

COMMONWEALTH OF PENNSYLVANIA



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December 12, 2013

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17101

RE: Petition of Peoples Natural Gas, LLC
For Approval of a Distribution System
Improvement Charge
Docket No. P-2013-2344596

Dear Secretary Chiavetta:

Attached for electronic filing is the Main Brief of the Office of Consumer Advocate in the above-referenced proceeding.

Copies have been served on the parties as indicated on the Certificate of Service.

Respectfully submitted,

A handwritten signature in black ink that reads "Erin L. Gannon".

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Attachment

cc: Honorable Mary D. Long
Honorable Jeffrey A. Watson
Certificate of Service

177630

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Peoples Natural Gas LLC :
For Approval of a Distribution System : Docket No. P-2013-2344596
Improvement Charge :

MAIN BRIEF OF THE
OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Main Brief pursuant to the Prehearing Order of Administrative Law Judges Mary D. Long and Jeffrey A. Watson (ALJs) dated June 24, 2013.

A. Background.

On February 14, 2012, Governor Corbett signed Act 11 of 2012 (Act 11 or Act) into law. Act 11 amends, *inter alia*, Chapter 13 of the Public Utility Code to permit water and wastewater utilities, electric distribution companies (EDCs), natural gas distribution companies (NGDCs) and city natural gas operations to petition the Pennsylvania Public Utility Commission (Commission) for implementation of a Distribution System Improvement Charge (DSIC). See, 66 Pa. C.S. §§ 1350-1360. See also, In re: Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order (August 2, 2012) (Final Implementation Order). Act 11 states that a DSIC is intended to provide for “timely recovery of the reasonable and prudent costs incurred to repair, improve or replace eligible property in order to ensure and maintain adequate, efficient, safe, reliable and reasonable service.” 66 Pa. C.S. § 1353.

In order to implement a DSIC, a utility must submit the following to the Commission: (1) an initial tariff; (2) evidence demonstrating that a DSIC is in the public interest and will facilitate the utility’s compliance with the Public Utility Code, Commission orders and regulations and other State and Federal requirements; (3) a Long-Term Infrastructure Improvement Plan (LTIIP); (4) certification that a base rate case has been filed within the previous five years; and (5) any other information required by the Commission. 66 Pa. C.S. § 1353(b). The Act provides that the Commission “shall, after notice and opportunity to be heard, approve, modify or reject the [DSIC] and initial tariff.” 66 Pa. C.S. § 1355.

The DSIC must be calculated to recover the fixed cost of eligible utility property and shall consist of depreciation and pretax return. 66 Pa. C.S. § 1357(a). Eligible utility property is property that has (1) not been previously reflected in rate base and (2) been placed in service during the three-month period ending one month prior to the effective date of the DSIC. Id. The DSIC must be updated quarterly. 66 Pa. C.S. § 1357(a)(2). A utility must file supporting data for each quarterly update with the Commission at least ten days prior to the effective date of the update and serve a copy on the OCA and the Office of Small Business Advocate (OSBA). 66 Pa. C.S. § 1357(d)(3).

Act 11 provides certain limitations on the utilities with regard to the implementation of a DSIC. See, 66 Pa. C.S. § 1358. Specifically, a DSIC initially may not exceed 5% of the distribution rates of EDCs, NGDCs or city natural gas operations. 66 Pa. C.S. § 1358(a)(1). Further, a DSIC shall be reset to zero, *inter alia*, (1) upon the effective date of new base rates and (2) if, in any quarter, the data filed with the Commission shows that the utility will earn a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under its DSIC. 66 Pa. C.S. § 1358(b). Additionally, Act 11 sets out specific audit and reconciliation procedures, including that any over-collections of eligible costs through the DSIC must be refunded to customers with interest. See, 66 Pa. C.S. § 1358(e).

