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Philadelphia Water, Sewer and Stormwater Rate Board
c/o Ms. Marie McNeill
Philadelphia Water Department
1101 Market Street, Fifth Floor
Philadelphia, PA 19107

RE: Philadelphia Water Department's Response to the Hearing Officer's Initial Reports

Dear Hearing Officer Brockway and Members of the Rate Board:

This correspondence is submitted by the Philadelphia Water Department ("Department" or "PWD") in response to the Hearing Officer's Reports captioned "Standards for Ratemaking" and "Projected Revenues and Expenses" (both dated May 9, 2016) which were transmitted to the parties in connection with the Philadelphia Water Department Rate Proceeding (FY 2017-2018). The aforesaid Hearing Officer Reports are collectively referred to as the "Reports." This writing is proffered pursuant to the Scheduling Order and Philadelphia Water, Sewer and Stormwater Rate Board ("Rate Board") Regulation II.8 (a) and identifies various areas where corrective action is necessary before the Reports are finalized.[1]

Standards for Ratemaking

Numbered Paragraphs 6-10. The Standards for Ratemaking Report includes a legal discussion and various legal conclusions which exceed the parameters prescribed in the Rate Board's Regulations ("Regulations"). That is, Section I (j) of the Regulations narrowly defines the Hearing Officer's Report to include a "summary of all written information submitted and all testimony presented" in both the public input and technical hearings. The Report captioned above reaches well beyond this definition in offering a legal discussion and various legal conclusions. Moreover, the Report addresses issues raised in the due process memoranda previously filed by the Public Advocate ("Advocate") and the Department without acknowledging PWD's position that the instant proceedings are legislative as opposed to adjudicatory in nature.

Stated differently, references in the Report to the Administrative Agency Law and the "substantial evidence" standard (as having applicability here) suggests that the proceeding is adjudicatory

[1] Section II.8(3) states that within seven days of the issuance of the Hearing Officer's Report, any participant may file a letter with the Board to indicate that its position has been misstated, that a false impression was created or that an error or omission has been made, in which case such letter shall become a part of the Hearing Record.

in nature.[2] The Department disagrees and has detailed its reasons in its Response to Due Process Memorandum (dated February 9, 2016) which is attached to this letter and incorporated herein by reference. As noted in the Department's Response, the most recent precedent applicable to PWD rate proceedings would indicate that the proceedings are legislative in nature. See, *Public Advocate v. Brunwasser*, 22 A.3d 261, __ Pa. Cmwlth.__ (2011).

The Department maintains that, as written, the Report is overly broad and should be corrected by, at a minimum, striking numbered paragraphs 6-10. These paragraphs create a false impression that a reviewing court will view this proceeding as an adjudication and apply the substantial evidence standard (as opposed to a lesser "arbitrary and capricious" standard applicable to a legislative proceeding). PWD will defer to the City of Philadelphia Law Department for resolution of all legal issues, including ratemaking standards applicable to this proceeding.

Numbered Paragraph 11. The Standards for Ratemaking Report also misstates Section 13-101 in omitting "impacts" on customer rates. The applicable provision is restated below:

> In fixing rates and charges the Board shall recognize the importance of financial stability to customers and fully consider the Water Department's Financial Stability Plan. In addition, the Board shall determine the extent to which current revenues should fund capital expenditures and minimum levels of reserves to be maintained during the rate period. When determining such levels of current funding of capital expenditures and minimum levels of reserves, the Board shall consider all relevant information presented, including but not limited to, peer utility practices, best management practices and projected impacts on customer rates. The Board shall set forth any such determination in the Board's written report pursuant to this chapter. [Emphasis added].

