

**BEFORE THE
PHILADELPHIA WATER COMMISSION**

IN RE: PHILADELPHIA WATER :
DEPARTMENT WATER AND WASTEWATER : **FY 2009-2012**
RATE INCREASE PROCEEDING :
:

**MAIN BRIEF OF THE PUBLIC ADVOCATE
ON BEHALF OF RESIDENTIAL CUSTOMERS (5/8" METERS)**

Hearing Officer Harris T. Bock, Esquire, Presiding

**Philip A. Bertocci, Esquire
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For the Public Advocate

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I. Introduction.

In this case, the Philadelphia Water Department (PWD) has proposed a series of rate increases for water/sewer service, all to become effective within 36 months and which will raise residential rates four times. Within 36 months, if this rate increase is granted, residential customers with typical usage would be receiving bills 30% higher than today under existing rates. The Department estimates that a typical household using 700 cubic feet of water monthly would pay \$3.84 more per month in this fiscal year, an additional \$3.38 more per month in FY2010, an additional \$3.73 more per month in FY2011 and still another additional \$3.91 per month in FY2012. By July 1, 2012, such customers would be paying \$14.86 more on a monthly basis than currently, \$178.32 more on an annual basis.

Viewed on a revenue requirement basis, rather than on a billing basis, the proposed rate increase is designed to produce \$317 million in incremental revenue - in- the- door over the four year period FY2009-FY2012. The percentage annual increases in the PWD's revenue requirement under its rate proposal are 6.4 % in each of the four years of the proposed rate period.

Although one of the PWD themes throughout the hearing process is that its proposals in content and methodology reflect long standing and traditional Department practices, the fact is that this rate proposal is on a percentage basis close to double the increase which the Water Commissioner granted four years ago for the period FY2005 through FY2008. PA-MAB St.1, Exhibit MAB-2b. In that case, the annual increases were 3.18% on a smaller overall revenue requirement. It goes without saying that the increases sought in this case are much greater than the annual rate of inflation for consumer goods.

The Hearing Officer in this case is called upon to apply the constitutionally based “just and reasonable” standard, which is not an arithmetic formula, but a broad standard which requires careful weighing of the interests of customers in affordable rates and reasonable service against the financial needs of the utility. Ratemaking in Philadelphia takes place, as anyone who attended the Public Input Hearings knows, in a community in which as many as one third of the households live close to, at, or below the poverty level. PA St.3, at 23-24. This fact must give added urgency to the necessity that rate orders hold increases for basic life necessities to no more than is absolutely necessary. That is the only way that a ratemaker may with good conscience look a woman like April Jones in the eye, and say that her pleas were heard and understood. She testified at the July 21, 2008:

Now, I live on a fixed income. So when you [water rates] go up and PECO goes up and then the Gas Company goes up and then the gasoline for our cars goes up, when does it stop? That’s my only question. Somebody’s got to give me an answer for that because everything’s going up but my income. The Federal Government don’t give me no increase because I’m on Social Security so I have to work a second job to supplement what I don’t get from Social Security.

Tr.57-58.

II. The Just and Reasonable Standard Is the Paramount Standard for All Ratemakers, and Requires That a Public Utility Prove Its Entitlement to a Proposed Rate with Substantial Evidence in Support of Each Element of Its Claim.

A. The Just and Reasonable Standard.

The paramount requirement in all rate proceedings is that the new rate be “just and reasonable.” This is a standard with federal and state constitutional dimensions. Because public

utility service is essentially a monopoly service, water and other utility rates are not set by the functioning of the market, but rather by public utility commissions or other administrative bodies. This standard is applicable to municipally owned utilities like the Philadelphia Water Department with the same force and effect as to an investor owned utility like PECO Energy. American Aniline Products, Inc. v. Lock Haven, 288 Pa. 420, 135 A. 726 (1927).

Ultimately, the task of a ratemaker is to set a rate which protects both ratepayers and the utility from being deprived of property within the meaning of the Due Process Clause contained in the 5th and 14th Amendments of the U.S. Constitution. The “just and reasonable” standard is a stringent standard, which requires the ratemaker to fulfill serious obligations to both customers and utilities. In performing that task, the ratemaker must balance the interests of customers in efficient utility service at the lowest possible rates, and the interest of the utility in obtaining sufficient revenues to conduct its operations, maintain its financial integrity and achieve access to the financial markets for revenue bonds at reasonable rates. Federal Power Commission v. Hope Natural Gas Co. 320 U.S. 591, 607, 64 S.Ct. 281, 290 (1944). In implementing the “just and reasonable standard,” a ratemaker must keep in mind that neither statutory law nor the Constitution imposes a unilateral obligation on customers to pay for the costs of service, without a reciprocal obligation on the part of the utility to provide full value in the form of full service. D.C. Transit System v. Washington Metropolitan Area Transit Commission, 466 F.2d 394 (D.C. Cir. 1972) (“Likely effect of a sought-after rate increase upon quality of carrier’s service is one of ‘practical results to the public’ to which due process indulges reasonable regulatory consideration”).

About a decade ago, the Pennsylvania Supreme Court, in a case involving the Philadelphia Gas Works, reemphasized the importance of the “just and reasonable” standard: “this Court is mindful that no applicable constitutional requirement is more exacting than the requirement of ‘just and reasonable’ rates.” Public Advocate v. Philadelphia Gas Commission, 544 Pa.129, 674 A.2d 1056, 1061 (1996). Philadelphia City Council has underscored the strict applicability of this standard in the Philadelphia Code, which requires that Water Department rates shall be “just, reasonable and non-discriminatory.” Philadelphia Code, §13-101(2)(d).

Even though ratemaking is not an exact science, the “just and reasonable” standard, as a matter of constitutional, state and municipal law, requires that the ratemaker base his/her determinations upon substantial evidence. As the Pennsylvania Superior Court has held:

The evidence which is produced ... must be of sufficient quantity and quality to enable the commission to properly make its findings and reach its conclusions based thereon; the evidence must be substantial. There is no precise formula which the commission may apply to every case ... but it is required to use some reasonably scientific method in its determination. The findings which are made must be definite, consistent, detailed, and supported by the substantial evidence....Findings in a rate case are required to be more detailed and more specific than in other utility proceedings.

City of Johnstown v. Pennsylvania Public Utility Commission, 184 Pa.Super 56, 133A.2d 246, 250 (1957)(emphases added).

The “substantial evidence” standard is a strict standard. Under that standard, a utility must do more than simply present a prima facie case, but rather must prove the elements underlying its rate increase request with “evidence which enables ... the [litigant] to prevail, precluding all reasonable inferences to the contrary.” Burleson v. Pa. P.U.C., 501 Pa. 433, 436; 461 A.2d 1234,

1236 (1983). Moreover, given the overwhelming advantage possessed by a utility in a rate case with regard to accessibility of the relevant data, the burden of proving the necessity of a particular proposed rate increase is on the utility. Berner v. Pa. P.U.C., 382 Pa. 622, 116 A.2d 738 (1955). Such rate case evidentiary requirements are universal, due to the just and reasonable standard, and not limited to Pennsylvania Public Utility Commission regulated utilities. In order to obtain a rate increase, a utility is constitutionally required to overcome contrary evidence and convincingly establish its need by known and measurable evidence.

B. The Use of the Test Year Concept Assures Certainty and Avoids Speculation.

In furtherance of this universal requirement that utility rate determinations arise from a solid foundation of empirical fact, standard ratemaking practice is to construct rates on the basis of a single test year. That single test year is commonly an historical test year (the Fiscal Year which has just ended) or the fully forecasted upcoming Fiscal Year (the year in which the proposed rates are to be implemented). Rates are established on the basis of revenues and expenses with particular adjustments proximately associated with that test year. Ratemaking on the basis of events projected to occur beyond the test year is avoided. This is because variations in the revenues and expenses of public utilities are complex, the function of multifaceted interactions between different budget elements. As a result, efforts to forecast revenue requirements and revenues in years beyond the test year are highly speculative. While certain specific increases or decreases in revenues or expenses may be anticipated, regulators and parties are less able to identify the panoply of offsetting factors which might render such specified increases or decreases insignificant for ratemaking purposes.

General regulatory practice utilizes only one test year for setting rates. PA St.1, at 9 (“The utilization of *four test years* for ratemaking purposes is *not* common practice.”). Regulatory practice in this state, both at the municipal and the Pennsylvania Public Utility Commission level, adheres to the single test year methodology. This adherence to a single test year methodology, for both investor owned and municipally owned utilities, was recently confirmed by PUC in a case involving the Philadelphia Gas Works (PGW). In 2006, PGW filed for a \$100 million rate increase (a rate increase designed to allow PGW to bill for \$100 million more annually than under existing rates). In that case, it utilized a single test year, but based its claimed revenue requirement on a five year forecast of its “needs” projected in terms of planning goals for internally generated funds for its capital program and year end levels of cash working capital, as well as the traditional debt service coverage ratio. In ruling against the rate increase, and awarding only \$25 million, the Commission stated:

The test year concept is a basic tenet of ratemaking that forms a sound and reasonable basis for establishing a representative level of prospective rates. It allows for a reasonable measure of predictability and semi-permanence in ratemaking. We are cognizant of the Company’s current financial situation and goals; however, we do not find them to justify peering five years into the future on such uncertain circumstances. We agree with the opposing Parties that the use of a five-year forecast is too speculative and unreliable for the setting of rates.

Pa. PUC v. Philadelphia Gas Works, PUC Docket No. R-00061931 (Order entered September 28, 2007) at 18; appeal pending, Philadelphia Gas Works et al. v. Pa. PUC, Commonwealth Court No. 1914 C.D. 2007.

This position, reaffirming longstanding state law, is further explained in the Pennsylvania Legal Encyclopedia:

Rate making principles require prospective rate making based upon a test year. The object of test year figures in a rate case is to reflect typical conditions. A rate proceeding must have some finality, and, for this purpose, a test year is used and accepted subject to adjustment by the Commission for unusual changes. For example, when there exists an unusual situation which shows that the test year figures are atypical, the Commission should adjust the test year data. This is especially true when some unusual or non-recurring item is the cause of the distortion.... Even though the Commission may not be oblivious to evidence relating to changes occurring after the test year when the changes substantially affect the rate proceeding, such evidence may be rejected when the changes are remote or would have the effect of distorting the test year data.

30 Pennsylvania Law Encyclopedia, “Public Utilities,” §41, City of Pittsburgh v. Pa. P.U.C., 187 Pa. Super. 341, 144 A.2d 648 (1958).

Thus, the test year concept requires that rates be established on the basis of a single test year, with minimal reference to anticipated financial changes which may occur in the post test year period. The impact of future events on the rate established on the basis of the test year is rarely known and measurable, and is not an appropriate basis for establishing rates in the present or for the future. Pa. P.U.C. v. U.G.I. Utilities, Inc. –Electric Division, 82 Pa. P.U.C. 488 (1994), 1994 WL 843074 (Pa. P.U.C.); Pa. P.U.C. v. ALLTEL Pennsylvania, Inc., 59 Pa. P.U.C. 447 (1985), (“recognizing a post test year adjustment claim that may occur nineteen months beyond the test year ... is violative of the test year concept which requires post test year adjustments to be known and measurable”). As the Advocate’s witness Mr. Bleiweis testified, “[t]here must be a ‘cut-off point’ upon which to determine rates and in my experience, this point is generally at or shortly after the end of the test year.” Pa. St.1, at 10.

In this case, as in previous cases, the PWD insists that it may reasonably utilize a multi-year test year concept, in which the use of cost class specific growth factors for the years beyond

the initial year, play a substantial role. The Department has traditionally justified this method on the grounds that rate cases cause it to incur additional costs. However, in light of the magnitude of the annual increases that the Department has routinely been seeking since 2001, the Advocate submits that customers would not object to more frequent rate cases, if they were necessary to prevent the gross discrepancies between the claimed revenue requirement, and actual results which have occurred in this decade. In retrospect, customers over the past decade have been charged rates which were unnecessarily high by tens of millions of dollars. In this case, the Hearing Officer should insist that any multi-year determination to be recommended manifestly exhibit the restrictions, limitations and conditions imposed by the requirement that rates be just and reasonable and based on substantial evidence.¹

¹ As a municipally owned utility, which is self-funded as an enterprise fund of the City, and which has no non-municipal regulator, the PWD's wide-reaching, important, and technically and managerially complex operations are subject to little if any independent review. The City recognized this fact when it enacted Philadelphia City Code Sections 13-101(1) and 13-201(1). Section 13-101(1) states:

Councilmanic Examination: At least once in every four years Council shall make or cause to be made an independent examination of the current operations and Capital Programming and Budgeting of the Water Department, and in connection therewith employ qualified consultants to advise the Council directly with respect to: (a) The formulated policy as prescribed by the Water Department for its capital program and the capital budget and sinking fund requirements. (b) The economic soundness of operational methods, universal meter operations, bill collecting and accounts receivable procedures, inventory control and similar factors. (c) The reserves necessary to stabilize rates for 3, 4 and 5 year periods.

Section 13-201(1) states: Councilmanic Examination: Council shall from time to time investigate and in connection therewith employ qualified consultants to advise the Council with respect to sewer rates in the same manner as authorized by Section 13-101(1) with respect to water rates, and to submit their findings directly to Council.

However, the PWD reports that no such examination has been conducted for at least ten years. PA-MAB-63. The periodic Engineering Reports submitted by Black & Veatch would not fulfill this requirement, because Black & Veatch does not serve City Council, but rather the Water Department, and its reports are intended for rating agencies and bond markets with an investment interest, not for Council, which by its nature, must assess the Department's viability in terms which include consideration of how much customers can reasonably be required to pay.

The annual budget reviews by City Council do not involve independent review by qualified consultants. Moreover, as a review of the transcripts for Council's budget hearings for the past few years would reveal, Council does not in fact engage in more than a very high level and summary review of the PWD's budgets and procedures. See Exhibit

C. The City Has Acknowledged in Water Department Regulations That Rates Must Be Established on a Reasonably Scientific Basis.

Consistent with the legal requirement that rates be established on a “reasonably scientific” basis, the PWD’s Water Regulation (hereinafter “Water Reg.”) 300.8 governing the Process for Setting Water and Sewer Rates, require the Hearing Officer to preside over the establishment of a record precise and complete enough to support a rate decision -- a “record supporting ...[the parties’] proposals and addressing other proposals submitted in the Rate Change Proceeding.” Water Reg. 300.8(a). The Hearing Officer’s Report must be “based on the Hearing Record.” Water Reg. 300.3(c)(4).

