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September 30, 2016

VIA eFILING

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17105-3265

Re: Pennsylvania Public Utility Commission
v.
Metropolitan Edison Company
Pennsylvania Electric Company
Pennsylvania Power Company
West Penn Power Company
Docket Nos. R-2016-2537349, *et al.*

Dear Secretary Chiavetta:

Enclosed for filing in the above-captioned consolidated proceedings is the **Initial Brief on behalf of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company (the "Companies").** The Initial Brief addresses the one issue that was reserved for briefing in the settlement of the Companies' base rate cases.

As indicated on the attached Certificate of Service, copies of the Initial Brief will be served on Administrative Law Judge Mary D. Long and all parties.

Very truly yours,

Anthony C. DeCusatis

Enclosures

c: Per Certificate of Service (w/encls.)

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION	:	
	:	
v.	:	**Docket Nos. R-2016-2537349, *et al.***
	:	
METROPOLITAN EDISON COMPANY	:	
PENNSYLVANIA ELECTRIC COMPANY	:	
PENNSYLVANIA POWER COMPANY		
WEST PENN POWER COMPANY		

CERTIFICATE OF SERVICE

I hereby certify and affirm that I have this day served copies of the **Initial Brief on behalf of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company** on the following persons, in the manner specified below, in accordance with the requirements of 52 Pa. Code § 1.54.

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Dated: September 30, 2016

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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METROPOLITAN EDISON COMPANY	:	
PENNSYLVANIA ELECTRIC COMPANY	:	
PENNSYLVANIA POWER COMPANY	:	
WEST PENN POWER COMPANY	:	

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September 30, 2016

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I. INTRODUCTION

A. Background And Procedural History

Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power") and West Penn Power Company ("West Penn") (individually, a "Company" and, collectively, the "Companies") submit this Initial Brief on the issue reserved for decision in the settlements of their base rate proceedings ("Settlements") announced at the evidentiary hearing held on September 7, 2016. The terms of the Settlements will be set forth in Joint Petitions for Partial Settlement ("Joint Petitions") to be filed by the parties on October 14, 2016, along with Statements in Support. The Joint Petitions will contain a detailed history of the consolidated proceeding.[1] Consequently, only a brief summary of major milestones is provided here.

On April 28, 2016, the Companies filed with the Pennsylvania Public Utility Commission ("PUC" or the "Commission") tariff supplements proposing increases in their annual distribution revenue as set forth below together with the docket numbers assigned to each case:

Company	Tariff Supplement	Proposed Increase	Docket No.
Met-Ed	Supplement No. 23 to Tariff Electric – Pa. P.U.C. No. 52	$140.2 million	R-2016-2537349
Penelec	Supplement No. 23 to Tariff Electric – Pa. P.U.C. No. 81	$158.8 million	R-2016-2537352
Penn Power	Supplement No. 17 to Tariff Electric – Pa. P.U.C. No. 36	$ 42.0 million	R-2016-2537355
West Penn	Supplement No. 10 to Tariff Electric – Pa. P.U.C. No. 38 Supplement No. 15 to Tariff Electric – Pa. P.U.C. No. 40	$ 98.2 million	R-2016-2537359

[1] The Companies' rate proceedings were consolidated for hearing, briefing and decision by the Prehearing Order issued on June 22, 2016.

On June 9, 2016, the Commission entered an Order (the "Suspension Order") suspending each of the tariff filings and referring them to the Office of Administrative Law Judge for investigation to determine the lawfulness, justness and reasonableness of the Companies' existing and proposed rates, rules and regulations. Accordingly, each Company tariff supplement was suspended, by operation of Section 1308(d) of the Public Utility Code, for seven months, or until January 27, 2017. All four cases were subsequently assigned to Administrative Law Judge Mary D. Long.

The Commission's Bureau of Investigation and Enforcement ("I&E") entered its appearance, and the Office of Consumer Advocate ("OCA") and the Office of Small Business Advocate ("OSBA") filed Complaints in all four Companies' proceedings. Complaints were filed against Penelec's proposed rates by four boroughs located in its service territory[2] and by the Penelec Industrial Customer Alliance ("PICA"). The Met-Ed Industrial Users Group ("MEIUG") and West Penn Power Industrial Intervenors ("WPPII") filed Complaints in the Met-Ed and West Penn proceedings, respectively.[3] Additionally, several individual residential customers filed Complaints against the proposed rates of the Companies that serve them.[4]

Petitions to Intervene in all of the Companies' proceedings were filed by the Clean Air Council, the Coalition for Affordable Utility Services and Energy Efficiency in Pennsylvania ("CAUSE-PA"), Citizens for Pennsylvania's Future ("PennFuture"), Wal-Mart Stores East, LP and Sam's East, Inc. ("Wal-Mart"), and the Pennsylvania State University ("PSU"). The

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[2] The four municipalities are the Borough of Sayre, the Borough of South Waverly, the Borough of Athens and Nicholson Borough.

[3] MEIUG, PICA and WPPII are ad hoc groups of industrial customers of each of the respective Companies.

[4] The Companies filed timely Answers to all Complaints until the entry of the Suspension Order and, thereafter, invoked 52 Pa. Code § 5.61(d), which provides that Answers are not required for Complaints docketed with a Commission-initiated rate investigation.

Environmental Defense Fund ("EDF") filed a Petition to Intervene in Met-Ed's rate proceedings, which the Company opposed. AK Steel Corporation ("AK Steel") filed a Petition to Intervene in West Penn's rate proceeding, and North America Hoganas Holdings, Inc. and the International Brotherhood of Electrical Workers, Local 459 filed Petitions to Intervene in Penelec's rate proceeding. All of the Petitions to Intervene were granted.

A Prehearing Conference was held on June 17, 2016, at which a schedule was established for the submission of testimony and the conduct of evidentiary and public input hearings. Additionally, the Companies' request to consolidate their four rate cases for hearings, briefing and decision, which was supported by the statutory advocates and not opposed by any party, was granted.

Between July 21 and August 18, 2016, twelve public input hearings were held at seven different locations throughout the Companies' service territories. The dates, times and locations of the public input hearings were established in Notices issued by the Commission on July 5 and 12, 2016, in the consolidated docket.

The Companies submitted supporting data with their respective tariff filings that included the prepared direct testimony of nine initial witnesses and the various exhibits sponsored by them. The Companies served Supplemental Direct Testimony on July 7, 2016. Subsequent stages of testimony were served as follows:

- On or before July 22, 2016, Complainant/Intervenor direct testimony and accompanying exhibits were served by I&E, OCA, OSBA, MEIUG/PICA/WPPII, Wal-Mart, AK Steel (submitted only as to West Penn) and EDF/PennFuture (submitted only as to Met-Ed).

- On August 17, 2016, the OCA served the supplemental direct testimony and accompanying exhibits of one of its witnesses.

- Also on August 17, 2016, rebuttal testimony and accompanying exhibits were served by the Companies, I&E, OCA, OSBA, MEIUG/PICA/WPPII, CAUSE-PA, AK Steel

and PSU (AK Steel and PSU submitted testimony only as to West Penn).

- On August 26, 2016, the Companies resubmitted two statements of rebuttal testimony (Statement Nos. 3-R and 10-R) with the portions responding to the direct testimony of witnesses for EDF and PennFuture removed.[5]

- On September 6, 2016, the OCA resubmitted the rebuttal testimony of Roger D. Colton (OCA Statement No. 4-R) with the portions responding to the direct testimony of witnesses for EDF and PennFuture removed.

- On August 31, 2016, surrebuttal testimony and accompanying exhibits were served by the Companies, I&E, OCA, OSBA, MEIUG/PICA/WPPII, CAUSE-PA and AK Steel (as to West Penn only)

Negotiations were conducted by the parties in an effort to achieve a settlement of the issues in this case. As a result of those negotiations, the Joint Petitioners were able to agree to the Settlements, which resolve all but one issue. In light of the Settlements and the waiver of cross-examination by all parties, a hearing was held on September 7, 2016, solely for the purpose of entering testimony and exhibits into the record and establishing dates for submitting Initial (September 29, 2016) and Reply (October 14, 2016) Briefs.

B. The Partial Settlements

The Settlements resolve all issues among the Joint Petitioners except one, being pursued by the OCA, concerning the terms of Rider R to Met-Ed's and Penelec's tariffs and Riders O and N, respectively, to Penn Power's and West Penn's tariffs. Those riders, which were approved by the Commission's Orders entered on June 9, 2016,[6] establish a Distribution System Improvement

[5] On August 15, 2016, Met-Ed filed a Motion to Strike the direct testimony of Paul Alvarez on behalf of EDF and Michael Murray on behalf of EDF/PennFuture. By her Order on Motion to Strike and Motion to Compel issued on August 25, 2016, Judge Long struck both statements.

[6] *Petition of Metropolitan Edison Company for Approval of a Distribution System Improvement Charge*, Docket No. P-2015-2508942 (June 9, 2016) ("Met-Ed DSIC Order"); *Petition of Pennsylvania Electric Company for Approval of a Distribution System Improvement Charge*, Docket No. P-2015-2508936 (June 9, 2016) ("Penelec DSIC Order"); *Petition of Pennsylvania Power Company for Approval of a Distribution System Improvement Charge*, Docket No. P-2015-2508931 (June 9, 2016) ("Penn Power DSIC Order"); *Petition of West Penn Power Company for Approval of a Distribution System Improvement Charge*, Docket No. P-2015-2508948 (June 9, 2016) ("West Penn DSIC Order") (collectively, "Companies' DSIC Orders").

Charge ("DSIC") that conforms to the terms of the "Model Tariff" the Commission adopted, pursuant to Section 1353 of the Public Utility Code,[7] in its Final Implementation Order for Act 11 of 2012.[8]

The reserved issue pertains to the formula in Riders N, O and R (hereafter referred to collectively as the "DSIC Rider") for calculating the "fixed cost" of "eligible property"[9] recovered through the DSIC. Specifically, the OCA, through its witness, Ralph C. Smith,[10] citing Section 1301.1, which was added to the Public Utility Code earlier this year,[11] contends that the formula in the DSIC Rider – and by extension, the formula in the Commission's Model Tariff – should be modified by inserting a term that deducts from the original cost of "eligible property" accumulated deferred income taxes ("ADIT") that may accrue with respect to that property. The Companies submitted the testimony of Richard A. D'Angelo, FirstEnergy's Manager – Rates and Regulatory Affairs – Pennsylvania, rebutting Mr. Smith's arguments.[12]

The OCA also contends that the issue reserved for briefing should properly be addressed in this proceeding because the DSIC Rider constitutes an existing "rate" of the Companies. The OCA submits that, as an existing "rate," the terms of the DSIC Rider are within the scope of its Complaints against the Companies' existing and proposed rates, which were consolidated with the Commission's investigation at this docket.

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[7] *See* 66 Pa.C.S. § 1353(b)(1) ("A petition for commission approval of a distribution system improvement charge shall include . . . [a]n initial tariff that complies with a model tariff adopted by the commission.").

[8] *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611 (Aug. 2, 2012) ("Final Implementation Order"), pp. 30-31 and Appendix A.

[9] *See* 66 Pa.C.S. §§ 1351 (defining "eligible property") and 1357(a)(3) (defining "fixed cost").

[10] OCA Statement No. 1, pp. 108-110.

[11] 66 Pa.C.S. § 1301.1.

[12] Companies' Statement No. 2-R, pp. 40-43. Mr. D'Angelo explained that Section 1301.1 does not apply to the DSIC and, even if it did, it does not eliminate or diminish the Commission's discretion to determine how ADIT should be recognized in the DSIC adjustment mechanism.

II. OVERVIEW AND SUMMARY OF ARGUMENT

A. The Reserved Issue Should Not Be Addressed In this Case

Given the procedural posture of the reserved issue, the Companies, in Section IV, *infra*, address that issue on its merits. However, as explained in Section III, *infra*, the reserved issue should not be addressed in this case. The reserved issue pertains to the terms of an adjustment clause established under Section 1357(c), which, as explained in Section IV.C.2, *infra*, is not a "base rate" and differs markedly from base rates established under the authority of Section 1308(d). This consolidated proceeding encompasses the Companies' base rates. Accordingly, the reserved issue is not properly within the scope of this proceeding.

B. The Companies' Argument On The Merits

In *McCloskey v. Pa. P.U.C.*,[13] the Commonwealth Court held that the Commission did not abuse the discretion afforded it under the Public Utility Code to set just and reasonable rates when it determined that incremental ADIT associated with quarterly additions of "eligible property" need not be included in the quarterly calculations of the DSIC.[14] The Court rejected the OCA's contention that the Commission-approved DSIC adjustment clause ignores the impact of ADIT. To the contrary, the DSIC, viewed in its entirety, takes ADIT into account because cumulative ADIT (i.e., ADIT related to *all* of a utility's property, including the ADIT associated with incremental additions of "eligible property") is fully reflected in the calculation of a utility's achieved rate of return on equity that is performed, and filed, each quarter. The utility's

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[13] 127 A.3d 860 (Pa. Cmwlth. 2015) ("*McCloskey*"). This case was an appeal from a Commission Order approving a DSIC for Columbia Gas of Pennsylvania, Inc. ("Columbia"). Similar issues were also decided against the OCA in an unreported opinion issued the same day in the OCA's appeal from a Commission Order approving a DSIC for Little Washington Wastewater Company ("Little Washington"). *McCloskey v. Pa. P.U.C.*, No. 1358 C.D. 2014 (Nov. 3, 2015) ("*McCloskey-Little Washington*").

[14] 127 A.3d at 870-871.

achieved rate of return on equity, in turn, is compared, each quarter, to its allowable rate of return on equity to determine if it has breached the "earnings cap"[15] and, therefore, must reduce its DSIC to *zero*. The Court determined that the Commission's approach, which recognizes cumulative ADIT, is reasonable and, therefore, the Commission had properly exercised its permissible discretion to set just and reasonable rates in rejecting the OCA's alternative, incremental approach. In so doing, the Court followed Pennsylvania appellate court precedent holding that there is no "single way" to determine just and reasonable rates; that the Commission is "'vested with discretion to decide what factors it will consider'" in establishing a rate, [16] and that the *entire* adjustment clause constitutes a "rate."[17]

Notwithstanding the foregoing, Mr. Smith and the OCA contend that the subsequent enactment of Section 1301.1(a) of the Public Utility Code[18] requires the Commission to adopt the very same proposed revision to the DSIC formula rejected by the Commonwealth Court in *McCloskey*.[19] Section 1301.1(a) was added to the Public Utility Code by Act 40 of 2016 ("Act 40")[20] to eliminate the use of so-called consolidated tax adjustments ("CTA") in calculating

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[15] *See* 66 Pa.C.S. § 1358(b)(3).

[16] 127 A.3d at 868, quoting *Popowsky v. Pa. P.U.C.*, 669 A.2d 1029, 1040 (Pa. Cmwlth. 1995). *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 313 (1989) (Rejecting the argument advanced by appellants in that case that "subsidiary elements" of a ratemaking methodology may be "examined piecemeal.")

[17] 127 A.3d at 867 (Accepting the Commission's position that "the DSIC charge and the limiting provisions of the customer protections under Act 11 must be considered together." The "earnings cap" is one of the "customer protections" embedded in the DSIC Model Tariff.) *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2338282 (Final Order entered May 22, 2014), p. 22 ("However, the ALJs stated that, 'in Pennsylvania, a rate is defined as more than just the individual components of the mechanism, but rather the entire mechanism and all rules and regulations associated with it.'") quoting R.D. issued Mar. 6, 2014), p. 45. *See also* 66 Pa.C.S. § 102 (defining a "rate" as including "any rules, regulations, practices, classifications or contracts affecting any . . . charge.").

[18] 66 Pa.C.S. § 1301.1(a).

[19] OCA Statement No. 1, pp. 108-110.

[20] Act 40 was enacted on June 12, 2016 to become effective in sixty days (i.e., by August 11, 2016) for "all cases where the final order is entered after the effective date of this section."

utility base rates.[21] Nonetheless, the OCA submits that Section 1301.1(a): (1) applies to the formula for calculating the DSIC incorporated in the Model Tariff; and (2) retroactively removes from the Commission the discretion to determine how ADIT should be recognized in establishing a just and reasonable DSIC adjustment clause. Both contentions are erroneous.

Act 40 does not apply to the DSIC for three reasons. First, Act 40 does not mention the DSIC or otherwise indicate that the amendments it was making to the Public Utility Code altered the method of calculating the DSIC that had been approved by the Commission and affirmed by the Commonwealth Court. To the contrary, Act 40 was explicitly designed to eliminate the use of CTAs.[22] Nothing within the four corners of that act or in its legislative history suggests it would alter the elements of the DSIC formula prescribed in Section 1357 or deprive the Commission of its discretion to determine *how* ADIT should be accounted for in designing DSIC tariffs.[23]

Second, the legislative history of Act 40 is clear that Section 1301.1 was intended to apply only to base rates established under Section 1308.[24] The lead sponsor of H.B. 1436, which became Act 40, stated that "this section applies to base rate cases" and "would only go into effect when a utility comes in for a base rate case."[25] Additional evidence from the text of Act 40 and

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[21] *See* Public Hearing In Re: House Bill 1436, Pennsylvania House of Representatives, Consumer Affairs Committee, Sept. 29, 2015 ("H.B. 1436 Public Hearing"), Tr. at 4-5 (Opening Statement of Chairman Robert Godshall): "House Bill 1436 would eliminate the consolidated tax approach and adopt a standalone approach used by a majority of the states and the Federal Energy Regulatory Commission." *See also House of Representatives Legislative Journal*, February 8, 2016, p. 117 (Remarks of Robert Godshall, Chairman, Consumer Affairs Committee (". . . this section applies to base rate cases . . ."). Copies of the Public Hearing transcript and the House Legislative Journal are attached as Appendices A and B, respectively.

[22] *See* Companies' Statement No. 2-R, pp. 40-41.

[23] *See* 1 Pa.C.S. § 1921(c) (Legislative intent may be ascertained from the "occasion and necessity for the statute," the "circumstances under which it was enacted," the "object to be attained," the "contemporaneous legislative history," and "legislative and administrative interpretations" bearing on the relevant statute.)

[24] 66 Pa.C.S. § 1308.

[25] House of Representatives Legislative Journal, Feb. 8, 2016, p. 117 (Remarks of Robert Godshall, Chairman, House Consumer Affairs Committee). *See also* Companies' Statement No. 2-R, pp. 41-42.

its legislative history also supports this conclusion. The DSIC is a "sliding scale of rates or other method for the automatic adjustment of rates"[26] that is based on the same authority granted under Section 1307.[27] As such, the DSIC is not a "base rate" and, therefore, Section 1301.1 does not apply to it.

Third, Act 40 expressly provides: "This section shall apply to all cases where the final order is entered after the effective date of this section."[28] The DSIC formula the OCA proposes to revise was approved in the Final Implementation Order as part of the Model Tariff that Section 1353(b) required the Commission to adopt. The Final Implementation Order was entered on August 2, 2012, and the DSIC formula it approved was affirmed by the Commonwealth Court in *McCloskey* in November 2015.[29] The Final Implementation Order was the "final order" that established the DSIC "rate" now challenged by the OCA. As such, Section 1301.1 does not apply to that "rate."[30] Moreover, even the Commission Orders approving the Companies' DSIC Rider, which found that it conforms to the Model Tariff, were also entered prior to the effective date of Act 40.[31]

Furthermore, even if Act 40 applied to the Model Tariff, it does not retroactively revoke or diminish the discretion afforded the Commission, and affirmed in *McCloskey*, to determine how ADIT should be reflected in the DSIC.[32] As previously explained, cumulative ADIT related to all of a utility's plant in service is fully reflected in the quarterly calculation of a utility's

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[26] 66 Pa.C.S. § 1357(c).

[27] 66 Pa.C.S. § 1358(e)(2). This section requires the reconciliation of revenues and costs "in accordance with section 1307(e)."

[28] As previously noted, the effective date is August 11, 2016.

[29] As previously noted, the OCA appealed from two Commission Orders that approved DSIC tariffs conforming to the Model Tariff. These two appeals were the "test cases" for challenging the terms of the Model Tariff.

[30] *See* Companies' Statement No. 2-R, p. 42.

[31] 66 Pa.C.S. § 1301.1(c)(2).

[32] *See* Companies' Statement No. 2-R, pp. 40-41.

achieved rate of return on equity used to determine whether it may charge a DSIC or, alternatively, must reduce the charge to zero if its "earnings cap" is exceeded. The DSIC formula does not ignore the impact on the DSIC of ADIT and, therefore, does not violate Section 1301.1(a) as the OCA contends. To the contrary, the Commission's Model Tariff accounts for ADIT – just not in the manner the OCA prefers. Simply stated, Act 40 did not strip the Commission of its discretion to choose the method for reflecting ADIT in the DSIC adjustment mechanism – a method that the Commonwealth Court has determined is just and reasonable.

The DSIC in its current form was embodied in the Model Tariff that was approved in the Final Implementation Order, pursuant to the authority conferred by Section 1357(c)[33]

III. THE RESERVED ISSUE PERTAINS TO THE TERMS OF AN ADJUSTMENT CLAUSE AND AS SUCH IS NOT WITHIN THE SCOPE OF THIS BASE RATE PROCEEDING

Section 1357(c), like Section 1307, authorizes an automatic adjustment clause, which is a rate mechanism that is legally separate from, and operates differently from, base rates, as explained in detail in Section IV.C.2, *infra*. Moreover, adjustment clauses, by their nature employ a process for establishing the charges billed to customers that differs markedly from the process used to establish base rates, which is delineated in Section 1308.

The Companies initiated this proceeding by filing proposed increases in base rates under Section 1308(d), and they did not propose any revisions to the terms of their DSIC Riders which were then pending approval by the Commission. Moreover, the Commission's Order initiating its investigation does not mention the DSIC. Notably, the Commission approved the DSIC Riders and initiated its investigation of the Companies' base rate filings at the same public meeting.

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[33] 66 Pa.C.S. § 1357(c).

In short, this consolidated proceeding encompasses only the base rates of the Companies and any associated *base rate* issues. Accordingly, the issue the OCA has reserved for briefing is not properly within the scope of this case and should not be addressed in this proceeding.[34]

IV. *MCCLOSKEY* REMAINS VALID AND CONTROLLING PRECEDENT ON THE ISSUE OF WHETHER THE COMMISSION, IN DESIGNING THE MODEL TARIFF, PROPERLY DETERMINED THAT IT MAY REFLECT THE CUMULATIVE IMPACT OF ADIT THROUGH THE "EARNINGS CAP" PROVISION OF THE DSIC

A. Background And History Of The DSIC: Since The Commission First Adopted A Form Of The DSIC In 1996, It Has Not Deducted Incremental ADIT In Calculating Quarterly Charges

In 1996, based on petitions filed by two water utilities, the Commission first approved a DSIC under the authority of Section 1307 of the Public Utility Code.[35] In its Orders in those cases, the Commission approved "Sample Tariff Language" setting forth the terms of the DSIC adjustment mechanism, including the formula for calculating the quarterly charge and the imposition of customer safeguards, including an earnings cap. With a few minor, mostly industry-specific, revisions that are not relevant to this case, the "Sample Tariff Language" approved in 1996 is virtually identical to the Model Tariff approved in the Final Implementation Order. In particular, the DSIC formula for calculating recoverable "fixed costs" of "eligible property" and the earnings cap in the Model Tariff are the same as the comparable formula and

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[34] *See* Companies' Statement No. 2-R, p. 42 (Explaining that, if the OCA desires to raise this issue, it should not be pursued in this base rate proceeding.)

[35] *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-00961031, 26 Pa.Bull. 4485 (Aug. 22, 1996) ("PAWC DSIC Order"); *Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-00961036, 26 Pa.Bull. 4490 (Aug. 22, 1996) ("PSWC DSIC Order"). (A copy of the PAWC DSIC Order, which is the same in all relevant respects as the PSWC DSIC Order, is attached as Appendix C.)

earnings cap adopted in 1996.[36] The two water utilities filed compliance tariffs with computations of the DSIC that, as the OCA has previously acknowledged, did *not* deduct incremental ADIT in calculating the quarterly charge.