The Act requires the Commission to prescribe by regulation or order specific procedures to be followed to approve a DSIC. 66 Pa. C.S. § 1358(d). See also, Final Implementation Order. In the Final Implementation Order, the Commission set forth specific customer notice requirements regarding the filing of a DSIC petition, the Commission's disposition of a DSIC petition and quarterly updates to the DSIC rate. See, Final Implementation Order at 26. The Commission also clarified certain of the Act's provisions, including that (1) the Act's percentage

rate caps are bill limitations as applied to the distribution charges on each EDC, NGDC, or city natural gas operation customer's bill, not to aggregated billing revenue and (1) for companies using the Commission's quarterly earnings report in determining whether a DSIC must be reset to zero, the cap shall be aligned to the "Adjusted Results" column in the report. Id. at 42-43. Attached to the Final Implementation Order is a model DSIC tariff.

B. Procedural History.

On January 23, 2013, Peoples Natural Gas Company (Peoples or Company) filed a Long Term Infrastructure Improvement Plan (LTIIP) pursuant to Section 1352 of the Public Utility Code, 66 Pa. C.S. § 1352. On February 12, 2013, the OCA filed Comments on the LTIIP. On March 4, 2013, Peoples filed Reply Comments.

On January 31, 2013, pursuant to Section 1353, Peoples filed a Petition for Approval of a Distribution System Improvement Charge (DSIC Petition). 66 Pa. C.S. § 1353. On February 19, 2013, the Pennsylvania Independent Oil and Gas Association (PIOGA) filed a Petition to Intervene. The OCA filed an Answer, Notice of Intervention, and Formal Complaint and Public Statement on February 20, 2013. Also on February 20, 2013, OSBA filed an Answer, Notice of Intervention and Public Statement. Customer Daniel Killmeyer filed a Formal Complaint against the DSIC on February 21, 2013.¹ Fifteen customers also filed letters in opposition to the implementation of a DSIC. On April 29, 2013, US Steel Corporation filed a Petition to Intervene.²

¹ The Commission's May 23, 2013 Order dismissed Mr. Killmeyer's Formal Complaint.

² The Commission's May 23, 2013 Order denied US Steel's Petition to Intervene as untimely. The Commission's Order provided that US Steel could file a Petition to Intervene nunc pro tunc in the hearings before the Office of Administrative Law Judge (OALJ), but that the Petition to Intervene was to be limited to those issues that were referred to the OALJ pursuant to the May 23, 2013 Order. May 23 Order at 4.

On February 2, 2013, Peoples filed a Petition for Approval of the Limited Waivers of Certain Tariff Rules Related to Customer Service Line Replacement (Waiver Petition). On February 21, 2013, the OCA and the Bureau of Investigation and Enforcement (I&E) filed Comments on the Waiver Petition.

Peoples is an NGDC serving approximately 360,000 customers in portions of thirteen counties in western Pennsylvania. DSIC Petition at 2. In its DSIC Petition and in testimony, Peoples asserted that it developed its proposed Tariff Supplement No. 11 in compliance with the Model Tariff attached to the Commission's Final Implementation Order (Model Tariff). DSIC Petition at 4; Peoples St. 1 at 4. Peoples requested that its initial DSIC be implemented for bills rendered on or after April 1, 2013. DSIC Petition at 4. Peoples proposed an initial DSIC using an 11.68% return on equity in the Direct Testimony of Andrew Wachter. Peoples St. 1, Exh. APW-1 at 3.

Peoples proposed to provide customer notice of quarterly changes to the DSIC through bill messaging, in the February 2014 Peoples View newsletter, and on the Company's website. DSIC Petition at 6; Peoples St. 1 at 7, Exh. APW-2. Peoples incorporated into its Tariff Supplement No. 11 the specific consumer protection provisions required by Act 11 and the Commission's model tariff. DSIC Petition at 4. Peoples asserts that its proposed DSIC tariff is in the public interest because it will ensure that customers will continue to receive safe and reliable service in the future. DSIC Petition at 6-7.

