard is not that the capital structure must be "atypical" before a hypothetical structure should be considered. I&E notes that Commission decisions have specifically avoided setting numeric standards to define efficient capital structures, instead using standards such as "in proper proportions," "on balance," and not "too heavily weighted" one way or another. I&E opines that a $15 million ratepayer expense based solely upon a capital structure chosen by the same PPL affiliates that benefit from the profitability of the rate regulated entity is unfair and unreasonable to ratepayers because it can be moderated without financial harm to PPL through a minor adjustment to the rate-regulated entity's capital structure. Therefore, I&E requests that its capital structure be adopted to impartially achieve a fair balance of ratepayer and shareholder interests. I&E Exc. at 21-22.

In reply, PPL states that the ALJ's recommendation should be accepted as its actual capital structure is not atypical and, pursuant to precedent, provides no basis to employ a hypothetical capital structure. Also, PPL states that it requires an equity ratio near the high end of the historic range employed by the barometer group companies to support its expanded infrastructure replacement program and its credit rating. According to PPL, the OCA and I&E misstate the circumstances that authorize the use of a hypothetical capital structure. PPL avers that both Parties rely on statements in cases

where the utility's equity ratio was outside the range of the equity ratios of barometer group companies to contend that a hypothetical capital structure should be employed in this proceeding where the actual equity ratio is clearly within the historic range of equity ratios employed by barometer group companies. PPL opines that while the cases cited identify the Commission's power to employ a hypothetical capital structure where the actual capital structure is extreme and atypical, they do not address how to determine when the actual capital structure is atypical. PPL R. Exc. at 3-4.

Next, PPL avers that its equity ratio is not atypical and provides no basis for use of a hypothetical capital structure and that its equity ratio is necessary to support its ability to attract capital and maintain its credit rating. PPL maintains that these are important considerations as it continues to ramp up its infrastructure replacement program. PPL avers that the OCA and I&E are ignoring the fact that PPL's unsecured bond was downgraded from Baa1 to Baa2 by Moody's Investors Service in April of 2010 due to Moody's opinion that PPL's cash flow metrics will decline from their recent levels due, in part, to the increased expenditures for capital investments needed to maintain PPL's aging delivery systems. According to PPL, the modest increase in the equity ratio was designed to avoid any further downgrade of PPL's rating to Baa3 and is consistent with projections of increasing equity ratios for other electric utilities as they expand their infrastructure replacement programs. PPL R. Exc. at 4-5.

Finally, PPL avers that the OCA's and I&E's claimed savings calculations are illusory because they incorrectly assume that PPL can undertake a dramatically expanded infrastructure program without strengthening its equity ratio. PPL states that it should not be placed at a disadvantage in raising capital and be placed at risk of a further downgrade by adopting a hypothetical equity ratio. Also, PPL avers that the OCA's and I&E's calculations are erroneous because they ignore the fact that a substantial part of the increase in PPL's equity ratio results from refinancing preference stock, which does not receive a tax deduction on dividends, with 50% equity and 50% tax deductible debt at a

small net savings to ratepayers. As a result, PPL explains that the Parties alleged savings from a lower equity ratio are significantly overstated because they incorrectly assume that the increased equity to refinance preference stock increases costs to ratepayers. PPL R. Exc. at 6.

d. Disposition

Upon our consideration of the evidence of record, the Recommended Decision and the Exceptions and Reply Exceptions filed by the Parties, we are persuaded by the position of PPL to adopt the Company's actual capital structure and affirm the recommendation of the ALJ. It is important to note that the actual capital structure represents the Company's decision, in which it has full discretion, on how to capitalize its rate base. This actual capitalization forms the basis upon which PPL attracts capital. PPL's debt cost rate of 5.50%, which all Parties have accepted for ratemaking purposes, fully reflects the capitalization determined by the Company to be appropriate. Absent a finding by the Commission that a utility's actual capital structure is atypical or too heavily weighted on either the debt or equity side, we would not normally exercise our discretion with regard to implementing a hypothetical capital structure. *See, Pa. PUC v. City of Lancaster –Water*, 1999 Pa. PUC Lexis 37 at *17; *Carnegie Natural Gas Co. v. Pa. PUC,* 433 A.2d 938, 940 (Pa. Cmwlth. 1981). With regard to these factors, we are persuaded by the arguments of PPL that its actual capital structure is not atypical, is within a range of reasonableness, and, pursuant to precedent, provides no basis to employ a hypothetical capital structure. Also, we are further swayed by PPL's assertion that it requires an equity ratio near the high end of the historic range employed by the barometer group companies to support its expanded infrastructure replacement program and its credit rating.

Accordingly, based upon the foregoing discussion, we shall deny the Exceptions of I&E and the OCA, and adopt the recommendation of the ALJ to utilize PPL's actual capital structure of 49.22% long-term debt and 50.78% common equity.

3. Cost of Debt

PPL proposed to use its expected cost of long-term debt and amortization of loss on reacquired debt for the FTY of 5.50%. PPL M.B. at 91. Both I&E and the OCA agree with PPL that 5.50% is the appropriate cost of long-term debt for purposes of this proceeding.[10] I&E M.B. at 83; OCA M.B. at 46. This cost of debt was unopposed by any Party. R.D. at 60. No Exceptions were filed on this issue. Finding the PPL proposed cost of debt to be reasonable and appropriate, we adopt it without further comment.

4. Cost of Equity

a. Overview

Although there are various models used to estimate the cost of equity, the Discounted Cash Flow (DCF) method applied to a barometer group of similar utilities, has historically been the primary determinant utilized by the Commission. *Pa. PUC v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, at 56 (Order entered July 14, 2011); *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-00049255, at 59 (Order entered December 22, 2004). The DCF model assumes that the market price of a stock is the present value of the future benefits of holding that stock. These benefits are the future cash flows of holding the stock, *i.e.*, the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than

[10] As noted above, PPL adjusted its long-term debt cost to reflect the results of the Company's actual issuance of $250 million of long–term debt, which reduced its weighted average long-term debt cost to 5.50%. PPL M.B. at 91.

dollars received today, the cash flow must be "discounted" back to the present value at the investor's rate of return.

b. Summary

In the instant proceeding, only PPL, I&E and the OCA presented a position on a reasonable rate of return on equity (ROE). The Parties' positions were generally developed through comparison groups' market data, costing models, reflection or rejection of risk and leverage adjustments and a management performance adjustment, as will be further addressed, *infra*. The following table summarizes the cost of common equity claims made and the methodologies used by the Parties in this proceeding:

	DCF (%)	RP (%)	CAPM (%)	CE (%)	Risk (%)	Leverage (%)	MEA (%)	ROE (%)
PPL-EDG	9.67	10.75	10.58	11.60	1.20	0.7	0.12	11.13
PPL-IEG	9.69	10.75	11.28	11.60	1.20	1.18	0.12	11.43
OCA	8.97	7.3	-----	-----	0	0	0	9.00
I&E	8.38	-----	8.68	-----	0	0	0	8.38
ALJ	9.68	-----			0	0	0.06	9.74

PPL proposed a common equity cost rate of 11.25% based on the results of the DCF, Risk Premium (RP), Capital Asset Pricing Model (CAPM) and Comparable Earnings (CE) methodologies. PPL included a risk adjustment of 120 basis points, a leverage adjustment of 70 basis points, and a management performance adjustment of 12 basis points to arrive at its total request. PPL stated that the use of more than one method

provides a superior foundation to arrive at the cost of equity. According to PPL, at any point in time, reliance on a single method can provide an incomplete measure of the cost of equity. PPL St. 11 at 5-6.

Both the OCA and I&E argued that an 11.25% return on equity is excessive. The OCA stated that it would result in a shareholder windfall at the expense of ratepayers and would result in rates that are unjust and unreasonable. The OCA stated that "the current and near-term future economic outlook is one that includes a low cost of capital." OCA St. 2 at 11-19. The OCA proposed a common equity cost rate of 9.00%, based primarily on the results of the DCF analysis without consideration of any of the additional adjustments proposed by the Company. The OCA utilized a CAPM, a Modified Earnings-Price Ratio (MEPR) and a Market-to-Book Ratio analyses as a check on the reasonableness of the DCF results. The OCA also cited numerous other jurisdictions which have awarded less than 10% returns on equity. OCA M.B. at 47-52 (citing *e.g.*, *In re PEPCO*, Order No. 85028 (MD PSC, July 20, 2012) (authorizing a 9.31% ROE)).

I&E recommended a cost of common equity of 8.38% based on the DCF methodology, with consideration of CAPM as a check, with no additional adjustments. I&E's analysis used a spot dividend yield and a 52-week dividend yield, and a combination of earnings growth forecasts and a log-linear regression analysis growth rate. Using the standard DCF model formula,[11] I&E recommended a dividend yield of 4.89% and a recommended growth rate of 3.49%. I&E M.B. at 84-86.

[11] I&E St. 1 at 24.

c. Cost Rate Models

i. Positions of the Parties

PPL performed a RP analysis to determine the cost of equity, based upon the basic financial tenet that an equity investor in a company has greater risk than a bond holder in a company. PPL explained this is because all interest on bonds is paid before any return is received by the equity investor, and, upon bankruptcy or dissolving a company, the bond holder receives his capital before any capital is provided to the equity investors. PPL M.B. at 109-110; PPL St. 11 at 44; Appendix G at G-2.

PPL claimed that the RP method has common sense appeal to investors, who would expect to earn equity returns in excess of bond returns, as has been the case for any extended period in the capital markets. Accordingly, the Company explained the RP method as determining the cost of equity by summing the expected public utility bond yield and the return of equities over bond returns (the "equity premium") over a historic period, as adjusted to reflect lower risk of utilities compared to the common equity of all corporations. PPL St. 11 at 49-50; PPL M.B. at 110.

The Company determined the RP cost of equity to be 10.75% as follows:

Interest Rate		Risk Premium		Cost Rate
5.25%	+	5.50%	=	10.75%

Id.

PPL also performed a CAPM analysis to estimate the cost of equity for the EDG and IEG and determined the risk free rate to be 3.75% based on current and near term project yields on long term treasury bonds. PPL St. 11 at 53-54. According to PPL,

the CAPM analysis determines a "risk-free" interest rate based on U.S. Treasury obligations and an equity risk premium that is proportional to the systematic (*i.e.,* beta) risk of a stock, which are combined to produce cost rate of equity. PPL St. 11 at 50-52.

PPL determined the market or equity premium to be 8.76% based upon an average of historic and projected market premiums. PPL St. 11 at 54; Appendix H at H-4 - H-6. PPL stated that betas are applied to the market premiums to adjust for electric company risks relative to the total market, and the betas are adjusted for the same reasons as the leverage adjustment to the DCF. PPL St. 11 at 52-53. Finally, the Company added a size adjustment to reflect greater risk for smaller firms relative to the market. PPL St. 11 at 54-55. The result of the PPL CAPM analysis was 11.78% for the EDG and 12.48% for the IEG. According to PPL, the results of the CAPM analysis indicate the upper range of the cost of equity analysis using the theoretical models typically employed in utility rate cases. PPL M.B. at 113.

PPL further performed a CE analysis. PPL noted that because regulation is a substitute for competitively determined prices, returns realized by non-regulated firms with similar risks can be used as a guide to determine a fair rate of return. PPL St. 11 at 56. Based on the PPL analysis, the comparable earnings group yielded an historical return of 10.9% and a forecasted return of 12.3%, which resulted in an average return of 11.6%. PPL M.B. at 113-114.

I&E stated that while it was not opposed to using the CAPM results as a comparison to the results of the DCF calculation, it is inappropriate to give the CAPM, RP and CE models comparable weight. I&E St. 1 at 38. I&E recommended against using the RP method and averred that it cannot be used because it relies on historic risk premiums achieved over bond yields which may not be applicable to the future. I&E St. 1 at 19.

Both the OCA and I&E used a CAPM as a check of reasonableness for their DCF calculations. However, both also believe there are shortcomings to this model, express concerns regarding its use and note their preference for using the DCF model to determine the cost of equity capital. I&E M.B. at 85; OCA St. 2 at 39.

I&E also performed an analysis of a return on equity using the CAPM methodology but gave no specific weight to its CAPM results because of its concerns that unlike the DCF, which measures the cost of equity directly by measuring the discounted present value of future cash flows, the CAPM measures the cost of equity indirectly and can be manipulated by the time period used. However, having presented two analyses – historic and forecasted – both of which are comprehensive in the time periods covered, I&E submitted that for purposes of providing another point of comparison, the 8.68% simple average of those two analyses confirmed the reasonableness of the I&E 8.38% return under its DCF calculation. I&E St. 1 at 31-36; I&E M.B. at 88-89.

In its CAPM analysis, OCA chose a risk free rate based on the long-term trend for Treasury Bonds, which it determined to be 4% for a forward looking CAPM analysis. Based on historical Morningstar data which shows an 11.8% return on stocks and a 5.8% return on long-term Treasury bonds since 1926, the OCA determined a risk premium of 6%; yielding an overall expected stock market return of 10% (4% + 6%). The OCA determined a beta of 0.69 based on *Value Line* beta coefficients for its electric group. Based on this analysis, the OCA's CAPM analysis yielded a cost of equity of 8.14% (4 %+(0.69*6%)). OCA St. 2 at 41-44.

I&E did not perform a CE analysis. I&E stated that the CE methodology is subjective in terms of the selection of comparable companies, has generally been rejected

by the Commission and, in PPL's particular analysis, compares projected returns of companies of dissimilar business and financial risks.[12] I&E M.B. at 92.

ii. ALJ's Recommendation

Based on the I&E position, the ALJ recommended that reliance on the RP method be denied. The ALJ concluded that the Commission's preferred method of determining a utility's ROE is the DCF model. The ALJ recommended utilization of the I&E DCF analysis. R.D. at 78, 93.

d. Dividend yields

i. Positions of the Parties

PPL derived the dividend yield by calculating the six month average dividend yields for each group and adjusting those yields for expected growth in the following year to produce the 4.67% for the Electric Delivery Group and 4.69% for the Integrated Electric Group. PPL St. 11 at 26; PPL M.B. at 104.

I&E stated that a representative yield must be calculated over a time frame sufficient to avoid short-term anomalies and stale data. The I&E's dividend yield calculation placed equal emphasis on the most recent spot (4.78%) and 52-week average (5%) dividend yields resulting in an average dividend yield of 4.89%. I&E St. 1 at 40-41; I&E M.B. at 86.

The OCA employed a 4.44% DCF adjusted yield, based upon the average dividend yield of its proxy group of similar companies. OCA St. 2 at 38; OCA M.B. at 55.

[12] I&E St. 1 at 19-23, 38-39.

ii. ALJ's Recommendation

For the reasons set forth by I&E, the ALJ recommended the adoption of the I&E proxy group and methodology for determining a 4.89% dividend yield. R.D. at 66.

e. Growth Rates

i. Positions of the Parties

PPL reviewed various methods of calculating investor expected growth rates and concluded that analysts' projections of growth rates are the best indicator of expected growth. PPL St. 11 at 34. PPL arrived at a range of growth rates from 4.50% to 5.08% for the EDG and from 4.59% to 6.00% for the IEG. PPL chose a growth rate of 5.00% based upon an average EDG growth rate of 4.87% and an average IEG growth rate of 5.14%. PPL M.B. at 105.

I&E used both earnings growth forecasts and a log-linear regression analysis data to calculate its expected growth rate. The I&E earnings forecasts were developed from projected growth rates using five-year estimates from established forecasting entities for the selected barometer group of companies, yielding an average five-year growth forecast of 4.79%. I&E St. 1 at 25-26.

I&E averred that investor forecasts may be biased and/or distorted by misestimates and, therefore, used a log-linear regression analysis to determine a more appropriate long term growth rate. I&E's log-linear regression analysis used historic earnings per share (EPS) from *Value Line* for the years 2006-2011, and the financial analysts forecasted growth rate to project EPS values for the FTY (2012) through 2016. The result of this log-linear regression analysis provided an average growth rate of 3.49%. I&E St. 1 at 25-30; I&E M.B. at 85-86.

ii. ALJ's Recommendation

The ALJ recommended using the 4.79% growth rate of I&E without the log-linear analysis. R.D. at 68.

Based upon the ALJ's recommendation with regard to her dividend yield recommendation of 4.89% and her 4.79% recommendation for PPL's growth rate, the ALJ recommended utilization of a DCF based 9.68% cost of equity, prior to the adoption of any of PPL's proposed adjustments.

iii. Exceptions

PPL excepts to the ALJ's conclusion with regard to its cost rate for common equity, stating that the ALJ's recommendation is far too low and should be increased to at least 10.5%. PPL avers that the principal error in the ALJ's analysis contained in the Recommended Decision is its sole reliance on an unadjusted DCF cost rate without any check on its validity. PPL submits that the ALJ simply rejects the results of other cost rate models based on alleged flaws in the models without recognition of the flaws of the DCF model. PPL Exc. at 6-7.

With regard to the ALJ's rejection of the RP method, PPL states that the RP method has particular applicability in this case because it reflects the prospective A-rated public utility bond yield under current market conditions. Therefore, PPL alleges, it reflects interest rates to be experienced by public utilities during the period rates will be in effect. According to PPL, using an A-rated bond yield produces an equity cost rate below PPL's cost rate because PPL is rated Baa2, indicating a higher cost of debt and equity. PPL notes that the OCA witness admitted that risk premiums tend to increase during periods of lower interest rates. PPL Exc. at 8; Tr. at 329-330. Accordingly, PPL submits that it is likely that the lower interest rates currently being experienced indicate

that the average historic premium understates the premium expected by investors for the future. This, PPL asserts, makes the RP analysis in this case conservatively low under current market conditions. PPL opines that the 10.75% RP provides a clear demonstration of the inadequacy of the unadjusted DCF analysis. PPL Exc. at 7-8.

With regard to the ALJ's rejection of the CAPM analysis as a check on the ROE recommendation, PPL submits that the ALJ simply accepted the OCA's and I&E's contention that there are "shortcomings" in the model. PPL avers that its CAPM analysis resulted in a cost rate of 10.58%, after removal of the 120 basis point size adjustment which the ALJ's rejects. PPL maintains that the ALJ did not provide any basis for rejecting the revised CAPM analysis excluding the size adjustment. PPL notes that the ALJ herself noted that the Commission has concluded that it is necessary to use other methods as a check on the results of the DCF, citing the Commission decision in PPL's 2004 rate case. PPL proffers that based on that decision, the ALJ's sole reliance on a DCF analysis with no leverage adjustment should not be adopted. According to PPL, the ALJ failed to follow the Commission precedent by either adding the leverage adjustment to the unadjusted DCF result or relying on other methods, such as the RP. PPL Exc. at 9-10.

PPL further excepts to the ALJ's apparent reliance on the Maryland *In re PEPCO* decision, *supra*, to justify an ROE less than 10%. PPL avers that neither the ALJ nor the OCA cites a further quote from the *In re PEPCO* decision provided in the Company's Reply Brief, which explained that the ROE that was approved for PEPCO reflected poor service quality and the effects of a revenue decoupling mechanism employed by PEPCO. PPL maintains that neither of those circumstances apply to PPL and, as such, the 9.31% ROE does not demonstrate the reasonableness of the ALJ's recommended allowance for PPL in this proceeding. PPL notes that the ROE should reflect prospective conditions, as relying too much on the past can risk under-estimating the cost of equity capital that PPL will face as it seeks to raise capital to fund its

expanded infrastructure improvement program during the period that rates set in this proceeding will be in effect. PPL Exc. at 16-19.

