

I. INTRODUCTORY STATEMENT

The Philadelphia Water Department (“Department”) has presented its case to Hearing Officer Harris T. Bock documenting the need for a rate increase to meet a projected revenue shortfall of \$316.9 million during the period FY 2009-2012. The Department specifically needs rate relief during this four year period to cover (a) personal services (salaries and benefits); (b) purchase of services (contractual services for such needs as natural gas, electricity, telephone, biosolids hauling, maintenance contracts, enhanced security and professional consultants); (c) materials, supplies and equipment (costs for chemicals, heating oil and sophisticated laboratory equipment). Additional expenses include the payments for indemnities for legal claims against the Department and payments to the City’s General Fund for such services rendered as procurement, auditing, fleet management, personnel, treasury and central finance. PWD Statement 1 at 2. The Department is proposing rates to achieve annual increases in revenues of approximately 6.4% in each fiscal year during the aforesaid period. PWD Statement 5 (Exhibit JRM-1 - Table 11).

The Hearing Officer, having now heard the evidence, must evaluate same to determine the justness and reasonableness of the Department’s proposed rate increase. In undertaking this task, the Hearing Officer should consider both the purpose and effect of the proposed rates.

The over-riding purpose of the requested rate relief is to allow the Department to continue to provide safe, reliable service to its customers, consistent with the Department’s mission to safeguard the environment and remain in compliance with applicable environmental requirements. The proposed rate increase is designed to accomplish this in three ways.

First, in accordance with the Philadelphia Home Rule Charter (“Charter”),¹ the Philadelphia Code and the Restated General Water and Wastewater Revenue Bond Ordinance of 1989 (“General Ordinance”),² the increase will allow the Department to generate revenues sufficient to pay its operating expenses, debt service and meet applicable investor and insurance covenants.

Second, the proposed rate increase will allow the Department to maintain its financial integrity and its ability to attract capital in the municipal bond markets. The Department must have ready access to capital on reasonable terms to allow it to finance the cost of repairs and replacements to utility infrastructure (e.g., the mains and facilities utilized in the conveyance and treatment of water, wastewater and stormwater for the benefit of Department customers).

Third, the rate filing provides for the establishment of rates premised upon cost causation (i.e., establishing a reasonable system of charges based upon cost of service). The Department’s proposal to allocate costs fairly and continue implementation of stormwater cost allocation reforms and the phase-in of this program over the Rate Period is designed to accomplish this objective.

As the Hearing Officer is aware, a number of events have transpired since the formulation of the rate increase request which will make it exceedingly difficult for the Department to meet all of its obligations during FY 2009-2012. As more fully described in a later discussion in this brief, those events include:

- the delayed implementation of new rates which will cause the loss of an estimated \$15 million (reducing the rate increase by that amount);

¹ First Class City Home Rule Act, 53 P.S. 13101.

² General Water and Wastewater Revenue Bond Ordinance of 1989 (Ordinance of City Council, approved June 24, 1993 – Bill No. 544).

- the enactment of new shut-off restriction policies by City Council which will cause an estimated \$5.0 million loss in revenues over the Rate Period;
- incremental inflationary increases in chemical and fuel costs will cause increased expenditures estimated at \$8.0 million;
- disputes with suburban customers that may result in revenue losses of up to \$15.4 million; and
- the effects of the FSA downgrade and sinking fund reserve substitution which, in the worst case scenario, could trigger the need to draw down the Rate Stabilization Fund by some \$67 million.

PWD Exhibit 25 (Tab 1). It is in the context of the current financial deterioration that the Department's proposals for rate relief must be evaluated as same are materially impacted by current circumstances. To be sure, the above events offer glaring confirmation that the Department has very little to offer in the way of adjustment to proposed revenue levels. Further, in view of the fact that the Department has made every effort to cut financial and operating costs, it now has no choice but to ask that its request be granted subject only to the adjustments proposed herein.

A. Just and Reasonable Rates.

The Public Advocate once again raised the issue of ratemaking conventions (i.e., the appropriate test period; known and measurable expenses, etc.) emanating from the application of the just and reasonable standard. This fundamental ratemaking standard requires that rates charged to customers be just, reasonable and sufficient to permit the utility to sustain its operations, maintain its financial integrity and attract capital at favorable interest rates. *See, Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). This standard is usually applied in association with accrual accounting methods (commonly used by PUC regulated utilities), but it also has applicability here.

In the instant context, however, the Department is required to establish rates based upon the legally enacted (modified accrual) basis of accounting. This accounting method is primarily based upon actual receipts or cash (rather than accrued revenues).³ Use of the legally enacted basis of accounting in the rate process is not (in and of itself) at odds with the just and reasonable standard. Rates can be fairly set using a variety of accounting methods (including the modified accrual method). The test is whether this accounting method (or any other) is fairly and appropriately applied.⁴ In the instant context, the FY 2009 Operating Budget (developed using the legally enacted basis of accounting) is the initial point of departure for determining revenue requirements for the Rate Period. PWD Statement 5 at 6. As discussed in this brief, revenue levels are vetted by City Council⁵ as well as Black & Veatch Corporation (“Black & Veatch”) in the determination of appropriate expenditure levels utilized in the four year rate plan.

In addition to establishing rates to reasonably recover operating expenses and debt service, pursuant to the rate plan, the Department must annually recover sufficient revenues to meet its rate covenants with investors. The rate covenant in the General Ordinance requires that the Department establish rates sufficient to produce net annual revenues which are at least 1.20

³ It is noteworthy that the “legally enacted” or “modified accrual” basis of accounting has been described in this record as “conservative.” PA Statement 1 at 7. If that means that, by use of this method, rates must be established so as to actually realize sufficient receipts to pay operating expenses and debt service – this is a correct characterization of this accounting method. Equally important is the fact that the modified accrual basis of accounting is the legally required accounting method for this venue. See, PWD Exhibit 4 (SI-7 2007 PWD Financial Statements).

⁴ The Department’s cash requirements are determined within the framework of the legally enacted basis of accounting and, in the first instance, are reviewed by Philadelphia City Council which has authorized expenditures associated with the Water Fund for FY 2009 at a level of \$592.4 million. PWD Exhibit 8 (PA-MAB-2). This is the base year from which the revenue requirement is determined, subject to adjustment. In addition to the aforesaid City Council review, Black & Veatch and the Department have undertaken an analysis of historical actual and budgeted expenses for each of the classes of expenses (including personal services, purchased services, materials and supplies, equipment, and interdepartmental charges) to make sure that the budgeted level of expenses included in the rate filing is reasonably applied in the test period (taking into account union contracts, current and prospective personnel levels, escalating chemical expenses, etc.)

⁵ The fact that the City Charter requires a balanced budget (one where revenues and expenses are equal), as determined by City Council, is one clear indication that the revenues and revenue requirements determined in this case should be reasonably aligned with Water Fund appropriations approved by Council (FY 2009 operating budget) as projected over a reasonable period of years. This is the general framework of the rate process within which we are engaged.

times the senior debt service requirements. The Department's covenants also require it to set rates so as to recover net revenues equal to 1.00 times on various annual deposits and total debt service requirements, as specified in the General Ordinance. Finally, the Department is required to set rates to produce net revenues (excluding amounts transferred from the Rate Stabilization Fund in a given year) equal to at least 90% of annual senior debt service requirements. PWD Statement 1 at 6.

In the end, the Department must not only establish rates to sustain its operations over a reasonable number of years, but also to maintain its financial integrity.⁶ Stated differently, the Department must be able to attract capital on favorable terms. This is also an integral part of establishing just and reasonable rates.

The Department is reasonably concerned that rates be set so that it can maintain (or improve) its bond ratings, because necessary funding for the vast majority of expenditures for the Department's capital program is derived through the issuance of revenue bonds. As more fully described below, the Department's six-year Capital Improvement Program (\$985.8 million) is a critical element of its operations as the water and wastewater systems require continuous repairs and replacements for (a) the water conveyance and wastewater/stormwater collector facilities over 130 square miles (City service area); and (b) treatment plants and other facilities serving water and wastewater customers in the City and adjacent suburbs.

⁶ The most fundamental principle in utility regulation is that operating revenues should be sufficient to produce earnings upon invested capital which maintains the integrity of that capital and permits the attraction of additional capital necessary for continued service operations. This principle was recognized early in the development of rate regulation by the United States Supreme Court in *Bluefield Waterworks and Improvement Company v. Public Service Commission*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944). The Supreme Court established in *Hope* that operating revenues should be sufficient to produce earnings to allow the utility to attract capital.

This principle has more recently been reaffirmed by both the United States and Pennsylvania Supreme Courts. The United States Supreme Court, following the *Hope* decision, stated that one of the elements always relevant in utility revenue determination is the return to be received by the utility given the risks involved in the enterprise. *Duquesne Light Company v. Barasch*, 488 U.S. 299, 314 (1989). The Pennsylvania Supreme Court has also

Access to the capital markets on favorable terms (capital attraction) is therefore a central issue in this case – and is very much a part of setting just and reasonable rates. The Department’s credit rating must be preserved (or improved) to fund its capital expenditures at least cost to customers.

The rating agencies have recently affirmed the Department’s “A” category bond ratings but, in so doing, have emphasized that the favorable rating and outlook are premised upon the expectation that the Department will implement sufficient new rates so as to fulfill its covenants with investors even with diminished cash reserves. PWD Exhibit 35; PWD Exhibit 4 (SI-42 - Attachment 14). The rating agencies have offered their guidance as to what must be done to preserve the Department’s creditworthiness. As stated by Standard & Poor’s in its ratings report dated, August 15, 2008:

The stable outlook reflects Standard & Poor’s expectation that the Water Department will adopt the currently proposed rate increases to continue to maintain current satisfactory coverage as rate stabilization reserves are drawn on, as forecast over the next several years. [Emphasis added].

PWD Exhibit 35. Likewise, Moody’s Investors Service, in affirming its “A3” rating and indicating a “stable” outlook, stated that a rating downgrade could be triggered by a violation of the rate covenant; or a reduction in cash reserves without improvements in coverage. *Id.* The importance of sufficient new rates is obviously critical to maintaining current favorable ratings.

It should also be noted that, even with the proposed rate relief, the Department will still be one of the least expensive providers of water and wastewater services in the region. PWD Statement 1 at 8.

reaffirmed this principle in its holding in *Pennsylvania Electric Company v. Pennsylvania Public Utility*

B. Prospective Nature of Ratemaking.

The record surely confirms that there are divergent views as to the appropriate determination of revenue requirements and the appropriate time horizon to be utilized for rates. In assessing the various arguments raised in this proceeding, however, it should not be forgotten that ratemaking is, by its nature, prospective and relies upon the reasonable projection of future revenues and revenue requirements.

Municipal regulatory commissions today commonly use fully projected test periods. In many municipal jurisdictions (such as San Antonio, Texas; Norfolk, Virginia; Dayton, Ohio; and Philadelphia), rates are set using multiple test years. PWD Exhibit 25 (Tab-18). A sample of jurisdictions using multiple test years is set forth below.

Multiple Test Year Jurisdictions

Utility	Number of Years of Approved Rate Increases
Charleston, South Carolina Water and Sewer	3
Metropolitan St. Louis Sewer District, MO	3
Norfolk, Virginia Water	3
San Antonio, Texas Water	5
Dayton, Ohio Water	5
Yakima, Washington Water and Sewer	5
Cloverdale, California Water and Sewer	3
New Orleans, Louisiana Water	5
Fayetteville, Arkansas Water and Sewer	3
Lee's Summit, Missouri Water and Sewer	5
Montgomery County, Ohio	5
Freeport, Illinois Water and Sewer	5
Columbia, Missouri	3
Independence, Missouri Water and Sewer	5
Springfield, Ohio	3
Garden Grove, California Water and Sewer	Multi-year
Los Angeles, California Sewer	Multi-year
Lawrence, Kansas Water and Sewer	5
Edmond, Oklahoma Water and Sewer	Multi-year
Cincinnati, Ohio Wastewater	3
Chino Hills, California Water and Sewer	Multi-year
Antioch, California Water and Sewer	Multi-year
Southwest Water Company, California Water (PUC regulated)	3

Commission, 509 Pa. 324, 502 A.2d 130 (1985).

One of the justifications advanced for use of future test periods is to avoid the need for frequent or unpredictable rate increase requests. By use of the proposed time horizon in this proceeding (FY 2009-2012), the Department would like to set rates so that (a) future filings will occur on a less frequent basis; (b) greater financial stability can be achieved; and (c) water and wastewater customers can plan their budgets with greater certainty. None of the foregoing can be accomplished, however, without the use of reasonable projections of future revenues and expenses. It should also be noted that rates have been established in this jurisdiction since 1993 using multiple test periods. Since that time (sixteen years ago), the Department has returned for rate relief on just three occasions.⁷

C. End Result Is Controlling.

The proof of the reasonableness of rates is the end result, not the model or methodology employed. The Department's rates are reasonably determined from FY 2009 budget data adjusted by budget and growth factors. Revenue requirements are determined with use of the most complete information available. The critical consideration is that there is a real basis for use of growth and budget factors to calibrate the test period revenue levels to the reality that the operators of the utility are reasonably aware will exist during the test period. Whether the adjustment is for personnel costs, fringe benefits, chemical expenses or debt service, the Department is trying to accurately capture reasonable expense levels and track revenues it can expect to realize.

Historical spending (even when utilizing a simple two or three year average) does not always realistically reflect prospective expense levels. For example, if the utility is aware that it is at historically low personnel levels, it would be unfair to base rates on an historic average.

⁷ The Department has been successful in meeting or extending the period projected for rates to remain in effect.

Ratemaking should not be wholly theoretical. There should be some reality test. The Department believes that rates can be more reasonably set with informed judgment and reasonable budget estimates than with blind adherence to historical averages or the application of a rigid method or formula that does not take into account recent or changed circumstances.

In truth, just and reasonable rates can be set in any number of ways. The test is whether the underlying revenue requirement reasonably reflects future costs; and, most importantly, that the end result is a reasonable one.⁸ *PA Public Utility Commission v. Pennsylvania Gas & Water Co. (Water Division)*, 492 Pa. 326, 424 A.2d 1213 (1980). The Public Advocate's own witness (Jerome D. Mierzwa) agrees with the need for the use of estimates and assumptions in ratemaking where appropriate. Tr. 46.

