RULES AND REGULATIONS

Title 31—INSURANCE

INSURANCE DEPARTMENT

[31 PA. CODE CH. 163]

Requirements for Funds Held as Security for the Payment of Obligations of Unlicensed, Unqualified Reinsurers

The Insurance Department (Department) adopts Chapter 163 (relating to requirements for funds held as security for the payment of obligations of unlicensed, unqualified reinsurers) to read as set forth in Annex A.

Under statutory insurance accounting principles, an insurer is permitted to reduce its liability or reserves for losses that are reinsured. When a reinsurer is neither licensed by the Department to transact insurance business in this Commonwealth nor included on the Department's list of qualified reinsurers, the obligations of the reinsurer must be secured in order for the ceding insurer to be permitted to take accounting credit for the reinsurance in its financial statements. These regulations establish minimum requirements for trust agreements, letters of credit and other forms of security acceptable to the Department for credit for reinsurance with unlicensed, unqualified reinsurers.

Statutory Authority

These regulations are adopted under the authority of sections 319—319.2 of The Insurance Company Law of 1921 (act) (40 P. S. §§ 442—442.2)

Comments

Notice of proposed rulemaking was published at 26 Pa.B. 996 (March 9, 1996) with a 30-day public comment period.

No comments were received from the standing committees. Comments were received during the 30-day public comment period from The Insurance Federation of Pennsylvania, Inc. (IFP). On May 8, 1996, the Independent Regulatory Review Commission (IRRC) submitted its comments and recommendations to the Department. The following is a summary of the comments and the Department's response in its final rulemaking.

1. *Substitution of Assets*

Section 163.6(b) (relating to requirements for assets held in trust accounts) requires prior written instructions from the beneficiary for each individual substitution or withdrawal of assets in a trust account for the following transactions:

- A substitution or withdrawal that occurs within 6 months of the date the trust account is funded.

- A substitution or withdrawal that, combined with other substitutions or withdrawals made within the preceding 12 months, exceeds 50% of the total fair market value of the assets in the trust account.

The IFP commented that § 163.6(b) was overly restrictive and burdensome and should be removed from the regulations. IRRC noted that the requirements in § 163.6(b) were based on the Department's past experience with insolvent insurers and agreed with the Department's position.

As a result of further discussions with the IFP, the Department has agreed to provide for a limited exemption from the requirements in § 163.6(b) for assets that have been designated as Class One or Class Two by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners (NAIC), as set forth in Annex A. The SVO Class One and Class Two securities are investment-grade, readily marketable assets. These types of assets were not involved in past problems with asset substitutions. Therefore, the Department believes that the amended language retains the restrictions needed to protect the value of assets in trust accounts. The Department also has made some structural changes to improve upon the overall clarity of subsection (b).

2. *Credit for Reinsurance with Unlicensed, Unqualified Reinsurers without Security for the Obligations of the Reinsurer*

The IFP proposed the addition of a new subsection (c) to § 163.20 (relating to other security acceptable to the Commissioner) to permit an insurer with a branch office in an alien jurisdiction to take credit for reinsurance with an unlicensed, unqualified reinsurer domiciled in that alien jurisdiction without collateral for the obligations of the reinsurer, subject to certain conditions. The conditions would place the burden on the Department of determining whether the standards of a foreign country are "substantially similar" to those of the Commonwealth. IRRC agreed with the Department's preliminary analysis that the IFP's proposal would place an inappropriate burden on the Department and did not support the proposal.

The Department has given the IFP's concerns further consideration but has not agreed to change its initial position. The Department believes existing laws and regulations provide sufficient alternatives for receiving credit for reinsurance. As referenced by IRRC, credit is allowed if an alien reinsurer: (1) becomes licensed to transact business in this Commonwealth; (2) becomes designated by the Commissioner as a qualified reinsurer; or (3) provides collateral for its obligations. In addition, § 161.8 (relating to credit for reinsurance ceded to alien nonaffiliated insurers which write no primary coverages in the United States) provides conditions under which partial credit for reinsurance with alien reinsurers may be taken without full collateralization. IRRC also noted the difficulties the Department would face in making an initial determination that an alien jurisdiction has laws and standards comparable to the Commonwealth, and in monitoring the status of those laws and standards on a continuing basis. Therefore, the Department believes that the IFP proposal unnecessarily increases the financial risk to domestic insurers associated with reinsurance agreements and has not included the proposal in its final-form regulations.

3. *Unnecessary Language.*

In response to IRRC's comments, the Department has deleted extraneous language to improve the clarity of the regulations as follows:

- The term "reinsurance credit" has been deleted as a term in addition to "credit for reinsurance" in § 163.1 (relating to definitions) and has been replaced in the body of the regulations with "credit for reinsurance."

- The second and third sentences of § 163.2 (relating to purpose) have been deleted.

• The phrase "notwithstanding subsection . . ." has been deleted in § 163.6(c) and §§ 163.8(3) and 163.15(10)(c) (relating to resignation or removal of trustee; and requirements for letters of credit).

• The phrase "subsequent intervals no less frequent than" has been deleted from § 163.7(3) (relating to duties and responsibilities of trustees).

4. *Definitions*

In response to IRRC's comments, the Department has revised § 163.1 to facilitate an understanding of the terms used in the regulations, as follows:

• Definitions of "company," "association," "exchange," "ceding insurer" and "qualified United States financial institution" have been added to § 163.1.

• The definitions of "grantor" and "trustee" have been moved from § 163.4(b) (relating to funds held in trust) to § 163.1.

• The definitions of "beneficiary" in § 163.4(b) and § 163.14(b) (relating to letters of credit) have been consolidated into a single definition in § 163.1 that references both trusts and letters of credit. The reference to the definition of "beneficiary" in § 163.19 (relating to actions or rights of the Commissioner) has been changed to reference § 163.1.

5. *Allowing for Co-Beneficiaries*

In addition to recommending that the definition of "beneficiary" be moved to § 163.1, the IFP recommended that the definition be expanded to allow for co-beneficiaries within the same holding company system. IRRC noted that the Department indicated in preliminary discussions that it did not oppose allowing co-beneficiaries for domestic insurers within the same holding company system, if the insurers are participating in a joint reinsurance pooling arrangement or other arrangement that establishes the respective rights of each insurer. The Department believes that a provision for co-beneficiaries must include an arrangement that precludes one beneficiary from withdrawing assets from the trust to the detriment of the other beneficiaries. IRRC agreed with the Department's position. Therefore, in response to the IFP's concerns, the Department has amended the definition of "beneficiary" to allow for co-beneficiaries who are members of the same holding company system and who are participants in a joint reinsurance pooling arrangement or other arrangement establishing the respective rights of each insurer.

The IFP's recommendation to allow co-beneficiaries included a revision to § 163.17(a) (relating to accounting in statutory financial statements for credit for reinsurance secured by letters of credit) to refer to a domestic ceding insurer "listed" as a beneficiary. The Department agrees that this change is consistent with the change in the definition of "beneficiary" and has made the amendment in these final-form regulations. The IFP also commented that allowing co-beneficiaries would require that the term "beneficiary" be made plural throughout the regulations and that the word "sole" be deleted § 163.5(b) (relating to general requirements for assets trust accounts). The Department believes that the change in the definition of the term is sufficient to allow for more than one beneficiary under the stated circumstances and has not made these further changes in the final-form regulations.

6. *Summarizing or Reciting Statutory Provisions Referenced in the Final-Form Regulations.*

IRRC recommended that the Department summarize, rather than refer to, the requirements in the authorizing statute, section 319.1(b) of the act (40 P. S. § 442.1(b)), in the final-form regulations as follows:

(a) IRRC recommended that the Department include in § 163.6(a) (relating to requirements for assets held in trust accounts) a list summarizing the types of security permitted by section 319.1(b) of the act. Reinsurance agreements may be subject to a number of statutory and regulatory requirements, including the act and Chapters 161 and 162 (relating to requirements for qualified reinsurers; and life and health reinsurance agreements). The Department believes that domestic insurers have ready access to and are familiar with these laws and regulations, as well as with the statutory accounting principles relating to reinsurance agreements. The Department also believes it is not advisable to summarize these statutory requirements in the regulations because it would increase the potential for misinterpretation and noncompliance with statutory requirements. The Department does not object to reciting, rather than summarizing, statutory language in the regulations if the statute is not lengthy or subject to misinterpretation if taken out of the context of the statute. However, because of the nature and length of section 319.1(b) of the act, the Department does not believe it should be recited in the regulations. Therefore, the Department has not amended § 163.6(a) in these final-form regulations.

(b) IRRC recommended that the Department include a summary of the requirements in section 319.1(b)(4) of the act in § 163.20(a). Because the applicable statutory language is not lengthy and is clearly understood outside the context of the statute, the Department has agreed to recite, rather than summarize, the applicable statutory language in § 163.20(a).

(c) IRRC also recommended that the Department specify in § 163.20(b) that an insurer may take credit for unencumbered funds in the form of cash or securities as identified in section 319.1(b)(1) and (2) of the act, rather than referring to "forms as permitted" under the statute. The Department has agreed to make this recommended change.

7. *Resignation or Removal of Trustee*

Section 163.8(3) establishes requirements that must be met before a trustee may resign or be removed. The IFP recommended the addition of a subparagraph (iv) to § 163.8(3) to clarify that a trustee may resign or be removed if a trust is replaced by alternative arrangements that qualify for credit for reinsurance under the regulation. IRRC agreed with the IFP's understanding that nothing in the regulations would otherwise prevent a trust from being replaced with a letter of credit or other forms of security acceptable to the Department. IRRC recommended that the IFP's provision be included in the final-form regulations.

The Department agrees that nothing in the final-form regulations precludes one form of security being replaced with another. However, the introductory statement in § 163.8 reads:

> This section applies if the resignation or removal of a trustee *does not result in the termination of the trust agreement* under § 163.9 (relating to termination of trust agreements). (emphasis added)

Therefore, the restrictions in § 163.8 apply only when there is a change in the trustee for an existing agree-

ment, not when an agreement is terminated and replaced with another form of security. Therefore, the Department has not included the recommended language in its final-form rulemaking because it contradicts, rather than clarifies, existing language.

8. *Required Provisions in Reinsurance Agreements*

Sections 163.11 and 163.16 (relating to requirements for provisions in reinsurance agreements entered into in conjunction with trust agreements; and provisions in reinsurance agreements entered into in conjunction with letters of credit) list provisions that shall be included in reinsurance agreements entered into in conjunction with trust agreements and letters of credit. The IFP recommended that "shall" be replaced by "may" or, in the alternative, that the required provisions be permitted to be included in a document other than the reinsurance agreement. IRRC noted that simply replacing the word "shall" with "may" would turn the requirements into options and recommended that the final-form regulations be clear that the provisions are required to be in either the reinsurance agreement or another specific document.

In response to these comments, the Department has amended the final-form regulations, as follows:

- § 163.11 has been amended to require that the provisions be included in either the reinsurance agreement or the trust agreement.

- § 163.16 has been amended to require that the provisions be included in either the reinsurance agreement or an ancillary agreement thereto.

9. *Nonrenewal of a Letter of Credit*

Section 163.16(3) of the proposed regulations provided that nonrenewal of a letter of credit is an event of default that allows the ceding insurer to draw down the full amount of the letter of credit. The IFP commented that the term "default" was not defined in the proposed regulations and was not appropriate in the event of nonrenewal. The IFP recommended language to specify that notice of nonrenewal is a "reason" that allows the ceding insurer to draw down the full amount of the letter of credit. The Department agrees with the IFP's comment and has included the recommended language in its final-form regulations.

10. *Typographical Errors*

IRRC noted several typographical errors in the proposed regulations and recommended that they be corrected in the final-form regulations.

The following errors were made in the Department's proposed regulations and have been corrected as follows:

- The reference to subsection (c) in § 163.6(e) has been changed to reference subsection (d).

- The reference to § 163.3(b) in § 163.7(a)(4) has been changed to reference § 163.6(b).

Fiscal Impact

The final-form regulations will not have a measurable impact on costs associated with the Department's analyses of financial statements filed by domestic insurers or with the conduct of onsite financial examinations. The final-form regulations will impose no significant costs on domestic insurers or reinsurers. Any costs required to bring existing reinsurance agreements, trust agreements and letters of credit into compliance with the final-form regulations will be mitigated by the 1-year grace period provided in the final-form regulations for existing agreements and letters of credit. The final-form regulations have no impact on costs to political subdivisions. While the final-form regulations have no immediate fiscal impact on the general public, the general public will benefit to the extent that adoption of the final-form regulations enhance the financial solvency of domestic insurers.

Paperwork

The final-form regulations impose no additional paperwork requirements on the Department, domestic insurers or reinsurers.

Persons Regulated

The final-form regulations apply to domestic insurers that enter into collateralized reinsurance agreements with unlicensed, unqualified reinsurers. The final-form regulations also affect financial institutions that enter into trust agreements or issue letters of credit used as collateral for these reinsurance agreements.

Contact Person

The contact person is Elaine M. Leitzel, Administrative Officer, Office of Regulation of Companies, 1345 Strawberry Square, Harrisburg, PA 17120, (717) 787-8840.