In rendering his decision, the Water Commissioner must “fully consider and give substantial weight to the Hearing Officer’s Report and the Hearing Record.” In addition, the Commissioner’s Decision must make explicit reference to the “sections of the Hearing Record supporting the conclusions” contained in his rate determination. Water Reg. 300.10(b). As the Common Pleas Court has ruled, the establishment of a record sufficient to support a decision is critical to “fair and well-reasoned rate setting.” Public Advocate et al. v. City of Philadelphia, Common Pleas, Phila. May Term, 1993, No. 2159 (Herron, J.) (Slip Opinion, September 14, 1993)(Court will enjoin water rate increase where Water Commissioner’s Rate Decision does not make explicit reference in the record to the evidence supporting his decision).

III. The PWD Has Not Carried Its Burden of Showing That It Needs a Rate Increase for

PWD-21 (City Council Budget Proceedings Transcript –FY2008 Water Department Budget, March 26, 2007); Exhibit PWD-23 (City Council Budget Proceedings Transcript – FY 2009 Water Department Budget, April 7, 2008).

FY2009 and Has Not Justified a Further 6.4% Increase in the Revenue Requirement for FY2010.

The record in this case establishes that the PWD has sufficient rates to meet all its debt service ratio and other bond related requirements and all its proposed cash working capital requirements without any rate increase at all in FY2009. It also shows that even without a rate increase in 2009, it would not need more than \$11 million in additional revenues in FY2010 to satisfy all legal and financial requirements. This conclusion becomes evident from review of the central document in this proceeding, the PWD's proposed "Table 11, Projected Revenue and Revenue Requirements." PWD St.5, Exhibit JRM-1, Table 11 (hereinafter "Table 11"). When that computer model based Table 11 is adjusted to reflect other options available to the PWD and to correct for unfounded assumptions, it becomes evident that the rate increase requested by the Department is not justified.

In PA-MAB-81a, the Advocate requested that the PWD provide a schedule similar to Table 11 for FY2009 in which it utilized the maximum allowable draw from the Rate Stabilization Fund. In its response, the Department provided a schedule attached hereto as PA Appendix 1, which shows that on the basis of *its own projections* concerning actual FY2009 expenditures, an increase in the revenue requirement of only \$2.8 million would be required. As the Advocate has demonstrated, in Sections V and VII below, the PWD's projected expenses are inflated by at least \$10 million, without the utilization of excess interest from the Debt Reserve Account. Exhibit PWD-32, Schedule 3. The Department's response to PA-MAB-81a demonstrates that full permissible utilization of the RSF would still permit the PWD to carry a year end balance of at least \$98 million, well above the \$45 million so-called fiscal year end

requirement.²

It is to be noted that this result could be achieved without diminution of the amounts projected in the PWD's Table 11 for transfer to the Capital Account (Table 11, line 22), for transfer to the Construction Fund (Table 11, line 37) and or to remain at year end in the Residual Fund (Table 11, line 39). In addition, all things being equal, the FY2009 year end RSF balance going into FY2011 would be in the \$113 million range, much greater than even indicated on that the PA-MAB-81a schedule, due to the fact that the FY2008 year end RSF year end balance is now estimated to have been about \$165 million, not the \$149.7 million appearing on Table 11. PWD Exhibit-37, Schedule 1.

If the Hearing Officer was to recommend a rate order covering two years, Exhibit PwD-32 (Schedule MAB Analysis) indicates that if all the Advocate's adjustments were accepted, the PWD would need only \$10.84 million in incremental revenues in that year, a percent increase in the revenue requirement of 2.3%, compared to the requested 6.4% shown on the Department's Table 11. On this Schedule, which has been attached as PA Appendix 2, it is noteworthy that this level increase is shown to be compatible with maintenance of at least the same levels of funding for the Capital Account, Construction Fund, and year end Residual Fund as under the PWD's Table 11.

² As explained in Section V below, the PWD has not established that in order to satisfy the rating agencies, it must have a year end RSF balance of now less than \$45 million. At the end of Section V, the Advocate opines that if the Hearing Officer should make recommendations which necessitate an estimate of what is an acceptable year end RSF, he should allow for no more than an amount in the \$12-20 million range, so long as requirements set forth in writing in the bond ordinances and credit insurance agreements are met. According to PA-MAB-81a, of course, the RSF balance is not an issue for FY2009.

On the basis of these known and measurable financial facts, the Advocate requests that the Hearing Officer recommend that no increase be implemented in FY2009, because such an increase would not be just and reasonable. In no event, should any rate recommendation allow for compression of rates in FY2009 or throughout the rate period due to the delays in the filing of this rate case. In the event that the Hearing Officer recommends a rate order which includes more than one year, that rate order should contain no increase in rates for FY2009 and allow no more than an \$11 million increase in FY2010.

IV. The PWD Has Not Met Its Burden to Establish that it Must Have Rates Sufficient to Result in a \$45 Million FY2012 Ending Balance in the Rate Stabilization Fund and/or 1.5x Debt Service Coverage from Recurring Revenues.

- A. PWD Has Not Shown How Much Cash Working Capital It Derives from Non RSF Sources Currently Available and How Much Cash Working Capital It Must Have from the RSF.

The central document in this proceeding is PWD's proposed "Table 11, Projected Revenue and Revenue Requirements." PWD St.5, Exhibit JRM-1, Table 11. Table 11 is a chart which sets forth the PWD's expenses and revenues under existing rates and itemizes the Department's claimed revenue requirements in each of the four year rate period through FY2012. Table 11 reflects the PWD's central claim in this proceeding that it must have a rate order covering a four year rate period, and that those rates must be sufficient to permit it to retain at least \$45 million in its Rate Stabilization Fund (RSF) at the end of FY2012.³ The Department submits that this RSF

³ In fact, Table 11 projects a balance of \$47.7 million at the end of FY2012, with slightly greater balances to be maintained beyond the end of the four year rate period. Table 11, line 42.

year end level is necessary: (1) in order to assure that it has “adequate” cash working capital; and (2) in order to maintain its current bond ratings. Tr.646, 649; Exhibit PWD-37, TR-5.

In order to meet this alleged \$45 million FY2012 year end requirement, the PWD projects year end balances between now and FY2012 which are tens of millions higher than \$45 million -- \$129.1 million at the end of FY2009, \$92.4 million at the end of FY2010, \$66.6 million at the end of FY2011, and does not quite even get down to \$45 million in FY2012, which ends at \$47.7 million. In all, adding up the excess above the so-called minimum requirements in each year, the PWD proposes to maintain RSF annual balances that are \$155.8 million more than is necessary to meet this so-called requirement.⁴ In the alternative, it claims that in any year in which maximum allowable use of the RSF would result in projected year end RSF levels below \$45 million, no funds should be withdrawn from the RSF, but rather rates should be increased to assure a 1.5x coverage ratio from recurring revenue (i.e., not including RSF funds) with the excess above the statutory 1.2x coverage being credited to the RSF for future use. Tr.650.

No one disputes that the PWD must have adequate cash working capital to assure that it can meet fluctuating daily cash needs which are typical of a substantial enterprise. However, there are two issues that must be considered. The first is how much cash working capital the PWD has under existing rates and how much is needed. The second is, once the working capital requirement is determined, how should it be provided. In this case, it has not been shown how much the PWD actually has, let alone how much is needed. Without answers to these questions,

⁴ This figure is calculated as follows: \$129.1 m. minus \$45 m = \$84.1m; \$92.4m. minus \$45m = \$47.4m.; \$66.6m minus \$45 m. = \$21.6m.; \$47.7m minus \$45 = \$2.7m. \$84.1m.+\$47.4m.+\$21.6m. + \$2.7m.= \$155.8m.

the Public Advocate submits that it is difficult to make a reasonable determination how that working capital should be acquired.

In previous rate proceedings, the PWD did not expressly include a claim for cash working capital to be drawn from the RSF in its rate increase filing. In the FY2005 Rate Case, the Water Commissioner determined rates reflected in a Table 11 which envisaged the reduction of the RSF to \$13.5 million at the end of FY2008. PA St.1, at Exhibit MAB-2b, line 43. Even more recently, in March 2007, the Official Statement for the 2007A and 2007B Revenue Refunding Bonds contained an updated Table similar to Table 11, which projected reduction in the RSF balance to \$8.2 million as early as FY2010 and maintenance of year end RSF balances of \$19.7 million for FY2012.⁵

Especially in light of this history, the PWD has failed utterly to meet its burden of establishing from the ground up what its cash working capital needs are. As Mr. Bleiweis points out, the Department has not performed a lead/lag study since 1992, and that study indicated a working capital requirement of only \$29.6 million under monthly billing. PA St.1, at 64. During the hearings, the PWD made reference to a more recent draft study, but did not submit it for review by the parties.

The PWD's expert Mr. McKinley testified that it has been PWD "practice" over the past dozen years to borrow money from the Rate Stabilization Fund to meet working cash needs;

⁵ Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, at 50, line 43. PWD-4, SI 8, Attachment 2.

however; significantly, he did not state how much was borrowed from the fund. Tr.156. Under the City's Restated General Water and Wastewater Revenue Bond Ordinance of 1989 (Bill No. 544) approved June 24, 1993 ("General Bond Ordinance") Section 4.05(c), the PWD has the authority to borrow "at the written direction of the City" from the Construction Fund and the Residual Fund, as well as from the RSF "at any time sufficient moneys are not available in the Revenue Fund to pay Operating Expenses and to make transfers required by Section 4.06...."⁶ There is no reason to accept the implication, intended or not, from Mr. McKinley's reference to PWD "practice" that the RSF is the PWD's only possible source of cash working capital.

Mr. McKinley also testified that there was a "kind of rule of thumb" in the utility industry that a "good dollar amount" for cash working capital can be "between 30, 60, 90 days' worth of O&M expense. Typically 45 days is quite common...." Tr.156. Taking 45 days as the standard, he stated that \$45 million would be adequate cash working capital for a utility with annual O&M expenses of \$360 million. With these assumptions, if one applied this standard to the 2009 test year, the result would be \$45 million.⁷ By this same logic, suppose that a thirty (30) day standard was determined to be adequate. The amount of cash working capital necessary would be \$28 million.⁸ Once again, the issue is not only how much cash working capital is needed, but also to what extent the PWD has sources of cash working capital other than the RSF.

⁶ This provision is paraphrased in the Introductory Statement, at page 13 of the Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, at 50, line 43. Exhibit PWD-4, SI-8, Attachment 2. The General Bond Ordinance has been provided as part of the record at Exhibit PWD 6, Binder 5, Attachment 19b.

⁷ $45/360 = .125$; $\$347 \text{ m.} \times .125 = \43 m.

⁸ $30/360 = .08$; $\$347 \text{ m.} \times .08 = \28 m.

B. The PWD's Claim Is Not Supported by Reference to Its Recent Bond Rating Notices.

The PWD claims that its cash working capital needs have been defined by the rating agencies and that the Department must conform to rating agency directives or experience a down grade in its ratings. However, the rating notices do not support this claim. As the PWD admits, no rating agency has put the PWD on credit watch or even qualified its current rating with a "negative" outlook. Tr.110. No rating agency has stated that its current level of cash working capital is unsatisfactory, or what level of cash working capital must be maintained for the PWD to avoid a downgrading of its bond ratings: "They did not give us a number, no, they did not." Tr.109-110. Notwithstanding the lack of support for any specific amount of cash working capital, the failure to enumerate all its sources of cash working capital in addition to the RSF, and the total silence of the rating agencies concerning what level of cash working capital is necessary, the PWD astonishingly claims that its projected \$45 million FY2012 RSF balance is necessary to satisfy the "requirement" of the rating agencies.

Where is that requirement to be found? In an effort to support its claim, the PWD relies on a few sentences in very general statements issued by Moody's Investor Services in the last two years that "[m]aintenance of the current rating is predicated on the system's ability to either maintain strong balances available for debt service or to maintain adequate debt service coverage through growth in net operating revenues while still maintaining satisfactory reserve levels." In general, Moody's anticipates a reduction in the funds available in the RSF, and warns that meeting only the statutory 1.2 debt service coverage ratio may not be enough to sustain the current rating,

unless net recurring revenues are sufficient to produce something above 1.2 coverage without use of RSF funds. At the same time, Moody's notes approvingly the fact that in FY2006 and FY2007, "net recurring revenues ...have improved to approximately 1.4 times in fiscal years 2006 and 2007..."⁹ Contrary to PWD's claims, Moody's does not even mention the working cash levels as a function of the number of days of working capital available.

The March 7, 2007 Fitch Ratings Notice does, as PWD states, emphasize the importance of maintaining a "healthy cushion in the RSF," while at the same time anticipating that in future years, there will be "significant draws on the RSF." While Fitch believes that satisfying the statutory 1.2x coverage requirement will not alone sustain the Department's bond ratings, this rating agency recognizes that for the foreseeable future, the combination of unrestricted cash (68 days in 2006!) and the availability of restricted cash for borrowing in the Construction Fund, the Residual Fund and the RSF provide a very strong back-up, even as the RSF is depleted. This general discussion does not support the PWD's claim that it must have at least a \$45 million year end balance in the RSF or nonrecurring revenues producing 1.5x coverage. Exhibit PWD-4, SI-42, Attachment 14.

Standard & Poor's lends even less support to the PWD's position than Moody's. In its August 15, 2008 Rating Notice, S&P upgraded the PWD's rating from A- to A. It did this in full and explicit recognition that the Department was often dependent on the RSF to meet its coverage

⁹ Moody's Rating Notice, August 8, 2008, Exhibit PWD-35. In its March 5, 2007 rating notice, at a time when the PWD was projecting reduction of the RSF to approximately \$11 million by fiscal year end 2010, Moody's maintained its a-/Stable rating while approvingly noting net recurring revenues that were 1.26x and 1.37x. Exhibit PWD-4, SI-42, Attachment 14.

and that there would be “[c]ontinued reliance on rate stabilization fund support – projected to continue over the forecast period 2009 through 2014 – to meet covenanted coverage levels.” It clearly recognizes the purpose of the RSF not as the principal source of cash working capital, but rather “to maintain assets to be drawn down to offset operating shortfalls and corresponding rate increases in the operating fund.” It approvingly notes that “debt service coverage before the transfer into the rate stabilization fund was 1.34x in fiscal 2007.”¹⁰

In sum, the PWD’s citation of bond rating statements does not come close to supporting the claim that it has been required (Tr. 646, 649) by the rating agencies to maintain rates sufficient to project a \$45 million RSF balance 4 years from now, or annual net recurring revenues which would produce 1.5x debt service.