Peoples proposed an initial DSIC rate of 0.71%, which is based on the three-month period December 2012 through February 2013.³ Peoples St. 1, Exh. APW-1 at 3. According to Peoples witness Andrew P. Wachter, Peoples' initial DSIC rate was calculated as follows: (1) the

³ The OCA notes that the Company states on page 5 of its Petition that the estimated DSIC rate is 0.69%. DSIC Petition at 5. The referenced exhibit, APW-1, and the initial proposed tariff provide a rate of 0.71%. DSIC Petition, Exh. 1 at 2; Peoples St. 1, Exh. APW-1 at 3.

fixed costs, including depreciation and pre-tax return, associated with the eligible property included in Supplement No. 11 from the period of December 2012 through February 2013; (2) the quarterly pre-tax return is multiplied against the net distribution system improvement costs to derive the quarterly capital costs recovery; 3) other costs, including depreciation expense over/under-collection, audit adjustments, etc. are then added to the quarterly capital cost recovery to derive the total DSIC revenue requirement. Peoples St. 1 at 4-5. The sum is then divided by one quarter of the annual projected revenue to derive the overall DSIC percentage. Id. at 5.

By Order entered May 23, 2013 at this docket, the Commission approved Peoples' LTIIP and DSIC, subject to the resolution of the matters raised in the present litigation. Petition of Peoples Natural Gas Co., LLC for Approval of a Distribution System Improvement Charge, Docket No. P-2013-2344596, Order at 64-66 (May 23, 2013) (May 23 Order). The Commission approved the Company's DSIC, subject to recoupment and/or refund pending final resolution of certain issues raised in the parties' Petitions and Answers. With regard to the Waiver Petition, the Commission approved the inclusion of the customer-owned lines in Peoples' LTIIP and referred the issue relating to the DSIC recovery of costs related to customer-owned service lines to be addressed in this proceeding. On July 1, 2013, Peoples filed the Supplemental Testimony of Mr. Wachter, Peoples St. No. 1-S, and Tariff Supplement No. 19 pursuant to the Commission's May 23 Order, with a DSIC rate of 0.35% for the effective period of July 1, 2013 through September 30, 2013. See generally, Peoples St. 1, Exh. APW-1S.

A Prehearing Conference was convened on June 21, 2013. In their Prehearing Order dated June 24, 2013, the ALJs set forth the litigation schedule and consolidated the complaints filed against Peoples' DSIC Petition for hearing and disposition. Pursuant to the established

litigation schedule in this matter, the OCA served the Direct and Surrebuttal Testimonies of Thomas S. Catlin.⁴ On November 6, 2013, the parties informed the ALJs that a Partial Settlement of the Issues had been reached on all but two issues related to the Accumulated Deferred Income Taxes (ADIT) and state income taxes. All parties waived cross-examination at the hearings. The Testimonies of the OCA, the OSBA and the Company were moved into the record at the hearing on November 12, 2013. The OCA now provides this Main Brief in accordance with the ALJs' Prehearing Order of June 24, 2013. The OCA's Proposed Findings of Fact, Conclusions of Law and Ordering Paragraphs are attached hereto as Appendix A.⁵

⁴ Mr. Catlin is a principal of Exeter Associates, Inc., a firm specializing in public utility issues. Mr. Catlin earned a Bachelor of Science degree in physics and math from the State University of New York at Stony Brook in 1974 and a Master of Science degree in water resources engineering and management from Arizona State University in 1974. Mr. Catlin's work at Exeter involves review and analysis of utility rate filings, utility affiliate relations, alternative regulatory mechanisms and regulatory restructuring issues. Mr. Catlin's education and experience is set forth in more detail in OCA St. 1 at 1-3.

⁵ Appendix B to this Main Brief contains a list of the testimony and exhibits sponsored by the OCA and admitted into the record of this proceeding.

II. LEGAL STANDARD

Peoples bears the burden of proof to establish the justness and reasonableness of every element of its proposed Distribution System Improvement Charge. As set forth in Section 315(a) of the Public Utility Code:

Reasonableness of rates- In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceedings upon the complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa. C.S. § 315(a). The Commonwealth Court interprets this principle as follows:

Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial. [Citations omitted.]

Lower Frederick Twp. v. Pa. PUC, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980); see also, Brockway Glass v. Pa. PUC, 63 Pa. Commw. 238, 437 A.2d 1067 (1981).

