NORMALIZATION

PUBLIC ADVOCATE

The Advocate posits that at least two expense categories in the 2018 rate case consist of non-recurring or extraordinary expenditures: Rate Case expenses and TAP implementation costs. PA Brief at 85, 87.

The Advocate states that, at least with respect to normalization, PWD's proposed 2018 Rate Case departs from accepted ratemaking practices, as Mr. Morgan explains:

> It is normal accepted ratemaking practice for utilities to amortize or normalize non-recurring or extraordinary expenditures both on their books and for ratemaking purposes. The rationale is to spread cost over the periods that benefit from the expenditure or to prevent over collection of costs. For example, the expenses incurred for presenting a rate case (legal, consultants, etc.) are usually amortized (or normalized) to reflect a reasonable filing period between rate cases.
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> PA Brief at 83, citing PA St. 1 at 10:2-7.

In substance, avers the Advocate failing to normalize non-recurring expenses, which are incurred in one fiscal year, but included in projected O&M expenses for all future years, permits PWD to charge customers multiple times for costs that it only incurs once.

The Advocate argues that PWD's explanation that it cannot normalize these expenditures, because under the accounting rules applicable to PWD, "expenditures are recognized and recorded as expenses at the time they are paid or encumbered," is without authority. PA Brief at 83-84, citing PWD St. 1R 12:7-8. Rather, the PA asserts, "sound utility ratemaking practices" that the Board must follow in developing rates and charges, Phila. Code §13-101(4)(b)(ii), takes precedence in this rate case despite the Department's cash accounting method for planning and managtement. According to the Advocate, the Philadelphia Code does not require that the Board set rates that yield 100% of all of PWD's O&M expenses in each fiscal year. Rather, it requires that rates and charges be "such as shall yield" sufficient revenues for PWD's operations. PA Brief at 84 citing Phila. Code §13-101(4)(a). The Advocate argues that this language authorizes and empowers the Board, for ratemaking purposes, to normalize expenses to avoid their duplication in rates while nonetheless ensuring that PWD's rates are adequate *over time* to fund operations. *Id.*

The Advocate asserts that PWD's claim that it cannot, for ratemaking purposes, normalize or amortize nonrecurring expenses is fundamentally at odds with the explicit recognition in the Philadelphia Code that accumulated reserves are available to "stabilize rates." *Id.*, citing Phila. Code §13- 101(1)(c). The Advocate explains that General Bond Ordinance established the Rate Stabilization Fund, directing that amounts accumulated in that fund can be transferred to the Revenue Fund for purposes of contributing to revenues available for operating expenses. *Id.*, citing PA-I-21(Attachment 1) (definition of "Net Revenues"). According to the Advocate, the Rate Stabilization Fund exists, in other words, in order to "stabilize rates and revenues and expenses that are out of alignment temporarily until they get back into alignment." *Id.*, citing 5/14 Tr at 265:1-3. Under PWD's theory, asserts the Advocate, the Board should permit PWD to recover multiple times for the same expense, completely disregarding the purposes of the Rate Stabilization Fund. *Id.*

The Advocate argues that PWD's claim that it has somehow taken into account, for budgeting purposes, the non-recurring nature of expenses in prior fiscal years when projecting its budget for successive fiscal years, is without any support on the record of this proceeding. *Id*. at 85. The Advocate points out that PWD's FY 2019 Budget has not been finalized, and its FY 2020 and FY 2021 Budgets have not even been contemplated, and therefore there is simply no support whatsoever for "the premise that PWD's non-recurring expenses in its base year have somehow been shifted, for purposes of projecting future rates, to compensate for other non- recurring expenses anticipated in future years." *Id*.

Ultimately, argues the Advocate, failing to normalize expenses for ratemaking purposes violates the fundamental precept that rates be cost-based. *Id.* The non-recurring expenses pointed out by the Advocate occur one time. *Id*. Charging customers for them over each forecast test year is impermissible because PWD has not identified the applicable cost-basis for them in each of the forecast test years. *Id.*

1. Rate Case Expense

The Advocate states that PWD's estimated rate case expense is a non-recurring cost which should be normalized for ratemaking purposes. *Id.* The Advocate cites the testimony of witness Morgan:

> PWD has estimated the total cost of this proceeding to be $3,188,000 which is included in the FY 2018 budget (PA-IX-23). I am recommending that rate case expenses be normalized over 2 years. Rate case expenses are incurred as a result of the Department filing to increase rates and not a normal cost that is incurred annually. It is standard ratemaking procedure that since these costs are not incurred every year, they should be normalized over the benefit period to avoid an overcollection of the cost. Also, given that I am recommending a two-year rate increase, this approach is consistent with the period over which the rates from this proceeding will be in effect.
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> PA St. 1 at 30:14-21.