The OCA appealed to Commonwealth Court from the PAWC and PSWC DSIC Orders and challenged the Commission's authority to approve DSIC adjustment mechanisms under Section 1307. While those appeals were pending, the Pennsylvania Legislature enacted a bill, which the Governor signed, adding subsection (g) to Section 1307.[37] Section 1307(g) explicitly authorized "[r]ecovery of costs related to distribution system improvement projects designed to enhance water quality, fire protection reliability and long-term system viability" and provided as follows:

> Water utilities may file tariffs establishing a sliding scale of rates or other method for the automatic adjustment of the rates of the water utility as shall provide for recovery of the fixed costs (*depreciation and pretax return*) of certain distribution system improvement projects, as approved by the commission, that are completed and placed in service between base rate proceedings. The commission, by regulation or order, shall prescribe the specific procedures to be followed in establishing the sliding scale or other automatic adjustment method. (Emphasis added.)

Notably, the Legislature used the same words in Section 1307(g) that the Commission employed in the previously-approved Sample Tariff Language to describe the formula for calculating the DSIC quarterly charge.[38] As previously explained, the water utilities' compliance filings, which were submitted and approved before Section 1307(g) was enacted, did not deduct incremental ADIT in calculating the DSIC. And, after Section 1307(g) was added, both of those

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[36] The earnings cap appears in the paragraph captioned "Earnings Reports" in both the Sample Tariff Language and the Model Tariff.

[37] 18 P.L. 1061, No. 156 (Dec. 18, 1996).

[38] *See* PAWC DSIC Order, Appendix A (Sample Tariff Language), p. 1 ("Purpose: To recover the fixed costs (depreciation and pre-tax return) . . ."

companies (and all other water utilities that subsequently implemented a DSIC) continued to calculate the quarterly charge without recognition of incremental ADIT. Consequently, the Legislature adopted the statutory language ("fixed costs (depreciation and pre-tax return)") with prior knowledge of the Commission's then-existing practices for calculating the DSIC's quarterly charges. Applicable rules of statutory construction provide that "administrative interpretations, not disturbed by the Legislature, are appropriate guides to legislative intent."[39] Thus, the history of the DSIC clearly demonstrates that the terms "fixed costs" and "depreciation and pretax return" did not exist in a vacuum either when they were used by the Legislature to describe the cost elements of the DSIC formula in Section 1307(g) or in subsequent iterations of DSIC-related Code sections.[40]

In 2012, with the Commission's support, the Legislature enacted, and the Governor signed, Act 11 of 2012 ("Act 11"), which, among other things, added Sections 1350-1360 to the Public Utility Code authorizing DSIC adjustment clauses for electric, natural gas, and wastewater utilities, in addition to water utilities.[41] Sections 1357 and 1358 address, respectively, the computation of charges under the DSIC and various customer protections. Those sections incorporated the operative provisions that had previously been adopted by the Commission in DSIC tariffs approved for water utilities under Section 1307(g).[42]

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[39] *Twp. of Derry v. Pa. Dept. of Labor and Indus.*, 12 A.3d 489, 495 (Pa. Cmwlth. 2011) (quoting *Hosp. Ass'n of Pa. v. Macleod*, 487 Pa. 516, 523 n. 10, 410 A.2d 731, 734 n. 10 (1908).

[40] *See* 66 Pa.C.S. § 1307(g) and 66 Pa.C.S. § 1357(a)(3) ("The fixed cost of eligible property shall consist of depreciation and pretax return . . .)".

[41] *See* 66 Pa.C.S. § 1351 (defining "eligible property" to include property of electric, natural gas, water and wastewater utilities).

[42] *See Tentative Implementation Order*, entered May 11, 2012, in *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611 ("Tentative Implementation Order"), p. 3 ("Additionally, Act 11 incorporates new statutory provisions in Chapter 13, based on the existing DSIC that has been used for over 15 years in the water utility industry . . .").

Of particular significance, Section 1357 retains the same verbal formulation to describe the calculation of the initial charge and quarterly updates that had been used by the Commission in the PAWC and PSWC DSIC Orders and by the Legislature in Section 1307(g): "The fixed cost of eligible property shall consist of depreciation and pretax return . . ."[43] In addition, in Section 1357(b), the Legislature provides a detailed elaboration on that language, which does not mention ADIT or any component of revenue requirement other than the "original cost of eligible property," "depreciation" and "pretax return." Although the specific elements comprising "pretax return" are further defined, that definition does not mention ADIT or deferred taxes as a possible source of capital that must be recognized in calculating initial or quarterly charges.[44]

In like fashion, Section 1358 spells out customer protections that mirror those the Commission first imposed for water utilities in its 1996 DSIC Orders. In particular, Section 1358(b)(3) provides that the DSIC mechanism must include the following term:

> The distribution system improvement charge shall be reset at zero if, in any quarter, data filed with the commission in the utility's most recent annual or quarterly earnings report show that the utility will earn a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under the distribution system improvement charge.

Section 1358 (a)(2), in turn, contains a provision that bears directly on the reserved issue:

> All proceedings, orders and other actions of the commission related to a distribution system improvement charge granted to a water utility and all practices and procedures of a water utility operating under a distribution system improvement charge prior to the effective date of this paragraph shall remain in effect unless specifically amended or revoked by the commission.

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[43] 66 Pa.C.S. § 1357(a)(3).

[44] The OCA asserts that incremental ADIT should be deducted from the original cost of eligible property because it represents a source of non-investor supplied "capital" that finances a portion of that property. As explained above, that concept is not present, or even suggested, in the detailed elements of "pretax return" described in Sections 1357(b)(1) and (2).

Given the long track-record of water utilities calculating quarterly charges under the DSIC without including incremental ADIT, Section 1358(a)(2) clearly evinces the Legislature's intent that the Commission should retain the authority to approve that practice as fully compliant with both the statutory mandates of Sections 1357 and 1358 and the Commission's duty to assure just and reasonable rates.

In summary, the history of the DSIC and the plain language of Sections 1357 and 1358 demonstrate that the statutory provisions authorizing the DSIC affirm the long-standing practice (now incorporated in the Model Tariff) that incremental ADIT need not be included in quarterly DSIC calculations in order for the DSIC adjustment mechanism, as a whole, to be just and reasonable.

B. The Final Implementation Order Approved A Model Tariff Incorporating The Same DSIC Formula In Use Since 1996, Which Does Not Deduct Incremental ADIT In Calculating Quarterly Charges Under The DSIC

After receiving input from various stakeholders in a working group meeting held on April 5, 2012, the Commission entered a Tentative Implementation Order on May 11, 2012 to propose procedures for implementing the amendments to the Public Utility Code made by Act 11, "including a DSIC process for investor-owned energy utilities."[45] The Tentative Implementation Order included, as Appendix A, a "model tariff" for the DSIC. As previously explained, Section 1353 required the Commission to adopt a "model tariff" and also requires that each petition to establish a DSIC contain "[a]n initial tariff that complies with the model tariff adopted by the Commission."[46] In short, the Commission's adoption of a "model tariff" is a statutory requirement that had to be satisfied before a utility could petition the Commission to implement

[45] Tentative Implementation Order, p. 3.

[46] 66 Pa.C.S. § 1353(b)(1).

a DSIC. It is also a proper exercise of the authority granted to the Commission by Section 1358(d): "The commission, by regulation or order, shall prescribe the specific procedures to be followed to approve a distribution system improvement charge."

After summarizing the relevant provisions of Section 1357, the Commission identified the Model Tariff it was proposing to issue and noted that the Model Tariff contained its proposed "formula" for calculating the DSIC.[47] In describing the DSIC formula, which mirrored the one previously used under Section 1307(g), the Commission explained that "the model tariff does not include a provision for accumulated deferred income taxes," which are "accounted for in the normal base rate case process" along with a number of "additional items" that would increase a utility's revenue requirement. The Commission stated that including ADIT, as well as the "additional items" of the kind it delineated, in calculating quarterly charges created "unnecessary complexities" and, therefore, it would "maintain the current calculation" employed under Section 1307(g), which excluded all of those elements.[48]

The Tentative Implementation Order was published in the *Pennsylvania Bulletin*, posted on the PUC's website and served on all jurisdictional water and wastewater companies, electric distribution companies, natural gas distribution companies and the Philadelphia Gas Works, as well as the statutory advocates.[49] The Commission also solicited comments from all interested parties.[50] Extensive comments were filed by a number of parties, including the OCA. In its comments, the OCA argued vigorously for revising the long-standing DSIC formula to insert a term deducting ADIT in calculating quarterly charges. A number of other parties submitted

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[47] Tentative Implementation Order at 15-16.

[48] *Id.* at 16.

[49] *Id.* at 22.

[50] *Id.* at 21.

comments and reply comments opposing the OCA's position.[51] Based on those comments and replies, the Commission concluded that there was no sound reason to depart from the DSIC formula that had been used successfully by water utilities since 1996:

> Accumulated deferred income taxes (ADIT) and a number of additional items, including working capital and taxes associated with DSIC-eligible property, are accounted for in the normal base rate case process. Upon review, we agree with PPL's comments that the DSIC is intended to be a straightforward mechanism which is easy to calculate, easy to audit and which does not require a full rate case analysis. Inclusion of an ADIT adjustment would be inconsistent with that goal and would likely invite litigation over its calculation. Moreover, we note that the water DSIC, used successfully for over 15 years, did not include an ADIT adjustment. And, in any event, consumers remain protected against over earnings by the earnings cap under Section 1358(b)(3) which "captures the revenue impact of all other adjustments and insures that the DSIC does not result in unreasonable rates." PPL Comments at 8.
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> Therefore, the Commission declines to adopt the OCA proposal to include, in the DSIC calculation, an adjustment for accumulated deferred income taxes. The adjustment, which was not previously used in the DSIC by the water industry, would add unnecessary complexities to the DSIC and, accordingly, will not be included in the model tariff.[52]

The Final Implementation Order adopted the Model Tariff. Thereafter, in every case where a utility has petitioned to establish a DSIC, the Commission has held that it was required to find, as a condition precedent to approving a DSIC, that the utility's initial tariff complied

[51] Final Implementation Order, pp. 38-39.

[52] *Id.*

with the Model Tariff.[53] Indeed, the Commission so held in its Orders approving the Companies' DSIC Rider.[54]

The DSIC tariff reviewed by the Commonwealth Court in *McCloskey* – like the DSIC tariffs approved for every other utility after the Act 11 was enacted – conformed to the Model Tariff approved in the Final Implementation Order. Consequently, as discussed in more detail hereafter, the Final Implementation Order is precisely the kind of "final order" contemplated by Section 1301.1(c)(2), which demarcates the threshold for the effectiveness of Section 1301.1(a).

C. Act 40 Did Not Legislatively Overrule *McCloskey* And Did Not Retroactively Strip The Commission Of Its Authority And Discretion To Determine How ADIT May Be Accounted For In The DSIC

Despite solid evidence to the contrary within the four corners of Act 40 and in its legislative history, OCA witness Smith contends that Section 1301.1(a)[55] legislatively overruled *McCloskey* and retroactively stripped the Commission of its discretion to determine how ADIT

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[53] *See e.g., Petition of PECO Energy Company for Approval of its Electric Distribution System Improvement Charge*, Docket No. P-2015-2471423 (Order entered Oct. 22, 2015), p. 25; *Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge,* Docket No. P-2012-2338282 (Order entered Mar. 14, 2013), p. 27; *Petition of PPL Elec. Util. Corp. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2325034 (Order entered May 23, 2013), p. 5.

[54] *E.g.*, Met-Ed DSIC Order, p. 6 ("Section 1353, 66 Pa.C.S. § 1353 requires utilities to file an initial tariff that complies with the Model Tariff adopted by the Commission.") The same language appears in the Penelec, Penn Power and West Penn DSIC Orders.

[55] Section 1301.1(a) provides as follows:

> If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates. If an expense or investment is not allowed to be included in a public utility's rates, the related income tax deductions and credits, including tax losses of the public utility's parent or affiliated companies, shall not be included in the computation of income tax expense to reduce rates. The deferred income taxes used to determine the rate base of a public utility for ratemaking purposes shall be based solely on the tax deductions and credits received by the public utility and shall not include any deductions or credits generated by the expenses or investments of a public utility's parent or any affiliated entity. The income tax expense shall be computed using the applicable statutory income tax rates.

may be accounted for in the DSIC adjustment mechanism. The OCA's contentions are erroneous and should be rejected. Act 40 does not apply to the DSIC and does not require the Commission to adopt the revision to the Model Tariff that the OCA unsuccessfully advocated to the Commission and the Commonwealth Court.[56]

1. Act 40 Has A Single Purpose – To Eliminate The Imposition Of CTAs – And Its Passage Did Not Alter The Pre-Existing, Approved Procedures For Implementing The DSIC

The express purpose of House Bill 1436 ("H.B. 1436") – the bill that became Act 40 – was summarized by the Commission's Chairman in her prepared testimony to the Pennsylvania House of Representatives Consumer Affairs Committee, as follows:

> The proposed bill introduces legislation that requires a public utility's federal income tax expenses to be calculated on a "stand-alone" basis – separate from gains or losses of any affiliates – when establishing base rates for the regulated public utility . . .[57]

Chairman Brown's description of H.B. 1436 was echoed by all of the witnesses who testified before the House Consumer Affairs Committee, including the Consumer Advocate, who stated that H.B. 1436 "would eliminate the longstanding consolidated tax savings adjustment."[58] The objective that H.B. 1436 was designed to achieve was also explained by the bill's lead sponsor in remarks on the House floor, as follows:

> [H.B. 1436] would simply treat utilities on a stand-alone basis so that the utilities' recoverable tax expense is based upon its operations, not those of unregulated affiliates.[59]

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[56] *See* Companies' Statement No. 2-R, pp. 40-42.

[57] Prepared Testimony of Gladys M. Brown, Chairman, Pennsylvania Public Utility Commission, before the Pennsylvania House of Representatives Consumer Affairs Committee (Sept. 28, 2015), p. 4. A copy of Chairman Brown's prepared testimony is attached as Appendix D.

[58] H.B. 1436 Public Hearing, Tr. 31.

[59] House of Representatives Legislative Journal, Feb. 8, 2016, p. 117.

Nothing in the testimony of any witness at the Public Hearing on H.B. 1436 or in the rest of the bill's legislative history evinces any intent to fundamentally alter the Commission's authority and discretion to establish procedures for calculating the DSIC – or any other adjustment clause.

In addition to ignoring the sole purpose of Act 40, the OCA, in advancing the arguments of its witness, Mr. Smith, commits a fundamental error by ignoring the legislative, administrative and judicial history that lay behind the terms of the DSIC embodied in the Model Tariff. That history has been recounted previously and amply demonstrates that the terms relevant to the ADIT issue (i.e., the "formula" and the "earnings cap") are well-established and deeply engrained in the DSIC itself. In like fashion, the OCA ignores the principle affirmed by *McCloskey* that Sections 1353-1358 preserve the Commission's authority and discretion to determine how specific components of a utility's costs are to be recognized in establishing a "rate" and that the entire DSIC tariff (the formula, the earnings cap and other customer protections) constitutes a "rate."

Act 40 does not purport to amend any of the DSIC-related sections of the Public Utility Code or to deprive the Commission of its discretion to determine how to design DSIC procedures consistent with the just and reasonable ratemaking standard. Given the extensive legislative, administrative and judicial history of the DSIC, there is no valid basis to read into Section 1301.1(a) a legislative intent to fundamentally change the structure of the DSIC or to retroactively strip the Commission of its Court-affirmed discretion to determine how ADIT should be accounted for the DSIC. Indeed, the existing Commission procedures are based on express authority granted by Sections 1353(a)(1) (dealing with the adoption of a Model Tariff), 1357(a)(3) (defining the elements of the "fixed cost" of eligible property), 1358(b)(3) (imposing

the "earnings cap") and 1358(d) (providing the Commission broad authority "by regulation or order" to "prescribe the specific procedures to be followed to approve" a DSIC).

Furthermore, even if Act 40 exhibited some ambiguity, Pennsylvania's rules of statutory construction require that the OCA's interpretation be rejected. Section 1921(c) of Pennsylvania's statutory construction law[60] provides that, if a lack of clarity appears in the words of a statute, then the "intention of the General Assembly may be ascertained by considering, among other matters" the following:

(1) The occasion and necessity for the statute.
(2) The circumstances under which it was enacted.
(3) The mischief to be remedied.
(4) The object to be attained.
(5) The former law, if any, including other statutes upon the same or similar subjects.
(6) The consequences of a particular interpretation.
(7) The contemporaneous legislative history.
(8) Legislative and administrative interpretations of such statute.

Applying the factors set forth above only reinforces the conclusion – evident from the absence of any mention of the DSIC in Act 40 – that Section 1301.1(a) does not apply to the DSIC. As previously explained, Act 40 was enacted for the sole purpose of eliminating the imposition of CTAs. Therefore, Sections 1921(c)(1), (2) and (4) require that its reach be limited to that purpose and not extended to fundamentally change the DSIC-related Code sections or to invalidate pre-existing Commission-approved DSIC tariffs adopted in compliance with those sections.

Similarly, Sections 1921(c)(5), (6) and (8) undercut the OCA's position. Sections 1353 through 1358 of the Public Utility Code establish the elements of the DSIC. As the Commonwealth Court held in *McCloskey*, those sections allow the Commission to exercise its

[60] 1 Pa.C.S. § 1921(c).

long-established ratemaking discretion to design DSIC procedures that produce a just and reasonable "rate" – recognizing that the "rate" consists of the entire DSIC tariff. The OCA's proposed interpretation would retroactively diminish the Commission's ratemaking authority, overturn a now well-established procedure for calculating the DSIC and contravene a Commonwealth Court decision holding that the Commission properly exercised its ratemaking authority in determining how ADIT should be accounted for in the DSIC. The language of Act 40 has neither the force nor the specificity necessary to topple those solid, pre-existing legislative, administrative and judicial structures.

Finally, and as discussed in more detail in the next section, the contemporaneous legislative history of Act 40 (Section 1921(c)(7)) leaves no doubt that Section 1301.1(a) of the Public Utility Code does not apply to adjustment clauses like the DSIC.

2. Section 1301.1(a) Applies To "Base Rates" And Does Not Apply – Nor Was It Intended To Apply – To Adjustment Clauses Such As the DSIC

The Public Utility Code authorizes two kinds of rates and two different approaches to calculating such rates. "Base rates" are established pursuant to authority conferred by Section 1308 of the Public Utility Code.[61] A "sliding scale of rates" or "adjustment clause" may be established under Section 1307[62] or similar provisions of the Public Utility Code that incorporate the authority conferred by Section 1307, such as the adjustment clause prescribed for the DSIC under Section 1357(c).[63] Thus, the Commonwealth Court has stated:

> While we recognize that a base rate filing under Section 1308 of the Code is the preferred method for a public utility to recover the

[61] 66 Pa.C.S. § 1308.

[62] 66 Pa.C.S. § 1307.

[63] 66 Pa.C.S. § 1357(c) ("Utilities may file tariffs establishing a sliding scale of rates or other method for the automatic adjustment of the rate of the utility to provide for recovery of the depreciation and pretax return fixed costs of eligible property, as approved by the Commission.").

> costs of providing service, we cannot ignore the fact that the General Assembly envisioned the automatic adjustment of rates in enacting Section 1307(a) of the Code.[64]

Pennsylvania's appellate courts have recognized important distinctions between "base rates" and "surcharges" imposed pursuant to automatic adjustment clauses. In particular, the Commonwealth Court has held that a "surcharge is quite different from a base rate" because it is "an amount added to a customer's regular bill that is established outside the normal ratemaking procedure."[65] As such, adjustment clauses are permitted only "in certain limited instances"[66] in order "to permit reflection in customer charges of changes in one component of a utility's cost of providing public service without the necessity of the broad, costly and time-consuming inquiry required in general rate cases."[67]

Base rates, on the other hand, employ "the test year concept, which requires a snapshot of the utility's revenues, expenses and capital costs during a one-year period" for the purpose of reflecting "typical conditions." Accordingly, all cost elements are "adjusted and normalized" to determine the utility's overall revenue requirement:[68]

> Under the test year concept, revenue, expenses and capital costs are to be simultaneously reviewed for the same period of time so that a utility may prove its new rates are "just and reasonable." [69]

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[64] *Popowsky v. Pa. P.U.C.*, 13 A.3d 583, 591 (Pa. Cmwlth. 2011) (Affirming the Commission's decision authorizing a water utility to implement a Purchased Water Adjustment Clause that adjusted rates solely for changes in the cost of purchased water.).

[65] *Popowsky v. Pa. P.U.C.*, 869 A.2d 1144, 1152 (Pa. Cmwlth. 2005) (Reversing a Commission decision authorizing a wastewater utility to implement a Collection System Improvement Charge on the grounds that the costs to be recovered exceeded the scope of permissible cost elements that should be considered under Section 1307 and, therefore, required the more comprehensive review of all elements of the utility's revenue requirement available only under a Section 1308(d) proceeding.).

[66] *Masthope Rapids Prop. Owners Council v. Pa. P.U.C.*, 581 A.2d 994, 999 (Pa. Cmwlth. 1990).

[67] *Pa. Indus. Energy Coal. v. Pa. P.U.C.*, 653 A.2d 1336, 1148 (Pa. Cmwlth. 1995).

[68] *Popowsky v. Pa. P.U.C.*, 869 A.2d at 1152.

[69] *Id.*

Pennsylvania appellate courts have also held that the process for authorizing automatic adjustment clauses and implementing "surcharges" under Section 1307 should not be expanded to encompass all, or even most, of the revenue requirement components that are comprehensively scrutinized in "base rate" proceedings. Specifically, the Commonwealth Court stated: "Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process . . ."[70]

The differences between the process authorized by Section 1307 (and similar adjustment clause provisions) to reflect changes in a limited number of cost components and the comprehensive review of a utility's total revenue requirement required by Section 1308 was considered by the Commission in the Final Implementation Order. Weighing those factors, the Commission determined that it was neither necessary nor appropriate to reflect incremental ADIT in the quarterly DSIC calculation and chose, instead, to account for cumulative ADIT through the "earnings cap" review process.

In the Final Implementation Order, the Commission analyzed and discussed the factors, in addition to ADIT, that could affect the calculation of "fixed costs" and concluded that none of those factors – neither those that would reduce recoverable costs nor others that would increase them – should be loaded into the otherwise straight-forward formula for calculating quarterly charges under the DSIC:

> Accumulated deferred income taxes (ADIT) and a number of additional items, including working capital and taxes associated with DSIC-eligible property, are accounted for in the normal base rate case process. Upon review, we agree with PPL's comments that the DSIC is intended to be a straightforward mechanism which

[70] *Pa. Indus. Energy Coal. v. Pa. P.U.C.*, 653 A.2d at 1349. *See also Popowsky v. Pa. P.U.C.*, 13 A.3d at 593. In *McCloskey*, the Commonwealth Court also found this consideration significant and relied upon it: "In the current controversy, although the OCA requested the inclusion of specific additional base rate adjustments to add to the DSIC calculation, the DSIC also excluded adjustments which would possibly benefit Columbia." *McCloskey, supra*, at 869.

> is easy to calculate, easy to audit and which does not require a full rate case analysis. Inclusion of an ADIT adjustment would be inconsistent with that goal . . .[71]

In summary, there are important and well-recognized differences between "base rates" and "adjustment clauses" that are mirrored in the processes used to establish each. While base rates are set only after a comprehensive review of all elements of a utility's revenue requirement for a selected test year, adjustment clauses are designed to recover a limited category of costs through a more streamlined and expedited process. The distinction between base rates and adjustment clauses was central to the way the Commission decided to account for cumulative ADIT and to structure the DSIC tariff. This distinction cannot be ignored in construing Act 40 and, as explained below, the legislative history and the text of Act 40 itself clearly establish that it does not apply outside the comprehensive review of all elements of a utility's revenue requirement that occurs in setting "base rates."