II. STATEMENT OF THE PROCEEDINGS

On April 4, 2008, the Department notified Philadelphia City Council of its intent to file proposed changes in rates for water and wastewater service to become effective July 1, 2008, or as soon thereafter as procedural requirements permit the enactment of new rates by regulation. On May 5, 2008, the Department filed with the Department of Records the following regulations and accompanying documentation, pursuant to Sections 8-407 and 5-801 of the Charter.

Proposed Philadelphia Water Department Regulations

- 300.0 Rates and Charges Definitions
- 301.0 Process for Setting Water, Sewer and Stormwater Management Service Rates
- 302.0 Water Charges

⁸ Just and reasonable rates are arrived at through balancing competing ratepayer and investor interests. In the instant context, however, the ratepayer is the citizen/owner of the enterprise which makes no profit. So even with a conservative determination of the revenue requirement and rates in accordance with the Charter, Philadelphia Code and bond covenants, all revenues are employed for the benefit of the ratepayer/citizen owner and sustain necessary utility operations or fall to the Rate Stabilization Fund to be used to defray future revenue increases. Simply put, all revenues earned stay within the Department for use in offsetting future revenue requirements and enhancing the compliance with covenants prescribed by the General Ordinance.

- 303.0 Sewer Charges
- 304.0 Stormwater Management Service Charges
- 305.0 Billing for Water, Sewer and Stormwater Management Service
- 306.0 Miscellaneous Water Charges
- 307.0 Miscellaneous Sewer Charges
- 308.0 Miscellaneous Stormwater Management Charges
- 309.0 Fire Service Connections.

In further support of this filing, the Department submitted pertinent engineering, financial and rate data as well as the prepared testimony of both the Department and Black & Veatch.

Mayor Michael A. Nutter, City Council President Anna C. Verna and City Controller Alan L. Butkowitz jointly appointed Harris T. Bock, Esquire to preside over the rate hearings and to prepare a report to the Water Commissioner summarizing the record and his recommendations. The Mayor, City Council President and City Controller also appointed Community Legal Services to serve as Public Advocate in the rate hearings.

In addition to the Public Advocate, the Commercial Customer Coalition (“CCC”), Philadelphia Large Users Group (“PLUG”), Penn Future/Next Great City and Philadelphia Housing Authority (“PHA”) are participants in this proceeding.⁹

Five public hearings and three days of technical hearings were held in connection with this rate case¹⁰ and a transcript of some 735 pages was accumulated in the technical hearings alone. Expert witnesses proffered by the parties in the technical hearings included Michael A.

⁹ The Philadelphia Large Users Group (“PLUG”) entered into a settlement agreement with the Department (subject to the Hearing Officer’s approval) modifying its status in the proceeding.

¹⁰ Public hearings were held in North Philadelphia, West Philadelphia, South Philadelphia, Roxborough, and Northeast Philadelphia during the period July 21 – July 31, 2008. Technical hearings were held on August 12-14, 2008 at the Philadelphia Gas Commission hearing room, 1515 Arch Street, 18th Floor, Philadelphia, Pennsylvania.

Bleiweis, Roger D. Colton, Jerome D. Mierzwa, Dennis M. Kalbarczyk and Kirk Dorn.¹¹ The Department also presented a full roster of witnesses which included Deputy Water Commissioners Joseph S. Clare, III and Debra McCarty, Anthony Griffith, James Palladino, Revenue Commissioner Keith J. Richardson and J. Rowe McKinley of Black & Veatch. A full listing of the statements and exhibits submitted in this record by all parties is set forth in Appendix A of this Brief.

III. GOVERNING LEGAL STANDARDS

Section 5-800 of the Charter conveys authority to the Department to operate the water and wastewater utilities. In addition, the Charter authorizes the Department to fix and regulate rates and charges for utility services. Specifically, Section 5-801 requires the Department to set rates that will yield annually amounts sufficient to cover its operating expenses and debt service, in accordance with standards City Council ordains. Per the Charter:

Rates and Charges. In accordance with the standards as the Council may from time to time ordain, the Water Department shall fix and regulate rates and charges for supplying water, including charges to be made in connection with water meters, and for supplying sewage disposal services. The standards pursuant to which rates and charges shall be fixed by the Department shall be such as to yield to the City at least an amount equal to operating expenses and interest and sinking fund charges on any debt incurred or about to be incurred for water supply, sewage, and sewage disposal purposes. In computing operating expenses, there shall be included proportionate charges for all services performed for the Department by all officers, departments, boards or commissions of the City.

Section 5-801. The City Council standards referenced above are set forth in the Philadelphia Code, Sections 13-101 and 13-201. Section 13-101(2) of the Code specifically states the following as to the determination of water rates:

All hearings were open to the public and were legally advertised consistent with applicable Department rate regulations. See, Exhibit HO-1.

¹¹ CCC also presented fact witnesses including Robert Rossi (St. Joseph's University); Larry Spielvogel (Inter-Faith Coalition on Energy); Floyd Ruppel (Trigen-Philadelphia Energy Corporation); Kenneth J. Braithwaite (Delaware Valley Health Council); John J. McCaffrey (University of the Sciences); and Ron Pluto (Building Owners and Managers Association).

Standards for Rates and Charges. Pursuant to Section 5-801 of the Charter, the Water Department shall fix and regulate rates and charges for supplying water, without further authorization of Council, in accordance with the following standards:

(a) The rates and charges shall be such as yield to the City at least an amount equal to operating expenses, including interest and sinking fund charges on all obligations of the City in respect of the water system and, in respect of water and sewer revenue obligations of the City, such additional amounts as, together with additional amounts charged in respect of the City's sewer system, shall be required to comply with any rate covenant and sinking fund reserve requirements approved by ordinance of Council in connection with the authorization or issuance of water and sewer revenue bonds, and proportionate charges for all services performed for the Water Department by all officers, departments, boards or commissions of the City.

(b) The rates and charges shall yield not more than the total appropriation from the Water Fund to the Water Department and to all other departments, boards or commissions, plus a reasonable sum to cover unforeseeable or unusual expenses, reasonable anticipated cost increases or diminutions in expected revenue, less the cost of supplying water to City facilities and fire systems and, in addition, such amounts as, together with additional amounts charged in respect to the City's sewer system, shall be required to comply with any rate covenant and sinking fund reserve requirements approved by ordinance of council in connection with the authorization or issuance of water and sewer revenue bonds. Such rates and charges may provide for sufficient revenue to stabilize them over a reasonable number of years.

(c) The rates and charges shall be equitably apportioned among the various classes of consumers.

(d) The rates and charges shall be just, reasonable and nondiscriminatory as to the same class of consumers.

(e) Special rates and charges, to be designated as "charity water rates and charges," shall be established for public and private schools, institutions of purely public charity, and places used for actual religious worship.

(f) Special rates and charges to be designated as "public housing water rates and charges" shall be established for property of the Philadelphia Housing Authority and shall be set so that Philadelphia Housing Authority receives a five percent (5%) reduction off of the Water Department's service and quantity charges. [Emphasis added].

The City Council standards applicable to wastewater rates (Section 13-201) parallel those set forth above and conservatively require that the Department fix and regulate rates so as to yield sufficient revenues over a reasonable period of years to pay its operating expenses,

including interest and sinking fund charges approved by Ordinance in connection with the issuance of bonds, meet its obligations to investors and pay proportionate charges for all services performed for the Department by all officers, departments, boards or commissions of the City. PWD Statement 1 at 4-6.

As alluded to above, the Department must collect sufficient revenues to meet its rate covenants, including that prescribed by the General Ordinance which requires, among other things, that the Department's annual net revenues be at least 120 percent of its senior debt service. The Department must also comply with additional rate covenant requirements with respect to the payment of deposits in various accounts and debt service, as prescribed by the General Ordinance. Also, the Department must establish rates and charges sufficient to yield net revenues (excluding amounts transferred from the Rate Stabilization Fund to the Revenue Account) at least equal to 90 percent of the Department's senior debt service requirements ("FGIC/FSA Covenant"). See, PWD Statement 5 at 8-9.

Taken together, the foregoing governing legal standards constrain the Department to fix and regulate rates so as to conservatively meet operating requirements and obligations to investors through creation of a stable revenue stream over a reasonable period of years. The instant rate filing is designed to specifically comply with all of the above legal requirements.¹²

IV. DESCRIPTION OF THE UTILITIES

A. Water System.

The water system provides water service to retail customers in the City over a 130 square mile service area. In addition, the system provides water service to Bucks County Water and

¹² Challenges to the legal standards, rate-setting procedures, and inclusion of certain costs in rates have been rejected uniformly by the courts during the last ten years. See, for example, *CEPA v. Marrazzo*, 575 A.2d 160 (Pa. Cmwlth. 1990), aff'd 600 A.2d 189 (Pa. 1992); *Public Advocate v. Philadelphia Water Department*, 26 Phila. 527 (Common Pleas, Phila. County, 1993), aff'd 662 A.2d 686 (Pa.Cmwlth. 1995).

Sewer Authority and Aqua Pennsylvania pursuant to agreements for wholesale water service. The water system obtains 56% of its water from the Delaware River and the balance from the Schuylkill River. It is currently authorized by the applicable regulatory authorities to withdraw up to 390 MGD from the Delaware River and 258 MGD from the Schuylkill River.

Water treatment is provided to the Department's 472,800 retail customers by three water treatment plants. The combined rated capacity of these plants is 540 MGD; and their combined maximum capacity is 683 MGD. The water system's infrastructure also includes 3,160 miles of mains and 28,000 fire hydrants. PWD Exhibit 7 (SI-8 - Official Statement, Water and Wastewater Revenue Bonds, Series 2007A and 2007B at Bond Engineering Report, pp. III-1 through III-27).

B. Wastewater System.

The wastewater system service area totals some 360 miles, of which 130 square miles are in the City; and 230 square miles are in suburban areas. Service to suburban areas is provided under agreements with adjacent municipalities and municipal authorities. Wastewater service is provided by three water pollution control plants, a biosolids handling facility, 16 pumping stations, 75,000 stormwater inlets and approximately 3,000 miles of sewer. *Id.*

The water pollution control plants consist of the Northeast and Southwest plants, each with secondary treatment capacity of 210 MGD and 200 MGD respectively; and the Southeast plant with 112 MGD secondary treatment capacity. The biosolids handling facility includes an operation and maintenance center, dewatering facility, receiving and mixing facility, barging and docking facilities and a pipeline between the Southwest plant and the biosolids facility. PWD Exhibit 7 (SI-8 - Official Statement, Water and Wastewater Revenue Bonds, Series 2007A and 2007B at Bond Engineering Report, pp. IV-1 through IV-38).

It should be noted that much of the conveyance and collection system serving the water and wastewater utilities is old and perennially in need of repair and upgrades. The water treatment and water pollution control plants are also in constant need of refurbishing and improvement. All of the foregoing are the focus of the Department's Capital Improvement Program – the debt service associated with which is a major element of this rate filing. This program is a critical part of the planned expenditures necessary to run the water and wastewater systems. Same is approved by Philadelphia City Council for a six year duration and includes improvements for the water and wastewater treatment plants, water and wastewater conveyance systems and collector system, among other areas. PWD Statement 2 at 6-7. Maintaining Department infrastructure so as to provide reliable service for customers and to fulfill the Department's mission as a caretaker of the environment, is at the core of this rate increase request. No party has questioned the propriety of planned capital expenditures which are supported by rates (debt service payments and direct capital contributions).¹³

V. ARGUMENT

A. The Department Must Establish Rates Sufficient to Pay Operating Expenses, Debt Service and Fulfill Rate Covenants With Investors.

Existing rates are inadequate to comply with the aforesaid legal requirements of the Charter, Philadelphia Code and covenants with investors under existing revenue bonds. Such legal requirements mandate that the Department impose, charge and collect sufficient revenues to pay annual operating expenses, debt service and fulfill bond covenants.

¹³ The Department's outstanding indebtedness as of the end of FY 2007 was \$1.76 billion, as documented in PWD audited financial statements. PWD Exhibit 4 (SI-7 – FY 2007 PWD Financial Statements at 14). The debt service on this outstanding debt constitutes a major portion of the requested revenue requirement and must be timely paid to maintain the Department's credit rating.

The Department's principal covenants¹⁴ are set forth in and required by the General Ordinance and the FGIC/FSA Covenant entered into in connection with the issuance of Series 1993 and 2003 Bonds. The rate covenant contained in the General Ordinance requires the Department to establish rates sufficient to yield Net Revenues in each fiscal year (after payment of operating expenses) at least equal to 1.20 times the Senior Debt Service Requirements for such fiscal year (both as defined in the General Ordinance). In addition, net revenues in each fiscal year must be at least equal to 1.00 times (i) Total Debt Service Requirements for such fiscal year; (ii) amounts required to be deposited in the Debt Reserve Account during such fiscal year; (iii) principal or redemption price of and interest on General Obligation Bonds issued by the Department and payable in such fiscal year; (iv) debt service requirements on interim debt payable in such fiscal year; and (v) the Capital Fund Deposit Amount for such fiscal year, less amounts transferred from the Residual Fund to the Capital Account during such fiscal year. PWD Statement 5 at 8; PWD Exhibit 7 (SI-8 - PWD Official Statement, 2007A and 2007B Bonds at 14).

In addition to the covenants described above, for each fiscal year ending on or after June 30, 2000, the Department is required by the Fiscal Agent, for the benefit of Financial Guaranty Insurance Company ("FGIC") and thereafter to Financial Security Assurance, Inc. ("FSA") through their insurance on the Series 2003 bonds, to establish rates and charges for the use of the water and wastewater systems sufficient to yield Net Revenue (excluding amounts transferred from the Rate Stabilization Fund into the Revenue Fund during the fiscal year) at least equal to 90 percent of the Senior Debt Service Requirements (excluding Debt Service due on any

¹⁴ The Department's bond covenants are enacted by Ordinance of City Council and then made a part of the transaction for the issuance of long-term debt. These covenants are binding upon the Department as prescribed by City Council and enforceable by bondholders as a part of the contract embodied in the bond.