The Advocate disputes PWD's claim that it could experience a revenue "shortfall" as a result of Mr. Morgan's normalization recommendations. *Id*. PWD acknowledges, however, that in so asserting, it completely ignores the existence of the Rate Stabilization Fund. *Id.*, citing 5/14 Tr. at 90:4-92:17. The Advocate notes that the substance of PWD's concern is that, in the year in which rate case expense is incurred, the revenues may not completely align with that expense. *Id.*, citing 5/14 Tr at 92:4-9. The Advocate points out that stabilizing rates despite the temporary misalignment of revenues and expenses is one of the purposes served by the Rate Stabilization Fund. *Id*, at 86. The Advocate further argues that, by normalizing rate case expense over the anticipated period between rate cases, PWD would fully recover that expense, and that PWD acknowledges this to be true. *Id.*, citing 5/14 Tr. at 96:1-7.

The Advocate also challenges PWD's further contention that, although described as rate case expense, the one-time projected cost should be included in all projected rate years because, in effect, PWD may spend it on something else. *Id.* The following back and forth, from the May 14 Technical Hearing demonstrates that PWD has simply projected its anticipated rate case expense into future years, without identification of what non-rate case services will be required or compensated for:

> [PWD Witness] … When we talk about rate case cost, the costs that are budgeted and projected for 2019 are the costs that are expected to be incurred in 2019. And then if there is a cost that is projected for 2020, that 2020 is the cost that we expect to incur for 2020. Now, is it exactly for rate case? It may not be exactly for rate case. It is for services that the same team of people that -- an example of a rate case is the same people are -- same group of consultants are going to be providing services, because they have already been selected for multiple years to provide services.
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> [Public Advocate] But have you identified those costs for fiscal 2020 at this time, what those costs would be?
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> [PWD Witness]: The costs are identified on the basis of projection, based off of the 2018 figures.
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> 5/14 Tr. at 96:16-99:3.

At page 87 of the brief, the Advocate sets out PWD's rate case expenses, which are included in the FY 2018 budget and utilized for purposes of projecting rates for FY 2019-2021, as shown in PWD's response to Public Advocate discovery (PA-IX-23):

Rate Proceedings Expenses and Proposed Expenses

Water Rate Board		2016 Rate Proceeding Expenses ($)		2018 Rate Proceeding Budget ($)
Hearing Officer		62,000		61,980
Board's Technical Expert		32,000		76,180
Public Advocate		300,000		325,000
Board's Counsel and Personnel		9,000		120,000
Court Reporting		17,000		25,000
Remaining Budget TDB		-		361,840
Sub-total	$	420,000	$	970,000
Water Department Consultants and Experts				
Cost of Service, Rate Design, Billing System Reporting , Testimony		1,300,000		1,043,000
Cost of Service Reporting (1)				200,000
Financial Advisory		55,000		55,000
PWD Outside Rate Counsel (2)		160,000		170,000
City Personnel Cost (3)		695,000		750,000
Sub-total	$	2,210,000	$	2,218,000
TOTAL	$	2,630,000	$	3,188,000

(1) Cost of Service Reporting was included as Billing System Reporting in 2016 Rate Proceeding

(2) Includes Bond Council

(3) Estimated Amounts used for City Personnel Cost

Of the total rate case expense budget, $3,188,000, Advocate witness Mr. Morgan identifies that, [with the exception of $361,840, the amount designated as "Remaining Budget TBD"], the entire udget clearly relates solely to the functions to be performed in this 2018 Rate Case. *Id.* The Advocate points out that, after the conclusion of this proceeding, none of the specifically identified expenses will recur. *Id.* Accordingly, for ratemaking purposes, the total amount to be normalized over the rate period selected by the Board should be $2,826,160. *Id.* If normalized over two years, this results in a downward expense adjustment of $1,413,080 for FY 2019 and FY 2020. If normalized over three years, the Advocate explains, this results in a downward expense adjustment of $1,884,107 for FY 2019, FY 2020 and FY 2021. *Id.*, citing PA TR-17 (Appendix B). The Advocate notes that this amount may be subject to even further adjustment, since the Black & Veatch rate model would also take into account potential spend and/or expense escalation factors. *Id.*, at 87-88.