Section 1921(c)(7) of Pennsylvania's statutory construction law requires the "contemporaneous legislative history" to be considered in construing a statute if a party, like the OCA here, raises issues that suggest the statute is susceptible to alternative interpretations.[72] When the contemporaneous legislative history of Act 40 is considered, it is clear that Section 1301.1(a) does not apply to the DSIC.

All of the extant evidence on this point shows that Act 40 was intended, and designed, to apply only to "base rates." Two important participants in the legislative process, the Chairman of the House Consumer Affairs Committee, and lead sponsor of H.B. 1436, and the Chairman of the Commission, who submitted testimony to the Committee, stated that Act 40 would apply

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[71] Final Implementation Order, p. 39.

[72] The Companies, on the other hand, view the absence of any reference to the DSIC in Act 40 to be dispositive that Section 1301.1(a) does not operate in the manner the OCA is trying to force upon it.

only to "base rates." Thus, Chairman Godshall, in remarks on the House floor, stated that "this section applies to *base rate cases*" and "would only go into effect when a utility comes in for *a base rate case*."[73] As previously noted, in her Prepared Testimony to the Committee, Chairman Brown stated in relevant part: "The proposed bill introduces legislation that requires a public utility's federal income tax expense to be calculated on a 'stand-alone' basis . . . *when establishing base rates* for the regulated public utility . . ."[74]

Chairman Godshall and Chairman Brown understand the ratemaking process and certainly appreciate the difference between "base rates" and adjustment clauses like the DSIC. Just as important, their association of Act 40 with the "base rate" process focuses on the significant distinction between the comprehensive revenue requirement analysis conducted in a base rate case – where ADIT issues can be considered in conjunction with all other cost elements during a seven-month suspension period – and the limited range of cost factors that are isolated and reflected in non-base rate proceedings under Section 1307 and similar adjustment clauses. Therefore, applying Act 40 only in base rate proceedings properly tracks the important distinction the Commission itself made between "base rates" and the DSIC process when it concluded that the OCA's proposed revisions to the DSIC formula are contrary to the nature of an adjustment clause.[75]

Additionally, the portion of Section 1301.1(a) that the OCA likely will cite as alleged support for its position provides that "[t]he deferred taxes used to determine the rate base of a

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[73] House of Representatives Legislative Journal, Feb. 8, 2016, p. 117 (emphasis added). (The first quote is from a longer passage that, as transcribed in the Legislative Journal, reads "this section applies to base rate cases where the PUC finally orders an issue after the effective date." From the context it appears reasonably clear that there was a transcription error that transposed "issues" and "order," and the passage should read "finally issues an order after the effective date.").

[74] Prepared Testimony of Gladys M. Brown, Chairman, Pennsylvania Public Utility Commission, p. 4 (see Appendix D).

[75] *See McCloskey*, 127 A.2d at 819 (Explaining that "additional base rate adjustments" are not required in calculating charges under the DSIC because the DSIC is an "alternative ratemaking mechanism.")

public utility for ratemaking purposes shall be based solely on the tax deductions and credits received by the public utility . . ." The reference to "determination of rate base" is further evidence that Section 1301.1(a) applies only in determining base rates.

The term "rate base" does not appear in any of the DSIC-related sections added to the Public Utility Code by Act 11. This is not a coincidence. The DSIC is designed to reflect only a subset (i.e. "fixed costs" of "eligible property")[76] of the elements that, in a base rate case, would be included in "rate base." The concept of "rate base" is, however, highly relevant in proceedings to establish base rates, where all of the elements that comprise a utility's "rate base," including, for example, cash working capital, prepaid expenses, materials and supplies, unamortized investment tax credits, experienced cost of removal, customer advances, contributions in aid of construction and customer deposits, are identified, quantified and added, or deducted, as appropriate, to determine a utility's investment on which it may earn a return. Consequently, Act 40's specific reference to "deferred income taxes *used to determine the rate base of a public utility for ratemaking purposes*" (emphasis added) is relevant only in the context of a base rate proceeding.

Finally, as discussed in the next section, use of the term "final order" in Section 1301.1(c)(2) is further textual support for construing Act 40 as applying only to base rates.

3. Act 40 Does Not Apply To The DSIC Because The Model Tariff – Which Constitutes The DSIC "Rate" – Was Approved By A Final Order Entered Before The Effective Date Of Act 40

Act 40 provides: "This section shall apply to all cases where the *final order* is entered after the effective date of this section."[77] Section 1301.1 became effective on August 11, 2016

[76] 66 Pa.C.S. § 1353(a)(1) and (2).

[77] 66 Pa.C.S. § 1301.1(c)(2)(emphasis added).

(i.e., sixty days after its enactment on June 12, 2016). Even if Act 40 applied to more than just base rates, the "final order" that is relevant for determining whether Section 1301.1(a) applies to the DSIC was entered prior to the effective date of that section.

The term "final order" is readily discerned in the context of a general base rate case because Section 1308(d) requires the Commission to enter a "final decision and order" prior to the end of the statutory suspension period:

> Before the expiration of such seven-month period, a majority of the members of the commission serving in accordance with law, acting unanimously, shall make a *final decision and order*, setting forth reasons therefor, granting or denying, in whole or in part, the general rate increase requested. [78]

Indeed, because a "final order" is so inextricably associated with base rate cases, and so easily identified in that context, the Legislature's use of the term "final order" in Act 40 also supports the conclusion that its legislative history impels – Act 40 only applies only to "base rates."

The term "final order" does not appear in any DSIC-related Code sections, nor does it appear in Section 1307. Even the term "order" appears only once. Notably, it is used in Section 1358(d), where the Commission is directed to approve "specific procedures" for the establishment of a DSIC by "regulation or order."[79] Thus, "order" in "regulation or order" refers to a Commission order establishing the terms, conditions and procedures of the DSIC adjustment mechanism. Reading Section 1358(d) in conjunction with the mandate of Section 1353(b)(1) that the Commission adopt a "model tariff," the "regulation or order" relates to, and provides the authority for, the Commission's approval of a "model tariff" embodying the terms, conditions and procedures that comprise the DSIC adjustment mechanism. Significantly, Section 1307

[78] 66 Pa.C.S. § 1308(d) (emphasis added).

[79] 66 Pa.C.S. § 1358(d) provides: "The commission, by regulation or order, shall prescribe the specific procedures to be followed to approve a distribution system improvement charge. A distribution system improvement charge approved by the commission shall provide: . . ." Sections 1358(d)(1)-(3), which follow, delineate specific components a DSIC tariff must contain.

employs the same approach, where the word "order" is used in the phrase "regulation or order" to identify the Commission's approval of the entire "system for automatic adjustment" of rates: "The commission, by regulation or order, upon reasonable notice and after hearing, may prescribe . . . a mandatory system for the automatic adjustment of their rates."

The statutory language employed in Sections 1353(b)(1) and 1358(d) is consistent with the definition of "rate" under Section 102, which includes: "any rules, regulations, practices, classification or contracts . . . affecting any . . . charge." For precisely this reason, the Recommended Decision in the PUC proceeding that the OCA appealed in *McCloskey* states: "[I]n Pennsylvania a rate is defined as more than just the individual components of the mechanism, but rather the entire mechanism and all rules and regulations associated with it."[80]

The principle that the entire adjustment mechanism is a "rate" is well-established. For example, the Texas Court of Appeals, applying a definition of "rate" that is virtually identical to the one in Section 102, held that "a rate schedule containing a variable or formula for determining the amount of a customer charge – specifically, a PGA [purchased gas adjustment] clause – was a 'rate' within GURA's [Gas Utility Regulatory Act's] definition."[81] The Federal Energy Regulatory Commission, with the approval of federal appellate courts, adheres to the same principle: "The Commission need not confine rates to specific, absolute numbers but may

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[80] *Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2338282 (R.D. issued Mar. 6, 2014), p. 45. *See* Final Order entered May 22, 2014, p. 58 ("[T]he Recommended Decision of Administrative Law Judges Mark A. Hoyer and Jeffrey A. Watson, issued on March 6, 2014, is adopted, consistent with this Opinion and Order.").

[81] *R.R. Comm'n of Texas v. Texas Coast Util. Coal.*, 357 S.W.3d 731, 739 (Tex. App. 2011). The Court of Appeals decision was affirmed by the Texas Supreme Court in *Texas Coast Util. Coal. v. R.R. Comm'n of Texas*, 423 S.W.3d 355, 364 (Tex. 2014) ("We thus conclude that the COSA [cost of service adjustment] clause constitutes a 'rate' under subsection (B) [of the definition of "rate"]. The definition of "rate" is set forth at 423 S.W.3d at 364 and tracks, virtually word for word, the corresponding portion of the definition of a "rate" in 66 Pa.C.S. § 102.

approve a tariff containing a rate 'formula' or rate 'rule' . . ."[82] Thus, the Court of Appeals for the District of Columbia also held that "[a] method or formula for calculating a rate, also called a 'rate rule,' when enshrined in an approved tariff, is itself a 'filed rate' . . ."[83]

For all the reasons set forth above, if Section 1301.1 were to extend beyond "base rates" – which it does not – that section still would not apply to the DSIC because the "final order" establishing the relevant "rate" (i.e., the entire adjustment mechanism) is the Final Implementation Order entered on August 2, 2012, that approved the Model Tariff. This conclusion is further supported by Section 1353(b)(1), which requires every petition to implement a DSIC to include "an initial tariff that complies with a model tariff adopted by the commission." As explained in Section IV.B. *supra*, in every case where a utility filed a petition under Section 1353(b), the Commission has held that it was required to find, as a condition precedent to approving a DSIC, that the utility's proposed tariff complies with its Model Tariff.

The fact that the Commission entered orders approving utility petitions that contained DSIC compliance tariffs does not detract from the finality of the Final Implementation Order. It is well-established that an order is "final" even if a utility is required to file a "compliance" tariff to implement its terms.[84] Indeed, the Commonwealth Court has held that an order may be final if it determines a fundamental issue, such as "structural separation" of two business lines of a utility, even if further proceedings are necessary to implement that determination.[85]

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[82] *Transwestern Pipeline Co. v. FERC*, 897 F.2d 570, 578 (D.C. Cir. 1990) (Holding that, where FERC "adopts a formula," courts may not disturb the FERC's determination that such a formula constitutes a "rate" under the Natural Gas Act.).

[83] *Accord ChevronTexaco Exploration and Prod. Co. v. FERC*, 387 F.3d 892, 894 (D.C. Cir. 2004).

[84] *Barasch v. Pa. P.U.C.*, 540 A.2d 966, 971 (Pa. Cmwlth. 1988) ("Review of the PUC's June 27 order establishes that the only matter left 'open' was PECO's calculation of the tariffs which would provide the increase allowed by the PUC. . . . Thus, we conclude that the June 27 order was a final order.").

[85] *Bell Atlantic-Pennsylvania, Inc. v. Pa. P.U.C.*, 763 A.2d 440, 460-461 (Pa. Cmwlth. 2000) ("The terms of the order state that the next step is a formal proceeding to address the issues necessary to *implement* structural

The fact that the OCA appealed to Commonwealth Court from the Commission's Orders approving Columbia's and Little Washington's compliance tariffs does not negate the finality of the Final Implementation Order for purposes of determining how Section 1301.1(c)(2) applies. Simply because the Orders on those compliance filings were deemed appealable does not mean that the Final Implementation Order itself was not a "final order" within the meaning of Section 1301.1(c)(2). In any event, the Commission's Orders appealed in *McCloskey* and *McCloskey-Little Washington* approved, in each instance, DSIC tariffs that mirrored the Model Tariff adopted in the Final Implementation Order. Thus, *McCloskey* and *McCloskey-Little Washington* effectively affirmed the Final Implementation Order, as evidenced by the fact that, after those decisions were issued, the OCA withdrew its appeals of Commission Orders approving DSIC tariffs for all other utilities that had been filed since the enactment of Act 11. As a consequence, the OCA cannot argue that finding the Final Implementation Order to be a "final order" within the contemplation of Section 1301.1(c)(3) would deprive it of its right to appeal the terms of the Model Tariff, since it clearly did so in the context of the Orders the Commonwealth Court reviewed in *McCloskey* and *McCloskey-Little Washington.*

Finally, the PUC Orders entered on June 9, 2016, approving the DSIC Rider for each of the Companies were also entered before Act 40's effective date. As previously explained, in each of those Orders, the Commission determined that the DSIC Rider complied with the terms of its Model Tariff. Therefore, even if the June 9 Orders were deemed necessary to make the Final Implementation Order "final" as to the Companies, that condition has also been satisfied.

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separation within one (1) year of the entry date of this order (emphasis added). The order therefore does not set further proceedings to reconsider or vary the corporate split, but to *complete* it . . ." (emphasis in original).

4. Even If Act 40 Applied To The DSIC Model Tariff Approved By The Final Implementation Order, It Does Not Retroactively Eliminate The Discretion Afforded The Commission To Determine *How* ADIT Should Be Accounted For In The DSIC Adjustment Mechanism

The argument advanced by Mr. Smith and the OCA theorizes that Act 40 fundamentally changed the nature and scope of the Commission's authority and discretion under the DSIC-related Code sections of Act 11. Specifically, they argue that Act 40 legislatively overruled *McCloskey* and mandates that the Commission revise the Model Tariff to insert a term deducting incremental ADIT associated with each quarterly addition of "eligible property."[86]

As previously noted, to support its position, the OCA will, no doubt, point to a sentence in Section 1301.1(a) that states:

> The deferred income taxes used to determine the rate base of a public utility for ratemaking purposes shall be based solely on the tax deductions and credits received by the public utility and shall not include any deductions or credits generated by the expenses or investments of a public utility's parent or any affiliated entity.

However, that sentence actually reinforces Act 40's express purpose to eliminate the use of CTAs in base rate proceedings (". . . and shall not include any deductions or credits generated by the expenses or investments of a public utility's parent or any affiliated entity"). Like the rest of the Act, the sentence quoted above does not mention the DSIC, does not reference any DSIC-related Code sections and does not purport to apply to "adjustment clauses" (a conclusion reinforced by its use of the term "rate base," as explained previously). Indeed, even the first half of the sentence ("shall be based solely on . . .") does *not* prescribe *how* such "deferred income taxes" are to be determined or reflected "for ratemaking purposes." Consequently, even if Section 1301.1(a) were to apply outside of a base rate proceeding, it does not revoke or diminish

[86] OCA Statement No. 1, pp. 109-110.

the Commission's discretion to determine the appropriate way to account for ADIT in the DSIC. In that regard, Act 40 leaves undisturbed the Commission's determination that "the General Assembly intended to leave the technical mechanics of the DSIC calculation to the Commission." This fundamental proposition was affirmed by *McCloskey*.[87]

Contrary to the holding in *McCloskey*, Mr. Smith essentially reprised the OCA argument the Commonwealth Court already rejected with his contention that there is only one way ADIT should be accounted for in DSIC tariffs. Specifically, the Smith/OCA position is that incremental ADIT must be deducted from "eligible costs" (or included as "zero-cost" capital in the composite "pre-tax return") in calculating quarterly charges. Underlying that position is the unstated assumption that unless the OCA's proposed revision to the rate formula is adopted, the Commission will not have accounted for ADIT anywhere in the DSIC adjustment mechanism. That assumption is incorrect.

As previously explained, the DSIC "rate" consists of the *entire* DSIC adjustment mechanism, with all of its terms, conditions, procedures and customer "safeguards," as they are set forth at length in the Model Tariff (and in the DSIC Rider for each of the Companies). As the Administrative Law Judges in Columbia's DSIC proceedings explained: "Based on the definition of a rate [in Section 102], the entirety of the rate is to be considered when determining whether it is just and reasonable, not just its individual components."[88] The Commission adopted and approved that holding,[89] and the Commonwealth Court affirmed it.[90]

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[87] "[T]he Commission is 'vested with discretion to decide what factors it will consider in setting or evaluating a utility's rates." 127 A.3d at 868.

[88] *Id.*

[89] *Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge, supra*, Final Order at 36-37.

As explained in Sections II, IV.B., IV.C.1 and IV.C.2, *supra*, the Commission carefully considered the limited scope of an adjustment clause like the DSIC, the limited number of cost components it was designed to reflect, and the admonition of Pennsylvania's appellate courts that adjustment clauses should not attempt to recreate base rate determinations and, in that way, "disassemble the traditional rate-making process."[91] Based on its analysis, the Commission concluded that it was neither necessary nor appropriate to reflect incremental ADIT in the quarterly calculation of charges under the DSIC formula.

The Commission did not, however, ignore the impact of ADIT. To the contrary, it determined that *cumulative* ADIT – ADIT related to all of a utility's plant in service, including quarterly additions of "eligible property" – is taken into account in calculating the rate of return on equity the utility actually earns each quarter. The product of that calculation, in turn, must be used to assess whether a utility is exceeding the previously-approved, allowable rate of return on equity employed in the DSIC formula and, if so, the utility must reset its DSIC to *zero*. As the Commission held in PPL Electric Utilities Corporation's DSIC Order: "[T]he earnings cap *is the accurate approach* as it captures the potential magnitude and complexity of ADIT and other costs without necessarily requiring the DSIC to be treated like a Section 1308(d) base rate proceeding."[92] In like fashion, in Columbia's DSIC Order, the Commission concluded that the earnings cap analysis is a superior mechanism for dealing with the ADIT issue than the incremental approach espoused by the OCA:

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[90] *McCloskey, supra*, at 869. *See also McCloskey* at 867 ("Therefore, in assessing whether the DSIC rate was just and reasonable, the Commission argues that the DSIC charge and the limiting provisions of the customer protections under Act 11 must be considered together.").

[91] *See Pa. Indus. Energy Coal. v. Pa. P.U.C., supra.*

[92] *Petition of PPL Elec. Util. Corporation for Approval of a Distribution System Improvement Charge*, Docket Nos. P-2012-2325034 et al (Order entered Apr. 9, 2015), p. 36 (emphasis added).

> As we stated in our *Final Implementation Order*, consumers will remain protected against over-earnings by the earnings cap provision under Section 1358(b)(3) of the Code. *Final Implementation Order* at 39. As Columbia points out, its quarterly earnings reports, which are used to determine the Company's achieved rate of return for earnings cap purposes, capture both upward and downward impacts of a wide variety of individual adjustments that would be considered in a base rate proceeding, including the current book amount of ADIT. Columbia R. Exc. at 13-14. Thus, we do not agree with the OCA that the earnings cap will fail to protect customers from being charged DSIC rates that are unjust or unreasonable. Additionally, we agree with the ALJs' reliance on the *Duquesne* case for the conclusion that the total effect of the rate should be considered in determining whether the DSIC is just and reasonable. *See*, R.D. at 45-46.

In the Columbia DSIC proceeding, the OCA also argued that accounting for cumulative ADIT through the earnings cap analysis lacks the degree of precision it believes necessary for the DSIC to be "just and reasonable."[93] That position was also rejected by the Commission and the Commonwealth Court[94] because the earnings cap analysis tracks the rate-setting process the Commission employed, with the Commonwealth Court's affirmance, in a non-general base rate case initiated by Equitable Gas Company ("Equitable").[95] In that case, Equitable requested an increase in base rates designed to recover the incremental costs of providing its employees post-retirement benefits other than pensions (also referred to as "other post-employment benefits" or "OPEBs").

Equitable had filed a general base rate case in 1991 that was concluded by settlement.[96] In 1994, Equitable filed a non-general base rate increase designed to recover the incremental

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[93] *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge, supra*, Final Order at 22-23.

[94] *See McCloskey* at 868-869.

[95] *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmwlth. 1996) (hereafter, "*Equitable*").

[96] *Id.* at 960.

costs of OPEBs that it began to recognize for financial accounting purposes in 1993.[97] In the litigated proceeding that ensued, Equitable presented a calculation of its actual, achieved rate of return. It also presented evidence showing that its experienced rate of return was less than a reasonable rate of return and that there were no projected savings in non-OPEB costs that would offset its incremental OPEB expense.[98]

The Commission, over the OCA's objection that Equitable had not satisfied its statutory burden, held that comparing Equitable's achieved rate of return to a reasonable rate of return was a lawful means of assessing Equitable's claim to recover incremental OPEB expense and determining if Equitable's proposed base rates were just and reasonable. In its decision on the OCA's appeal, the Commonwealth Court concurred, holding that the same evidentiary standards used in a general base rate case did not apply to a non-general base rate case and that the Commission had ample authority and discretion to "determine whether the public utility's rates are just and reasonable based on the general information" filed by Equitable.[99]

The earnings cap process imposed under Section 1358(b)(3) and incorporated in the Model Tariff tracks the kind of rate analysis approved in *Equitable*. In fact, the earnings cap process is, if anything, more rigorous, because it measures a utility's achieved return on equity against the Commission's previously-determined allowable return rate and repeats that analysis *every quarter* that a DSIC is in effect. Additionally, a DSIC cannot be implemented unless a utility has filed a base rate case within the prior five years.[100]

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[97] *Id.* at 959-960.

[98] *Id.* at 963.

[99] *Id.* at 962.

[100] *See* 66 Pa.C.S. §§ 1353(b)(4) and (5).

Given the Commonwealth Court's decision in *Equitable*, there is no valid basis for the OCA to contend that the quarterly earnings cap analysis required by the Model Tariff is insufficiently precise to assure that the DSIC adjustment mechanism is a just and reasonable rate. If the process approved in *Equitable* was adequate under the circumstances of that case, it is certainly acceptable in the context of an adjustment clause like the DSIC, where the evidentiary bar is set even lower than in a non-general base rate case.[101] On this basis, the Commonwealth Court, in *McCloskey*, held that the Commission's decision to account for ADIT through the earnings cap analysis represents the exercise of the same lawful authority and discretion the Court had affirmed in *Equitable*.[102]

As the Commonwealth Court noted, long-standing Pennsylvania appellate court precedent establishes that "there is no single way to arrive at just and reasonable rates"[103] and the Commission is "'vested with discretion to decide what factors it will consider in setting or evaluating rates.'"[104] As the Commonwealth Court also stated, Pennsylvania precedent is congruent with the United States Supreme Court's decision in *Duquesne Light Co. v. Barasch*, *supra*, holding that the recognition or non-recognition of a "single element" is not "the appropriate standard" for determining whether rates are "just and reasonable."[105] Accordingly, the Commonwealth Court held as follows:

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[101] *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge, supra*, Final Order at 35 ("As we indicated in our *Final Implementation Order*, we believe that the DSIC is intended to be a straight-forward mechanism that is easy to calculate and audit, and does not require a full rate case analysis."). *See also* Final Order at 36 ("[W]e believe that the inclusion of an ADIT adjustment would [as the OCA proposes] involve a level of analysis and complexity that goes beyond the scope of what is required by Act 11 with regard to the calculation of the DSIC.").

[102] *McCloskey* at 868-869.

[103] *Id.* at 868.

[104] *Id.* (internal citations omitted).

[105] *Id.*

> Consequently, even without the inclusion of specific additional base rate adjustments in the ADIT calculation, Columbia's DSIC surcharge mechanism, which was an alternative ratemaking mechanism, was consistent with the implementation of Act 11. Applicable law only requires that the DSIC surcharge mechanism *as a whole* be just and reasonable.[106]

In summary, the Commission, in developing the Model Tariff for the DSIC, did not ignore the impact of ADIT. The DSIC mechanism accounts for ADIT through the earnings cap analysis, which includes cumulative ADIT on all utility property as well as all other costs that impact a utility's "bottom line." The earnings cap requires a utility to stop charging the DSIC altogether if its achieved rate of return exceeds the allowable equity return rate previously approved by the Commission. This test is run every quarter when charges under the DSIC are updated.