Regulatory Review

Under section 5(a) of the Regulatory Review Act (71 P. S. § 745.5(a)), on February 27, 1996, the Department submitted a copy of the notice of proposed rulemaking, published at 26 Pa.B. 996 (March 9, 1996), to IRRC and to the Chairpersons of the House Committee on Insurance and the Senate Committee on Banking and Insurance for review and comment. In compliance with section 5(b.1) of the Regulatory Review Act, the Department also provided IRRC and the Committees with copies of the comments received, as well as other documentation.

In preparing these final-form regulations, the Department has considered the comments received from IRRC, the Committees and the public. These final-form regulations were deemed approved by the House and Senate Committees on November 20, 1996. IRRC met on November 21, 1996, and approved the regulations in accordance with section 5(c) of the Regulatory Review Act.

Findings

The Insurance Commissioner finds that:

(1) Public notice of intention to adopt this rulemaking as amended by this order has been given under sections 201 and 202 of the act of July 31, 1968 (P. L. 769, No. 240) (45 P. S. §§ 1201 and 1202) and the regulations thereunder 1 Pa. Code §§ 7.1 and 7.2.

(2) The adoption of this rulemaking in the manner provided in this order is necessary and appropriate for the administration and enforcement of the authorizing statutes.

Order

The Insurance Commissioner, acting under the authorizing statutes, orders that:

(a) The regulations of the Department, 31 Pa. Code, are amended by adding §§ 163.1—163.20 to read as set forth in Annex A.

(b) The Commissioner shall submit this order and Annex A to the Office of General Counsel and Office of Attorney General for approval as to form and legality as required by law.

(c) The Commissioner shall certify this order and Annex A and deposit them with the Legislative Reference Bureau as required by Law.

(d) The regulations adopted by this order shall take effect upon publication in the *Pennsylvania Bulletin*.

LINDA S. KAISER,
Insurance Commissioner

(*Editor's Note:* For the text of the order of the Independent Regulatory Review Commission relating to this document, see 26 Pa.B. 5915 (December 7, 1996).)

Fiscal Note: Fiscal Note 11-135 remains valid for the final adoption of the subject regulations.

Annex A

TITLE 31. INSURANCE

PART VIII. MISCELLANEOUS PROVISIONS

CHAPTER 163. REQUIREMENTS FOR FUNDS HELD AS SECURITY FOR THE PAYMENT OF OBLIGATIONS OF UNLICENSED, UNQUALIFIED REINSURERS

Sec.

§ 163.1. Definitions.

The following words and terms, when used in this chapter, have the following meanings, unless the context clearly indicates otherwise:

Act—The Insurance Company Law of 1921 (40 P. S. §§ 341—991.1718).

Association—Individuals, partnerships or associations of individuals, authorized to engage in the business of insurance in thIS Commonwealth as insurers on the Lloyds plan.

Beneficiary—The domestic ceding insurer, or domestic ceding insurers who are members of the same holding company system and are participating in a joint reinsurance pooling arrangement or other arrangement establishing the respective rights of each ceding insurer within the same holding company system, for whose benefit a trust or letter of credit has been established and any successor of the beneficiary by operation of law. If a successor in interest to the named beneficiary is effectuated by the issuance of an order by a court of law, the successor beneficiary shall include and be limited to the court appointed domiciliary receiver, including a liquidator, rehabilitator or conservator.

Ceding insurer—An insurer that has transferred all or part of the insurance or reinsurance risk it has written to another insurer or reinsurer.

Commissioner—The Insurance Commissioner of the Commonwealth.

Credit for reinsurance—An increase in assets or reduction in liabilities for reinsurance in financial statements filed with the Department by domestic insurers in accordance with statutory insurance accounting principles.

Department—The Insurance Department of the Commonwealth.

Domestic—Incorporated or organized under the laws of the Commonwealth.

Exchange—Individuals, partnerships and corporations, authorized by the laws of the Commonwealth to exchange with each other inter-insurance or reciprocal insurance contracts.

Grantor—An unlicensed, unqualified reinsurer that has established a trust for the benefit of the beneficiary.

Insurer—A stock or mutual insurance company, including a title insurance company, association or exchange.

Qualified United States financial institution—

(i) An institution that meets the following qualifications:

(A) Is organized or, in the case of a United States office of a foreign banking organization, licensed under the laws of the United States or a state thereof.

(B) Is regulated, supervised and examined by United States Federal or state authorities having regulatory authority over banks and trust companies.

(C) Has been determined by either the Commissioner or the Securities Valuation Office of the National Association of Insurance Commissioners or a successor thereto to meet standards of financial condition and standing that are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the Commissioner.

(ii) For purposes of specifying those institutions that are eligible to act as a fiduciary of a trust, the term also means an institution that meets the following qualifications:

(A) Is organized or, in the case of a United States branch or agency office of a foreign banking organization, licensed under the laws of the United States or any state thereof and has been granted authority to operate with fiduciary powers.

(B) Is regulated, supervised and examined by Federal or State authorities having regulatory authority over banks and trust companies.

Trustee—A qualified United States financial institution as defined in section 319.1(g) of the act (40 P. S. § 442.1(g)).

Unlicensed, unqualified reinsurer—An assuming insurer which is neither:

(i) Licensed by the Department to transact insurance business in this Commonwealth.

(ii) Included on a list of qualified reinsurers published and periodically reviewed by the Commissioner under section 319.1(a) of the act (40 P. S. § 442.1(a)).

§ 163.2. Purpose.

Section 319.1(b) of the act (40 P. S. § 442.1(b)) establishes conditions whereby a domestic ceding insurer may be allowed to take credit for reinsurance when the assuming reinsurer is an unlicensed, unqualified reinsurer. This chapter establishes minimum require-

ments for trust agreements, letters of credit and other forms of acceptable security for which credit will be allowed for reinsurance ceded to unlicensed, unqualified reinsurers.

§ 163.3 Scope.

This chapter applies to licensed domestic insurers subject to section 319.1(b) of the act (40 P. S. § 442.1(b)) relating to credit for collateralized reinsurance with unlicensed, unqualified reinsurers.

§ 163.4. Funds held in trust.

Trust agreements established for funds held on behalf of a domestic ceding insurer as security for the payment of the obligations of an unlicensed, unqualified reinsurer shall comply with section 319.1(b)—(e) of the act (40 P. S. § 442.1(b)—(e)) and this chapter.

§ 163.5. General requirements for trust agreements.

(a) A trust agreement shall be entered into between the beneficiary, the grantor and a trustee.

(b) A trust agreement shall be established for the sole benefit of the beneficiary.

(c) A trust agreement shall be made subject to and governed by the laws of the state in which the trust is established.

(d) A trust agreement may not be subject to any conditions or qualifications outside of the trust agreement.

(e) A trust agreement may not be conditioned upon any other agreements or documents, except for the reinsurance agreement for which the trust agreement is established.

(f) A trust agreement may not transfer liability from the trustee for the trustee's own negligence, willful misconduct or lack of good faith.

(g) A trust agreement shall create a trust account into which the assets shall be deposited.

(h) A trust agreement shall prohibit invasion of the trust corpus for the purpose of paying compensation to or reimbursing the expenses of the trustee.

(i) A trust agreement shall prohibit the grantor from terminating the trust agreement on the basis of the insolvency of the beneficiary.

§ 163.6. Requirements for assets held in trust accounts.

(a) Assets in the trust account shall be in the form of security permitted by section 319.1(b) of the act (40 P. S. § 442.1(b)) and shall be valued at current fair market value.

(b) A trust agreement shall permit substitution or withdrawal of assets from the trust account only as provided by the following:

(1) Within 6 months of the date the trust account is funded, no substitution or withdrawal of assets may occur except on written instructions from the beneficiary for each individual substitution or withdrawal at the time the substitution or withdrawal is executed.

(2) After 6 months from the date the trust account is funded, no substitution or withdrawal of assets may occur except in accordance with prior written instructions from the beneficiary listing specific types of permitted substitutions or withdrawals of assets that the trustee determines are at least equal in market value to the assets withdrawn and that are in the form permitted by section 319.1(b) of the act and subsection (a); except that, if a substitution or withdrawal of assets, together with other substitutions or withdrawals made within the preceding 12 months, exceeds 50% of the total fair market value of the assets as of the first day of the first month within the preceding 12-month period, the substitution or withdrawal shall be made only on written instructions from the beneficiary for each individual substitution or withdrawal at the time the substitution or withdrawal is executed.

(c) The restrictions on substitutions of assets set forth in subsection (b) do not apply to the substitution of assets that have been designated as Class One or Class Two by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners if the substitution results in the deposit of SVO designated Class One or Class Two securities that are at least equal in fair market value to the assets withdrawn.

(d) Upon call or maturity of a trust asset, the trustee may withdraw the asset without the consent of the beneficiary, if the trustee provides notice to the beneficiary, liquidates or redeems the assets, and the proceeds are paid into the trust account no later than 5 days after the liquidation or redemption of the assets.

(e) A trust agreement shall permit the beneficiary to have the right to withdraw assets from the trust account at any time, without notice to the grantor, subject only to written notice of the withdrawal from the beneficiary to the trustee.

(f) No statement or document other than the written notice by the beneficiary to the trustee under subsection (e) shall be required to be presented by the beneficiary to withdraw assets, except that the beneficiary may be required to acknowledge receipt of withdrawn assets.

§ 163.7. Duties and responsibilities of trustees.

A trust agreement shall require the trustee to:

(1) Receive and hold the assets in a safe place at an office of the trustee in the United States.

(2) Determine that the assets are in a form so that the beneficiary, or the trustee upon direction by the beneficiary, may negotiate the assets without consent or signature from the grantor or another person.

(3) Furnish to the grantor and the beneficiary a statement of the assets in the trust account upon the inception of the account and at the end of each calendar quarter.

(4) Notify the grantor and the beneficiary within 10 days of any deposits to or withdrawals from the trust account; except as provided in § 163.6(b) (relating to requirements for assets held in trust accounts).

(5) Upon written demand of the beneficiary, immediately take the steps necessary to transfer absolutely and unequivocally all right, title and interest in the assets held in the trust account to the beneficiary and deliver physical custody of the assets to the beneficiary.

§ 163.8. Resignation or removal of trustee.

This section applies if the resignation or removal of a trustee does not result in the termination of the trust agreement under § 163.9 (relating to termination of trust agreements):

(1) The trustee may resign upon delivery of a written notice of resignation, effective no later than 90 days after notice to the beneficiary and grantor.

(2) The trustee may be removed by the grantor by delivery to the trustee and the beneficiary of a written

notice of removal, effective no later than 90 days after notice to the trustee and the beneficiary.

(3) The resignation or removal of the trustee may not be effective until the following requirements have been met:

(i) A successor trustee has been appointed and approved by the beneficiary and the grantor.

(ii) A trust agreement has been executed by the successor trustee which complies with section 319.1(b)—(e) of the act (40 P. S. § 442.1(b)—(e)) and this chapter.

(iii) The possession of, and title to, all assets in the trust have been transferred to the new trustee.

§ 163.9. Termination of trust agreements.

(a) The trustee shall deliver written notification of termination to the beneficiary at least 30 days, but not more than 45 days, prior to termination of the trust account.

(b) Upon termination of the trust account, assets not previously withdrawn by the beneficiary may not be delivered to the grantor except with the written approval of the beneficiary.

§ 163.10. Permitted provision in trust agreements.

The grantor may have the full and unqualified right to vote any shares of stock in the trust account and to receive from time to time payments of any dividends or interest upon any shares of stock or obligations included in the trust account.

§ 163.11. Requirements for provisions in reinsurance agreements entered into in conjunction with trust agreements.

When a reinsurance agreement is entered into in conjunction with a trust agreement and the establishment of a trust account, either the reinsurance agreement or the trust agreement shall contain provisions that:

(1) Require the reinsurer to enter into a trust agreement and to establish a trust account for the benefit of the reinsured.

(2) Specify what recoverables and reserves, or both, the agreement is to cover.

(3) Require the reinsurer, prior to depositing assets with the trustee, to execute assignments or endorsements in blank, or transfer legal title to the trustee of all shares, obligations or other assets requiring assignments so that the ceding insurer, or the trustee upon the direction of the ceding insurer, may negotiate these assets without consent or signature from the reinsurer or any other entity.

(4) Require that all settlements of account between the ceding insurer and the reinsurer be made in cash or its equivalent.

§ 163.12. Accounting in statutory financial statements for credit for reinsurance secured by trust agreements.

(a) A trust agreement established in compliance with this chapter may be used by a domestic ceding insurer to take credit for reinsurance ceded to an unlicensed, unqualified reinsurer in a financial statement required to be filed with the Department if the trust agreement is executed and the trust account is established and funded on or before the date on which the domestic ceding insurer files the financial statement.

(b) Credit for reinsurance shall be allowed for reinsurance ceded to an unlicensed, unqualified reinsurer only if the trust account is established in compliance with this chapter. The credit may not exceed the lesser of the current fair market value of assets available to be withdrawn from the trust account or the specific obligations under the reinsurance agreement that the trust account was established to secure.

§ 163.13. Existing trust agreements and underlying reinsurance agreements.

Domestic ceding insurers may continue to take credit for reinsurance ceded to unlicensed, unqualified reinsurers under reinsurance agreements with underlying trust agreements when both the reinsurance agreements and the underlying trust agreements were executed prior to January 18, 1997, if the reinsurance agreements and trust agreements were executed in compliance with applicable State laws and regulations in existence immediately preceding January 18, 1997, until January 19, 1998, after which no credit will be allowed until the reinsurance agreements and underlying trust agreements are brought into compliance with this chapter.