In terms of a common sense reading of the above provision (which must be considered in the context of rate setting), the Department's Financial Plan is submitted of record and includes a summary of comments by rating agencies on the Department's above-average debt levels (PWD Exhibit 4 at 32) and a comparison of the Department's cash on hand with peer utility practices (*Id.* at 34); best management practices are addressed in the testimony of David Jagt, Melissa LaBuda and Katherine Clupper in this proceeding. Tr. 65; 72-73; 146 (2/22/16); and cash funded capital expenditures (pay-go financing) are addressed in the above testimony and referenced in the Department's Brief (pages 4-6). Ms. Clupper's testimony also explains why greater pay-go financing is beneficial to customers over time (PWD Statement 7 at 9 and 10). The Rating Agency reports attached to Ms. LaBuda's testimony document the common theme that the rating agencies view the Department's current debt levels as high and of heightened concern due to the new ratemaking board (See PWD Statement 2, ML Exhibit 2, Fitch Report at pages 1 of 4; Moody's Report at page 1-3 of 7 and Standard & Poors Report at page 3 and 4 of 7).

[2] See, *Blumenschein v. Housing Authority of Pittsburgh,* 379 Pa. 566, 573, 109 A.2d 331, 334–5 (1954), *appeal dismissed,* 350 U.S. 806, 76 S.Ct. 68, 100 L.Ed. 724 (1955).

Projected Revenues and Expense

General Comments – The Projected Revenues and Expenses Report correctly indicates that, at the Board's direction, Black & Veatch will run the rate model to inform the Board of the impact of the various scenarios they may wish to evaluate. Given the intricacies of the rate model, it would be prudent to run the assumptions prior to voting on a final scenario to adopt for the rate decision in this case. As indicated in the Department's Brief and Proposed Findings of Fact, Mr. Morgan's proposed adjustments were prepared independent of running the rate model and the summary of the impact of such adjustments (prepared by Mr. Morgan and provided with the Report) is not the best guide of actual revenue/revenue requirement impact in this case.

Associated Pension Costs – The Projected Revenues and Expenses Report indicates an absence of clarity as to where pension costs are addressed by the participants in their respective briefs. Please note that the Department's proposal for additional pension costs, pension obligations and benefits tied to new staffing are addressed in the Department's Proposed Findings of Fact at 77; and 186-190. The Advocate advanced the position that these costs should be excluded from proposed revenue requirements. See, PA Hearing Exhibit 1.

Decision Matrix Exemplar

The decision matrix below is an example as to how the Rate Board might organize the various issues to be decided to facilitate a decision (vote) as to each one. This is simply an illustration. Most of the major adjustments are included below (obviously more can be added).

Decision Matrix

Description of Adjustment	Department Position	Public Advocate Position	Rate Board Resolution
Liquidated Encumbrances	PWD uses recent experience to project Class 200 and 300 liquidated encumbrances using a 12% factor. Use of recent experience is appropriate because FY 2013-2014 policy shift (atypical event) caused spike in liquidated encumbrances. The Advocate's recommended use of three year historical average, including period during which policy shift occurred, skews (biases) the result. *See, PWD Proposed Findings at 133-142.*	The Advocate proposes use of three year historical average (FY 2013-2015) including the period identified by PWD as atypical. Use of this average yields a 19.23% liquidated encumbrance factor. *See, PA Summary of Adjustments at 2; PA Statement 1 at 31-32.*	
Revenue Growth Rate	The Department maintains that the use of a three year average is inappropriate for the projected decrease in billed volume for 5/8-inch meter General Service customers because of the annual volatility in the average usage per	The Public Advocate proposes to use a three year historical average (FY 2013-2015) of 0.05% in projecting the projected decrease in the average sales volume per account for 5/8-inch General Service customers. *PA Statement*	