2. TAP Implementation Costs

The Advocate argues that TAP Implementation Costs are similar to the 2018 Rate Case Expense, and should be normalized. *Id.* at 88. The Advocate points out that PWD's FY 2018 budget, upon which its fully projected test year expense assumptions are based, includes substantial expenditures for the implementation of the Tiered Assistance Program (TAP). *Id.* As Mr. Morgan explains:

> The FY 2018 budget includes an increase of $1,569,366 in contracted services related to the Tiered Assistance Program (TAP) and other regulatory matters. The Department explains that $1,100,000 of this total represents costs related to the WRAP/TAP implementation cost, bond engineering, affordable rate studies and reporting. I am recommending an adjustment to normalize the $1,100,000 over a 2-year period. The implementation of the TAP program is a non-recurring event. Therefore, the inclusion of

> the full costs in rates as a normal recurring cost would result in an overstatement of expenses.
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> *Id.*, citing PA St. 1 at 31:20-32:2.

The fundamental PA arguments, for and against normalization of this expense, are essentially the same as those discussed regarding Rate Case Expense. *Id.* However, unlike Rate Case Expense, "implementation" of TAP has already occurred, and will not recur, per the Advocate. *Id.*, citing 5/14 Tr. at 106:5-9. According to the Advocate, then, although PWD claims it has identified additional expenses for the implementation of TAP, in excess of those included in its FY 2018 Budget, those expenses have not been included in the FY 2018 Budget assumptions upon which rates are forecast. *Id.* citing 5/14 Tr. at 104:8-17.

The Public Advocate states that its recommendation takes into account that, with a new program, adjustments to TAP may be necessary during the period between rate cases. *Id.* Again, however, PWD has identified no specific costs associated with "implementation of TAP" during FY 2019, FY 2020 or FY 2021. *Id.* However, the Public Advocate acknowledges that, it is appropriate to account for some incremental expense associated with refining PWD processes and administration of TAP, in light of the PA's recommendations concerning program modifications, and to continue to support modifications to the TAP program as may be necessary. *Id.* For this purpose, the Public Advocate proposes the normalization of the $1,100,000 implementation costs as reasonable and necessary, to take into account those improvements to TAP which the Board should order as part of this proceeding, and the work to be accomplished by PWD prior to its next rate proceeding. *Id.* at 89. If the $1,100,000 implementation cost is normalized over two years, the result is a $550,000 downward expense adjustment. *Id.*, PA St. 1 at LKM-2. If that cost is normalized over three years, the result is a $733,333 downward expense adjustment. *Id.*, citing TR-17. As with rate case expense, the Advocate notes that this amount may be subject to further adjustment, since the Black & Veatch rate model would also take into account potential spend and/or expense escalation factors. *Id.*

THE DEPARTMENT

The Department states that it anticipates incurring Rate Case Expenses and TAP Implementation Costs in each of the proposed FPFTYs. PWD Brief at 41. With regard to rate case expense, the Department states that the costs that are budgeted and projected for FY 2019 are the costs that are expected to be incurred in that year. *Id.*, citing Tr. 96 (May 14, 2018). As budgeted, the category of expense characterized as "rate case" expenses by the Advocate are <u>not</u> limited to expenses incurred in the preparation or presentation of this rate proceeding. *Id.* The Department posits that this is self-evident "by the simple fact that costs related to this rate proceeding are being incurred throughout the Rate Period." *Id.*

According to the Department, this category of expenses, rather than being limited to expenses incurred for this rate proceeding, is actually related to ongoing expenses for the same teams of people/consultants who are providing (and will continue to provide) other services to the Department. *Id.*, citing Tr. 254-255 (May 14, 2018). Many of the consultants have been selected (and contracted) to provide such service over multiple years. Between rate proceedings, the

Department states, it does rate-related tasks that it cannot do during a rate proceeding. *Id.*, citing Tr. 255 (May 14, 2018). According to the Department, those tasks are "captured" in the same accounting category as more traditional rate case expenses. *Id.*

With regard to TAP implementation costs, the Department avers they are ongoing annual expenses and are expected to continue throughout the life of the program. *Id.*, citing Tr. 104 (May 14, 2018). The Department also notes that there are still parts of the program that need to be fully-implemented. *Id.,* citing Tr. 105-106 (May 14, 2018). According to the Department, a major component, and specific driver, of continued "implementation" costs is the requirement to have electronic applications. Tr. 104 (May 14, 2018); Response to Transcript Request ("TR") 12. This requirement is ongoing and will continue in the test period, according to the Department, stating that electronic application cost alone is $3 million dollars. *Id.*, citing Tr. 104 (May 14, 2018). In addition, the Department notes, the TAP ordinance contains certain reporting requirements that require tracking of applications, and the way WRB obtains those tracking metrics is through bar-coded applications. *Id.*, citing Response to TR-12.