In reply, the OCA avers that the ALJ was correct in primarily relying on the DCF results to arrive at a reasonable ROE for PPL. The OCA states that the ALJ spent considerable effort in her Recommended Decision reviewing and discussing the results of the Parties' various ROE estimating studies, other than the DCF, and that PPL's criticism of the ALJ for relying on an unadjusted DCF result without any check on its validity is unwarranted. According to the OCA, the ALJ correctly concluded that the Commission primarily relies on the DCF method to establish a reasonable ROE. The OCA points out that the ALJ provided an extensive discussion and review of the results of the RP analysis, the CAPM analysis, and PPL's CE study, which led the ALJ to conclude that they should not be relied upon in this proceeding. The OCA submits that the ALJ's conclusion to rely primarily on the DCF method to arrive at an ROE recommendation is consistent with well-established Commission precedent and should be accepted. OCA R.Exc. at 4-8.

In response to PPL's Exception with regard to the *PEPCO* decision referenced by the ALJ, the OCA states that PPL's attempt to differentiate the *PEPCO* decision from its situation is without merit. The OCA submits that the quoted portions of the *PEPCO* Order only serve to reinforce the fact that the ALJ's recommendation of a 9.68% ROE is adequate and reasonable. According to the OCA, PPL is similar to PEPCO as it owns no generation, has no competition for distribution service and serves a heavily residential customer base, so PPL's attempts to distance itself from PEPCO is without merit and should be rejected. OCA R.Exc. at 10-14.

In its Reply Exceptions, I&E asserts that the ALJ's 9.68% calculated ROE is supported by the record and should be adopted. I&E asserts that as this Commission recently confirmed, although it may review other results as a check, the Commission

relies primarily on the DCF methodology. I&E R.Exc. at 18 (citing *Pa. PUC v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, at 56 (Order entered July 14, 2011)). Therefore, I&E avers that PPL's assertions are erroneous as the DCF has always been the primary standard. Notwithstanding this position, I&E posits that the reasonableness of the ALJ's recommendation was confirmed by I&E's two CAPM analyses, the historic and forecasted. According to I&E, its 8.68% simple average of its two CAPM studies, employing the same simple averaging PPL undertook of its four methodologies, confirmed the reasonableness of I&E's DCF return of 8.38%. I&E points out that since the ALJ rejected its log linear regression analysis, the ALJ's recommended 9.68% recommended ROE is substantially higher than the 8.68% check provided by its CAPM analysis. I&E R.Exc. at 17-19.

iv. Disposition

Upon our consideration of the record evidence, we agree with the finding of the ALJ that the Company's cost of equity in this proceeding should primarily be based upon the use of the DCF methodology. We also are persuaded by the arguments of PPL that it is important to temper the results of the unadjusted DCF results in comparison to the results from the other cost of equity methodologies as presented by the Parties in the context of this proceeding. Sole reliance on one methodology without checking the validity of the results of that methodology with other cost of equity analyses does not always lend itself to responsible ratemaking. We conclude that methodologies other than the DCF can be used as a check upon the reasonableness of the DCF derived equity return calculation. *See*, *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-00049255, at 67 (Order entered December 22, 2004). It is important to recognize that each of the Parties presenting a cost of equity position in this proceeding have done so. We also note that we historically have primarily relied upon the DCF methodology in arriving at previous determinations of the proper cost of equity and utilized the results of methods, such as the CAPM and RP methods, as a check upon the reasonableness of the

DCF derived equity return amount, tempered by informed judgment. As such, where evidence based on the CAPM and RP methods suggests that the DCF-only results may understate the utility's current cost of equity capital, we will give consideration to those other methods, to some degree, in determining the appropriate range of reasonableness for our equity return determination. Therefore, we are not in agreement with the ALJ that the proper ROE in this proceeding should be determined based strictly on the reliance of the unadjusted DCF calculations presented by the Parties.

In *Lower Paxton Township v. Pa. PUC,* 317 A.2d 917, 920-921 (Pa. Cmwlth. 1974), the Commonwealth Court recognized that the Commission may consider its judgment as well as other factors which affect the cost of capital, including the utility's financial structure, credit standing, dividends, risks, regulatory lag and any peculiar features of the utility involved. The Court stated that "the cost of capital is basically a matter of judgment governed by the evidence presented and the regulatory agency's expertise." *Id*. at 921. Here, we are guided by the legal analysis in *Lower Paxton.* In this case, we will rely upon the DCF methodology and informed judgment in arriving at our determination of the proper cost of common equity. In particular, we note that the evidence presented in this case based on the CAPM and RP methods produced a range of results that was consistently higher than the results produced by a DCF-only approach. This suggests that, while properly computed in the abstract, the DCF-only results understate the current cost of equity for PPL and that consideration should be given to the CAPM and RP evidence in determining the appropriate range of reasonableness. Furthermore, we note that the setting of the proper return on equity is even more critical in this proceeding as our Pennsylvania jurisdictional utilities implement plans to accelerate the greatly needed replacement of aging infrastructure. Attracting capital to Pennsylvania at reasonable rates to accomplish this infrastructure replacement has never been more important to PPL, its customers and the Commonwealth of Pennsylvania.

Based upon our analysis and review of the record evidence, we find that a range of reasonableness for the cost of equity in this proceeding is from 9.0% to 11.25%. We conclude that within that range, considering PPL's need to fund $1.6 billion of planned distribution improvements between 2012 and 2016, a cost of common equity of 10.28% is reasonable and appropriate to incorporate into our return determinations under the circumstances of this proceeding. We note that this return on equity is exclusive of any of the PPL-requested adjustments to be discussed, *infra.* We note, further, that (1) the DCF-derived cost of equity ranged from 8.38% (I&E) to 9.69% (PPL); (2) the range determined from the RP methodology was 7.3% (OCA) to 10.75% (PPL); and (3) the range of the CAPM calculations was 8.14% (OCA) to 11.28% (PPL). Based upon our consideration and analysis of this evidence, as explained herein, we are of the opinion that an equity return of 10.28% is reasonable and appropriate for PPL.

Accordingly, the Exceptions of PPL are granted, in part, to the extent consistent with the foregoing discussion.

f. Leverage Adjustment

i. Positions of the Parties

PPL promoted a leverage adjustment in this proceeding, which it explained was designed to adjust the DCF cost rate for the different percentage level of debt in the capital structure when capital structure is calculated at the market prices of equity and debt securities as opposed to book value. PPL M.B. at 105.

PPL proposed a 70 basis point leverage adjustment to its EDG and a 118 basis point leverage adjustment to its IEG. PPL theorized that if regulators use the results of the DCF to compute the weighted average cost of capital based on a book value capital structure used for ratemaking purposes, the utility will not, by definition, recover its risk-adjusted capital cost. PPL believed this is because market valuations of equity are based

on market value capital structures, which in general have more equity, less debt and, therefore, less risk than the capitalization measured at its book value. PPL St. 11 at 35.

The Company pointed out that the Commission has accepted the leverage adjustment in a number of cases, including PPL's last fully litigated rate case in 2004. PPL M.B. at 107 (citing *Pa. PUC v. Pa. American Water Co.*, Docket No. R-0001639 (Order entered January 10, 2012) (60 basis point adjustment); *Pa. PUC v. Philadelphia Suburban Water Company,* Docket No. R-00016750 (Order entered August 1, 2002) (80 basis points); *Pa. PUC v. Pa. American Water Co.*, Docket No. R-00038304 (Order entered November 8, 2004) (60 basis points affirmed); *Popowsky v. Pa. PUC*, 868 A.2d 606 (Pa. Cmwlth. 2004); *Pa. PUC v. Aqua Pa. Inc.*, Docket No. R-00038805 (Order entered August 5, 2004) (60 basis point adjustment); *Pa. PUC v. PPL Electric Utilities Corp.,* Docket No. R-00049255 (Order entered December 22, 2004) (45 basis point adjustment); *Pa. PUC v. PPL Gas Utilities Corp.,* Docket No. R-00061398 (Order entered February 8, 2007) (70 basis points)).

According to PPL, use of the DCF alone, and without consideration of the leverage adjustment, significantly understates the cost of equity. PPL opined that when investors' expectations of future earnings are pessimistic due to factors including future regulatory allowances, there is the potential for the DCF to be circular and not market based. PPL St. 11 at 24; PPL M.B. at 108.

I&E argued that rating agencies assess financial risk based upon the Company's booked debt obligations and the ability of its cash flow to cover the interest payments on those obligations by using financial statements, particularly income statements, for their analyses, not market capitalization.

I&E pointed out that, while the Commission has granted this adjustment on occasion, it has also rejected it:

> In a Blue Mountain Water Company case on remand from Commonwealth Court to clarify findings concerning fair rate of return, the Commission identified seven principles that were applied to analyze the company's required and lawful rate of return. The Commission's third identified principle stated that "[m]arket price-book value ratios are not a goal of regulation but a result of regulation, general economic factors and individual company's characteristics of management, operations and perceived future. *In general, we view a market-book ratio in the area of one-to-one as appropriate for regulated industry*."[13]
>
> In a 2008 case involving Aqua Pennsylvania, Inc., the Commission rejected the ALJ's recommendation for a leverage adjustment stating, "the fact that we have granted leverage adjustments in the past does not mean that such adjustments are indicated in all cases."[14] In a 2007 Metropolitan Edison Company case, the Commission rejected the Company's financial risk increment related to the leverage difference between market capital structures and book value capital structures.[15] Most recently in a City of Lancaster case, the Commission agreed with Ms. Sears' recommendation to reject the leverage adjustment, stating "any adjustment to the results of the market based DCF as we have previously adopted are unnecessary and will harm ratepayers. Consistent with our determination in *Aqua 2008* there is no need to add a leverage adjustment."[16]

I&E M.B. at 73-74.

[13] *Pa. PUC v. Blue Mountain Consolidated Water Co*., 1982 WL 213115, at 1 (emphasis added).

[14] *Pa. PUC v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, at 38 (Order entered July 31, 2008).

[15] *Pa. PUC v. Metropolitan Edison Co.*, Docket No. R-00061366, at 34 (Order entered January 11, 2007).

[16] *Pa. PUC v. City of Lancaster – Bureau of Water*, Docket No. R-2010-2179103, at 79 (Order entered July 14, 2011).

I&E determined that there are six cases in which the Commission accepted the leverage adjustment, most recently in 2007. According to I&E, the adjustment has been proposed in sixty-eight cases over a twenty-three year period, yielding six successful results. Finally, I&E charged that PPL's formulae for the adjustment are flawed as it used formulae which do not appear in the research cited to support it. I&E M.B. at 100.

The OCA recommended against the Company's leverage adjustment because there was no evidence to support a risk difference between a market-based capital structure and a book value capital structure. Rather, according to the OCA, the claim that the DCF results should be increased by 70-118 basis points due to PPL's leverage adjustment is "not sound ratemaking." OCA M.B. at 60. The OCA submitted that no ROE-enhancing adder is needed or appropriate for PPL based on the facts of this matter. As the OCA witness testified:

> While there are certainly many aspects of rate of return analysis that are subject to judgment and, thus, debate regarding the proper application of a particular technique, Mr. Moul's use of an imaginary risk difference between a market-based capital structure and a book value capital structure is not one of them. There is no evidence available in the literature of financial economics to support any risk difference between market-value and book-value capital structures. Miller and Modigliani (supposedly the source of Mr. Moul's "leverage" adjustment) do *not* compare market-value and book value capital structures.

OCA St. 2-SR at 4. (emphasis in original).

According to the OCA, PPL testified that when utility market prices exceed book values, a risk difference exists between market-value capital structures and book-value capital structures, and market-based cost of equity estimates should, therefore, be adjusted upwards to account for that risk difference. The OCA noted that this is the basis

for PPL's "leverage adjustment." OCA St. 2 at 55-56. The OCA witness testified as to the flawed nature of this theory, in relevant part:

> There simply is no difference in financial risk when the market-value capital structure of a firm is different from the book-value capital structure. Financial risk is a function of the interest payments on the debt issued by the firm. That is, a firm's debt payments create financial risk and when the amount of debt used to finance plant investment increases relative to common equity the financial risk increases. Whether the capital structure is measured with market values or book values, the debt interest payments do not change and, therefore, financial risk does not change. As a result, market-value capital structures are useful as indicators of financial risk only when they are compared with other market-value capital structures (as Miller and Modigliani do in their treatise), and Mr. Moul's mixed-metaphor comparison of market-value and book-value capital structures has no economic meaning.

OCA St. 2 at 56.

> The Company is making an improper comparison between market value capital structures and book value capital structures in order to claim that a financial risk difference exists. When utility common equity market prices are above book value, the capital structure measured with market values will have a higher equity percentage and lower debt percentages than the capital structure measured with book value. That does not mean, as the Company claims, that those different capital structure measures signify any difference whatsoever in financial risk.

OCA St. 2 at 61.

The OCA acknowledged that, in some cases, the Commission made an adjustment to a DCF based cost of equity such as that proposed by PPL. However, the OCA claimed that, more recently, the Commission has not adopted PPL's leverage adjustment, as Mr. Hill testified:

> [I]t is important to note that this Commission has rejected "financial risk adders" in Docket No. R-00061366 (Metropolitan Edison (Met Ed), Pennsylvania Electric, Opinion and Order, January 11, 2007, p. 136). The "financial risk adders" in the Met Ed case were based on the leverage/risk difference between market-value capital structures and book value capital structures, just as Mr. Moul's are. In addition, in Docket No. R-00072711, Aqua Pennsylvania, Inc., July 17, 2008, at pages 35 through 39, this Commission specifically rejected Mr. Moul's leverage/risk analysis—the same leverage/financial risk adjustment Mr. Moul uses in his testimony in this proceeding.

OCA St. 2 at 57. The OCA argued that other state commissions have uniformly recognized this type of adjustment as unwarranted in their decisions. OCA M.B. at 62 (citing *West Virginia Public Service Comm'n v. West Virginia-American Water Works*, 2004 W. Va. PUC Lexis 6 at *18 (2004)). In addition to the West Virginia Public Service Commission, other Commissions have rejected similar market-to-book adjustments to the DCF model. The District of Columbia Public Service Commission rejected a company's arguments that an adjustment to the DCF was appropriate to meet investors' requirements. OCA M.B. at 62 (citing *In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Increase Existing Rates and Charges for Gas Service,* 2003 D.C. PUC Lexis 220 at *72 (2003)).

In its surrebuttal testimony in this proceeding, the OCA summarized the reasons this Commission should reject PPL's "fictional leverage" adjustment:

> - The comparison of market value capital structures and book value capital structure to measure financial risk differences, is not supported in the literature of finance;
>
> - There is no financial risk difference between market value and book value capital structures because

interest expense (the actual source of financial risk) doesn’t change, regardless of the capital structure measurement perspective;

- One company cannot have two levels of financial risk (i.e., one based on book value and one based on market value);

- The DCF model does not “mis-specify” the cost of equity when market prices are different from book value, and utilities are able to attract capital on reasonable terms absent any so-called “leverage” adjustment;

- Moul’s “leverage” adjustment is, fundamentally, a market-to-book ratio adjustment, and this Commission has rejected market-to-book ratio adjustments in the past;

- The “leverage” adjustment is based on the “fair value” of the capital employed in financing the utility operation, as such it is a surrogate for “fair value” rate base, which results in a revenue requirement higher than that required by law in a regulatory jurisdiction in which rates are to be based on original cost (depreciated book value);

- A utility market price significantly above book value indicates that investors expect that firm to earn a return above its cost of equity, but according to Mr. Moul’s “leverage” adjustment the higher the market price, the greater the upward adjustment necessary, which would exacerbate the over-recovery;

- The “leverage” adjustment recommended by Mr. Moul has been presented in dozens of regulatory jurisdictions. It has been rejected by all of those jurisdictions (including, recently, Pennsylvania).

OCA St. 2-SR at 11. The OCA submitted that for the reasons just discussed, and taking the record as a whole, such an adjustment should not be considered in this matter. OCA M.B. at 60-64.

ii. ALJ's Recommendation

For the reasons developed by the OCA and I&E, the ALJ recommended that the Company's leverage adjustment be denied. R.D. at 76.

iii. Exceptions

PPL excepts to the ALJ's rejection of its proposed leverage adjustment, noting that the Commission has accepted a leverage adjustment in a number of cases, including PPL's last fully litigated rate case in 2004, where the Commission adopted a forty-five basis point adjustment. PPL avers that the ALJ appears to conclude that the OCA's and I&E's criticisms of the leverage adjustment are a basis to reject the leverage adjustment, despite the fact that it has been accepted on numerous occasions in the past and each of these criticisms have been offered in the past. PPL points out that the principal criticism offered by the OCA and I&E is that there is no risk difference between a capital structure where equity is valued at market as compared to book prices, because the amount of interest that must be paid on debt remains the same. PPL opines that the error of this argument is that the interest amounts are greater as a percentage of book equity capitalization than they are as a percentage of market equity capitalization. Therefore, asserts PPL, the risk of debt payments is less as a percentage of market equity capitalization than it is at book equity capitalization. PPL states that because the DCF sets the equity cost rate at market capitalization, it understates the investor cost rate when applied to the rate base. According to PPL, the ALJ erred in declining to include a leverage adjustment when relying solely on the DCF analysis to arrive at the recommended cost of equity. PPL Exc. at 11-16.

In reply, the OCA states that the ALJ was correct to reject the leverage adjustment, as she accepted the fact that artificially increasing the ROE based on a technique that finds no support in the financial literature, does not represent sound ratemaking. Additionally, the OCA avers that PPL's leverage adjustment has been thoroughly reviewed and rejected in virtually every regulatory jurisdiction where it has been proposed, noting that since 2007, PPL's witness has testified in twenty-four regulatory jurisdictions, and none has specifically accepted and utilized the "leverage/risk" adjustment. According to the OCA, there is no need for a leverage adjustment within the confines of standard regulatory practice or a need for such a mechanism in Pennsylvania. OCA R. Exc. at 8-10.

In its Reply Exceptions, I&E asserts that the leverage adjustment is wholly discretionary and, in this case, fundamentally unnecessary, not only for the reasons directly noted by the ALJ, but also because PPL's inputs into its 9.68% DCF calculation are already overstated. Further, I&E opines that today's investment market does not support PPL's ROE. According to I&E, both PPL's calculated growth and dividend rates within its DCF analysis already provide the equity boost that PPL seeks through its leverage adjustment. I&E explains that the PPL 5% growth rate was based on its average barometer group growth rates, which were flawed in I&E's opinion because they did not satisfy even its own criteria. I&E submits that though accepting its unadjusted growth rate of 4.79%, the ALJ nonetheless arrived at a calculated return on equity of 9.6%, the same DCF return calculated by PPL using inflated growth rates. I&E avers that because PPL's DCF calculation already has inflated inputs, a further upward boost from the leverage adjustment is unnecessary. I&E R. Exc. at 19-20.

iv. Disposition

Based upon our analysis of the evidence of record, we are persuaded by the arguments of the OCA and I&E that PPL's requested leverage adjustment is not reasonable and should be denied. The fact that we have granted leverage adjustments in a few select cases in the past as noted by PPL does not mean that such adjustments are warranted in all cases. The award of such an adjustment is not precedential but discretionary with the Commission. In fact, the Commission has rejected leverage/financial risk adjustments that are similar to the one proposed by PPL in this proceeding. *See, e.g., Pa. PUC v. Aqua Pennsylvania, Inc.*, Docket No. R-00072711, at 38-39 (Order entered July 31, 2008). Moreover, in the context of our determination, *supra*, of a reasonable return on equity for PPL of 10.28%, we conclude that there is no need to have an artificial upwards adjustment to compensate for any perceived risk related to PPL's market-to-book ratio. Accordingly, we shall deny the Exceptions of PPL and adopt the ALJ's recommendation to reject PPL's requested leverage adjustment.

g. Risk Adjustment

i. Positions of the Parties

PPL proposed a 120 basis point upward adjustment because the Company believes that as the size of a firm decreases, its risk and, hence, its required return, increases. Further, PPL used the SBBI Yearbook to argue that the returns for stocks in lower deciles had returns in excess of those shown by the simple CAPM. PPL St. 11 at 54-55.