The earnings cap analysis is a lawful exercise of the Commission's ratemaking authority that has previously been approved in *Equitable* as an appropriate means of establishing just and reasonable rates in a non-general base rate case. It is also consistent with the "streamlined" process employed in adjustment clauses and incorporated in the DSIC-related sections of the Public Utility Code by Act 11. Thus, even if Act 40 applied to the DSIC – which is does not, for the reasons previously discussed – nothing in Act 40 revokes or diminishes the Commission's authority and discretion to determine *how* ADIT should be accounted for in the DSIC mechanism.

As the Court held in *McCloskey*, the entire DSIC adjustment mechanism, including both the DSIC formula and the earnings cap, constitutes the "rate" that must be assessed for justness and reasonableness. Viewed in that way – as it must be, there is no valid basis to conclude that the Commission abused its discretion in deciding that the quarterly earnings cap analysis

[106] *Id.* at 869 (emphasis in original).

properly accounts for cumulative ADIT and, taken together with all the other provisions of the Model Tariff, produces a just and reasonable rate. Accordingly, *McCloskey* remains valid and controlling legal precedent, and the OCA's proposal to revise the DSIC formula to include incremental ADIT in calculating quarterly charges should be rejected.

V. CONCLUSION

The reserved issue should not be addressed in this proceeding for the reasons discussed in Section III, *supra*. If, however, the reserved issue is considered in this case, then, for all the reasons discussed above, the Administrative Law Judge should issue a Recommended Decision, and the Commission should enter a final order, finding and determining that Act 40 does not apply to the DSIC and, even if it did, Act 40 neither legislatively overruled *McCloskey* nor revoked or diminished the Commission's discretion to determine that cumulative ADIT is properly taken into account in the earning cap analysis required by the Model Tariff (and

incorporated in the DSIC Rider for each of the Companies). Accordingly, the OCA's proposed revision to the DSIC formula should be rejected.

Respectfully submitted,

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PROPOSED FINDINGS OF FACT

1. Act 11 of 2012 ("Act 11") added Sections 1350-1360 to the Public Utility Code.[1] Sections 1350-1360 extend to electric, natural gas, and wastewater utilities the authority, previously conferred on water utilities by former Section 1307(g), to implement a Distribution System Improvement Charge ("DSIC").

2. On May 11, 2012, the Pennsylvania Public Utility Commission ("PUC" or the "Commission") issued a Tentative Implementation Order in *Implementation of Act 11 of 2012*, Docket No. M-2012-229361. In the Tentative Implementation Order, the Commission proposed a "Model Tariff" to be adopted pursuant to Sections 1353(b)(1) and 1358(d) and solicited comments on the Model Tariff and other DSIC implementation issues.

3. The Office of Consumer Advocate ("OCA") submitted comments on the Tentative Implementation Order in which it proposed, among other things, that accumulated deferred income taxes ("ADIT") should be deducted from the original cost of "eligible property" in the formula set forth in the Model Tariff for calculating the "fixed costs" that are recoverable in quarterly charges under the DSIC. The OCA's position was opposed in the reply comments of other parties.

4. On August 2, 2012, the Commission entered a Final Implementation Order in *Implementation of Act 11 of 2012*, Docket No. M-2012-229361 ("Final Implementation Order"). In the Final Implementation Order, the Commission rejected the OCA's proposal to revise the Model Tariff's formula to deduct ADIT from the original cost of eligible property (or recognize

[1] 66 Pa.C.S. §§ 1350-1360. Hereafter "Section" and "Sections" refer to the Public Utility Code unless it is explicitly stated otherwise or the relevant context indicates that another statutory provision is being cited.

ADIT as non-investor supplied capital in determining the applicable pretax rate of return) in calculating quarterly charges under the DSIC.

5. In the Final Implementation Order, the Commission found and determined that ADIT is properly accounted for in the DSIC through the earnings cap analysis required by Section 1358(b)(3), which provides that quarterly charges must be reduced to zero if a utility's actual rate of return on equity exceeds its previously-approved rate of return on equity used to calculate the pretax return component of the DSIC formula. The earnings cap analysis recognizes a utility's cumulative ADIT (i.e., ADIT on all of its utility property including quarterly additions of "eligible property" that qualifies for the DSIC).

6. Following the entry of the Final Implementation Order, a number of utilities filed petitions to implement a DSIC tariff. In each of its Orders approving those petitions, the Commission determined that the utility's proposed DSIC tariff had to conform to the Model Tariff approved in the Final Implementation Order.

7. All of the Commission Orders approving DSIC tariffs entered after the Final Implementation Order and prior to November 3, 2015 were appealed by the OCA to the Commonwealth Court on the issue of whether the Commission had properly accounted for ADIT in the DSIC Model Tariff. Two of those appeals, involving Columbia Gas of Pennsylvania Inc. ("Columbia") and Little Washington Wastewater Company ("Little Washington"), became the test cases for the lawfulness of the Model Tariff, and the remaining appeals were stayed pending the Commonwealth Court's decisions in the those two cases.

8. On November 3, 2015, the Commonwealth Court issued its Opinion and Order in *McCloskey v. Pa. P.U.C.*, 127 A.3d 860 (2015) ("*McCloskey*"), which held that the Commission had properly accounted for ADIT through the earnings cap provision of the DSIC. On the same

day, the Court issued its unreported Opinion and Order in the Little Washington appeal at No. 1358 C.D. 2014 (Nov. 5, 2015) ("*McCloskey-Little Washington*"), which followed the Court's decision in *McCloskey*.

9. On February 16, 2016, Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power") and West Penn Power Company ("West Penn") (individually, a "Company" and, collectively, the "Companies") each filed a Petition for Approval to Establish and Implement a Distribution System Improvement Charge. The Petitions were accompanied by proposed DSIC Riders to the Companies' respective tariffs. The OCA filed a Complaint in each Company's case, but did not raise any issue as to ADIT.

10. On June 9, 2016, the Commission entered Opinions and Orders at Docket Nos. P-2015-2508942 (Met-Ed), P-2015-2508936 (Penelec), P-2015-2508931 (Penn Power) and P-2015-2508948 (West Penn)[2] that approved the Companies' Petitions and DSIC Riders. The Opinion and Orders also referred to the Office of Administrative Law Judge two issues, which relate to whether the DSIC should apply to certain transmission and primary voltage customers and whether revenues billed under certain other riders to the Companies' tariffs constituted "distribution revenues."

11. On April 28, 2016, the Companies filed tariff supplements and supporting data for proposed increases in their annual electric distribution revenue constituting general base rate increases under Section 1308(d). The Companies' base rate cases assigned Docket Nos. R-2016-

[2] The Commission assigned the same docket numbers used for the Companies' respective Long-Term Infrastructure Improvement Plans, which had been filed in 2015 and approved by Orders entered on February 11, 2016.

2537349 (Met-Ed), R-2016-2537352 (Penelec), R-2016-2537355 (Penn Power) and R-2016-2537359 (West Penn).

12. The OCA filed Complaints against the Companies' existing and proposed rates at the above-referenced docket numbers. Other parties filed Complaints or Petitions to Intervene, and the Bureau of Investigation and Enforcement entered its appearance.

13. The Commission entered an Order suspending each of the Companies' tariff filings until January 27, 2017, for investigation and referred the matters to Administrative Law Judge Mary D. Long for hearings and decision.

14. A Prehearing Conference was held on June 17, 2016, at which a procedural schedule was adopted. At the Prehearing Conference, the Companies' request to consolidate their four rate cases was granted. Additionally, all outstanding complaints against the Companies' rates were consolidated with the Commission's investigation.

15. Following the Prehearing Conference, in accordance with the established schedule, non-Company parties served direct testimony and various parties served rebuttal, supplemental direct and surrebuttal testimony.

16. The parties engaged in negotiations to resolve the issues in the consolidated proceeding. As a result of those negotiations, the Joint Petitioners were able to agree to settlements that resolved all but one issue. In light of the settlements and waiver of cross-examination by all parties, a hearing was held on September 7, 2016 solely for the purpose of entering testimony and exhibits into the record and establishing dates for briefing the issue reserved for decision.

17. The issue reserved for decision, which the OCA is pursuing, pertains to the DSIC formula in the Companies' DSIC Riders approved by the Commission in its Orders entered on June 9, 2016.

18. The reserved issue was raised by the OCA's witness, Ralph C. Smith, who submitted direct testimony (OCA Statement No. 1, pp. 108-110) contending that Section 1301.1, which was added to the Public Utility Code earlier this year, requires the Commission to revise the DSIC formula in the Companies' DSIC Riders (and, by extension, in its Model Tariff) to insert a term deducting ADIT in calculating quarterly charges. The Companies submitted the testimony of Richard A. D'Angelo (Companies Statement No. 2-R, pp. 40-43) rebutting the arguments advanced by Mr. Smith.

19. Act 40 of 2016 was enacted on June 12, 2016, to become effective in sixty days (by August 11, 2016) for "all cases where the final order is entered after the effective date of this section."

20. Act 40 added Section 1301.1 to the Public Utility Code and repealed Section 1307(g).

21. Section 1301.1(a) states in relevant part as follows:

> The deferred income taxes used to determine the rate base of a public utility for ratemaking purposes shall be based solely on the tax deductions and credits received by the public utility and shall not include any deductions or credits generated by the expenses or investments of a public utility's parent or any affiliated entity.

22. House Bill 1436 ("H.B. 1436") was the bill that became Act 40.

23. A Public Hearing was held on H.B. 1436 by the Pennsylvania House of Representatives' Consumer Affairs Committee on September 29, 2015.

24. Robert Godshall is the majority Chairman of the Consumer Affairs Committee and was the lead sponsor of H.B. 1436.

25. Chairman Godshall described the purpose of H.B. 1436 as follows:

> [H.B. 1436] would simply treat utilities on a stand-alone basis so that the utilities' recoverable tax expense is based upon its operations, not those of unregulated affiliates.

House of Representatives Legislative Journal, Feb. 8, 2016, p. 117.

26. Tanya J. McCloskey, Acting Consumer Advocate, testified at the Public Hearing that H.B. 1436 "would eliminate the longsstanding consolidated tax savings adjustment."

27. No witness at the Public Hearing testified that H.B. 1436 would alter the DSIC-related sections of the Public Utility Code.

28. Gladys M. Brown, Chairman of the Commission, submitted a written statement to the Consumer Affairs Committee on September 28, 2015. In her statement (p. 4), Chairman Brown described H.B. 1436, as follows:

> The proposed bill introduces legislation that requires a public utility's federal income tax expenses to be calculated on a "stand-alone" basis – separate from gains or losses of any affiliates – when establishing base rates for the regulated utility . . .

29. In debate on the floor of the House Representatives upon the third consideration of H.B. 1436, Chairman Godshall offered remarks in favor of the bill and stated that "this section applies to base rate cases" and "would only go into effect when a utility comes in for a base rate case." *House of Representatives Legislative Journal*, Feb. 8, 2016, p. 117.

30. The Model Tariff approved by the Final Implementation Order contains a DSIC formula that does not deduct ADIT in the calculation of quarterly charges under the DSIC.

31. The Model Tariff approved by the Final Implementation Order contains an earnings cap provision.

32. The analysis required to apply the earnings cap provision of the Model Tariff is comparable to, and more rigorous than, the method of assessing just and reasonable base rates employed by the Commission in approving an Equitable Gas Company non-general base rate increase. The Commission's Order was affirmed by the Commonwealth Court in *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmwlth. 1996) ("*Equitable*").

33. The Companies' DSIC Riders conform to the Model Tariff, as the Commission found and determined in the Opinions and Orders entered on June 9, 2016, *supra*.

34. The Final Implementation Order was entered prior to the effective date of Section 1301.1.

35. The Opinions and Orders approving the Companies' DSIC Riders as conforming to the Model Tariff were entered prior to the effective date of Section 1301.1.

36. The DSIC mechanism set forth in the Model Tariff and the Companies' DSIC Riders is a "sliding scale of rates or other method for the automatic adjustment of the rates of the utility" (*see* Section 1358(c)) and, as such, is not a base rate.

37. "Rate base" is a concept employed in establishing base rates under Section 1308. Rate base includes all of the elements that represent the investment on which a utility is entitled to earn a return in addition to the depreciated original cost of plant in service.

38. Pursuant to Section 1357(a) and (b), the DSIC is an adjustment mechanism that is designed to recover the "fixed cost" of "eligible property" as defined in Sections 1351 and 1357(a).

39. The "fixed cost" of "eligible property" is only a subset of the elements that comprise "rate base" as that concept is employed in base rate proceedings.

40. The issue reserved by the OCA pertains to the terms of an automatic adjustment clause established under Section 1357(c).

41. This proceeding was initiated to establish base rates under Section 1308(d). The Commission's Order initiating the investigation of the Companies' rate filings said nothing about investigating, or considering revisions to, their DSIC Riders. The Commission voted to approve the DSIC Riders at the same public meeting at which it voted to investigate the Companies' base rate filings, and the Orders pertaining to both were entered on June 9, 2016.

PROPOSED CONCLUSIONS OF LAW

1. A Section 1308(d) proceeding to establish base rates is not the proper proceeding in which to consider the reserved issue, which pertains to the DSIC – an automatic adjustment clause established under the authority of Section 1357(c).

2. Considering the absence of any reference to DSIC-related sections of the Public Utility Code in Act 40 or in its legislative history, and applying Pennsylvania's statutory construction law (1 Pa.C.S. §§ 1921 *et seq.*), Section 1301.1 does not apply to the calculation of quarterly charges under the formula for the DSIC incorporated in the Model Tariff pursuant to Sections 1357 and 1358 and in the Companies' DSIC Riders, which conform to the Model Tariff.

3. Section 1301.1 applies only to base rates established under Section 1308 and, therefore, does not apply to the DSIC adjustment mechanism or to any other "sliding scale of rates" or "method for the automatic adjustment" of rates.

4. Section 102 provides that a "rate" includes "any rules, regulations, practices, classifications or contracts affecting any . . . charge."

5. The entire DSIC adjustment mechanism set forth in the Model Tariff (and in the DSIC Riders that conform to the Model Tariff), including, without limitation, the formula for quarterly charges and the earnings cap provision, is a "rate." *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2338282 (Final Order entered May 22, 2014), p. 22 ("However, the ALJs stated that 'in Pennsylvania, a rate is defined as more than just the individual components of the mechanism, but rather the entire mechanism and all rules and regulations associated with it.'") quoting R.D. issued Mar. 6, 2014), p. 45. *See also McCloskey* at 869.

6. Even if Section 1301.1 applies to more than base rates, it does not apply to the DSIC because the Final Implementation Order was the "final order" approving the relevant "rate" and was entered before the effective date of Section 1301.1.

7. Even if the Opinions and Orders entered on June 9, 2016, approving the Companies' DSIC Riders were deemed necessary to make the Final Implementation Order final as to the Companies, that condition was satisfied prior to the effective date of Section 1301.1.

8. Even if Section 1301.1 applied to the DSIC adjustment mechanism, it does not legislatively overrule *McCloskey* nor does it eliminate or diminish the Commission's discretion, affirmed in *McCloskey*, to determine *how* ADIT may be accounted for in the DSIC adjustment mechanism.

9. Even if Section 1301.1 applied to the DSIC, *McCloskey* remains valid and controlling precedent on the issue reserved by the OCA.

10. Even if Section 1301.1 applied to the DSIC adjustment mechanism, it does not legislatively overrule *Equitable*.

11. *Equitable* remains valid and controlling precedent on the issue reserved by the OCA and establishes that the earning cap is a lawful means of accounting for ADIT in the DSIC.

12. The earnings cap properly accounts for ADIT in the DISC adjustment mechanism.

13. Revising the DSIC formula to include a term deducting ADIT (or reflecting ADIT as non-investor supplied capital in the pretax return in the pretax return component of the DSIC formula) would not be necessary to comply with Section 1301.1 even if Section 1301.1 applied to the DSIC.

14. Revising the DSIC formula to include a term deducting ADIT (or reflecting ADIT as non-investor supplied capital in the pretax return component of the DSIC formula) is not necessary to assure that the DSIC adjustment mechanism is a just and reasonable rate.

PROPOSED ORDERING PARAGRAPHS

1. The issue being pursued by the OCA and reserved for decision pertains to the terms of an automatic adjustment clause and should not properly be considered in this consolidated base rate proceeding.

2. If the reserved issue were to be considered in this proceeding, then the OCA's proposed revision to the Companies' DSIC Riders – and by extension, to the Model Tariff – should be rejected because Section 1301.1 does not apply to the DSIC Riders and, even if it did, *McCloskey* remains valid and controlling precedent that affirms the Commission's discretion to determine how ADIT may be accounted for in the DSIC rate mechanism.

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APPENDIX A

COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES
HOUSE CONSUMER AFFAIRS COMMITTEE

* * * * * * * * * * *

PUBLIC HEARING IN RE: HOUSE BILL 1436

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BEFORE: HONORABLE ROBERT GODSHALL, MAJORITY CHAIRMAN
HONORABLE ELI EVANKOVICH
HONORABLE ROB. W. KAUFFMAN
HONORABLE KURT A. MASSER
HONORABLE CARL WALKER METZGAR
HONORABLE TINA PICKETT
HONORABLE THOMAS QUIGLEY
HONORABLE PETER J. DALEY, MINORITY CHAIRMAN
HONORABLE RYAN BIZZARRO
HONORABLE TINA DAVIS
HONORABLE MARK A. LONGIETTI
HONORABLE ROBERT MATZIE
HONORABLE BRANDON NEUMAN
HONORABLE PAT SCHWEYER
HONORABLE PAM SYNDER

HEARING: Tuesday, September 29, 2015
Commencing at 9:16 a.m.

LOCATION: Main Capitol Building
Room B-31 MC
Harrisburg, PA

WITNESSES: Terrance J. Fitzpatrick
Charles V. Fullem
Mark Kempic
Mark Kaplan
Rod Nevirauskas
Tanya J. McCloskey
Elizabeth Rose Triscari

COMMITTEE STAFF PRESENT:

AMANDA RUMSEY
COUNSEL, EXECUTIVE DIRECTOR CONSUMER AFFAIRS - REPUBLICAN RESEARCH

STEPHEN BALDWIN
RESEARCH ANALYST, REPUBLICAN CAUCUS

JANE HUGENDUBLER
LEGISLATIVE ADMINISTRATIVE ASSISTANT, REPUBLICAN CAUCUS

NED SMITH
LEGISLATIVE AIDE, REPUBLICAN CAUCUS

ELIZABETH ROSENTEL
EXECUTIVE DIRECTOR, DEMOCRAT CAUCUS

JAMIE MACON
LEGISLATIVE ASSISTANT

JERRY LIVINGSTON
RESEARCH ANALYST

BRETT BIGGICA
RESEARCH ANALYST

I N D E X

P R O C E E D I N G S

CHAIRMAN GODSHALL: In having arrived, I'd like to call the meeting hearing to order. This is a hearing on House Bill 1436 of which I am a sponsor. We'll get started by having the members --- now, I'm going to get away from that at this point. I don't think we need it. We all have our nameplates. House Bill 1436 requires a utilities income tax expense for ratemaking purposes be considered on a standalone basis. I want to reassure the Committee that although the term tax is used in the bill, the bill does not address how taxes paid to the Commonwealth or the IRS are calculated. Rather, the bill solely addresses the issue of a tax expense applied to a utility for ratemaking purposes.

Currently, a ratemaking policy dictated by the Courts and not the General Assembly requires a consolidated income tax expense approach. Under this approach, the combined tax expense of the regulated utility and its unregulated affiliates is used when setting rates through a base rate case at the PUC. While this method may seem to benefit utility ratepayers, general ratemaking policy prohibits consideration of actions of an unregulated affiliate when setting rates of a regulated entity and effectively results in a subsidy to utility ratepayers by an unregulated entity. I know that's a lot of words in there. House Bill 1436 would eliminate the

consolidated tax approach and adopt a standalone approach used by a majority of the states and the Federal Energy Regulatory Commission. I believe there are 45 states that do it the way we're proposing here.

This is a session day and we must conclude this hearing by 11:00 a.m. I ask both presenters and members to be aware of the time constraints and keep your presentations, questions and answers as succinct as possible. And Chairman Daley, do you have any comments at this point?

CHAIRMAN DALEY: Nothing.

CHAIRMAN GODSHALL: No comments. I wish sometimes that would be the same for me, but anyway, we're going to start. Utility Panel. Okay. First, we're going to open with the Utility Panel. Terry Fitzpatrick, President and CEO, Energy Association of Pennsylvania; Charles Fullem, Director, Rates and Regulatory Affairs of First Energy; Mark Kempic, President, Columbia Gas of Pennsylvania; Mark Kaplan, CFO, Duquesne Light Company; and Rod Nevirauskas, Director, Rates and Regulations, Pennsylvania American Water Company. Gentlemen. After this panel, we're going to have an advocate panel doing the same thing as what we're doing here. Terry, when you speak, introduce yourself, you know, as you go along. Okay. You're going to open, Terry?

MR. FITZPATRICK: Yes. Good morning, Chairman Godshall and Chairman Daley, members of the Committee. I'm

Terry Fitzpatrick, President and CEO of the Energy Association of Pennsylvania. We're a trade group that includes the electric and the natural gas utilities operating in Pennsylvania, and thanks for the chance to be before you today. Just by way of introduction, I'm going to give an overview of this issue and try to summarize it for you. I'm sitting here, frankly, with folks with the rate departments generally of the utilities, and they can explain some of the details of this better than me, but I'll give an overview and then turn it over for them for a little more explanation and maybe example of how their companies are particularly affected by this issue.

The hearing today is on House Bill 1436. It would amend the Public Utility Code to require that in rate proceedings before the PUC, the federal tax expense of a utility must be calculated on a standalone basis. And that is, the tax expense must be based on the utility's own operations, expenses, and investments, and not on those of the utility's unregulated affiliates or parent company. We support this legislation and request that the Committee approve it at the earliest opportunity.

The background of this is that the Federal Internal Revenue Code allows a group of affiliated companies to file returns on a consolidated basis, and what that does is it allows the losses of one affiliate to offset the income earned by another, so that if you look at the entire group, they pay

less in tax than they would if they each filed individually. In a utility ratemaking proceeding where a utility is part of that consolidated group, that raises the question of how to determine the utility's share of that group tax liability. And I want to emphasize, that's what has to be done here in that kind of a case. You need to determine what's the responsibility of each of those affiliates for the --- you know, for the tax return and the tax liability.

Now, a strong majority of states and the federal government, the Federal Energy Regulatory Commission, addressed this issue consistently with how they handle other financial issues involving utility and its unregulated affiliates. They seek to keep them separate. They calculate the utility's tax expense based on its own operations, investments, and expenses, and not on those of the unregulated affiliates, and this is what we call the standalone approach, and this is of course what House Bill 1436 would do.

In Pennsylvania, however, the state appellate courts have mandated a policy followed by a small and shrinking number of jurisdictions and have required the PUC to make a consolidated tax adjustment so that the rates of the utility are reduced to reflect the tax benefits arising from the business activities of the unregulated affiliate.

We submit that the majority of states and the Federal Energy Regulatory Commission have it right in that the

standalone basis should be used. The approach is fair and consistent with general regulatory requirements that utilities and unregulated affiliates maintain separate books and records, and that's a policy that's designed to prevent utility customers from subsidizing unregulated businesses. Well, the reverse is true. Fairness requires that subsidies from the unregulated businesses to utility customers should also be prevented just as utility rates may not be increased to recover losses of an unregulated affiliate, so too the rates of a public utility should not be decreased based upon tax losses arising from the activities of these unregulated affiliates.

This approach, we believe, fairly allocates benefits and burdens. So if utility customers bore the burden of an expense, they would also receive the benefit of a tax deduction related to that expense, but they would not receive the benefit of a tax deduction that arose from an expense that was borne by the shareholders of an unregulated affiliate.