§ 163.14. Letters of credit.

Letters of credit held by or on behalf of a domestic ceding insurer as security for the payment of the obligations of an unlicensed, unqualified reinsurer under a reinsurance agreement shall meet the requirements of section 319.1(b)—(e) of the act (40 P. S. § 442.1(b)—(e)) and this chapter.

§ 163.15. Requirements for letters of credit.

(a) A letter of credit shall:

(1) Be clean, irrevocable, unconditional and evergreen as provided under section 319.1(b)(3)(i) of the act (40 P. S. § 442.1(b)(3)(i)).

(2) Contain an issue date and date of expiration with a term of at least 1 year.

(3) Contain an evergreen clause which prevents the expiration of the letter of credit without due notice from the issuer and provides for at least 30 days notice prior to expiration date or nonrenewal.

(4) Stipulate that the beneficiary need only draw a sight draft under the letter of credit and present it to obtain funds and that no other document need be presented.

(5) Indicate that it is not subject to any condition or qualifications outside of the letter of credit.

(6) Be conditioned upon no other agreement, document or entity, except for the reinsurance agreement for which the letter of credit is issued.

(7) Include a clearly marked section which indicates that it contains information for internal identification purposes only and which contains the name of the applicant and other appropriate notations to provide a reference for the letter of credit.

(8) Contain a statement to the effect that the obligation of the qualified United States financial institution, as defined in section 319.1(g) of the act, under the letter of credit is in no way contingent upon reimbursement of the issuer by the applicant with respect thereto.

(9) Contain a statement that the letter of credit is subject to and governed by the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce (Publication 500 or subsequent updates) and the laws of the Commonwealth, and drafts

drawn thereunder shall be presentable at an office of a qualified United States financial institution.

(10) Contain a provision for an extension of time to draw against the letter of credit in the event that one or more of the occurrences specified in Article 17 of Publication 500 (or subsequent updates) occur.

(b) A letter of credit shall be issued or confirmed by a qualified United States financial institution authorized to issue letters of credit under section 319.1(g)(1) of the act.

(c) A letter of credit may be issued by a qualified United States financial institution authorized to issue letters of credit under section 319.1(g)(2) of the act if the following conditions are met:

(1) The letter of credit is confirmed by a qualified United States financial institution authorized to issue letters of credit under section 319.1(g)(1) of the act.

(2) The issuing qualified United States financial institution formally designates the confirming qualified United States financial institution as its agent for the receipt and payment of the drafts.

(3) The letter of credit meets other requirements of this chapter relating to letters of credit.

§ 163.16. Provisions in reinsurance agreements entered into in conjunction with letters of credit.

When a reinsurance agreement is entered into in conjunction with a letter of credit, either the reinsurance agreement or an ancillary agreement thereto shall contain provisions that:

(1) Require the reinsurer to provide letters of credit to the ceding insurer.

(2) Specify what recoverables and reserves are covered by the letter of credit.

(3) Specify that notice of nonrenewal of the letter of credit is a reason that the ceding insurer may draw down the full amount of the letter of credit.

§ 163.17. Accounting in statutory financial statements for credit for reinsurance secured by letters of credit.

(a) A letter of credit may not be used by a domestic ceding insurer to take credit for reinsurance ceded to an unlicensed, unqualified reinsurer unless the letter of credit has been issued with the domestic ceding insurer listed as a beneficiary and is in compliance with section 319.1 of the act (40 P. S. § 442.1) and this chapter.

(b) Credit for reinsurance secured by a letter of credit shall be allowed in an amount not exceeding the lesser of the amount of the letter of credit or the specific obligations under the reinsurance agreement which the letter of credit was issued to secure.

§ 163.18. Existing letters of credit.

Domestic ceding insurers may continue to take credit for reinsurance secured by letters of credit where both the reinsurance agreements and underlying letters of credit were executed prior to January 18, 1997, if the reinsurance agreements and letters of credit were in compliance with applicable State laws and regulations in existence immediately preceding January 18, 1997, until January 19, 1998, or the renewal date of the letter of credit, whichever time is less, after which no credit will be allowed until the reinsurance agreements and letters of credit are brought into compliance with this chapter.

§ 163.19. Actions or rights of the Commissioner.

The failure of a trust agreement or letter of credit to specifically identify the beneficiary as defined in § 163.1 (relating to definitions) to include a court appointed domiciliary receiver may not be construed to prevent the Commissioner from becoming the successor of the beneficiary as a court appointed domiciliary receiver or to otherwise affect any rights which the Commissioner may possess under the laws and regulations of the Commonwealth.

§ 163.20. Other security acceptable to the Commissioner.

(a) A domestic ceding insurer may take credit for reinsurance for funds or letters of credit provided by a noninsurer parent corporation of the ceding insurer if the requirements of section 319.1(b)(4) of the act (40 P. S. § 442.1(b)(4)) are met, as follows:

(1) The funds or letters of credit are held subject to withdrawal by, and under the control of, the ceding insurer.

(2) The type, amount and form of the funds or letters of credit receive the prior approval of the Commissioner.

(b) A domestic ceding insurer may take credit for unencumbered funds deposited with or withheld by the ceding insurer in the United States if the funds are subject to withdrawal, transfer or substitution solely by the domestic ceding insurer, are under the exclusive control of the domestic ceding insurer, and are in the form of cash or securities as identified in section 319.1(b)(1) and (2) of the act.

[Pa.B. Doc. No. 97-77. Filed for public inspection January 17, 1997, 9:00 a.m.]

Title 52—PUBLIC UTILITIES

PENNSYLVANIA PUBLIC UTILITY COMMISSION
[52 PA. CODE CH. 53]

[L-930082]

Small Water and Sewer Company Rate Methodologies

The Pennsylvania Public Utility Commission (Commission) at a public meeting held August 8, 1996, adopted an order to promulgate a final regulation regarding the above-referenced subject. The regulations reduce regulatory burdens and paperwork requirements on small water and wastewater utilities seeking rate changes under the provisions of the Public Utility Code. The revisions permit small water and wastewater companies to establish emergency maintenance and operations funds, reserve accounts and to apply for a purchased water clause under 66 Pa.C.S. § 1307 (relating to sliding scale of rates; adjustments) if a substantial portion of their finished water is purchased from an independent entity.

At its public meeting of August 8, 1996, the Commission adopted an order issuing revisions and changes to its regulations which reduce regulatory burdens and paperwork requirements on small water and wastewater utilities seeking rate changes under the provisions of the Public Utility Code. The revisions permit small water and wastewater companies to establish emergency maintenance and operations funds, reserve accounts and to apply for a purchased water clause under 66 Pa.C.S.

§ 1307 (relating to sliding scale of rates; adjustments) if a substantial portion of their finished water is purchased from an independent entity.

These provisions were drafted under a petition by an ad hoc coalition of small water and wastewater utilities. They are intended to address the difficulty which some small utilities have in navigating the complex and expensive ratemaking process, and also to address the increasing capital demands placed on small companies as a result of increasingly stringent environmental and water quality regulations.

The contact persons are John A Levin, Law Bureau, telephone (717) 787-5978 and Shirley Leming, Law Bureau, 782-4597.

Regulatory Review

Under section 5(a) of the Regulatory Review Act (71 P. S. § 754.5(a)), the Commission submitted a copy of the final rulemaking, which was published at 24 Pa. B. 4594, and served on August 30, 1994, to the Independent Regulatory Review Commission (IRRC) and the Chairpersons of House Committee Consumer Affair and the Senate Committee on Consumer Protection and Professinal Licensure for review and comment. In compliance with section 5(b.1) of the Regulatory Review Act, the Commission also provided IRRC and the Committees with copies of all comments received as well as other documentation.

In preparing these final-form regulations, the Commission has considered all comments received from IRRC, the Committees and the public.

These final-form regulations was deemed approved by the House Committee on Consumer Affairs and were approved September 25, 1996, by the Senate Committee on Consumer Protection and Professional Licensure, and were disapproved by IRRC on October 3, 1996. A report and order was submitted to the legislative committees under section 7(b) of the Regulatory Review Act (71 P. S. § 754.7(b)) on November 4, 1996. No action was taken by the legislative committees and the regulations are thereby deemed approved.

Public Meeting held
August 8, 1996

Commissioners Present: John M. Quain, Chairperson; Lisa Crutchfield, Vice Chairperson; John Hanger; David W. Rolka; Robert K. Bloom

Final Rulemaking Order

By the Commission:

I. *History of the Proceeding*

With this order, the Commission hereby issues new rules with regard to alternative ratemaking for small water and sewer[1] utilities. On June 28, 1993, the Commission issued an advance notice of proposed rulemaking at the above docket, published at 23 Pa.B. 3290 (July 10, 1993) and later issued a notice of proposed rulemaking (NPR) by order entered May 13, 1994, published at 24 Pa.B. 4594 (Sept 10, 1994). Comments on the proposed rulemaking were due on October 25, 1994. Four sets of comments were received.[2]

This rulemaking proceeding was prompted by a petition filed by an ad-hoc coalition of small water and wastewater companies (SURG) on May 29, 1992, at P-920583. SURG's petition prompted issuance of an Advance Notice of Proposed Rulemaking, in which the Commission circulated a draft of proposed regulations intended to address what SURG characterized as a serious problem afflicting small water and wastewater companies unable to cope with ratemaking procedures and the cost of rate litigation in a system originally designed to address the rates of large and sophisticated utilities.

> These problems tend to afflict smaller, less sophisticated utilities—in particular, small water and sewage companies—many of whom (or whose predecessors) escaped regulation at the outset of operations. When all or most of a utility's rate base is excluded for either of these reasons, the utility earns little or no return on a per-books basis. As a consequence, rate base ratemaking fails to generate a return for small utilities that have little or no net rate base; this lack of return results in a situation where no revenue stream exists to finance normal operations and capital additions or improvements.

SURG petition at 2.

This situation has become even more acute since 1992. Recent changes in environmental and clean water laws affect all water and wastewater utilities, regardless of size. Many small companies are now required to install and maintain expensive filtration, chlorination or waste treatment facilities, engage in sophisticated testing and comply with detailed environmental and safety reporting requirements. These increased obligations have resulted in the doubling or tripling of the annual cost of water for some companies, and has stressed some small water and wastewater company managements beyond their capabilities. Regionalization is one answer (that is, the merging or consolidation of smaller companies into bigger companies). Fifteen years ago, this Commission regulated approximately 400 small water and wastewater companies and company divisions. Through mergers and acquisitions, we now regulate approximately 210. However, regionalization is not a panacea, and many small water and wastewater companies and divisions are geographically isolated from other systems and may not be suitable for acquisition or merger.

We now count 81 of those companies as problem water companies (most of which report less than $250,000 in annual revenues). Each has recently been the subject of a large number of customer complaints alleging inadequate service, has experienced an income loss over a 2-3 year period, has not filed for a change in rates for a 3-5 year period, has been the subject of Department of Environmental Protection (DEP) water quality complaints or has failed to file annual reports with or pay assessments to this Commission in violation of 66 Pa.C.S. § 504 and 52 Pa. Code § 65.19. Our experience is that those five factors indicate financial and managerial problems which presage a steady downward spiral of service quality, and in serious cases, service interruptions or bankruptcy.

This is not a hypothetical problem. Six small water and wastewater companies in the Commonwealth have filed for Federal bankruptcy protection in the last 5 years. In our view, inflationary and regulatory pressures on small water and wastewater companies will not abate in coming years, but increase. Many communities which have heretofore relied upon individual residential and commercial wells and groundwater have already found or will shortly find such sources no longer available, environmentally restricted or contaminated. At the same time, new development continues in the Commonwealth, along with a

[1] "Sewer" utilities are increasingly coming to be known as "wastewater" utilities. We have conformed with this change in the text of this order and in the proposed regulations. We do not intend any substantive change as a result.

[2] Comments were received from IRRC, Office of Trial Staff, Office of Consumer Advocate and Philadelphia Suburban Water Company as well as correspondence from the Honorable David R. Wright, who was then Chairperson of the Consumer Affairs Committee of the House of Representatives.

continuing need for the creation and continued operation of small, regionally isolated water and wastewater companies. Such companies are often operated by a small developer or other real estate investor incidental to a subdivision of land, and are often staffed by no more than a handful of full time employes. These regulations address companies with gross annual revenues of $250,000 or less. Based upon typical residential bills of $250-500 annually per household, such companies might serve 500 to 1000 residential customers, but many are much smaller.

The typical public utility rate case involves the presentation of accounting, managerial, engineering, financial and other expert testimony and evidence. Rate base/rate of return regulation, which has been the ratemaking methodology used most commonly for fixed utilities such as water, wastewater, telecommunications, electric and gas utilities, has been based upon the reasonable assumption that such utilities are heavily capital intensive industries. It also assumes that the level of investment by the owners of the enterprise is a fair measure of the level of return which may be fairly demanded by such owners, and that therefore the valuation of the rate base of such utilities is a necessary element in determining what is a fair return, as a component of overall just and reasonable rates. Contested rate cases often require days of hearings, hundreds or even thousands of pages of transcript and the consideration of a mass of detailed data on plant valuation, depreciation, Federal and State taxation, applicable market rates of return, expected revenues under the proposed rates, expenses, test year normalizations of unusual or nonrecurring revenues and expenses, and rate structure issues. It is not unusual for small utilities to request recovery of $50,000 to $100,000 or more in rate case expenses, boosting the overall rate burden on customers. Because such companies have few customers, the burden is correspondingly greater, and rate case expense may easily comprise one quarter or more of the total annual cost of providing water service. Such costs do not include the costs expended by various governmental entities involved in the issues. The Commission and the Office of Consumer Advocate (OCA), the Office of Trial Staff (OTS), and the Office of Small Business Advocate (OSBA) are all funded through utility assessments.