Alternatively, I&E charged that PPL's rate of return recommendations are also grossly overstated by its assignment of several faulty assumptions of risk to PPL. I&E noted:

> While some technical market literature supports adjustments relating to a company's size, in a critical point of distinction, this literature is *not* specific to the utility industry. On the other hand, utility-specific academic literature specifically argues against a size adjustment for utilities. A specific study of utility stocks and the size effect concluded as follows:
>
> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that *there is no need to adjust for the firm size in utility rate regulation*.[17]

As to unpredictability, I&E stated that "one cannot expect risky companies to always outperform less risky companies; otherwise they would not be risky." I&E M.B. at 101-103.

ii. ALJ's Recommendation

The ALJ recommended that PPL's proposed size adjustment be denied. R.D. at 82.

iii. Exceptions

No Party filed Exceptions on this issue with regard to the ALJ's recommendation. Finding the ALJ's recommendation to be reasonable, we adopt it without further comment. Accordingly, PPL's proposed size adjustment is denied.

[17] I&E M.B. n. 220; I&E St. 1 at 55, citing Dr. Annie Wong, "Utility Stocks and the Size Effect: An Empirical Analysis," *Journal of Midwest Finance Association*, 1993, at 95-101 (emphasis added), reproduced in I&E Exh. I, Sch. 15.

h. Management Effectiveness Adjustment

i. Positions of the Parties

PPL included a twelve basis points management effectiveness adjustment to its return on equity claim. Both I&E and the OCA oppose any allowance for management effectiveness.

The Company summarized its evidence in support of this adjustment as follows:

> PPL Electric's management is effectively controlling costs, while at the same time, providing customers with high quality service and expanded service options. As detailed in the Statement of Reasons, the Company has taken substantial efforts to improve productivity and manage costs, including, but not limited to: (1) new technology to improve productivity and including advanced meters; (2) a smart grid distribution automation system, which will provide direct reliability benefits to over 60,000 customers in the project area and lead to increased reliability benefits to all customers by providing system operators advanced and timely situational awareness and control capabilities through a wider deployment throughout PPL Electric's service territory; (3) a work and asset management system, which is a new large scale software solution that will improve associated work management business processes in order to more effectively and efficiently manage the portfolio of work; (4) several initiatives to improve storm processes including call handling time and volume; (5) increased investment to address aging infrastructure, which will have a positive, long-term benefit in controlling reactive operating costs; and (6) capital investment in information systems to support customer choice and to provide expanded self-service options for customers, which improves service to customers while controlling operating costs. In addition, the Company is testing and evaluating a variety of applications and features that will expand the capabilities of the current system and equipment over the next five years.

PPL M.B. at 116-117.

I&E argued that the twelve basis points sought by PPL translates into an additional $3 million in rate revenues. Tr. at 335; I&E M.B. at 116. I&E argued further that there is considerable room for improvement in several areas, including preventable major outages, customer service calls answered within thirty seconds, the number and percentage of bills not rendered to residential customers and small businesses, and the number of disputes with no response within thirty days. I&E M.B. at 119-120. As I&E saw it, PPL's requested twelve basis point upward adjustment to the cost of equity is neither warranted nor supported. I&E opined that it should be rejected. I&E M.B. at 123.

The OCA agreed with I&E. The OCA referred to the $832,000 that PPL has either agreed to pay or was ordered to pay in fines and penalties. OCA M.B. at 65.

ii. ALJ's Recommendation

The ALJ stated that PPL presented substantial evidence of management effectiveness in a number of areas, including advanced metering infrastructure, operating initiatives, customer contact center, customer education, energy efficiency programs, and customer assistance programs. According to the ALJ, the provision of safe, reliable, adequate and reasonable service is the minimum required by the Code, and simply meeting that standard does not warrant excessive rewards. However, the ALJ concluded that the actions taken by PPL in its response to Commission initiatives, and in providing excellent, albeit imperfect, service, in meeting the needs of its ratepayers and customers, merited a management effectiveness increase of six basis points. R.D. at 89

iii. Exceptions

In its Exceptions, PPL notes that the ALJ correctly summarized PPL's evidence presented to support its management performance adjustment. However, PPL criticizes the ALJ for recommending a six basis point adjustment in lieu of its twelve basis point request, as she relied on certain criticisms of PPL where the Company agreed to negotiate payments to resolve certain alleged violations of the Code or Commission Regulations. PPL avers that these limited circumstances do not provide a basis for denying PPL's requested twelve basis point adjustment to the cost of equity. PPL Exc. at 19.

The OCA excepted to the ALJ's recommendation, stating that the ALJ erred by awarding any management performance bonus as the evidence of record does not support such a conclusion. The OCA maintains that all regulated utilities in Pennsylvania are required to provide safe, adequate, reasonable and efficient service as a matter of law. 66 Pa. C.S. § 1501. The OCA avers that a utility must be doing more than providing efficient and reasonable service in order to receive more than the indicated rate of return. The OCA references its Cross Exhibit 1, which listed five separate dockets where the Commission's Prosecutory Staff had investigated PPL for potential violations of the Code and avers that such actions do not support the award recommended by the ALJ. OCA Exc. at 15-18.

I&E also excepted to the ALJ's recommendation, alleging that it is not supported by the evidence. I&E avers that PPL selectively presented evidence of "high quality" service and alleges that PPL essentially sought an investor reward for implementing statutorily-mandated programs that were purely ratepayer funded through Commission-mandated rates that guaranteed PPL recovery with interest through separate surcharges and riders. I&E opines that while the Commission has the discretion to reward management, because such action essentially sanctions approval of a ratepayer premium, the Commission should exercise that discretion circumspectly. According to I&E, circumstances warranting investor rewards should be the exception not the norm.

I&E opines that PPL's service is not exceptional, finding instead that it was at times above average, at other times below average, and sometimes just average. According to I&E, PPL presented no clear evidence of any particular shareholder commitment that justifies gratuitous ratepayer funding. I&E Exc. at 23-26.

In reply, PPL states that clearly a public utility has a statutory duty to provide adequate, efficient, safe and reasonable service at just and reasonable rates. However, PPL posits that it is the efforts and manner in which the utility meets the statutory requirements that the Commission considers when determining if a management performance adder is appropriate. For example, PPL provides that the Commission awarded a twenty-five basis point adder to compensate a utility where it "promoted and accomplished cost efficiencies in several operational aspects". PPL R.Exc. at 9 (citing *Pa. PUC v. West Penn Power Co*., 1994 Pa. PUC Lexis 144 at *147). Similarly, PPL notes that the Commission awarded a twenty-two basis point adder where a utility's "managerial performance related to its water quality, customer service and low income program continues to be laudable." PPL R.Exc. at 8-9 (citing *Pa. PUC v. Aqua Pennsylvania, Inc.,* Docket No. R-00072711, at 50 (Order entered July 31, 2008)).

PPL avers that in this proceeding, I&E and the OCA ignore the record evidence of the exceptional manner in which PPL has exceeded its statutory obligation to provide adequate, efficient, safe and reasonable service and facilities at just and reasonable rates. According to PPL, the record evidence demonstrates that PPL's management is effectively controlling costs, while at the same time, providing customers with high quality service and expanded service options. In response to the Parties' allegations with regard to the five instances over the last four years where PPL paid a civil penalty, PPL responds that these parties overlook that PPL has 1.4 million customers and has millions of interactions with these customers annually. PPL points out that in only four instances has any penalty been applied, and in three of those cases the Company settled the matter without any finding of any violation. PPL submits that in

only one instance in the past four years has it been found to have violated the Code, and on that occasion, it was assessed a civil penalty of $100. Given the Company's efforts, PPL opines that the requested twelve basis point adder clearly is modest and within the range previously awarded by the Commission. PPL R.Exc. at 9-10.

In its Replies to Exceptions, the OCA notes its continuing opposition to the management performance bonus in its entirety and requests that the Commission modify the ALJ's recommendation and remove the six basis point ROE adder. OCA R.Exc. at 14.

In its Replies to Exceptions, I&E similarly notes that PPL's evidence does not support any management bonus. I&E R.Exc. at 17.

iv. Disposition

Pursuant to the Code, the Commission may reward utilities through rates for their performance. In pertinent part, Section 523 of the Code, 66 Pa. C.S. § 523 provides:

> **§ 523. Performance factor consideration.**
>
> (a) **Considerations.** – The Commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.

> (b) **Fixed utilities.** – As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:
>
> > (1) Management effectiveness and operating efficiency as measured by an audit pursuant to Section 516 (relating to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.
> >
> > * * *
> >
> > (4) Action or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management, cogeneration or small power production for electric and gas utilities.
> >
> > * * *
> >
> > (7) Any other relevant and material evidence of efficiency, effectiveness and adequacy of service.

Based upon our analysis of the evidence of record, we are persuaded by the arguments of the Company that its management performance related to its advanced metering infrastructure, operating initiatives, customer contact center, electric competition, customer education, energy efficiency programs, and customer assistance programs is laudable and warrants consideration as a factor in our final cost of equity allowance. Accordingly, we shall grant PPL's Exception and adopt its twelve basis point management effectiveness adjustment to our prior return on equity recommendation in recognition of its exemplary managerial performance. In the context of the evidentiary record developed in this proceeding, we conclude that this adjustment is reasonable, appropriate and conservative based on Section 523 of the Code and the similar allowances in the prior Commission decisions cited by the Company. The ALJ's

recommendation of a six basis point allowance shall be modified, consistent with the foregoing and the Exceptions of I&E and the OCA are denied.

i. Summary on Common Equity

i. Positions of the Parties

As noted above, there are four methods of determining the cost of equity: DCF, RP, CAPM, and CE. PPL relied on each of these methodologies in presenting its recommended return on equity of 11.25%.

I&E argued that equal weight should not be given to the four different methodologies as PPL did in its evaluation.

Both the OCA and I&E took issue with the Company's analysis in arriving at the proposed cost of equity and capital structure. The OCA pointed out that the Commission has indicated a preference for using the DCF method to establish reasonable common equity costs.

While calculating average returns on equity for its respective groups of 11.13% and 11.43%, PPL's indicated cost of common equity reflects an upward adjustment of seventy basis points for its EDG and 118 basis points for its IEG to account for the leverage claim. It further reflects an upward adjustment of 120 basis points for both EDG and IEG to reflect its claim that PPL has higher business risk due to its small size relative to its proxy group. Finally, the indicated cost of common equity reflects PPL's upward adjustment of another twelve basis points to reflect PPL's requested award for claimed management efficiency.

I&E opposed PPL's calculated return on equity for several reasons. First, I&E averred that PPL's selected barometer group was flawed in that several of its

selections failed to meet PPL's own purportedly objective selection criteria. Second, I&E maintained that PPL gave undue weight to the RP and CE methods. Third, I&E claimed that PPL employed an inflated DCF growth rate and a dividend yield adjustment that was unnecessary. Fourth, according to I&E, PPL employed inflated CAPM betas. Finally, I&E rejected PPL's extra-method adjustments for leverage, size (business risk), and management efficiency as they are unsupported and inappropriate.

ii. ALJ's Recommendation

The ALJ concluded that the Commission's preferred method of determining a utility's ROE is the DCF model. Consequently, the ALJ recommended adoption of I&E's DCF analysis, consisting of a dividend yield of 4.89% and a growth rate, prior to I&E's log-linear adjustment, of 4.79%. Additionally, the ALJ recommended adoption of a six basis point adjustment to PPL's ROE for management effectiveness. The result of the ALJ's recommendations equates to an overall ROE of 9.74%. R.D. at 93.

iii. Disposition

The ALJ recommended that the Company's position of an actual capital structure consisting of 49.22% long-term debt and 50.78% common equity along with a long-term debt cost rate of 5.50% be adopted. Additionally, the ALJ recommended adoption of the I&E position on PPL's cost of equity capital of 9.74%. According to the ALJ, the evidence overwhelmingly demonstrated that PPL's claim for a return on equity of 11.25% and an overall rate of return of 8.47% overstated what reasonable investors should expect from a regulated public utility and is not necessary for PPL to safely and reliably provide electric distribution service to its captive ratepayers. Based on these recommendations, the resulting overall rate of return per the ALJ is 7.65%.

Capital Type	Ratio (%)	Cost Rate (%)	Weighted Cost (%)
Debt	49.22	5.50	2.71
Equity	50.78	9.74	4.95
Total	100.00		7.65

R.D. at 93-94.

Based upon the foregoing, we conclude that PPL's capital structure should be based upon the Company's actual capital structure of 49.22% debt and 50.78% equity. PPL's cost of equity capital is properly determined by the DCF analysis performed by the Parties, with other methods utilized as a check on the reasonableness of the DCF results. Accordingly, we adopt a cost of equity rate of 10.4%. In addition, the 10.4% approved ROE is inclusive of the twelve basis point management efficiency adjustment as requested by the Company. Each of the remaining PPL requested ROE adjustments are rejected as unreasonable.

The following table summarizes our final determinations concerning PPL's capital structure, cost of debt and cost of common equity, as well as the resulting weighted costs and overall rate of return of 7.99%:

Capital Type	Ratio (%)	Cost Rate (%)	Weighted Cost (%)
Debt	49.22	5.50	2.71
Equity	50.78	10.4	5.28
Total	100.00		7.99

F. Taxes – Gross Receipts Tax

1. Positions of the Parties

PPL's total FTY gross receipts tax (GRT) expense claim is $50.102 million, which consists of two components. The first component is a pro forma calculation of gross receipts tax for the FTY at present rates of $43.930 million. PPL Exh. Future 1, Sch. D-11 at 3. The second component is $6.172 million, resulting from the proposed rate increase. PPL M.B. at 133; PPL Exh. Future 1, Sch. D-12 at 6.

I&E recommended a total GRT allowance of $49.168 million, which is a $934,000 reduction to the Company's total claim. The recommendation consists of a pro forma allowance of $43.1 million and a rate increase allowance of $6.068 million, assuming a full rate increase. The recommended GRT adjustments are reductions of $830,000 to the pro forma claim and $104,000 to the rate increase claim. I&E's recommendation is based on the fact that PPL's tax liability for the GRT is limited to the actual revenues PPL receives. As such, I&E recommended that the GRT tax allowance in rates should be calculated using the net revenues collected by PPL. I&E M.B. at 69; I&E St. 2 at 46-48.

2. ALJ's Recommendation

The ALJ found that I&E's recommendation to calculate the GRT allowance using net revenues was reasonable and should be approved, because it is a better match of the claimed actual receipts of revenue that will produce the Company's actual GRT tax liability. R.D. at 95, 96; I&E St. 2 at 46-48. The ALJ stated that the Pennsylvania Department of Revenue (DOR) Corporation Tax Bulletin 2011-02, issued July 20, 2011 (Bulletin), confirmed that the Company's net uncollected revenues would not reduce its GRT tax liability. The ALJ also stated that the Company did not provide any evidence to support that the cost of documentation would exceed the overvaluation of GRT, and the

Company's witness confirmed that the Company maintains records of customers' bad debts. R.D. at 97.

3. Exceptions

In its Exceptions, PPL avers that its GRT should be recovered in full. PPL Exc. at 37. PPL states that the ALJ's recommendation should be rejected because it disregards changes in the calculations of GRT imposed by the DOR in the Bulletin. *Id*. at 37-38. PPL opines that the Bulletin makes use of the deduction from gross receipts for uncollectible accounts almost impossible. PPL explains that, under the Bulletin, its liability for GRT is no longer limited to actual revenues received, but, instead, PPL must file GRT using the accrual method of accounting. As such, a reduction against taxable gross income for an uncollectible account requires PPL to match each write-off to the tax period when the receipts are reported as taxable to Pennsylvania. PPL indicates that it does not have the capability to perform this tracking for the write-offs of amounts for its 1.4 million customers. *Id*. at 38; PPL St. 8-RJ, Part 1, at 36-37. PPL submits, while it is correct that it does maintain records of its customers' bad debts, this does not enable PPL to meet the onerous reporting and accounting requirements that the Bulletin requires. PPL Exc. at 38.

In its Replies to Exceptions, I&E argues that the ALJ correctly determined that the Bulletin confirmed I&E's adjustment to PPL's GRT claim on the basis that PPL's tax liability is the net of uncollectibles. I&E notes that, using the accrual methodology, PPL will deduct from its accrued billed revenues accounts that are written off. I&E asserts that PPL did not present any evidence to prove there are obstacles to it following the requirements in the Bulletin and distinguishing between billed and collected revenues. I&E R.Exc. at 24. I&E avers that, absent evidence that PPL pays taxes on uncollected revenues and that the cost of avoidance exceeds the benefit, the ALJ's decision should be adopted. *Id*. at 25.

4. Disposition

We agree with the ALJ's determination that I&E's recommendation to calculate the GRT allowance using net revenues is reasonable and should be adopted, as it is a better match of the claimed actual receipts of revenue that will produce the Company's actual GRT tax liability. The Bulletin supports I&E's adjustment on the basis that PPL's tax liability is billed revenues net of write-offs and recoveries. PPL will use the accrual method of accounting to deduct from its accrued billed revenues accounts that are written off. The Bulletin states the following, in pertinent part:

> If a taxpayer uses the accrual method of accounting to report its gross receipts, then the taxable gross receipts shall be calculated as follows:
>
> Billed revenues on an accrual basis (no reserves for bad debts)
> Less: Accounts actually written off for previously taxed Pennsylvania bad debts
> Plus: Collections of previously written off Pennsylvania taxable bad debts
>
> Taxable Gross Receipts

I&E Exh. 2-SR, Schedule 1, at 1.

Additionally, as PPL has explained, the Bulletin requires taxpayers claiming a deduction for bad debts to provide the DOR, upon request, with the following documentation: (1) the type and amount of receipts being written off; (2) the customer's location; and (3) the tax period during which the receipts were reported as taxable to Pennsylvania. *Id*. at 2. PPL submits that the DOR's reporting requirements are onerous and would require significant and costly changes to its billing and payment system. PPL M.B. at 134. Nevertheless, as I&E asserts, PPL has not presented any concrete evidence to show that it could not comply with the DOR's reporting requirements, such as cost analyses, evidence of system testing, or evidence of actual complexities. *See*, I&E Exc.

at 24; I&E M.B. at 70-71. PPL has also indicated that it does maintain records of customers' bad debts. Based on the evidence, we find that I&E's adjustment is reasonable. Accordingly, we shall deny PPL's Exception and adopt the ALJ's recommendation on this issue.

G. Rate Structure and Rate Design

This section of the Opinion and Order addresses cost of service, rate design and rate structure allocation issues. When a utility files for a rate increase, it must file a cost-of-service study (COSS) assigning to each customer class a rate based upon operating costs that it incurred in providing that service. 52 Pa. Code § 53.53; *Lloyd v. Pa. PUC,* 904 A.2d 1010, 1015 (Pa. Cmwlth. 2006). Public utility rates should enable the utility to recover its cost of service and should allocate this cost among its customers. These rates are required by statute to be just, reasonable and non-discriminatory. 66 Pa. C.S. §§ 1301, 2804(10).