Subordinated Bonds) in such fiscal year for so long as the Series 1993 Bonds insured by FGIC and Series 2003 Bonds insured by FSA are outstanding. PWD Statement 5 at 9.

The Department must increase rates to comply with its rate covenants with investors. Such compliance is necessary as a condition precedent to maintaining its favorable credit rating and funding its capital program. Absent new rates, the Department would fail to meet required coverage levels – placing its favorable bond ratings in jeopardy. PWD Statement 1 at 6.

Technical compliance with rate covenants is essential to maintain the Department’s current favorable bond ratings. Current ratings are “A-” by Fitch IBCA; “A” Standard & Poor’s; and “A3” by Moody’s. *Id.* at 6; PWD Exhibit 35. These ratings are important as the Department must issue debt to fund its capital program prospectively and would like to do so at the least cost to its customers. To this end, the proposed rate increase is designed to produce coverage levels as required by the rate covenants, per the chart below:

Projected Coverage Levels for the Rate Period

	<i>FY 2009</i>	<i>FY 2010</i>	<i>FY 2011</i>	<i>FY 2012</i>
Senior Debt Service Coverage	1.20	1.20	1.20	1.20
Total Debt Service Coverage	1.07	1.08	1.08	1.08

PWD Statement 1 at 7. In addition to the above referenced program of renewal and replacement of existing infrastructure, the Department must also employ capital funds to pay many of the costs associated with environmental regulations (including those related to the stormwater management program and water quality). PWD Statement 2 at 7.

B. The Proposed Rate Increase is Essential to Implementation of the Department’s Capital Program.

As more generally alluded to above, the Department will issue \$325 million of debt in early calendar year 2009 and an additional \$350 million in FY 2012 to supplement funding of its continuing capital program which requires cumulative expenditures of almost \$985.8 million for

the period FY 2009-2014. A significant component of this program is dedicated to water main and sewer replacement and rehabilitation. Necessary improvements to treatment plants and other facilities are also funded under this capital program (as well as projects related to storm flood relief and improvement of facilities related to the disposal of side stream wastes such as biosolids, etc.). The following table sets forth major elements of the Department's Capital Improvement Program, as approved by Philadelphia City Council.

Capital Improvement Program¹⁵ (000)

Engineering & Administration	\$ 147,803
Improvements to Treatment Plants	252,000
Conveyance System (new and reconstruction)	131,880
Collector System (new and reconstruction)	141,100
Storm Flood Relief	295,000
Vehicles	<u>18,000</u>
	\$ 985,783

The vast majority of these program expenditures are expected to be funded with bond proceeds. The Department also funds a portion of its capital program through internally generated funds, however. A Capital Account Deposit is planned is every year of the Rate Period for this purpose. See discussion, *infra*. In addition, transfers can be made between the RSF and Residual Fund for purposes of financing construction. Ironically, actual transfers projected to be made to the Residual Fund in prior years were substantially less than projected. To be sure, in absence of a bar to such transfers to fund the capital program (there is none), the RSF could have theoretically been depleted to reduce capital expenditures (over \$150 million is spent annually). That approach would not have been sound financial planning, as there are a variety of financial needs that the Department must meet, including maintaining adequate working capital and sustaining customer rates at reasonable levels.

C. The Department's Overall Rate Plan Is Reasonable.

The Department's overall framework for new rates (multiple year rate plan) is reasonable and should not be changed.¹⁶ Policy reasons underpinning the use of a multiple year rate plan include its facilitation of the Department's ability to levelize rates so that customers and the utility can plan accordingly. The Department also lives within the constraints of revenue levels granted for the rate period approved. This gives predictability to the rate process.

Customers have a reasonable expectation that rate increases should be implemented gradually. PWD Exhibit 32 (Schedule 4) illustrates this point. In the scenario presented in that Table 11 run, a revenue increase of 14.3% is necessitated in FY 2011 (utilizing the Advocate's revenue requirement assumptions). The Department would like to avoid such a sharp increase in rates in a given year by following its four year rate plan with levelized increases coordinated with the careful management of the Rate Stabilization Fund.¹⁷

¹⁵ See, PWD Statement 2 at 7; PWD Exhibit 4 (SI-41 - Capital Improvement Program FY 2009-2014).

¹⁶ Public Advocate witness, Michael A. Bleiweis, recommends use of either a single or two year time horizon for new rates. PA Statement 1 at 66-67. This position has been repeatedly rejected in prior rate cases and should not be sanctioned now. A single or two year rate plan would have the Department perennially engaged in the rate process. There is a major expense tied to this proceeding (\$1.6 million and climbing) tied not only to the cost of litigation but the inordinate amount of time expended by Department employees who also have to run the utility (Deputy Commissioners McCarty and Clare among many others).

¹⁷ It is important to note that the Department has historically utilized the RSF as a source of working capital. The Department estimates this present need at \$45 million. This estimate is consistent with the lead-lag study undertaken in the 1990's establishing a \$30 million working capital need when the Department's revenues and revenue requirements were significantly lower. As indicated in this record, a working capital need of 30-60 days would be prudent. Tr. 156. Given the Department's current revenue levels, by this measure, a working capital need of \$45-90 million is justified. The results of a recently completed lead-lag study by Mitchell & Titus confirms that a working capital allowance of some \$89 million is appropriate. Tr. 151-156. Please note that the current use of a \$45 million working capital allowance also serves as a cushion against unexpected events (e.g., FSA downgrade), so that the Department will always be a going concern. See discussion, *infra*.

The investment community also takes substantial comfort in the fact that the RSF is prudently managed, as they know that reserves are important to any enterprise. Investors also know that there is a real possibility of error in realizing anticipated revenues given the payment and collection patterns, local shut-off restrictions, the current economy, interest rates and inflation in material and supplies (largely chemical costs). Taken together, the financial health of the utility can turn quickly from relative prosperity to grave uncertainty. The testimony of the City's financial advisor, Anthony Griffith, underscores this point. Tr. 324. Financial reserves are important. The Moody's and Standard & Poor's rating agency reports also stress the importance of maintaining satisfactory coverage as the RSF is drawn down. PWD Exhibit 35.

The Hearing Officer should be aware that the structure of the instant rate increase is consistent with prior Department multiple year rate filings, and with the City's overall long-term budget planning process. The Department should not be second-guessed in managing its financial plan – such decisions appropriately reside with senior management.¹⁸

By way of background, in 1993, Commissioner Kumar Kishinchand approved the Department's first multiple year rate filing premised upon levelizing annual increased revenue requirements over a three year period. The Public Advocate opposed the use of a multiple year rate plan in that case; and his position was rejected.¹⁹

Similarly, in FY 2001, the Department proposed a four year rate process to levelize the required increase in annual revenue. Commissioner Kishinchand again approved the use of a multiple year rate plan over the objection of the Public Advocate.²⁰

In FY 2005, the Department again proposed a four year rate filing. The proposed average increase in annual revenue requirements in that case was 5.7% over four years. The Advocate again raised his concerns about multiple year rate filings in that proceeding and was rejected by Commissioner Bernard Brunwasser.²¹

In all cases identified above, legal and policy concerns weighed heavily in favor of a multiple test year approach to ratemaking which was implemented in the final rate decision in

¹⁸ Senior management has seen this utility in good times and bad. They know that there is always a risk that some combination of interest rates, collections and economic conditions can throw their financial plan into a tailspin. This management also knows how hard it was to work their way back from being excluded from the bond markets in 1991 (after a technical default) to its current status as an "A" rated utility. Tr. 137. The Department submits that establishing its financial plan is purely a management function and should not be "second guessed" in the regulatory process. See, *NAACP v. PUC*, 5 Pa. Cmwlt. 312, 290 A.2d 704 (1972); *Bell Telephone Co. v. Driscoll*, 343 Pa. 109, 21 A.2d 912 (1941). In short, the regulatory process should not supplant management functions or act as a super board of directors – senior management is supposed to run this utility.

¹⁹ *In Re Matter of a Proposed Increase in Rates for Water and Wastewater Utilities* (FY 1993-1996), Rate Decision at 11-12.

²⁰ *In Re Matter of a Proposed Increase in Rates for Water and Wastewater Utilities* (FY 2001-2004), Rate Decision at 8.

²¹ *In Re Matter of a Proposed Increase in Rates for Water and Wastewater Utilities* (FY 2005-2008), Final Rate Decision at 10.

each case.²² It is the Department's position that this issue has been determined with finality in this jurisdiction.²³ The Department contends that even in administrative proceedings, litigation of the same issue between the same parties is collaterally estopped at some point. At the very least, the Hearing Officer should be guided by the precedent of the last three rate decisions in approving the utilization of the four year rate plan.

D. The Department Has Made Every Reasonable Effort to Lower Costs to Its Customers.

The Department's request for rate relief was formulated after the Department had taken every reasonable measure to reduce financial and operating expenses. Since the last rate increase (FY 2005), the Department has reduced financial and operating expenses in the following areas:

- refinanced \$345 million of outstanding debt, yielding savings of \$14.6 million;
- transferred \$59.9 million in Water Residual Fund balances to Capital Fund reducing the need for and size of additional debt issuances;
- achieved bond rating upgrades (Moody's "A3," S&P "A," Fitch "A-") with attendant reduction in borrowing costs;
- implemented a new billing system to assist in billing/collection activities; and
- continued work of the Revenue Protection Unit to investigate and recover unpaid revenues, additional billings of some \$18.8 million.

PWD Statement 1 at 3-4; Exhibit PWD 35 (Rating Upgrade). Cumulative savings derived from the efforts of the Department in recent years have kept water, sewer and stormwater charges at minimum levels and have allowed the Department to remain competitive.

²² As stated previously, policy reasons underpinning the use of a multiple year rate plan include its facilitation of the Department's ability to levelize rates so that customers and the utility can plan accordingly. The Department has also used the Rate Period to phase-in significant reforms such as those related to stormwater cost allocation in this case.

²³ Per the Department's Memorandum of Law concerning the alternate rate plans identified during the course of the proceeding, the Department believes that prior precedent should guide the Hearing Officer in this case (as a single and two year rate formulation has been rejected repeatedly in prior rate decisions).

It should come as no surprise, given the significant efforts of the Department to cut financial and operating costs, that its rates compare favorably with those in the suburbs and with comparable utilities in the region. As confirmed by Deputy Commissioner Clare in this record, even with the approval of increased rates, the Department will still be one of the least expensive providers of water and wastewater services in the region as illustrated below:

Regional Residential Monthly Water and Sewer Charges

<u>Utility</u>	<u>Water Charges</u>	<u>Sewer Charges</u>
Aqua Pennsylvania	\$ 45.60	\$ N/A
Pennsylvania American Water Co.	41.53	N/A
New Jersey American Water Co.	33.53	N/A
North Wales Water Authority	22.85	N/A
North Penn Water Authority	23.68	N/A
Doylestown Township	30.23	49.76
CCMUA (Camden County)	N/A	26.25
Trenton	21.58	23.30
Philadelphia Water Dept. (proposed)	20.36	19.87 ²⁴

PWD Statement 1 at 8.

E. The Department’s Projections of Operating Expenses and Debt Service Should Be Approved.

The projections of operating expenses and debt service, for the period rates will remain in effect, are reasonable and should be adopted in this case. As detailed in the record, operation and maintenance expenses for the Rate Period were determined utilizing the FY 2009 operating budget as a starting point. PWD Statement 5 at 15. FY 2009 budgeted expenses were adjusted based upon an analysis of historical/actual expenditures versus budgeted expenses for each of the various budgetary categories (e.g., personal services, purchases of services, materials and supplies, equipment and interdepartmental charges) to adjust the FY 2009 budget to an estimated expenditure level for the Rate Period. *Id.*

In estimating expenditures for each category of the budget, the Department and Black & Veatch used projected increases that will likely occur during the Rate Period as well as growth factors conservatively estimated based upon historical experience and corroborated by reliable measures of growth and inflation. *Id.*

Consistent with this approach, an adjustment is made for personal services expense as to which a 0.5% factor (representing a net increase in filled positions of approximately 10 per year) was used recognizing the anticipated increase in personnel levels expected in the future, as compared to prior staffing levels and authorized staffing under the budget. A recent increase in staffing of 23 positions in the first six weeks of FY 2009 indicates that this growth factor may actually be understated. In addition, the anticipated labor settlement was reflected in the revenue requirement, including a one-time bonus of \$1,500 per employee followed by annual increases of 2%, 3% and 4% in FY 2010, 2011 and 2012 respectively.²⁵ For electric power costs, Black & Veatch projected an annual increase of 2.5% from FY 2009 until mid-2011 based upon a review of historic trends. Thereafter, due to the discontinuation of the Department's discount agreement with PECO, power costs are projected to increase by 11.9% in mid-2011 and 16.5% in FY 2012. Chemical costs are projected to increase by 9.0% annually based upon recent experience and the Producer Price Index. For other expense categories, based upon the past three years of history (growth and inflation), a 3.0% growth rate is projected. PWD Statement 5 at 15. Fringe benefits, which are directly related to personal services expenses, were estimated to be 73.0% of personal services expenses in FY 2009 and rise to 88.8% by 2014. PWD Statement 5 at 16-17.²⁶

²⁴ Stormwater charges are excluded from the above illustration as most jurisdictions reported recover such charges through a separate assessment.

²⁵ As stated later in the brief, the Department will agree to an adjustment related to the negotiated one-time bonus (\$1,100 vs. \$1,500 projected in the arte filing).

²⁶ Personal services expense related to fringe benefits is an example of a budgeted expense that is significantly growing and must be realistically reflected in the revenue requirements for the Rate Period. PWD Exhibit 25 (Tab 15). The growth in this expense is troubling because personnel costs are a dominant component of the budget

Inter-departmental charges were projected for the Department's proportionate charges for services provided directly by other City departments and agencies. The Water Revenue Bureau charges for service in connection with the meter reading, billing and collection of revenues for water and wastewater service falls within this category, as do charges for services provided by the Law and Finance Departments, among others.