The greatest regulatory problem with the rate base/rate of return paradigm is presented when a small water or wastewater utility has little or no rate base on which to base a return. That circumstance may come about in several different ways. An older utility may have reached full depreciation of its plant (mains, buildings, and the like) over the years, or the utility may have been constructed largely with customer contributions.

The Public Utility Code enjoins upon the Commission the duty to enforce the Public Utility Code (66 Pa.C.S. § 501), to assure that rates are just and reasonable (66 Pa.C.S. § 1301) and that service is adequate, efficient, safe and reasonable, and reasonably continuous (66 Pa.C.S. § 1501). It is nowhere enjoined upon the Commission that it must pursue these ends in an absurd manner, or to adhere to practices that have the paradoxical result of defeating the Public Utility Code's purpose and intent.

We regard the continued application of the rate base/rate of return model to small water and wastewater company rate cases as counterproductive and harmful to the public interest in some cases. It is poor public policy to continue practices which prevent small companies from obtaining legitimate revenue increases because they are legally or financially unable to navigate or fairly utilize the ratemaking process.

Since issuance of our proposed rulemaking in 1994, the Commonwealth Court has handed down a decision in *Popowsky v. Pa.P.U.C.*, 674 A.2d. 1149 (Cmwlth. Ct. 1996) (*LP Water and Sewer*) with direct bearing on this rulemaking. The Court was squarely presented with the question of the lawfulness of the use of the operating ratio methodology in a challenge to a Commission rate order by OCA. The Court found that the Legislature has given the Commission considerable latitude to determine which is the appropriate rate setting methodology in any particular case, and that the Public Utility Code does not limit our discretion to use of the rate base/rate of return methodology. OCA had argued before the Court, as it argued previously in this rulemaking proceeding, that 66 Pa.C.S. § 1311(d) proscribes the use of an operating ratio for setting the rates of any utilities but "common carriers." Our Commonwealth Court found, on the contrary, that:

> [T]hat analysis is an incorrect reading of the statute. The statute only provides that public utilities which are engaged exclusively as common carriers may use an operating ratio. Section 1311(d) does not preclude the PUC from using such a ratio to set the rates of other public utilities...The code is silent as to what particular method the PUC must implement at arriving at a reasonable rate, and "as long as there is a rational basis for the PUC's methodology, such decisions are left entirely up to the discretion of the PUC which, using its expertise, is the only one which can properly determine which method is the most accurate given the particular circumstances of the case and economic climate."

LP Water and Sewer at 1155, (citing *West Penn Power v. Pa.P.U.C.*, 607 A.2d 1132, 1135 (1992)). We regard this case as dispositive of the challenges raised regarding the legality of the operating ratio methodology by commentors.

II. *Comments*

Four sets of comments, in addition to correspondence from the Chairperson of the House Consumer Affairs Committee, have been received with regard to the proposed rules. Comments were received from the Independent Regulatory Review Commission (IRRC), OCA, OTS and the Philadelphia Suburban Water Company (PSWC). The Honorable David R. Wright, who was then Majority Chairperson of the House Consumer Affairs Committee, states in a letter to the Commission that he has no comments with regard to the proposed regulations.

A. IRRC Comments

IRRC adopted OCA's comments with regard to the lawfulness of the operating ratio method of ratemaking. As this issue has now been resolved by the holding in *L.P. Water & Sewer*, we simply note that the operating ratio method is indeed lawful and authorized by the Public Utility Code. IRRC also adopts OCA's suggestion that the "used and useful" rule prohibits use of an Emergency Maintenance and Operation Fund (EMOF). We note that the "used and useful" rule prohibits the collection by a utility of a return upon plant that is not used or useful in the public service. While we allow no return on EMOF contributions, (and indeed, in an operating ratio environment, return on rate base is an irrelevant concept) the EMOF is clearly used and useful in that it provides a reserve for coping with emergencies in a manner similar

to insurance, but with greater regulatory controls. We note, moreover, that customer contributions in aid of construction (with no return) are presumptively legal, commonplace and would be unlawful under IRRC's interpretation of the Public Utility Code.

IRRC has requested that we provide the "approximate proportion of small water and sewer utilities in financial difficulties because of the ratemaking process and explain how the proposed regulation will alleviate this problem." A 1995 survey of water companies (not including small wastewater companies) indicates that nearly 80 companies are considered to be "problem water companies" throughout the Commonwealth and nearly all of which would qualify as small water companies under these rules. We believe that all or nearly all of these water companies are to some extent suffering financial difficulties because of the time, difficulty and expense associated with traditional rate base/rate of return formal ratemaking procedure. As we have noted elsewhere, regionalization is one solution to the problem of troubled small water and sewer companies, not the sole solution.

Neither law, nor sound public policy requires that this Commission pursue one solution to the exclusion of all others. Although IRRC appears to see a conflict between alternative ratemaking procedures for small companies and the regionalization effort, we believe that perception is incorrect. The goal remains, under any ratemaking methodology, to set "just and reasonable" rates. It cannot lawfully be the policy of the Commonwealth to make the ratemaking process so arduous and expensive that small companies cannot obtain the rate relief to which they are otherwise entitled. It is *a fortiori* more improper to, as IRRC and PSWC seem to suggest we do, create a difficult ratemaking environment solely to encourage small water and wastewater companies to sell out to larger companies.

With respect to IRRC's inquiry as to how many small water and sewer companies will qualify as small water and wastewater companies under these rules, according to 1995 annual reports, of 233 water utilities and 90 wastewater utilities reporting actual or estimated revenues in 1995, 172 water utilities and 69 wastewater utilities have revenue of $100,000 or less, 22 water utilities and 5 wastewater utilities have annual revenues of greater than $100,000 and less than $250,000 annually, and 39 water utilities and 16 wastewater utilities have annual revenues of greater than $250,000.

We believe that § 53.54(b)(2) and (4) adequately define the purpose and applicability of the operating ratio method and properly lays the burden of demonstrating its applicability in any particular rate case upon the utility desiring to employ the methodology. It would therefore be inadviseable to add language, as IRRC suggests, which further limits or defines the applicability of the methodology. We note that small companies may, through new construction, replacement of old plant or otherwise, acquire a sufficiently increased rate base so that use of the operating ratio methodology is no longer appropriate. It would be unwise to require that the operating ratio methodology be the subject of a one-time election, as IRRC suggests.

With respect to use of "rate case history," "quality of service" and "efficiency of operation" and "fairness of the resulting return," listed as subparagraphs (v), (vi) and (x), in § 53.54(b)(2), we note that we have no desire to utilize the operating ratio to "prop up" a hopelessly inefficient or mismanaged utility, nor to unjustly reward a utility with a record of management failure or which frequently files meritless or frivolous rate claims, and will take such factors into account in setting the operating ratio so as not to improperly reward such behavior. We believe that the operating ratio methodology should be informed, overall, by fairness. Since the ultimate test of all rates is whether they are "just and reasonable," the fairness of the return resulting from the operating ratio method is highly relevant to our deliberations.

With regard to the purchased water cost adjustment, IRRC is correct that a utility which chooses to file such an adjustment tariff will be required to immediately reduce its rates and reflect the full cost reduction if the cost of purchased water goes down, but may only collect purchased water cost increases prospectively from the date of filing. This provision prevents companies from attempting to "net out" cost increases and decreases by delaying the reporting of purchased water cost decreases until later increases have "netted out" the difference.

We also decline IRRC's invitation to limit the applicability of emergency fund or reserve accounts to utilities which utilize an operating ratio. Small water and wastewater companies with limited access to capital have need of both devices whatever the ratemaking methodology.

B. OTS Comments

OTS, the prosecutorial office of the PUC, indicates that it "has the same concerns about the revised proposal as it did regarding the original proposal" and accordingly, attached a copy of its 1993 comments to our advance notice of proposed rulemaking, incorporating them by reference. As our notice of proposed rulemaking has adequately dealt with OTS's 1993 comments, we see no need to engage in further analysis.

OTS further asserts that 66 Pa.C.S. § 1315 prohibits "rate base inclusion and any other form of rate recognition for capital plant expenditures relating to plant which is not yet used and useful in the public service." OTS thus opines that our proposed reserve fund violates § 1315, even though such funds are to be treated as "customer contributions," and as a result do not provide any revenue available for return to the utility.

We believe that OTS has grossly misread § 1315. While the "used and useful" doctrine applies to all utilities, the cited section clearly applies only to "electric utilities," and not to other utilities. This rulemaking proceeding is clearly limited to small water and wastewater utilities.

If we read OTS's comments to be founded instead upon the "used and useful doctrine," again, we believe that OTS has misread the law. The EMOF and reserve fund provisions do not represent either an addition to rate base or a return of interest upon invested capital. Instead, both provisions are akin to customer contributions in aid of construction, or prepaid insurance provisions. A utility may not collect any interest or include any portion of either contribution in its rate base, assuming that it chooses to employ a rate base/rate of return methodology for claiming rate relief. We therefore reject OTS's comments with regard to the reserve fund.

C. OCA Comments

OCA filed more extensive comments. OCA suggests that raising the §§ 53.52(b)(2) and 53.54(a)(6) eligibility caps (for small water company rate treatment) is inappropriate. OCA suggests that the proposed cap, $250,000, would discourage regionalization. As we have noted elsewhere in this order, much regionalization has already been accomplished over the last 15 years and equally important, inflation continues to impact the present $100,000 thresh-

old. It is only proper that fixed threshold numbers such as these either be indexed or periodically adjusted. Our judgment is that the annual revenue threshold of $250,000 will reach most of the smallest companies, that is to say, those with fewer than approximately 500 customers. While we support regionalization, it is not an end in and of itself, but a means of assuring service to customers who would otherwise be served by ailing or insolvent management. There may be many companies within the proposed threshold that are not easy candidates for regionalization, but which may be rehabilitated by the availability of appropriate rate relief.

OCA suggests that instead of utilizing operating ratio, we engage in an annual "generic rate of return" process for all small water companies. Small water companies would then file rate cases that would be resolved within the "predetermined generic range of common equity" determined in such annual proceedings. We do not understand how OCA's suggestion reduces the expense and difficulty of small water company rate proceedings, and note that OCA suggests that "parties would retain the right to argue on the record as to the company's appropriate return on equity within the Commission's generic range or to argue that the company's return on equity should be outside that range." In our view, OCA's suggestion amounts to adding a generic annual proceeding on top of our existing rate setting process, with no benefit to either ratepayers or small water companies. For similar reasons, we reject OCA's suggestion to add additional filing requirements for small water and wastewater utilities.

OCA supports our proposed "purchased water" adjustment, but suggests that certain information be required to be filed to substantiate such cost changes. We believe the suggested language is appropriate and have largely adopted it.

OCA suggests that we adopt time limits for certificates of public convenience and certain notice requirements for initial service, abandonment or transfers of utility assets. While these are interesting concepts to which we have given some previous informal consideration, they are outside the scope of this rulemaking. We suggest that OCA raise these issues in a future application proceeding, or in the alternative, prepare a more detailed petition describing these proposals.

OCA argues that operating ratios are not permitted by the Public Utility Code. As noted above, the Commonwealth Court has held otherwise. With respect to the public policy arguments and suggested changes raised by OCA, they have been previously considered and rejected.

With respect to the proposed EMOF fund, OCA continues to oppose it on grounds similar to its comments in the proposed rulemaking proceeding. We note that a persistent theme in small water company crises and service difficulties is that inability of small companies to obtain access to capital. While larger companies can easily issue long-term debt or equity, small companies have neither the skill, financial stability nor economies of size and scale to consider borrowing from the public capital markets. Traditional borrowing sources are also difficult to access. Banks are understandably reluctant to lend money to small, troubled water companies. OCA's objections to EMOFs bear no rational relationship to the real problems faced by the small water and wastewater companies in this Commonwealth. Given the final rules' emphases on reporting and other requirements, there appears to be no need to impose third party escrow obligations on EMOFs.[3] We reject OCA's comments with respect to reserve accounts for the same reasons.

D. PSWC Comments

PSWC filed comments essentially suggesting that these regulations would make it harder for PSWC to acquire small companies in regionalization efforts.

> PSWC is concerned that, by making it easier for small troubled water companies to obtain rate relief, the Commission might inadvertently perpetuate their existence and/or encourage new, similarly ill-equipped, systems to commence operations, such as those created by real estate developers that become public utilities as a result of their building activities.

It should be pointed out that not every troubled small water or wastewater company is well suited for acquisition by an existing large company. Regionalization has already been pursued for a number of years, and many of the obvious or easiest candidates for regionalization have already been merged into or acquired by stronger companies. Further, we do not regard the remedies as mutually exclusive. Finally, as PSWC correctly points out, many small water and wastewater companies are created as an incident to land development. We find PSWC's suggestion that these regulations will cause the sprouting of a new crop of financially unviable small water and wastewater utilities to be an unlikely scenario.