C. The PWD Is Inappropriately Subverting the Rate Stabilization Fund From Its Purpose.

The Advocate further submits that the approach which the Department has chosen for obtaining recognition of its cash working capital needs is fundamentally flawed. As Standard & Poor’s clearly recognizes, City Council created a Rate Stabilization Fund, whose purpose is expressly reflected in its name, and which was meant to be used primarily for that purpose.¹¹ As

¹⁰ S&P Ratings Notice, August 15, 2008, Exhibit PWD-35; the S&P August 1, 2007 Ratings Notice showed a similar equanimity regarding the projected depletion over time of the RSF, anticipating at the same time that there would be rate increases in the post-FY2008 period, and approvingly noting that net recurring revenues in 2006 were 1.32x. PWD-4, SI-42, Attachment 14.

¹¹ See Sections 4.04(d), 4.05(c) and 4.13 of the General Bond Ordinance. City Council’s intent that the RSF be used for the purpose for which it was created is reflected in the provision which provides that funds may be temporarily borrowed from the RSF, “until such loaned amounts are required by the Water Department for purposes of the Fund making the loan.” Exhibit PWD 6, Binder 5, Attachment 19b.

the PWD recognizes in its Financial Statements for Fiscal Year Ended June 30, 2006, the Rate Stabilization Fund's purpose is "to maintain assets to be drawn down to offset future deficits (and corresponding rate increase requirements) in the Water Department Operating Fund."¹² Until this rate case, the PWD has always observed that purpose, and attempted to determine a series of rate increases whose severity would be offset by the full utilization of resources from the RSF. While the RSF has served as one source of cash working capital during its history, that was only a secondary function, which was available when that function was not inconsistent with the RSF's primary purpose. PA St.1, at 63.

In this Rate Case, it has become apparent that due to the flawed nature of the PWD's rate setting methodology, the RSF has become an engine for the transformation of customer funds into a cash reserve, which has served to increase the burden upon customers, rather than to protect them from unwarranted rate increases. As testimony at the evidentiary hearings demonstrated, the last Rate Case in 2005 was based on projections of increased costs and revenues that were to result in \$195 million in incremental revenue over the four year rate period. At the same time, the PWD maintained that that rate increase was necessary, even with the anticipated spend down of the RSF from \$128.6 million at the beginning of FY2005 to \$13.5 million at the end of FY2008. Instead, what actually happened, was that at the end of FY2008, there was \$160.3 million in the RSF, a variance of \$146.8 million.¹³ Although the PWD resists this conclusion, the fact is that in

¹² Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, Appendix I, at 23. Exhibit PWD-4, SI-8, Attachment 2.

¹³ In its response to PA-MAB-18 (Supplemental), the PWD updated its estimate of the actual year end RSF FY2008 balance to \$160.3 million. In Exhibit PWD-32, Schedule 1 and 2, PWD appears to concede that the most

retrospect, almost three quarters of the rate increase that customers paid for over the past four years went into the RSF; conversely, the 2005 series of rate increases could have been, and should have been only one fourth as great as they were. Tr.92-98. As Mr. Bleiweis testified, over the last four years, customers have paid rates “substantially higher than they needed to be.” PA. St.1, at 16. Did the PWD intend this result all along? No, but the weaknesses of the methodology used to project costs and to establish rates on the basis of financial forecasts rather than a single test year, produced this result.

Now, however, the Department seeks in this case to institutionalize this transformation of the RSF from its primary purpose to a source of cash working capital. Indeed, one of the main factors driving its request for the level of increased revenues which it is seeking – 6.4% more per year in each of four consecutive years, over twice the rate of inflation – is to have \$45 million in the RSF at the end of FY2012. Never mind that in all but the last year of the rate period, the PWD would have vastly more in the RSF at fiscal year end than the \$45 million which it asserts, but does not prove to constitute a cash working capital requirement.

Even if one assumes for the purposes of argument that the PWD needs \$45 million in cash working capital, the PWD’s plans to fund the RSF with the primary purpose of supplying those needs is not appropriate. Once the RSF reaches a certain level, the 90% rule requires that the fund be maintained, but not utilized to its full extent. Why should customers continue, over the

recent estimate of the FY2008 year end RSF balance is \$164.7 million. Exhibit PWD-32, Schedules 1 and 2. Thus, the variance between projected and actual was \$152.2 million. Thus, a little over 75% of the last rate increase ended up in the RSF.

proposed rate period, to provide levels of cash via the RSF which are vastly above the amounts which the PWD claims it needs? On average, over the four years of the PWD's proposed rate period, the RSF would show an average year end balance of at least \$82 million (Table 11, line 42), over \$42 million on average than even the PWD claims is necessary.

In this proceeding, the PWD has insisted in maintaining this mechanism as its primary source of cash working capital and even embedding it in its rate structure in a manner which drives up costs to customers. Customers are being required to fund PWD's cash working capital, not just the cost of that capital. In PA-MAB-78, the Advocate asked why the PWD has taken the position that it is "preferable to recover all cash working capital through rates to existing customers, rather than utilize a tax exempt short term borrowing facility authorized by statute to lessen the burdens on existing customers associated with providing cash work capital..." Like the Philadelphia Gas Works, the PWD is authorized under the state Philadelphia Municipal Utility Inventory and Receivables Financing Act, 53 P.S. §§ 16999.1 et seq. ("Municipal utility" defined as "Any city-owned, leased or operated utility facility providing services to the public for a fee including, but not limited, to, water facilities, sewer facilities, gas facilities, ... and solid waste facilities which the city may now or hereafter be authorized to own, lease or operate.")¹⁴

In response to this question, the PWD asserted without giving reasons that it did not

¹⁴ The Philadelphia Gas Works has long had a tax exempt commercial paper program (TXCP) which provides a line of short term credit up to \$200 million. The PWD's short term credit needs would certainly be less, because its revenues and expenses are less volatile than PGW's, which has seasonal revenues and expenses reflecting the needs of residential heating customers and the high fluctuating costs of natural gas itself. See the recent Philadelphia ordinances concerning this TXCP program which are available at www.phila.gov. The most recent ordinances are Ordinance No. 070047 (3/1/07), No. 051138 (12/15/05) and No. 020245 (5/9/02).

“believe that such line of credit would be adequate to relieve any concern by the rating agencies or the investor public.” This is not an acceptable answer, given the fact that short term borrowing is standard business practices for most utilities. The PWD also correctly observes that “these lines of credit provide for certain payment based on the mere availability of the line, in addition to the interest charged on any outstanding balances.” The issue, however, is not whether there would be a cost to the PWD for a line of credit in the form of a tax exempt commercial paper program, but how that cost would compare to the costs to customers of supplying out of their own post tax earnings not only the cost of the working capital but the working capital itself. The Advocate submits that when one considers that consumer credit card debt costs are about 18% per year, and that the PWD’s cost of borrowing is in the 5% range, the choice in favor of establishing a TXCP program for cash purposes is a “no-brainer.” PA-St.1, at 65.

In support of its position, the PWD also claimed that without the existence of a year end \$45 million RSF balance, the Department would have to charge higher rates, to provide some level of “cushion” in the event that it was not able to precisely manage its cost and revenues exactly to the 1.2x level. On this point, the Department stated that it would need to target revenues at between 1.4 to 1.5 times debt service (or about \$35 million annually above the 1.2x level) to assure that unexpected increased expenses or unanticipated decreased revenues would not prevent it from making its 1.2x coverage requirements.¹⁵

¹⁵ On the basis of FY2009 projections, the difference between 1.5x and 1.4x is a little over \$17 million annually. In this response, the PWD appears to have backed off the claim that it “must” have 1.5x, absent a \$45 million RSF balance. PA-MAB-78.

In addition, the PWD claims that without the \$45 million RSF balance, it would need to maintain higher levels in the Residual Fund “to ensure that cash balances and reserve levels are adequate to maintain our current bond ratings.” This response, of course, begs the question. The issue is not whether it needs cash balances and reserve levels, but what those levels should be and how they should be funded. The Department’s response on this issue does not inspire consumer confidence, because it does not appear to reflect a comparative analysis of the costs and benefits of instituting a TXCP program which aims to minimize costs to customers while maintaining the utility’s financial integrity.

D. Conclusion—Rate Stabilization Fund/Cash Working Capital.

In conclusion, the PWD has not established what its working capital needs are, and the extent to which they can be satisfied by temporary borrowing from resources like the Residual Fund and the Capital Fund. It has not shown that the rating agencies have established a “requirement” that the Department maintain year end balances in RSF of at least \$45 million or satisfy a 1.5x debt service coverage requirement from recurring revenues. It is clear that under Table 11 as proposed, customers are required to maintain vastly greater amounts in the RSF than are necessary to satisfy any working capital needs that may exist, and that the burden should be on the Department to show why it should not create a Tax Exempt Commercial Paper program which would result in customers funding on the cost of working capital, not the working capital itself.

If the Hearing Officer recommends a two year rate period, then the level of cash working capital that is necessary is an academic question, because of the high levels in the RSF during this

period. If the Hearing Officer recommends a rate period that goes beyond two years, the issue becomes more important. In light of the fact that the PWD's Official Statement for the 2007A and 2007B Water and Wastewater Refunding Bonds projected as acceptable RSF levels for FY2010 and FY2012 in the \$11.8 to \$19.7 million range, this is the level that the Advocate recommends be utilized as the end FY2012 balance in any run to determine the level of rates in a rate period greater than two years.¹⁶

V. The PWD's Budget Factors Are Not An Appropriate Basis for Establishing a Base FY2009 for Ratemaking Purposes.

A. The Cost Base for This Rate Case Should Be the Updated, Adjusted FY2009 Approved Budget.

According to the methodology which the PWD has adopted for this case, the data with which this series of four rate increases begins are the estimated expenditures contained in the "preliminary" FY2009 Philadelphia Water Department budget, not the budget which was actually approved by City Council. These estimates were then further modified by another series of estimates based on "budget factors." A budget factor is a ratio based upon historical data of the amount actually spent to the budgeted amount for a particular Class of expenditures in a particular Division in a fiscal year. The preliminary FY2009 budget, of course, was at best based on FY2007 results and perhaps some data from FY2008, the latest data available, but rather dated nonetheless. Budget factors were then applied to the preliminary FY2009 budget to establish

¹⁶ Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, at 50, line 43. PWD-4, SI 8, Attachment 2.

projected costs for FY2009. It is important that the FY2009 budget data be as accurate as possible, because any inaccuracies in this data will be compounded by application of growth factors for the years after FY2009. Accepting for the purposes of this case that the adjusted FY2009 budget should serve as the base for this case, this methodology should utilize not the preliminary, but the final updated approved FY2009 budget as its point of departure. The Advocate's witness has recommended adjustment to the preliminary FY2009 budget as filed in this rate case, to bring it into line with the actual, updated FY2009 Department budget as approved by City Council. PA St.1 at 26. This update reduces the filed FY2009 PWD Budget by \$0.8 million dollars, which results in a reduction in the Revenue Requirement of between \$0.8 and \$0.9 million annually in each year of the rate period. Exhibit PWD-32, Schedule 3.

B. The Budget Factors to Be Applied to the FY2009 Budget Should Be Determined Using the Advocate's More Consistent Rule Based Methodology.

As PWD witness Mr. McKinley has conceded, with the possible exception of updating the various fund balances as of fiscal year end FY2008, the PWD's rate increase request is based on projected FY2009 spending, not historical data.¹⁷ Because the Department typically does not spend the full amount provided in its approved budgets, the FY2009 Budget is adjusted for ratemaking purposes using budget factors. Black & Veatch develops budget factors for each PWD Division for each Class of expense after a review of historical versus budgeted expense data. The first cause for concern is that the historical data consulted was not particularly recent. It did not include actual FY2008 data. PA St.1, at 18. Moreover, as the Advocate's witness

¹⁷ PWD St. 5, at 15.

testified, this process is also highly subjective. Throughout the Black & Veatch explanations of its method, the focus is upon applying “experience,” “judgment,” the “anticipations” of unnamed and undocumented PWD personnel rather than an identifiable rule or rules of decision. PA St.1, at 19-21.

Moreover, Mr. Bleiweis’s review of the budget factors for Class 200-All Other expenses in the Operations Division revealed that the Department does not even confine itself to a choice of two year, three year or five year averages when determining budget factors. For example, for Class 200-All Other expenses in the Operations Division, the PWD adopted a 97.5% budget factor, in contrast to a two year average of 94.72%, a three year average of 87.99% and a five year average of 91.64%. PA St.1, at 19-20. When the budget factor is higher than it should be, then expenses are overstated, resulting in “lower income and an ultimate higher revenue requirement.” PA St.1, at 20. In contrast, utilizing an average of the two and three year budget factors for this category of expenses would result in a reduction in revenue requirement of \$2.7 million, from \$43.2 million to \$40.5 million. PA St.1, at 20.

Based on this analysis, the Advocate’s witness Mr. Bleiweis recommended that the Department’s adjusted FY2009 budget be determined utilizing an average of the two year budget factor and a three year budget factor, unless there is compelling reason to deviate in particular cases from this general rule of decision. PA St.1, at 21. If this recommendation were followed, it would result in annual reductions in the revenue requirement of between \$6 and \$7 million in each year from FY2009 through FY2012. Exhibit PWD-32, at Schedule 3.

C. The Budget Factor Utilized by the PWD for Class 100 (Personal Services) in the Operations Division Should Be Changed to Reflect Historical Data.

In all budget classes except one, Class 100-Personal Services, the budget factor selected by Black & Veatch and applied to the FY2009 approved budget sets the single base line upon which growth factors are successively applied for succeeding years in the throughout the rate period. For Class 100- Personal Services in the Operations Division, one of the largest expenses in the PWD budget, however, the PWD utilizes a budget factor which increases by 0.5% for each year – from 96.6% in FY2009, to 97.1% in FY2010, to 97.6% for FY2011, to 98.1% for FY2012. PA St.1 at 22. The PWD justifies this proposal as the means it has chosen to reflect expanded programs anticipated to be implemented during the rate period.¹⁸

This increase in the budget factor is not based on historical data.. To the contrary, as Mr. Bleiweis testified, the number of PWD employees at fiscal year end has declined each year since FY2003, diminishing from 1,852 employees to 1,724 employees at year end FY2007. Moreover, the budget-to-actual factor in these years hovered between 93.28% (FY2006) and 94.62% (FY2007), with FY2005 at 93.65%.¹⁹ Moreover, as Mr. Bleiweis testified, this is not the first rate case in which the PWD has utilized this claim as a basis for increasing its revenue requirement, only to absorb the incremental revenues while personnel counts continued to decline. In the 2005

¹⁸ The different adjusted FY2009 budgets for Class 100 (Personal Services) for each of these three fiscal years, serves as the base upon which the percentage wage increases resulting from the application of estimated growth factors (in the absence of a labor contract for the period beyond year end FY2009) have been calculated.