1. Cost of Service Methodology

a. Positions of the Parties

PPL stated that the fundamental purpose of a cost allocation study is to aid in revenue allocation and the design of rates to be charged by identifying all of the capital and operating costs incurred by a utility to provide service to all of its customers, and then assigning or allocating those costs to individual rate classes on the basis of how those rate classes cause the cost to be incurred. PPL maintained that as a result of the *Lloyd* decision, *supra,* cost of service studies have assumed a greater degree of importance in utility ratemaking, but it still should be recognized that cost allocation is not an exact science, that there is no single correct cost allocation methodology and that the Court did not hold that all other considerations are to be disregarded. PPL M.B. at 136-137.

PPL presented a fully-allocated COSS, showing the allocation of its distribution costs among the various rate classes at both present and proposed rates for the historic (PPL Exh. JMK-1) and future (PPL Exh. JMK-12) test years. According to PPL, the filed COSS in this proceeding is virtually identical to the methodology adopted by the Commission in its 2010 base rate proceeding using the class maximum non-coincident peak (NCP) demand method, which is based on the highest demand imposed by each rate class on its distribution system, to allocate its demand-related distribution costs. PPL St. 8 at 19.

As in 2010, PPL's COSS utilized a "heightened" level of data analysis, using allocators to classify primary voltage level distribution facilities into their demand-related and minimum or no-load customer-related cost components. PPL stated that this method more accurately reflects cost causation than the method used in preceding rate cases, which allocated primary voltage level distribution facilities solely on the basis of demand. PPL St. 8-R at 9. PPL stated that prior to its 2010 case, the Company's cost allocation studies were criticized because not all of the primary voltage level distribution facilities used in its minimum size system studies had been classified into their applicable customer related and demand related components. PPL claimed that this modification is consistent with the National Association of Regulatory Commissioners (NARUC) Electric Utility Cost Allocation Manual (Manual) recommendations "that primary voltage level overhead and underground conductors be classified into their demand-related and customer-related cost components." *Id.;* PPL M.B. at 137-138.

Only the OCA opposed the Company's COSS, and on substantially the same grounds as it opposed the Company's COSS in the last base rate case. The OCA argued that primary plant should be classified on a 100% demand basis, with only secondary plant allocated to both demand and customer components. OCA St. 3 at 18. The OCA presented density studies which it claimed do not support allocation of

distribution plant based on customer count. As a "compromise" position, OCA recommended that the Commission allocate 100% of primary plant on a demand basis and apply the OCA's minimum size study to allocate secondary plant on a customer and demand basis. OCA M.B. at 77-82.

The OCA further argued that the Parties have misinterpreted the Commission's 2010 Order that NARUC has updated its cost of service principles since issuing the 1992 NARUC Manual, and argued that its recommendation reflects a compromise. OCA R.B. at 33-38.

The OSBA, PPLICA and REG supported PPL's position on COSS allocation and believe that it is consistent with the NARUC Manual and reflects a more realistic operation of PPL's system than the OCA counterproposal.

The OSBA stated that its primary focus in this case has been to determine whether the COSS presented by the Company conformed to the COSS approved by the Commission in the 2010 base rate case. The OSBA concluded that it did, and therefore, there was no need to re-litigate it in this proceeding. OSBA M.B. at 7.

REG agreed with the Company's classification of distribution plant as partially customer-related and partially demand-related, and the Company's allocation of the plant. This, REG argued, is consistent with the Commission's disposition of the Company's last rate case as well. REG M.B. at 4-5.

PPLICA argued in favor of the Company's COSS, which it believed properly allocates primary distribution facilities costs in both a customer and demand component and is consistent with NARUC policies. PPLICA characterized the OCA approach as "a results-driven density analysis with no meaningful relation to the cost of service principles historically applied by the Commission and supported by NARUC."

PPLICA M.B. at 7. PPLICA averred that PPL's COSS provides a reasonable basis for assessing distribution-related rates of return for each rate schedule, consistent with Commission precedent and NARUC recommendations. *Id.* at 8.

According to PPLICA, there are two recognized methodologies to estimate the customer component of distribution costs: (1) the minimum intercept method; and (2) the minimum size method, which is the method used by PPL. Each is designed to estimate the component of distribution plant cost incurred by a utility to connect a customer to the system. The minimum size method is designed to reflect costs associated with changes in both the number of distribution customers and the loads of these customers. It reflects a classification of the distribution facilities that would be required to simply interconnect a customer to the system, regardless of the kW load of that customer. PPLICA St. 1-R at 4-5; PPLICA M.B. at 9.

b. ALJ's Recommendation

The ALJ concluded that the other Parties rejected the OCA's arguments most persuasively. For the reasons set forth above by the Parties, the ALJ recommended that the Company's COSS be approved, and the OCA alternative be denied. R.D. at 108.

c. Exceptions

In its Exceptions, the OCA opines that the ALJ erred in recommending the use of PPL's COSS to allocate the revenue increase. The OCA avers that the PPL COSS is flawed because it does not accurately reflect cost causation, is inconsistent with the 1992 NARUC Manual and the updated NARUC Report, and is inconsistent with the historical method that PPL used prior to 2010. The OCA submits that, prior to 2010, PPL classified primary distribution plant as 100% demand related and further classified secondary distribution plant as partially demand and partially customer related.

According to the OCA, this method was approved by the Commission in the 2004 and 2007 PPL rate cases, and is the same COSS method that the OCA has proposed in the present case. The major change, starting with the 2010 case, is that PPL now classified primary distribution plant as 63% customer related and 37% demand related. This change, avers the OCA, has caused over one billion dollars of such costs to be shifted from a demand basis to a customer count basis. OCA Exc. at 18-19.

Next, the OCA notes that the ALJ relied on the arguments of the Company and the other Parties in adopting PPL's COSS, whereby the central point made was that the Commission had already ruled against the OCA in PPL's 2010 rate case and should do the same here. The OCA avers that PPL's COSS method does not follow the 1992 NARUC Manual in many respects, and is inconsistent with the more recent 2000 NARUC Report. The OCA states that in the 2010 rate case, PPL's recommended allocation of the entire increase to the residential class was adopted by the Commission, partially because the Commission found the OCA's approach did not accurately reflect the costs incurred to serve the residential class. *Id*. at 20 (citing *Pa. PUC v. PPL Electric Utilities Corporation*, Docket No. R-2010-2161694, at 46 (Order entered December 21, 2010) (*PPL 2010*)). However, the OCA avers that in the 2010 case its approach was identical to PPL's own COSS method used in 2004 and 2007. According to the OCA, PPL's proposed COSS in the instant proceeding contains bias to the residential class that negates any possibility of that class reaching "cost of service" anytime in the foreseeable future. OCA Exc. at 19-20.

Additionally, the OCA maintains that both primary and secondary distribution plant should be classified as 100% demand related, consistent with how regulatory bodies in over thirty states classify such plant. The OCA avers that it has recommended a reasonable and appropriate compromise COSS that maintains a customer/demand split for the secondary distribution plant but allocates primary plant on demand only, which is exactly what PPL did prior to 2010. Further, the OCA then

classified secondary distribution plant as partially demand and partially customer related, just like PPL's current and prior COSSs, but with a more appropriate customer component than PPL based on its revisions to PPL's minimum size study and consistent with how such a study is to be performed as per the 1992 NARUC Manual. OCA Exc. at 20-21.

The OCA submits that the ALJ's and other Parties' reliance on *PPL 2010* is misplaced as the Commission has substantial evidence in this record that it did not have in 2010, specifically: (1) PPL's proposed COSS is an outlier in its classification of primary distribution plant as having a customer component; (2) to the extent that a customer component should be a part of distribution plant cost assignment, PPL's minimum size study fails to follow the 1992 NARUC Manual's specific instructions for performing such a study; and (3) the fact that adhering to PPL's proposed COSS will always result in the residential class being allocated a substantial portion of future rate increases with little to no hope of ever achieving cost of service. OCA Exc. at 21.

The OCA maintains that using the method that has been accepted in over thirty states, a 100% demand allocation, the indexed rate of return for the RS class, at present rates, would be 124%. Using the method that PPL proposed in this proceeding, the indexed rate of return for the RS class would be only 63%, per the OCA. The OCA avers that its compromise position, 100% demand allocation only for primary plant, shows the Residence Service (RS) class at an indexed rate of return of 112% at present rates. Therefore, according to the OCA, at current rates under an accurate and reasonable COSS, the RS class is paying more than its cost to serve. As a result, the OCA avers that the Commission's holding in *PPL 2010* should not be controlling here. OCA Exc. at 23-24.

In reply, PPL states that its COSS is virtually identical to the methodology adopted by the Commission in the 2010 base rate proceeding, which was fully litigated

on this issue. PPL avers that the Commission fully considered and rejected the OCA's proposal in the 2010 base rate proceeding and that the OCA has offered no change in law or fact that would warrant a departure from that decision. PPL maintains that the ALJ properly approved its COSS. PPL R.Exc. at 16.

In its Replies to Exceptions, the OSBA first notes that, contrary to the OCA's argument, PPL has actually proposed to reduce the customer component of distribution plant costs in the instant proceeding relative to the method that was explicitly approved by the Commission in the Company's 2010 case, to the benefit of residential customers. The OSBA avers that for the OCA to prevail on the issue of cost allocation, it must demonstrate both that the Commission erred in its decision in the 2010 case to allow for the classification of primary system distribution plant costs into both demand and customer components and that the Commission has consistently erred over the past decades in approving PPL's cost classification methodology for secondary distribution system costs. The OSBA notes that the Commission considered virtually all of the evidence presented by the OCA in this proceeding in the 2010 case and rejected the OCA's conclusion. Moreover, the OSBA notes that, in objecting to PPL's method for classifying secondary system plant costs, the OCA is challenging an approach PPL has used for years if not decades. According to the OSBA, in the OCA's view, Commission precedent prior to 2010 is relevant only if it favors residential customers, which is both wrong and inconsistent. OSBA R.Exc. at 4-6.

In response to the OCA's assertion that regulatory bodies in thirty states do not include any customer component in classifying either primary system or secondary system distribution costs, the OSBA states that cost allocation is often hotly debated among the parties to a regulatory proceeding. The OSBA explains that the economic issue of the classification of distribution plant costs is essentially an issue involving residential and small to medium business customers, as large industrial customers are generally served at transmission voltage and have no stake in this issue. According to the

OSBA, the smaller business customers are generally unrepresented in utility regulatory proceedings, so it is unclear whether the regulatory pattern alleged by the OCA results from hard cost analysis, or simply a lack of representation. The OSBA maintains that in either event, the thirty jurisdictions are ignoring the basic principle that this Commission has accepted. As this principle has long been followed in Pennsylvania, the OSBA submits that the alleged practices of other jurisdictions are irrelevant. OSBA R.Exc. at 6-7.

Next, the OSBA submits that the OCA characterization of the "updated NARUC report" as an update to the 1992 NARUC Cost Allocation Manual is deceptive at best. The OSBA explains that the 1992 NARUC Manual was published as a NARUC Report. The report to which the OCA refers to as an update is nothing of the kind, but, in fact, a report prepared by the Regulatory Assistance Project entitled "Charging for Distribution Utility Services: Issues in Rate Design." The OSBA avers that this document contains little in the way of specifics for distribution cost classification and allocation and does not necessarily reflect the positions of NARUC. As a result, the OSBA recommends that the Commission give no weight to this consultant's report. OSBA R.Exc. at 7-8.

In its Replies to Exceptions, PPLICA states that PPL's proposed COSS is firmly supported by NARUC principles, designed to achieve cost of service rates and should be approved. PPLICA points out that while the OCA refers to the updated report as a "NARUC" report, the document is not an official NARUC publication. Also, PPLICA states that the OCA's claim that this document establishes PPL's minimum size system COSS as an outlier is specious. According to PPLICA, this report's statement that allocating primary distribution plant on a 100% demand basis "is used in more than thirty states" dates back to 2000, almost thirteen years ago. PPLICA avers just as PPL classified primary distribution plant on a 100% demand basis before updating its classification methods in 2010, many of the states referenced in the report may have

modified their methodologies. Therefore, PPLICA asserts that the Commission should not accord significant weight to stale data. PPLICA R.Exc. at 4-5.

PPLICA further replies that PPL's minimum size study is completely consistent with the NARUC Manual, and that it is worth noting that the same study employed by PPL in this proceeding was fully litigated in the Company's 2010 case and adopted by the Commission. Additionally, PPLICA notes that PPL's minimum size study reflects the Company's actual installations rather than the theoretical adjustments applied by the OCA. Lastly, PPLICA argues that PPL's proposed COSS contains no inherent bias towards any rate class as alleged by the OCA. PPLICA R.Exc. at 5-7.

d. Disposition

Based upon our review of the record evidence, we are in agreement with the ALJ that PPL's proposed COSS should be approved. It is important to note that the PPL COSS methodology is supported by all the Parties which offered a position on this issue, with the exception of the OCA. We have reviewed the OCA's position and Exceptions on this issue and are not persuaded by the arguments it presented in support of its recommended COSS methodology. The position presented by the OCA was considered and rejected by the Commission in the litigation of PPL's 2010 base rate proceeding. *Pa. PUC v. PPL Electric Utilities Corp*., Docket No. R-2010-2161694, at 46 (Order entered December 21, 2010). We conclude that the OCA has not presented convincing arguments in this proceeding that would cause us to re-evaluate our determination in PPL's prior proceeding. PPL's proposed COSS in the instant proceeding is virtually identical to the COSS approved in 2010, is consistent with the NARUC Manual and more accurately reflects cost-causation principles than the COSS methodology the Company utilized prior to the 2010 base rate case. We conclude that PPL has carried its burden of proof on this issue, and we shall adopt the ALJ's recommendation. Accordingly, we shall deny the Exceptions of the OCA.

2. Revenue Allocation

a. Positions of the Parties

PPL explained that its proposed allocation of revenue requirement among the various rate classes in this proceeding is driven largely by the Commonwealth Court's decision in *Lloyd, supra.* PPL stated that this case is the fourth in a series that have purportedly attempted to move PPL's distribution rates to true cost of service. PPL St. 5 at 8. The Company sought to establish cost of service, and then to apply those costs to the appropriate rate schedules. Because that approach produced a distribution rate increase to customers served under Rate Schedule Residential Thermal Storage (RTS) of about 165 percent, which PPL considered to be unjust and unreasonable, it developed an alternative allocation, which limited the increase to Rate RTS from 165% to approximately 78%. According to PPL, the goal was to bring all rate classes closer to the system average rate of return, while still considering the principle of gradualism. *Id.* at 10; PPL M.B. at 152-153.

The Company's proposal is as follows:

	Relative Rate of Return	
Rate Classes	**Present Rates**	**Proposed Rates**
RS	63.03%	83.81%
RTS	-65.31%	23.05%
GS-1	133.55%	99.05%
GS-3	285.18%	196.34%
LP-4	163.36%	118.44%
LP-5	-90.72%	98.94%
LPEP	353.09%	256.26%

GH-2	86.64%	103.55%
SL/AL	100.49%	99.65%
Total	100%	100%

PPL Exh. JMK-2 at 8-11; PPL M.B. at 154.

The OCA stated that for the second time in two years, PPL has proposed to allocate nearly the entire revenue increase to the RS and RTS rate classes. The OCA noted that of PPL's $104.6 million increase requested, PPL proposed to allocate over $99 million to the residential class with over $3.5 million of that amount allocated to RTS customers. The OCA averred that these increases amount to an annual increase to distribution rates of 20.9% and 77.6%, respectively. OCA M.B. at 66.

The OCA recommended an alternative revenue allocation that it claims reflects the results of a properly conducted, reasonable and equitable cost of service study. The OCA submitted that while cost of service should guide the Commission when setting rates in this proceeding, other ratemaking principles such as gradualism, avoidance of rate shock and basic fairness must not be abandoned. As such, the OCA recommended that no rate class receive a revenue decrease and that no class sustain an increase greater than 150% of the system-wide percentage increase, or no more than 21.45%. *Id.* at 95.

The OCA's proposal results in the following indexed rate of returns by class:

Relative Rate of Return

Rate Classes	**Present Rates**	**Proposed Rates**
RS	112%	111%

RTS	-93%	-53%
GS-1	180%	131%
GS-3	104%	109%
LP-4	-13%	11%
LP-5	-88%	-4%
LPEP	399%	289%
GH-2	30%	50%
SL/AL	90%	111%
Total	100%	100%

OCA St. 3 at 37, 41; OCA M.B. at 96-97. According to the OCA, this proposed revenue allocation results in a reasonable movement of all classes to cost of service at PPL's proposed revenue increase, while also recognizing the need for gradualism. OCA M.B. at 97.

REG and PPLICA supported PPL's proposed revenue allocation as consistent with the COSS. According to these Parties, the Company's proposed revenue allocation moves all rate classes closer to cost of service in accordance with the Company's COSS and consistent with *Lloyd*. REG M.B. at 5; PPLICA M.B. at 13-17.

PPLICA pointed out that Rate Schedule LP-5 customers will experience a 59.1% increase, and although Rate Schedule LP-4 customers do not experience an increase, their current rates remain above cost of service. PPLICA recognized that the movement towards actual cost of service rates as set forth is reasonable, and did not oppose this allocation. PPLICA M.B. at 16.

PPLICA argued that the Commission should not give any credence to OCA's COSS, and as the OCA's proposed allocation is based on its flawed COSS,

neither should the Commission give any credence to the OCA's recommendation. PPLICA St. 1-R at 8; PPLICA M.B. at 15.

b. ALJ's Recommendation

The ALJ concluded that as the OCA alternative was based on its COSS, and not on the Company's, which she recommended be adopted, the OCA alternative should be denied. The ALJ recommended adoption of the Company's revenue allocation, with the actual numbers to be based on the proportionate adoption of the actual revenue requirement approved. R.D. at 110.

c. Exceptions

In its Exceptions, the OCA submits that its COSS should be adopted as a guide to set rates in this proceeding and for purposes of establishing a fair and reasonable allocation of the revenue increase. The OCA avers that PPL's COSS is unduly discriminatory against residential customers and PPL's proposed revenue allocation is based on that study. The OCA maintains that its proposed allocation is based upon a more reasonable COSS and recognizes gradualism and fairness and caps increases to any one rate class at no greater than 150% of the system-wide percentage increase, or 21.45%. The OCA opines that its revenue allocation method results in a reasonable movement of all classes to cost of service at PPL's proposed revenue increase, while also recognizing the need for gradualism. OCA Exc. at 31-34.

In reply, PPL states that its proposed revenue allocation follows the Company's COSS and substantially moves all rate schedules toward the system average rate of return. PPL avers that since the OCA's revenue allocation is premised on its flawed COSS, its resulting revenue allocation was properly rejected by the ALJ. PPL R. Exc. at 16-17.

In its Replies to Exceptions, the OSBA points out that, as the OCA readily admits, the adoption of the OCA's revenue allocation proposal requires the Commission to agree to the OCA's version of the COSS. According to the OSBA, because the ALJ correctly rejected the OCA cost allocation methodology, the OCA's revenue allocation methodology should similarly be rejected. OSBA R.Exc. at 13-14.