III. *Conclusion*

Accordingly, in order to enable the Commission to carry out its responsibilities under the Public Utility Code to ensure that water and wastewater service is rendered in accordance with the provisions of the Public Utility Code's requirements that service be rendered in a safe, adequate and reliable fashion at just and reasonable rates, the Commission is amending its regulations as described above and as set forth in the final-form regulations contained in Annex A. Under 66 Pa. C.S. §§ 1301—1304, 1307—1309, the Commonwealth Documents Law, 45 P.S. §§ 1201, et seq., and the regulations promulgated thereunder at 1 Pa. Code §§ 7.1—7.4, the Commission adopts these final-form regulations amending existing regulations at 52 Pa. Code §§ 53.52 and 53.54, as noted above and in the manner set forth in Annex A; *Therefore,*

It Is Ordered That:

1. The Commission's regulations at 52 Pa. Code Chapter 53, §§ 53.52 and 53.54 are amended as set forth at Annex A with ellipses referring to existing text.

2. The Secretary shall submit this order and Annex A to the House and Senate designated standing committees, and IRRC for formal review.

3. The Secretary shall submit this order and Annex A to the Office of Attorney General for approval as to legality and to the Governor's Budget Office for review of fiscal impact.

4. A copy of this order and Annex A shall be served upon the OCA, the OSBA, the OTS, and those persons who filed comments in response to our notice of proposed rulemaking.

5. The Secretary shall certify and deposit this order and Annex A with the Legislative Reference Bureau for publication in the *Pennsylvania Bulletin*.

6. These amendments shall become effective immediately upon publication in the *Pennsylvania Bulletin*.

[3]OCA did not supply amemdatory language for any of its suggested changes, as we requested in paragraph 2 of our order.

Public Meeting held
November 1, 1996

Commissioners Present: John M. Quain, Chairperson; Lisa Crutchfield, Vice Chairperson; John Hanger; David W. Rolka; Robert K. Bloom

REPORT AND ORDER

By the Commission:

On October 11, 1996[1], the Independent Regulatory Review Commission (IRRC) disapproved our final-form regulation with regard to an alternative form of rate regulation of small water and wastewater utilities, which we adopted at public meeting on August 8, 1996, and which was presented for regulatory review on September 13, 1996. On October 18, 1996, the Public Utility Commission (Commission) notified the Governor, the designated standing committees of the Legislature, and IRRC of our intention to implement the final-form regulations without revisions or further modification, pursuant to the relevant provisions of the Regulatory Review Act, 71 P.S. § 745.7(a). Pursuant to the act, we are required to:

> submit a report to the designated standing committee of each House of the General Assembly, and [IRRC] within 40 days of the agency's receipt of [IRRC's] disapproval order. The agency's report shall contain the final-form regulation, the findings of [IRRC], and the response and recommendations of the agency regarding the final-form regulation.

As we have noted in earlier orders at this docket, this rulemaking was prompted by a call for help from an ad hoc group of small water and sewer utilities who told the Commission in a 1992 petition that the expense and complexity of the existing regulatory scheme was endangering the viability of very small water and sewer utilities.

The call for help was in the form of a petition filed by an ad-hoc coalition of small water and wastewater companies (SURG) on May 29, 1992 at P-920583. At that time, SURG told the Commission that:

> At issue are problems with exclusion of plant due to inadequate original cost records or findings of indirect or imputed contributions in aid of construction. These problems tend to afflict smaller, less sophisticated utilities—in particular, small water and sewage companies—many of whom (or whose predecessors) escaped regulation at the outset of operations...Small water and sewage utilities with little or no rate base must be given an opportunity to earn real and reasonable revenues (as opposed to the hypothetically adequate revenues which result when the majority of plant in use and in service is deleted from the ratemaking process), if they are to be able to render safe, adequate and reasonable service...Some attempt should be made to at least use per books income and expenses as a check as to the adequacy of revenues, because viability is not truly a ratemaking function, but a function of business reality. And, neither the industry, nor the regulators can, in the long-term, ignore the fact that the capital improvements now facing large and small water companies alike will require massive infusions of capital which will not be forthcoming if the borrowing utility is a real-world financial cripple. Furthermore, PENNVEST cannot and will not be available for all the necessary borrowing because its funds are limited and because even PENNVEST requires some level of financial well-being.

SURG proposed amendments to Title 52, Chapter 53 which formed the basis of these final regulations, but which were extensively modified by the Commission during the promulgation of these regulations. It is notable, however, that the SURG draft contained provisions permitting use of an operating ratio method of ratemaking for small water and sewer utilities, permitted creation of an *Emergency Maintenance and Operation Fund* and a *Reserve Account* to be funded as "customer contributions in aid of construction." The significance of that accounting designation is that such funds would be considered to be ratepayer capital, not shareholder capital, and the utility would not be permitted to earn a return upon, nor charge depreciation upon assets or expenditures derived from either fund.

It is also significant that the Office of Consumer Advocate (OCA), which responded to the SURG petition on June 19, 1992, supported such a rulemaking, although it "disagrees with several of the specific statements and recommendations contained in the Petition." OCA proposed that with regard to the "reserve account" proposed by SURG, that:

> the utility should be required to request the establishment of a reserve account as part of its initial rate filing...In addition, any type of reserve account mechanism must have certain protections. For example, the money contained in the fund should be treated as customer contributions...In short, the OCA sees a reserve account with proper restrictions as a possible short term measure until the utility is in an improved financial position.

OCA Answer to SURG Petition, page 2.

OCA similarly approved of the use of the operating ratio methodology and the Emergency Maintenance and Operation Fund in principle, although it wished to impose much stronger safeguards than those originally proposed by SURG.

In response to SURG's petition and the responses thereto, including OCA's response, the Commission issued an Advance Notice of Proposed Rulemaking (ANPR) at 23 Pa. B. 3290 (July 10, 1993). The ANPR utilized SURG's petition as a model, although SURG's provisions were significantly redrafted and modified to better meet the public interest and impose safeguards of the kind suggested by OCA.

OCA did not like the ANPR draft, and (for the first time) suggested that not only was the ANPR unwise, but as to the operating ratio and funding provisions, that it was statutorily without support and contrary to the provisions of the Public Utility Code. OCA's change in legal position has formed the primary basis of IRRC's opposition to and disapproval of these regulations, and has already proven to be erroneous when tested before our appellate courts.

After these regulations were promulgated in proposed form in 1994, 24 Pa. B. 4594 (September 10, 1994), OCA continued its opposition, asserting, among other things, that the operating ratio methodology was unlawful, pursuant to OCA's interpretation of 66 Pa.C.S. § 1311. IRRC filed comments on November 28, 1994, which essentially adopted OCA's legal position. IRRC, echoing the OCA analysis, specifically asserted in its comments that 66 Pa.C.S. § 1311(d) is evidence that "if the legisla-

[1]IRRC amended its order on October 15, 1996, correcting its erroneous statement that this rulemaking had been disapproved by the Senate Committee on Consumer Affairs and Professional Licensure. In fact, the rulemaking was approved by the Senate Committee on September 25, 1996, and was "deemed approved" by the House Consumer Affairs committee through inaction at its meeting on October 2, 1996.

ture had intended to allow operating ratios to be used to establish rates for water and small utilities (sic), it would have expressly provided for such as it did for common carriers in Section 1311(d)."

That judgment, which turned upon an erroneous application of statutory construction principles, was finally revealed as erroneous by a 1996 decision of the Commonwealth Court of Pennsylvania, *Popowsky v. Pa.P.U.C.*, 674 A.2d. 1149 (Cmwlth. Ct. 1996) (*LP Water and Sewer*), in which OCA had an opportunity to test its legal theories in front of a panel of experienced appellate judges. The Court was squarely presented with the question of the lawfulness of the use of the operating ratio methodology in a challenge to a Commission rate order by OCA. The Court found that the Legislature has given the Commission considerable latitude to determine which is the appropriate rate setting methodology in any particular case, and that the Public Utility Code does not limit our discretion to use of the rate base/rate of return methodology.

OCA had argued before the Court, as it argued previously in this rulemaking proceeding, that 66 Pa.C.S. § 1311(d) proscribes the use of an operating ratio for setting the rates of any utilities but "common carriers." Commonwealth Court found, on the contrary, that:

> [T]hat analysis is an incorrect reading of the statute. The statute only provides that public utilities which are engaged exclusively as common carriers may use an operating ratio. Section 1311(d) does not preclude the PUC from using such a ratio to set the rates of other public utilities...The code is silent as to what particular method the PUC must implement at arriving at a reasonable rate, and "as long as there is a rational basis for the PUC's methodology, such decisions are left entirely up to the discretion of the PUC which, using its expertise, is the only one which can properly determine which method is the most accurate given the particular circumstances of the case and economic climate."

LP Water and Sewer at 1155, (citing *West Penn Power v. Pa.P.U.C.*, 607 A.2d 1132, 1135 (1992))

IRRC's 1994 comments also cited and adopted a variety of other reasons for its opposition: that there was no evidence that an operating ratio method was supported by economic and financial theory, that establishment of an EMOF fund and Reserve account were prohibited by the "used and useful" rule of utility ratemaking (another legal position espoused by OCA), and that the proposed purchased water provision should be drafted so as to require water utilities to reflect both decreases and increases in an updated purchased water rate (as drafted, the provision requires passthrough of decreases, but allows utilities to absorb increases at their discretion).

We carefully considered the comments of IRRC and those of the other three commenting parties, and on August 14, 1996, issued final rules substantially similar to those issued in proposed form. On September 25, 1996, the Senate Consumer Affairs and Professional Licensure Committee approved this final-form rulemaking. The House Consumer Affairs Committee took no action with respect to these rules at its October 2, 1996, meeting, causing these regulations to be "deemed approved" pursuant to 71 P. S. § 745.5(c).

On October 3, 1996, IRRC met to consider this rulemaking, among others. While the IRRC Commissioners expressed sympathy for the goals of this rulemaking, they also expressed an opinion, based upon the OCA legal analysis, that the Public Utility Code prohibited the result. As discussed below, neither the Public Utility Code, nor the "used and useful" rule are inimical to these regulations. IRRC's opinion to the contrary is based upon an erroneous reading of the law and a misreading of ratemaking procedures.

Before discussing the legal issues, it is desireable to revisit the policy considerations which prompted the original petition and the final-form rulemaking.

According to 1995 annual reports, of 233 water utilities and 90 wastewater utilities reporting actual or estimated revenues in 1995, 172 water utilities and 69 wastewater utilities have revenue of $100,000 or less, 22 water utilities and 5 wastewater utilities have annual revenues of greater than $100,000 and less than $250,000 annually, and 39 water utilities and 16 wastewater utilities have annual revenues of greater than $250,000. Since the final-form rules target small water and wastewater utilities with annual revenues of $250,000 or less, we believe that they are properly designed to address the problems we have identified as unique to small water and wastewater utilities.

There is a continuing crisis for small water and wastewater utilities in the Commonwealth due to several recurring factors. First, small companies have problems of economy of scale, management, and access to capital that do not weigh as heavily upon larger companies. Secondly, all water and wastewater utilities, but especially the smaller companies, have been hard pressed to meet the increasingly stringent requirements of environmental legislation and regulation. Third, navigating the sometimes highly complex, technical and arduous process of public utility ratemaking can challenge even a well funded utility with expert legal assistance. Small companies may find that their relatively modest requests for rate relief are largely eaten up, or even dwarfed, by the cost of preparing technical and legal submissions that are required in a traditional, full-blown, rate base/rate of return proceeding.

It is our intention under these rules to relieve the smallest water and wastewater utilities of a significant portion of the unnecessary regulatory burden of justifying necessary rate relief, while retaining all of our necessary powers to curb waste, fraud and managerial abuse of discretion. In addition, we intend to provide such small utilities with the ability to meet their obligations to timely comply with their environmental and operational obligations by providing them a way to fund such obligations in a manner that substantially benefits their ratepayers.

Finally, we intend to permit small water utilities, many of whom purchase the bulk of their water in finished form from another utility, to quickly reflect purchased water cost increases and decreases without the need for filing a comprehensive and logically unnecessary base rate case.

Recent changes in environmental and clean water laws affect all water and wastewater utilities, regardless of size. Many small companies are now required to install and maintain expensive filtration, chlorination or waste treatment facilities, engage in sophisticated testing and comply with detailed environmental and safety reporting requirements. These increased obligations have resulted in the doubling or tripling of the annual cost of water for some companies, and has stressed some small water and wastewater company managements beyond their capabilities. Regionalization is one answer (that is, the merging or consolidation of smaller companies into bigger compa-

nies). Fifteen years ago, this Commission regulated approximately 400 small water and wastewater companies and company divisions. Through mergers and acquisitions, we now regulate approximately 210. However, regionalization is not a panacea, and many small water and wastewater companies and divisions are geographically isolated from other systems and may not be suitable for acquisition or merger.

We now count 81 of those companies as problem water companies (most of which report less than $250,000 in annual revenues). Each has recently been the subject of a large number of customer complaints alleging inadequate service, has experienced an income loss over a 2-3 year period, has not filed for a change in rates for a 3-5 year period, has been the subject of Department of Environmental Protection (DEP) water quality complaints or has failed to file annual reports with or pay assessments to this Commission in violation of 66 Pa.C.S. § 504 and 52 Pa. Code § 65.19. Our experience is that those five factors indicate financial and managerial problems which presage a steady downward spiral of service quality, and in serious cases, service interruptions or bankruptcy.