This standalone approach also, in addition to being more fair, it also has the advantage of encouraging investment. Currently because of this consolidated tax adjustment, an unregulated affiliate of a Pennsylvania utility is at a competitive disadvantage relative to other companies that do not have utility affiliates in the Commonwealth. And this is so because the unregulated affiliate of the Pennsylvania utility is forced to give back to utility customers some of the

tax benefits related to its activities, while a competing company that does not have a utility affiliate in Pennsylvania can retain and can reinvest those tax benefits.

Just to give an example, a company that was engaged in natural gas production in Pennsylvania that's affiliated with a Pennsylvania utility is at this type of competitive advantage that I talked about because while the company that has the utility affiliate in PA has to flow back some of the tax benefits to utility customers, its competitor can retain those benefits and can reinvest them in gas exploration and production. And this isn't just a theoretical issue that I'm raising, because the reason the Federal Energy Regulatory Commission changed its policy and adopted the standalone approach back in the '80s was because at that time, it was trying to encourage gas production, and the pipelines that it regulated had affiliates that were involved in gas exploration and production.

Now, over the past several decades, there's been a clear trend away from making this consolidated tax adjustment. As I said, FERC began moving away from it in the '70s and '80s. In addition to that, in 2007, Virginia adopted a statute providing that the utility's federal tax expense has to be treated on a standalone basis. In 2013, the Texas legislature amended their law to prohibit the use of a consolidated tax adjustment for electric utilities. And finally, just last

year, the New Jersey Board of Public Utilities entered an order modifying its CTA policy and greatly reducing the subsidy to utility customers.

Now, if it weren't for the Appellate Court decisions here, frankly, this is an issue we would take up with the PUC. It really should have been left with the PUC in the first place, but because the courts have now mandated this, this is why we need to come to the legislature to have this policy changed.

So in summary, to encourage investment in PA and align the Commonwealth with the policy followed by a strong majority of other states and the federal government, we would respectfully request the General Assembly to enact House Bill 1436 which adopts this standalone approach in rate proceedings and eliminate the consolidated tax adjustment. Thanks very much.

CHAIRMAN GODSHALL: Thank you. What we're going to do is we're going to hold off questions until --- because a lot of questions will probably be answered by the future speakers, so you can continue with the next speaker. Identify yourself and go forward.

MR. FULLEM: Good morning, Chairman Godshall, Chairman Daley, and members of the Committee. I'm Chuck Fullem, Director of Rates and Regulatory Affairs in Pennsylvania for First Energy Service Company, which is a

direct subsidiary of First Energy Corporation. The Pennsylvania Rate Department of FirstEnergy Services provides regulatory support for each of the FirstEnergy's wholly-owned Pennsylvania operating companies, which include Met-Ed, Penelec, Penn Power, and West Penn Power. Today, I am here to support House Bill 1436.

CHAIRMAN GODSHALL: Excuse me. For the members, all of this testimony is in your folders. I'm sorry. Go ahead.

MR. FULLEM: Just to reiterate what Chairman Godshall started the meeting with today, to be clear, House Bill 1436 does not change the amount of taxes paid to the federal government or to the Commonwealth of Pennsylvania by any of our companies. And as Mr. Fitzpatrick explained, House Bill 1436 addresses what is known as a consolidated tax adjustment, which is purely a regulatory construct used in Pennsylvania in a small and shrinking minority of jurisdictions to appropriate the tax benefits generated by a nonregulated affiliate and hand them over to customers of a regulated utility in the form of lower rates.

The Pennsylvania Competition Act resulted in traditional electric utilities being split in the regulated distribution companies and unregulated generation companies. Since the passage of the Competition Act, our distribution companies have kept separate books and records from our generation companies, and the distribution and generation

companies must issue their own debt. These actions help assure, in fact, they result in, the rates of a public utility will not be increased in any way to recover the losses of the generation company. Likewise, the rates of a public utility should not be decreased based on the losses --- tax losses arising from the operation of the generation company.

In Pennsylvania, the Public Utilities Commission has had their hands tied and are unable to create that balance because of a 30-year-old court case that predates the Competition Act that mandates the imposition of the consolidated tax adjustment. House Bill 1436 would eliminate the CTA by specifying that the calculation of the allowable federal income tax expense for ratemaking be established based on the expense and revenue of each individual EDC. House Bill 1436 is therefore consistent with the structure of electric distribution regulation created by the Competition Act. It will also benefit the citizens of the Commonwealth of Pennsylvania by supporting increased cash available for EDCs to support their long-term infrastructure improvement plans, which are designed to increase investment to improve service to our Pennsylvania customers. Thank you.

MR. KEMPIC: Good morning. My name is Mark Kempic. I'm president of Columbia Gas of Pennsylvania. I wanted to thank Representative Godshall and Daley --- Representative Daley, as well as all of the other representatives for

listening to our positions here this morning. Just as a means of introduction, Columbia Gas of Pennsylvania is one of seven different companies within the family of companies called NiSource. We operate in seven different states. Pennsylvania is the only state that does consolidated tax adjustment for ratemaking purposes in such a heavy-handed manner as we're discussing here today. I'm here today to talk about why this is so important to Pennsylvania, why it's so important to Columbia Gas of Pennsylvania, and the practical impact that it's going to have on companies like Columbia Gas of Pennsylvania. I'm doing it a little bit differently than the other --- the other panelists. You'll see that I have a presentation as opposed to words. I tend to talk through things and I encourage a lot of questions, but I respect Chairman Godshall's request that all questions be held until the end, so please write them down as you think of the questions.

If you go to the presentation on the second page, we believe the current system is arbitrary, outdated, and really irresponsible. As Terry Fitzpatrick said, it's arbitrary because it allows this commingling of unregulated funds with regulated funds. It's out of sync with traditional standard ratemaking processes where you do what they call wing fencing to keep all of the utilities, expenses, and revenues in one bucket. This incorporates unregulated dollars, expenses, into

that bucket. We believe that's incorrect.

Second reason that it's arbitrary is it's really out of sync with reality. The utilities do not actually get the benefit of the taxes. It's done for ratemaking purposes. You don't actually get the benefit of the tax. This works simply to lower the return on equity that the utility is able to achieve, making it more difficult to attract investment in Pennsylvania, which I'll talk about in a second.

Third, I'd like to point out, I agree with what Terry said about investing in unregulated activities like Marcellus shale. As we know, we need midstream investment in Pennsylvania, eliminating this --- supporting House Bill 1436 will actually encourage utilities to get into that type of business as it did at the federal regulatory --- federal level. However, more importantly, there are currently situations like Columbus Gas where we do our financing through an unregulated affiliate. There are consolidated taxes mixed with Columbia Gas of Pennsylvania's revenues, and it impacts us in a negative fashion, as we'll discuss today. So it's no only about investing in the unregulated pipelines, it's about investing in Pennsylvania's regulated utilities as well. It's outdated. I won't go into the detail about how many --- only five other states do this this way. I would argue that Pennsylvania's is the most heavy-handed method in all of the 50 states.

Finally, it's really irresponsible because it shakes

the investor's credibility in utilities. You don't know, as I'll discuss in a second, whether Pennsylvania is going to be a good state to invest in when it comes to the utility investment. If you flip to the next page, we're speaking about utility investment. You see Columbia Gas's investments since 2006. You see that we have increasingly invested in Pennsylvania so much that we are now at about $200 million of investment in Pennsylvania. The thing I love about this is if you look back at 2006, 2007, there we were investing basically at our depreciation rate, which is, you know, you invest basically just to keep the pipes replaced that you need to keep replaced. Because of the work done in Pennsylvania on the legislation that we know as DISC, we have been able to get investment in Pennsylvania to keep a lot of people working. We've created about 800 to 850 jobs. These are good-paying jobs. These are people that are doing construction services. These are welders. These are people paving streets after we replace pipes. These are all family-sustaining jobs. If we don't address the consolidated tax adjustment for ratemaking purposes, this could impact our ability to keep these jobs in place.

The thing I love about this investment, it's in Pennsylvania. It's literally in the soil in Pennsylvania. Not that we want to --- I'll be very clear. Not that we want to outsource this, but the beauty about utility investment is it's

in the soil in Pennsylvania. You have to do it locally. In some of our poorer communities, that's what so essential about this and that's why we want to protect this.

So if you flip the page, you're probably saying, well, Mark, you've invested a lot in Pennsylvania over the past seven years or so. What's changed? This has been the policy in Pennsylvania for 20 years. We're hearing that. The point is, there's an interplay with what we call bonus depreciation of the federal government, and the consolidated tax adjustment is out of sync with that interplay. The bonus depreciation has masked the impact of consolidated tax adjustment on Columbia Gas of Pennsylvania, but you never know when you're making the investment whether you're going to have bonus depreciation. So what happens ultimately is you make a decision to invest, and then if bonus depreciation isn't passed, the consolidated tax adjustment comes back and it's a gotcha. Not a Godshall, it's a gotcha after the fact, and it destroys the viability of your investment after the fact. That's what's so insidious about how the consolidated tax adjustment is done through the ratemaking process.

So if you flip the page one more time, here are some of the concerns that we have. Those 850 or so jobs that we said that we've created, it would threaten those. Just to put this into context, the impact of the consolidated tax adjustment on Columbia Gas of Pennsylvania alone, the value of

that is enough to fund our entire leak repair program for an entire year. So that's 3,400 leaks or so that we repair every year, that's the value that will be taken out of the company, impairing our ability to repair leaks, impairing our ability to replace pipe, impairing our ability to extend our service into other areas because it would lower our rate of return.

Just this past week --- I'm sorry, just this past month, I went to our corporate parent and we were awarded additional capital of over 12 million additional dollars to replace pipe in Pennsylvania. The very clear discussion was, we are getting that capital in Pennsylvania because of DISC, because we are a good investment, because again, we're above and beyond what's necessary to replace the leaking pipe. We're doing this because we want to get ahead of the leaks, we want to replace that pipe before it needs to be replaced. We want to do that while gas bills are low, which they are right now, so we want to get ahead of the game here. If the consolidated tax adjustment legislation is not passed, we're worried that it will no longer be a good investment for Pennsylvania, and we will have to fight much harder to maintain those very beautiful levels of investment and keeping all of those people in Pennsylvania employed.

So with that, I will conclude my comments, and I will be available for any questions. Thank you.

CHAIRMAN GODSHALL: What I'm going to do at this

time, because we're running real good time-wise, I'm going to, you know, ask for questions on the previous three --- on the previous three people that had given us a report.

Terry, starting with you, it's been suggested that this is just an automatic rate increase. You know, even with --- if this would pass, everything would go to the PUC. And the overall picture would be what's looked at by the PUC. Maybe you can sort of clarify, you know, that statement or misstatement.

MR. FITZPATRICK: You're correct. It would not be an automatic rate increase, clearly, Chairman, and there's a couple reasons for that. First of all, this wouldn't take effect, if at all, until a company comes in and files a rate proceeding before the Commission. At that point, it would be one of the issues among the multitude of issues that are looked at in the case, and all of them can affect the rate recovery. Furthermore, not every utility is affected by this. Some may not file a consolidated tax return, or if they do, because of their peculiar circumstances, they just might not be impacted. I mean, we did survey our companies about the rate impacts and some said none. You know, it wouldn't have any effect at all. So clearly, there's no automatic rate increase built in here.

And I guess I'd also make the fundamental point, though, we think for all these years, frankly, the utility --- because of this issue, the utility shareholders have been

subsidizing the ratepayers because the --- again, the tax benefit ---. In every case that I have looked at, and I have looked at cases in Pennsylvania and around the country, this always comes up in a situation where it's the utility that has the income and it's the unregulated affiliate that has the loss. And I think the reason for that isn't hard to understand. I mean, utilities are generally steady. They don't have exorbitant returns, that's regulated, but they have steady returns, so they have the income. It's the other businesses that are more risky that have the losses. It always comes up in that context.

CHAIRMAN GODSHALL: Another question that I have is on that bonus. I don't quite understand that bonus that you were talking about.

MR. FITZPATRICK: Right. I should have explained that a little bit better. Sorry for that. Bonus depreciation is a federal policy that encourages investment. It started in about 2006, 2007, when the economic downturn happened. And the way that it works, and I'm no tax expert, but the way that it works is it basically eliminates the impact of consolidated tax adjustments on at least Columbia Gas of Pennsylvania. So we have been able to avoid any impact of consolidated tax adjustment through the ratemaking process because of the existence of bonus depreciation. It is not passed for 2015 yet. We don't know if it will be. We think it will be for '15

and '16, but we're not sure. But the point is, our investment decisions had to be made prior to that. So if it's not passed, the consolidated tax adjustments will start to kick in for Columbia Gas of Pennsylvania, and when we go for a rate case, our rates will be lowered to the tune of probably well over $10 million, which will impact our ability to continue to fund our programs. So it's an interplay, it's a complicated interplay, but it essentially wipes out the impact of a consolidated tax adjustment for ratemaking purposes when it exists.

CHAIRMAN GODSHALL: Thank you. Representative Longietti?

REPRESENTATIVE LONGIETTI: Thank you, Mr. Chairman. And thank you, to all of you, for trying to explain as simple as possible, a somewhat complex but somewhat simple matter. And I know we're not here to talk necessarily about taxes. I understand the difference between the two, but just curious, in your mind, why is it fair to have consolidated tax return for tax purposes but that shouldn't be the case when it comes to rate cases? I don't know if anybody can answer that question.

MR. FULLEM: You know, I think for me, the easiest way to explain that is, you know, we've talked about how it --- it's talked about what we call or what's been referred to as the actual taxes paid doctrine where it's been known that Pennsylvania has attempted to follow the actual taxes paid. And I see that as flawed because it doesn't recognize the

potential for the tax losses of an affiliate to actually be carried forward in the future years to offset future gains by that affiliate. You know, the corporate parent is making a decision to allow for that consolidation and to take that cash now to reduce their tax burden today, but if that affiliate --- we didn't take it at that time, they could have carried it forward to a future date, and at that time it would have been essentially to offset the costs of that affiliate that incurred the loss and would have accrued the shareholders. Because we've made essentially a cash decision, I don't see how that, and to manage that cash, means that ultimately those losses should then be passed through to an affiliate's ratepayers. So I think it ignores the fact that the affiliate that incurred the loss would have had the ability to capture the benefits of that loss in a future time frame.

REPRESENTATIVE LONGIETTI: And I assume that it's the federal tax that's probably the most concerning?

MR. FULLEM: Yeah. The consolidated tax adjustment is known in regulatory jargon that we're talking about today is all about federal taxes and it doesn't really apply to the state tax.

REPRESENTATIVE LONGIETTI: What's the carry forward on the federal basis? I know in Pennsylvania, we have limits on ---.

MR. FULLEM: There is a limit but I don't know what

that limit is off the top of my head.

REPRESENTATIVE LONGIETTI: Thank you.

CHAIRMAN GODSHALL: Are there any other questions at this time? Mr. Fullem? Well, this would be spread across all --- this would be spread across all classes. We're not just talking about the consumer. It's across the board.

MR. FULLEM: Yes. I mean, the effect of the --- from a ratemaking perspective, the consolidated tax adjustment gets spread to all classes based on the same methodology that we use to assign federal income taxes to the industrial class, the residential class, and the commercial class. So it would be a burden that would be shared by all or passed on to all. And I have been told that the carry forward for federal income tax purposes is 15 years, so obviously those affiliates could carry that forward for a lengthy period of time. But yes, Mr. Chairman, it would be --- it's not just borne by the residential customer.

CHAIRMAN GODSHALL: Thank you very much. If there are no further questions, we are going to continue on with our testifiers.

MR. KAPLAN: Okay. Thank you. Good morning. Good morning, Chairman Godshall, Chairman Daley, and members of the Committee. My name is Mark Kaplan. I'm senior vice president, chief financial officer, and treasurer for Duquesne Light Holdings. Duquesne Light's utility serves about 600,000

customers covering about 817 square miles in Allegheny and Beaver Counties. For reasons stated in the testimony of Terry Fitzpatrick, president and CEO of Energy Association of Pennsylvania and other members of the panel, we support House Bill 1436 to eliminate the CTA as approved by the FERC in nearly every other state.

I'm not going to read in its entirety my prepared testimony. Rather, I'm going to spend some time just focusing on those things that are unique to Duquesne. Within our consolidated group, we have a nonregulated affiliate called DQE Communications, which has added nearly 50 new employees over the last five years. DQE Communications has been named in Pittsburgh's Top 100 Fastest-Growing Companies in the area. When computing the taxable income for this affiliate company, we are permitted to take a tax deduction for a large portion of this capital spend, the bonus depreciation that we just discussed here previously. When we do that, we reduce the tax cash paid to the federal government. DQE Communications will use this tax cash savings to invest in capital, expand the business, and create jobs. However, the current CTA imposed by the appellate courts results in Duquesne Light's customers receiving a portion of DQE Communications's tax benefits.

Through the CTA mechanism, any loss from DQE Communications will ultimately reduce utility customer rates even though its customers do not pay for the DQE Communications

investment nor take any risk associated with a nonregulated business. By flowing a tax benefit associated with the affiliate's tax loss to the utility in the form of lower rates, the communications businesses denied the use of the tax benefit within its own operations. The affiliate is financially handicapped by the CTA because of its relationship to the regulated utility, whereas another communications business without a PUC-regulated affiliate suffers no such detriment and would be able to fully utilize any tax benefits generated from its own separate company operations. The utility is not permitted to increase rates to recover losses of its nonregulated affiliates. However, the CTA operates to only decrease rates based upon the tax losses arising from the nonregulated affiliates. This situation demonstrates the fundamental flaw in the CTA, and respectfully why it must be fixed through this legislation. Just to give you perspective in terms of what the CTA has meant to us in terms of our last couple of rate cases, on average, the CTA impact has been less than 50 cents per month per customer over our last couple of rate cases.

I want to thank you for the opportunity to present this testimony and I will be happy to entertain any questions that you may have.

CHAIRMAN GODSHALL: I was interested in --- believe it or not, I read this stuff last night. That was during the

Pirates game when there wasn't a lot of activity, but 50 cents per month, maybe you can expound, you know, on that exactly --- you know, just exactly where you're going there.

MR. KAPLAN: Yeah. So at least in our particular instance, when we look at what the impact of the CTA has been historically, it hasn't been significant to our customers. However, when you look at the CTA mechanism, that's highly dependent upon the profitability of the other companies that are within the consolidated tax group that we talked about, and also what the profitability is of the utility, whether it be bonus depreciation or not be bonus depreciation. And so while in our case it has not been significant in the past, it is a calculation that does have a good deal of variability associated with it that makes it difficult to plan around because there are so many variables that one has to consider in looking at what your CTA will be going forward.

CHAIRMAN GODSHALL: Is there anybody else? What is your projected impact on rates under a standalone --- under a standalone if standalone is approved?

MR. KAPLAN: Well, in our case, if we use our past rate cases as a predictor of the future, it would be about 50 cents per customer. So as a result of doing standalone calculations, customer rates would increase a little less than 50 cents per month per customer.

CHAIRMAN GODSHALL: Representative Longietti?

REPRESENTATIVE LONGIETTI: Thank you, Mr. Chairman. It's one of those mornings where I have another committee meeting, so I wanted to ask this question because I'm not going to necessarily be here for all of the next panel. So the advocate says in their testimony to eliminate the consolidated tax savings as proposed in House Bill 1436 would allow a utility to collect from ratepayers hypothetical taxes it never pays to the federal or state government. This would be a direct transfer from ratepayers to shareholders' profit. I just want to hear the other side of that statement.

MR. FITZPATRICK: I'll take a shot at it first, Representative. The important thing to remember here is, the utility is not paying the taxes itself, so the term actual taxes paid is a bit deceptive, frankly, because no matter which way you look at this, you've got to somehow allocate that tax responsibility among all of the affiliates. So in that sense, any way that you did it would be hypothetical, but that's the task that you have to do. The real question is, what's the most fair way to allocate that among all of the different affiliates? And we think it's look at each of their circumstances, look at their operations, their expenses, their investments, and determine what it would be for each of them on a standalone basis.

REPRESENTATIVE LONGIETTI: Thank you.

CHAIRMAN GODSHALL: No further questions? Thank

you. We will continue with the next testifier.

MR. NEVIRAUSKAS: Good morning. My name is Rod Nevirauskas. I'm the director of rates and regulation for Pennsylvania American Water. I appreciate the opportunity to speak to the group this morning regarding this very important bill, House Bill 1436. Pennsylvania American Water provides water and wastewater service to more than 2.2 million people in 400 communities across the Commonwealth. We're the largest investor in water utility in the state, providing water and wastewater service to approximately 670,000 customers. We own and maintain more than 10,000 miles of pipeline in Pennsylvania.

I'm trying not to be too redundant with what you've already heard this morning, so I'm going to talk about a couple other things. The CTA is bad regulatory policy because it creates a commingling of funds. It has long been regarded as a sound regulatory policy not to commingle or combine the income and expenses of public utilities with those of nonregulated affiliates for fear that utility customers could end up subsidizing or being subsidized by non-utility operations.

Pennsylvania American Water customers do not subsidize losses of American Water's unregulated operations, nor should they. However, because of the Pennsylvania treatment of consolidated taxes, American Water's nonregulated subsidiaries are subsidizing Pennsylvania American Water

customers for ratemaking purposes only at an estimated $5 million annually. That's the impact on Pennsylvania American right now, about $5 million annually, a little over $5 million, and then it averages out to about 45 cents per month per residential customer.

We've heard a little bit about investment. Pennsylvania American will invest approximately $250 million this year in infrastructure. This regulatory policy penalizes investors by passing a portion of the tax benefits of the unregulated losses to Pennsylvania American's water customers. Pennsylvania American Water competes for infrastructure dollars from our parent company. Needless to say, unfair regulatory policies detract from our ability to attract capital dollars to invest in Pennsylvania. Okay.

The customers don't shoulder the financial risks of American Water's unregulated affiliate companies. However, they do benefit from the allocation of the consolidated tax adjustment because the allocation reduces federal tax expense for ratemaking purposes. In other words, regulated utilities are not permitted to recover the expenses of their nonregulated affiliates. Therefore, Pennsylvania customers should not get the benefit of the tax loss. And as we've heard before, the adoption of House Bill 1436 would result in no reduction to the taxes paid to the state or federal government, adjustments for ratemaking purposes only.

If I could just summarize with one sentence, the consolidated tax adjustment takes the tax benefits that are earned by one company, in this case, a nonregulated affiliate, and gives those benefits to the customers of another company in the form of reduced rates, and we feel that's just unfair and inappropriate. Thank you.

CHAIRMAN GODSHALL: Thank you. Any questions? As I was reading through this testimony, you know, last night, as I said, it sort of reminded me of something I was involved in a number of years ago, and that was the DISC regulation or law that we put in place, and I heard at that time, and I know Representative Daley was also involved back then, but it's ---. We heard the sky was going to be falling and so forth, and I think the DISC legislation has helped an awful lot of companies, and I do know that as far as the --- especially down in the southeast, without naming names, but ---. Mark, I didn't look at you. You know, without naming names, I know that some of our gas companies are looking at pipes that are 50 years and 75 years and possibly even 100 years old and have to be, you know, replaced, and they just have to be replaced. And it is a problem. And I know that the DISC legislation has helped an awful lot to get, you know, away from some of that. You know, we haven't replaced all of those pipes, but there are still thousands of miles of pipes that have to be replaced and should be replaced very quickly. So you know, I look at this

as a following, really, of that DISC legislation in modernizing what we're doing, you know, for our utilities. And I believe, as I did in the DISC legislation, that something is necessary. The PUC has given some comments that they are neutral on this whole thing, but they have also made some suggestions which I think should be looked at. So you know, I appreciate your testimony this morning. I appreciate your comments and your answer to the questions, and Pete, do you have anything?

CHAIRMAN DALEY: I don't. I do not.

CHAIRMAN GODSHALL: Okay. I do appreciate what you said, and we're going to go to our next group of testifiers. Is there anything anybody wants to say in conclusion to what we've done here today?

MR. FITZPATRICK: I would just add, I agree entirely with you that this has a lot of similarities to the DISC and it will encourage more investment to come to Pennsylvania, or to keep high levels of investment coming to Pennsylvania, and I just wanted to thank you for recognizing that and to thank you for the DISC and thank you for giving me an opportunity to comment today.