¹⁹ Exhibit PWD 5, OMone-3, OMone-4.

Rate Case, the PWD was allowed to increase its revenue requirement on the basis of identical projections, but increased personnel levels did not occur. Tr.230-231.²⁰ Once again, the Department's methodology demonstrates the folly of establishing rates on the basis of data which is not historically based, and which reflects only the anticipations or wishes of certain Department managers.

In summary, no provision should be made for the wholly speculative proposed increases in that budget factor in successive fiscal years. Moreover, if a budget factor is to be used for Class 100 Operations Division, it should be the average of two year and three year average – 93.9%. PA St.1, at 25.

D. Estimated Costs for Class 500 (Indemnities) Are Vastly Overstated.

It might be expected that the PWD would treat Indemnities similarly to other budgeted expenses for ratemaking purposes. However, in the case of Indemnities, the PWD does not apply a budget factor which reflects actual versus budgeted amounts. Rather, the final FY2009 budget contains \$6.270 for Indemnities, which represents 95% of the FY2008 budgeted expense of \$6.6 million.²¹ There seems to be no principled reason for adopting this 95% factor, a determination still more arbitrary than the normal approach of choosing between 2, 3 or 5 year averages of

²⁰ See Water Commissioner's Rate Determination for FY2006-2008 (July 22, 2005), at 8, 10-11; Recommended Decision (Phase II) before Henri P. Marcial, Hearing Officer (June 17, 2005), at 8-9 (Findings of Fact 30, 31).

²¹ In point of fact, accepting this methodology for the purposes of argument, the adjusted budgeted amount of \$6.270 million should be reduced to \$6.175, because the FY2008 budgeted expense was not \$6.6 million, but \$6.5 million. Exhibit PWD-5, OMone-9.

actual-to-budget. As Mr. Bleiweis' testimony demonstrates, the actual indemnity expense has not exceeded the budgeted amount since 1995, and has usually been well below that amount. Using a weighted five year average, the Advocate recommends that a 48.45% factor be applied to the FY2009 budget amount for Class 500 Indemnities which is thought to be \$6.5 million. PA St.1, at 43.²² This results in an adjusted FY2009 budget amount of \$3.26 million, a \$3.01 million reduction from the proposed \$6.27 million.

At the hearings, the Department presented evidence that of the \$6.5 million FY2008 budgeted amount, \$1.4 million had been "reserved" for claims not yet adjudicated, and that \$4.5 million had been paid, leaving a balance of \$0.6 million. The reserved amounts do not represent "obligations" either in the form of adjudications or settlements, but only potential expenditures. Tr.288. Consistent with the Department's depiction of "obligations" in PA-MAB-58 (Supplement), the reserved amounts should not be equated with "obligations" for the purposes of determining the 95% Indemnities factor. FY2008 thus presents yet another year when Indemnities obligations were substantially lower than what was budgeted. Exhibit PWD-25, Tab 14. Moreover, unless the Department is going to uniformly consider actual FY2008 data in determining budget factors, it should not be allowed to pick and choose the actual FY2008 data that it will present for consideration.

It is anticipated that the Department will try to justify its \$6.5 million annual expense on the grounds that it is self-insured, and that this expense category is more "volatile" than other cost

²² The PWD applies its budget factors against the FY2008 budgeted amount, as if that was the FY2009 budgeted amount. We have not succeeded in locating the FY2009 budgeted amount for Indemnities in the filing.

categories. However, a review of the historical data set forth in Mr. Bleiweis's testimony does not bear out this claim. PA St.1, at 42-43. In any given year, the Department will spend less than expected on certain cost categories and more than expected in others. Moreover, in the event that Indemnities charges exceed anticipated levels, the Department may borrow money from the Rate Stabilization Fund, Residual Fund and the Construction Fund to pay such an extraordinary expense. General Bond Ordinance, Section 4.05(c). It is to be noted that the Department is also projecting annual Residual Fund balances throughout the rate period in the \$5 million range. This provides another hedge against claims which are greater than reasonably expected.²³

The Advocate therefore recommends that the adjusted FY2009 Indemnities expense be reduced from \$6.27 million to \$3.26 million, a reduction of \$3.01 million. Over the four year rate period, this adjustment alone results in a reduction in the revenue requirement of at least \$12.8 million.²⁴

VI. The PWD's Utilization of Growth Factors and Failure Sufficiently to Distinguish Between Recurring and Non-Recurring Items Improperly Inflates Its Projected Revenue Requirement.

²³ Finally, it is worth noting that the Department's Financial Statements note that claims against the City are payable out of the General Fund, except claims against the City Water Department ... which are paid out of their respective funds and only secondarily out of the General Fund which is then reimbursed for the expenditure." PA-MAB-58. This is yet another reason why the projected Indemnities expense should not be derived by a different method from other potential expenditures.

²⁴ In addition, it is to be noted that the PWD has applied a "growth factor" of 3.0% annually to this expense for each of the three years following FY2009. Over the four year rate period, the application of this growth factor alone would result in total increased costs to be recovered through rates of \$0.56 million. If the FY2009 Indemnities adjusted number is reduced to \$3.26 million, as requested by the Advocate, and a growth factor is applied over FY2010-2012 period, the revenue requirement required by application of the Advocate's recommended 2.5% growth factor would be reduced by a little over \$0.3 million.

Sections 13-101(2)(b) and 13-201(2)(b) of the Philadelphia Code are ordinance provisions which authorize the PWD to fix rates and charges which, inter alia, “may provide for sufficient revenue to stabilize ...[rates and charges] over a reasonable number of years.” The PWD relies upon this provision to support its claim that it may permissibly base its rates on four successive future test years, and may utilize growth or inflation factors to establish revenue requirements in the second, third and fourth years of the rate period. In making this claim, the PWD fails to recognize that the ordinance permits, but does not require, that the ratemaker set rates for more than one year. In addition, the PWD fails to recognize that whatever authority may be derived from this ordinance for ratemaking in this manner is severely qualified by the overarching constitutionally based requirement that rates be “just and reasonable,” achieving an equitable balance of the interests of customers in quality service at affordable rates and the interest of the utility in maintaining its financial integrity. This same constitutional requirement mandates that the utility establish by means of known and measurable data that its claimed revenue requirement has scientific validity.

A. Annual Growth Factors Applied to Test Year Data Are Not Reliable and Do Not Result in the Determination of Known and Measurable Costs.

In building up its revenue requirement for the FY2009- FY2012 period, the PWD applies what are termed “growth factors” on an annual basis to the FY2009 budgeted expenses which have been themselves already adjusted through the use of budget factors. Application of growth factors in this manner assumes that all expenditures within a particular category will increase without fail each year and that they will all increase by the same percentage each year. Of course,

such an assumption is not consistent with generally recognized economic reality, in which some expenses will increase, increase not as much as expected, decrease, or stay the same. As Mr. Bleiweis testifies, the level of subjectivity associated with the choice of “growth factors” raises a major problem of equity to the ratepayer”:

Though a certain amount of subjectivity is necessary in developing rates, using inflation factors to determine future budgets over a multi-year period is highly suspect. The problem is one of piling estimates upon estimates, in this case, starting with budgeted data (which is an estimate in itself), applying one set of estimated factors to adjust the base estimates to actual and then applying another set of estimates to adjust for growth.

Strictly speaking, under traditional ratemaking methodology, only known and measurable costs to be incurred within a relatively short period after the end of the test year may be provided for in rates. The PWD’s use of “growth factors” does not produce costs recognized to be known and measurable. Dauphin Consolidated Water Supply Company v. Pa. P.U.C., 55 Pa.Cmwlth. 624, 423 A.2d.1357 (1980)(only known wage increases to become effective within 6 months of end of test year may be included in rates); Pa. P.U.C. v. U.G.I. Utilities, Inc. –Electric Division, 82 Pa.P.U.C. 488 (1994), WL 843074 (Pa.P.U.C.).

In light of these regulatory standards, the Advocate submits that the Hearing Officer should reject PWD’s practice of utilizing growth factors in order to establish the costs underlying its claimed revenue requirements in the years following FY2009. PA St.1, at 9-10, 34-35. In the event that the Hearing Officer interprets Philadelphia Code Sections 13-101(2) and 13-201(2) to authorize a more liberal use of post-test year data, whether in the form of growth factors or anticipated increases in particular expense categories, there should be full comprehension that there are compelling constitutionally based constraints which impose severe limitations on any

determinations which are not consistent with typical regulatory standards regarding what is “known and measurable.”

This objection to the use of growth factors to utility “anticipations” of increased expenses is not merely abstract or doctrinal. Actual PWD experience over the past four years has demonstrated how unreliable the utilization of growth factors over a multi-year test period can be for the determination of a revenue requirement. In this Rate Case, the PWD is utilizing essentially the same methodology which it used in the 2005 PWD Rate Case to project its expenses and revenues. Tr.102-105. A comparison of Total Operating Expenses over the three year rate period including FY2005, FY2006 and FY2007, for which complete actual data is available (including “preliminary actual” results for FY2008), shows that for whole period, the PWD had projected expenditures of \$853 million, but spent only \$808 million, \$45 million or 37% less than rate increase provided for those three years.²⁵ Even considering the “preliminary actual” results for FY2008, there is still a projection of \$17 million more over the four year rate period than was actually spent.²⁶ In sum, while it may be undeniable that there currently exist general inflationary trends in the American economy, the PWD’s uncritical and systematic use of growth factors is as likely to overestimate future costs as it is to capture them.²⁷

²⁵ See PA St.1, Exhibit MAB-2b, line 10.

²⁶ See the response to PA-MAB-18, line 22.

²⁷ In this connection, the PWD’s reflexive application of growth factors even to its Capital Improvement Program projections is altogether uncritical. The annual City Council approval of the PWD’s six year capital program is not the equivalent of the approval of the annual Operating Budget. First, the capital program is in current year dollars, even when projecting five years into the future. Second, as the PWD acknowledges, the capital program is resubmitted and revised every year, and in some years, “many of the line items has not been increased due to limitations on available funding.” PA-MAB-79. Such City Council reviews are for information purposes only and are

B. Expenses Claimed for Increases in Personal Services Constituting More Than Half of the Department's Operating Budget Are Not Known and Measurable.

PWD labor expense (not even including labor expenses embedded in Interdepartmental Charges) is budgeted for FY2009 at \$98.2 million, which adjusted by a budget factor of 96.6% yields \$95 million in costs in FY2009, approximately one third of the annual operating expenses for Water & Wastewater Operations, Table 11, line19. Fringe benefits account for an additional \$73.8 million, which adjusted by a budget factor of 104%, constitutes \$76.8 million, or another 26% of Water & Wastewater Operations, Table 11, line 19. PA St.1, at 44. These figures include a provision for a \$1500 per employee bonus, but no across the board wage increase in FY2009. PA St.1, at 23-24. When this rate filing was composed, there was an expectation that the City would arrive at a new labor agreement effective July 1, 2008, which would provide a schedule of bonuses and/or scheduled percentage increases over a three to four year period, and which would also provide specific information concerning future fringe benefit costs.

However, as if to validate the Advocate's witnesses warning that costs do not always rise as anticipated, a labor agreement was reached in early July which resulted in an \$1100 per employee bonus (\$400 less than anticipated by the PWD) for FY2009, and which postponed negotiations on wages and benefits for FY2010 and beyond to the coming calendar year. PA St.1, at 24. This \$400 reduction in contracted labor expense for FY2009 requires an adjustment in the

not intended to serve as the basis for projecting a revenue requirement, even if, as PWD counsel pointed out, the forecast FY2012 next bond issuance is not projected to impact debt service during the four year rate period. Tr.250.

overall labor expense reduction, resulting in a \$0.744 million downward adjustment in FY2009 labor costs. Exhibit PWD-32, Schedule 3, line 5.

More significantly, as a result, there is no known and measurable data for increases in labor costs and benefits for the years beyond FY2009. The projections contained in the filing were based on estimated wage increases of 2% in FY2010, 3% in FY2011, and 4% in FY2012. The sole basis for these estimates, as Mr. McKinley stated, were “recent labor union contracts” utilized as a “guide” in making these projections. The sole basis for estimating 4% annual increases in the cost of fringe benefits were projections contained in the City’s 5-Year Plan. Recent labor union contracts and the City’s 5-Year Plan do not provide sufficient guidance for ratemaking. The City is operating under a new leadership, and it is yet to be seen whether the Nutter administration will follow practices adopted by the Street administration. In truth, these increases in personal services and fringe benefits represent only “guesstimates.”

For a ratemaker intent upon keeping the rate determination in this case within constitutional boundaries, this situation presents a particular challenge. It was anticipated that by the time of the hearings in this case, there would be in place a labor agreement which would provide known and measurable data due to a signed labor contract outlining labor costs for FY2009 and a few years thereafter. This contract would have transformed costs which were not known and measurable at the time of filing into costs which could have been included in rates by the time of the hearings in this case.