This is not a hypothetical problem. Six small water and wastewater companies in the Commonwealth have filed for Federal bankruptcy protection in the last 5 years. In our view, inflationary and regulatory pressures on small water and wastewater companies will not abate in coming years, but increase. Many communities which have heretofore relied upon individual residential and commercial wells and groundwater have already found or will shortly find such sources no longer available, environmentally restricted or contaminated. At the same time, new development continues in the Commonwealth, along with a continuing need for the creation and continued operation of small, regionally isolated water and wastewater companies. Such companies are often operated by a small developer or other real estate investor incidental to a subdivision of land, and are often staffed by no more than a handful of full time employes. These regulations address companies with gross annual revenues of $250,000 or less. Based upon typical residential bills of $250-500 annually per household, such companies might serve 500 to 1,000 residential customers, but many are much smaller.

The typical public utility rate case involves the presentation of accounting, managerial, engineering, financial and other expert testimony and evidence. Rate base/rate of return regulation, which has been the ratemaking methodology used most commonly for fixed utilities such as water, wastewater, telecommunications, electric and gas utilities, has been based upon the reasonable assumption that such utilities are heavily capital intensive industries. It also assumes that the level of investment by the owners of the enterprise is a fair measure of the level of return which may be fairly demanded by such owners, and that therefore the valuation of the rate base of such utilities is a necessary element in determining what is a fair return, as a component of overall just and reasonable rates. Contested rate cases often require days of hearings, hundreds or even thousands of pages of transcript and the consideration of a mass of detailed data on plant valuation, depreciation, Federal and State taxation, applicable market rates of return, expected revenues under the proposed rates, expenses, test year normalizations of unusual or nonrecurring revenues and expenses, and rate structure issues. It is not unusual for small utilities to request recovery of $50,000 to $100,000 or more in rate case expenses, boosting the overall rate burden on customers.

Because such companies have few customers, the burden is correspondingly greater, and rate case expense may easily comprise one quarter or more of the total annual cost of providing water service. Such costs do not include the costs expended by various governmental entities involved in the issues. The Commission, the Office of Consumer Advocate, the Office of Trial Staff, and the Office of Small Business Advocate are all funded through utility assessments.

The greatest regulatory problem with the rate base/rate of return paradigm is presented when a small water or wastewater utility has little or no rate base on which to base a return. That circumstance may come about in several different ways. An older utility may have reached full depreciation of its plant (mains, buildings, and the like) over the years, or the utility may have been constructed largely with customer contributions.

The Public Utility Code enjoins upon the Commission the duty to enforce the Public Utility Code (66 Pa.C.S. § 501), to assure that rates are just and reasonable (66 Pa.C.S. § 1301) and that service is adequate, efficient, safe and reasonable, and reasonably continuous (66 Pa.C.S. § 1501). It is nowhere enjoined upon the Commission that it must pursue these ends in an absurd manner, or to adhere to practices that have the paradoxical result of defeating the Public Utility Code's purpose and intent.

We regard the continued application of the rate base/rate of return model to small water and wastewater company rate cases as counterproductive and harmful to the public interest in some cases. It is poor public policy and false economy to prevent small companies from seeking and obtaining otherwise legitimate revenue increases simply because of an inability to legally or financially navigate or fairly utilize the ratemaking process.

IRRC Order of Disapproval

IRRC's *Order on Regulation No. 57-149, Small Water and Sewer Company Rate Methodologies* raises three major issues: the purported unlawfulness of the Emergency Operations and Maintenance Fund (EMOF) and Reserve Accounts, the justification for use of an operating ratio, and finally, the technical construction of the purchased water adjustment clause. We will take each of those objections in order:

IRRC Challenge to Lawfulness of EMOF and Reserve Account

As noted above, OCA originally had no legal objection to these funds, but suggested that both should be accompanied by stronger safeguards against misuse. We have significantly strengthened and improved such safeguards from the proposal originally made by OCA. Such safeguards ensure both that the funds are administered reasonably, and that the funds are applied for the purpose of providing service to the public.

IRRC and OCA now contend that both funds run afoul of the "used and useful" rule, which has been applied in many years of decisions both in this Commonwealth and in other states, and as explicated by the Supreme Court in *Barasch v. Pa.P.U.C.*, 516 Pa. 142, 532 A.2d 325 (1987), *affirmed sub nom: Duquesne Light Co. v. Barasch*, 488 U.S. 299, 102 L.Ed. 2d 646, 109 S. Ct. 609, (1989). In that case, the Supreme Court heard an appeal from this Commission's allowance of the $34.7 million cancellation cost of four nuclear power plants. The Supreme Court, interpreting the provisions of a newly enacted provision of the Public Utility Code, 66 Pa.C.S. § 1315, held that it was an expression of general ratemaking law in Pennsyl-

vania which prohibited utilities from earning a return upon, or recovering the costs through rates of any facility which not "used and useful" in the public service.

In that decision, the Supreme Court took pains to distinguish the matter at issue (cancellation costs for a facility which would never provide service to the public) from costs for plant which could and probably would provide service to the public in the future. Citing *Barasch v. Pa.P.U.C.*, 507 Pa. 430, 490 A.2d 806 (1985), the Supreme Court distinguished the inclusion in rate base of nuclear fuel purchased for use in an uncompleted nuclear power plant, stating:

> In that case, we held that a utility could properly include in its rate base the cost of nuclear fuel purchased for use in an uncompleted nuclear plant. However, an important fact in that case was that the fuel could also have been used in other facilities that were currently in service. Utilities have traditionally been allowed to recover the cost of useable supplies and materials.

Barasch, 516 at 163, 532 A.2d at 335 (note 8)

The major problem with IRRC's analysis is that it lacks an essential grounding in the distinction between plant which may be included in rate base, akin to a utility investment (the basis of the utility's claim for a fair return) and customer contributions, which are decidedly not utility investments, and upon which the utility is entitled to no return, nor depreciation, and which are for the benefit of ratepayers, not utility shareholders. Funding through customer contributions does not create a rate base issue which is suceptible to the "used and useful" analysis employed by IRRC and OCA. IRRC's analysis is also not informed by the myriad of situations, even in traditional rate base/rate of return proceedings, in which utilities are permitted to recover expenses, or to claim rate base costs[2] which have some element of future service to them. Insurance premiums are one example of "rates now for future benefits" on the expense side, cash working capital, decommissioning expense, capitalized pension benefits and qualified land held for future use constitute examples on the rate base side.

More recently, the *Barasch* "used and useful rule" has been narrowed by the Supreme Court. In *Popowsky v. Pa.P.U.C.*, 165 Pa. Commonwealth Ct. 605, 645 A.2d 912 (1994), the Commonwealth Court found that it was error for the Commission to permit Metropolitan Edison to recover $68 million in decommissioning costs (the cost of radiological decommissioning and the costs of removing nonradiological facilities and structures of Three Mile Island 2, a plant which was destroyed by a 1979 accident), because the plant "will not now or ever provide utility service to MetEd's customers." The Supreme Court reversed in *Popowsky v. Pa.P.U.C.*, 542 Pa. 99, 665 A.2d 808, narrowing its 1987 *Barasch* case, and holding that:

> Given what we have already said about the fundamental principles of this state's public-utility jurisprudence, it should be clear that no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service (citation omitted). Nevertheless, to charge ratepayers for decommissioning costs is perfectly consistent with the cited language from *Barasch*. When ratepayers pay decommissioning costs, they are not reimbursing the utility for the cost of the power plant itself. Nor are they providing a rate of return on the utility's investment in the plant...*Barasch* was not intended as a sweeping change in the law defining ratepayer liability for operating expenses of utilities. Rather, it was an application of 66 Pa.C.S. § 1315, holding that construction costs for canceled nuclear power plants could not be charged to ratepayers, regardless of whether the utility labeled the expenditures as construction costs or operating expenses.
>
> Utilities have not been limited to charging ratepayers for only those expenses which directly and immediately supply commodities to their customers (citations omitted). Clearly the costs of providing present utility service are more encompassing. One such cost is that of maintaining compliance with federal laws governing removal of radioactive contamination...In determining just and reasonable rates, the PUC has discretion to determine the proper balance between interests of ratepayers and utilities...There is ample authority for the proposition that the power to fix "just and reasonable" rates imports a flexibility in the exercise of a complicated regulatory function by a specialized decision-making body and that the term "just and reasonable" was not intended to confine the ambit of regulatory discretion to an absolute or mathematical formulation, but rather to confer upon the regulatory body the power to make and apply policy concerning the appropriate balance between prices charged to utility customers and return as on capital to utility investors consonant with constitutional protections applicable to both...Further, the PUC is obliged to consider broad public interests in the rate-making process.

Popowski, at 542 Pa. 106-107, 665 A.2d at 811-812 (1995).

It should be emphasised that the "used and useful" line of cases are specifically concerned with rate base claims, that is, utility assets which are claimed by a utility as part of its rate base, upon which it is entitled to earn a return. These regulations have been specifically drafted to prevent either EMOF or Reserve Account funds from being claimed as part of a utility's rate base. Instead, they are specifically drafted and defined as "customer contributions" which may not be the basis of a utility return claim, may not be the basis of a utility depreciation claim, and are subject to strict and extensive PUC oversight with regard to utilization and disbursement. Moreover, with regard to the EMOF fund, the regulations specifically prescribe that if claimed, it shall be in lieu of any "cash working capital" claim, a rate base claim that is both lawful for ratemaking purposes and a component of nearly every utility rate filing in Pennsylvania. *Pittsburgh v. Pa.P.U.C.*, 169 Pa. Superior Ct. 400, 82 A.2d 515.

IRRC's error arises out of its dismissal of the material distinction between plant constructed with investor assets, and customer contributions in aid of construction. Customer contributions in aid of construction have a long history in the ratemaking process, both in Pennsylvania and elsewhere. There are many situations in which utility plant may be funded with customer contributions rather than with ratepayer investment. In the end, the decision is based upon the Commission's determination of the public interest.

[2]The distinction between a rate base and an expense claim is directly related to the expected duration of the service life of the item acquired. Capital assets, that is, plant or other expenditures with a service life in excess of 1 year, are generally considered to be includible in rate base, may serve as the basis of a return by the utility, and are depreciable over time. Noncapital expenditures constitute expenses for ratemaking purposes, and the ratemaking process establishes a test year for the purpose of analyzing all such expenses to establish a "normal" annual expense claim. Expenses may not serve as the basis for a utility return.

The Commission has found that small water and sewer companies have significant and continuing problems financing both ordinary needed improvements to their systems, and the additional improvements required as a result of the recent tightening of environmental and water quality laws. Small companies are typically unable to obtain access to bond or equity financing in the National capital market, are not attractive candidates for bank or other secured loan financing, and may have few or no cash reserves from which to self fund such improvements. The improvements and expenditures which will be made through the EMOF and Reserve Account funds directly benefit all customers of such small utilities. Not only is there no practical alternative to customer contributed funds, such funding actually saves ratepayers money in that they are not required to pay the utility a return on contributed capital, nor to pay annual depreciation charges on plant and facilities constructed through customer contributions. Given the choice between no service or poor service and good service at reasonable rates, it appears that customer contributed funding of the EMOF and Reserve Accounts is in the public interest.

IRRC also cites *Barasch, et al v. Pa.P.U.C.*, 127 Pa. Commonwealth Ct. 544, 562 A.2d 414 (1989) (*Staffaroni*) [which it incorrectly styles as *Staffaronei v. Pa.P.U.C.*]. *Staffaroni* involved recovery of interest expense related to PENNVEST financed facilities which were not used after construction because they were found to be contaminated with high levels of barium. The *Staffaroni* court found that the facilities were not "used and useful" because they were not, in fact of use to the public. That case is easily distinguished as a classic application of the "used and useful" doctrine to prohibit the earning of a return upon facilities that do not serve the public. We conclude that the *Staffaroni* case simply does not speak to the issue of the lawfulness of these regulations which create a fund from customer contributions that does not result in any profit or return to the utility and which is directly supervised by the Commission to ensure that the fund is used for projects which do in fact benefit the public. The Commission urges the Legislature to approve these provisions as being manifestly in the public interest.

IRRC Challenge to Use of Operating Ratio

As noted above, IRRC originally adopted OCA's position during consideration of the proposed form of these regulations that use of an operating ratio methodology for small water and wastewater utilities is prohibited by 66 Pa. C.S. § 1311(d), despite our explanation that that provision is permissive rather than prohibitory. The Commission was able to lay that erroneous interpretation to rest in the *LP Water & Sewer* decision of Commonwealth Court. IRRC's fallback position is to question the wisdom of the operating ratio, contending its appropriateness. It appears that IRRC both overlooks the long history of the use of the operating ratio methodology in transportation rate proceedings in the Commonwealth, and also overlooks the obvious benefits in rate case streamlining which the operating ratio methodology offers small companies.

First, the operating ratio methodology is not new. It has been specifically authorized for use in transportation rate proceedings for many years. In summary, the operating ratio methodology permits the Commission and the parties to a rate case to agree upon a barometer group of similar companies, analyse their ratio of revenues to a reasonable estimate of expenses and derive an appropriate operating ratio to determine what level of operating revenue (profit) is reasonable under the circumstances. It does not forclose a detailed analysis of the instant utility's actual operating expenses, which continue to be subject to examination for reasonableness and prudence.