In addition to operating expenses and associated growth factors, debt service charges are projected in the filing to increase during the Rate Period and foreseeable future. Projected debt service on proposed bonds is set forth below:

Projected Debt Service on New Bonds²⁷

<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
\$ 21,142,000	\$ 21,142,000	\$ 21,142,000	\$45,224,000

The rate filing assumes, based upon estimated market conditions, that new bonds (in FY 2009 and 2012) can be sold at blended interest rates of 5.0% and 5.5%, respectively. PWD Statement 5 at 18. More aggressive assumptions can be made as to the trend in bond interest rates, but given bond insurance costs which make Department bonds more marketable (with a "AAA" rating), the 5.0% projected cost is reasonable for ratemaking purposes particularly given the upward trend in bond interest rates which will likely prevail in 2009. Tr. 296. The projected 5.5% interest rate applicable to the second planned transaction scheduled for early 2012, will have no impact on the rate filing (as interest payments associated with that issue will not become due until 2013).²⁸ Tr. 246-247.

(Classes 100 and 800) at approximately \$115 million annually. See, PWD Exhibit 8 (PA-MAB-2). On its face, this large item is an indicator that the revenue requirement over the period FY 2009-2012 may be insufficient. Any deficiency in this area (29% of the operating budget) will only be compounded by fuel, chemical and electricity costs which have also risen dramatically in the recent term. PWD Exhibit 25 (Tab 13).

²⁷ See, PWD Statement 5 (Exhibit JRM-1, Table 11).

²⁸ The Public Advocate initially recommends that a lower interest rate be utilized for the second bond transaction in 2012. PA Statement 1 at 47. Upon learning that the financial impact of the second transaction is beyond the Rate

In addition to the above, there are two other revenue requirements. The first is an interest earnings payment to the City. This payment reflects application of the 1974 General Ordinance, as amended and supplemented, that in any fiscal year in which a balance exists in the Department's Operating Fund, a payment may be made to the City's General Fund which does not exceed the lowest of (i) the amount of interest earnings on Sinking Fund Reserves transferred to the Operating Fund during the fiscal year or (ii) \$4,994,000. PWD Statement 5 at 26. See discussion, *infra*.

The second additional revenue requirement is the required Capital Account Deposit. Under the General Ordinance, the Department is required to make a Capital Account Deposit in each fiscal year, in an amount not less than one percent of the total value of the net assets of the Department. *Id.* During FY 2009-2012, the amount required to be deposited each year is set forth below:

Capital Account Deposit

Fiscal Year 2009	\$ 18,179,000
Fiscal Year 2010	\$ 18,570,000
Fiscal Year 2011	\$ 18,961,000
Fiscal Year 2012	\$ 19,352,000

PWD Statement 5 (Exhibit JRM-1, Table 11). Capital Account deposits are used by the Department to finance capital improvements for the water and wastewater systems.

Table 11 (PWD Statement 5 – Exhibit JRM-1) presents a cash flow statement of projected revenues and revenue and rate covenant requirements for water and wastewater utility operations for the period of Fiscal Years 2009 through 2012 under the framework of the General Ordinance. This table indicates that the Department's projected revenues with rate relief will exactly comply with the requirements of the General Ordinance (1.2x coverage). In previous

Period (when debt service payments associated with the new issue become due), Mr. Bleiweis signaled his

years this has been acceptable, without a cushion above required coverage, because the Department was able to “manage” to this coverage level with the benefit of adequate balances in the Rate Stabilization Fund (“RSF”).²⁹

Under some of the scenarios identified by the Public Advocate, maximum use of the RSF may jeopardize the Department’s ability to manage to 1.20x coverage as there will be no margin for error provided by the RSF balance in certain years.³⁰ The Department’s rate plan takes into account the need to maintain a minimum balance in the RSF of \$45 million to make sure it can always (a) manage to 1.20 times coverage and fulfill its rate covenants even as the RSF reserves are gradually drawn down; and (b) maintain a working capital balance to manage monthly cash flow variations in the revenue account. Table 11 (as proposed in the rate filing) best represents a reasoned financial strategy to fulfill rate covenant obligations and meet operational needs of the utility. See, Appendix B.

F. Financial Events Are Already Negatively Impacting the Rate Plan.

Numerous events have already occurred since the preparation of the rate filing that have or will negatively impact the Department. Those events are summarized in the table below.

ambivalence about this adjustment. Tr. 246-247.

²⁹ As explained in the record, the existence of an adequate balance in the RSF means that the Department can target exactly 1.20 times coverage, without worry of the necessity of a margin for error. Without the RSF, the Department would have to target higher levels of coverage to make sure it could always meet its coverage requirements. Prior to 1993, the Department did not have a RSF and a 1.50 times coverage level was necessarily used as a target in the financial plan. Maintaining that level of coverage (as opposed to 1.20 times) would cost customers some \$60 million of coverage related revenue requirements.

³⁰ The Department must meet the 1.20x coverage test or risk default on its bonds. In FY 1991, the Department technically defaulted on its obligations and paid a very heavy price (preclusion issuing debt for one year; reduction of its bond rating to just above investment grade). It took over ten years and a series of rating upgrades to restore the Department’s credit. Needless to say, the Department does not want to repeat that financial fiasco. Tr. 137.

Negative Events Impacting the Rate Increase Proposal

<u>Description of Event</u>	<u>Estimated Impact</u>
A. Delay in Rate Proceeding ³¹	\$ 15.0 million
B. Effects of Credit Crisis/Sinking Fund Reserve Substitution ³²	<p>\$67.0 million reduction in cash available for Rate Stabilization Fund transfers;</p> <p>\$8.0 million related to the "Alternate Rate" on 2003/2005 bonds, additional remarketing and liquidity costs, costs of remarketing 1997B Bonds and the additional interest costs anticipated as a result of remarketing and fixing the interest rates on the 1997B bonds for period FY 2009-2012.</p>
C. PHA Ordinance ³³	\$ 10.0 million
D. Shut-Off Restrictions ³⁴	\$ 5.0 million
E. Inflationary Increases ³⁵	\$ 8.0 million

³¹ The November 1 implementation date (delayed from the originally planned July 1 date) will result in a loss of revenues in FY 2009 of approximately \$15.0 million. The loss is significant because it reduces cash reserves during the Rate Period (a) impeding the Department's ability to continue to manage to required coverage levels as planned; and (b) limiting cash reserves for working capital. PWD Exhibit 25 (Tab 1); Tr. 128-130.

³² The Department is also impacted by recent credit failures in the financial markets in connection with bond insurance companies. One indication of how this affects the Department can be seen with regard to the imminent downgrade of FSA (one of our bond insurers). Recent financial news indicates that at least one of the major rating agencies (Moody's) is evaluating FSA for a potential downgrade. A downgrade could have a significant negative impact on the Department in several ways: (1) FSA holds the surety on the Department's sinking fund reserve – a downgrade could result in the Department having to provide additional security in the form of cash or a letter of credit or another surety for the sinking fund reserve in the amount of \$67 million; (2) FSA is also the insurer on the 2003 and 2005 variable rate bonds that were issued in conjunction with the Department's fixed to floating rate swap. The downgrade could a further increase the debt service payments (change in alternate rate could result in greater net interest rate payment by PWD) associated with these bonds; and (3) DEXIA (a sister company of FSA) serves as the liquidity provided on the 2003/2005 swap – a downgrade would result in increased liquidity costs to the Department. PWD Exhibit 25 (Tab 1); Tr. 136.

³³ City Council is considering a change in the PHA discount policy, raising that discount from 5% to 25%. PHA has received a 5% discount since 1998. Prior to that year, it received a 25% discount which City Council is likely to reinstate. Any new Council action will supersede the rate determination of the Water Commissioner. The impact of the increased discount would be a diminution of revenues of \$10 million during the Rate Period. PWD Exhibit 25 (Tab 1); Tr.134. PHA proffered the prepared testimony of Kirk Dorn in this case in furtherance of its position that it should receive a greater discount (25%) in rates. PHA Statement 1 at 7. The Department submits that the Hearing Officer is without authority to extend the Department's discount policy – only City Council can do that.

³⁴ An Ordinance was recently enacted requiring additional shut-off restrictions so as to prohibit shut-offs on holidays, Fridays and weekends throughout the year. The Department will now be restricted from pursuing shut-off activities for two-thirds of the year (including the winter moratorium on termination of service). The Department believes this will adversely impact collection levels. The above referenced additional shut-off restrictions are estimated to impede collections by one-half percent in combination with the current economy or \$2.5 million annually during the Rate Period. PWD Exhibit 25 (Tab 1); Tr. 69-70.

³⁵ Another factor adversely affecting the rate filing is the unanticipated run-up in fuel and energy costs. The rising price of fuel is impacting a wide range of the Department's operations. That is, such rising costs affect the Departments (a) cost of gasoline and diesel fuel for its fleet; and (b) the cost of chemicals used in its water and

F. Suburban Wholesale Customer Issues ³⁶	Arbitration demanded by Bucks County Water & Sewer Authority and pending discussions with other Suburban Customers may impact assumed revenues in the rate filing by \$13.0 million over the rate period FY 2009-2012. Updated Renewal, Repair and Replacement rates for DELCORA impact assumed revenues in the rate filing by \$2.4 million over the rate period FY 2009-2012.
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The cumulative negative impact of the foregoing events (should all occur as estimated) would exceed \$128 million over the Rate Period. The point of this discussion is that the Department is already faced with substantial financial challenges over the Rate Period, before the parties adjustments are even considered.³⁷ In reality, the uncertainty which the parties argue biases the process in the Department’s favor is actually working to the utility’s detriment. It must be remembered that the majority of the obligations of the Department are dominated by personnel and debt service costs – those are subject to union agreements and the rate covenants that are inviolable. These obligations only increase over time with the issuance of new debt or the inevitable negotiation of a multi-year agreement with the union workforce (which will mirror compensation increases of the recent past). In the instant context, the Department is therefore

wastewater treatment facilities (which are derived from petroleum by products and all of which must be transported). The foregoing increases also affect the costs of electricity and natural gas and puts upward pressure on the cost of labor, contracted services, materials, supplies and equipment. A conservative impact of the incremental inflationary impacts since the rate filing is \$2.0 million annually (this estimate assumes \$500,000 in additional fuel costs and \$1.5 million in incremental treatment chemical costs. PWD Exhibit 25 (Tab 1); Tr. 277-279.

³⁶ The Department has been contacted by the Bucks County Water and Sewer Authority (“BCWSA”), DELCORA and Aqua Pennsylvania concerning new rates applicable to those suburban wholesale customers in their respective service areas. BCWSA has requested arbitration concerning its rates (claiming rates were not developed in accordance with its agreement with the Department). The Department has also been requested to provide additional information with regard to new rates by DELCORA and Aqua Pennsylvania and has agreed to extend the deadline for filing a dispute for Aqua Pennsylvania. The estimated impact of disputes with the above customers is approximately \$3.8 million per year at FY 2009 cost levels. PWD Exhibit 25 (Tab 1).

³⁷ Per the table above, a total of some \$128 million in potential economic variance may impact the Department during the Rate Period. A majority of the events described in the table are either ongoing or imminent (e.g., delay in the rate proceeding; shut-off increases, inflationary increases, FSA downgrade). Just a few of these events can produce financial ruin for the Department. For example, if the Department has to cash fund its sinking fund reserve or should it be forced to terminate its swaps with an attendant requirement to pay millions of dollars in ready cash, the Department’s status as a going concern would be called into question. Financial reserves are vital to an

placed in a difficult financial situation, but is willing to manage the situation presented, as it has in the past, so as to maintain the current four year rate plan.

The Advocate has proposed \$149 million in adjustments to the rate filing. PWD Exhibit 32 (Schedule 3). It must be noted that the numerous adjustments to the revenue requirement recommended by the Public Advocate will only assure dramatic revenue increases in future years, as demonstrated by PWD Exhibit 32 (Schedule 4). Stated differently, if the Advocate has his druthers, rates will again be raised in at least two years time. The unfortunate reality is that under such a scenario, the percentage increase in FY 2011 will likely be on the order of 14.3% or more, rather than the levelized increases of 6.4% proposed by the Department in this case. In view of the foregoing, the Hearing Officer should carefully weigh the alternatives presented.

G. The Department Has Agreed to Reasonable Adjustments to the Rate Filing.

The Department, by this writing, agrees to adjust the rate filing in the following areas based upon the record of this proceeding.

Department Proposed Adjustments to Rate Filing

Rate Compression	\$15.0 million reduction to proposed revenues due to the delay in rate filing implementation. ³⁸
Personnel Costs	\$1.0 million downward adjustment to revenue requirements due to implementation of \$1,100 bonus (as opposed to projected \$1,500 bonus).
Indemnities	\$2.0 million one-time reduction in Indemnities expense given historic experience.

enterprise the size of the Department. The financial plan underpinning this rate request is modest in targeting \$45 million as an ending balance in 2012.

³⁸ Tr. 128.

The Department believes that the foregoing adjustments represent all that it can prudently offer in view of events since the rate filing which will make financial management of the Department increasing difficult over the four year rate period.

H. Additional Adjustments to the Revenue Requirement Should Be Rejected.

The Public Advocate recommends numerous adjustments to the Department’s revenues and requirements. The revenue adjustment relates to current collection levels which the Advocate believes can be increased from 85.5% to 86.0%.³⁹ Additional adjustments to the revenue requirement are summarized below. The Department believes that approval of additional adjustments, over and above the roughly \$18 million already agreed upon would be wholly imprudent – particularly in light of the negative financial impacts identified previously.

Proposed Adjustments to Department Expenses (\$000)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>
Budget Factors				
Actual/Budget Factors (Class 100-400)	(6,061)	(6,264)	(6,597)	(6,967)
Personal Service/Interdepartmental Expenses				
Eliminate Salary Increases/No Inflation	(744)	(3,431)	(9,542)	(17,936)
Eliminate Staffing Level Increases	(127)	(1,000)	(1,926)	(2,934)
Eliminate Fringe Inflation	0	(3,148)	(6,646)	(10,627)
Non-Recurring Expenses				
Eliminate Non-Recurring Costs	0	(2,684)	(2,763)	(2,846)
Growth Factors				
Reduce Other Inflation (2.5%)	0	(529)	(1,089)	(1,678)
Reduce Electric Cost Inflation (2.5%)	0	0	(1,890)	(5,150)
Reduce Chemical Cost Inflation (2.5%)	0	(1,499)	(3,170)	(5,030)
Miscellaneous				
Reduce Indemnities Expense	(3,073)	(3,149)	(3,228)	(3,308)
Eliminate Excess Interest Earnings Transfer	(2,568)	(2,782)	(2,782)	(3,790)

³⁹ The Advocate’s collection factor adjustment artificially increases revenues by \$2.09 million, \$2.07 million, \$2.05 million and \$2.03 million in FY 2009, 2010, 2011 and 2012, respectively. PWD Exhibit 32 (Schedule 3). In

PWD Exhibit 32 (Schedule 3).⁴⁰ The above proposed adjustments are addressed in the discussion that follows in this section of the brief.