The PWD is left in these circumstances with projections based on “previous labor

agreements, which reflected lower percentage increases in the early years and increasing percentage increases in the latter year of the agreements...” PA St.1, at 23-24; PWD Exhibit 25, Tab 7, Tab 8. In these circumstances, when incremental labor costs in budget categories constituting more than one half of the PWD’s Operating Budget are not known, the Advocate submits that no wage increases should be recognized for FY2010, FY2011 and FY2012, since such increases are neither known nor measurable. PA St.1, at 25. In the absence of a collective bargaining agreement, there have been no preliminary indications concerning what level of wage increase, if any, will be agreed to for FY2010 and beyond. Moreover, especially in light of the Department’s insistence on the use of multiple test years, any effort to determine this cost on the basis of the existing record, presents severe risk to customers.²⁸

The Advocate recognizes that an adjustment of this magnitude would require the parties to reconsider whether setting rates on the basis of the Department’s four year financial plan is feasible and legally permissible under these circumstances. This reconsideration would be

²⁸ There are two relatively recent Pennsylvania Public Utility Commission decisions in which the PUC addressed this issue in the context of a single test year analysis. In a recent Philadelphia Suburban Water Company rate case, the Commission allowed inclusion in rates for a union labor contract that was only projected to be negotiated and implemented three full months after the end of the future test year. The union labor contract solely affected the Shenango Valley Division serving only 20,000 of PSWC’s several hundred thousand customers, and the employees in that division had received an increase every year in the previous ten years. Pa. PUC v. Philadelphia Suburban Water Company, 219 P.U.R. 4th 272, 2002 WL 31221445 (Pa.P.U.C.). In the other case, involving a Pennsylvania-American Water Company, the PUC allowed inclusion of wage increases for non-union employees which had not yet been agreed to and which were to take effect one day after the end of the future test year. In that case, there was deemed sufficient basis for knowing the percentage amounts of the wage increase, because corresponding percentage wage increases had already been granted to union employees. Pa. P.U.C. v Pennsylvania-American Water Company, 97 Pa.P.U.C. 1, 2002 WL 1729883 (Pa.P.U.C.). Both of these cases are distinguishable on many grounds from this case, where multiple test years have been proposed, where the increases are projected to take place more than one year after the initial future test year, where the increases apply to the whole unionized labor force, not just a small portion of that force, and where there is less evidence concerning the level of increases that might be granted, because past practice is less consistent.

especially appropriate because it is clear from the Department's response to PA-MAB-81(a) that the Department has ample resources for FY2009 without any rate increase at all.²⁹ In the Advocate's view, it would be appropriate and legal for the Department to hold the record open in this rate proceeding, for updating after the end of FY2009, when the terms of the City's future wage agreement will be known.

C. Particular Proposed Growth Factors Should Be Reduced.

Class 100, 200, 300, and 400 PWD Expenses. For most non-Class 100 expenditures, the Department has proposed to use an annual growth factor of 3%, which is based on the five year average inflation index for All Urban Consumers. PA St.1, at 36. This index, which includes food and energy costs is not appropriate, because the PWD has utilized a different factor for energy, and because food costs are not relevant to the costs of running a water/wastewater utility. If an inflation factor is to be used at all, Mr. Bleiweis recommends that it be based on the Consumer Price Index for All Items Less Food & Energy. Utilization of this index based on the five years 2003 through 2007 results in an 2.5% growth factor. PA St.1, at 37. This adjustment would result in an adjustment in the revenue requirement over the four year rate period of \$3 million. Exhibit PWD-32, Schedule 3, line 11.

²⁹ The schedule entitled MAB-81a Scenario, using the projections contained in the PWD's original Table 11, with no cost or revenue adjustments, indicates that only a \$2.837 million rate increase (0.90%) would be necessary in that year, assuming maximum use of the Rate Stabilization Fund. In fact, the Advocate has identified adjustments in costs which would yield a \$13.4 million reduction in the FY2009 revenue requirement. Moreover, this schedule, like the original Table 11, understates the beginning year balance in the Rate Stabilization Fund (\$150 million versus \$164.7 million).

Class 800 Expenses. PWD Interdepartmental Charges include Class 800 payments to the General Fund for certain services performed for the Water Department by other agencies of City government, as well as payments for the Water Revenue Bureau, Law Department, Public Properties, Fringe Benefits, and Indemnities. PA St.1, at 38. This discussion does not include Indemnities, which have been addressed above. In developing its claimed revenue requirement, the PWD has applied 3% growth factors to these expenses. As with other non-Class 100 expenditures, and for the same reasons, the Advocate submits that if growth factors are to be utilized, the Hearing Officer should recommend a growth factor of no more than 2.5% applied to the adjusted FY2009 Class 800 budget amounts. PA St.1, at 39-40. The reduction in the revenue requirement over the four year rate period resulting from this adjustment has been included in the \$3 million adjustment for Class 100, 200, 300 and 400 expenses shown on Exhibit PWD-32, Schedule 3, line 11.

Purchased Power and Chemicals. The Department has also proposed separate growth factors for purchased power and for chemicals. For power, the PWD proposes a 2.5 % growth factor for FY2010, an 11.9% factor for FY2011 and a 16.53% factor for FY2012. PA St.1, at 32-33. Power and chemicals are significant costs in the PWD's budget. In the adjusted FY2009 budget, these costs account for a total of \$44.6 million, \$20.5 million for electricity, and \$24.1 million for chemicals.³⁰ These costs represent 15.3% of the PWD costs for Water and Wastewater Operations (Table 11, line 19).

³⁰ See Exhibit PWD-5, OMone-7, L.30, col.6 and OMone-7, L.33, col.6.

In this case, the Advocate's witness Mr. Bleiweis has recommended that if any growth factor is utilized, it should be 2.5%. This is not because he believes that power costs and energy dependent chemical costs are unlikely to increase more than other costs over the next few years. Nor is it because he believes that there will necessarily be another agreement with PECO Energy allowing the PWD to continue to receive power at discounted rates when the current agreement expires at the end of calendar 2010, at the mid-point of FY2011. He recognizes that these proposed growth factors are based upon the anticipations and estimations of experienced PWD staff. However, while these judgments may be quite appropriate for planning purposes, they are not appropriate for ratemaking purposes. Tr.238, 293-294. In this case, the PWD has the heavy burden of establishing by substantial evidence that these projected costs are known and measurable. The Advocate submits that the record does not support the PWD's claims for power and chemicals.

If the Hearing Officer should recommend any rate increase extending beyond the end of FY2009, and chooses to utilize a growth factor for electric costs and chemical costs, that growth factor should be the "default" growth factor of 2.5%. PA St.1, at 37. This adjustment, if applied to the whole four year proposed rate period would total at least \$7 million for electricity and \$9.7 million for chemicals. Exhibit PWD-32, Schedule 3, lines 12, 13.

D. Sound Ratemaking Methodology Requires Elimination of Non-Recurring Expenses from All Test Year(s).

The final 2009 PWD budget, which is the basis for projected data in the Black & Veatch

model, contains what can be termed “non-recurring expenditures.” Mr. Bleiweis explained this term as follows:

Certain expenditures occur on a regular, recurring basis, that is, by the nature of the Department water and wastewater business, expenses occur each and every year. Some examples of recurring expenditures would be for salaries and related expenses, chemicals, power, etc. Other expenditures occur only on a one-time basis. An example of a non-recurring expenditure would be expenses for a special project.

PA St.1, at 27. Under standard ratemaking practice, rates should be based only upon test year recurring expenditures. It is thus normal for non-recurring expenditures to be either amortized or eliminated for ratemaking purposes.³¹ Only by making such adjustments can test year expenses meet the ratemaking criteria of being both known and measurable and representative of future periods. Pa. PUC v. PPL Gas Utilities Corp., 255 P.U.R. 4th 209, 245-46 (2007), 2007 WL 517121 (Pa.P.U.C); Pa. PUC v. National Utilities, Inc., 87 PA PUC 1, 1997 WL178638 (Pa.P.U.C.).

In this proceeding, the Department did make some non-recurring expense adjustments in the model. For instance, it removed from the FY2010 projected budget the \$3 million Class 100 (Personal Services) expenditure associated with the FY2009 non-recurring bonus provided for in the recent City labor settlement. Other non-recurring expenses anticipated by the PWD are contained in what is termed “Add Packages.” Essentially, these Add Packages present justification in written form for new programs that the Department proposes to be included in a budget, in this case the FY2009 budget. Black & Veatch identified \$1.3 million of proposed

³¹ Under the legally enacted method of accounting, amortizations of expenses over a number of years are not utilized.

expenditures for Class 200 (Purchase of Services) as being non-recurring in the FY2010, not the FY2009 budget.³² However, the justifications accompanying the Add Packages identified a total of \$3.102 million of non-recurring expenditures for Class 200 for FY2009. PA St.1, at 28-30. At the hearings, the PWD attempted to defend its under-estimation of non-recurring expenses by asserting that the Department would experience substantial non-recurring (albeit “somewhat unpredictable”) expenses in future years in the rate period. Tr.273-274. This fact, even if true, does not satisfy the “known and measurable” requirement and is not relevant for ratemaking purposes. Moreover, the inclusion of non-recurring expenses in test year costs would saddle customers with a rate requirement which includes these expenses again, with associated growth factors, in each and every year of the rate period.

Thus, as shown on PA Appendix 4, a total of \$3.012 million of expenditures identified in the Add Packages should be eliminated from FY2009 (and therefore from subsequent fiscal years), not merely the \$1.3 million which was belatedly eliminated from FY2010, since they comprise a conservative estimate of test year non-recurring Add Package expenditures. The Department is correct that \$3 million of known and measurable bonus related labor expenditures can be recognized in the adjusted FY2009 test year, but should not be included in the FY2010 test year or subsequent test years, since such payments are non-recurring. These adjustments would result in annual reductions in the revenue requirement of about \$2.75 million in each fiscal year of the rate period for FY2009 and beyond.³³

³² Exhibit PWD-5, OMone-7, column 15

³³ In this respect, the Advocate disagrees with the “Revenue Impact” Schedule 3 provided as a part of

E. PWD Expenditures for the Water Security Project Which May or May Not Be Supplemented by a Federal Grant Are Primarily Contractual and Are Projected for Only the First Three Years of the Proposed Four Year Rate Period.

The Exhibits associated with Deputy Commissioner Clare's Direct Testimony included \$3.9 million in FY2009 budgeted amounts for Water Security. PWD St.1, Exhibits JC-1,JC-2, JC-3; PA St.1, at 30-32. At the hearings, the PWD clarified that this amount represented the first year of a three year project, which was partially dependent on a federal grant which had not yet been received. Whether or not the grant is received, the Department specified that it intended to spend \$0.86 million per year in FY2009, 2010 and 2011 on this project. Tr.242-243. Judging from Exhibit JC-2, approximately two thirds of this project involves contractual purchased services. It is not appropriate to add growth factors to purchased services.

For these reasons, because of the predominantly contractual nature of this project, any growth factors associated with this \$0.86 million expense should be eliminated for FY2010 and FY2011. Since this project is a three year project, it should not be included in FY2012 costs, in the event that recommended rate order covers four years.

VII. All Excess Interest in the Debt Reserve Account Must Be Deemed Available for Deposit in the Revenue Account, Not Transferred to the City's General Fund.

The PWD proposes to transfer a total of \$11.922 million in excess interest in the Debt

Exhibit PWD-32. As shown on PA Appendix 4, \$3.102 million for non-recurring "Add Packages" should be eliminated from the adjusted FY2009 test year and, accordingly, would not show up in any subsequent test year. Exhibit PWD-32, Schedule 3.

Reserve Account to the City's General Fund over the four year rate period, \$2.568 million in FY2009, \$2.782 million in FY2010, \$2.782 million in FY2011, and \$3.790 million in FY2012.³⁴

As the owner of Philadelphia's water/wastewater utility, the City proposes this transfer, despite the fact that customers have historically paid all operating and management expense of the PWD, supplied the capital and paid for the cost of capital for its capital programs, and have provided working capital and the cost of that working capital through rates. While these transfers are legally permissible under the City's Restated General Water and Wastewater Revenue Bond Ordinance of 1989 (Bill No. 544) approved June 24, 1993 ("General Bond Ordinance") up to the annual amount of \$4.924 million in excess interest, and have been upheld by the Courts, they are never required.³⁵ In fact, a ratemaker has the authority to deny recovery for such transfers when such transfers would render the overall impact of the rate determination "unjust" and "unreasonable."³⁶

As the owner of the utility, the City has, under the General Bond Ordinance, the authority to direct that this excess interest be transferred to the Revenue Fund, where it may be utilized as

³⁴ Table 11, line 36.

³⁵ Public Advocate et al. v. City of Philadelphia and Philadelphia Water Department, 662 A.2d 686 (Pa.Cmwlth., 1995); see also Applemans et al. v. City of Philadelphia et al., 826 F.2d 214 (3d Cir. 1987). The General Bond Ordinance has been provided as part of the record at Exhibit PWD- 6, Binder 5, Attachment 19b.

³⁶ In Public Advocate v. Philadelphia Gas Commission, 544 Pa.129, 674 A.2d 1056 (1996), the Pennsylvania Supreme Court upheld a rate determination which included an annual statutorily required \$18 million payment by the municipally owned Philadelphia Gas Works to its owner the City of Philadelphia as a valid cost recoverable through rates. In contrast to this case, the City ordinance providing for this payment contains no indication that any other disposition of the \$18 million would be permissible. Even that decision, however, did not state that including the statutorily required \$18 million City Payment in rates was valid in all cases. The Court stressed that the ratemaker's focus should be on the "overall impact" of the rate, which must not be unjust and/or unreasonable. Id., at 1062.

operating revenue to be used for any purpose including satisfying debt service coverage ratios. However, the PWD has contended that it is required by the General Bond Ordinance to transfer excess interest up to a maximum of \$4.994 million annually from the Debt Reserve Account to the Residual Fund for transfer to the City.³⁷ To the contrary, the General Bond Ordinance does not require such a transfer. Transfer of the projected excess interest to the Revenue Fund does not entail a violation of the General Bond Ordinance or any bond covenant. If the projected \$11.99 million in excess interest from the Debt Reserve Account were transferred to the Revenue Fund during the rate period, these funds would count as Net Revenues for all purposes, including satisfying the 1.20x debt service ratio covenant.³⁸ This transfer would reduce dollar for dollar the amount of any requested rate increase. PA St.1, at 48.

The General Bond Ordinance provides the City with at least two options concerning excess interest from the Debt Reserve Account. It may direct transfer of such money to the Residual Fund for disbursement to the City's General Fund. However, it may also direct transfer of such money to the Revenue Fund, where it may count as Net Revenues for debt service coverage purposes. The General Ordinance specifically states that the City may direct the Fiscal Agent to transfer "excess interest" from the Debt Reserve Account to the Revenue Fund. General Ordinance Section 4.09 states: "Any money in the Debt Reserve Account in excess of the Debt

³⁷ PWD St.-1, at 12.

³⁸ The PWD's pre-filed direct testimony is misleading on this point. That testimony states that "because these excess interest earnings are paid directly by the Water Residual Fund, avoiding this payment would have no direct effect on coverage." PWD St.-1, at 12. However, even if sums transferred to the Residual Fund can not utilized to meet debt service ratio coverage requirements, there is no rule which mandates that excess interest may only be transferred to the Residual Fund. Indeed, General Bond Ordinance Section 4.09 provides that excess interest may be transferred directly from the Debt Reserve Account to the Revenue Fund.