It should be pointed out that the traditional rate base/rate of return methodolgy is a legal construct and not the product of academic research. Because utilities are traditionally capital intensive, Pennsylvania, and many other jurisdictions have utilized the value of the utility rate base as a measure of the utility's investment and have applied market derived earnings data to that rate base as the basis for estimating what constitutes a fair return to the company.

What works for a large utility is not necessarily appropriate for a small utility or one without a substantial rate base. The cost of presenting a traditional rate base/rate of return case is driven partly by legal expense and partly by the expense of presenting witnesses in the various specialized issues. Utilization of an operating ratio methodology both ensures just and reasonable rates and substantially reduces rate case expense by eliminating the need for valuation and rate of return testimony and the compilation of expensive studies on those two subjects. While IRRC questions the rate case savings which may result from a switch in methodologies, our extensive experience with rate case litigation over many years persuades us that the savings are real and will be significant.

Secondly, use of the operating ratio methodology substantially simplifies and reduces many of the complex and somewhat arcane disputes which surround every rate case with regard to the determination of the appropriate test year rate base level, and the appropriate determination of market data to be employed to determine the appropriate fair rate of return to apply to the utility's rate base. For very small companies, these weighty disputes may have little impact in terms of overall rates, but drive up the cost, and time required to complete a contested ratemaking proceeding. Sending small water and wastewater companies through a rate setting procedure designed and tested for setting rates for sophisticated multi-million dollar utilities is like swatting a fly with a trip hammer. Accordingly, the Commission urges the General Assembly to approve these regulations with regard to use of the operating ratio methodology.

IRRC Opposition to Purchased Water Adjustment

IRRC appears not to have any objection to the purchased water provision of § 53.54(c) in general, but objects to its application in certain situations. As written, the provision permits any small water utility to file a sliding scale rate tariff, pursuant to 66 Pa.C.S. § 1307, to recover the cost of water it purchases from another water system. Small systems often purchase finished water from other systems, often from municipal systems, and distribute it for resale to their own customers. Even a system with its own supply and treatment facilities may need to purchase water on occasion in the event of facility unavailability. Section 53.54(c) requires that small utilities immediately reflect and pass through to their rate payers any reduction in the cost of purchased water, but leaves it up to management discretion whether to, and when to pass through any increases. If management decides to recover such increases, they must act promptly to file for a change in the sliding scale rate, as recovery of increases is permitted only from the date of filing. IRRC finds that distinction to be unfair, and opines that "this could result in a utility not being able to recover a significant portion of all its costs."

The provision was drafted to give utility managers some leeway and discretion. A generally applied rule of

ratemaking is that utilities should always be permitted to voluntarily absorb cost increases instead of passing those increases on to customers. We can envision a number of reasons why a prudent management would wish not to pass along a temporary or relatively minor increase in purchased water costs. We also expect utility management to be aware of their rights and obligations. We therefore do not completely understand IRRC's insistence that utility management needs to be protected from itself by requiring the pass through of cost increases which might otherwise be absorbed at management's discretion. We believe the provision to be a major improvement from the present situation in which small utilities must file a comprehensive rate case to recover any change in purchased water costs.

In sum, we believe these provisions are in the public interest and urge the General Assembly to approve them as drafted; *Therefore,*

It is Ordered:

1. This Report and Order containing the response and recommendations of this Commission, and Annex A, consisting of the final-form regulations and the findings of IRRC shall be served forthwith upon the designated standing committees of each House of the General Assembly, and IRRC.

5. Upon approval or acquiescence in accordance with 71 P. S. § 745.7(d), the Secretary shall certify and deposit this order and the final-form regulations with the Legislative Reference Bureau for publication in the *Pennsylvania Bulletin*.

6. These regulations shall become effective immediately upon publication in the *Pennsylvania Bulletin*.

JOHN G. ALFORD,
Secretary

(*Editor's Note*: For the text of the order of the Independent Regulatory Review Commission relating to this document, see 26 Pa.B. 5181 (October 26, 1996).)

Fiscal Note: Fiscal Note 57-149 remains valid for the final adoption of the subject regulations.

Annex A

TITLE 52. PUBLIC UTILITIES

PART I. PUBLIC UTILITY COMMISSION

Subpart C. FIXED SERVICE UTILITIES

CHAPTER 53. TARIFFS FOR NONCOMMON CARRIERS

INFORMATION FURNISHED WITH THE FILING OF RATE CHANGES

§ 53.52. Applicability; public utilities other than canal, turnpike, tunnel, bridge and wharf companies.

* * * * *

(b) Whenever a public utility other than a canal, turnpike, tunnel, bridge or wharf company files a tariff, revisions or supplement which will increase or decrease the bills to its customers, it shall submit in addition to the requirements of subsection (a), to the Commission, with the tariff, revision or supplement statements showing all of the following:

* * * * *

(2) The operating income statement of the utility for a 12-month period, the end of which may not be more than 120 days prior to the filing. Water and wastewater utilities with annual revenues under $250,000 and municipal corporations subject to Commission jurisdiction may provide operating income statements for a 12-month period, the end of which may not be more than 180 days prior to the filing.

* * * * *

(c) If a public utility files a tariff, revision or supplement which it is calculated will increase the bills of a customer or a group of customers by an amount, when projected to an annual basis, exceeding 3% of the operating revenues of the utility—subsection (b)(4) divided by the operating revenues of the utility for a 12-month period as defined in subsection (b)(2)—or which it is calculated will increase the bills of 5% or more of the number of customers served by the utility—subsection (b)(3) divided by subsection (a)(2)—it shall submit to the Commission with the tariff, revision or supplement, in addition to the statements required by subsections (a) and (b), all of the following information:

(1) A statement showing the utility's calculation of the rate of return or operating ratio (if the utility qualifies to use an operating ratio under § 53.54 (relating to small water and wastewater utililities)) earned in the 12-month period referred to in subsection (b)(2), and the anticipated rate of return or operating ratio to be earned when the tariff, revision or supplement becomes effective. The rate base used in this calculation shall be supported by summaries of original cost for the rate of return calculation. When an operating ratio is used in this calculation, it shall be supported by studies of margin above operation and maintenance expense plus depreciation as referred to in § 53.54(b)(2)(B).

* * * * *

§ 53.54. Small water and wastewater utilities.

(a) *Procedures.*

(1) Whenever a small water or wastewater utility desires to file a change in its tariff which increases annual revenues, it may advise the Commission of its intention in letter form and request the necessary Commission forms. When filing, the utility shall set forth its proposed tariff changes and reasons for the changes, together with the necessary completed Commission forms. If the utility is unable to fully complete the necessary forms, it may request assistance from the Commission staff.

(2) The small water utility or wastewater utility is required to fully cooperate with the Commission staff in providing the necessary information to complete these forms if the utility is unable to do so on its own.

(3) Upon completion of the Commission forms in a manner satisfactory to the Commission staff, the small water or wastewater utility shall file a tariff or tariff supplement, along with the completed forms, incorporating the proposed changes. The effective date of the proposed increase contained in the tariff or tariff supplements may not be less than 61 days after the filing, and customers shall be notified in accordance with § 53.45(a)(2) (relating to notice of new tariffs and tariff changes).

(4) On the basis of the tariff filing, the accompanying data and completed forms, the staff shall determine tentative allowable revenues and submit a report to the Commission.

(5) If the proposed revenues exceed the tentative allowable revenues, the Commission will suspend the supple-

ment but with a "condition subsequent" added, to the effect that if the utility within a specified number of days files a superseding supplement which produces the allowable revenues found by the staff and which has a rate structure satisfactory to the Commission, the suspension and investigation orders of the Commission shall be deemed inoperative and terminated. However, if the utility fails to meet the "condition subsequent," or if a customer files a formal complaint, the utility may present the supporting data and the additional facts referred to in this section in formal proceedings. Additionally, in these formal proceedings, the utility may agree to accept the most recent rate of return or operating ratio allowed a water or wastewater utility by the Commission in a fully-litigated water or wastewater utility rate case, but the agreement will not be binding on the Commission or any formal complainant.

(6) A water or wastewater utility with a gross revenue of less than $250,000 annually shall be considered a small water or wastewater utility for purposes of short-form rate filings.

(b) *Operating ratio methodology.*

(1) This ratemaking method develops a revenue requirement where little or no rate base exists. The operating ratio at present rates shall be calculated as a ratio of operating expenses to operating revenues, where the numerator shall include operations and maintenance expense, annual depreciation on noncontributed facilities, amortization of multiyear expenses and applicable taxes and the denominator shall consist of the utility's operating revenues at present rates.

(2) The appropriate target operating ratio in a particular case shall be determined by considering at least the following factors:

(i) The operating ratios of comparable water or wastewater utilities.

(ii) Coverage of actual hypothetical, or both, interest expense.

(iii) A comparison of the cost of service with the cost of service of similar companies which do not employ an operating ratio rate methodology.

(iv) Current market conditions, including price inflation.

(v) The quality of service and efficiency of operations.

(vi) The rate case history.

(vii) Whether there is any rate base and, if so, whether any depreciation expense is being claimed in the filing.

(viii) An acquisition adjustment, if any.

(ix) Financial resources.

(x) The fairness of the resulting return.

(3) An increase or decrease in operating revenues shall be determined by dividing the utility's reasonable and legitimate operating expenses by the target operating ratio determined in paragraph (2), and subtracting that amount from the test period operating revenues.

(4) The operating ratio methodology shall be available to water and wastewater utilities with annual gross revenues (excluding current year Contributions In Aid of Construction (CIAC)) of less than $250,000. If a water or wastewater utility wishes to employ an operating ratio methodology in calculating its rates, it shall make this request in the context of a rate case, and shall bear the burden of proving all necessary elements thereof.

(c) *Purchased water cost adjustment—sliding scale of rates.*

(1) A water utility with annual gross revenues of less than $250,000, may establish a sliding scale of rates under 66 Pa.C.S. § 1307 (relating to sliding scale of rates; adjustments) upon 60 days' notice to customers, to recover the cost of purchased water obtained from municipal authorities or entities which are not affiliated interests as defined in 66 Pa.C.S. § 2101 (relating to the definition of affiliated interest). The purchased water cost adjustment filing shall be accompanied with a tariff or tariff supplement which establishes the new rates to be placed into effect, a calculation showing the application of the new rate schedule to the company's average level of customer usage, an income statement demonstrating the effect of the tariff or tariff supplement upon the utility's revenues for the period in which the proposed tariffs would be in effect, a copy of the notice provided to customers and a verification that all customers have received notice of the proposed rate change.

(2) A purchased water cost adjustment shall be revised and refiled within 60 days of a decrease in purchased water costs, and shall be designed to pass through to customers the entire reduction in purchased water costs from the date the reduction becomes effective. A purchased water adjustment may be revised and refiled at any time after an increase in purchased water costs, and shall be designed to recover cost increases prospectively from the date of filing only.

(3) Within 30 days following the end of the calendar year, every public utility utilizing a purchased water cost adjustment shall file the report prescribed by 66 Pa.C.S. § 1307(e) for the preceding 1-year period ending December 31st. These reports shall be reviewed by the Commission's Bureau of Audits, and, if no complaint or objection is raised within 45 days after filing, either by the Commission's Bureau of Audits or another person, the reports shall be deemed approved.

(d) *Emergency Maintenance and Operation Fund (EMOF).*

(1) *EMOF.* An expense claim in lieu of a cash working capital claim which may be allowable in anticipation of emergencies such as extraordinary repairs and maintenance, drought conditions, extraordinary environmental and physical damages to sources of supply, floods, storms, freeze-ups, or other health and welfare-threatening situations. The burden of demonstrating that actual or proposed disbursements from the fund are reasonable and in the public interest shall be borne by the utility.

(2) *Methodology*. The Fund expense may not exceed 45 days of average operating expenses, excluding taxes and depreciation. If a claim for Fund expense is made, no additional claim for cash working capital shall be made or considered.

(3) *Procedures.* The amounts allocated for an EMOF shall be kept in a separate cash account and disbursements shall be restricted to the uses in paragraph (1). The utility shall report all disbursements from the Fund to the Commission within 10 days and shall provide a summary of each year's disbursements on its Annual Report. Disbursements from the Fund which are found by the Commission to have been made improperly, or in violation of a statute, regulation or order of the Commission or other Commonwealth agency shall be returned to

the account or be refunded to ratepayers as the Commission may direct. A person or individual who makes, authorizes or directs disbursement from a Fund which is improper or in violation of any statute, regulation or order of the Commission shall be subject to 66 Pa.C.S. § 3301 or § 3301 (relating to civil penalties for violations); and criminal penalties for violations).

(4) *Availability*. The Commission may authorize funding a Fund for water and wastewater utilities with annual gross revenues (excluding current year CIAC) of less than $250,000.

(e) *Reserve account*

(1) *Reserve account*. A segregated account to be funded by customer contributions collected through base rates for the purpose of making capital improvements to utility plant pursuant to a long-range plan developed in conjunction with the Commission or the Department of Environmental Protection, or as required to assure compliance with State or Federal safe drinking water statutes or regulations. The burden of demonstrating that actual or proposed expenditures are reasonable and in the public interest shall be borne by the utility.