In its reply, PPLICA states that the OCA's proposed COSS is contrary to Commission precedent and unsupported by the NARUC Manual and, as such, any revenue allocation based on the OCA's proposed COSS must be summarily rejected. In response to the OCA's argument about gradualism, PPLICA acknowledges that gradualism is a legitimate ratemaking construct designed to mitigate unreasonable rate increases. However, according to PPLICA, because PPL's COSS shows that residential customers are paying rates significantly below cost-of-service, PPL's revenue allocation limits gradualism adjustments to ensure that customers paying above-cost rates move reasonably closer to cost-of-service. PPLICA posits that as the ALJ's recommendation to approve PPL's revenue allocation incorporates gradualism, it should be approved by the Commission without modification. PPLICA R.Exc. at 9-10.

d. Disposition

Based upon our prior determination and discussion, *supra,* with respect to the rejection of the OCA COSS, we are in agreement with the ALJ that PPL's proposed revenue allocation should be approved. As the OCA's revenue allocation recommendation is based upon its COSS, which we have rejected, we conclude that its allocation proposal should similarly be denied. Additionally, we find that PPL's revenue allocation proposal is consistent with *Lloyd,* moves all rate classes closer to cost of service in a reasonable manner and considers the principle of gradualism. Accordingly,

we shall adopt the recommendation of the ALJ and deny the OCA Exceptions on this issue.

3. Revenue Scaleback

a. Positions of the Parties

As the Commission is approving a lesser revenue requirement than sought by PPL, an important consideration is the determination of how the proposed revenue allocation will be affected by the scaleback in rates.

In this proceeding, PPL and the OCA support a proportional scaleback, with no decrease in revenues for classes that do not receive a rate increase. PPL St. 5-R at 4; OCA St. 3 at 42.

I&E proposed applying the first $1,784,000 to lower the revenue requirement for Rate Schedule RTS customers, with any further reductions applied to Rate Schedules RS, GH-2, SL/AL, and on a conditional basis, LP-5. I&E St. 3 at 16-17.

The OSBA recommended a revenue-based scaleback which would allocate any overall rate increase approved by the Commission to each rate class in proportion to the Company's proposed revenues from each class. OSBA St. 1 at 13.

PPLICA supported the scaleback recommendation proposed by the OSBA in the event that the Commission approves an overall revenue increase lower than the Company's requested $104.6 million increase. PPLICA argued that application of a proportional scaleback in this proceeding would hinder progress to cost of service rates by reducing rate increases for customers paying below cost of service rates pursuant to PPL's COSS, but not allowing correlating adjustments for customers whose present rates are above cost of service. PPLICA M.B. at 19, PPLICA R.B. at 9.

PPLICA further asked that should the Commission not adopt the OSBA recommendation, then the scaleback should be applied to all rate classes receiving an increase as proposed by the Company and the OCA, with no further exclusions, as would apply under I&E's proposal. PPLICA opposed the restrictions on the scaleback for Rate Schedule LP-5 that I&E recommended, since that rate schedule is already targeted for a substantial increase. PPLICA M.B. at 18-19.

b. ALJ's Recommendation

The ALJ stated that in the *Lloyd* decision, the Commonwealth Court disapproved the setting of rates according to a flat across-the-board percentage, because there was no dispute that the cost of serving each rate class varied and that rates for certain classes were subsidizing rates for others in the interest of keeping the increase in the total bills of each class to 10% or less. Accordingly, the ALJ found that any scaleback should be utilized to bring the rates of each rate schedule closer to the cost of service. R.D. at 111.

However, the ALJ concluded that this concept, applied blindly, would result in reductions to customers who were not expecting an increase, or greater reductions to some customers than were originally proposed, to the detriment of those whose rates will rise more than necessary. Therefore, the ALJ recommended that PPL's proposal to apply any scaleback on a proportional basis to only those rate schedules that receive increases should be adopted by the Commission. R.D. at 112.

c. **Exceptions**

In its Exceptions, I&E states that it agrees with the ALJ, but believes the Commission should moderate the increases proposed for the Rate RTS usage rate and the LP-5 customer charge before the proportionate scale-back is applied. I&E Exc. at 29-30.

In its Exceptions, the OCA stated that, as a general principle, it has no disagreement with PPL's proportional scaleback approach. However, the OCA disagrees with using PPL's revenue allocation as a starting point for the proportional scaleback. The OCA submits that its revenue allocation be used as a starting point for a proportional scaleback in this proceeding. OCA Exc. at 34.

The OSBA also excepted to the ALJ's recommendation, stating that the ALJ erred in recommending a proportional scaleback of the rate increase for only those customer classes that were assigned rate increases by PPL. The OSBA avers that Rate Schedule GS-3 is significantly overpaying its cost of service at current rates, and only received mild relief under PPL's original proposed revenue allocation.[18] The OSBA avers that the problem with the proportional scaleback is the progress toward cost-based rates that was part of the original intent of the Company's revenue allocation will not be retained. Under the method adopted by the ALJ, certain customer classes will not benefit from the reduction in PPL's proposed rate increase. The OSBA alleges that the I&E scaleback proposal results in the same unacceptable result. The OSBA recommends that any reduction in the overall increase be shared among the rate classes in proportion to the Company's originally proposed revenues. According to the OSBA, its recommended scaleback methodology maintains the progress towards cost-based rates that was present in PPL's original revenue allocation proposal. OSBA Exc. at 5-12.

[18] The OSBA included Tables showing that the GS-3 class rate of return at present rates is 11.4 percentage points above system average, and, even with the proposed rate decrease, remains 8.2 percentage points above system average at PPL's proposed rates. OSBA Exc. at 8.

Exceptions to the ALJ's recommendation were also filed by PPLICA, wherein it states that the ALJ erred in rejecting the OSBA recommendation of a revenue-based scaleback. PPLICA observes that PPL has now filed four base rate cases since *Lloyd*, without achieving cost-based rates for certain rate schedules. PPLICA avers that it is imperative that any scaleback applied to the lower revenue requirement also reflect continued progress towards cost-based rates. PPLICA opines that despite the ALJ explicitly acknowledging the directives and principles from *Lloyd*, the ALJ inexplicably declined to adopt the revenue-based scaleback proposed by the OSBA. PPLICA echoes the comments of the OSBA that approval of a proportional scaleback would reverse progress towards cost-based rates by reducing rates for customers receiving an increase, but still paying below cost rates. At the same time, rate schedules currently paying above-cost rates, but not receiving an increase, would be excluded from a scaleback, explains PPLICA. According to PPLICA, no reasonable basis exists for approving a scaleback that reverses progress towards cost-based rates. PPLICA Exc. at 3-6.

In reply to the arguments of the OSBA and PPLICA, PPL states that the scaleback method recommended by the ALJ is fair and should be approved. PPL maintains that the ALJ's recommended scaleback is the same method the Company proposed in its 2010 case, which was litigated and adopted by the Commission. PPL avers that both the scaleback recommended by the ALJ and the method proposed by the OSBA would move rate classes towards the system average return. However, PPL opines that as a matter of fairness, any scaleback of revenues should be applied to those customer classes that would have received a rate increase under the Company's original proposal. PPL R.Exc. at 17.

In its Replies to Exceptions, the OCA states that the ALJ was correct in recommending the use of a proportional scaleback. The OCA notes that the OSBA recommendation was directly addressed in PPL's 2010 case and rejected by the ALJ and

the Commission, which stated that asking one class to pay more of an increase than the final total increase in revenue would be unreasonable. According to the OCA, the OSBA's proposed scaleback methodology would impose additional costs on certain rate classes, over and above the total revenue increase authorized, in order to provide additional rate decreases to other rate classes. The OCA avers that neither the OSBA nor PPLICA provide evidence to support the idea of what constituted unreasonable rates in 2010 is now acceptable. OCA R.Exc. at 15-17.

In its Replies to Exceptions, PPLICA first states that since the OCA's proposed revenue allocation is *per se* unreasonable, any scaleback based upon it should be disregarded by the Commission. Additionally, PPLICA avers that an increase-based scaleback will significantly hinder progress towards cost-based rates. PPLICA requests that the Commission deny any proposal to apply a proportional increase-based scaleback and adopt the revenue-based scaleback proposed by the OSBA. PPLICA R.Exc. at 10-11.

d. Disposition

Based upon our review of the record evidence, we are in agreement with the recommendation of the ALJ that PPL's proposed proportional scaleback only to those classes that were proposed to receive rate increases, of the requested revenue increase, are fair, reasonable and should be approved. We find that the OCA's Exceptions with regard to the proper starting point are without merit, as we have herein previously rejected the OCA recommended allocation proposals. We further conclude that the I&E's Exceptions with regard to first providing relief to certain designated rate classes before the proportional scaleback is applied are also without merit.

The OSBA, as well as PPLICA, filed Exceptions opposed to the adoption of a proportional scaleback. These Parties are of the opinion that a revenue based

scaleback should be adopted and applied to all customer classes, whether they were to originally receive no increase or a rate decrease. On this point, we are persuaded by the comments of PPL that the ALJ's recommended scaleback is the same method the Company proposed in its 2010 case, which was litigated and adopted by the Commission. Neither the OSBA nor PPLICA have presented sufficient evidence to warrant our reconsideration of this issue in this proceeding. We find that, as a matter of fairness, those customer classes that have not been allotted any rate increase via the Company's original revenue allocation should not receive rate decreases as argued by the OSBA and PPLICA. We conclude that PPL's proposed scaleback methodology maintains the gradual movement to cost based rates and is appropriate under the unique circumstances in this proceeding. Accordingly, the Exceptions of I&E, the OCA, the OSBA and PPLICA are denied, and the ALJ's recommendation is adopted.

4. Residential Customer Charge

a. Positions of the Parties

PPL's current residential distribution schedules are RS, RTS, and Residential Time-of-Day (RTD). In PPL's presently effective residential Rate Schedule RS, a large portion of the distribution revenue is being collected through usage or kWh charges. PPL's minimum size system study indicated that residential customers should be paying a much greater monthly customer charge than the current monthly charge of $8.75. In this proceeding, PPL has proposed raising the Rate Schedule RS customer charge from its present $8.75 per month to $16.00 per month and decreasing the kWh charges from $0.03364 to $0.03340. PPL St. 5 at 11-14. The Company pointed out that its COSS supports a charge of $36.70, and this increase moves the rate schedule closer to the cost of serving it. PPL M.B. at 162-163.

The OCA, the CEO and I&E opposed PPL's proposal to increase the Rate Schedule RS customer charge.

The OCA opposed the increase to residential customers because it is based on the Company's COSS, which it also opposed. The OCA objected further that the Company's proposal will disproportionally impact low-income, low-usage customers and would result in a "significant disincentive" for customers to conserve. OCA M.B. at 106.

The CEO opposed the increase in the fixed monthly customer charge because it takes away a customer's motive and ability to conserve. The CEO stated that one of the only defenses that a family has against sharp increases in energy costs is conservation, CEO St. 1 at 5, and this proposal eliminates the ability to reduce that cost through conservation efforts. CEO M.B. at 7.

The Company pointed out that there is an energy charge component that is being reduced by 0.7%, and that the distribution charge is small in the context of the energy portion of the bill, which comprises 86% of the charges on the average customer's bill. According to PPL, this still provides an adequate opportunity for savings due to conservation. PPL St. 5-R at 6; Exh. DAK4; PPL M.B. at 164.

I&E developed its own offering based upon a direct customer analysis. In preparing its direct customer cost analysis, I&E stated that it was guided by long-standing Commission precedent that identifies the appropriate items to be included in a customer charge. According to I&E, those items that change with the addition or loss of a customer are the direct customer costs that were identified in the Company's cost of service study and are as follows: meter expenses, expenses for services and customer installations, expenses for meter reading and customer records & collection, other customer accounting expenses, depreciation expense and net salvage amortized for meters and services, and the rate base related return and income taxes on customer-based rate base. I&E maintained that the Commission has long held these costs to be those most appropriately included in a customer cost study. I&E M.B. at 131 (citing *Pa. PUC*

v. West Penn Power Company, 59 Pa. P.U.C. 552 (1985)). I&E noted that recently the Commission accepted a direct customer cost analysis identical to the analysis it presented in this proceeding[19] in the Columbia Gas of Pennsylvania base rate case at Docket No. R-2010-2251623 (Order entered October 14, 2011). I&E recommended that the RS customer charge remain unchanged at $8.75 per month. I&E M.B. at 130-133.

The Company countered that the OCA and I&E alternative customer cost analyses include only meters and services and exclude all other customer costs, which should be included in a customer charge. PPL M.B. at 170. Further, PPL pointed out that "conservation cannot and does not trump cost of service." PPL M.B. at 164.

However, in response to the positions of the other Parties, PPL proposed an alternative plan that includes a residential customer charge of $14.09 per month, consistent with the recent Commission decision in *Pa. PUC v. Aqua Pennsylvania, Inc.,* Docket No. R-00038805 (Order entered August 5, 2004) (*Aqua*). PPL stated that the costs included in its alternative Rate Schedule RS customer charge of $14.09 per month properly reflect meters and services net plant and related O&M expenses; meter reading and billing and collection expenses, and the Company's Meter Data Management System; as well as related employee benefits, administrative and general expenses and other O&M expenses related to the above items. These revenue requirement cost components represent the same type of direct and indirect cost components as those approved in *Aqua*. PPL M.B. at 172. The only difference is that PPL also included $12,678,000 for customer call center-related expense. PPL averred that this expense was not specifically addressed in *Aqua*, but it is consistent with the expenses included in the customer charge in *Aqua,* because it is a directly assignable customer service-related expense, and it varies with the number of customer calls and the number of customers. *Id*. at 173; PPL St. 8-RJ (Part 2) at 8.

[19] Tr. at 541-42.

While PPL opined that the customer component of each rate schedule should include all customer-related costs determined by the cost of service study, if the Commission wished to consider an alternative compromise customer charge, PPL posits that its alternative proposal of $14.09 would be acceptable as it would recover the same type of direct and indirect cost components as those approved in *Aqua*, and would provide some improvement in the level of fixed cost recovery in the customer charge. PPL St. 5-R at 15; PPL M.B. at 172-173.

I&E responded that it is improper to offer a compromise outside the context of a settlement, and that without an actual settlement the Company's position still needs to rely on substantial evidence to support it, which it did not provide. I&E R.B. at 107.

b. ALJ's Recommendation

The ALJ stated that while it would be improper to propose a compromise position for the first time in a brief or exception, it is not improper to propose an alternative during the litigation, when the supporting data already appears in the record, as PPL did in this proceeding. The ALJ recommended approval of the PPL alternative as it is based on an approved cost of service study, which clearly illustrates that customer-related costs for the residential class include elements that I&E ignored in its own analysis and determination of a proper residential customer charge. The ALJ found that it is reasonable to include some of these additional elements in calculating the residential customer charge, as the Commission allowed in the *Aqua* case. R.D. at 120.

According to the ALJ, the Company will be ensured recovery of more of its fixed costs, which are clearly more customer-related than usage-related, while still allowing some revenue to be recovered through usage-based charges. Thus, customers will be provided with more accurate price signals, while still being afforded some

opportunity to control their monthly distribution bills through conservation. For these reasons, the ALJ concluded it is appropriate and reasonable to accept PPL's compromise position regarding the residential customer charge. R.D. at 120.

c. Exceptions

In its Exceptions, I&E states that the ALJ's recommendation to adopt the Company's compromise lacks legal support. I&E avers that as originally proposed, PPL's entire residential increase was to be recovered from an 82% increase to its RS customer charge without providing any direct customer cost analysis. I&E notes that PPL provided only a COSS, which is an entirely different cost analysis. According to I&E, PPL found very few, if any, distribution system-related costs that were a function of usage and proposed to recover essentially all fixed costs in the customer charge. I&E states that PPL included all fixed costs that it classified as customer related, as opposed to demand related, in the customer charge and made no distinction between direct and indirect costs. I&E avers that fixed costs and customer costs are not synonymous and opines that fixed costs assigned to the customer charge should be limited to those fixed costs for which there is a direct impact from an individual customer, such as metering and billing. I&E Exc. at 30-31.

Next, I&E notes that although PPL moderated its Rate RS proposal in rebuttal, it still failed to conduct an appropriate customer cost analysis. Rather, I&E asserts that PPL presented a "study" that included both direct and indirect costs that it claimed authorized a $36.70 RS customer charge, but under which PPL only claimed a "compromise" RS customer charge of $14.09.[20] I&E avers that the ALJ's reliance on one aberrant Commission order from 2004, *Aqua,* to support her recommendation to

[20] I&E asserted that PPL produced no such "study" and made no such "compromise" offer with respect to its originally proposed non-residential customer charges. I&E Exc. at 32.

adopt the PPL compromise position lacks adequate legal support. I&E opines that the *Aqua* case is not controlling as the holding of that case, with respect to the inclusion of indirect costs in the calculation of a customer charge, has not been reaffirmed or reapplied since 2004. I&E maintains that since 1985 and most recently in 2011, with the one exception being *Aqua*, the Commission affirmed the basic customer cost analysis it originally articulated in 1985. I&E Exc. at 31-33.

Lastly, I&E states that as *Aqua* formed the sole basis presented by the ALJ for adoption of the Rate RS customer charge, the ALJ's recommendation should be rejected. I&E maintains that PPL's "compromise" RS customer charge fails to meet the parameters of a properly constructed customer cost analysis. Additionally, I&E asserts that the ALJ's recommendation is not supported by the overwhelming Commission precedent and, unless prepared to enunciate a new standard, the Commission should reject it. Further, I&E notes that customers will lose control over a substantial part of their bill, very likely deterring conservation efforts despite the millions of dollars customers have invested in energy conservation efforts. I&E Exc. at 35-36.

The OCA also excepts to the ALJ's recommendation, arguing that PPL's proposed customer charge is based on its flawed COSS results, does not represent the results of a direct customer cost analysis, would disproportionately impact low-income, low-usage customers and would result in a significant disincentive for customers to engage in conservation activities. The OCA recommends that the Rate RS customer charge continue to be set at its correct level of $8.75. The OCA avers that the ALJ erred by accepting PPL's alternative RS customer charge without a direct cost study as support for such a charge. According to the OCA, the Commission has repeatedly expressed its preference for a direct cost study, which includes only direct costs and not indirect costs, as PPL has done in its alternative proposal as a basis to set customer charges. The OCA notes that, in contrast to the decades of Commission precedent on this issue, PPL supports its alternative customer charge with the lone case of *Aqua*. The OCA submits

that the *Aqua* decision was fact specific and provides no support for PPL's current proposal. OCA Exc. at 34-36.

Next, the OCA explains that it performed a direct customer cost analysis, consistent with Commission precedent, and found that the direct residential customer costs ranged from $7.70 per month to $8.24 per month. Therefore, the OCA is of the opinion that the current RS customer charge of $8.75 is reasonable and should not be increased. The OCA avers that PPL's proposed customer charge will disproportionately impose adverse impacts on the customers least able to afford those bill increases and should not be accepted. OCA Exc. at 36-37.

In its Replies to Exceptions, PPL states that unlike the case relied upon by I&E, nothing in *Aqua* limits the Commission's holding only to that case. PPL avers that the Commission clearly stated that requests to include allocated indirect costs, such as employee benefits, local and payroll taxes, and other general and administrative costs, should be reviewed on a case-by-case basis, citing *Aqua,* at 70-72. PPL further submits that there is no order from either the Commission or the appellate courts overturning or otherwise limiting the Commission's conclusion in *Aqua*. PPL maintains that it followed the Commission's conclusion in *Aqua* and proposed the inclusion of the same type of direct and indirect cost components approved by the Commission in *Aqua*. PPL continues that I&E and the OCA failed to offer any criticisms or reasons to exclude from the customer cost study and customer charge the indirect costs that PPL allocated for employee benefits, local and payroll taxes, and other general and administrative costs. For these reasons, PPL opines that the ALJ properly rejected the positions of I&E and the OCA. PPL R.Exc. at 17-18.