The Department says that, to be clear, the level of these expenses in each FPFTY reflects the anticipated level of these expenses on a normal/ongoing level for that FPFTY. "Simply put, each of these expenses is an ongoing annual expense." *Id.*

For these reasons, the Department argues that the Public Advocate's normalization (amortization) proposal should be rejected. The Department cites the AWWA manual for the proposition that normalization (or amortization) is done to account for conditions not expected to continue during the FPFTY. *Id.*, at 42, citing AWWA Rate Manual at 10. The Department continues that normalization is <u>not</u> appropriate to normalize the Department's costs between the separate FPFTYs presented in this proceeding. *Id.*

From a ratemaking perspective, each FPFTY is set using the cash needs approach. *Id.*, citing the AWWA Manual at 12. The Department explains that this means that each FPFTY measures the revenue requirement to provide the total revenues required by the Department to meet its cash expenditures in that FPFTY. *Id.* The Public Advocate's proposal would do <u>significantly less</u> than that according to the Department. Stated differently, the normalization proposed by the Public Advocate would only provide a portion of the funds to cover anticipated expenses: half if a two-year period is adopted or one-third if a three-year period is adopted. *Id.* The Department argues that this could lead to a revenue shortfall. The Public Advocate does not provide adequate funds in the first FPFTY (2019) to pay for all of the costs incurred in that year and would not provide any additional funds for ongoing expenses during 2020 and 2021 FPFTYs. *Id.*

The Department asserts that acceptance of the Public Advocate's normalization proposal would force the Department to either use funds allocated for other expenses to pay for these expenses or operate at deficit for these expenses. *Id.* The Department argues that neither option is a reasonable outcome. *Id.* In addition, the COS study effectively reflects a normalization of these costs, since PWD budgeted costs are adjusted by actual-to-budget factors based upon historical experience; and RSF transfers mitigate/levelize the need for additional revenues during the Rate Period. *Id.*, at 42-43.

RECOMMENDATION

The Department's arguments are internally inconsistent. On the one hand, the Department says that each FPFTY measures the revenue requirement to provide the total revenues needed in that year to meet its cash requirement, and that normalization would force the Department to operate at a deficit (or use funds allocated for other expenses). On the other hand, the Department argues that the COS study effectively reflects a normalization of these costs, since, among other things, RSF transfers mitigate and levelized the need for additional revenues. This latter observation is precisely the point made by the Public Advocate - normalization spreads the cost over time so as to avoid requiring consumers to pay for 100% of a non-recurring cost in one year, and to avoid double or triple recovery of the same cost if continued past the year of incurrence. The RSF is intended to enable precisely this smoothing of revenue collections.

As to the Rate Case expense, the Department's explanation of the uses to which such funds are to be put in the years following the incurrence of the Rate Case expense itemized in response to PA-9-23 is unpersuasive and incomplete. First, the Department says the Board should pay no attention to the label "rate case expense," because in the rate years proposed here there would not be the same costs, but there would be others performed by the same contractors. Use of the term "rate case expense," then, is at least confusing. The Department also fails to provide sufficient detail about the activities in the near term of the persons and firms whose expenses were reflected in the FY 2018 budget to determine if indeed the costs they will reasonably impose on the Department are comparable, if not equal to, the actual rate case expense. The Public Advocate reasonably excepts the "remaining budget TBD" from the normalization, in recognition that these are apparently incremental costs not driven by the rate case. The balance, $2,826,160, should be normalized over two years. This results in a downward expense adjustment of $1,413,080 for FY 2019 and FY 2020. This amount, $1,413,080, should be dropped from the revenue requirement if the Board authorizes rates for FY 2021. If the Department prefers, the $2,826,160 could be normalized over three years, resulting in a downward expense adjustment of $1,884,107 for FY 2019, FY 2020 and FY 2021. The Department will not experience a deficit once the amortization is complete. In the meantime, as the Department itself acknowledges, it has the RSF available to cover the temporary mismatch, if such exists.

The Department's picture with regard to TAP implementation costs is similarly unclear. The Advocate agrees that there will be continuing implementation costs. The Department has not sufficiently identified them, however. Particularly if the Department wishes to base rates on a fully projected test year, it bears the responsibility to show what costs will in fact be incurred. That the Department states it will incur electronic application costs alone of $3 million, a figure three times the approximately $1 million at issue in this adjustment, does not clarify the situation. It is not clear the extent to which the application development is a capital cost, as opposed to an expense, for example. The Department wishes the Board to approve a budget-based revenue requirement for a future year, it needs to provide a clearer picture of the activities and their associated costs. In this context, the Advocate's recommendation of a two- or three-year amortization of the entire FY 2018 budget for implementation is a reasonable adjustment.