1. Actual/Budget Factors.

Public Advocate witness, Michael Bleiweis, again criticizes the Department's use of actual-to-budget factors in the rate filing. He indicates that such factors are highly subjective. PA Statement 1 at 20. As the Hearing Officer is aware, the Department reviews historical data including data going back as far as five years in determining actual-to-budget factors. This review takes into consideration historical results, trends in results and experience and judgment. More weight is given to the more recent 2-3 years of experience – but trends and longer term experience are not completely discounted.

Mr. Bleiweis proposes to use a simple average of two and three year data to determine actual-to-budget expenses for Classes 100-400 in this case. He believes this will reduce the subjectivity in the analysis. In point of fact, the use of his approach is no less subjective than the Department's method – its basis is simply different.

It should be remembered that the Advocate recommended use of a five year average in the last case. Tr. 245. The Advocate maintained last time that use of such an average would reduce subjectivity and smooth any aberrations in expenditures to arrive at more normalized levels of spending for use in ratemaking. The Advocate rejects this approach now and instead embraces a different methodology (simple average of the most recent 2 and 3 year period data). The table below depicts the difference in using a five year average versus a simple average of two and three year data.

addition, it should be noted that the Advocate's use of final FY 2009 budgeted expenditures yields an additional \$3.38 million reduction in expense levels.

⁴⁰ The Advocate also proposes an adjustment to the time horizon for setting rates which is a pivotal issue in this case. See discussion, *supra*.

Comparison of Public Advocate Actual/Budget Recommendations (\$000)

<u>Methodology</u>	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>Cumulative</u>
5 Year Average	\$ (4,413)	\$ (4,517)	\$ (4,673)	\$ (4,844)	\$ (18,447)
Simple Average of 2-3 Year Data	(6,061)	(6,264)	(6,597)	(6,967)	(25,889)
Difference	\$ 1,648	\$ 1,747	\$ 1,924	\$ 2,123	\$ 7,442

It turns out that the simple average of the historical 2 and 3 year period data yields a significantly bigger adjustment in this case (\$7.4 million higher) than the five year average. The Advocate definitely finds this attractive. A subjective (albeit informed) determination follows to use this approach.

The Advocate indicates that “unless there is a compelling reason” otherwise, his recommendation (to use the simple average of the two and three year period data) should be adopted in this case. PA Statement 1 at 21. The Department submits that there is a compelling reason to do otherwise. Senior management has used its operational knowledge of the utility to arrive at a realistic determination of the revenue requirement. It has not only reviewed two and three year data but other historic data to realistically assess and determine appropriate levels of expenditure for ratemaking purposes.⁴¹ Mr. Bleiweis is merely asking to substitute his judgment for that of the Department. The Department has a more reasoned basis for its decisions than arriving at the largest possible downward adjustment in the revenue requirement. It is actually trying to determine expenditure levels that will allow it to efficiently manage this utility for the

⁴¹ By way of illustration, in the last rate proceeding, the FY 2005 budget included \$10.7 million in additional Class 200 costs for the lateral program, which was later abandoned. Budgeted funds were never used – hence the lower budget-to-actual ratio. Similarly, Class 200 costs associated with the Biosolids Recycling Center were appropriately excluded from the rate filing in this case. The point is that informed judgment is absolutely necessary to adjust the budget for ratemaking. The simplistic application of averages on the surface appears objective, but potentially brings with it bias or plain error as aberrations which are obvious to the utility system operator are overlooked.

next four years. Senior management has to live with the consequences of these decisions. The Department's actual-to-budget factors should be accepted.⁴²

2. Personal Services.

a. Salaries.

Public Advocate witness, Michael Bleiweis, is also critical of the Department's projected expenditures for salaries and benefits for its approximately 1,965 employees (water fund and capital fund employees). PWD Statement 2 at 2. The Department has forecast salary increases for its employees in-line with recent experience with its unionized workforce. Increases in salaries and benefits are projected for FY 2010, 2011 and 2012 at 2, 3, and 4 percent, respectively. Recent history indicates that salary levels for semi-skilled workers (predominant labor category) have increased by roughly 2.3-3.0% annually (including bonuses) over the past three wage agreements (since 1998). PWD Exhibit 25 (Tab 7). The Department's forecast is consistent with this history. As stated by Deputy Commissioner Joseph Clare with reference to the foregoing:

We went through the last 12 Water Department budgets. Semi-skilled laborer is a very important position in the Water Department. We have literally hundreds of them throughout the Department. You can see in each year from 1999 to 2009 they've gotten either an increase or a bonus with regularity.

I mean there's not a single year where they didn't either get a wage increase or a bonus, and the bonuses are very consistent with the projections that we included in the budget and that Black & Veatch included in the rate plan.

Tr. 268.

In the last case, Mr. Bleiweis applied a five year average of personnel costs to determine the reasonableness of the Department's projections. Utilizing such an average (including salary

⁴² The Advocate also recommends that the Department's 0.5% annual increase to actual-to-budget factor for Class 100 expenses applicable to the projected reduction in personnel vacancies should be rejected. PA Statement 1 at 25.

bonuses) would yield a 3% average increase over the period FY 2005-2009. The Department's estimates are reasonable by the test applied by the Advocate in the last proceeding. As the Hearing Officer will note, however, the Advocate has changed his mind as to this issue as well. The appropriate question is why was a change in position proposed in this case?

The Advocate argues this time that we cannot know with absolute certainty what the terms of future labor agreements will be. But that is always the case. Even when labor agreements are negotiated for fixed terms, they are often opened and re-negotiated before the term has expired, as a way to avoid labor strife. Given the circumstances presented, the Department must use the information available to make an informed judgment of future labor expenses to be used for ratemaking. Recent history (whether utilizing a five year average or longer period) yields the same result of a roughly 3% annual increase in wages/benefits. PWD Exhibit 25 (Tab 7). The projections utilized in the rate filing parallel the terms of the last agreement with steps of 2, 3 and 4 percent. *Id.* (Tab 8).

The Department's approach is actually cheaper for customers than applying an annual 3% increase as would be indicated by the experience of the recent past – because of the compound effect of the increase over succeeding years of the Rate Period. The Hearing Officer should be guided by the substantial evidence presented by the Department in this context, fully recognizing that the Advocate saw the wisdom of using a five year average of personnel costs in the last rate case (which is consistent with the Department's proposal) and is apparently having a momentary lapse in judgment.⁴³

This recommendation is later addressed in this section of the brief.

⁴³ The Advocate raises similar criticisms of Inter-departmental expense projections (which are dominated by personal services costs) in opposing the 2, 3 and 4 percent factors applied in FY 2010, 2011 and 2012, respectively, applied to the majority of this expense. PA Statement 1 at 39-40. The Department is also consistent in its opposition to the Advocate as to this issue. See discussion, *supra*. As to the small balance of Inter-departmental charges not determined by personal services charges, please see the later general discussion of growth factors in this section of this brief.

b. Fringe Benefits.

The Advocate also recommends that no inflation factor be applied to fringe benefits in this case indicating that, other than the Five Year Plan, the Department offered no substantiation for this increased level of expenditure. PA Statement 1 at 44-45; 70. In point of fact, in addition to the City's Five Year Plan, the Department presented its FY 2007 Financial Report, the Report of the PEW Charitable Trusts, "Philadelphia's Quiet Crisis: The Rising Costs of Employee Benefits" and the rebuttal testimony and exhibits of Deputy Commissioner Joseph Clare on this point. PWD Exhibit 25 (Tab 25); Tr. 289-294.

This is clearly an area where the Department will face major increases in expenditures over the Rate Period and to turn a "blind eye" to benefit increases, as the Advocate recommends, is incomprehensible. Total benefits as a percentage of payroll have been rising precipitously for a number of years and now comprise at least 73% of personal services expense and are projected to rise to 88.8% by 2014.⁴⁴ PWD Statement 5 at 16. Expenditures for benefits have also been outpacing the budget (actual benefit expenses have exceeded the budget in FY 2006, 2007 and 2008). PWD Exhibit 25 (Tab 15). For the Advocate to expect no increase in this area of expense for the Rate Period is ludicrous.

Pension expense has also exceeded budgeted levels since FY 2006. As documented in the Department FY 2007 Financial Report, City pension costs have escalated from \$392.3 million in FY 2005 to \$556.3 million in FY 2007. PWD Exhibit 25 (Tab 16). The Hearing Officer should take notice of the fact that these costs for the City are not trending flat or downward and represent a major financial challenge for the Department. He should also note

⁴⁴ The Department's projections of the escalation of fringe benefits is premised in the first instance upon the City's Five Year Plan (prepared under the direction of the current City Finance Director) and its ongoing knowledge of the issue based upon numerous documents tracking payroll and fringe benefits, as summarized in the Summary of payroll and Fringe Benefits Costs FY 2003-2009; and Fringe Benefit memoranda routinely received by the Deputy

that roughly one-third of non-uniformed employee pension costs are related to the Department. Tr. 291. This is not a small matter. The Department must be able to meet this obligation to its employees which is estimated to increase roughly in-line with projected wage increases.⁴⁵

c. Reduction in Vacancies.

The Advocate also contends that no adjustment should be made to recognize the projected reduction in vacancies in the Department. PA Statement 1 at 22. The rate filing projects that roughly 30 vacant positions (10 positions per year) will be filled over the period FY 2010-2012. That is the premise for the 0.5% actual-to-budget adjustment. *Id.* As documented in this record, the Department has already filled at least 23 positions since July 1, 2008 and expects greater cooperation from the City's Personnel Office in filling many additional vacancies. Tr. 231-235. The Hearing Officer should be aware that Department has had numerous vacancies because of past City hiring freezes that have left it to operate at personnel levels far below the optimum. It is finally making good progress in filling these positions. Tr. 266-267.

The Advocate's position is at odds with the actual progress being realized in filling vacant positions. Twenty-three of the projected thirty vacancies to be filled have, in fact, already been filled. To be sure, more vacancies will be created as some personnel leave their positions with the Department over the Rate Period. Filled to budgeted positions percentages have been improving over time, however, with the Department experiencing its highest vacancy levels in FY 2006. The table below tracks budgeted to filled positions going back to FY 2005.

Water Commissioner from the Office of the Finance Director documenting trends in such costs. PWD Exhibit 25 (Tab 15).

⁴⁵ Wage increases are projected for FY 2010, 2011 and 2012 at 2, 3, and 4 percent, respectively. PWD Statement 5 at 16.

Department Budgeted and Filled Positions FY 2005-2009

Fiscal Year	Positions Filled	Positions Budgeted	Vacancies	Percent Filled
2005	1,758	2,054	296	86.0%
2006	1,730	2,035	305	85.0
2007	1,724	2,016	292	86.0
2008	1,740	1,971	231	88.0
2009	1,760	1,928	168	91.0%

PWD Exhibit 25 (Tab 6). The above table documents the Department's progress in filling vacant positions over the last five fiscal years and, taken together with recent success in filling 23 vacant positions, suggests that the projected reduction in vacancies (utilizing the 0.5% budget-to-actual factor) is reasonable.

3. Non-Recurring Expenses.

The Department has made an adjustment for non-recurring expenditures in the rate filing based upon its judgment and evaluation of proposed new projects reflected in the FY 2009 Operating Budget. Some projects (that the Advocate may view as non-recurring) were left in the projections for subsequent fiscal years for ratemaking purposes based upon the belief that these projects would either be continued in future budgets or that there would be some comparable programs to take their place. The amount of these projects total approximately \$1.802 million. Non-recurring projects in the FY 2009 Operating Budget which were excluded for purposes of projecting revenue requirements for FY 2010 and future years, amounting to \$1.3 million, include the following projects: PWD Strategic Plan; L/T Financial Plan and Affordability Analysis; Energy/Audit Feasibility Study; and SW Development Website.

The Public Advocate is critical of the foregoing and recommends that expense projections for ratemaking be reduced by \$3.102 million to reflect non-recurring expenses. PA Statement 1 at 29. This adjustment is premised upon the following summary of new projects that the Advocate classifies as non-recurring in nature:

Summary of Non-Recurring Project Costs

<u>Project</u>	<u>Project Expenditure</u>
PWD Strategic Plan	\$100,000
L/T Financial Plan and Affordability Analysis	200,000
Stormwater Reallocation Implementation	200,000
Nutrients/PCB & Flow Agreement	150,000
LIMS Software	400,000
Stormwater Allocation Mitigation Assistance	500,000
Energy/Audit Feasibility Study	250,000
PWD Stormwater Development Website	750,000
Stormwater Technical Plan Review Support	500,000
GPS Installation	52,000
Total Project Expenditures	\$3,102,000

PA Statement 1 at 29.

The problem with the adjustment is that it fails to take into account the fact that (a) \$1.3 million of the above expenditures have already been excluded from the rate plan; (b) in every budget there are non-recurring new programs the cost of which is at the level or exceeds the level of expenditure above; and (c) the above non-recurring project costs pale in comparison to historic levels of new program expenditures that have not been included in the rate plan. Tr. 276.

In the first instance, the Department has already recognized \$1.3 million in non-recurring expenditures, so the dispute is only about \$1.802 million. Secondly, in every budget there are non-recurring expenditures. As shown on PWD Exhibit 25 (Tab 9), such expenditures average around \$2.0 million annually. In view of the amount in dispute, there's nothing to adjust. New expenditures replace the previous year's expenditures. Thirdly, the Department has budgeted \$27 million in new program expenditures in FY 2009, which level of expenditure is in line with average expenditures (\$21 million) over the last five years. There are no new program expenditures included in the rate plan for FY 2010-2012. Assuming new program expenditures are made at levels comparable to the last five years, any adjustment for non-recurring expenditures would be completely offset. A graphic depiction of the comparison of new programs expenditures and non-recurring expenses is set forth on PWD Exhibit 25 (Tab 9). As shown on the table included in that exhibit for FY 2009, the non-recurring element (as calculated by the Department) represented approximately 6% of new program expenditures – and was obviously more than offset by new programs not included in the rate filing. Even according to the Advocate's estimate of non-recurring expenses (\$3.102 million), this item is offset by several fold. *Id.* There should be no adjustment for non-recurring expenses.⁴⁶

4. Growth Factors.

a. Class 200-400 (Excluding Power and Chemical Costs).