Reserve Requirement shall be transferred to the Revenue Fund at the written direction of the City.”

At the hearings, the PWD’s counsel suggested that the ratemaker must take into account the fact that the transfer of excess interest from the Debt Reserve Fund, whether to the Revenue Fund or to the Residual Fund, can only be made at the “written direction” of the City Finance Director.³⁹ Because such “written direction” is required, the PWD argues that it must make its projections as if the excess interest from the Debt Reserve Account, at least up to \$4.9 million, will not be available for transfer to the Revenue Fund. In making this claim, the PWD incredibly acts as if it were not actually a department of the City government, and as if those charged with ownership decisions regarding the PWD did not include the Water Commissioner.

This claim can not withstand serious examination. The PWD is a municipally owned utility. Under Sections 5-800(a) and 5-800(b) of the Philadelphia Home Rule Charter, the PWD is charged with operating the “City’s water supply system” and the “City’s sewage system and sewage disposal plants.” The Water Commissioner is described under the Home Rule Charter, Section 3-101 as a “department head,” part of the City’s management team. The decision concerning whether the PWD will make a payment of excess interest to the General Fund, just like the decision concerning the timing and even the amount of the requested rate increase filing, is an ownership decision. Tr.142. Whether the Water Commissioner alone may be able or not to determine whether the City by “written direction” will opt for transfer of excess interest to the

³⁹ Tr.248-249. In actuality, the General Bond Ordinance makes reference not to the Finance Director, but to the “written direction of the City.” See General Bond Ordinance Sections 4.09, 4.12 and passim.

Revenue Fund (or to the Residual Fund for transfer to the City) is absolutely irrelevant for rate making purposes. The issue is whether in the overall context of determining a revenue requirement, and rates to fund that requirement, payment of such excess interest should be considered a necessary expense justifying an overall increase in the revenue requirement over the four year rate period of at least \$12 million.

If the ratemaker determines that this expense is not necessary in the overall context of fixing just and reasonable rates, then the ratemaker should deny the expense, in the same way that a ratemaker would deny recovery for other expenses as not providing a direct benefit to customers. The ratemaker, of course, does not have the authority to prevent an expenditure from being made. In this case, even though the ratemaker might require an adjustment to exclude recovery for the payment of excess Debt Reserve Account interest to the General Fund, that payment might be made nonetheless. Such action would be no different from the action of an investor owned utility, which makes expenditures for which a Commission had denied recovery in full or in part. A utility ownership which acts in this manner, does so with the understanding that due to its expenditures on a non-recoverable item, it will not have the use of certain funds for the programs and projects which have been recognized and provided for in rates.

For these reasons, the Advocate requests that the Hearing Officer recommend adjustment of the revenue requirement in this case to reflect the transfer of excess interest from the Debt Reserve Account to the Revenue Fund.

VIII. The Rate Determination Should Be Based Upon Collection Factors of 86%, 9.00% and 2.5%.

The Department uses collection factors to estimate the extent to which it will translate customer billings into cash receipts necessary to satisfy the revenue requirement in any fiscal year. PA St.1, at 13; Exh. PWD-4, SI 34. In this case, the Department maintains that it is reasonable to project collection factors over four years to be no more than 85.5% for the current year, 9.00 % for the first prior year, and 2.50% for the second prior years and all previous years. To the extent that the Department underestimates its collection factors, it overestimates its need for rate increases to provide the cash to operate the utility. In this case, these projections are too low. To take that position is to state with equanimity that WRB performance will stagnate at subpar historical levels over the next four years!

The PWD's collection factors consist of three components: a current year collection factor, a first prior year collection factor and a second prior year collection factor. The "current year" collection factor projects the receipts for service received in the current fiscal year as a percentage of billings rendered in the current fiscal year. The "first prior year" collection factor consists of all collections on those billings received in the next fiscal year. The "second prior year" collection factor includes all collections on those billings received beyond the "first prior year." If revenues are collected four years after they are billed, these collections are reflected in the "second prior year" collection factor.

The Department's proposed 85.5% current year collection factor represents an average of that collection factor over the five year period extending from 2003 through 2007. This estimate plainly does not take account of changes which have occurred at Water Revenue in the past eight

months, beginning with the implementation of a new multi-million dollar billing system.⁴⁰ As the Public Advocate's witness noted, the PWD has recognized that the WRB's new billing system is expected to enhance collection capability. In reply to PA-MAB-3e, the Department stated:

This past January, the department's new billing system went on line. This system enhances the Water Revenue Bureau's (WRB) ability to track customer billing history and enable it to automatically flag delinquent accounts as soon as this status is triggered. As we move forward, PWD and WRB plan to better integrate early notification of customer billing delinquency with the department's enforcement shut-off unit.

PA St.1, at 15.

This statement is consistent with the representations made by Black & Veatch in the April 2005 Engineering Report submitted in support of the Water and Wastewater Revenue Bonds, Series 2005A and 2005B concerning expected improvements in WRB performance:

The Department is currently working with the Water Revenue Bureau, the Mayor's Office of Information Services, and others on a project to develop a replacement for its current billing system. The project is currently referred to as "Project Ocean." Project Ocean is the first application to reside on the City of Philadelphia's Oracle ERP and will replace the twenty-five (25) year old application systems currently supporting WRB with a single consolidated solution. The new system will permit WRB to align its business processes with an application designed around industry "best practices" and will facilitate the streamlining of WRB business processes, resulting in cost savings to the WRB through the elimination of redundant processes. Additionally, the new system will provide expanded collection capabilities to enable the WRB to increase revenues. (Emphases added).⁴¹

⁴⁰ See Office of the Controller, City of Philadelphia Pennsylvania, Water Billing System, Corrective Action Needed to Prevent Recurrence of Prior Implementation Failures, August 2007 ("We have reviewed the City of Philadelphia's last four failed efforts at replacing the Water Revenue Bureau's water billing system, which cost customers and City taxpayers an estimated \$35-40 million...."), available on the Controller's web site through www.phila.gov.

⁴¹ Black & Veatch, Final Engineering Report submitted as part of Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, at II-21-22. Exhibit PWD-4, SI-8, Attachment 2.

In addition, the Water Revenue Bureau itself anticipates that the new billing system will enhance collections. As the recently appointed Revenue Commissioner Keith J. Richardson (whose authority encompasses the Water Revenue Bureau) stated in an interview with the Daily News in February, 2008, with the aid of the new billing system, the WRB's performance will improve: "We had to crawl and walk before we could start running," he said. "We had to take baby steps." PA Exhibit 2. After funding the expenditure of tens of millions of dollars on the new billing system, customers have a right to expect that all aspects of WRB service will improve, including the collection ratio.⁴²

The Public Advocate submits that even in the short run, one or two years, the WRB can reasonably be expected to achieve a higher collection ratio, especially for current year collections. As the response to TR-4 indicates, the WRB has in response to the Controller's 2007 audit made

⁴² Commissioner Richardson went into more detail in a similar vein in his February 13, 2008 reply to City Controller Alan Butkovitz regarding the results of the Controller's 2007 audit, where he quoted each of the Controller's findings, and then provided a response:

TEST OF SAMPLE ACCOUNTS

Failure to Shut Off Delinquent Accounts Timely

Recommendation:

Management should reevaluate the entire collection process, and in connection with the implementation of a new billing system known as *basis2*, develop procedures to track complete water usage and payment history for all customer accounts, and to automatically start collection efforts when accounts become delinquent. [403607.01]

Response:

The need for an automated case management process is a primary reason that Revenue has long advocated the development of a new water billing system. The new system, *basis2*, was implemented on January 2, 2008. It provides for the automated referral of accounts for shutoff and other enforcement processes based upon rules that are established in the system. Collection procedures were evaluated as part of the needs analysis for the new system and new procedures were incorporated in the configuration of *basis2*. Emphasis added.

Office of the Controller. City of Philadelphia Pennsylvania. Review of Delinquent Water and Sewer Accounts. February 2008, at 13-14. Exhibit PWD-4, SI-20, Attachment 7.

substantial inroads on the uncollected outstanding balances owed on federal and state accounts. Exhibit PWD-37, TR-4.

While the Department has no difficulty in projecting increased costs and ever increasing revenue requirements many years into the future, it does not exhibit the same facility when the issue is prospects for an improvement in the collection ratio. In fact, it misleadingly presents a proposed upward adjustment to the collection factor as having the same effect on the revenue requirement as a downward adjustment in costs! Exhibit PWD-32, Schedule 3 (line titled “net revenue requirement impact”); Tr.641. However, a 0.5% increase in the current year collection factor from 85.5% to 86%, if justified, will not have the \$2 million annual negative impact on revenues as the PWD claims. While a reduction in costs automatically leads to a reduction in the revenue requirement, an increase in the collection factor does not necessarily have any effect on the revenue requirement. That increase simply means that the WRB may bill at a lower rate level in order to generate the same level of receipts needed to satisfy the revenue requirement.

IX. Any Rate Order in This Case Must Concurrently Require that the PWD and the WRB Commit to Full Compliance with PWD Regulations and Inaugurate a Comprehensive Program Aimed at Improving the Quality of Service Provided by the WRB.

A. Assessment of the Quality of Customer Service Is an Integral Part of Determining Just and Reasonable Rates.

As the Pennsylvania Public Utility Commission has stated in considering the rate request of the Philadelphia Gas Works, the City of Philadelphia’s other municipally owned utility, t

“service is an essential consideration in determining just and reasonable rates.” Citing the landmark case, D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Commission, 466 F.2d 394, 422 (D.C. Cir. 1972), cert. denied, 409 U.S.1086, the Commission has also stressed that the requirement that service quality be considered in ratemaking has a constitutional basis, and consequently can not be trumped by ordinance or statute. Pa.P.U.C. v. Philadelphia Gas Works, 94 Pa.P.U.C. 479, 489, 2000 WL 33143808.⁴³ As Mr. Colton has testified, service in the utility context is not limited just to the physical delivery of the commodity, whether it be water, gas or electricity, but also the “entire range of supplier-consumer transactions throughout the customer cycle,” including the activities of the Water Revenue Bureau. PA St.3, at 6.

In D.C. Transit, the federal appeals court upheld the decision of a transit commission to refuse a rate increase request by a public utility whose need for additional cash was well documented, on the grounds that the utility’s service was inadequate. In so doing, the appeals court upheld the transit commission’s determination that a rate increase should not be granted concurrently with commitments by the utility to improve its service, because under the existing circumstances, the utility could not give sufficient assurance that if it received a rate increase, the utility would make good on its commitments to improve service. D.C. Transit, at 397, 403. In so holding, it stated that “the caliber of a utility’s service may constitutionally qualify as a prominent

⁴³ In taking this position, the Commission has also relied on Section 526 of the Public Utility Code, 66 Pa.C.S. § 526, which states that the Commission may reject a request for increased rates when it concludes that the utility has not provided an adequate quality of service. As an Administrative Law Judge has explained, the term “service” under the Public Utility Code is “clearly broad enough to include the billing and collections practices of a public utility, including PGW. The Commission has interpreted and applied Section 1501 to include adequate customer service, see, e.g., Chapter 56 of the Commission’s regulations in Title 52 of the Pennsylvania Code (regarding Standards and Billing Practices for Residential Customers)”, Roderick Berry v. Philadelphia Gas Works, 99 PA PUC 125, 2004 WL 1778058 (Pa.P.U.C.), at 11.

and even decisive factor in the regulation of its rates.” Id., at 422.

In this case, the Public Advocate has presented un rebutted testimony concerning the deficiencies in the customer service provided by the Water Revenue Bureau. These deficiencies are directly relevant to the PWD’s rate requests, because a water utility’s obligation to provide a commodity which is a basic necessity of life does not stop at providing pure water, but extends to providing the processes and procedures appropriate to assure that its customers may be assured of reasonably continuous service without unreasonable interruptions. Philadelphia residents must be able to obtain service on reasonable conditions, maintain service even when temporarily unable to pay in full and on time, and to obtain service restoration when service is terminated on equitable terms under the totality of the circumstances.

The Department’s own Water Regulations implicitly recognize the connection between just and reasonable rates and the quality of customer service when they specify that “[f]or all purposes related to the Rate Change Proceeding, the Water Department shall be considered to include the Water Revenue Bureau of the Revenue Department.” Water Reg. 300.2(m). Consistent with this regulation, any recommendation concerning corrective measures which must be made regarding the PWD’s customer service should be directed to both the PWD and the WRB.⁴⁴

⁴⁴ PWD and WRB insistence at the hearings on the lines of demarcation between the Water Revenue Bureau and the Water Department is one of the factors which weigh on the side of conditioning any rate increase recommendation on more specific assurances concerning customer service by all parties. Tr.119; PWD St.6, at 2. The insistence that the Home Rule Charter imposes “bright lines” between the responsibilities of the PWD and WRB is also not consistent with the fact that the Water Commissioner regularly with the Finance Director

B. Roger D. Colton's Investigation Demonstrates a Pressing Need to Improve Customer Service Provided by the PWD/WRB.

In his Direct Testimony, the Advocate's witness Roger D. Colton, a nationally recognized expert on issues regarding consumer access to utility service, provided a preliminary report, on the basis of about six weeks research, discovery and analysis, concerning the level of service currently provided by the Water Revenue Bureau in comparison not even to best practices but rather to the general practice of commission regulated utilities. In his review, he examined the following components of PWD customer service: Deferred Payment Plans – Non-Low-Income; Water Revenue Conference Committee; Water Revenue Assistance Program (WRAP); Appeals and Disputes; Internal Compliance with Department Customer Service Regulations; Lessons from the Public Input Hearings; Basic Planning and Internal Improvement Processes. PA St.3, at 13-49.