With regard to the Parties' comments on the impact on low income/low usage customers, PPL agrees that increasing the monthly charge while essentially maintaining the usage charge at its current level will result in a greater than average

percentage increase to low use customers, regardless of their income level. However, PPL avers that as a utility with an obligation to serve, it must provide infrastructure to serve the needs of those customers. PPL states that utility rates should be designed based upon cost of service, not customers' income levels. According to PPL, ability to pay issues should be addressed through USPs, not by setting rates that disregard the cost of service. PPL R.Exc. at 19.

d. Disposition

Upon our consideration of the evidence of record herein, we shall adopt the ALJ's Recommendation on this issue that PPL's compromise proposal is reasonable and should be approved. In this regard, we conclude that PPL's original proposal is excessive, disregards the principle of gradualism and is not reasonable. Additionally, we conclude that the recommendations of I&E and the OCA that the residential customer charge not be increased at all in this proceeding are equally unreasonable as they are not based on a proper cost analysis. We further conclude that the ALJ correctly recommended that, consistent with *Aqua,* other customer-related costs are properly includable in a customer charge cost analysis. We find that the I&E proposed limitation of costs to only services and meters excludes all other customer costs that should be included in a customer charge and is unreasonably narrow.

With regard to the concerns expressed by the opposing Parties that PPL's compromise proposal discourages conservation, we note our agreement with the Company's observation that the distribution charge is relatively small in the context of the energy portion of a customer's bill, which comprises approximately 86% of the charges on the average customer's bill. Therefore, we find that this will provide a more than adequate opportunity for customer savings due to energy conservation.

Therefore, we find that PPL has met its statutory burden of establishing the reasonableness of its compromise proposal. Accordingly, we adopt the recommendation of the ALJ and deny the Exceptions of I&E and the OCA on this issue.

5. Non-Residential Customer Charges

a. Positions of the Parties

PPL proposed increases to the customer charges in the Small General Service -- Rate Schedule GS-1 (GS-1), Large General Service – Rate Schedule GS-3 (GS-3), Large Power Firm Service at 12 kV – Rate Schedule LP-4 (LP-4), and Large Power Service at 69 kV – Rate Schedules LP-5, LP-6, and IS-T (LP-5,LP-6 and IS-T).

PPL proposed to increase the customer charge for Rate GS-1from $14.00 to $16.00 per month and decrease the demand charge from $4.530 to $4.258 per kW. PPL stated it has installed demand meters on all GS-1 customer premises, except for small unmetered constant load accounts. PPL St. 5 at 15; PPL Exhs. DAK 1, DAK 2; PPL Exh. 1, Exhibits Regs.

PPL proposed to increase the customer charge for Rate GS-3 from $30.00 to $40.00 per month and decrease the demand charge from $4.510 to $4.192 per kW. PPL St. 5 at 15; PPL Exhs. DAK 1, DAK 2; PPL Exh. 1, Exhibits Regs.

PPL proposed to increase the customer charge for Rate LP-4 from $160.19 to $170.00 per month and decrease the demand charge from $2.136 to $2.127 per kW. PPL St. 5 at 16; PPL Exhs. DAK 1, DAK 2; PPL Ex. 1, Exhibits Regs.

PPL proposed to increase the customer charge for Rate Schedule LP-5 from $709.00 to $1,125.00 per month. PPL stated that presently, there are only two customers on Rate Schedule LP-6. As there is no difference between Rate Schedules LP-6 and

LP-5, PPL proposed to eliminate LP-6 and move the two remaining customers to Rate Schedule LP-5. Finally, PPL proposed to eliminate Rate Schedule IS-T because there are no customers on this interruptible service program. According to PPL, all of its interruptible service programs have been superseded by PJM Interconnection LLC's (PJM) programs. PPL St. 5 at 17; PPL Exhs. DAK 1, DAK 2; PPL Exh. 1, Exhibits Regs. PPL M.B. at 157-162.

According to PPL, its proposals to increase the customer charges and reduce the demand charge for these rate schedules are consistent with *Lloyd*, which held that rate structures should be adjusted to reflect the cost of service to each rate class and to eliminate cross-subsidization. *Id.*

I&E argued that the customer charges for these rate schedules should not be increased. I&E used its own direct customer cost analysis which, the Company argued, excludes certain items that the Company evaluation includes. I&E St. 3 at 12-14.

The Company averred that its minimum size system study is the appropriate basis for determining the fixed customer costs that are incurred to serve customers, and that those fixed costs should be recovered through a fixed customer charge. PPL argued that I&E's approach to setting the fixed monthly customer charges ignores the customer costs of the fixed and permanent infrastructure that the electric distribution company is obligated to provide and which exists between a customer's service and the transmission substation from which the customer's load is served. PPL M.B. at 174.

b. ALJ's Recommendation

The ALJ stated that as she accepted the Company's cost of service-based evaluation for residential customers, it was consistent to accept it for the commercial and

industrial customers as well. Therefore, the ALJ recommended that PPL's proposals be approved. R.D. at 121.

c. Exceptions

In its Exceptions, I&E states that the ALJ's recommendation to adopt the Company's non-residential customer charges to be consistent with the recommendation regarding the residential customer charge lacks factual support. I&E avers that its customer cost analysis did not distinguish between residential and non-residential classes, but was guided solely by the results of the properly constructed direct customer cost analysis. I&E points out that, while PPL proposed an alternative customer charge for the residential class, the Company produced no study or compromise offer with respect to its originally proposed non-residential customer charges. I&E asserts that the ALJ's recommendation to adopt PPL's non-residential customer charges to be consistent with the residential class is actually inconsistent since PPL did not present a compromise analysis applicable to the non-residential customer charges. Therefore, I&E opines that on the basis of that error, the ALJ's non-residential recommendation should not be adopted. I&E Exc. at 30-36.

In reply, PPL acknowledges that it has the burden of proof to establish that its proposed non-residential customer charges are just and reasonable; however, it is not required to develop and present alternatives that it does not support. PPL avers that the evidence demonstrated that I&E's non-residential customer charges are based on its own direct customer cost analysis, which is based on a flawed process. PPL R.Exc. at 19-20.

d. Disposition

Upon our consideration of the record evidence, we conclude that PPL's proposed non-residential customer charges are reasonable and should be approved.

While the ALJ's comment concerning consistency may not be entirely accurate[21], we find that her recommendation to approve PPL's non-residential customer charges is correct. It is important to note that none of the other Parties directly affected by these increased customer charges were opposed to the increase. Only I&E filed Exceptions to the ALJ's recommendation based on its own customer charge cost analysis that we have previously rejected. Accordingly, finding the ALJ's recommendation to be otherwise reasonable and duly supported by the evidence of record herein, it is adopted. The Exceptions of I&E on this issue are denied.

6. Net Metering for Renewable Customer-Generators Rider

a. Positions of the Parties

PPL proposed two changes to its Net Metering tariff provisions for Renewable Customer-Generators. First, PPL proposed to establish a limitation on the size of generator relative to the associated customer usage that would be eligible for net metering. Second, PPL proposed to clarify that, for eligible customer-generators served under PPL's Time of Use default service rate option, a weighted average of the on-peak and off-peak hour prices would be used to derive the Price to Compare for the purpose of compensating customer-generators for excess generation. PPL St. 5 at 25; PPL Exh. DAK 2; PPL M.B. at 180-181.

Both SEF and Granger opposed PPL's proposal to limit the eligibility for net metering based on the size of the generator relative to the associated customer usage. Granger opposed the as-filed proposal, as the Company proposed to limit the generation in all new net-metering applications to 110% of the customer-generator's connected load.

[21] The ALJ stated that as she accepted the Company's cost of service-based evaluation for residential customers, it was consistent to accept it for the commercial and industrial customers as well. However, we note that PPL did not present a compromise analysis for the non-residential customer charge as it did for the residential customer charge.

SEF pointed out that the Company had provided no evidence to support an allegation that net metering customers cause PPL to incur costs that support an increase in the customer charge and asked that this allegation be rejected. Granger M.B. at 9, SEF R.B. at 1-2.

In response to this opposition, PPL withdrew this proposal and instead proposed a tariff revision to comply with the wording from the policy adopted by the Commission in the Commission's Final Order entered March 29, 2012, at Docket No. M-2011-2249441.[22] This revision limits the 110% restriction to the business model where a third-party developer builds, owns, operates and maintains an alternative energy generation system on or near a customer's property and sells power and/or alternative energy credits to that customer. PPL St. 5-R.

Granger stated that the Company's revised proposal incorporated language from that Commission Order, and, consequently, it did not oppose the proposal. Granger M.B. at 9.

No party opposed PPL's second proposal, which was to revise the tariff to use the weighted average of the on-peak and off-peak hour TOU prices to derive the Price to Compare for customers served under PPL's Time of Use default service rate option. PPL explained that the stated purpose of this proposal was to ensure that compensation for excess generation by TOU customer-generators more closely reflects their actual on-peak and off-peak usage and generation. PPL M.B. at 180-182.

b. ALJ's Recommendation

The ALJ recommended that the revised net metering proposals be approved. R.D. at 126.

[22] *Net Metering – Use of Third Party Operators*, Docket No. M-2011-2249441 (Order entered March 29, 2012).

c. Disposition

No Party filed exceptions to the ALJ's recommendation. Finding it to be reasonable, we adopt it without further comment.

7. Competitive Enhancement Rider (CER)

a. Positions of the Parties

The Company proposed a new rider, the CER, to recover the costs of all customer education programs. PPL will estimate the total costs it expects to incur, on a calendar-year basis, to provide consumer education programs and competitive retail electricity market enhancement initiatives for all customers who receive distribution service from PPL. According to PPL, the CER will be a Section 1307(e), 66 Pa. C.S. § 1307(e), cost recovery mechanism developed to recover the Company's education and retail market enhancement (RME) related costs. PPL St. 8 at 30-32; PPL Exh. DAK 2; PPL M.B. at 180.

PPL argued that the Commission and the appellate courts have held that an automatic adjustment clause is appropriate when the expenses to be recovered are substantial, subject to variation and beyond the control of the utility. PPL M.B. at 206 (citing *Popowsky v. Pa. PUC,* 869 A.2d 1144, 1159 (Pa. Cmwlth. 2005); *Pennsylvania Industrial Energy Coalition v. Pa. PUC,* 653 A.2d 1336 (Pa. Cmwlth. 1995); *Pa. PUC v. Newtown Artesian Water Co.,* Docket No. R-2009-2117550 (Order entered April 15, 2010); *Pa. PUC v. Philadelphia Thermal Energy Corp.,* 1991 Pa. PUC Lexis 80). According to PPL, its competitive enhancement expenses meet each of these standards. PPL M.B. at 206.

The Company estimated that the costs of the mandates in the RMI and other proceedings will be more than $6 million annually, at least at the beginning, but will depend on the Commission's direction and are not within the control of the Company. PPL M.B. at 206.

The OCA, the OSBA, and Direct Energy have raised various issues and concerns regarding the proposed CER.

The OCA cautioned that care must be taken to prevent double recovery of these costs. In addition, the OCA noted that the Commission had recently held that the competitive enhancement costs should not be collected from ratepayers but from the EGSs. OCA M.B. at 125 (citing *Petition of FirstEnergy,* Docket No. P-2011-2273650, at 136 (Order entered August 16, 2012). The OCA recommended three safeguards: (1) that the allowed costs must conform to the standards in the Commission's May 10, 2007 Order at Docket No M-000061957; (2) that competitive enhancements costs incurred by PPL, consistent with the Commission's directive, be collected from EGSs; and (3) that there be quantifiable assurances in place to prevent double recovery of these costs, such as through the CER and within the approved revenue requirement in this case. *Id.* at 125-126.

The OCA also recommended that the costs be allocated on a per kWh basis instead of per customer, reasoning that those with higher usage will benefit more from the information. According to the OCA, costs are incurred on a per customer basis and should be allocated accordingly. OCA M.B. at 126.

REG avers that Rate CER should be applied only to those customers and customer classes that benefit from the programs, activities, and enhancements funded by Rate CER. As customers already shopping know that they can shop and that Rate CER provides an incentive to customers to shop to the extent that it is imposed on them, Rate

CER is best imposed on non-shopping customers to provide them with an incentive to shop and should not be imposed upon customers who have already selected alternative suppliers. REG M.B. at 6; REG R.B. at 1.

PPLICA limited its argument to cautioning the Commission to ensure that the Company's costs are not duplicated in multiple education programs. PPLICA M.B. at 21. PPLICA noted further that the Company's proposal to recover costs of RME programs from the EGSs that benefit from them is consistent with the Commission's Final Order in *Investigation of Pennsylvania's Retail Electricity Market: Intermediate Work Plan,* Docket No. I-2011-2237952 (Order entered March 2, 2012) and, therefore, PPLICA supported this proposal. PPLICA M.B. at 21.

Regarding recovery of costs, PPLICA opined that the costs allocated to a customer class should be recovered per customer, not per kWh, as proposed by the OCA as this is contrary to cost causation principles. PPLICA did not oppose approval of the proposal to recover CER costs through a fixed monthly customer charge. PPLICA M.B. at 23.

PPL asserted that to the extent it recovers these costs from EGSs, they would not be recovered through the CER. PPL M.B. at 209.

b. ALJ's Recommendation

The ALJ recommended that the CER be approved, and that the costs incurred by the Company in implementing the RME programs, including consumer education costs not recoverable from the EGSs, be recovered using the CER. The ALJ further recommended that as all customers benefit from the robust competitive market, then all customers should bear the costs involved in its development, on a per customer basis. R.D. at 128.

c. Exceptions

In its Exceptions, the OCA states that it opposes the ALJ's recommendation regarding retail market enhancement programs, and submits that this type of cost recovery for RME programs is inconsistent with the Commission's directives in this area. The OCA cites to the Commission's recent decision wherein the Commission held that EGSs should pay for RME costs. *Petition of FirstEnergy*, Docket No. P-2011-2273650, at 136 (Order entered August 16, 2012). The OCA avers that *FirstEnergy* is consistent with the Commission's decision to require EGSs to pay for the costs of opt-in auction programs in *Investigation of Pennsylvania's Retail Electricity Market: Intermediate Work Plan, supra,* at 79. OCA Exc. at 37-38.

The OCA also states that consumers that use more energy clearly have greater potential to benefit from these customer education programs than consumers who use very little electricity. Therefore, the OCA opines that a per kWh based rider better equates the costs and benefits of these programs. The OCA submits that whatever consumer education costs are ultimately recovered from ratepayers should be done on a kWh basis. OCA Exc. at 38-39.

The OSBA also excepted to the ALJ's recommendation, stating that there is no need at this time for yet another PPL reconcilable charge. The OSBA avers that implementing another rider will simply lead to the need for enhanced regulatory oversight to ensure that the costs claimed under the new rider include only those costs that were specifically identified as being associated with that rider. The OSBA notes that it agrees with PPL that it should be allowed to fully recover these costs, that many of these costs should be recovered from EGSs and that other Pennsylvania EDCs have similar riders. However, the OSBA does not believe that these costs should be recovered in the context of the instant distribution rate proceeding. The OSBA opines that a rate

rider designed to recover RME costs would be better addressed in the Company's pending default service proceeding at Docket No. P-2012-2302074. According to the OSBA, it is established Commission policy that RME costs should be borne by EGSs and that this issue should be resolved in default service proceedings. OSBA Exc. at 15 (citing *FirstEnergy, supra,* at 136). OSBA Exc. at 13-15.

Next, the OSBA maintains that if the Commission does decide that the CER is necessary, then PPL's rate design for recovering the costs of the CER program should be changed. Instead of recovering these costs equally across all of the Company's customers as recommended by the ALJ, the OSBA submits that these costs should be directly assigned to PPL's rate classes for which costs can clearly be attributed. Furthermore, the OSBA avers that costs not specifically associated with a rate class should be allocated using some reasonable cost-based allocation factor. Then the Company should develop a separate CER charge for each rate class or rate class group, based on the allocated costs. OSBA Exc. at 16-17.

Finally, the OSBA submits that it is much more reasonable to directly assign costs, where possible, so that the cost-causing customer class pays. The OSBA asserts that in light of the high level of shopping that already exists among PPL's non-residential customers, it is not clear that there is any benefit to be gained by developing RME programs for these customers. Additionally, if RME programs apply only to the residential class, PPL's proposal to effectively allocate those costs among all customers is clearly at odds with both cost causation and fairness considerations. OSBA Exc. 17.

In reply, PPL states that its proposed CER is appropriate for three principal reasons. First, PPL avers that such automatic adjustment clauses are appropriate for expenses that are substantial, vary and are beyond the utility's control. According to PPL, initially the CER annual expenses will total more than $6.0 million and, thus, are substantial. PPL opines that they are subject to variation because they will change

depending on Commission mandates in the RMI and other proceedings, and they are beyond PPL's control as they are incurred under Commission directives. Second, PPL avers that a CER permits a more flexible approach because it can be adjusted annually should the need for spending levels change in the future. PPL notes that such flexibility is not available if these costs are recovered through base rates. Third, PPL avers that other EDCs are employing Commission approved rider mechanisms to recover expenses incurred in response to the RMI. PPL R.Exc. at 23.

In response to the concerns expressed regarding the double recovery of costs, PPL maintains that the use of a specific reconcilable rider for all customer education expenses would assure that all costs are recovered only once. PPL opines that the possibility of double recovery would be eliminated as these expenses would all be reviewed annually in one reconciliation proceeding, and these expenses and revenues would be trued-up annually to make sure that only actual expenses are recovered. PPL R. Exc. at 23-24.

In response to the rate design issue expressed by the Parties, PPL avers that customer education costs should be recovered as it proposes on a per customer basis. PPL submits that this is consistent with cost causation because it costs the same to send a notice to an industrial customer as to a residential customer. PPL R.Exc. at 24.

Finally, PPL notes that the OSBA's proposal that the CER be addressed in PPL's default service proceeding is impractical, as it is too late for such matters to be considered in that proceeding since the record is closed. Also, PPL submits that it is important for PPL's proposed CER to be considered in this base rate case because, if it is adopted, it will have a direct impact on the level of base rates charged to customers. If it is not adopted, PPL claims that these costs would have to be recovered through base rates. PPL R.Exc. at 24.

In its Replies to Exceptions, PPLICA states that the ALJ correctly approved recovery of the costs included within the CER on a per customer basis. PPLICA avers that the costs potentially recoverable through the CER are generally customer costs and therefore rightfully recovered on a per customer basis. According to PPLICA, potential CER costs comprise broad marketing and education programs, which are readily distinguishable from the more consumption or demand-oriented energy efficiency and conservation plans administered under Act 129 of 2008. PPLICA R.Exc. at 11.

d. Disposition

We are in agreement with the ALJ that PPL's proposed CER is appropriate and should be approved. The CER is meant to recover the costs incurred by PPL to implement the RME Programs, including consumer education costs, not recoverable from EGSs, and should be designed on a per customer basis as proposed by PPL. We are persuaded by the arguments in favor of the CER presented by the Company. We agree that the costs proposed to be recovered through the CER qualify for recovery under an automatic adjustment clause, consistent with the Commonwealth Court's reasoning in *Pennsylvania Industrial Energy Coalition v. Pa. PUC,* 653 A.2d at 1349. We also concur that the CER provides a more flexible methodology for the Company to recover these Commission mandated expenses, and the CER is consistent with Commission approved recovery mechanisms we have adopted in other EDC proceedings. Furthermore, we agree with PPL that these costs are properly recoverable on a per customer basis, consistent with cost-causation principles. Accordingly, we shall adopt the recommendation of the ALJ and deny the Exceptions of the OCA and the OSBA on this issue.