Growth factors, as used by the Department in this filing, are applied to FY 2009 budgeted expenses to determine projected expenses for the Rate Period. The growth factor that is employed in development of the revenue requirement for Class 200-400 in this instance

⁴⁶ The Advocate also criticizes the Department with regard to the Security Grant project indicating that adjustments to the revenue requirement were in order. PA Statement 1 at 32; 69. As documented in the record, however, only \$858,000 of security expenses is in the revenue requirement – representing the ongoing Department expenditure

(excluding chemical and electric utility costs), is 3.0%. Same was developed based upon three years of history within the Department for inflation and growth in expenses, as well as a review of various cost indices, including the Producer Price Index for the past three years. PWD Statement 5 at 16.

The Public Advocate is critical of the use of the growth factor proposed for Class 200-400 and argues that, if such an adjustment is to be made, an inflation factor should be utilized based upon the Consumer Price Index (CPI) minus food and energy components. The Advocate believes that the growth factor employed by the Department overstates the level of inflation that can be expected during the Rate Period.

The Department contends that the Advocate’s recommendation, utilizing the CPI index (minus food and energy components) is misplaced, as there is a significant component of energy costs that directly or indirectly drive expense levels upward (e.g., costs of many materials and supplies are also driven up by rising fuel prices). The Producer Price Index (PPI) is a more meaningful measure of inflation for the Department. PWD Statement 5 at 16. Nonetheless, if one chose to rely on the CPI (minus food and energy components), including the most recent data from 2008, an average inflation rate for the last five years of approximately 2.8% would be the result, not the 2.5% factor recommended by the Public Advocate.⁴⁷

Consumer Price Index (Less Food and Energy)

<u>Fiscal Year</u>	<u>Index Value</u>	<u>Percentage Change</u>
2004	208.8	3.42
2005	215.3	3.11

whether or not the federal grant monies are received. Tr. 276-277. Other planned expenditures are wholly contingent on the receipt of federal funds. No adjustment to the revenue requirement in this area is at all necessary.

⁴⁷ The Advocate omitted from his analysis the most recent CPI data (through June, 2008) which increased the average inflation rate from 2.5% to 2.76%. PWD Exhibit 25 (Tab 12).

2006	221.7	2.97
2007	225.6	1.76
2008 (June)	231.2	2.48
Average		2.76%

PWD 25 (Tab 12). The point of this discussion is that the Department’s growth factor utilized for Class 200-400 is in line with a number of measures of inflation. If anything, it is understated compared to the NACWA Index which indicates that an increase in inflation of 6.4% (average level of inflation 2005-2007) would be appropriate;⁴⁸ or the CPI (All Urban Consumers in Philadelphia Area) which indicates a 3.32% increase in inflation (average level of inflation 2005-2007). PWD Exhibit 8 (PA-MAB-27).

The Advocate takes a parting shot at the Department’s growth factor indicating that although the Department may have some historic basis for choosing the factor utilized, he believes that “subjective judgment” really underlies the determination of this factor.⁴⁹ PA Statement 1 at 33. However, as illustrated above, there are a number of indices that corroborate the fact that the use of this growth factor is reasonable, if not understated. The NACWA and CPI (All Urban Consumers in Philadelphia Area) indices bear this out. And even the correct calculation of the CPI (minus food and energy) – recommended by the Advocate – indicates a 3% growth factor is reasonable.

⁴⁸ The NACWA Index indicates average levels of inflation of 6.4% over the period 2005-2007. The percentage change in that index for 2007 was 5.7%. PWD Exhibit 25 (Tab 12).

⁴⁹ Ironically, the Advocate once again shows that his approach to determining appropriate growth factors is highly subjective. That is, the Advocate recommends the use of the CPI (minus food and energy). It is his contention that the problem in using the larger CPI index (for all urban consumers) is that much of the increase is due to costs in food and energy. He also emphasizes the point that the Department accounts for growth separately. The Advocate then under values the CPI in excluding 2008 data. Tr. 281. And then he utilizes the same growth factor for Class

b. Power Costs.

The Department projected electric power costs to increase by 2.5% from FY 2009 until mid-year 2011 based upon a review of historic trends. Power costs from mid-year FY 2011-2012 reflect an increase in power costs based upon the expiration of the current contract agreements with PECO Energy (which expire in December, 2010). The expiration of the current 15% discount in rates is a known event. Tr. 284-285. Power costs for FY 2012 are conservatively projected to increase by 11.9% in FY 2011 and 16.5% in 2012. PWD Statement 5 at 16; PWD Exhibit 8 (PA-MAB-25); Tr. 280.

The Department has learned from PECO Energy that its electric bill will likely increase from the current \$18 million levels to \$25 million annually. Tr. 280. The percentage increase included in the revenue requirement for FY 2011-2012 is less than the amount that rates could increase. So even if the PUC grants PECO a substantial portion of the requested incremental revenue requirement, the Department will face an increase well over the projected revenue requirements (an increase from \$18 million to \$25 million would represent a 39% increase). The above is stated to suggest, that the assumptions underlying this growth factor are reasonable and should be approved.

The Advocate recommends a 2.5% growth factor be utilized for power costs throughout the Rate Period. In view of the upcoming PECO rate increase and the magnitude of electric power costs for the utility, such a recommendation is irresponsible. A reasonable estimate of electric costs should be in line with near-term reality. PECO Energy has already announced its intentions after a moratorium on rate increases for this utility that exceeds ten years. The PUC action will likely grant some rate relief (of the 39% rate increase request it has stated it will

200-400 as for power costs throughout the Rate Period in any event. *Id.* at 36. One can admire legerdemain, but this would appear to be a subjective use of data. See discussion, *infra*.

propose) upwards of the amounts projected by the Department (11.9% in FY 2011 and 16.5% in FY 2012). The problem is that the estimate utilized by the Department may be too low. In light of the circumstances presented, the Department's estimate is the most reasonable alternative presented in this record and should be adopted.

c. Chemical Costs.

The Department projected chemical costs to increase by 9% annually beginning in FY 2010 based upon the PPI and Department experience. PWD Statement 5 at 16. The Public Advocate recommends that a 2.5% factor be utilized for these costs as none of the Department's estimates are known and measureable. PA Statement 1 at 37. There is very little amplification of this point. Assuming that the Hearing Officer reasons that some reasonable projection should be applied in this context, an index that tracks chemical costs (or fuel costs since same are correlated) should be used. The Department relies upon the PPI and its own experience in conservatively estimating an increase in chemical costs at 9% annually. Its chemical contracts are tied to the PPI. Tr. 281. Examination of the growth in this index is an appropriate test of the reasonableness of Department projections. In this instance, the PPI has increased on an average annual basis over the period FY 2003-2008 by 8.8%. The Department's estimate (9%) is in-line with the main barometer of increases in this area (particularly given that the Department's chemical contracts are tied to this index). This projection should be adopted as reasonable.

5. Indemnities Charges.

The Department projected indemnities expense at \$6.5 million. This amount was determined by applying a 95% actual-to-budget factor to budgeted expense levels. PWD Exhibit 5 (B&V Workpapers – Omone-9 and OMtwo-3); PWD Exhibit 8 (PA-MAB-45; 58). Public Advocate witness Michael Bleiweis is critical of this expense and recommends that a 48.45%

factor be applied to budgeted indemnities expense for ratemaking purposes. Mr. Bleiweis uses a five year average of indemnities expense as the basis for his recommendation. His recommendation would lower indemnities expense by \$3.4 million. PA Statement 1 at 43.

The Department is opposed to the Public Advocate’s position, as it is self-insured. In view of this status, the Department must maintain adequate reserves to insulate itself against losses in a given fiscal year that could compromise its ability to provide service or place it in jeopardy of missing its coverage requirement. To be sure, indemnity claims are the upshot of litigation which are not as predictable as other operating expenses. One claim can cause the Department to exceed its reserves (that’s the nature of litigation). It should be noted that indemnities expense already exceeds \$5.9 million in FY 2008. Tr. 286. The Department is amenable to compromise by accepting a one-time reduction of this claimed expense in the total amount of \$2.0 million over the Rate Period. This expense would also be subject to a 3% growth factor, as proposed in the rate filing.

6. Excess Interest Earnings.

The Department has included in its revenue requirements an interest earnings payment to the City (sometimes referred to as the “scoop payment”). This payment is made pursuant to the 1974 General Ordinance, as amended and supplemented. The Ordinance requires that a payment be made to the City’s General Fund in any fiscal year when a balance exists in the Department’s Operating Fund which does not exceed the lowest of (a) the amount of interest earnings on the Sinking Fund Reserve transferred to the Operating Fund during the fiscal year; or (b) \$4.994 million. Projected annual payments during the Rate Period are set forth below:

FY 2009	\$ 2,568,000
FY 2010	\$ 2,782,000

FY 2011	\$ 2,782,000
FY 2012	\$ 3,790,000

PWD Statement 5 at 20 (Exhibit JRM-1 – Tables 12 and 13).

The Public Advocate is critical of the transfer to the General Fund and recommends instead that the monies be transferred to the Revenue Fund where it could benefit customers. PA Statement 1 at 48. This matter is beyond the Department’s discretion. Tr. 248. The City Finance Director makes this call. The Hearing Officer should be aware that the City has included receipt of these payments in its Five Year Plan and the Mayor’s Operating Budget. The City would be hard pressed to forego receipt of these payments in the current economy, as that would leave a substantial revenue hole in the General Fund.

7. Collection Factor.

The Department uses a 97% overall collection factor in this rate filing. This total collection factor is comprised of an 85.5% current collection factor, a 9.0% first prior year collection factor and a 2.5% second prior year collection factor. The Public Advocate believes an 86.0% current collection factor is achievable based upon an average of performance during the period FY 2003-2007. The Advocate relies upon a flawed calculation of the current collection factor to reach this conclusion.

To be sure, the Department would like its collections to be better. However, current collection levels have hovered around 85.5% in the recent past and are not likely to improve in the present recessionary economy. Achieved current collection percentages are set forth below:

Current Collection Factors

2003	84.78%
2004	85.40%
2005	86.11%
2006	85.39%

PWD Exhibit 25 (Tab 4). This above data indicates that 85.5% is the appropriate collection factor to utilize based upon the correct calculation of the five year average that the Advocate recommends. The Advocate has not disputed the corrected calculation of the applicable five year average. Tr. 219.

To the degree the Advocate wants to adhere to his initial recommendation (86%) as a goal, then he is contradicting his own position concerning the consistent use of averages in municipal ratemaking projections. Tr. 265. The goal he has set, in this instance, departs from the experience of the last five years. In continuing to advance this recommendation, he is also discounting the impact of price elasticity of demand (given higher rates may be implemented), the current recessionary economy, new shut-off restrictions (which bar termination of service during two-thirds of the year), among other considerations. See, Tr. 225-226. As stated by Deputy Commissioner Clare:

...Collection rates are impacted by many things. They're impacted by the economy. They're impacted by rate resistance, as we call it, so that every time there's a rate increase, our collection rates go down for a period because people either withhold money consciously or just as a matter of their ability to pay, the payments don't roll in nearly as quickly. So there are a number of things that impact collection rates. Certainly the shut-off restrictions would impact them adversely.

Tr. 70-71. The Public Advocate ignores the foregoing and wagers instead that the new billing system will make all of the difference. Tr. 224. As pointed out in the record, the anticipated positive impact of the new billing system has not been the experienced to date. Tr. 124. The Advocate appears to be grasping at straws. In fairness to the Advocate, his recommendation (although starkly contradictory to his own position concerning the consistent use of averages in municipal ratemaking) is no less unrealistic than his other proposals.

8. Rate Stabilization Fund Adjustment.

The Commercial Customer Coalition (“CCC”) also advances a revenue adjustment concerning the Rate Stabilization Fund (RSF). It is their contention that the RSF should be used to further offset the FY 2009 revenue requirement and mitigate the need for a compression adjustment to rates. As stated by CCC expert witness, Dennis M. Kalbarczyk:

PWD’s first fiscal year 2009 \$30 million annual revenue requirements increase request should be financed with \$10 million of funds from the PWD’s rate stabilization fund. In brief, the current balance of this fund is estimated to be \$160 million at the beginning of July 1, 2008 as compared to \$149 million beginning balance as projected in its as-filed case. Thus, the first year rates should be designed to produce only \$20 million of annual requirements in fiscal year 2009.

CCC Statement DMK-1 at 5-6. The Department views this recommendation as parallel to its own compression adjustment and concurs that the RSF can be appropriately used for this purpose.⁵⁰

I. The Department’s Proposed Cost Allocation and Rate Design Should Be Approved.

The Hearing Officer should approve the Department’s proposed cost allocation and rate design as same are premised upon cost causation. Per the record, proposed rates have as their foundation the cost of service studies performed by Black & Veatch. The water and wastewater cost of service studies consist of essentially three components (1) the determination of the cost

⁵⁰ There have been so many ideas as to how to use the RSF by the Public Advocate that its prospective usefulness to (a) levelize rates; (b) economically manage meeting required coverage levels (without a cushion above 1.20 times); and (c) meet working capital needs of the utility are called into question. As noted previously, using RSF to its maximum in every year possible, as opposed to prudently managing it to stabilize rates over a reasonable period of years, may bring with it higher costs for consumers. Using the RSF as proposed by the Department, is clearly a boon to customers in this case. During the Rate Period, the Department has proposed to utilize the RSF to offset rates to the tune of \$102 million. In addition, the Department has suggested that an additional \$15 million would be made available to offset the costs of the delay in implementing new rates. In the absence of the RSF, the revenue requirement to be borne by customers would be substantially higher and the annual increases in this case would be on the order of 9.0% as opposed to 6.4%.

of service to be recovered from charges for water and wastewater service; (2) the allocation of cost of service to functional cost components which recognizes the system characteristics; and (3) the distribution of functionalized cost of service components to customer classes. PWD Statement 5 at 22.