In his investigation, Mr. Colton focused on areas where the evidence seemed to suggest that the problems encountered by customers were not merely "anecdotal," isolated and random occurrence resulting from the personality conflicts, misunderstandings, and bureaucratic snafues which can always occur in servicing almost half a million customers. His attention was drawn to

concerning the WRB's budget. Moreover, the PWD has been consistently representing that it operates in a cooperative mode with the Water Revenue Bureau. As set forth in the recent Official Statement, "In accordance with a 1992 agreement, both the Office of the Director of Finance and the Water Commissioner monitor collection of water and wastewater revenues. The cooperation between these two City agencies has improved reporting on revenue collections, implementation of monthly billing, collection of aged receivables by private collection agencies, and enforcement actions. Weekly meetings with the WRB and Water Department serve to maintain communications and enable prompt and direct response to issues involving both the WRB and the Water Department. Official Statement relating to \$345,035,000 The City of Philadelphia Pennsylvania Water and Wastewater Revenue Refunding Bonds, Series 2007A and Series 2007B, Appendix II, Final Engineering Report, at II-21 (Exhibit PWD-4,

areas where the PWD/WRB is not following its own regulations (dispute/appeal process; tenant customer provisions), where the PWD/WRB is not informing customers of the range of options permitted under the regulations (payment agreements, Water Revenue Bureau Conference Committee agreements) and where the processes and procedures, as well as results in the PWD/WRB's efforts to address the affordability issues of low income customers appear in his expert judgment are not sufficient to the task (WRAP program).

From this perspective, he states that the PWD/WRB "is either unaware of, or indifferent to, the full dimensions of its customer service obligation as a public utility." PA St.3, at 49. He concludes that there is there is significant cause for concern regarding PWD/WRB conduct, and that there is substantial room for improvement in the way in which the WRB delivers or fails to deliver customer service with respect to payment troubled customers. PA St.3, at 50.

C. The WRB Has Formally Recognized the Need for Improvement and Committed to Taking Positive Steps Toward Providing High Quality Service Assisting Customers to Obtain, Maintain and Restore Service.

In response to the Hearing Officer's request, the recently appointed Revenue Commissioner Keith J. Richardson, whose Revenue Department includes within it the Water Revenue Bureau, submitted Direct Testimony concerning the WRB customer service. PWD St. 6. He appeared at the hearings with the Deputy Revenue Commissioner, Michelle L. Bethel, appointed in July, 2008, who supervises all the functions of the Water Revenue Bureau, and who is Mr. Richardson's appointee. PWD St.6, at 2.

SI-8, Attachment 2).

Mr. Richardson testified that:

As part of my new involvement with the Bureau, I am undertaking a full review of customer services offered to make sure some are consistent with or on a path toward “best practices” for a municipal utility. I am 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 part of my review of WRB. Our shared goal is to achieve the highest level of customer service at the Bureau.

* * *

I envisage a full review of services offered by the Bureau (similar to an audit), with associated reforms to follow. This will not take place in a matter of days or in the context of hearings. It will be a much longer process. I invite the Public Advocate to participate in such a collaborative process so that the input of his constituents will be very much apart of reforms to be undertaken. That is why we have proposed to participate in mediation with the hearing officer to reach a reasonable consensus on next steps and a specific implementation plan for reform.

PWD St.6, at 3.

On the basis of previous discussions between PWD Deputy Commissioner Clare, Revenue Commissioner Richardson and counsel, in which the Public Advocate proposed the general outlines of a Customer Compact (Exhibit PA-3, at A-1 through A-10), the Revenue Commissioner present a list of areas to be addressed with the aim of making administrative reforms necessary to accomplish the objectives – “the highest quality customer service for water customers.” PWD St.6, at 3. In topical form, following Mr. Richardson’s direct pre-filed testimony, PWD St.6, at 4, those five areas were as follows:

1. Provision of straight-forward, understandable information about a customer bill in response to inquiry.

At the hearings, Mr. Richardson testified that his goal “hopefully” was to have programs in place by July 1, 2009 that would provide at least a rudimentary account history. He was not

familiar with the types of automated account histories provided by PGW and by PECO but intended to meet with PGW “hopefully” in September as part of the process of determining how to proceed toward this goal. Tr.581.

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.

At the hearings, under questioning, Mr. Richardson was not willing to say that “high quality customer service” involved specifically providing “reasonably continuous service without unreasonable interruptions” (the PUC standard contained at Public Utility Code Section 1501, 66 Pa.C.S. § 1501).Tr.584-586. When asked whether the WRB could commit to providing within thirty days a one page summary of payment agreement options to customers who come to the WRB, he stated that he would commit to developing such a summary and that it could “probably” be accomplished within the ninety day time frame. Tr.589.

3. Implementation of an informal dispute/review process with an immediate supervisor.

In the Advocate’s view, reasonable customer service requires that termination of service be stayed during the pendency of even an informal dispute. At the hearings, Mr. Richardson also committed to stay service terminations “while we are engaging the customer during a disputed issue.” Tr.590. If the dispute process became an appeal, either within the WRB, or to the Tax Review Board, the stay would continue until the matter was resolved. Tr.596, 597.

There is little benefit to a dispute process which does not result in more complicated and difficult questions being decided by supervisory personnel with the requisite knowledge to make a

decision consistent with law, regulation and common sense. Under questioning, Mr. Richardson was not willing to commit at this time for more training at the supervisory level on the more complex customer service issues. Those more complex issues concerns treatment of applicants for service, for payment agreements or for USTRA status, who were not record owners of their homes, but rather tenants, tenants in possession whose landlord is whereabouts unknown, lease purchasers, occupants with ownership interests like intestate heirs of unadministered estates and legatees of unprobated estates, and occupants whose claim to ownership was in dispute. Such training would ensure that these common problems are efficiently addressed in the most knowledgeable and appropriate way. Tr.593-596.

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.

At the hearings, Mr. Richardson committed to a time frame for implementation of this appeal process, stating however, that "I would hope to see something before this fiscal year is over to be in place as we are as a department not following the regulations that are in place currently and I want to make sure that we are in compliance with them." Tr.600.

5. Implement clear program guidelines for WRAP, e.g., requirements for WRAP should be clearly stated. Specific eligibility determination and program guidelines can be negotiated as a part of the proposed mediation process.

In his testimony, Mr. Richardson expanded on his view regarding the WRAP program:

my vision is in working with the Department, to market [the WRAP program] ...the two grant programs, the City grant and the Utility Emergency Services Fund, along with our WRAP program, because there may be more folks that we need to reach out there. We

need to take advantage of looking at the various customers that are getting funded through PGW's programs and LIHEAP and kind of make our program more user friendly; instead of asking for so much documentation, to make it a little bit more readily accessible....

Tr. 603. While not ruling out the creation of a "dedicated" unit to service WRAP participants, he emphasized that the entire Department should be focused also on assisting customers with regard to WRAP as well." Tr.604.⁴⁵ He expected to make serious progress on this initiative within six months. Tr.613.

Notwithstanding his recognition that WRAP is not serving all customers presently in need of this type of program, Mr. Richardson declined to commit to an enrollment target of 20,000 WRAP participants within twelve months. Tr.605. And he hesitated to make a commitment when asked whether the Department would adopt a policy of having its customer service representatives proactively provide information concerning WRAP certain classes of customers in clear jeopardy who contact the WRB for information or assistance. Customers in jeopardy would include those with proposed Sheriff's Sales for back water/sewer bills, those with pending or implemented water/sewer service terminations, those seeking payment agreements for outstanding balances greater than \$1200 while expressing an inability to pay, and those subject to WRB Municipal Court enforcement actions seeking personal judgments for back water/sewer bills. Rather, he suggested that a broader public relations campaign concerning WRB programs was sufficient to inform and educate customers concerning these programs, as if there was something inconsistent with pursuing both courses of action simultaneously. Tr. 607-612.

⁴⁵ In contrast, the Advocate's witness Mr. Colton recommended that the PWD/WRB undertake as one of the near term action steps the creation of a dedicated staffing section within the Department to address the customer service needs of "vulnerable customers," including but not limited to low-income customers. One of the roles of this

D. The Hearing Officer Should Recommend That Any Rate Order Be Conditioned Upon a PWD/WRB Commitment to Formally Recognize the Obligation to Serve Tenant Customers Without Unauthorized Preconditions Such as Payment of a Landlord's Outstanding Balance.

One critical part of the topics covered by the Advocate's original proposed Basic Consumer Contract, residential tenant applications for service where the customer is designated on the lease as responsible for water/sewer service, was not included in Mr. Richardson's testimony. The topic was particularly important, because failure to observe customer and applicant rights as set forth in the Water Regulations, is per se an indication of bureaucratic overreaching incompatible with quality customer service. Mr. Richardson was asked to acknowledge that the practice of refusing such a tenant application for service upon the grounds that the landlord owed an outstanding balance was not authorized by the Water Regulations. He declined to make such acknowledgment, indicating that he needed to be better informed by counsel and by the "City" concerning this issue. Tr.616. He was unwilling to commit to submit this issue to mediation. Tr.617. He further stated that he would have a response on this issue in "five to six months." Tr.616.

While Mr. Richardson's reluctance to commit himself on this issue may be understandable, in light of the fact that he may not have had sufficient time to gain a clear understanding of the legal issues involved, the Advocate submits that five or six months should not be required to understand the legal issue at stake. The PWD/WRB has stated unequivocally that it is authorized to refuse the application of a tenant whose lease requires him/her to assume

unit would be the enrollment of low-income customers into WRAP. PA St.3, at 56-57.

responsibility for water service, “on the grounds that the owner of the property has an existing outstanding balance for service to the tenant’s dwelling that the owner has not paid or arranged to pay.” PA-RDC-I-42 (Supplemental). That view is expressed in Tenant Customer Policy-Customer Service 5.10(v) provided in response to PA-RDC-I-42.

There is no basis for this position in law or regulation. As Mr. Colton points out with painstaking specificity, under the Water Regulations, the WRB “will” accept such a tenant as a customer so long as certain conditions are met (Water Reg. 100.2). Such a tenant is “qualified” to become a water/sewer customer unless s/he falls under an exclusive list of enumerated exceptions (Water Reg. 100.2(b)). Service “will be provided” to a tenant applicant who does not fall under the exclusive exception list (Water Reg. 100.2(d)(3)). An applicant who may be a tenant “shall be entitled” to be a customer unless s/he falls into the exclusive exception list (Water Reg.100.2(e)(1)). Nowhere among the enumerated exceptions to tenant eligibility can be found the requirement arbitrarily imposed as a matter of policy that the tenant’s landlord must not have an outstanding balance for service provided to the tenant’s dwelling. PA St.3, at 39-40. Moreover, no City ordinance or any other applicable law authorizes this denial of access to service to such tenants.

The effect of this policy is to place a tenant faced with potential termination of service in an untenable position which he/she could not reasonably have foreseen before paying a down deposit, a first and last month’s rent, and the expenses of moving into a residence. Few tenants have the resources to obtain a TRO or an injunction requiring a landlord to pay the bill; nor do they have the resources to pay the landlord’s bill themselves; nor should an illegal WRB policy

place them in that situation. By this policy, the PWD/WRB abusively shifts collection duties and the risk of non-collection from itself to innocent and isolated individual tenants. This policy also ignores the fact that the PWD is protected due to its ability to lien the property and to recover an allowance for uncollectibles through rates, protections no available to the unfortunate tenants.

E. The Hearing Officer Should Recommend That Any Rate Order Be Concurrently Conditioned on the PWD/WRB's Acceptance of Mr. Colton's Recommendations Concerning the Basic Consumer Compact, Development of a Customer Service Improvement Plan and Creation of a Customer Service Working Group

Despite Mr. Richardson's unwillingness to fully commit on certain issues, as discussed above, the Advocate submits that the PWD/WRB has given not a guarantee but at least sufficient assurance of its intentions and its ability to undertake a customer service improvement initiative in the WRB to take this case out of the D.C. Transit category, where any rate order should be denied, pending the implementation by the PWD/WRB of such an initiative. Both the Revenue Commissioner and the Deputy Revenue Commissioner appeared in this proceeding as a new Revenue Department management team in a new City administration. Their participation in this case has been a welcome occurrence, and is grounds for hope that significant progress can be made toward bringing some of the "new day" values of quality citizen/customer service to the Water Revenue Bureau. Mr. Richardson's commitment to submit the full range of issues that have been identified to mediation does not necessarily ensure that all the necessary improvements will be made, but it is a first step in a series of important steps that there is good reason to believe will be taken – all in the right direction.

Consistent with the testimony of Mr. Colton, the Advocate submits that the Hearing

Officer should condition his recommendations concerning any rate order in this case on several PWD/WRB actions regarding customer service:

(1) the PWD/WRB should submit all the issues raised by the Basic Consumer Compact, including issues related to tenant customers for mediation, focused not on whether measures will be taken to address the identified shortcomings of existing customer service, but what are the best measures suited to address the problems. Such mediation should be plenary, in that the mediation process should be available to the parties as other issues are mutually identified for discussion.

(2) the PWD/WRB, with the assistance of an outside consultant, shall undertake the development of a Customer Service Improvement Plan with appropriate performance goals, as set forth in the testimony of Mr. Colton in PA St.3 at 58-61, to address the full range of changes in policy, staffing levels, training, necessary technology, changes in processes and procedures and necessary financial resources.

(3) the PWD/WRB shall convene a Customer Service Working Group as set forth in the testimony of Mr. Colton in PA St.3 at 61-62. This Working Group should consist of the PWD and WRB, the Public Advocate, and other community based interested community-based stakeholders. The mission of this group shall be to make recommendations for customer service improvements both in the context of fulfillment of the Basic Consumer Compact and beyond the four corners of that Compact. The Customer Service Working Group shall be provided adequate financial resources for the Public Advocate to participate, with appropriate technical assistance, as well as financial resources for the WRB to retain customer service technical professional

assistance.

(4) the Public Advocate and the Hearing Officer have a duty to take the appropriate precautions to assure that the commitments that have been made will lead to actual immediate and near term improvements in PWD/WRB customer service, and that they will lay the foundation for the longer term measures which are necessary to fulfill the daunting task of providing high quality customer service to Philadelphia residential water customers, a significant percentage of whom are poor. Assessment of the PWD/WRB progress toward improving customer service can best be made in the context of a rate case, which tests how all parties to the regulatory compact have performed. The need to maintain the highest level of accountability for PWD/WRB is an additional reason to limit the rate order in this case to a two year order.⁴⁶

X. The PWD's Rate Design Follows Accepted Methodologies and Avoids Unreasonable Discrimination.

In general, on the basis of the review of this filing performed by the Public Advocate's expert witness Jerome D. Mierzwa, the Public Advocate supports the rate design that has been proposed by the PWD in this case – a rate design which follows accepted methodologies, avoids unreasonable discrimination, and is similar to that adopted in PWD cases. PA St.2 at 5.