8. Purchase of Receivables

a. Positions of the Parties

PPL purchases, at a discount, the accounts receivable of EGS customers who participate in the Purchase of Receivables (POR) program. This discount is composed of an uncollectible accounts percentage factor and a development, implementation, and administrative factor. Uncollectible expenses are those costs that result from customers not paying for service, and the amount of the non-payment is written off. Uncollectible accounts expense associated with generation supply and transmission service for default service customers is separated from the Company's distribution rates and recovered through the Merchant Function Charge (MFC) and included in its Price to Compare. The cost of uncollectible expense is recovered from default customers through the MFC and from shopping customers through the discounted rate at which PPL purchases the accounts receivable within the POR program. PPL M.B. at 184-185.

The MFC percentages for the residential and small C&I customer classes have been calculated on the Company's expected 2012 uncollectible accounts expense for those customer classes. Based thereon, PPL proposed to change the MFC for the residential class from 1.80% to 2.23% and for small C&I customers from 0.10% to 0.23%. PPL St. 8 at 29-30; PPL St. 8-R at 43-44; PPL Exh. JMK 4.

PPL stated that in the ordinary course of business, the entity rendering the service is responsible for the costs and actions associated with billing and collection of payments, and also bears the risk of non-payment or late payments. Under a POR program, the EGS sells its accounts receivable to PPL and receives immediate payment for the amount due minus a discount meant to reflect collection risk and the time value of money. A POR program, therefore, allows the seller of the receivables to receive payment sooner and avoid the costs and risks associated with collecting any delinquent amounts owed by the customer. PPL M.B. at 184.

PPL explained that the existing POR program was authorized by the Commission's Order in *Petition of PPL Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivables Program and Merchant Function Charge*, Docket No. P-2009-2129502 (Order entered November 19, 2009). In that Order, the Commission approved a settlement of the following factors: (1) the discount rate for residential service was 1.37%, consisting of an uncollectible accounts expense percentage factor of 1.32% and a POR administrative factor of .05%; (2) in order to participate, an EGS would sell all of its residential customer accounts receivables to the Company; (3) participating EGSs agreed to not reject new customers based on credit-related issues and would not require a deposit; (4) budget billing would be available to customers of participating EGSs; and (5) for small commercial and industrial shopping customers, the discount rate was 0.17%, reflecting an uncollectible accounts expense percentage factor of 0.12% and a POR administrative factor of 0.05%. PPL stated that the percentages were increased in the 2010 base rate case, *Pa. PUC v. PPL Electric Utilities Corporation,* Docket No. R-2010-2161694 (Order entered December 21, 2010). *Id.* at 185.

The Company noted that, in this proceeding, it based its proposed numbers on its actual write-offs from 2011, which were approximately $40 million. PPL M.B. at 187; PPL St. 8-R at 43. To calculate the amount sought, PPL used its proposed 2012 budget amount, which is the sum of projected write-offs and the projected change in the reserve for doubtful accounts for 2012. PPL M.B. at 187; PPL St. 8-R at 44.

Direct Energy and DR opposed PPL's expected 2012 uncollectible accounts expense. Direct Energy recommended, instead, that PPL be permitted to recover 100% of its uncollectible accounts expense by implementing a non-bypassable/non-reconcilable charge applicable to all customers. In the alternative, Direct Energy recommended modifying the Company's proposal in the following manner: (1) by reducing the discount rate to reflect the amount of late payment charges that the Company collects and which offset its net uncollectible accounts expense; and (2) by

reducing the discount factor by an administrative cost credit to return to the EGSs the amounts that have been collected through the administrative cost adder but which the Company did not track. Direct Energy St. 1 at 9-11; Direct Energy M.B. at 9.

Direct Energy averred that the Company's proposal must be rejected because there is no record basis to support allocation of the proposed uncollectible accounts expense percentage to generation service customers. Direct Energy claimed that while PPL has proposed that shopping and default customers pay at the same percentage level, it has not provided evidence to support a finding that this is just and reasonable. In fact, the Company admitted that it did not track write-offs by the shopping/default categories. Direct Energy M.B. at 12; Tr. at 404. While Direct Energy pointed out that it is possible that one category may be more reliable in paying bills than the other, and that the shoppers may be unfairly charged here, it is just as likely that the default customers are effectively subsidizing shopping customers. Direct Energy M.B. at 1.

Direct Energy also stated that the Company's proposal will stall development of a fully robust competitive retail market. Direct Energy noted that "[t]he level of competition in PPL's service territory is good, but it could be much better. The current levels of shopping need not only be sustained but increased in order to meet the Commonwealth's goal of a fully competitive retail electric market. PPL's service territory presents the best opportunity to do that, but only if the Commission continues to remain vigilant about properly allocating costs to EGSs." *Id.* at 14 (footnotes omitted).

According to Direct Energy, the levels of uncollectible discount that PPL is proposing to charge through the POR program will have a significant negative effect on the development of competition because EGSs cannot administer their own programs efficiently and inexpensively and have no real choice but to rely on the Company. *Id.* at 15.

PPL denied that this increase will have a negative effect on the competitive market. While Direct Energy and DR argued that the EGSs would have to bear the difference in cost until the expiration of existing fixed-price contracts, PPL pointed out that there should have been no reasonable expectation that the discount rate would remain static indefinitely. According to PPL, such risk was willingly undertaken by the EGSs, is a business risk, and cannot be used to shift the risk of doing business as an EGS to PPL and its customers. PPL R.B. at 105-106.

Direct Energy stated that the Company's failure to properly support its own proposal opens the door for the Commission to consider the Direct Energy alternative, which is to collect total projected uncollectible accounts expense through a non-bypassable charge for all distribution customers. According to Direct Energy, this eliminates the need for determining the actual uncollectible expense. Direct Energy opined that this approach is superior to the Company's because it is consistent across shopping lines and does not contain the possibility of shoppers subsidizing default customers. Direct Energy M.B. at 18.

PPL argued that the dual MFC/POR method appropriately unbundles the uncollectibles charge and properly assigns risk of nonpayment and that Direct Energy's proposal to refund all amounts that PPL has received under the administrative component of the POR should be rejected as impermissible retroactive ratemaking. PPL M.B. at 189-193. PPL also argued that the Commission has no authority to direct a change in its POR program due to its voluntary nature. *Id.* at 185.

Direct Energy responded that the POR is a tariffed program, which results in the requirement that it be just and reasonable. Direct Energy R.B. at 6-7. Direct Energy and DR further claimed that PPL should be required to use late payment charges to reduce the POR and MFC percentages. Direct Energy R.B. at 2, DR R.B. at 3.

PPL responded that late payment charges are paid, and are, therefore, not uncollectible but are revenue, as reflected in its accounting for decades and repeatedly approved by the Commission. PPL M.B. at 188; PPL St. 8-RJ at 8. In addition, PPL pointed out that late payment charges are used to reduce the overall distribution of revenue requirement for customer rate classes that bear the working capital requirement associated with overdue accounts receivable. PPL averred that granting this request would result in double counting. PPL M.B. at 188. Therefore, according to PPL, should the request be granted, the late payment fees would need to be split between the POR and MFC customers, accompanied by an adjustment in base rate revenues, which would increase rates for all distribution customers. PPL St. 8-RJ; PPL M.B. at 189.

b. ALJ's Recommendation

The ALJ recommended that the Company be required to track uncollectibles by default customers and shopping customers separately, and the correct percentage can be discerned from there. The ALJ noted that the proposed percentage is supported by the past uncollectibles in total, but there is no calculation of which uncollectibles are from default customers and which are from shopping customers. According to the ALJ, this is not consistent with the terms of the settlement from which the POR program was conceived:

> 25. The Company will monitor individual EGS uncollectible percentages for small C&I customers pursuant to Section12.9.2.6 of the tariff supplement provided in Appendix A and will adjust the discount rate for an individual EGS based upon the provisions contained therein.

R.D. at 131 (quoting *Petition of PPL Electric Utilities Corporation Requesting Approval of a Voluntary Purchase of Accounts Receivables Program and Merchant Function Charge,* Docket No. P-2009-2129502 (Order entered November 19, 2009)).

The ALJ expressed concern that PPL's procedure does not require the Company to determine the actual amount of its uncollectible expenses in order to recover them. The ALJ concluded that the actual amount of the uncollectible expenses is required in order to fairly charge customers the correct amount. Therefore, the ALJ found that PPL should be directed to take the next step and determine that amount for shoppers and to determine that amount for default customers, and to collect it accordingly. The ALJ recommended that PPL's proposed increase in the POR discount rate should be delayed for ninety days until the Company provides data indicating the proportions of uncollectibles attributable to default customers and to shopping customers, to support the proper discount rate. R.D. at 133, 142, O.P. # 10.

The ALJ further recommended that if PPL does not comply with this directive then the percentage discount rates currently in effect in its POR Program should remain in effect. R.D. at 142, Ordering Paragraph No. 11.

The ALJ also stated that Direct Energy and DR had not sustained their burden of proving that their alternatives were appropriate choices for the Commission to adopt in this case. R.D. at 133.

Additionally, the ALJ concluded that late payment fees are presently added to revenues, and that is where they should remain. *Id.* at 134.

c. Exceptions

In its Exceptions, Direct Energy avers that although the ALJ correctly concluded that PPL has failed to prove its increase for the POR discount rate, the ALJ erred in directing PPL to continue the current POR/MFC discount mechanism. Instead of continuing PPL's problematic mechanism, Direct Energy recommended that PPL be required to recover the currently unbundled uncollectible accounts expense in a non-

bypassable charge applicable to all customers. Direct Energy avers that PPL's POR program, which reflects total uncollectible expense in the POR discount rate, has resulted in continuing and significant increases to the POR discount rate. Direct Energy compared the January 1, 2010, POR rate of 1.32% to the proposed rate in this proceeding of 2.23%. Direct Energy further notes that if the PPL proposal is adopted, then PPL's POR program would have the highest discount rate of all the Pennsylvania EDCs. Direct Energy Exc. at 3-5.

Direct Energy avers that its proposed non-bypassable mechanism would eliminate the need to determine the specific uncollectible accounts expense for shopping customers, while allocating the uncollectible accounts expense across all customers consistent with traditional rate-making principles. According to Direct Energy, while the ALJ criticizes its proposal because it does not require a calculation of actual uncollectible accounts expense for shopping customers, the fact here is that PPL cannot make that calculation. Direct Energy opines that even the ALJ acknowledged that when the actual uncollectible accounts expense cannot be calculated, Direct Energy's approach is better than the one used by PPL, as she stated that it is "less unfair in its inherent unfairness." Direct Energy Exc. at 8 (quoting R.D. at 133).

Next, Direct Energy states that even if the ALJ's recommendation to continue PPL's current POR discount is adopted, the ALJ erred in failing to recommend adjustments to the calculation of the POR discount rate. According to Direct Energy, the Commission must direct that the initial starting point for the uncollectible accounts expense portion of the POR discount must be the same level of uncollectible accounts expense used to determine PPL's revenue requirement. From there, Direct Energy posits that the Commission should further adjust the POR discount rate to: (1) offset the uncollectible accounts expense percentage factor by the unbundled portion of the revenue PPL receives from late payment charges related to generation rates; and (2) create an administrative credit of 0.05% to the POR discount rate to return to EGSs the money PPL

has collected during the POR program through the administrative component based on PPL's admitted failure to track actual incremental administrative costs and to quantify them. Direct Energy Exc. at 10-11.

In its Exceptions, DR first asserts that the ALJ should have set the POR discount at the 1.7% uncollectibles rate she adopted for ratemaking purposes. DR states that there is no real dispute in this case that the POR discount is the same as the uncollectibles rate and that PPL currently does not track uncollectibles separately as between shopping and non-shopping customers. Tr. at 404-405. Therefore, DR posits that PPL does not possess the historical data that would allow the immediate development of an appropriate uncollectible expense level, based on actual experience, for residential or commercial customers and differentiate between shopping and non-shopping customers. DR opines that any PPL proposed differentiation would be speculative, which is not permitted. According to DR, the more certain path would be to require PPL to implement a POR discount based upon an uncollectible expense rate of 1.7%, which the ALJ accepted as reasonable. DR Exc. at 3-4.

Next, DR excepts to the ALJ's decision not to require PPL to use late payment fee revenue to reduce the POR discount. DR asserts that PPL cannot, and does not, reasonably dispute the fact that applying late payment fee revenue from shopping customers to offset the CWC expense for default service results in a subsidy to default service. DR submits that it proposed a reasonable means of eliminating this subsidization by using the late payment fee revenue from shopping customers to offset the uncollectibles expense of shopping customers. According to DR, under the methodology used today, shopping customers subsidize non-shopping or default service customers with every dollar of late payment fee revenue. DR asserts that this revenue should instead be used in a manner that provides at least some benefit to shopping customers, not an exclusive benefit to default service customers as it does today. DR Exc. at 5-6.

In reply, PPL states that it fully explained why Direct Energy's non-bypassable proposal should be rejected, including the fact that the Commission recently considered and rejected the very same proposal in PPL's 2010 base rate case. Also, PPL states that if the ALJ recommendation is approved by the Commission, the Company can and fully intends to promptly comply with the recommendation to track and separately determine the uncollectible accounts expense for shopping customers. In response to the Parties' proposal that the POR discount rate be set at the 1.7% three-year average of uncollectible accounts expense accepted by the ALJ, PPL opines that the 1.7% rate understates PPL's projected uncollectible accounts expense. PPL R. Exc. at 20-21.

PPL next notes that Direct Energy and DR continue to argue that late payment charges from shopping customers offset or reduce uncollectible accounts expense. PPL asserts that is not the case as these charges represent an addition to a utility's revenues and offset accounts receivable. PPL explains that late payment charges are actually paid by customers and the revenues received from late payments are, by definition, not uncollectible. According to PPL, the proposal advanced by Direct Energy and DR would result in double counting of late payment revenues by crediting these revenues to customers twice. PPL R. Exc. at 21.

Lastly, in response to Direct Energy's proposal in regard to the administrative component of the POR discount rate, PPL claims that Direct Energy ignores the record evidence that the Company has incurred incremental expenses with its POR program. PPL asserts that the POR is a Section 1308 rate and cannot be retroactively changed. PPL R. Exc. at 21.

In its Reply Exceptions, PPLICA states that the ALJ correctly rejected the proposal that PPL implement a non-bypassable charge for recovery of uncollectibles expense currently recovered through the POR discount. PPLICA asserts that the ALJ's rejection of a non-bypassable charge reflects the many flaws inherent in this proposal,

including the potential for double charging customers not eligible for PPL's POR program and the rebundling of generation, transmission and distribution charges. PPLICA requests that the Commission adopt the ALJ's recommendation. Further, PPLICA avers that the ALJ's rejection of this proposal is fully consistent with Commission precedent and the Code. PPLICA explains that the Commission addressed a similar proposal from the Retail Energy Supply Association in PPL's 2010 rate case and held that "EGSs should bear the collection risk for their own customers, either by including it in the charges to those customers or by selling their receivables to PPL at a discount." PPLICA R. Exc. at 13 (quoting *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-2010-2161694, at 153 (Order entered December 21, 2010)). PPLICA further asserts that adoption of Direct Energy's proposal would violate Section 2804(3) of the Competition Act, 66 Pa. C.S. § 2804(3), which requires EDCs to unbundle generation, transmission and distribution rates. PPLICA R. Exc. at 12-13.

In its Replies to Exceptions on this issue, the OSBA states that although the Direct Energy language it quotes in its Exceptions does not say so, Direct Energy is addressing the residential class uncollectibles rate. The OSBA explains that for the majority of Direct Energy's Exceptions, the 1.7% is referred to as "the uncollectibles rate" when it is, in fact, just the rate for the residential customers. While the OSBA agrees with Direct Energy that the uncollectibles rate determined for the residential class should be used to develop both the residential MFC and the residential POR discount, the OSBA cautions that the 1.7% factor is not appropriate for the non-residential classes. According to the OSBA, the Small C&I and Large C&I MFC and POR discount rates should reflect the uncollectibles rates applicable to those classes. OSBA R. Exc. at 14-15.

d. Disposition

First, with regard to Direct Energy's recommendation for the use of a non-bypassable distribution charge applicable to all customers to collect uncollectible expenses, we find that PPL correctly explained that the use of a non-bypassable charge is improper and has previously been rejected in PPL's prior 2010 base rate proceeding. In that Order we held that the collection risk for shopping customers should remain with the EGSs. *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-2010-2161694, at 95. We affirm that position in the instant proceeding. Therefore, the Exceptions of Direct Energy are denied on this issue.

Next, we agree with the ALJ's recommendation to delay the implementation of the Company's proposed increase in the POR discount percentage for ninety days. We concur with the ALJ's directive that the currently effective rates remain in effect until PPL provides the required breakdown on these expenses between shopping and non-shopping customers. Once this information is developed, the Commission will have thirty additional days to finalize an appropriate course of action. We note that the Company stated in its Replies to Exceptions that it can and fully intends to promptly comply with the ALJ's recommendation to track and separately determine the uncollectible accounts expense for shopping customers. We also agree with the ALJ that if PPL fails to provide this information, then the currently effective discount rates shall remain unchanged. Therefore, the Exceptions of Direct Energy and DR are denied on this issue.

In response to the Direct Energy and DR recommendation to offset uncollectible accounts expense with late payment fees, we are persuaded by the arguments of PPL that late payment fees do not reduce uncollectibles. We agree with PPL that late payment charges are actually paid by customers and are used to reduce the overall distribution of revenue requirement for customer rate classes that bear the

working capital requirement associated with overdue accounts receivable. Accordingly, we adopt the recommendation of the ALJ on this issue and deny the Exceptions of Direct Energy and DR.

In conclusion, we address the recommendation of Direct Energy that since PPL did not track the incremental expenses under the 0.05% administrative cost component of the POR discount rate, then PPL should be directed to refund all amounts collected to date under this component until the amount PPL has collected is returned. We find it disappointing that PPL did not track these costs. The administrative component of the POR rate was designed with cost recovery of incremental costs in mind. However, the tariff did not provide for these refunds. In order to avoid a repetition of this failure, the Parties should address the issue in future proceedings so as to provide a more equitable outcome.

Going forward, we direct PPL to track and make an appropriate filing with the Commission describing all revenues and incremental costs incurred to develop, implement, and administer the POR service, including costs since inception, associated with implementation of its POR service if it desires to seek any further administrative cost recovery in the future. If, at that time, it is determined that PPL over-recovered historical administrative costs, future cost recovery will only be allowed once the historical over-recovery is netted out. Accordingly, we shall adopt the ALJ's recommendation, as modified by this Opinion and Order, and deny the Exceptions of Direct Energy.

In summary, we hold that PPL's proposed POR program discount rates remain as currently in effect for ninety days and that PPL is directed to provide the breakdown of uncollectible expenses between shopping and non-shopping customers within ninety days. If PPL does not comply with this directive, then the percentage rates currently in effect in its POR program shall remain in effect. Furthermore, the

recommendations of the intervening Parties with regard to the implementation of a non-bypassable charge, the offset of late payment fees and the refund of the administrative cost component are denied, consistent with the discussion herein.

IV. CONCLUSION

We have reviewed the record as developed in this proceeding, including the ALJ's Recommended Decision and the Exceptions and Replies to Exceptions filed thereto. Based upon our review, evaluation and analysis of the record evidence, the Exceptions filed by the various Parties hereto are granted or denied, and the ALJ's Recommended Decision is modified, consistent with the discussion in this Opinion and Order; **THEREFORE,**

V. ORDERING PARAGRAPHS

IT IS ORDERED:

1. That the Exceptions of the Office of Small Business Advocate, Direct Energy Services, PP&L Industrial Customer Alliance, the Commission on Economic Opportunity and Dominion Resources, filed on November 8, 2012, are denied, consistent with this Opinion and Order.