The total revenue requirements to be derived from charges for water and wastewater service are synonymous with, and are the definition of, the total cost of service. As a basis for developing an equitable rate structure, these costs are allocable to the various customer classifications according to respective service requirements. *Id.* at 22.

For the water utility, allocations of these requirements to customer classes should take into account the quantity of water use, relative peak capacity requirements placed on the system, the number and size of services to customers, and proprietary interest in the system investment. *Id.*

For the wastewater utility, factors considered in estimating service requirements of each customer class include the annual volume and peak rates of sanitary wastewater, infiltration, and stormwater flows; wastewater strengths; the number and sizes of customers served; and proprietary interest in system investment. *Id.*

After the allocation of costs to functional cost components, the same are distributed to customer classes. To do this, customers with similar characteristics are assigned to specific classes. Units of service for each class are determined for each of the functional cost component categories. Unit costs of service are determined by dividing the cost of service allocated to each functional cost component by the total system units of service applicable to the respective cost component. The unit costs are then applied to the units of service for each class with the total class cost of service being the sum of the allocated costs for all cost components. The units of

service of each customer class provide a means of proportionate distribution of costs previously allocated to functional cost components to the customer classes.

Analysis of resulting costs of service to each customer class provides the basis for design of the proposed rate schedules. In this case, rate schedules for water and wastewater service to retail customers are designed to consist of a service charge and volume charges applicable to billable usage for each utility. A surcharge rate applicable to customers with high strength wastewater is also included in the proposed wastewater rate schedule. *Id.* at 14.

It is noteworthy that the proposed charges for water and wastewater service recognize that eligible senior citizens, charities and schools (among others) are provided service at a discounted rate pursuant to the Philadelphia Code. In addition, the proposed rate design recognizes the requirements of the Charter, Philadelphia Code and the General Ordinance that the Department impose, charge and collect in each fiscal year rates sufficient to generate revenues to meet operating requirements, debt service and its rate covenants.

The discussion below focuses upon the various cost allocation and rate design recommendations advanced by the interveners in this proceeding. The following witnesses presented testimony in this area – Jerome D. Mierzwa (on behalf of the Public Advocate) and Dennis M. Kalbarczyk (on behalf of the Commercial Customer Coalition).

1. Public Advocate Recommendations.

Public Advocate witness Jerome Mierzwa is generally supportive of the Department's recommended cost allocation and rate design. He specifically concludes that the use of the "base-extra capacity" method of cost allocation is reasonable (as one of the two most commonly accepted cost of service methodologies).⁵¹ PA Statement 2 at 4. He also observes that such

⁵¹ The base-extra capacity method classifies costs under four primary functional categories (a) base or average capacity, (b) extra capacity, (c) customer and (d) direct fire protection. Customer costs are then further divided

methodology, as applied by the Department in this case, is consistent with the standards of the American Water Works Association's Manual M1 (*Principles of Water Rates, Fees and Charges* – more commonly referred to as the Water Rates Manual). *Id.* at 5. The Public Advocate witness also finds that the cost allocations for wastewater service, as used by the Department, are reasonable and consistent with industry practice. PA Statement 2 at 10. Mr. Mierzwa makes one practical criticism concerning fire connection charges, as he saw no reason for public and private fire connection charges to be decreased while other charges are being increased, only to be adjusted upwards again in the near term. Instead, the Public Advocate witness indicates that these rates should be maintained at current levels for the present and increased later in the Rate Period. *Id.* at 7. The Department concurs with this recommendation.

2. Commercial Customer Coalition Recommendations.

The Commercial Customer Coalition is again critical of the Department's approach to cost allocation and rate design in this proceeding. Their overall recommendation is to shift a greater share of the rate increase to smaller customers.⁵² CCC Statement DMK-1 at 7. Dennis M. Kalbarczyk is the lead witness for CCC.⁵³ He advances a series of criticisms of the

between meter and service line related and account or bill related costs. Per the cost of service study used in this case, extra capacity costs were then divided between maximum day and maximum hour costs. Once investments and costs were classified into the aforesaid functional categories, same are allocated to the customer classes. Base costs are allocated according to average water use; and extra capacity costs are allocated on the basis of water use in excess of average. Meter and service related costs are allocated on the basis of relative meter and service investment or a proxy thereof. Account related customer costs are allocated in proportion to the number of customers or the number of bills. PWD Statement 5 at 27-29; PA statement 2 at 4-5. It is noteworthy that Mr. Mierzwa opines that the cost of service study and allocation methods used by the Department are reasonable. See, PA Statement 2 at 5.

⁵² It should be noted that the Department has already minimized the impact of this rate increase on larger users by keeping the fourth usage block at base costs. The Department's water volume charge rate structure is in four usage blocks. Residential usage is almost exclusively in the first block. Larger users have some usage in the initial blocks, but because of their volume of usage, they predominately use water in the third and fourth blocks.

⁵³ Mr. Kalbarczyk is supported by a number of fact witnesses identified above, including representatives from St. Joseph's University, University of the Sciences, Delaware Valley Health Council and the Interfaith Coalition on Energy, among others. All expressed their concerns about the impact of new rates on their operations. Members of this coalition also complain of increased costs being charged to them while they enjoy some combination of the following: (a) charitable discount rates (25% reduction from full cost of service rates); (b) declining block rates; and/or (c) sewer rebate credits (large user discount/allowance for water volumes not returned to the sewer system). Residential customers (except for low income seniors) do not enjoy such favorable treatment. St. Joseph's

Department's cost of service methodology and rate design. Id. at 6-7. Mr. Kalbarczyk's specific criticisms concern the following issues:

- customer classes should be expanded to include small and large customers, hospitals, universities and other groups with unique service characteristics;
- separate rates should be developed for these expanded customer classes;
- maximum day and hour peaking factors understate cost responsibility for residential customers;
- the fixed variable cost of service methodology should be used for wastewater cost determination/allocation.
- customer billing and collection costs should be allocated on a cost causative basis;
- lower volumetric rates should apply for the second, third and fourth usage blocks;
- conjunctive billing should be offered to large customers; and
- compression of rates should be avoided.

CCC Statement DMK-1 at 6-7.

University also noted that charges for water and wastewater service were much more favorable on the side of their campus served by the Department (as opposed to that portion of campus served by Aqua Pennsylvania). Tr. 431-433.

The common thread running through all testimony submitted concerned improved customer service and communication through the appointment of commercial customer representatives, a large user council, and outreach on certain other issues. In addition, the development of customer classes distinguishing commercial, institutional and industrial customers from other customer groups and developing rates tracking cost causation – were also themes throughout the testimony submitted, as was the general request for programs promoting conservation. During the course of the hearings, the Department indicated its willingness to appoint commercial customer representatives, establish a Large Users Group, and assist with conservation activities. In addition, the Department identified solutions for the major individual issues identified by Trigen (i.e., a sewer rental factor can be utilized to address fact that a large percentage of water consumed by Trigen does not reach the wastewater system as is the case with most other customers), ICE (i.e., meter downsizing has been seriously undertaken and the Department will work with ICE members to make additional progress) and St. Joseph's University (i.e., the Department will support conservation measures such a waterless urinals and other steps to make the campus more efficient). The Department is also committed to an ongoing dialogue with CCC as to all areas of concern.

a. New Customer Classes.

Mr. Kalbarczyk recommends that customer classes should be expanded to provide more specific groups of customers taking into consideration unique characteristics, service requirements and other factors related to larger meter customers. At a minimum, he believes that classes should include separate groupings for small and large industrials, large hospitals, universities and other categories in order to be appropriately differentiated from other customers. CCC Statement DMK-1 at 6. The CCC witness points out that it is important to create separate classes of customers to track cost causation. It is his continuing belief that larger customers are subsidizing residential customers. This general thesis was rejected by the Commissioner Brunwasser in the last rate proceeding. As stated by the Commissioner:

The CCC has raised concerns about the subsidization of residential customers (5/8 inch meters) by larger commercial and industrial customers...As the Hearing Officer has indicated, the Hearing Record does not support this conclusion. Testimony was provided by the Department's expert...and by both the Public Advocate's cost of service experts, Mr. Galligan and Mr. Catlin, that the rate design is appropriate. Mr. Galligan concluded that the Department's cost of service calculations were consistent with generally accepted cost based ratemaking principles... Mr. Catlin also concluded that the City ratemaking method is acceptable. By phasing-in cost of service adjustments, the City utilized the principle of gradualism that is recommended by the CCC's expert, Mr. Kalbarczyk...An exact balance of all costs by meter size would require a level of analysis, complication and cost well beyond the limits of general standards for ratemaking. It would be wrong to conclude that the subsidization of residential customers has been ongoing for some period of time. Quite the opposite – a significant balancing of storm water costs was undertaken during the previous rate period with the result that larger customers are now paying their fair share. [Emphasis added].

2005 Rate Decision at 14-15. As is the case with much of CCC's testimony, it is assumed that larger customers are subsidizing residential customers when that has not historically been the case; and no evidence has been presented to document otherwise. Ironically, the parties articulating this argument are the recipients of a sizeable subsidy (charitable discounts are

received by most of the members of this coalition, including the churches, hospitals and schools). Residential customers aren't so lucky (save a dwindling number of seniors who receive the senior discount).

It is noteworthy that the Public Advocate's witness (despite the protestations of Mr. Kalbarczyk) has once again indicated in this record that the cost of service calculations are consistent with generally accepted cost based ratemaking principles and that the rate design is appropriate. PA Statement 2 at 5; 10-11. The Department utilized the American Water Works Association ("AWWA") sponsored base-extra capacity method for its cost allocation process. Tr. 482

Nonetheless, Mr. Kalbarczyk protests loudly that the cost of service methodology is inappropriately applied and places reliance on a selective reading of prior rate decisions to criticize the water cost allocations.

The Department would suggest, in the first instance, that CCC has not made the case that there exists a subsidization of residential ratepayers by larger users. If Mr. Kalbarczyk wants to embrace true cost of service ratemaking, he should renounce charitable discounts. The money this would save the Department could be used to go to the expense of establishing the customer classifications he recommends and do the necessary field work to confirm the appropriate assignment of customers to new groupings. The stumbling block presented is the costly process of setting up a new rate classification system and to what end. Assuming discount policies are not abandoned, there will never be a level playing field for all customers.

b. Maximum Day and Hour Peaking Factors.

Mr. Kalbarczyk is critical of the use the maximum day and hour peaking factors used by the Department for water cost allocation. The Department utilizes maximum day and hour demand factors of 2.0 and 3.6, respectively, for the residential class in the rate study. Mr.

Kalbarczyk believes that typical maximum day and hour demand factors for the residential class are around 2.5 and 5, respectively, in his experience in other jurisdictions. CCC Statement DMK-1 at 24. He observes that the higher the demand factors, the greater the cost assigned. He concludes that the Department's use of lower demand factors for the residential class, artificially increases the cost responsibility of other classes. *Id.*

The Department maintains that Mr. Kalbarczyk's experience, as documented in his resume, is dominated by smaller jurisdictions such as the Borough of Ambler, the Borough of Schuylkill Haven and the City of Lancaster. Those jurisdictions are more characteristically suburban in nature, with significantly larger parcel sizes and higher discretionary (peak) usage by their residential customers, as driven largely by lawn irrigation. Tr. 393; 489. Philadelphia is quite different with its smaller properties (largely row homes) and extremely small level of discretionary water use such as lawn watering (due to small green spaces, if any). As a consequence, residential customers in Philadelphia do not have the large differences between peak day and peak hour usage which is typically seen in more suburban water utility systems. As stated by Mr. McKinley:

...in Philadelphia, we have a situation where we have 400,000 residential accounts, the vast majority of which are row homes, very little green space, very little lawn irrigation that goes on; and what you find in the City of Philadelphia is the system as a maximum day demand on a coincident basis has a 1:33/1:34 peak day to average day ratio. It's a very low peak day to average day ratio. It's indicative of the urban environment we have here and the types of customers.

If you look more at a suburban type of community where you have more residential customers, for example, single-family detached, larger lawns, you tend to have a much, much higher peak demand for the system and that drives the demand factors by class to a greater level.

Here we have a very small peak demand and so very small demands from each of the customer classes served by the City, and you have to recognize

all that when you establish a demand factor used in your cost of service study. [Emphasis supplied].

Tr. 393-394. Mr. Kalbarczyk extrapolates from his own experience in suburban jurisdictions that residential peaking factors in Philadelphia must be the same as he has observed in his work experience. This is not the case. Urban jurisdictions, like Philadelphia, are much different than the more suburban clients listed in Mr. Kalbarczyk's resume of experience. Tr. 404-405; 410. The CCC witness also indicates that demand studies by class should be undertaken to establish the relationship of non-coincidental maximum day and maximum hour demands by class relative to coincidental peak demands on the system. He omits to state, however, that this is a very expensive undertaking and that municipal utilities rarely undertake such studies. Tr. 398; 401.

As stated by Mr. McKinley:

I did say it is unusual for municipal utilities to do demand studies by class. It's a very costly process and I would think the rule of thumb – and I work with utilities across the country – is that less than 5 or 10 percent do such studies.

Id. In the absence of such demand studies, Mr. McKinley corroborates the reasonableness of demand factor assumptions by his review of diversity considerations on the system (i.e., recognizing that not all customer classes peak at the same time). The relationship of the sum of the non-coincidental class peak demands relative to the coincidental system peak demand indicates the level of diversity on the system. In this instance, the relationship is between 1.05 to 1.40. Tr. 396. This establishes the range to test the reasonableness of demand factors employed. The demand factors used in this case (and previous rate cases) fall within this range. Mr. Kalbarczyk opines, without substantial basis, that the residential peaking factors should be higher. In absence of a demand study, his thesis remains unproven. The relevant information

available to us (corroborated by system diversity considerations) indicates that the demand factors utilized in the cost of service are appropriate and valid metrics for the purposes intended.

c. **Fixed/Variable Cost of Service Methodology.**

Mr. Kalbarczyk also criticizes the Department's wastewater cost allocation methodology for not recognizing variable peaking factors by class. CCC Statement DMK-1 at 28. He observes that the Department's wastewater cost of service study first allocated costs on a functional cost basis and then allocated various capacity related costs to the customer classes using the same capacity (or peaking) factor for each customer class (unlike the water cost of service study which reflected higher peaking factors for residential customers and lower peaking factors for commercial and industrial customers). *Id.* Mr. Kalbarczyk believes that the Department's approach is flawed because it ignores (what he presumes are) lower peaking factors for commercial and industrial customers.