CHAIRMAN GODSHALL: Thank you. We have Tanya McCloskey, Acting Consumer Advocate, and Elizabeth Triscari, Esquire, Deputy Small Business Advocate. Ladies, when ready.

MS. MCCLOSKEY: Thank you. And good morning, Chairman Godshall, Chairman Daley, and members of the

Committee. My name is Tanya McCloskey and I'm the acting consumer advocate for the Office of Consumer Advocate. Thank you inviting me to give comments before this Committee regarding House Bill 1436.

House Bill 1436 concerns the computation of income tax expense for ratemaking purposes and would eliminate the longstanding consolidated tax savings adjustment. The Commission and the Courts have for decades established that just and reasonable rates under Section 1301 of the Public Utility Code require the consolidated tax savings adjustment. The adjustment reflects what has been called the actual taxes paid doctrine and is as simple as its name. Utilities may only collect from ratepayers the taxes that the utilities actually pay to the state and federal government.

It is basic ratemaking that the rates of the utility are to be set on the basis of providing a fair rate of return on the investment in plant used and useful in providing adequate utility service after the allowance for proper operating expenses, taxes, depreciation, and other legitimate items. While the Commission has discretion in considering what expenses incurred by the utility may be charged to ratepayers, the Commission cannot include hypothetical expenses that are not actually incurred by the utility. To eliminate the consolidated tax savings adjustment as is proposed in House Bill 1436 would allow a utility to collect from ratepayers

hypothetical taxes that it never pays to the federal or state government. The additional expense included in rates would be a direct transfer from the ratepayers to the shareholders' profits.

If House Bill 1436 had been in place for the last several base rate cases filed by our major electric, natural gas, and water utilities, tax expense included in rates would have increased by $28.6 million annually for just these seven utilities. I provide a table in my testimony showing the tax expense savings for these seven utilities. The amount of the rate increase needed to collect this expense is much higher than the 28.6 million as there will be additional taxes on the revenue required for this additional expense. This is what is known as the gross up factor in ratemaking. When grossed up for ratemaking purposes, my office has calculated that the actual increase in rates for just these seven utilities is approximately $51.7 million per year.

Utility challenges to the consolidated tax savings adjustment are not new, extending back many decades. The Pennsylvania Appellate Courts, though, have been consistent and clear in rejecting all challenges. I have included an appendix with these cases dating back to 1956. Most importantly, the Courts have recognized that there is no place in ratemaking for claims for hypothetical expenses which are not actually incurred by the utility.

I do not often quote from the Courts in my testimony to this Committee, but in this instance, the Courts have perhaps said it best. For example, in 1980, the Pennsylvania Commonwealth Court captured the point as follows, and I quote, we cannot condone a plea which would allow a parent company to collect a phantom tax. In reality, it is never paid to the government, but retained by the company as profit and passed on to the ratepayer by way of a subsidiary-claimed non-existent tax expense, end quote.

The Pennsylvania Supreme Court put the issue firmly to rest in the landmark 1985 case, Barasch v. Pennsylvania Public Utility Commission. In that case, the Pennsylvania Supreme Court concluded that it, too, could not condone the inclusion of fictitious expenses in the rates charged to customers. The arguments against the consolidated tax savings adjustment mostly center around a perceived unfairness that ratepayers are not asked to pay for the losses of the affiliates, but they are able to receive the benefit of the tax loss. Many benefits accrue to the corporation through a holding company structure. In fact, approval of such structures for utility was intended to provide affirmative public benefits under the Public Utility Code. As to taxes, one of the key benefits from the use of the consolidated group tax return, which I must note is a voluntary choice on the part of the parent company, is that it allows the parent company to

use the losses of some affiliates that otherwise they may have been unable to use or significantly delayed the use for purposes of reducing the overall tax liability of the corporation. Public utilities, because of the authorized rate of return in the regulation, most often generate positive income so that the losses of the other affiliates can be timely used by the parent company to its benefit.

The Pennsylvania Supreme Court also aptly described the serious flaw in this argument. While the quote is lengthy in my testimony and I will not read it here, the key point is that when a utility joins a larger group, for example, to increase its purchasing power and lower its costs, we would not condone including theoretical higher costs in the ratemaking process. There is no reason to treat taxes differently. If we allow our utilities to become part of multistate holding companies but then treat them solely as a standalone company for ratemaking tax purposes, the tax benefits of the holding company structure will simply be lost to Pennsylvania and its ratepayers.

Another argument that has been made against the consolidated tax savings adjustment is that there will be a loss of investment. Tax dollars collected from ratepayers are not intended to fund investment, and indeed, these hypothetical tax dollars are not required to be invested by the utility or in the utility at all. This hypothetical tax expense is paid

to the parent company, and the parent company can retain it as a profit or invest the dollars in other affiliates if it so chooses.

Additionally, the General Assembly has already provided for further investment and infrastructure through the implementation of the Distribution System Improvement Charge in 2012. Allowing a hypothetical expense to further investment would simply go around the carefully crafted mechanism established by the General Assembly with its many consumer protections.

I do recognize that some states have moved away from the use of consolidated tax savings adjustment over the years. This does not provide support, however, for overturning decades of Pennsylvania Commission and Court precedent that have ensured that ratepayers pay only those costs that are actually paid or payable by the utility. I do find it interesting, though, that while our utilities would like to adopt other states' consolidated tax policies, they are not asking for the lower return on equity that is often granted to utilities in those states.

Thank you for the opportunity to testify here today on the impact of House Bill 1436 on ratepayers. I look forward to answering any questions you may have.

MS. TRISCARI: Good morning, Chairman Godshall, Chairman Daley, distinguished members of the House Consumer

Affairs Committee, participating utility companies, and other interested stakeholders that are here today. Thank you for this invitation to testify before your Committee today.

My name is Elizabeth Rose Triscari. I serve as Pennsylvania's Deputy Small Business Advocate. Small Business Advocate, John Evans, regrets that he wasn't able to join us here today, but he asked me to please come and give you our position, the OSBA's position, on House Bill 1436.

As many of you know, the OSBA is charged with representing the interests of Pennsylvania's small business utility customers. In order to protect those interests, we as OSBA must oppose House Bill 1436 because it seeks to overturn the Commonwealth's longstanding actual taxes paid doctrine and it would result in an inequitable increase in the utility rates of small businesses. I'm not going to go into what the actual taxes paid doctrine is. I think Ms. McCloskey covered that very well, but again, I just want to make the point that this doctrine does not allow a utility company to charge ratepayers hypothetical tax expenses that are not actually payable, that they're not liable for, that they will never pay.

In contrast, House Bill 1436 would permit a utility to calculate what taxes it would have paid if it had filed on a standalone basis instead of what taxes it actually paid by participating in a consolidated return with unregulated affiliates. If House Bill 1436 becomes law, the result would

be the taxes the utility is not actually liable for, that it does not actually pay, will be charged to ratepayers. This is not sound ratemaking. It is a generally accepted ratemaking principle that utilities are permitted to recover through rates their actual cost of providing service to customers or earning a fair rate of return on the investment in plant used and useful in providing adequate utility service. A reasonable allowance for federal income taxes is included in this cost of service. However, House Bill 1436 goes well beyond this general principle and would permit utilities to recover from ratepayers taxes that are not payable. It would allow utilities to charge ratepayers for theoretical expenses for which the utility is not liable for and will never pay.

I also want to make a point as far as small businesses are concerned. This is going to be a double hit to them in their rates. They pay rates at home as residential customers and also as small businesses. Small businesses are job creators in the Commonwealth. They operate on very thin margins as it is, and as you've seen from Ms. McCloskey's testimony, we're talking about real dollars here and a real significant increase to rates if this bill were to go into effect. The OSBA does not believe it is fair to charge these small businesses who already pay well enough in federal taxes to also now have to be on the hook for federal taxes the utility company itself does not have to pay.

Thank you for your time and attention. I welcome any questions or comments you may have.

CHAIRMAN GODSHALL: I read the testimony, as I said, last evening, and I've heard it again, but Pennsylvania is one of only a few states, about four or five states, to continue to require a CTA approach, and why is a standalone policy that's been adopted by a large majority of the states including the Federal Energy Regulatory Commission not appropriate for Pennsylvania when it is for all of the other states?

MS. MCCLOSKEY: I think there are a lot of differences in other states as well, and one of the important points is that Pennsylvania, when it does mergers and consolidations and allows for these multistate holding companies, which has been occurring over the last several decades, has what's called an affirmative public benefits standard. Other states have a do no harm, I'll call it, type of standard. So in Pennsylvania, it's part of the compact, so to speak, of granting merger approval that these affirmative benefits be provided to ratepayers as part of the approval process. I think as well, as I pointed out, other states do provide much lower rates of return, authorized rates of return in their ratemaking process than what Pennsylvania has traditionally provided as well.

CHAIRMAN GODSHALL: I don't have a comparison on that, so you know, I'm just taking your word for it, but on

another issue, you used the word hypothetical. In response to the OCA statement that when a CTA is used, a utility tax expense is hypothetical, according to written comments submitted by the PUC, quote, when consolidated tax returns are used by a parent corporation, each subsidiary of a parent corporation calculates its separate income deductions, tax liability, tax credits on a standalone basis. Each subsidiary then submit its calculations to the parent, end of quote. Based upon this statement, it seems that the tax expense of the regulated utility is not hypothetical but rather is calculated on a standalone basis, and then combined with the expenses of other subsidiaries. Why should this separately calculated figure not be used in favor of tax expense that incudes regulated and unregulated entities when setting the rates of a utility that effectively stands alone in all other ratemaking considerations?

MS. MCCLOSKEY: Well, I think there's a difference between the calculation of the tax liability and the actual expense that's paid. All of the companies do make a calculation based on a standalone basis, but when the parent voluntarily chooses to file a consolidated group to the mutual benefit of the corporation, it then combines those to determine its own tax expense and tax liability into one, and then that tax expense is what is --- the utility then that is allocated to it is what is paid up to the parent corporation. So I think

that's a correct description of how it's calculated, and then when you get to what is actually paid, that's when the actual expense that each company is assessed by the parent corporation is determined.

CHAIRMAN GODSHALL: But it really wouldn't be hypothetical. I mean, it's actual.

MS. MCCLOSKEY: Well, no. If you use the standalone, it's hypothetical because they never pay that expense to the parent. They pay a different expense to the parent. They never pay the taxes calculated on a standalone basis to the parent company. And that's why the Courts have called it a hypothetical tax expense.

CHAIRMAN GODSHALL: Any other questions? Representative Daley?

CHAIRMAN DALEY: Thank you, Mr. Chairman. I just wanted to thank all of the panelists. I know it's a real complicated issue on both sides of the fence here, and I know my staff has worked on some questions here, and I know that they've had an ongoing dialog with every one of you. And I want to thank the Chairman for his questions. Thank you.

MS. MCCLOSKEY: Thank you.

MS. TRISCARI: Thank you.

CHAIRMAN GODSHALL: If there are no other questions, I just want to also thank all of the panelists for --- you know, and I do agree with my co-chairman that, you know, when I

started on this last night, I kept going backwards to find out what some of these, you know, CTCs and OCAs and every --- all of the other ones that were in your testimony. So anyway, the public --- oh, the Public Utility Commission was not able to participate in today's hearing because all of their Commissioners are in some kind of do-hickey, I'm not sure what, and comments for the inclusion in the ---. They have submitted comments for inclusion. As I said, they were neutral on the issue, and they did submit a few suggestions, so we will take a look at it, and I'll say thank you very much and meeting is adjourned.

MS. MCCLOSKEY: Thank you.

MS. TRISCARI: Thank you.

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HEARING CONCLUDED AT 10:15 A.M.

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CERTIFICATE

It is hereby certified that the foregoing proceedings are a true and accurate transcription produced from audio on the said proceedings and that this is a correct transcript of the same.

Sargent's Court Reporting Service, Inc.

APPENDIX B

COMMONWEALTH OF PENNSYLVANIA

LEGISLATIVE JOURNAL

MONDAY, FEBRUARY 8, 2016

SESSION OF 2016 200TH OF THE GENERAL ASSEMBLY No. 7

HOUSE OF REPRESENTATIVES

The House convened at 1 p.m., e.s.t.

THE SPEAKER (MIKE TURZAI) PRESIDING

PRAYER

The SPEAKER. Our prayer today will be offered by the Reverend Dr. Grover G. DeVault of Calvary Church in Lancaster, Pennsylvania, and he is the guest today of Representative Day and Representative Mentzer.

Reverend, please.

REV. DR. GROVER G. DeVAULT, Guest Chaplain of the House of Representatives, offered the following prayer:

Thank you, Mr. Speaker.

Prayer is so important individually, collectively, not only for ourselves, but for our nation and for our communities; for our families, especially; for those who are serving in the military. So I ask you all, please, to join with me as I lead us in this prayer of invocation.

God, our creator, our sustainer, we pray that You will accept from the bottom of our hearts our gratitude for placing us in the position of distinct leadership. We pray for guidance as elected leaders for ourselves and also for our staffs. We take great pride in our accomplishments, our cities, our farms, our schools, our hospitals, and yes, even for our very form of government. Lord, we ask You to preserve it.

May this body do all that it can to restore the people's trust in our legislators. We grieve, Lord, over our failures and our shortcomings. You alone know our fears, our frailties, and our weaknesses. Lift us above them so that we will face the future unafraid. With You on our side, we will be fearless, afraid of no one and of nothing. When our enemies come down on us like those who are ready to eat us up alive, we pray that You will cause us to be collected and cool, because our refuge is in You.

Grant that this body who serves this great Commonwealth will have the overpowering energy to demonstrate a love for all people that produces respect and honor and trust for all Your people. Grant that this body may have the power to fulfill the promises that they have made to protect and provide and bring pleasure to all of our communities. Enable all of us to have the courage and the strength to be honest, true, and faithful to the offices we serve. We plead for Your instruction, Your guidance and insight.

Save our leaders in the government, O God, from themselves and those who would influence them as You have saved them from their enemies. Let no personal ambition bind them to their opportunities. Help them to give battle to hypocrisy wherever they find it, and give them a divine common sense and a selflessness that shall make them think of service and not gain, especially in the matter of budget. May we extol the wonder of our freedom and our liberties to seek justly and to walk justly before our people and our God. With Your help, may we lead our people to live a secure and a peaceful life.

We ask all of this in Your strong and most glorious name. Amen.

PLEDGE OF ALLEGIANCE

(The Pledge of Allegiance was recited by members and visitors.)

JOURNAL APPROVAL POSTPONED

The SPEAKER. Without objection, the approval of the Journal of Wednesday, January 27, 2016, will be postponed until printed.

COMMUNICATION FROM INDEPENDENT FISCAL OFFICE

The SPEAKER. The Speaker acknowledges receipt of the Independent Fiscal Office's report, entitled "Economic and Budget Outlook: Commonwealth of Pennsylvania Fiscal Years 2015-16 to 2020-21."

(Copy of communication is on file with the Journal clerk.)

UNCONTESTED CALENDAR

RESOLUTION PURSUANT TO RULE 35

Mr. REED called up HR 646, PN 2731, entitled:

A Resolution designating the week of January 31 through February 6, 2016, as "Physician Anesthesiologist Week" in Pennsylvania.

On the question,

Will the House adopt the resolution?

GUESTS INTRODUCED

The SPEAKER pro tempore. Located in the rear of the House, the Chair welcomes Kezia Ellison, founder of Educating Teens About HIV/AIDS, Inc. With her is Dr. Albertha Graham-Ellison, vice president and program director. They are the guests of Representative Wheatley. Please rise and be recognized.

APPROPRIATIONS COMMITTEE MEETING

REPUBLICAN CAUCUS

The SPEAKER pro tempore. The gentlelady, Ms. Major. Ms. Major is recognized for announcements.

Ms. MAJOR. Thank you, Mr. Speaker.

First I would like to announce that the Appropriations Committee will meet this afternoon at 2:30 in the majority caucus room. I would like all members of the Appropriations Committee to please report to the majority caucus room at 2:30.

I would then like to announce, Mr. Speaker, that Republicans will caucus today at 3 p.m. I would ask our Republican members to please report to the caucus room at 3. Mr. Speaker, we would be prepared to come back on the floor at 4 p.m. Thank you.

The SPEAKER pro tempore. The Chair thanks the lady.

The Appropriations Committee will meet at 2:30 in the majority caucus room.

DEMOCRATIC CAUCUS

The SPEAKER pro tempore. The Chair recognizes the gentleman, Mr. Frankel, for an announcement.

Mr. FRANKEL. Thank you, Mr. Speaker.

Democrats will caucus at 3 p.m. Democrats will caucus at 3 p.m.

The SPEAKER pro tempore. The Chair thanks the gentleman.

RECESS

The SPEAKER pro tempore. The House is now in recess until 4 p.m., unless sooner recalled by the Speaker.

AFTER RECESS

THE SPEAKER (MIKE TURZAI) PRESIDING

The time of recess having expired, the House was called to order.

LEAVES OF ABSENCE

The SPEAKER. Representatives Greg ROTHMAN, Adam HARRIS, and Tarah TOOHIL have all requested to be placed on leave for the rest of the day. Without objection, those leaves will be granted.

BILLS REPORTED FROM COMMITTEE, CONSIDERED FIRST TIME, AND TABLED

HB 1793, PN 2820 (Amended) By Rep. ADOLPH

An Act making an appropriation from the General Fund to the Executive Offices for the purpose of the Public Employee Retirement Commission for the fiscal year July 1, 2015, to June 30, 2016.

APPROPRIATIONS.

HB 1806, PN 2767 By Rep. ADOLPH

An Act making an appropriation from the General Fund to the Department of Human Services for the purpose of medical assistance payments - critical access hospitals for the fiscal year July 1, 2015, to June 30, 2016.

APPROPRIATIONS.

BILLS REREPORTED FROM COMMITTEE

HB 1260, PN 1662 By Rep. ADOLPH

An Act renaming the bridge on that portion of Township Route 431/436, Cooney Road, over US Route 22 in Munster Township, Cambria County, as the PFC Thomas A. Cooney Memorial Bridge.

APPROPRIATIONS.

HB 1371, PN 1913 By Rep. ADOLPH

An Act renaming the bridge on Tower Road spanning U.S. Route 219 in Croyle Township, Cambria County, as the Trooper Herbert A. Wirfel Memorial Bridge.

APPROPRIATIONS.

HB 1407, PN 2771 By Rep. ADOLPH

An Act designating a bridge on State Route 2014 over the Muncy Creek in Muncy Creek Township, Lycoming County, as the Private Walter L. Smith Spanish-American War Memorial Bridge; and designating a portion of State Route 2044 in Lycoming County as the Lance Corporal William F. Merrill Vietnam Veterans Highway.

APPROPRIATIONS.

HB 1436, PN 2690 By Rep. ADOLPH

An Act amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, in rates and distribution systems, providing for computation of income tax expense for ratemaking purposes.

APPROPRIATIONS.

HB 1709, PN 2552 By Rep. ADOLPH

An Act designating the bridge carrying U.S. Route 222 Business over the Schuylkill River, Riverfront Drive and Norfolk Southern Railroad in the City of Reading, Berks County, commonly referred to as the Bingaman Street Bridge, as the 65th U.S. Infantry Regiment, Borinqueneers Memorial Bridge.

APPROPRIATIONS.

Mr. Speaker, this clearly amends two separate articles in the Crimes Code; one does chapter 27, one does section 3300. They are fundamentally different. While yes, they are crimes, that in and of itself is not a unifying theme on which we can base constitutionality, and regardless of how passionate we are about the underlying issues, we must, as the Bucks County Representative previously chastised me for, we must operate under the existing case law, a case law in a decision that I assume he supported.

So therefore, Mr. Speaker, while we never like to pick amongst friends and colleagues or even issues that we are passionate about, we must ensure that we arrive at the constitutional conclusion and keep these two issues separate. Thank you.

The SPEAKER. Those who believe the amendment is germane will be voting "aye"; those who believe the amendment is not germane will be voting "nay."

On the question recurring,
Will the House sustain the germaneness of the amendment?

The following roll call was recorded:

YEAS–134

Barbin	Dunbar	Knowles	Quinn
Barrar	Evankovich	Kortz	Rader
Bizzarro	Evans	Kotik	Rapp
Bloom	Fabrizio	Krueger	Ravenstahl
Boback	Farina	Longietti	Readshaw
Boyle	Flynn	Mackenzie	Reese
Bradford	Frankel	Mahoney	Roae
Briggs	Freeman	Maloney	Roebuck
Brown, R.	Gainey	Markosek	Rothman
Brown, V.	Galloway	Matzie	Rozzi
Bullock	Gergely	McCarter	Sainato
Burns	Gibbons	McClinton	Samuelson
Caltagirone	Gillen	McNeill	Santarsiero
Carroll	Gillespie	Metcalfe	Santora
Cohen	Godshall	Metzgar	Schreiber
Conklin	Goodman	Miccarelli	Schweyer
Costa, D.	Grove	Miller, D.	Simmons
Costa, P.	Hanna	Milne	Sims
Cox	Harhai	Moul	Snyder
Cruz	Harkins	Mullery	Stephens
Culver	Harper	Murt	Sturla
Daley, M.	Harris, J.	Mustio	Tallman
Daley, P.	Heffley	Neilson	Taylor
Davidson	Hennessey	Neuman	Tobash
Davis	Jozwiak	O'Brien	Toepel
Dawkins	Kaufer	O'Neill	Truitt
Dean	Kauffman	Ortitay	Vereb
Deasy	Kavulich	Parker, D.	Vitali
Delozier	Keller, M.K.	Pashinski	Warner
DeLuca	Keller, W.	Payne	Watson
Dermody	Killion	Petrarca	Wentling
DiGirolamo	Kim	Pyle	Wheatley
Donatucci	Kinsey	Quigley	Youngblood
Driscoll	Kirkland		

NAYS–61

Adolph	Fee	Maher	Ross
Baker	Gabler	Major	Saccone
Benninghoff	Gingrich	Marshall	Sankey
Causer	Greiner	Marsico	Saylor
Christiana	Hahn	Masser	Schemel
Corbin	Harhart	McGinnis	Sonney
Cutler	Helm	Mentzer	Staats
Day	Hickernell	Millard	Topper
DeLissio	Hill	Miller, B.	Ward
Diamond	Irvin	Nesbit	Wheeland
Dush	James	Oberlander	White
Ellis	Kampf	Peifer	Zimmerman
Emrick	Keller, F.	Petri	
English	Klunk	Pickett	Turzai,
Everett	Lawrence	Reed	Speaker
Farry	Lewis	Regan	

NOT VOTING–0

EXCUSED–5

Acosta	Schlossberg	Thomas	Toohil
Harris, A.			

The majority having voted in the affirmative, the question was determined in the affirmative and the amendment was declared germane.

BILL PASSED OVER

The SPEAKER. At this time we are going to be going over HB 1581.

SUPPLEMENTAL CALENDAR B

BILLS ON THIRD CONSIDERATION

The House proceeded to third consideration of **HB 1436, PN 2690,** entitled:

An Act amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, in rates and distribution systems, providing for computation of income tax expense for ratemaking purposes.

On the question,
Will the House agree to the bill on third consideration?
Bill was agreed to.

(Bill analysis was read.)

The SPEAKER. This bill has been considered on three different days and agreed to and is now on final passage.

The question is, shall the bill pass finally?

Representative Vitali, you are recognized.

Mr. VITALI. Thank you, Mr. Speaker.

I rise in opposition to this bill, and admittedly, I am not overly familiar with the subject matter, but I have tried to get the opinions of institutions whom I respect. And I would suggest to the members, if you represent anybody who pays electricity bills, strongly consider voting against this, because if this bill passes, your constituents' utility bills will increase.

Mr. Speaker, I would just like to note for the record, this bill, even as it was amended in committee, is still opposed by, one, the Office of Consumer Advocate; two, the Office of Small Business Advocate; three, the Wolf administration; and four, the Pennsylvania Utility Law Project.