	account (due to climate and customer usage patterns). *See, PWD Proposed Findings at 143-146.*	*1 at 18.*	
Payroll Spend Factors	PWD payroll spend factor is premised upon the fact that vacancies have already been taken into account in the budget process. The Advocate's adjustment erroneously concludes that all vacancies are assumed to be filled in the rate filing. *PWD Proposed Findings at 147-153.*	The Advocate recommends that a three year historical average FY 2013-2015 should be used to project payroll expenditures for the Rate Period. This adjustment is based on the assumption that that PWD projected that all vacant positions would be filled during FY 2017-2018 (by use of a 100% spend factor). *PA Summary of Adjustments at 2; PA Statement 1 at 23.*	
Billing Adjustment	The Department maintains that the use of a billing adjustment factor is a reasonable factor of safety to provide a small allowance for potential negative impacts to the various assumptions included in the projection of revenue from service billings including projected billed volume per account, customer usage patterns (billed volume distribution), and collection factors. *PWD Proposed Findings at 154-159.*	The Advocate recommends the elimination of the Billing Adjustment Factor. *PA Summary of Adjustments at 2; PA Statement 1 at 19.*	
Additional Adjustments			
WRAP	City Grants are provided to low-income households that qualify for the WRAP program and need assistance to pay-off accumulated arrears. These grants were not incorporated in prior budgets and are only applicable to FY 2017 (last year of the program). The projected *contra revenues* reflected in the rate filing are vital to vulnerable customers (in FY 2017) pending the implementation of the new Affordable Rate Program in the following fiscal year. *PWD Proposed Findings at 160-169.*	The Advocate recommends the elimination of projected *contra revenues* in connection with City Grants that support the WRAP program. It quantifies the revenue impact of its adjustment at $4.0 million, assuming the costs were historically captured in the operating budget. *PA Summary of Adjustments at 2*.	
SMIP/GARP	SMIP/GARP are programs needed to comply with requirements under the COA entered into with the PaDEP which prescribes interim milestone requirements at five and ten years. The Department is "on course" to meet or exceed its first five year interim milestone requirements. This first five year interim milestone requires 744 greened acres. By year 10 of the COA, a significantly higher greened acre threshold is required (2,148 greened acres). Penn Future and PLUG support planned expenditures for SMIP and GARP. *PWD Proposed Findings at 170-178.*	The Advocate recommends the elimination of additional SMIP/GARP grants needed to assist customers with stormwater management. *PA Summary of Adjustments at 3*.	

CSO Reimbursement	The CSO reimbursement is contractually required under the Sugarhouse tax settlement agreement. Under Section 10 of the agreement, Sugarhouse is entitled to offset, against its tax settlement payments, the costs of its work on the former Laurel Street Combined Sewer Overflow. The revenue requirements associated with this adjustment are $1.8 million and $3.5 million in FY 2017 and 2018, respectively. This revenue requirement is contractually required; and PWD is obligated to make the General Fund whole for the amount of the offset. *PWD Proposed Findings at 179-185.*	The Advocate recommends the elimination of revenue requirements associated with the planned reimbursement of the General Fund for an upfront payment for a combined sewer outfall. *PA Summary of Adjustments at 3.*	
Additional PWD Staffing	PWD indicates that additional Department staffing is required during the Rate Period for a variety of reasons such as (1) adding an accountant position in the Finance division; (2) adding a construction projects technician, executive assistant and head of security for the Human Resources and Administration division; (3) adding staff for the Planning and Environmental Services division to address increasing regulatory requirements; (4) additional staff at Planning & Engineering for the sewer lateral inspection program; and (5) additional staff position at Public Affairs for a Creative Affairs Director. A summary of supporting detail for these staffing decisions is provided in PWD Hearing Exhibit 4 at 1. The supporting detail describes operating needs to run a particular division of the utility (e.g., adding staff to support financial planning and assist with feasibility studies and long range planning). *See, PWD Proposed Findings at 186-190.*	The Advocate recommends that all revenue requirements for additional Department staffing be rejected as unsupported in the record. *PA Summary of Adjustments at 2.*	
Engineering Expenses	The additional revenue requirement associated with Engineering Expenses ($1.1 million – FY 2017-2018) is needed to properly identify PWD infrastructure in the right of way. PWD is required to physically mark the location of utility underground infrastructure (PA Act 287). This work is currently performed by survey crews together with their work closing out capital public works projects. *PWD Proposed Findings at 191-196.*	The Advocate recommends that costs for "mark out" of water and sewer infrastructure prior to excavation be eliminated. *PA Summary of Adjustments at 2.*	