However, two issues have surfaced in this case which require further comment. The first involves rates for the Philadelphia Housing Authority and the second, PWD rate proposals concerning

⁴⁶ In this connection, Mr. Colton recommends that the "PWD step rate increase, at a maximum, be limited to two years. At the time of the next rate filing, PWD should be required to file its compliance documents not only with respect to the Basic Consumer Compact but also with the intermediate actions.... This recommendation introduces fundamental accountability to PWD through the rate-setting process. It creates a reporting and review

public and private fire protection services.

- A. The Hearing Officer Does Not Have the Legal Authority to Recommend That PHA's Discount Be Increased from 5% to 25%.

The Philadelphia Housing Authority currently receives a 5% discount off the Water Department's service and quantity charges for PHA properties pursuant to Philadelphia Code Section 13-201(2)(f). In this proceeding, PHA requests that the Hearing Officer recommend that the discount be increased to 25%. PHA St.1, at 4. The PHA's request is based on the claim that PHA's primary funder, the US. Department of Housing and Urban Development (HUD) has cut the budgets of "PHA and other cities' and counties" housing authorities by more than 20 percent in the past six years.

The Public Advocate respectfully submits that the Hearing Officer is precluded by Water Regulations from making such a recommendation. Water Regulation 300.3(d) states that the Hearing Officer "has no authority, power, or right to make any ruling which is contradictory to these regulations, the Philadelphia Code, the Home Rule Charter, or the existing laws of the Commonwealth of Pennsylvania." Water Reg. 300.3(d). Moreover, the Water Commissioner himself does not have the authority to make a Rate Determination providing PHA with a discount greater than the discount that has already been provided by City Ordinance.

As the City Ordinance itself recognizes, just and reasonable rates must be non-discriminatory. That does not mean that discounts may never be granted or once granted, altered

process that cannot occur without going through a rate case at the conclusion of the two-year period." PA St.3, at 55.

in amount. However there must be adequate grounds to justify both the discount itself and the amount of the discount. In City Council, PHA should be prepared to why there is a sound public policy reason for shifting millions of dollars of costs from the federally funded PHA to the PWD's residential customers, a large portion of whom are low or lower income. PA St.3, at 23-24.

The Hearing Officer should therefore not recommend that the PHA discount be increased from 5% to 25%.

B. Public and Private Fire Protection Rates Should Not be Reduced Only to Be Soon Increased Above Present Levels.

As Mr. Mierzwa observes, the PWD proposes "to reduce the FY2009 rates for public and private fire protection service by 14.1 percent and 18.16 percent, respectively." In subsequent years, the rates are expected to rise so that by either FY2011 or FY2012, these fire service rates will exceed the current rates. Under these circumstances, the Advocate submits that it is more reasonable to leave fire service rates at current levels. If a rate period extending for only two years is approved, it would not be necessary to change the rates at this time. If a rate period extending for three or four years is approved, then fire protection service rates should be increased for the year in which the cost of service is not covered by current rates. The additional revenues generated between now and the time when the cost of service exceeds current fire protection rates should be distributed proportionately to reduce the rates of all other customer classes. PA St.2, at 7.

XI. Hearing Officer's Proposal.

It is clear from the record in this case that, contrary to the PWD's filing, there is no immediate need for a rate increase in FY2009, and that the post-FY23009 personal services costs and fringe benefits, which comprise a substantial portion of the Department's claim for increased revenues, will not be "known" for another year. It is also clear that due to the deficiencies of the PWD's rate making practices, the rates granted in the last rate case – 8.42% for FY2005, and 3.18% per year for FY 2006, 2007 and 2008 – were much more than were necessary, and resulted in over 75% of the incremental rates being deposited in the Rate Stabilization Fund, rather than being used for projected operating costs.

In these circumstances, the Hearing Officer has inquired how the Department would view a rate recommendation for the period FY2009 and FY2010, but "suspending the request for the third and fourth year with the understanding that once we have fiscal '09 and maybe six months of fiscal '10 figures, that we reopen the hearings at that point in time and look to the two fiscal years at that point in time?"(Tr.115-116)(hereinafter "Proposal"). In this Proposal, the reopening of the proceedings would not "require another rate case to be filed but it would allow the Commissioner to see a more recent snapshot and maybe everybody get a more reasonable look at the rates by just updating the information rather than a new filing." Tr.116; cf. 666-667. Under this Proposal, an update could occur without the need for a new cost of service study. Although the Hearing Officer does not so state, it would appear that FY2009 would continue to be utilized as the initial test year in this case, with expense projections adjusted in the light of actual data from FY2008, and fiscal year fund balances adjusted to reflect FY2009 actual results. The

Advocate assumes that the Hearing Officer would consider a review of progress made in the Water Revenue Bureau's customer service improvement initiatives at that time also.

The Advocate appreciates the Hearing Officer's acknowledgment that particularly under the circumstances of this case, the PWD's record appears to fall short of the minimum "known and measurable" requirements, especially due to the piling of estimates upon estimates in the out years. However, given the size and complexity of the PWD, which operates both as a water and wastewater utility, and the conservative nature of the City's budgeting and accounting processes, the Advocate believes that a rate order based upon two test years is the maximum that could conceivably satisfy the known and measurable standard which is the constitutional sine qua non for the fixing of "just and reasonable" rates. The Advocate submits that any rate order entered in this case should be based at the most on two test years. Any further rate increases should be based on a full review of a new rate case filing. Moreover, if a rate order was to be recommended on the basis of two test years, it should be understood that the PWD would not necessarily be required to file for increased rates to be implemented in FY2011, but would be free at its discretion, to delay the refiling as appropriate.

That having been said, the Advocate disagrees with the PWD's contention that the Proposal is "in direct contradiction with the Department's regulations" requiring that the Hearing Officer "use best and most timely efforts to conform the technical review hearings and related process to the time frames set forth herein to ensure that the Hearing Officer's Report ... is submitted 125 days from the submission of proposed changes in rates and charges to City

Council.”⁴⁷ What the Hearing Officer is obligated to do under this regulation is to make “best efforts” to submit a Hearing Officer Report within the 125 day time, a task which the PWD in this case has recognized as impracticable. The regulation does not preclude the Hearing Officer from making in that Report a proposal of the type at issue here. Needless to say, so long as the Hearing Officer submits his Report within the time frame required by Water Reg.300.8(b)(1) or, as in this case, exhibits the “best and most timely efforts” as reflected in a schedule accepted without objection by the PWD, he would not be in violation of Water Reg.300.3(d) requiring that his ruling be in conformity with the applicable charter, laws and regulations.⁴⁸

The PWD next argues that the Proposal would “run afoul” of Home Rule Charter Section 5-801 and Philadelphia Code Sections 13-101 and 13-201. However, nothing in Charter Section 5-801 addresses the time frame within which rates must be determined, and nothing in the Charter expressly authorizes fixing rates on multiple test years, instead of one test year. As for Philadelphia Code Sections 13-101 and 13-201, previously quoted in this Main Brief, they most certainly do not require that the Department’s revenue requirements be met “over a reasonable period of years.” The language of the ordinance is unequivocally and unmistakably permissive, stating only that “rates and charges may provide for sufficient revenue to stabilize them over a

⁴⁷ The PWD cites not to the current regulations, but the regulations as proposed in this filing, which contain the same provisions concerning the time frame for submitting the Hearing Officer’s Report and the limitations on the Hearing Officer’s authority. However, the proposed regulations number these provisions differently, 300.7(b) instead of 300.8(b)(1), and 310.2(d) instead of 300.3(d). Since the existing regulations, not the proposed regulations, are the ones currently in effect, we use the numberings contained in the current regulations.

⁴⁸ The PWD also claims that the alternate rate process that might be proposed could cause the PWD to be in default on its debt service, rate and insurance covenants. PWD Memorandum, at 4. The PWD has not cited and the Advocate has not discovered any provision in the General Bond Ordinance, Supplemental Bond Ordinances or insurance agreements which would bar the Hearing Officer from making his Proposal to the Water Commissioner and the Water Commissioner from accepting it.

reasonable number of years.”

Just as the PWD’s efforts to hedge in the Hearing Officer are without merit, so are the Department’s efforts to limit the scope of the Public Advocate’s advocacy. The Department argues that in an administrative proceeding, certain issues ultimately are subject to principles of res judicata, collateral estoppel, and by implication stare decisis. This argument is based mainly on the view that ratemaking is a quasi-judicial process. As the PWD states, citing Tennessee v. Elliott, 478 U.S. 788 (1986), in some circumstances, when an administrative agency “acting in a judicial capacity” (emphasis added) resolves an issue of fact, that finding has a preclusive effect on other litigation. PWD Memorandum, at 7. However, ratemaking has long been held to be quasi-legislative, not judicial or quasi-judicial. Arizona Grocery Co. v. Atchison, T.& S.F.Ry. 284 U.S. 370, 386-389 (1932); Cheltenham & Abington Sewerage Co. v. Pa. PUC, 344 Pa. 366, 25 A.2d 334 (1942); Pa. PUC v. Columbia Gas of Pennsylvania, Inc., PUR Slip Copy, at 10; 1991 WL 338320 (Pa.P.U.C.) In this ratemaking process, the Water Commissioner is conducting a rulemaking resulting in amendment to the PWD’s Regulations; the rights of an individual private litigant are not being adjudicated.⁴⁹ Moreover, what the PWD seeks to preclude is an argument concerning appropriate application of a constitutional standard, not a pure issue of fact. Res judicata, collateral estoppel, and stare decisis concerning the issues at stake in this case do not apply from one rate case to the next.⁵⁰

⁴⁹ Moreover, the claim that this case involves the “same parties” as the prior rate cases in which a Public Advocate has been appointed also misses the mark. PWD Memorandum, at 6. The residential customer class represented by the Public Advocate is not comprised of all the same customers as in 1993, 2001 and 2005, but includes new members and has lost other members..

⁵⁰ The Advocate recognizes that under Pennsylvania law, a utility may not repeat efforts to obtain

The grand finale of the Department’s spurious objections to the Proposal is a chamber of bureaucratic horrors – the possible need for a new RFP process for the appointment of a Hearing Officer and the Public Advocate, possible need for the Mayor, the President of City Council and the City Controller to approve those appointments, and added expense. PWD Memorandum, at 6, fn. 12. The Advocate submits that the purely bureaucratic hurdles would not be insurmountable, even if they actually were found to exist and to be unavoidable. As for the expense, given the very large amounts of money at stake, and the burdens in terms of millions of dollars that have been needlessly imposed on customers in the past, customers would gladly accept relatively small extra costs in order to get a final order, which in the words of the Philadelphia Code, will yield rates which are “not more” than reasonably necessary. Philadelphia Code, §§ 13-101(2)(b), 13-201(2)(b).

In conclusion, the Advocate submits that customers have a desperate need for an authoritative analysis of all aspects of this rate filing from an independent party who stands outside of the administrative and bureaucratic framework of City government. The Hearing Officer is appointed precisely because he is not part of the system, and able to identify a red herring(s) when he sees it. Although the Advocate submits that the Hearing Officer is required by law to recommend no more than a two year rate order, with no increase in the first year, it is clear that there are no legal impediments, let alone significant legal impediments, to the Hearing Officer’s Proposal.

recovery through the PUC for a particular, specific expense claim, recovery of which had been denied in a prior rate case. No utility or party, however, is barred from repeatedly proposing alternative ratemaking methodologies, to be

XII. Conclusion.

For all the foregoing reasons, the Public Advocate requests that the Hearing Officer make the following recommendations pursuant to the “just and reasonable” standard and other subordinate legal requirements:

1. As set forth in Section III, the rate order should determine rates at most for two years, with no rate increase for FY2009, and a rate increase of no more than \$11 million in FY2010.

2. As set forth in Section IV, any rate order which extends more than two years should require maximum annual use of the RSF consistent with levelized rates for the period beyond FY2009, and a Rate Stabilization Fund Balance which does not exceed the \$12-20 million range . Such order should also provide that year end residual fund balances and construction fund transfers should not exceed the levels projected in the PWD’s Table 11.

3. As set forth in Sections V, VI and VII, and summarized on Appendix 4, the Hearing Officer should recommend that the Public Advocate’s proposed expense adjustments be incorporated in any rate determination, whether for one, two, or more years.

4. As set forth in Section VI(A), footnote 27, the determination of any revenue requirement that might be issued in this case should not utilize growth factors applied to the Department’s FY2009 Capital Improvement Plan.

reviewed by the ratemaker for conformity with existing law and regulation as it evolves.

5. As set forth in Section VIII, the rate determination should be based upon collection factors of 86% for the current year, 9% for the first prior year, and 2.5% for the second prior year and beyond.

6. As set forth in Section IX:

(a) the PWD/WRB should submit all the issues raised by the Basic Consumer Compact, including issues related to tenant customers for mediation, focused not on whether measures will be taken to address the identified shortcomings of existing customer service, but what are the best measures suited to address the problems. Such mediation should be plenary, in that the mediation process should be available to the parties as additional issues are mutually identified for discussion.

(b) the PWD/WRB, with the assistance of an outside consultant, shall undertake the development of a Customer Service Improvement Plan with appropriate performance goals, as set forth in the testimony of Mr. Colton in PA St.3 at 58-61, to address the full range of changes in policy, staffing levels, training, necessary technology, changes in processes and procedures and necessary financial resources.

(c) the PWD/WRB shall convene a Customer Service Working Group as set forth in the testimony of Mr. Colton in PA St.3 at 61-62. This Working Group should consist of the PWD and WRB, the Public Advocate, and other community based interested community-based stakeholders. The mission of this group shall be to make recommendations for customer service improvements both in the context of fulfillment of the Basic Consumer Compact and beyond the

four corners of that Compact. The Customer Service Working Group shall be provided adequate financial resources for the Public Advocate to participate, with appropriate technical assistance, as well as financial resources for the WRB to retain customer service technical professional assistance.

(d) Formal assessment of the PWD/WRB progress toward improving customer service shall be made in the context of the PWD's next rate case.

7. As set forth in Section X, the Hearing Officer shall make no recommendation concerning PHA's request to increase its discount from 5% to 25%.

8. As set forth in Section X, public and private fire protections rates should not be reduced, and the additional revenues generated between now and the time when the cost of service exceeds current fire protection rates should be distributed proportionately to reduce the rates of all other customer classes.

9. Grant residential customers any other relief which is just and appropriate.

Respectfully submitted,

PHILIP A. BERTOCCI, ESQUIRE
THU B. TRAN, ESQUIRE

For the Public Advocate

September 9, 2008