Mr. Speaker, I am going to struggle a little bit because I do not know the subject matter that much, but I have the testimony of the Acting Consumer Advocate at a Consumer Affairs meeting held on September 29.

I just would like to read a couple of selected passages by Tanya McCloskey on September 29, 2015. She said: "To eliminate the consolidated tax savings adjustment as is proposed in HB 1436 would allow a utility to collect from ratepayers hypothetical taxes that it never pays to the federal or state government. This additional expense included in rates would be a direct transfer from ratepayers to shareholders' profit."

This bill, if passed, is going to cause utility bill payers like we represent to pay more and shareholders' profits to increase, and you are talking about a lot of money. I am just going to read. It says, "If HB 1436 had been in place for the last several base rate cases filed by our major electric, natural gas, and water utilities...rates would have increased by $28.6 million annually for just seven utilities."

Mr. Speaker, if I may continue, the Consumer Advocate also said that the courts, and I am quoting her, "...the Courts have recognized that there is no place in ratemaking for claims for hypothetical expenses which are not actually incurred by the utility...," and that is what is happening here.

If I may just – bear with me. "I urge the Committee to table House Bill 1436 as it will negatively impact Pennsylvania ratepayers by requiring them to pay tens of millions in higher rates every year in order to fund hypothetical tax expenses that a utility never incurs and never pays."

Now, one of the arguments you hear is, well, all the other States are doing it. Why should we not be doing it? All the other States do it this way. In anticipation of Representative Godshall making that amendment, I just want to give Tanya McCloskey's response, and she says, "I do recognize that some states have moved away from the use of the consolidated tax savings adjustment over the years.... I do, however, find it interesting that while our utilities would like to adopt other states' consolidated tax policies, they are not asking for the lower return on equity (profit) that is granted to utilities in those states."

Mr. Speaker, just moving along, if I could. This is the testimony of the Office of Small Business Advocate. It says that the Office of Small Business Advocate must oppose HB 1436 because it seeks to overturn the Commonwealth's longstanding actual taxes paid doctrine and will result in an inequitable increase in utility rates to small businesses – an inequitable increase in utility rates to small businesses. It goes on to say – forget that one.

This goes on to say, this is the Small Business Advocate, that HB 1436 would also be a double-hit to small businesses who would see an increase in both residential rates at home, as well as an increase in business utility rates – a double-hit to small businesses.

And finally, I want to read from the Pennsylvania Law Project letter, dated September 29. It says, "Specifically, HB 1436 would eliminate a well-established rule that a utility may only collect from ratepayers the taxes that the utility actually pays the state and federal government." It concludes by saying, "...we oppose HB 1436 as it would result in unjustified utility rate increases for consumers."

Mr. Speaker, I urge a "no" vote.

The SPEAKER. Representative Longietti, on HB 1436.

Mr. LONGIETTI. Thank you, Mr. Speaker.

Mr. Speaker, I rise in support of HB 1436. This was a bill that was worked out in committee with a significant amendment on a bipartisan basis. It simply follows what the vast majority of States currently do, which is allow regulated utilities to be judged on a stand-alone basis when it comes to ratemaking.

So it was worked out in committee and had bipartisan support, and I ask members to support it. Thank you.

The SPEAKER. Representative Godshall.

Mr. GODSHALL. Thank you, Mr. Speaker.

What this bill does and what it does not do I guess we could debate all day, but this bill would not impact the amount of Federal or State income taxes paid by public utilities, which is what the intent of the bill does and says. It would simply treat utilities on a stand-alone basis so that the utilities' recoverable tax expense is based upon its operations, not those of unregulated affiliates. More specifically, it requires that a public utility's Federal income tax expense be calculated on a stand-alone basis separate from any danger losses of unregulated affiliates in rate proceedings before the Pennsylvania Public Utility Commission. Everything that is done in here, it has to go back to the PUC, must go back to the PUC. And we are one, in Pennsylvania, with only two States, ourselves and West Virginia, who calculate what we have, the taxes in this bill, with what we have before us today.

HB 1436 requires any positive difference in revenue resulting from calculation of tax expense for ratemaking purposes under the consolidated tax adjustment method and the stand-alone method as follows – this is very important – 50 percent. If there is any gain at all, 50 percent to support distribution system, reliability, and infrastructure as determined by the PUC, and this section applies to base rate cases where the PUC finally orders an issue after the effective date.

What we have done here, we worked on this bill, and the Consumer Affairs Committee deals with public utilities on a regular basis, and as I said, we are one of two States which calculate taxes the way it was calculated here right now in Pennsylvania. It brings us in line with the utilities around the country, and if there is any gain, if there is any gain, 50 percent of that gain must go to infrastructure, infrastructure and development of the infrastructure in the municipality. If cost comes up, elimination will have a minimal effect on residential customers, about the cost of a cup of coffee on the monthly bill, and would only go into effect when a utility comes in for a base rate case.

This morning I talked to one of the major utilities, which is PECO, and it will have absolutely totally no effect on their customers. I ask for a favorable vote.

LEAVE OF ABSENCE CANCELED

The SPEAKER. It is my understanding that Representative Schlossberg wishes to be placed back on the master roll. He is on the House floor.

CONSIDERATION OF HB 1436 CONTINUED

The SPEAKER. Representative Pete Daley, on the bill.

Mr. DALEY. Thank you, Mr. Speaker.

I join my colleague, Representative Godshall, that this bill is a product of the stakeholders working with members of the committee on both sides of the aisle to reach an agreement on something that we all can live with. It embodies the essence of lawmakers working together on a major issue, and I am proud to

be a part of that with my cochair. I want to thank Chairman Godshall and all the members, Republican and Democrat, for working together in supporting the amendments that we have offered, proffered in committee, and I urge my colleagues in the House to support this bill.

Thank you, Mr. Speaker.

BILL PASSED OVER TEMPORARILY

The SPEAKER. At this time we are going to be going over HB 1436, PN 2690.

* * *

The House proceeded to third consideration of **HB 1712, PN 2772,** entitled:

An Act establishing the Private Dam Financial Assurance Program and the Private Dam Financial Assurance Fund.

On the question,
Will the House agree to the bill on third consideration?
Bill was agreed to.

(Bill analysis was read.)

The SPEAKER. This bill has been considered on three different days and agreed to and is now on final passage.

The question is, shall the bill pass finally?

Agreeable to the provisions of the Constitution, the yeas and nays will now be taken.

The following roll call was recorded:

YEAS–195

Adolph	Evans	Kortz	Rader
Baker	Everett	Kotik	Rapp
Barbin	Fabrizio	Krueger	Ravenstahl
Barrar	Farina	Lawrence	Readshaw
Benninghoff	Farry	Lewis	Reed
Bizzarro	Fee	Longietti	Reese
Bloom	Flynn	Mackenzie	Regan
Boback	Frankel	Maher	Roae
Boyle	Freeman	Mahoney	Roebuck
Bradford	Gabler	Major	Rothman
Briggs	Gainey	Maloney	Rozzi
Brown, R.	Galloway	Markosek	Saccone
Brown, V.	Gergely	Marshall	Sainato
Bullock	Gibbons	Marsico	Samuelson
Burns	Gillen	Masser	Sankey
Caltagirone	Gillespie	Matzie	Santarsiero
Carroll	Gingrich	McCarter	Santora
Causer	Godshall	McClinton	Saylor
Christiana	Goodman	McGinnis	Schemel
Cohen	Greiner	McNeill	Schlossberg
Conklin	Grove	Mentzer	Schreiber
Corbin	Hahn	Metcalfe	Schweyer
Costa, D.	Hanna	Metzgar	Simmons
Costa, P.	Harhai	Miccarelli	Sims
Cox	Harhart	Millard	Snyder
Cruz	Harkins	Miller, B.	Sonney
Culver	Harper	Miller, D.	Staats
Cutler	Harris, J.	Milne	Stephens
Daley, M.	Heffley	Moul	Sturla
Daley, P.	Helm	Mullery	Tallman
Davidson	Hennessey	Murt	Taylor
Davis	Hickernell	Mustio	Tobash
Dawkins	Hill	Neilson	Toepel
Day	Irvin	Nesbit	Topper
Dean	James	Neuman	Truitt
Deasy	Jozwiak	O'Brien	Vereb
DeLissio	Kampf	O'Neill	Vitali
Delozier	Kaufer	Oberlander	Ward
DeLuca	Kauffman	Ortitay	Warner
Dermody	Kavulich	Parker, D.	Watson
Diamond	Keller, F.	Pashinski	Wentling
DiGirolamo	Keller, M.K.	Payne	Wheatley
Donatucci	Keller, W.	Peifer	Wheeland
Driscoll	Killion	Petrarca	White
Dunbar	Kim	Petri	Youngblood
Dush	Kinsey	Pickett	Zimmerman
Ellis	Kirkland	Pyle	
Emrick	Klunk	Quigley	Turzai,
English	Knowles	Quinn	Speaker
Evankovich			

NAYS–1

Ross

NOT VOTING–0

EXCUSED–4

Acosta	Harris, A.	Thomas	Toohil

The majority required by the Constitution having voted in the affirmative, the question was determined in the affirmative and the bill passed finally.

Ordered, That the clerk present the same to the Senate for concurrence.

CONSIDERATION OF HB 1436 CONTINUED

The SPEAKER. HB 1436 is back in front of the House. That is PN 2690.

On the question recurring,
Shall the bill pass finally?

The SPEAKER. Representative Vitali, for the second time on the bill today.

Mr. VITALI. I just want to remind the members that this legislation has been opposed by the Office of Consumer Advocate, the Office of Small Business Advocate, the Pennsylvania Utility Law Project, and the Wolf administration, and it will result, predictably, in higher rates to your constituents who pay utility bills at the expense of more profits to utility shareholders.

So I ask you to vote, vote against this bill. It very well may be that if you vote for this bill, you may be accused by your constituents of not acting on their behalf, but because we have laid out these arguments, you really cannot say you have not been warned.

I ask for a "no" vote. Thank you.

The SPEAKER. Representative Pam Snyder.

Mrs. SNYDER. Thank you, Mr. Speaker.

Mr. Speaker, we worked very hard in a bipartisan manner in committee to make this bill a better bill than it started, and I would encourage an affirmative vote. Thank you.

The SPEAKER. Representative Godshall.

Mr. GODSHALL. Just in conclusion, there is a lot of bipartisanship that went into this bill. We worked hard. We have a good bill, and I ask for a favorable vote. Thank you.

On the question recurring,

Shall the bill pass finally?

The SPEAKER. Agreeable to the provisions of the Constitution, the yeas and nays will now be taken.

The following roll call was recorded:

YEAS–155

Adolph	Ellis	Krueger	Quinn
Baker	Evankovich	Lawrence	Ravenstahl
Barbin	Evans	Lewis	Readshaw
Barrar	Everett	Longietti	Reed
Benninghoff	Fabrizio	Mackenzie	Reese
Bizzarro	Farina	Maher	Regan
Bloom	Farry	Mahoney	Roebuck
Boyle	Fee	Major	Rothman
Briggs	Flynn	Markosek	Rozzi
Brown, V.	Frankel	Marshall	Saccone
Bullock	Gergely	Marsico	Sainato
Burns	Gibbons	Masser	Sankey
Caltagirone	Gillespie	Matzie	Santora
Carroll	Gingrich	McClinton	Saylor
Causer	Godshall	McGinnis	Schemel
Christiana	Goodman	McNeill	Schlossberg
Conklin	Greiner	Mentzer	Schreiber
Corbin	Grove	Miccarelli	Schweyer
Costa, D.	Hanna	Miller, B.	Simmons
Costa, P.	Harhai	Milne	Sims
Cruz	Harkins	Moul	Snyder
Cutler	Harris, J.	Mullery	Sonney
Daley, M.	Heffley	Mustio	Staats
Daley, P.	Helm	Neilson	Stephens
Davidson	Hickernell	Nesbit	Tallman
Davis	Hill	Neuman	Taylor
Dawkins	Irvin	O'Brien	Toepel
Day	James	O'Neill	Topper
Dean	Kampf	Oberlander	Truitt
Deasy	Kauffman	Ortitay	Ward
DeLissio	Kavulich	Parker, D.	Warner
Delozier	Keller, M.K.	Pashinski	Watson
DeLuca	Keller, W.	Payne	Wheatley
Dermody	Killion	Peifer	Wheeland
Diamond	Kirkland	Petrarca	Youngblood
DiGirolamo	Klunk	Petri	Zimmerman
Donatucci	Knowles	Pickett	
Driscoll	Kortz	Pyle	Turzai,
Dunbar	Kotik	Quigley	Speaker
Dush			

NAYS–41

Boback	Galloway	Kinsey	Roae
Bradford	Gillen	Maloney	Ross
Brown, R.	Hahn	McCarter	Samuelson
Cohen	Harhart	Metcalfe	Santarsiero
Cox	Harper	Metzgar	Sturla
Culver	Hennessey	Millard	Tobash
Emrick	Jozwiak	Miller, D.	Vereb
English	Kaufer	Murt	Vitali
Freeman	Keller, F.	Rader	Wentling
Gabler	Kim	Rapp	White
Gainey			

NOT VOTING–0

EXCUSED–4

Acosta	Harris, A.	Thomas	Toohil

The majority required by the Constitution having voted in the affirmative, the question was determined in the affirmative and the bill passed finally.

Ordered, That the clerk present the same to the Senate for concurrence.

* * *

The House proceeded to third consideration of **HB 1260, PN 1662,** entitled:

An Act renaming the bridge on that portion of Township Route 431/436, Cooney Road, over US Route 22 in Munster Township, Cambria County, as the PFC Thomas A. Cooney Memorial Bridge.

On the question,

Will the House agree to the bill on third consideration?

LEAVE OF ABSENCE

The SPEAKER. Representative GROVE wishes to be placed on leave. Without objection, that request will be granted.

CONSIDERATION OF HB 1260 CONTINUED

On the question recurring,

Will the House agree to the bill on third consideration?

Bill was agreed to.

(Bill analysis was read.)

The SPEAKER. This bill has been considered on three different days and agreed to and is now on final passage.

The question is, shall the bill pass finally?

Agreeable to the provisions of the Constitution, the yeas and nays will now be taken.

The following roll call was recorded:

YEAS–195

Adolph	Evans	Kotik	Rapp
Baker	Everett	Krueger	Ravenstahl
Barbin	Fabrizio	Lawrence	Readshaw
Barrar	Farina	Lewis	Reed
Benninghoff	Farry	Longietti	Reese
Bizzarro	Fee	Mackenzie	Regan
Bloom	Flynn	Maher	Roae
Boback	Frankel	Mahoney	Roebuck
Boyle	Freeman	Major	Ross
Bradford	Gabler	Maloney	Rothman
Briggs	Gainey	Markosek	Rozzi
Brown, R.	Galloway	Marshall	Saccone
Brown, V.	Gergely	Marsico	Sainato
Bullock	Gibbons	Masser	Samuelson
Burns	Gillen	Matzie	Sankey
Caltagirone	Gillespie	McCarter	Santarsiero
Carroll	Gingrich	McClinton	Santora
Causer	Godshall	McGinnis	Saylor

APPENDIX C

NOTICES

Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge; Doc. No. P-00961031

[26 Pa.B. 4485]

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

Public meeting held
August 22, 1996

Opinion and Order

By the Commission:

I. *Background*

On March 15, 1996, the Pennsylvania-American Water Company (PAWC or company) filed the above-referenced petition with this Commission requesting regulatory approval to file and implement an automatic adjustment clause tariff that would establish a Distribution System Improvement Charge (DSIC or surcharge) under section 1307(a) of the Public Utility Code. 66 Pa.C.S. § 1307(a). Section 1307 (a) provides statutory authority for a utility to establish, subject to Commission review and approval, a tariffed automatic adjustment clause mechanism designed to provide "a just and reasonable return on the rate base" of the public utility.

As proposed by PAWC, the DSIC would operate to recover the fixed costs (depreciation and pre-tax return) of certain nonrevenue producing, nonexpense reducing infrastructure rehabilitation projects completed and placed in service between section 1308 base rate cases. The company maintains that the property additions eligible for the DSIC will be limited to revenue neutral infrastructure projects, consisting principally of replacement investments in so-called "mass property" accounts. The DSIC is designed to provide the company with the resources it needs to accelerate its investment in new utility plant to replace aging water distribution infrastructure, facilitating compliance with evolving regulatory requirements imposed by the Safe Drinking Water Act (SDWA) and the implementation of solutions to regional water supply problems.

To illustrate its point, the company states that it has 5,600 miles of mains, that it is currently rehabilitating between 25 and 30 miles of main each year, and that, at that pace, it would require between 185 and 225 years to make all of the needed improvements to existing facilities. The company also states that water service, more than any other utility service, is critical to maintaining public health as water is "a necessity of life and vital for public fire protection services." Petition at 3.

The company alleges that the DSIC may enable it to reduce the frequency of its base rate cases and place the company in a better position to absorb increases in other categories of costs for a longer period, particularly during times of relatively low interest rates. Any reduction in rate case filing frequency would generate costs savings which would inure to the benefit of customers and the Commission. In its petition, the company proposes certain accounts for recovery, time-frames and other procedures to be followed in implementing the DSIC. The details of those procedures will be discussed below.

To begin with, the company proposes that the DSIC become effective for service rendered on and after July 1, 1996. The company also proposes that the initial charge to be calculated would recover the fixed costs of eligible plant additions that have not previously been reflected in the company's rate base and will have been placed in service between January 1, 1996 and May 31, 1996. Thereafter, the company proposes to update the DSIC on a quarterly basis to reflect eligible plant additions placed in service during the 3-month periods ending 1 month prior to the effective date of each DSIC update. Petition at 3-4.

As to its geographic applicability, the company states that the DSIC will not apply initially to customers located within the authorized service territory formerly served by the Pennsylvania Gas and Water Company (PG&W) that was acquired as of February 16, 1996. Likewise, the company's investment in infrastructure improvements made within the service territory acquired from PG&W are not included in the initial calculation of the surcharge under the DSIC. Petition at 1-2.

The company also proposes that the DSIC be capped at 5% of the amount billed to customers under otherwise applicable rates and charges, exclusive of amounts recovered under the State Tax Adjustment Surcharge (STAS). If the cap is reached, the company would not seek any additional increases. Petition at 4.

As with any section 1307 automatic adjustment clause, the DSIC will be subject to an annual reconciliation, whereby the revenue received under the DSIC for the reconciliation period will be compared to the Company's eligible costs for that period. The difference between such revenues and costs will be recouped or refunded to customers, as appropriate, in accordance with section 1307(e). Petition at 5.

Lastly, in terms of procedures, the company proposes that the DSIC will be reset to zero as of the effective date of new section 1308 base rates that provide for prospective recovery of the annual costs that had previously been recovered under the DSIC. Petition at 5. And to avoid over recovery of costs in the absence of a base rate case, the company also proposed that the DSIC will be reset to zero if, in any quarter, data filed with the Commission in the company's then most recent Annual or Quarterly Earnings Report shows that the company will earn a rate of return that would exceed the rate of return used to calculate its fixed costs under the DSIC. Petition at 5.

In terms of the legal issues raised by its petition, the company also states that its proposed automatic adjustment clause and procedures are lawful for a number of reasons found in statutory and case law. With regard to statutory law, PAWC states that section 1307(a) of the Public Utility Code, 66 Pa.C.S. § 1307(a), provides that a company may establish a sliding scale of rates or such other method for the automatic adjustment of the rates to recover a variety of costs. Petition at 19. Moreover, the company has cited circumstances in which the Commission has authorized the use of section 1307(a) automatic adjustment clauses to recover a wide array of expenses, depreciation and capital costs. See *Pennsylvania Industrial Energy Coalition v. Pa. P.U.C.*, 653 A.2d 1336 (Pa. Cmwlth. 1995) (PIEC) (recovery of electric utilities' demand-side management costs); 52 Pa. Code § 69.181 (recovery of gas utilities' take or pay liabilities to pipeline suppliers); 52 Pa. Code § 69.341(b) (recovery of gas utilities' gas supply realignment costs and stranded costs resulting from Federal Energy Regulatory Commission Order 636); and 52 Pa. Code § 69.353 (recovery of water utilities' principal and interest due on PennVEST obligations). Petition at 20-21.

Answers were filed by the Office of Trial Staff (OTS) (Answer filed April 4, 1996), the Office of Small Business Advocate (OSBA) (Answer filed May 3, 1996), the Pennsylvania-American Water Large Users Group (PAWLUG) (Answer filed May 6, 1996), and the Office of Consumer Advocate (OCA) (Comments and testimony filed May 6, 1996). Protests to the petition were also filed by individual customers.

In its answer, the OTS requests that the Commission deny the company's petition based on legal and technical grounds. With regard to the legal objections, the OTS argues that, since the facilities are "new" facilities, the company is attempting to circumvent a base rate review through the use of a surcharge, in violation of the Court's decision in *PIEC*.

The OSBA's answer did not submit legal arguments opposing the implementation of the DSIC. Rather, the OSBA has requested that the Commission conduct a thorough investigation regarding the reasonableness and lawfulness of the proposed tariff supplement as they affect the company's various customer classes.

In its comments, the OCA argues against the implementation of the DSIC alleging that the company does not need the DSIC mechanism and that implementation of a DSIC mechanism would provide in excess of a fair return to the company. With regard to legal arguments, OCA challenges the legality of the surcharge based upon the same arguments outlined in OTS' answer based on its interpretation of section 1307(a) and the *PIEC* decision.

On April 16 and May 30, 1996, the company filed replies with the Commission addressing the comments raised in the answers filed by OTS, OSBA, PAWLUG and OCA. In PAWC's reply to the various parties concerning the legality of the DSIC, the company continued to support the legality of a surcharge under section 1307(a) of the Public Utility Code and the Commonwealth Court decision in *PIEC*, and supplied rebuttal arguments in support of its need for the DSIC and the legality of its proposal.

II. *Discussion*

At the outset of this discussion regarding the PAWC petition, we believe it necessary to clarify the Commission's view of the scope of this proceeding and the nature of the PAWC proposal. Because the PAWC petition requests regulatory approval to file and implement a certain type of automatic adjustment clause, we will not address, in this order, the specific factual issues that may be raised by the proposed tariff supplement and sample DSIC rate calculations submitted as Exhibits A and B to the petition. The Commission views these exhibits as no more than an illustration of how the company's proposal would operate. Indeed, as explained below, the specific tariff supplement proposed by PAWC will not be approved by this order.

Therefore, to the extent that parties have objections and/or complaints to the rates to be charged by means of an automatic adjustment clause that provides for the recovery of a water company's infrastructure improvement costs, those objections and/or complaints would be appropriately addressed to an actual PAWC tariff filing that contains specific rates to be charged to consumers based on specific distribution system improvement expenditures. A section 701 complaint would be the appropriate procedural vehicle to challenge such a tariff filing and, provided that factual issues are raised, the filing of such a complaint will entitle the complainant to a hearing before an administrative law judge and an adjudication of the complaint.

Thus, the key issues raised by the PAWC petition, and to be resolved in this order, are generic threshold issues regarding (1) the legality of the type of automatic adjustment clause proposed by the company and (2) the appropriate general structure of such an automatic adjustment clause that conforms to the requirement of the statute and Pennsylvania case law. In other words, this proceeding will address the legal issue concerning the adoption of the surcharge pursuant to section 1307(a) of the Code. In addition, the Commission will outline the general parameters of a surcharge mechanism that meets the requirement of the statute, that is consistent with the case law, that has adequate safeguards to protect consumers' interests and, therefore, constitutes a surcharge that is likely to receive regulatory approval when filed.