Escalation Factors	Finance Division Class 800 expenditures are primarily staffing costs (excluding the CSO reimbursement discussed above) and should be escalated like Class 100 expenses. The Class 100 escalation factor (3%) is based upon the recently negotiated labor agreements and was not contested by the Advocate. This adjustment is therefore inconsistent with its position with regard to Class 100 expenses. The Advocate also over-estimates the value of this adjustment (claiming a downward adjustment of $1.5 million and $3.6 million in FY 2017 and 2018, respectively. The actual value of this downward adjustment is $65,452 and $134,176 in FY 2017 and 2018, respectively. *PWD Proposed Findings at 197-204.*	The Advocate recommends a downward revision in the Finance Division Class 800 expenses. Public Advocate witness Morgan recommends a 2% escalation factor based upon the GDP-PI index. *PA Summary of Adjustments at 2.*	
Contributions/Indemnities	PWD proposes that a 100% spend factor should be utilized for Contributions/Indemnities expense based upon recent experience. This revenue requirement is particularly important because the Department is self-insured (i.e., 100% funding is required to address abatements and other customer service requirements. See, Tr. 41-44 (4/6/16). In advancing this adjustment, the Advocate again ignores Mr. Morgan's admonition about the use of three year historical averages when there are atypical events in the period chosen to calculate the average. In this instance, the atypical event took place in 2015 when claims were not timely processed (yielding $3.8 million in Indemnities expense compared to the $6.5 million budgeted). See, PWD Exhibit 5 at 17. In addition, legislation pending before City Council (to assist homeowners with abatements following water main breaks) will only increase Indemnities expense. Tr. 49-52 (4/6/16). Finally, the level of claims in FY 2016 suggests that PWD could exceed the budgeted levels $6.5 million by fiscal year-end (unless settlements are administratively paused until FY 2017). Taken together, the foregoing suggests that a higher claims experience can reasonably be	The Advocate recommends a downward adjustment in Contributions/Indemnities spend factor. Public Advocate witness Morgan notes that historically PWD has averaged approximately 77% of the budgeted amounts for this category of expense (utilizing historical three year average – FY 2013-2015). Applying this percentage to the revenue requirement for FY 2017 and 2018 yields a $1.5 million reduction in each year. PA Summary of Adjustments at 3.	

	expected during the Rate Period. *PWD Proposed Findings at 205-219.*		
Bond Interest Rate	An interest rate of 5.25% is projected by PWD in the rate filing. New money bond issues are planned for FY 2017 and 2018 (in the amounts of $270 million and $275 million, respectively). PWD Exhibit 5 at 10. It should be noted that the Department's interest rate assumption is in-line with projected interest rates used by the Office of the City Treasurer for the Rate Period. Moreover, debt service is calculated in the rate filing to reflect calculated savings from the issuance of Series 2015B Bonds. The Department maintains that no further adjustment is warranted. *PWD Proposed Findings at 220-227.*	The Advocate recommends a 5.0% interest rate assumption. PA Statement 1 at 32-33. The proposed adjustment would result in a reduction in the projected interest rate for future bond issues (during FY 2017-2018) to reduce the revenue requirement by some $675,000 (according to its calculation). *PA Summary of Adjustments at 3.*	
Inter-Departmental Charges	PWD maintains that additional Inter-Departmental costs are required to provide (1) additional Water Revenue Bureau staffing and office space in support of the Affordability Program and (2) additional City Finance pension, pension obligation, and benefit costs for the additional Department and Inter-Departmental staffing. See, PA-ID-8; PA-EXE-145. Additional WRB staffing and office space are for the Affordability Program. PA-ID-13; PWD Hearing Ex. 4. Additional staffing and space are required to meet the needs of the new program while existing staff continue to support the existing WRAP and other WRB daily operations. Costs for pension, pension obligations and benefits associated with planned additional staffing are included in the rate filing. Detailed workpapers in support of this revenue requirement are provided in the response to PA-EXE-145. The pension, pension obligation and benefits for additional staffing are based on the ratios of the projected annual Total Water Fund pension, pension obligations and benefit costs to the projected total annual Water Fund salaries and wages (Class 100). PWD Hearing Exhibit 4 at 3.	The Advocate recommends that all revenue requirements for additional Inter-Departmental Charges be rejected. PA Summary of Adjustments at 3.	

	These additional costs are necessary for, among other things, the successful implementation of the new Affordability Program. *See, PWD Proposed Findings at 228-235*.		

Please note that the above response will be supplemented upon the submission of subsequent reports of the Hearing Officer. Thank you for your attention to this matter.

Respectfully submitted,

/s/ Andre C. Dasent

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