2. That the Exceptions of PPL Electric Utilities Corporation, the Office of Consumer Advocate, the Bureau of Investigation and Enforcement, filed on November 8, 2012, are granted in part, consistent with this Opinion and Order.

3. That the Recommended Decision of Administrative Law Judge Susan D. Colwell, issued on October 19, 2012, is adopted as modified by this Opinion and Order.

4. That PPL Electric Utilities Corporation shall not place into effect the rates, rules and regulations contained in Supplement No. 118 to Tariff – Electric Pa. P.U.C. No. 201, as filed.

5. That PPL Electric Utilities Corporation is authorized to file tariffs, tariff supplements and/or tariff revisions, on less than statutory notice, and pursuant to the provisions of 52 Pa. Code §§ 53.1, *et seq.,* and 53.101, designed to produce an annual distribution rate revenue increase of approximately $71.065 million, to become effective for service rendered on and after January 1, 2013.

6. That PPL Electric Utilities Corporation shall file detailed calculations with its tariff filing, which shall demonstrate to the Commission's satisfaction that the filed tariff adjustments comply with the provisions of this final Opinion and Order.

7. That PPL Electric Utilities Corporation shall allocate the authorized increase in operating distribution revenue to each customer class, and rate schedule within each customer class, in the manner prescribed in this Opinion and Order.

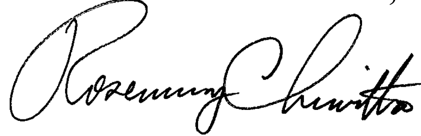
8. That PPL Electric Utilities Corporation shall comply with all directives, conclusions, and recommendations contained in the body of this Opinion and Order, which are not the subject of an individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering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

9. That the Formal Complaints filed by the Office of Consumer Advocate, the Office of Small Business Advocate and PP&L Industrial Customer Alliance are sustained in part, consistent with this Order.

10. That the Formal Complaints filed by William Andrews; Tracey Andrews; Eric Joseph Epstein; Dave A. Kenney; Roberta Kurrell; Donald Leventry; John G. Lucas and Helen Schwika, and any other Formal Complaint not specifically noted but filed prior to issuance of this Opinion and Order, are hereby dismissed.

11. That, upon Commission approval of the tariff, tariff supplements and/or tariff revisions, submitted in compliance with this Opinion and Order, the investigation at Docket Number R-2012-2290597 shall be marked closed.

BY THE COMMISSION,



Rosemary Chiavetta
Secretary

(SEAL)

ORDER ADOPTED: December 5, 2012

ORDER ENTERED: December 28, 2012

Pennsylvania Public Utility Commission

v.

PPL Electric Utilities Corporation
Docket No. R-2012-2290597

Commission Tables Calculating Allowed Revenue Increase

Table I	Income Summary
Table II	Rate of Return
Table III	Revenue Factor
Table IV	Adjustments
Table V	Interest Synchronization
Table VI	Cash Working Capital: O&M Component
Table VII	Cash Working Capital: Accrued Taxes
Table VIII	Cash Working Capital: Interest Payments
Table IX	Cash Working Capital: Summary
Table X	Capital Stock Tax
Table XI	Gross Receipts Tax
Table XII	Reconciliation

TABLE I
PPL Electric Utilities Corporation
INCOME SUMMARY
R-2012-2290597
($000s)

Commission Final Allowance

		Pro Forma Present Rates (Revised) [1]	Commission Adjustments [2]	Commission Pro Forma Present Rates	Commission Revenue Increase	Total Allowable Revenues
		(1)	(2)	(3) = (1) + (2)	(4)	(5) = (3) + (4)
1.	Operating Revenue	780,425	0	780,425	71,030	851,455
2.	Expenses:					
3.	O & M Expense	417,869	(11,966)	405,903	1,759	407,662
4.	Depreciation	139,719	0	139,719	0	139,719
5.	Taxes, Other	53,516	(734)	52,782	4,149	56,931
6.	Income Taxes:					
7.	State	1,571	1,346	2,917	6,506	9,423
8.	Federal	(7,321)	4,245	(3,076)	20,516	17,440
9.	Deferred Inc.	28,861	0	28,861	0	28,861
10.	ITC	(915)	0	(915)	0	(915)
11.	Total Expenses	633,300	(7,109)	626,191	32,930	659,120
12.	Income Available for Return	147,125	7,109	154,234	38,100	192,334
13.	Rate Base	2,420,963	(13,237)	2,407,726		2,407,726
14.	Rate of Return	6.08%		6.41%	38,100 (0)	7.98822%

[1] PPL Exh. Future-1 Revised 7-16-12; Schedule D-1, Column 6.
[2] From Table IV - Adjustments

TABLE II
PPL Electric Utilities Corporation
RATE OF RETURN
R-2012-2290597

Commission Final Allowance

		Structure	Cost	After-Tax Weighted Cost	Effective Tax Rate Complement	Pre-Tax Weighted Cost Rate
		(1)	(2)	[(3)=(1)x(2)]	(4)	[(5)=(3)x(4)]
1.	Total Cost of Debt			2.70710%		2.70710%
2.	Long-term Debt	49.22%	5.50%	2.70710%		2.71%
3.	Short-term Debt	0.00%	0.00%	0.00000%		0.00%
4.	Preferred Stock	0.00%	0.00%	0.00000%	0.585065	0.00%
5.	Common Equity	50.78%	10.40%	5.28112%	0.585065	9.03%
6.	Totals	100.00%		7.98822%		11.74%
7.	Pre-Tax Interest Coverage (11.74% / 2.70710%)	4.336%				
8.	After-Tax Interest Coverage (7.872% / 2.70710%)	2.951%				
9.	Tax Rate Complement (1-(35%+(9.99% X (1-35%))	58.50650%				

TABLE III
PPL Electric Utilities Corporation
REVENUE FACTOR
R-2012-2290597

Commission Final Allowance

Line	Description	Value
1.	100%	100.0000%
2.	Uncollectible Accounts Factor	-2.23000%
3.	(Line 1-Line 2)	97.7700%
4.	PUC, OCA, OSBA Assessment Factors	0.2460%
5.	Gross Receipts Tax (GRT) (Modified per Commission Order)	5.7684%
6.	Other Tax Factors (PA CST)	0.0746%
7.	(Sum of Lines 4, 5 and 6)	6.0890%
8.	Effective Assmt/GRT/CST (Line 7)	6.0890%
9.	Factor after Assmt, GRT and CST (Line 3 - Line 8)	91.681%
10.	State Corporate Net Income Tax Rate	9.990%
11.	Effective State Income Tax Rate (Line 9 x Line 10)	9.1589%
12.	Factor After Local and State Taxes (Line 9 - Line 11)	82.5220%
13.	Federal Corporate Income Tax Rate	35.00%
14.	Effective Federal Income Tax Rate (Line 13 x Line 12)	28.883%
15.	Revenue Factor (100% - Effective Tax Rates); (Line 1 - (Lines 2, 3, 8, 11 and 14))	53.6393%

TABLE IV
PPL Electric Utilities Corporation
SUMMARY OF COMMISSION ADJUSTMENTS
R-2012-2290597
($000)

Commission Final Adjustments

	Adjustments	Rate Base	Revenues	Expenses	Depreciation	Taxes-Other	State Income Tax	Federal Income Tax
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	RATE BASE:							
2.	CWC:							
3.	Int. & Div. (Table VI)	(63)						
4.	Taxes (Table V)	174						
5.	O & M (Table VI)	(13,348)						
6.	TAXES OTHER:							
7.	Gross Receipts Tax (Table XI)					(259)	26	82
8.	Capital Stock Tax (Table X)					(475)	47	150
9.	REVENUES:							
			0				0	0
10.	EXPENSES:							
11.	Rate Case Normalization - PPL Revision			1,200			(120)	(378)
12.	Environmental Management			(103)			10	33
13.	Storm Damage Claim - PPL Revision			(3,500)			350	1,103
14.	Office of General Counsel			(1,200)			120	378
15.	Office of the Chairman			(387)			39	122
16.	Consumer Education: Act 129 Move to CER Rider			(2,494)			249	786
17.	Consumer Education: Pre Act 129			(5,482)			548	1,727
18.	DEPRECIATION:							0
					0		0	0
					0		0	0
19.	TAXES:							
20.	Interest Synchronization (Table V)						77	242
21.	TOTALS	(13,237)	0	(11,966)	0	(734)	1,346	4,245

Notes:

Rate Case Expense and Office of General Counsel: PPL Exhibit Future 1-Revised presents PPL's revised rate case expense which removes $1.2 million representing the double counting of OGC expense. See PPL Future Future 1-Revised Schedule D-6. This $1.2 needs to be added back to Rate Case Expense to reflect adoption of the ALJ's recommended treatment of this expense.

Storm Damage Claim: PPL reduced its claim due to the unavalibility of this type of insurance.

Office of General Counsel: This duplicated expense was removed from the Rate Case Expense claim in PPL Future 1-Revised Schedule D-6. The ALJ's R.D. reflected this as a reduction to the OGC expenses.

Consumer Educatio Pre Act 129: The ALJ's R.D. allowed this expense only to the end of the FTY but the adjustment was inadvertantly excluded from the Tables attached to the R.D.

TABLE V
PPL Electric Utilities Corporation
INTEREST SYNCHRONIZATION
R-2012-2290597

Commission Final Adjustments

		Amount (000)
1.	Company Rate Base Claim (PPL Exh. Furure 1-Revised Sch. C-1)	$2,420,963
2.	Commission Rate Base Adjustments (From Table IV)	($13,237)
3.	Commission Rate Bas (Line 1 - Line 2)	$2,407,726
4.	Weighted Cost of Debt (From Table II)	2.7071%
5.	Commission Interest Expense (Line 4 x Line 3)	$65,180
6.	Company Claim (PPL Exh. JMK 2 p. 28, Line 1)	$65,947
7.	Commission Adjustment (Line 6 - Line 5)	$767
8.	Company Adjustment	$0
8.	Net Commission Interest Adjustment (Line 7 - Line 8)	$767
10.	State Corporate Net Income Tax Rate	9.99%
11.	State Corporate Net Income Tax Adjustment (Line 10 x Line 9) (Flow to Table IV)	**$77**
12.	Net Commission Adjustment for Federal Taxable Income (Line 9 - Line 11)	$690
13.	Federal Income Tax Rate	35.00%
14.	Federal Income Tax Adjustment (Line 13 x Line 12) (Flow to Table IV)	**$242**

TABLE VI
PPL Electric Utilities Corporation
CASH WORKING CAPITAL: O & M COMPONENT
R-2012-2290597

Commission Allowance

Line	Description	(000)
1.	Total O&M Expense per PPL (PPL Exh Future 1-Revised Sch. C-4, p. 2)	$465,055
2.	Jurisdictional Factor (See Line 15 Below)	85.973%
3.	Jurisdictional O&M Expense (Line 1 X Line 2)	$399,823
4.	Commission O&M Adjustments (From Table IV)	($11,966)
5.	Net O&M Expense (Line 3 - Line 4)	$387,857
6.	O&M Expense per Day (Line 5 / 365 days)	$1,063
7.	Average Lag Days (ALJ R.D. at 19-20; Order at Section II C.)	9.60
8.	Commission Allowed O&M CWC Requirement (Line 6 X Line 7)	$10,201
9.	Company Claim (PPL Furure 1-Revised Sch. C-4, p. 2)	$27,391
10.	Jurisdictional Portion of Company Claim (Line 2 X Line 15)	$23,549
11.	Commission Adjustment to Rate Base (Line 8 - Line 10); (Flow to Table IV)	**($13,348)**

Line	Description	Amount
12.	O&M Expense Per Company Filing:	
13.	Total O&M (PPL Future 1-Revised Sch. D-1, Col. 5)	$486,045
14.	Jurisdictional O&M (PPL Future 1-Revised. D-1, Col. 6)	$417,869
15.	Jurisdictional Factor (To Line 2 above)	85.973%

TABLE VII
PPL Electric Utilities Corporation
CASH WORKING CAPITAL: ACCRUED TAXES
R-2012-2290597

Commission Allowance

		Pro Forma Taxes (000)	Twelve-Month Accrued Factor per Company	Accrued Taxes (000)
		(1)	(2)	(3) = (1) X (2)
1.	Federal Income Tax	($1,312)	(5.95000%)	$78
2.	PA Corporate Net Income Tax	$11,864	(3.86000%)	($458)
3.	PA Gross Receipts Tax (See Below)	$47,861	33.64000%	$16,100
4.	PA Capital Stock Tax	$2,017	(3.86000%)	($78)
5.	PA PURTA Tax	$2,832	21.14000%	$599
6.	Total Accrued Taxes (Sum of Lines 1 - 5)			$16,241
7.	Accrued Taxes per ppl (PPL Exh. Future 1-Revised, Sch. C-4, p. 4, Line 6)			$16,068
8.	Adjustment to Accrued Taxes (Line 6 - Line 7) (Flow to Table IX)			**$173**

PA Gross Receipts Tax

9.	Per Company (Future Revised Schedule D-11 p 13)	$43,670
10.	Adjustment Due To Allowed Revenue Increase (Allowed Increase X 0.059)	$4,191
		$47,861

PA Capital Stock Tax

11.	Per Company (Future Revised Schedule D-11 p. 2)	$1,954
12.	Adjustment Due To Allowed Revenue Increase (Allowed Increase X 0.0089)	$63
		$2,017

TABLE VIII
PPL Electric Utilities Corporation
CASH WORKING CAPITAL: INTEREST PAYMENTS
R-2012-2290597

Commission Allowance

		(000)
1.	Rate Base (Table I)	$2,407,726
2.	Weighted Average Cost of Debt (Table II)	2.70710%
3.	Interest Expense (Line 1 x Line 2)	$65,180
4.	Daily Amount of Interest Expense (Line 3 / 365)	$178.57
5.	Interest Payment Lag Days	32.90
6.	Commission CWC Interest (Line 4 x Line 5)	$5,875
7.	Company Claimed CWC Interest	$5,938
8.	Commission Adjustment (Flow to Table IX)	($63)

TABLE IX
PPL Electric Utilities Corporation
CASH WORKING CAPITAL
R-2012-2290597

		(000)
1.	O&M Expense (PPL Future 1-Revised, Sch. C-4 p. 2, Line 4)	$27,391
2.	Average Prepayments (PPL Future 1-Revised Sch. C-4, p. 3, Line 15)	$3,174
3.	Accrued Taxes (PPL Future 1-Revised, Sch C-4 p. 4, Line 6)	$16,068
4.	Interest Payments (PPL Future 1-Revised Sch. C-4, p. 5, Line 9)	($8,061)
5.	Total CWC per Company (Sum of Lines 1 through 4)	$38,572
6.	Jurisdictional CWC	$31,593
Commission Adjustments		
7.	Calc O&M Difference (From Table VI Row 11)	($13,348)
8.	Calc Accrued Tax Difference (From Table VII)	$173
9.	Calc Interest Payment Difference (From Table VIII)	($63)
10.	Commission CWC Adjustments (Lines 7 + 8 + 9)	($13,237)
11.	Total CWC (Line 6 + Line 10)	$18,356

TABLE X
PPL Electric Utilities Corporation
CAPITAL STOCK TAX (CST)
R-2012-2290597

		(000) Present Rate Adjustment		(000) Proposed Rate Adjustment	
	Net Income				
1.	2008	$87,403		$87,403	
2.	2009	$103,885		$103,885	
3.	2010	$80,572		$80,572	
4.	2011	$129,591		$129,591	
5.	2012	$97,491		$140,630	
6.		$498,942		$542,081	
7.	Average (Line 6 / 5)	$99,788		$108,416	
8.	Net Worth at December 31, 2012 (Note 2)	$1,790,672		$1,833,811	
9.	Pa Capital Stock value (Per Statutory Formula)		$1,196,704		$1,258,269
10.	Statutory Exemption		($160)		($160)
11.	Value of Capital Stock less Statutory Exemption		$1,196,544		$1,258,109
12.	Apportionment Percentage		95.4053%		95.4053%
13.	Pa CST Value (Line 11 x Line 12)		$1,141,566		$1,200,302
14.	PA CST at 0.89 mills (Line 13 x 0.89 mills)		$1,016		$1,068
15.	Less: PA Education tax credit		($217)		($217)
16.	PA CST at Proposed Rates (Line 14 + Line 15)		$799		$851
17.	Less: PA CST at Present Rates (PPL Sch D-11 p. 2)		$1,941		$799
18.	Jurisdictional Allocation (Note 3 Below)		41.6070%		41.6070%
19.	Adjustment to PA CST (Forward to Table IV)		($475)		$52

	Note 1	
20.	Net Income at Present Rates	$97,491
21.	Net Income from Proposed Rate Increase (Table XI Line 9)	$ 38,100
22.	Total 2012 Net Income (Line 19 + Line 20)	$135,591
	Note 2	
23.	Net Worth at Present Rates	$1,790,672
24.	Net Worth from Proposed Rate Increase (Table XI Line 9)	$ 38,100
25.	Total 2012 Net Worth (Line 22 + 23)	$1,828,772
	Note 3	
26.	Total PPL Electric (PPL Exhibit JMK-2 p. 22)	$1,954
27.	PA Jurisdictional (PPL Exhibit JMK-2 p. 22)	$813
28.	Allocation for PA Jurisdictional (Line 26 / Line 25)	41.6070%

TABLE XI
PPL Electric Utilities Corporation
GROSS RECEIPTS TAX (GRT)
R-2012-2290597

	Commission Allowance	($000)
1.	Base for GRT (PPl Exh JMK2 p. 26)	$744,568
2.	Less Uncollectible Accounts Expense (PPL Exh JMK 2 p. 51)	($14,055)
3.	Net Gross Receipts (Line 1 - Line 2)	$730,513
4.	GTR Rate	5.90%
5.	GRT on Net Gross Receipts (Line 4 X Line 5)	$43,100
6.	PA Jurisdictional Base for GRT (Line 1 X (1 - 0.0059))	$740,175
7.	Less Uncollectible Accounts Expense (PPL Exh JMK 2 p. 51)	($14,055)
8.		$726,120
9.	GTR Rate	5.90%
10.	GRT on Jurisdictional Net Gross Receipts (Line 9 X Line 8)	$42,841
11.	Reduction to GRT by Excluding Uncollectible Accounts Expense (Line 5 - Line 10) (Flow to Sch. IV)	($259)

Table XII
PPL Electric Utilities Corporation
R-2012-2290597
RECONCILIATION OF
Operating Revenue and Applicable Tax
Commission Allowed Rate Increase
(000)

Commission Allowance

Line No.	Description	Amount
1.	Commission Allowed Increase (Table I)	$71,030
	Provision for Uncollectibles (Line 1 x 2.23%)	$1,584
2.	PUC, OCA, OSBA Assessment	$175
	PA Gross Receipts Tax ((Line 1 - Line 3) * 59 mils)	$4,097
3.	PA Capital Stock Tax (Table X Line 16)	$52
4.	Sub Total	$5,908
5.	Taxable Income for PA CNI Tax (Line 1 - Line 4)	$65,122
6.	PA CNI Tax (Line 5 * 9.99%)	$6,506
7.	Federal Taxable Income (Line 5 - Line 6)	$58,616
8.	Federal Income Tax (Line 7 * 35%)	$20,516
9.	Operating Income (Line 7 - Line 8) (See Table I, Col. 4, Line 12)	$38,100