To begin with, we applaud companies who present this Commission with innovative ideas to address recurring problems for their respective industries. In the water industry, companies are faced with the dual tasks of improving the quality of the water delivered to customers due to the new mandates of the SDWA and other governmental requirements and, at the same time, maintaining an aging water utility infrastructure. We recognize that, in recent years, PAWC and other Pennsylvania water companies have been required to make significant investments in new utility plant for projects such as the filtration of surface water supplies, the replacement of aging water distribution plant and the implementation of meter replacement programs. In addition, water companies face the daunting challenge of rehabilitating their existing distribution infrastructure before the property reaches the end of its service life to avoid

serious public health and safety risks.

In the Commission's judgment, the establishment of a DSIC along the lines proposed by PAWC can substantially aid the water company in meeting these challenges on behalf of the water consuming public. We agree with the company that the establishment of a DSIC would enable the company to address, in an orderly and comprehensive manner, the problems presented by its aging water distribution system, and would have a direct and positive effect upon water quality, water pressure and service reliability. For these reasons, we endorse the concept of using an automatic adjustment clause to address this regulatory problem for the water industry in Pennsylvania and, in particular, the type of DSIC proposed by PAWC.

A. *Legal Issues*

In Pennsylvania, utility costs are recovered from customers through section 1308 base rates and through section 1307 automatic adjustment clauses. The purpose of a section 1307 automatic adjustment clause is to provide an automatic mechanism enabling utilities to recover specific costs not covered by general rates. *Allegheny Ludlum Steel Corporation v. Pa. P.U.C.*, 501 Pa. 71, 75 n.3, 459 A.2d 1218, 1220 n.3 (1983). Moreover, section 1307(e), 66 Pa.C.S. § 1307(e), provides that the automatic adjustment clause procedures shall include an annual report detailing the revenues collected and the expenses incurred under the automatic adjustment clause, followed by a public hearing to reconcile the amounts and to determine any refunds owed to customers or additional recovery due from customers.

Until recently, an automatic adjustment clause has usually been applied only to gas and electric companies. However, the Commission has provided for the recovery of capital costs in at least one instance to date, i.e., for PECO Energy's costs to convert oil-fired units to units which burn natural gas. *Philadelphia Electric Co. ECR No. 3*, Docket No. M-00920312 (Order adopted April 1, 1993). The Commission has also adopted a policy statement which encourages water companies to seek section 1307(a) cost recovery for their PENNVEST debt costs, 52 Pa. Code § 69.361, and policy statements approving section 1307 cost recovery for certain FERC Order 636 stranded costs, 52 Pa. Code § 69.341 (b)(4), and electric utility coal uprating costs, 52 Pa. Code § 57.124(a). Moreover, since 1970, the Commission has authorized all utilities to use an automatic adjustment clause mechanism to recover certain incremental changes in State tax rates. 52 Pa. Code § 69.44.

Pennsylvania case law regarding the permissible scope of section 1307 cost recovery, while not extensive, supports a broad interpretation of that section. In *National Fuel Gas Distribution Corp. v. Pa. P.U.C.*, 473 A.2d 1109, 1121 (Pa. Cmwlth. 1984), the Commonwealth Court held that the purpose of section 1307 of the Code is to permit reflection in customer charges of changes in one component of a utility's cost of providing public service without the necessity of the "broad, costly and time-consuming inquiry" required in a section 1308 base rate case. Moreover, under the 1995 *PIEC* decision, the Commonwealth Court adopted the Commission's legal position that its use of section 1307 was not limited to fuel and purchased power costs. At the same time, the Commonwealth Court cautioned that section 1307 should have limited application and should not override the traditional ratemaking process. *PIEC* at 1349. In determining whether DSM costs could be recovered through the section 1307 mechanism, the Court wrote:

> Although we agree that Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process, *the General Assembly did not limit the allowance of automatic adjustment to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the PUC or the utilities to initiate the automatic adjustment of costs within specific procedures* . . . In this case, Section 1319 of the Code specifically states that all prudent and reasonable costs should be recovered and sets forth requirements that the proposed programs be determined to be "prudent and cost-effective" by the PUC (or the Bureau of Conservation, Economics and Energy Planning as designated by the PUC), before any costs may be recovered through the surcharge mechanism.

PIEC at 1349 (emphasis added). The Court then concluded that the recovery of DSM costs under section

1307 was lawful because the language of section 1307 gives the Commission discretion to establish automatic adjustment clauses for the recovery of prudently incurred costs, and because in section 1319 the legislature specifically identified and provided for the recovery of prudent and reasonable costs for developing DSM programs.

Clearly, the Court in *PIEC* recognized the importance of the statute (section 1319) in providing for the recovery of development costs of the DSM programs via section 1307. However, the Court also recognized that the language of section 1307 is not limited to a narrow set of costs (as advocated by the industrials), that whether the costs at issue should be recovered via an automatic adjustment clause is a matter of Commission discretion, and that the court "is not free to substitute its discretion for the discretion properly exercised by the PUC in establishing the surcharge method." *PIEC* at 1349.

Turning to the PAWC proposal to file and implement an automatic adjustment clause to recover its distribution system improvement costs, we find that the proposal is appropriately limited and narrowly tailored to recover a specific category of utility costs--the incremental fixed costs (depreciation and pre-tax return) associated with nonrevenue producing, nonexpense reducing distribution system improvement projects completed and placed in service between base rate cases. Recovery of this narrow set of costs is clearly permitted under section 1307(a) (which has no cost category limitation in its language) and Pennsylvania case law; and, in the Commission's judgment, this proposal is in no way a mechanism to "disassemble" the traditional ratemaking process for several reasons: first, the DSIC is designed to identify and recover the distribution system improvement costs incurred between rate cases; second, the costs to be recovered represent a narrow subset of the company's total cost of service; and third, the DSIC amount will be capped at a relatively low level to prevent any long-term evasion of a base rate review of these plant costs. Indeed, the company's proposal recognizes that there will be a full review of these costs in a subsequent section 1308 base rate proceeding. We also note that the DSIC is designed to reflect only the costs of the eligible plant additions that are actually placed in service during the 3-month periods ending 1 month prior to the effective date of each surcharge update; this key provision serves to avoid any potential violation of section 1315 and this State's long-standing "used and useful" rule.

Additionally, we find that sections 1307(d) and (e) provide broad auditing powers to the Commission and a formal reconciliation mechanism to carefully monitor the operation of such a surcharge. While admittedly section 1307(d) is addressed to fuel cost adjustment audits, we do not view the Commission's auditing power over automatic adjustment clauses as limited to only fuel costs, given the broad auditing and investigative powers granted to the Commission via sections 504, 505, 506, and 516 of the Public Utility Code. 66 Pa.C.S. §§ 504, 505, 506, 516. Nor would we be likely to approve a utility's request for approval of an automatic adjustment clause in the absence of its complete agreement that the Commission has such auditing powers. Moreover, section 1307(e) provides for a mandatory annual reconciliation report regarding the revenues and expenses recovered via an automatic adjustment clause and a "public hearing on the substance of the report and any matters pertaining to the use by such public utility" of the automatic adjustment clause. As such, the costs to be recovered via the company's DSIC proposal will be subject to the Commission's auditing powers, an annual reconciliation report and public hearings.

B. *General Tariff Parameters*

The basic elements of a tariff supplement to implement a lawful DSIC mechanism include a statement of purpose and description of eligible property, a specification of its effective date and the dates of its subsequent quarterly updates, details regarding the computation methodology and appropriate consumer safeguards. The proposed tariff supplement included with the PAWC petition, as Exhibit A, has no such details. Therefore, in order to provide guidance to PAWC and any other water utility that may need to implement a DSIC, the Commission has developed sample tariff language that, if used in a water utility's section 1307 proposed tariff supplement, is likely to receive the Commission's approval. The sample tariff language is contained in Appendix A to this order.

A properly designed tariff supplement to establish a DSIC that meets the requirement of section 1307 and contains adequate consumer safeguards should include the following features:

--specification of the eligible plant accounts by type and account number;

--elimination from eligibility of (a) the costs of extending facilities to serve new customers[1] and (b) the costs of projects funded by PENNVEST loans;

--include recovery of main extensions installed to eliminate dead ends and to implement solutions to regional water supply problems that have been documented as presenting a significant health and safety concern to existing customers;

--provision of a prospective January 1, 1997 effective date for the tariff supplement and the property eligible for the initial filing;

--if more than 2 years have elapsed since the utility's last base rate case, use of the equity return rate determined by staff and specified in the latest Quarterly Earnings Report released by the Commission;

--greater specification of the depreciation and pretax return elements in the formula to calculate the DSIC;

--added provision to provide interest to consumers for any over recoveries during operation of the DSIC; and

--provision for customer notice of any DSIC changes.

Thus, use of the sample tariff language will fully explain the DSIC computation, including a listing of DSIC eligible property and related account numbers, so that in future years the purpose and intent of the DSIC surcharge will be apparent from reading only the tariff supplement. Additionally, the inclusion of plant account numbers and descriptions of property eligible for DSIC cost recovery parallels the format used for other section 1307 surcharges, such as the ECR for electric utilities, the GCR for gas distribution utilities and the SCR for steam heat companies.

With these key changes to PAWC's proposal, the eligible property, filing dates, calculation parameters, and consumer safeguards will be clearly specified. Moreover, we note here that the provisions (1) for resetting the DSIC to zero if the company's rate of return exceeds its allowable rate of return, and (2) for resetting the DSIC to zero as of the effective date of new section 1308 base rates that provide for prospective recovery of the eligible plant costs both serve as effective and reliable rate mechanisms to insure that the DSIC automatic adjustment clause will not produce rates in excess of a fair return to the utility, as required by section 1307(a). We also note that the provision of a 5% of billed revenues cap on the maximum amount of any DSIC insures that the surcharge mechanism will not evade the section 1308 base rate process and its intensive top-to-bottom review of all company revenue, expense, rate base and return claims. See Appendix A. In other words, the 5% cap will insure that the surcharge will not allow the company to avoid a base rate review of the eligible property in perpetuity.

Accordingly, although we are denying the PAWC petition to the extent that it requests permission to file and implement a section 1307(a) tariff supplement to implement a surcharge as set forth in its Exhibit A, we invite the company to file a new tariff supplement consistent with the parameters outlined in the sample tariff language set forth in Appendix A to this order. The sample tariff language in Appendix A is identical to that recommended for the Philadelphia Suburban Water Company at Docket No. P-00961036 which has also requested permission to establish a DSIC surcharge.

As with other section 1307 tariff filings, the new tariff supplement would provide for a notice period of no less than 60 days to allow sufficient time for staff review of the proposed tariff supplement and its initial rates for consistency with the sample tariff language and for accuracy of the plant account, depreciation, pre-tax return and other elements of the DSIC calculation. If recommended for approval by staff and formally approved by the Commission, the tariff supplement and initial rates to implement the DSIC will be permitted to go into effect, subject to the outcome of any timely filed complaints. Subsequent quarterly updates, however, may be filed on 10 days notice as originally proposed by the

company.

Therefore, It Is Ordered That:

1. The petition filed by the Pennsylvania American Water Company (PAWC) to file and implement a section 1307(a) automatic adjustment clause tariff that would establish a Distribution System Improvement Charge (DSIC) is hereby approved in part and denied in part consistent with this order.

2. All protests, answers and other objections filed with respect to the PAWC petition are hereby granted in part and denied in part consistent with this order.

3. Any complaints regarding the rates to be charged under a DSIC tariff supplement may be filed if and when PAWC files a tariff supplement with specific rates in accordance with the tariff parameters outlined by this order.

4. The parameters set forth in the Appendix A are hereby adopted to serve as sample tariff language to be implemented for tariff supplements to establish a DSIC.

5. The normal auditing, reconciliation, reporting and public hearing procedures applicable to all 1307 (e) filings will likewise apply to all DSIC tariff supplements.

6. This order be published in the *Pennsylvania Bulletin*.

7. This order be served upon Pennsylvania American Water Company, the Office of Consumer Advocate, the Office of Small Business Advocate, the Office of Trial Staff, the Pennsylvania-American Water Large Users Group, and the National Association of Water Companies.

JOHN G. ALFORD,
Secretary

APPENDIX A

Sample Tariff Language

Distribution System Improvement Charge (DSIC)

I. *General Description*

Purpose: To recover the fixed costs (depreciation and pre-tax return) of certain nonrevenue producing, non-expense reducing distribution system improvement projects completed and placed in service and to be recorded in the individual accounts, as noted below, between base rate cases and to provide the Company with the resources to accelerate the replacement of aging water distribution infrastructure, to comply with evolving regulatory requirements imposed by the Safe Drinking Water Act and to develop and implement solutions to regional water supply problems. The costs of extending facilities to serve new customers are not recoverable through the DSIC. Also, Company projects receiving PENNVEST funding are not DSIC-eligible property.

Eligible Property: The DSIC-eligible property will consist of the following:

--services (account 323), meters (account 324) and hydrants (account 325) installed as in-kind replacements for customers;

--mains and valves (account 322) installed as replacements for existing facilities that have worn out, are in deteriorated condition, or upgraded to meet Chapter 65 regulations of Title 52;

--main extensions (account 322) installed to eliminate dead ends and to implement solutions to

regional water supply problems that have been documented as presenting a significant health and safety concern for customers currently receiving service from the Company or the acquired Company;

--main cleaning and relining (account 322) projects; and

--unreimbursed funds related to capital projects to relocate Company facilities due to highway relocations.

Effective Date: The DSIC will become effective for bills rendered on and after January 1, 1997.

II. *Computation of the DSIC*

Calculation: The initial charge, effective January 1, 1997, shall be calculated to recover the fixed costs of eligible plant additions that have not previously been reflected in the Company's rate base and will have been placed in service between September 1, 1996, and November 30, 1996. Thereafter, the DSIC will be updated on a quarterly basis to reflect eligible plant additions placed in service during the 3-month periods ending 1 month prior to the effective date of each DSIC update. Thus, changes in the DSIC rate will occur as follows:

Effective Date of Change	**Date To Which DSIC-Eligible Plant Addition Reflected**
April 1	February 28
July 1	May 30
October 1	August 31
January 1	November 30

The fixed costs of eligible distribution system improvement projects will consist of depreciation and pre-tax return, calculated as follows:

Depreciation: The depreciation expense will be calculated by applying to the original cost of DSIC-eligible property the annual accrual rates employed in the Company's last base rate case for the plant accounts in which each retirement unit of DSIC-eligible property is recorded.

Pre-tax return: The pre-tax return will be calculated using the State and Federal income tax rates, the Company's actual capital structure and actual cost rates for long-term debt and preferred stock as of the last day of the 3-month period ending 1 month prior to the effective date of the DSIC and subsequent updates. The cost of equity will be the equity return rate approved in the Company's last fully-litigated base rate proceeding for which a final order was entered not more than 2 years prior to the effective date of the DSIC. If more than 2 years shall have elapsed between the entry of such a final order and the effective date of the DSIC, then the equity return rate used in the calculation will be the equity return rate calculated by the Commission Staff in the latest Quarterly Report on the Earnings of Jurisdictional Utilities released by the Commission.

DSIC Surcharge Amount: The charge will be expressed as a percentage carried to two decimal places and will be applied to the total amount billed to each customer under the Company's otherwise applicable rates and charges, excluding amounts billed for public fire protection service and the State Tax Adjustment Surcharge (STAS). To calculate the DSIC, one-fourth of the annual fixed costs associated with all property eligible for cost recovery under the DSIC will be divided by the Company's projected revenue for sales of water for the quarterly period during which the charge will be collected, exclusive of revenues from public fire protection service and the STAS.

Formula: The formula for calculation of the DSIC surcharge is as follows:

$$DSIC = \frac{(DSI \times PTRR) + Dep + e}{PQR}$$

Where:

DSI = the original cost of eligible distribution system improvement projects.

PTRR = the pre-tax return rate applicable to eligible distribution system improvement projects.

Dep = Depreciation expense related to eligible distribution system improvement projects.

e = the amount calculated under the annual reconciliation feature as described below.

PQR = Projected quarterly revenue including any revenue from acquired companies that are now being charged the rates of the acquiring company.

Quarterly updates: Supporting data for each quarterly update will be filed with the Commission and served upon the Office of Trial Staff, the Office of Consumer Advocate and the Office of Small Business Advocate at least 10 days prior to the effective date of the update.

III. *Safeguards*

Cap: The DSIC will be capped at 5% of the amount billed to customers under otherwise applicable rates and charges.

Audit/Reconciliation: The DSIC will be subject to audit at intervals determined by the Commission. It will also be subject to annual reconciliation based on a reconciliation period consisting of the 12 months ending December 31 of each year. The revenue received under the DSIC for the reconciliation period will be compared to the Company's eligible costs for that period. The difference between revenue and costs will be recouped or refunded, as appropriate, in accordance with section 1307(e), over a 1 year period commencing on April 1 of each year. If DSIC revenues exceed DSIC-eligible costs, such overcollections will be refunded with interest. Interest on the overcollections will be calculated at the residential mortgage lending specified by the Secretary of Banking in accordance with the Loan Interest and Protection Law (41 P. S. § 101, et seq.) and will be refunded in the same manner as an overcollection.

New Base Rates: The charge will be reset at zero as of the effective date of new base rates that provide for prospective recovery of the annual costs that had theretofore been recovered under the DSIC. Thereafter, only the fixed costs of new eligible plant additions, that have not previously been reflected in the Company's rate base, would be reflected in the quarterly updates of the DSIC.

Earning Reports: The charge will also be reset at zero if, in any quarter, data filed with the Commission in the Company's then most recent Annual or Quarterly Earnings reports show that the Company will earn a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under the DSIC as described in the Pre-tax return section.

Customer Notice: Customers shall be notified of changes in the DSIC by including appropriate information on the first bill they receive following any change. Anexplanatory bill insert shall also be included with the first billing.

[Pa.B. Doc. No. 96-1559. Filed for public inspection September 13, 1996, 9:00 a.m.]

[1] For purposes of the DSIC surcharge, the existing customers of a newly-acquired water company are not "new customers" and, thus, the replacement of aging water distribution facilities by the acquiring water utility in order to maintain safe, reliable and adequate service to such customers would be eligible for DSIC recovery.

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APPENDIX D

Prepared Testimony of

Gladys M. Brown
Chairman
Pennsylvania Public Utility Commission

before the

Pennsylvania House of Representatives
Consumer Affairs Committee

House Bill 1436

September 28, 2015

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Chairman Godshall, Chairman Daley, and Members of the Committee:

While I am unable to attend this hearing, I appreciate the opportunity to present testimony on House Bill 1436. As described in the following, the Public Utility Commission (Commission or PUC) maintains a neutral position on this legislation. We further offer for your consideration suggestions which the PUC believes can benefit utility ratepayers and the public at large.

Background – Consolidated Tax Adjustment

Pennsylvania is currently one of a small number of states that requires a consolidated tax adjustment to a public utility's tax expenses when setting rates. When consolidated tax returns are used, each subsidiary of a parent corporation calculates its separate income, deductions, tax liability and tax credits on a standalone basis. However, the subsidiary does not then file a separate federal income tax return or pay the calculated tax to the Internal Revenue Service. Rather, the subsidiary submits its calculations (and, typically, the amount of its standalone tax liability, if any) to the parent corporation. As is permitted by the Internal Revenue Code[1], the parent corporation then offsets taxable income generated by some subsidiaries with tax losses and credits generated by other subsidiaries to arrive at a net amount representing the taxable income of the consolidated group.

Prior to the 1980s, public utilities, when filing for rate increases before the Commission, were able to claim federal income tax expenses equal to the full amount of their "stand alone" tax liabilities. This was even allowed when the regulated public utility participated in a consolidated tax return filing of its parent holding company, which may have numerous subsidiaries, including both regulated public utilities and unregulated companies, which may possibly result in an aggregate tax liability significantly less than the sum of the members' tax liabilities as individually computed.

[1] 26 U.S.C. §§ 1501-1505

In *Barasch v. Pennsylvania Public Utility Commission*[2], the Pennsylvania Supreme Court considered the question of what treatment to afford the tax savings of utilities resulting from participation in a consolidated tax return. The Supreme Court affirmed the prior decision of the Commonwealth Court, which had reversed and remanded the Commission's decision to not take into account the adjustment to tax expense proposed by the Office of Consumer Advocate to reflect the utility's proportionate share of the savings that result from the utility participating in the consolidated tax return of its parent company[3]. The court in *Barasch* stated that:

> "[A]lthough the Commission is vested with broad discretion in determining what expenses incurred by a utility may be charged to the ratepayers, the Commission has no authority to permit, in the rate-making process, the inclusion of hypothetical expenses not actually incurred. When it does so, as it did in this case, it is an error of law subject to reversal on appeal."

It was also noted that Pennsylvania appellate courts, for many years, had refused to permit utilities to include in consumer rates tax expenses that, because of participation in a consolidated return, they did not actually pay to the government.[4]

Furthermore, the Supreme Court noted that the arguments advanced by the Commission and the utility failed to recognize the basic ratemaking maxim that only expenses that are actually paid or payable by the utility may be included for the purpose of ratemaking. The Court determined that all tax savings arising out of participation in a consolidated return must be recognized in ratemaking; otherwise it would condone the inclusion of fictitious expenses in the rates charged to the ratepayers.[5]

The basic premise of the Supreme Court's determination was the "actual taxes paid" doctrine. As a result, the Supreme Court held that the

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[2] 507 Pa. 561, 493 A.2d 653 (1985)
[3] *Cohen v. Pennsylvania Public Utility Commission*, 78 Pa. Cmwlth. Ct. 545, 468 A.2d 1143 (1983)
[4] *Cohen*, 78 Pa. Commonwealth Ct. at 559, 468 A.2d at 1150
[5] *Barasch/UGI*, 507 Pa. at 568, 493 A.2d at 656

ratepayers are entitled to the benefits of reduced tax expenses accruing to the utility by its participation in a consolidated tax return.[6]

It should be noted that these adjustments can potentially result in an increase in tax liability for utilities. This may be the case when a utility's affiliates have experienced strong earnings over the course of many years.

Presently, the Commission is aware of three states that have not abolished the use of consolidated tax adjustments; New Jersey, West Virginia and Pennsylvania.

HB 1436

The proposed bill introduces legislation that requires a public utility's federal income tax expense to be calculated on a "stand-alone" basis – separate from the gains or losses of any affiliates – when establishing base rates for the regulated public utility, even when the public utility participates in the consolidated tax filing of its parent company and has benefitted tax-wise from those same gains or losses of an unregulated affiliate on a consolidated basis.

The elimination of the consolidated tax adjustment and implementing the "standalone" tax approach for ratemaking purposes would be a departure from the "actual taxes paid" doctrine established by the Pennsylvania courts and followed for many years. The net result will be to eliminate this potential downward adjustment to consumer rates for utilities that participate in a consolidated tax return.

[6] *Id.* at 570, 493 A.2d at 657

PUC Suggestions

If the legislature desires to depart from the "actual taxes paid" approach to ratemaking, it should do so in a manner that ensures that funds from any incremental increase in consumer rates due to elimination of the consolidated tax adjustment are used for the benefit of the consumers who paid those rates. In other words, the incremental increase in rates that accrues to the public utility as a result of computing its current or deferred income tax expense using the "stand alone" tax approach should not be passed to the parent company, shareholders or affiliated companies; rather, those incremental amounts should be used for infrastructure improvement and repair in Pennsylvania.

In this fashion, the additional amounts paid in rates by the utility's consumers, due to elimination of the consolidated tax adjustment, would be spent in a manner that directly benefits service to those consumers and the Commonwealth.

An alternate approach would be to require that any tax savings realized by a utility using the "stand alone" method for calculating tax expenses in determining rates are shared between ratepayers or infrastructure investments in Pennsylvania and the utility's shareholders, parent company or affiliated companies according to a ratio predetermined in the legislation.

In sum, the Commission maintains a neutral stance on this piece of legislation. With that said, if the intent of the legislation is to encourage investment in utility infrastructure, it would be advantageous to ensure that those improvements have a beneficial impact in Pennsylvania.

The Commission appreciates your interest in this matter and stands ready as a resource to help the Committee address any questions that may arise from this testimony or during the pendency of deliberation of HB 1436.