Former Commissioner Kishinchand acknowledged this recommendation in the 2001 proceeding, but indicated that peaks on the wastewater system were not likely caused by sanitary flows (with presumed variable peaking factors), but by stormwater flows. 2001 Rate Decision at 14. Department witness J. Rowe McKinley confirms this fact in the hearings in this case. Tr. 489-490 Mr. McKinley plainly indicates that water related peaking factors have no relevance to the wastewater system. *Id.* Specifically, it is "discretionary use", such as lawn irrigation, that yield different demand factors by class for a water utility. This discretionary water usage which is largely responsible for creating these peak demands are not returned to the wastewater system, thus effectively negating the existence of significant peaking factors between customer classes. Particularly in the context of combined sewers for sanitary and stormwater flows (as exist in Philadelphia), it is obvious that sewers are sized for storm or flood conditions. Sanitary flows

are only a fraction of stormwater flows. This obvious fact may account for the scarcity of data documenting variable peaking factors for wastewater. Mr. Kalbarczyk also concedes that he is not aware of any jurisdiction that uses the methodology he proposes. For all of the above reasons, use of this method of cost allocation should be rejected.

d. Customer Billing and Collection Costs.

Mr. Kalbarczyk is critical of the Department’s cost of service study indicating that it inappropriately allocates costs associated with customer billing and collections to customer classes based upon equivalent number of bills.⁵⁴ His premise is that larger customers have more favorable collection factors. CCC Statement DMK-1 at 21-22. Once again, Mr. Kalbarczyk submits no substantiation for his position. His proffer is an interesting table documenting the impact of using a hypothetical 99% collection factor for larger customers on the percentage increase for residential, commercial and industrial customers in this case, as set forth below.

Collection Factor Hypothetical

<u>Class of Service</u>	<u>Revenues Received</u>	<u>Adjust. Cost of Service</u>	<u>Percentage Increase</u>
As Filed			
Residential	\$ 79,571,000	\$ 85,442,000	7.4%
Commercial	45,121,000	49,509,000	9.7%
Industrial	11,309,000	12,864,000	13.8%
Total	\$136,001,000	\$147,815,000	

⁵⁴ The Department allocates customer costs (e.g., meter related, billing collecting and accounting expenses) on the basis of the number and size of water meters in service and the number of bills rendered. The estimated number of equivalent bills for each classification is based upon the number of bills rendered and the estimated ratios of meter reading, billing and collection costs of customers with larger meters to such costs attributable to customers with a 5/8 inch meter. The ratios used for this determination are set forth in PWD Statement 5 (Exhibit JRM-1 – Table 19). Mr. Kalbarczyk is critical of the use of equivalent bill ratios because it places greater cost responsibility on larger customers. However, as noted in the record the costs related to meter reading, customer service and other considerations for larger customers are also larger. Tr. 415; PWD Exhibit 12 (CCC-II-6). Equivalent bill ratios, as employed by the Department, are an appropriate metric to recognize variances in cost incurrence by different customer groups.

Adjusted			
Residential	\$ 78,407,495	\$ 85,442,000	9.0%
Commercial	46,051,330	49,509,000	7.5%
Industrial	11,542,175	12,864,000	11.5%
Total	\$136,001,000	\$147,815,000	

CCC Statement DMK-1 at 23. The table is meant to convey that larger users percentage increase in this rate proceeding should be lower as they have a higher revenue collection factor compared to residential customers. The problem is, of course, proving this generalization. Among the classification of commercial and industrial properties are small businesses (corner groceries, beauty shops, laundromats) and vacant properties that do not uniformly have higher collection factors. To assume a 99% collection factor for this group in a recessionary economy is a real leap of faith. The Water Revenue Bureau also pursues delinquent commercial and governmental accounts that fall within the groupings in the above table (using collection agencies in some instances) confirming that larger customers are not uniformly creditworthy, as Mr. Kalbarczyk is assuming. In short, I am sure CCC members are all great credit risks, the problem in the instant context is that not all commercial and industrial customers maintain that standing. Residential customers are not the sole culprit in addressing collections issues.

e. Rate Design Recommendation.

1. Lower Tail Block Rates.

Mr. Kalbarczyk finally recommends that “due to flaws and shortcomings” of the Department’s rate filing and absent a fully adjusted cost of service study to address CCC concerns, a lower volumetric rate for the second, third and fourth steps of the declining rate structure should be adopted. This over-arching recommendation is made without record support.

As the Hearing Officer is aware, the Department's water volume charge rate structure is in four usage blocks. Residential usage is almost exclusively in the first block. Larger users have some usage in the initial blocks, but because of their volume of usage, they predominately use water in the third and fourth blocks. So what Mr. Kalbarczyk is attempting (after failing to substantiate any of his recommendations) is to advance this final proposal to put the "d" back in declining block rates. CCC specifically recommends that the existing rates when adjusted should retain the existing ratio between the first block to the remaining second, third and fourth blocks. CCC Statement DMK-1 at 7. The problem with this approach is that it departs from cost of service ratemaking.

Mr. McKinley indicated in this record that in the rate study in 2001, there were much higher peak demands than exist on the system today. For example, the 75/25 relationship between base and maximum day demands that we see today was in the range of 70/30 previously. Tr. 483. These changes in system demand characteristics are appropriately reflected in the rate blocks. In other words, as peak demands moderate, the steps in the rate structure become more compressed because more costs are being shifted to the base cost component which is a common cost to all four of the rate blocks. Tr. 483-484. As stated by Mr. McKinley:

The differences in the rate steps are related to peaking, residential versus commercial versus industrial. We talked about that a little this morning, the peak demand costs. So what we've done is we've compressed, leveled rates, made less of an increase between the rate blocks, because more of our system cost is allocable to the base cost component...That's why the larger rate blocks, went up by a larger percentage...

Tr. 484. The significance of the foregoing is that the objective of the rate design proposed in this case is to track cost causation. There is a cost of service study to support this that utilizes a AWWA sponsored methodology and is consistent with cost of service based ratemaking standards according to all but one of the experts presented in this area of the case.

Ironically, Mr. Kalbarczyk points out in his testimony that rates should be designed on the basis of cost of service (as the principal objective). CCC Statement DMK-1 at 17. He also indicates that departures from cost of service are considerations for the politicians, not rate designers. Id. at 18. Mr. Kalbarczyk indicated he was a member of the latter group, not the former. Tr. 526. Nonetheless, his recommendations here have all the earmarks of things political (without cost basis).

2. Conjunctive Billing.

As if to prove my point, Mr. Kalbarczyk recommends that conjunctive billing be permitted for commercial and industrial customers that receive service through multiple meters. Conjunctive billing would allow customers to combine volumes from multiple meters to qualify for the volume discounts in the rate blocks under the water rate design. CCC contends that conjunctive billing would allow the Department to recognize the economies of scale it benefits from serving these customers. CCC Statement DMK-1 at 33-34.

The Department has established the usage blocks in its water rate design to track cost causation. That is why there is a declining block structure. The usage for larger customers is mostly in the third and fourth blocks. The usage in the fourth block is essentially the base cost of water – that's it. Mr. Kalbarczyk's proposal plainly indicates that he wants a discounted rate for his constituents below the base cost of water. The Department cannot give away water (below cost) without other customer groups subsidizing the effort. This proposal cannot be reconciled with cost of service principles.

VI. THE DEPARTMENT AND WATER REVENUE BUREAU ARE COMMITTED TO IMPROVEMENTS IN THE AREA OF CUSTOMER SERVICE.

Public Advocate witness Roger Colton is critical of the Department and the Water Revenue Bureau with regard to customer service issues. PA statement 3 at 13. Mr. Colton

indicates that the Department has an affirmative obligation to provide equitable customer service; and that equitable service involves addressing and meeting the disparate customer service needs of this utility's service territory. He further notes that, as a municipal utility, the Department has a further obligation to act in an open, transparent, reasonable manner toward its citizen/customers. *Id.* at 5.

In his testimony, the Public Advocate witness selects specific components of the Department's customer service delivery for review including administration of its (a) deferred payment plans; (b) the Water Revenue Assistance Program ("WRAP"); (c) appeals and disputes; and (d) tenant issues. *Id.* at 13-50. Mr. Colton also draws upon anecdotal evidence from the public hearings to illustrate the need for reforms in customer service.⁵⁵ *Id.* at 41-43.

The Department and Water Revenue Bureau are fully supportive of the Public Advocate's position (in principle) and have invited the Advocate to participate in a mediation (or collaborative) to be promptly convened by the Hearing Officer to address his concerns.⁵⁶

The newly appointed Revenue Commissioner, Keith J. Richardson and Deputy Commissioner Michelle Bethel⁵⁷ appeared at the hearings to affirm their commitment

⁵⁵ Commissioner Richardson notes in his testimony that the customer complaints raised in the rate proceeding were all being addressed. At the time of the submission of his testimony five complaints had been resolved; and documentation of same was included in Exhibit B to his testimony. The remaining complaints have been resolved since the hearings, as identified in PWD Exhibit 37 (TR-2). As stated by the Commissioner, the Water Revenue Bureau takes each one of these complaints very seriously and will address all underlying concerns about the quality of customer service illustrated by same. PWD Statement 6 at 2-3.

⁵⁶ Mr. Colton identifies "immediate action steps" that need to be undertaken to address the Advocate's concerns about customer service issues. Same are to be encompassed in the mediation process. An appropriate (albeit ambitious) time-line for this process to be undertaken and substantially completed would be by the end of this calendar year. The Advocate witness also identifies additional "next steps" to be completed in a two year time horizon. The Department and Water Revenue Bureau are committed to addressing all relevant concerns within approximately one year.

Mr. Colton also tries to tie customer service reforms to a two year rate process. It bears emphasis that these reforms need to promptly proceed without regard to timing of the next rate hearings. The Department's position concerning the appropriate time horizon for rates is discussed elsewhere in this brief. See discussion, PWD Brief at 18-20.

⁵⁷ Commissioner Richardson was appointed by Mayor Michael A. Nutter in January, 2008. Deputy Commissioner Bethel was appointed in July, 2008 to oversee the Water Revenue Bureau.

undertaking a full review of customer services offered to make sure same are consistent with or on a path toward “best practices” for a municipal utility. Both indicated that they were anxious to explore with the Public Advocate specific ways to improve customer services related to direct customer contacts, informal dispute resolution, administrative appeals, customer assistance programs and so many other areas as a part of their review of the Water Revenue Bureau (“WRB” or “Bureau”). Their shared goal is to achieve a higher level of customer service at the Bureau. See, PWD Statement 6 at 3.

As a part of the proposed mediation process, the Commissioner initially identified the following areas to be addressed:

DISPUTES, APPEALS AND HEARINGS

1. Provision of straight-forward, understandable information about a customer bill in response to inquiry, e.g., including the amount of the current bill (specifying late fees, if any), past due amounts, total bill, dollar amounts and usage associated with past bills, shut-off status (if applicable), minimum dollars to avoid shut-off (if applicable), etc. The framework and form of presentation of customer billing and related information can be negotiated as a part of the proposed mediation process.
2. Access to staff, with the primary goal of high quality customer service emphasizing direct customer contact and assistance in resolving customer disputes in a fair and respectful way, e.g., access to appropriate staff for information concerning payment, billing and consumption information, adjustments to billing and/or payment agreements and to address termination issues – whether via telephone or in-person visit. The details of specific access whether via telephone or in-person can be reached as a part of the proposed mediation process.
3. Implementation of an informal dispute/review process with an immediate supervisor, when necessary, e.g., when a customer contact does not resolve an outstanding issue, the customer will be informed of his/her right to dispute the issue with an immediate supervisor and the determination of the supervisor will be reduced to writing and transmitted to the customer. Written notice of the dispute process involving WRB supervisory staff (stated in a simple, understandable manner) will also be communicated to customers in writing. At the conclusion of supervisory review, the customer will be informed in writing of the decision reached by WRB and alternatives presented to resolve the issue (e.g., payment agreement, extended payment agreement, customer assistance programs and requirements related thereto). A detailed informal dispute/review process with a WRB immediate supervisor can be arrived at as a part of the proposed mediation process.
4. Implementation of an appeal process within WRB, e.g., when a dispute is not resolved with an immediate supervisor a customer can appeal to designated supervisory staff within WRB with no direct involvement with collections. Such an appeal will be undertaken pursuant to Department

regulations and will be an informal opportunity to be heard calculated to facilitate the customer's participation. Any decision will be transmitted to the customer in writing and will detail the nature of the dispute, steps necessary for the customer to resolve the dispute (if the dispute is not resolved by the decision) and the basis for the decision. Appeal rights to the Tax Review Board will be set forth in any adverse decision. A specific framework for appeal including proposed regulations for same can be negotiated as a part of the proposed mediation process.

WATER REVENUE ASSISTANCE PROGRAM (WRAP)

5. Implement clear program guidelines for WRAP, e.g., requirements for WRAP should be clearly stated. Specific eligibility determinations and program guidelines can be negotiated as a part of the proposed mediation process. WRB will also have appropriate staff to administer the WRAP program. Customers in WRAP will also have written acknowledgment of participation in such program setting forth their monthly WRAP payments, any arrearages on WRAP payments and the amount of the suspended balance.

PWD Statement 6 at 4. As stated by the Commissioner, he will join with the Public Advocate to expand the above framework and determine administrative reforms necessary to accomplish its overall objectives – the highest quality customer service for water customers. None of this is to say that we will initially agree on all issues or all next steps to be undertaken. It is his hope, however, that with the assistance of the Hearing Officer that the parties can enter into a collaborative for change to accomplish shared goals as we both enter a mediation process in good faith.

VII. CONCLUSION

For all of the foregoing reasons, the Department requests that its application for rate relief in the modified amount of \$298.9 million be granted.

Respectfully submitted,

/s/ Andre C. Dasent

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