(2) *Procedures*. The amounts to be allocated to the reserve account will be determined by the Commission after review of the utility's proposed capital budget and the justification for that budget. Funds in the reserve account shall be kept in a separate interest bearing cash account. Interest accrued shall be credited to the reserve account and shall become part of the corpus of the reserve account. Funds from the account shall not be employed for a purpose other than those permitted under this section. Disbursements from the fund shall not be made without written authorization by the Commission upon petition, shall be restricted to the uses in subsection (d)(1), and shall be made in accordance with a capital budget submitted with the initial rate filing or as modified with the consent of the Commission. In proposing any modifications of the capital budget, the Commission or a party may solicit the advice or testimony of the Department of Environmental Protection. The utility shall report all disbursements from the reserve account by written notice to the Commission and to other persons as the Commission may direct. Disbursements from the reserve account which are found by the Commission to have been made improperly, or in violation of any statute, regulation or order of the Commission or other Commonwealth agency shall be returned to the account or be refunded to ratepayers as the Commission may direct. A person who makes, authorizes or directs a disbursement from a reserve account without authorization by the Commission in accordance with these rules shall be subject to 66 Pa.C.S. § 3301 or § 3302.

(3) *Accounting*. Plant capitalized by means of the Reserve Account shall be accounted for as a contribution in aid of construction.

(4) *Availability*. The Commission may authorize funding of a reserve account for water and sewage utilities with annual gross revenues (excluding current year CIAC) of less than $250,000.

[Pa.B. Doc. No. 97-78. Filed for public inspection January 17, 1997, 9:00 a.m.]

Title 58—RECREATION

GAME COMMISSION

[58 PA. CODE CH. 141]

Game Lands and Goose Hunting

To effectively manage the wildlife resources of this Commonwealth, the Game Commission (Commission) adopted the following change:

Amend § 141.25 (relating to early and late goose hunting seasons) by establishing new season dates with the guidelines approved by the United States Fish and Wildlife Service (USFWS) and establishing new geographical boundaries for this season.

The amendment is adopted under 34 Pa. Code (relating to the Game and Wildlife Code) (code).

1. *Introduction*

The Commission, at its October 8, 1996, meeting proposed, and by notational vote finally adopted amendments to § 141.25 for 1997. The change provides for a late Canada goose hunting season from January 15 through February 15 unless one of those dates is a Sunday, in most of this Commonwealth with the exception of parts of the northwestern and southeastern regions.

These special seasons, which were originally adopted under sections 322(c)(1) and 2102(b)(1) of the code (relating to powers and duties of Commission; and regulations) will established with the approval of the Atlantic Waterfowl Council (AWC) and the USFWS. The primary purpose of the early and late seasons is to reduce resident Canada goose populations which should reduce crop damage and nuisance goose complaints.

2. *Purpose and Authority*

Resident Canada goose populations have been increasing in most of this Commonwealth since the 1970's. Associated with these increases have been increases in crop damage and nuisance complaints. The Commission has sought to direct harvest pressure at growing resident goose populations through longer seasons and larger bag limits. At the same time, the USFWS has closed the regular goose season because of concerns about migratory populations.

The early and late Canada goose seasons allowed in prior years were successful in harvesting nuisance geese and providing additional recreational opportunities. This solution to the nuisance resident goose problem can only work over a period of time, however. That is why the Commission has adopted a late season for 1997. Part of northwestern Pennsylvania has been excluded from the late season because the USFWS has allowed a regular goose season. Part of southeastern Pennsylvania has been excluded by the USFWS because of a concern that a high percentage of migratory geese may be harvested.

Section 322 of the code specifically empowers the Commission to ". . . fix seasons . . . and daily, season, and possession limits for any species of game or wildlife." Section 2102(b) of the code mandates that the Commission promulgate regulations relating to seasons and bag limits. The authority for the permit aspects of the amendment is section 2901(b) of the code (relating to authorization to issue permits).

3. *Regulatory Requirements*

The changes do not involve regulatory requirements above what is already in § 141.25. A migratory game bird license is required to hunt Canada geese in the late season.

4. *Persons Affected*

Persons wishing to hunt Canada geese in this Commonwealth in the late season would be affected by this amendment. Farmers and others experiencing crop and other goose damage in the affected area would benefit from the reduction in populations.

5. *Comments and Response Summary*

No written comments were received.

6. *Cost and Paperwork Requirements*

There is no additional cost or paperwork.

7. *Effective Dates*

The effective date is January 15, 1997, until modified or rescinded by the Commission.

8. *Contact Person*

For further information on the proposed changes, contact James R. Fagan, Director, Bureau of Law Enforcement, 2001 Elmerton Avenue, Harrisburg, PA 17110-9797, (717) 783-6526.

Findings

The Commission finds that:

(1) Public notice of intention to adopt the administrative amendment adopted by this order has been given under sections 201 and 202 of the act of July 31, 1968 (P. L. 769, No. 240) (45 P. S. §§ 1201 and 1202) and the regulations thereunder, 1 Pa. Code §§ 7.1 and 7.2.

(2) The adoption of the amendment of the Commission in the manner provided in this order is necessary and appropriate for the administration and enforcement of the authorizing statute.

Order

The Commission, acting under authorizing statute, orders that:

(a) The regulations of the Commission, 58 Pa. Code Chapter 141, are amended by amending § 141.25 and Appendix E to read as set forth in Annex A.

(b) The Executive Director of the Commission shall submit this order and Annex A to the Office of Attorney General for approval as to legality.

(c) The Executive Director shall certify this order and Annex A and deposit them with the Legislative Reference Bureau as required by law.

(d) This order shall take effect upon publication and applies retroactively to January 15, 1997.

DONALD C. MADL,
Executive Director

(*Editor's Note*: The proposed amendment of § 135.2 (relating to unlawful actions), included in the proposal at 26 Pa.B. 5442 (November 9, 1996), will be considered by the Commission at a later date.)

Fiscal Note: 48-95-A. No fiscal impact; (8) recommends adoption.

Annex A

TITLE 58. RECREATION

PART III. GAME COMMISSION

CHAPTER 141. HUNTING AND TRAPPING

§ 141.25. Early and late goose hunting seasons.

(a) *Early season and description.*

(1) Subject to approval of the United States Fish and Wildlife Service, there will be an early Canada goose hunting season starting on September 1 (except when Sunday, then September 2), and ending on September 25 (except when Sunday, then September 24) Statewide. Geese may be taken on the Pymatuning State Park Reservoir and an area to extend 100 yards inland from the shoreline of the reservoir excluding the area east of L. R. 20006.

(2) Geese may not be taken in that portion of Crawford County which is in the area south of Route 6 from the Ohio line to its intersection with Route 322 in the town of Conneaut Lake and north of Route 322 west to the Ohio line, or in Lancaster/Lebanon Counties in the area east of S. R. 501 from Shaefferstown to the Pa. Turnpike, north of the Pa. Turnpike to S. R. 272, west of S. R. 272 to S. R. 897, and south of S. R. 897 to Shaefferstown, referred to as closed areas.

(3) *Bag limit.* There is a daily bag limit of three and a possession limit of six with the exception of the closed areas in Crawford and Lancaster/Lebanon Counties.

(b) *Late season and description.*

(1) *Areas.* Subject to approval of the United States Fish and Wildlife Service, there is a late Canada goose hunting season beginning on January 15 (except when Sunday, then January 16), and ending on February 15 (except when Sunday, then February 14) Statewide, with the exception of Erie, Mercer, Butler, Crawford and the area east of I-83 from the Maryland State line to the intersection of U. S. Route 30 to the intersection of S. R. 441, east of S. R. 441 to intersection of I-283, east of I-283 to I-83, east of I-83 to intersection of I-81, east of I-81 to intersection of I-80, and south of I-80 to the New Jersey State line.

(2) *Bag limit.* There is a daily bag limit of five and a possession limit of ten geese.

(3) *Map.* See map of Late Canada Goose Areas in Appendix E.

(c) *Shooting hours.* Shooting hours for goose hunting during the early and late goose hunting seasons is 1/2 hour before sunrise to sunset.

(d) *Permit required.*

(1) Licensed hunters wishing to hunt Canada geese during the early or late season shall obtain a permit and goose harvest report card for the respective season in one of the following ways:

(i) By sending their name, address and telephone number together with a self-addressed stamped envelope to the Harrisburg Office of the Commission.

(ii) By submitting their name, address and telephone number at the sales counter of the Commission's Harrisburg Office or one of its regional offices.

(2) Early and late goose hunting permits will be issued free-of-charge.

(3) Individuals hunting geese during the early or late goose season shall have in their possession a valid

Pennsylvania hunting license, the appropriate early or late goose hunting permit and a Migratory Bird Hunting and Conservation (Duck) Stamp, if they are 16 years of age or older.

(4) Recipients of early and late goose hunting permits shall return a properly completed goose harvest report card to the Harrisburg Office of the Commission within 10 days following the close of the respective early and late seasons. Failure to return a properly completed goose harvest report card could result in the loss of eligibility to receive future early or late goose season permits.

(e) *Unlawful acts*. It is unlawful to:

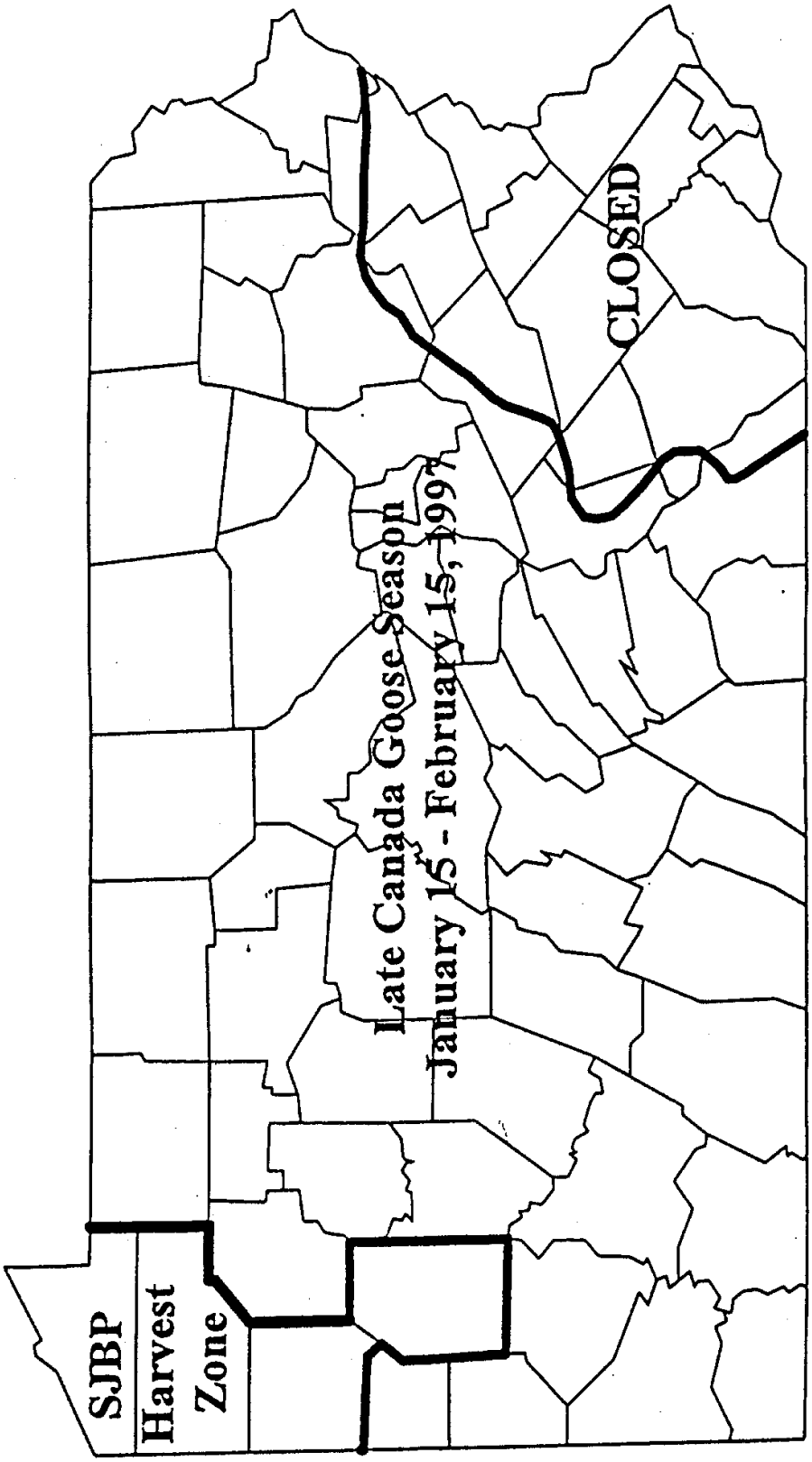
(1) Hunt Canada geese during the early or late goose hunting seasons inside the boundaries of the closed area.

(2) Hunt Canada geese during the early or late goose hunting seasons without the required permit for the respective season.

(3) Fail to return the goose harvest report card within the allotted time, even if no harvest occurred.

(4) Provide false information on the goose harvest report card.

APPENDIX E



[Pa.B. Doc. No. 97-79. Filed for public inspection January 17, 1997, 9:00 a.m.]