The Pennsylvania Supreme Court has stated that the party with the burden of proof has a formidable task to show that the Commission may lawfully adopt its position. Even where a party has established a prima facie case, the party with the burden of proof must establish that “the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.” Burleson v. Pa. PUC, 461 A. 2d 1234, 1236 (Pa. 1983) (Burleson). Thus, a utility has an affirmative burden to establish the justness and reasonableness of every component of its rate request.

The OCA points out that Pennsylvania law is clear that there is no similar burden for a party proposing an adjustment to a utility rate filing. See, e.g., Berner v. Pa. PUC, 383 Pa. 622, 116 A. 2d 738 (1955) (Berner). In Berner, the Pennsylvania Supreme Court stated:

[T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden, is by statute, on the utility to demonstrate the reasonable necessity and cost of the installations and that is the burden which the utility patently failed to carry.

Berner, 382 Pa. at 631, 116 A.2d at 744. The Commission recognizes this standard in its rate determinations. Pa. PUC v. Equitable Gas Co., 57 Pa. PUC 423, 471 (1983). See also, University of Pa. v. Pa. PUC, 86 Pa. Commw. 410, 485 A.2d 1217 (1984). Thus, it is unnecessary for the OCA (or any challenger) to prove that Peoples' proposed rate is unjust, unreasonable, or not in the public interest. To prevail in its challenge, Pennsylvania law requires only that the OCA show how Peoples failed to meet its burden of proof.

In conclusion, Peoples must affirmatively demonstrate the reasonableness of every element of its proposed DSIC calculation and demonstrate that its proposed rate is just, reasonable, and in the public interest. The OCA will show that Peoples has failed to satisfy its statutory burden in the manner set forth below.

III. SUMMARY OF ARGUMENT

In 2012, the General Assembly amended Chapter 13 of the Public Utility Code to permit wastewater utilities, electric distribution companies, natural gas distribution companies and city natural gas operations to implement a DSIC. See, 66 Pa. C.S. § 1350 *et seq.* The issue in this proceeding is how the DSIC rate should be calculated to meet the requirements of Act 11 and the mandate of Chapter 13 that all rates be just and reasonable, consistent with all applicable laws and ratemaking principles. 66 Pa. C.S. §§ 1301, 1350-1360. The particular concerns raised by the OCA and addressed in this Brief, are that the DSIC rate should not be calculated to recover: (1) a return on dollars that were not invested by shareholders and (2) state taxes that were not paid by the utility. OCA St. 1 at 8-12, 13-15. The premise underlying each is that when a utility receives tax benefits, those benefits accrue to the ratepayers by reducing the revenue requirement that rates are calculated to recover. Id.

Peoples proposes that the DSIC revenue requirement should be calculated as if those tax benefits do not exist. Peoples St. 3-R at 4-10; OCA St. 1-S at 6-8. Instead, the OCA submits that if a utility enjoys the privilege of establishing a surcharge rate to recover plant investment without filing a base rate case, the tax benefits associated with that plant investment must also be reflected in the surcharge rate. OCA St. 1 at 9-11, 13-15; OCA St. 1-S at 6-8. As discussed herein, this is consistent with the existing jurisprudence of Chapter 13, in which Act 11 was established. Nothing within Act 11 expressly provides otherwise. See, e.g., 1 Pa. C.S. § 1932 (the rules of statutory construction provide that statutes are to be constructed in harmony with existing law and as part of a general and uniform system of jurisprudence); Popowsky v. Pa. PUC, 869 A.2d 1144, 1159 (Pa. Commw. Ct. 2005) (Popowsky 2005) (all provisions of the Code that relate to ratemaking must be read together). See also, Erie Sch. Dist. Appeal, 39 A.2d 271,

155 Pa. Super. 564 (1944); Northern Tier Solid Waste Auth. v. Dep't. of Revenue, 860 A.2d 1173 (2004) (Northern Tier).

The express language of the statute limits DSIC recovery to costs incurred by utilities. 66 Pa. C.S. §§ 1351, 1353. Federal income tax benefits associated with DSIC plant investment generate zero-cost funds that partially pay for that plant investment, *i.e.*, not all of the plant investment must be financed or paid for by shareholders. OCA St. 1 at 8-9. State income tax benefits associated with DSIC plant investment reduce the Company's taxable income, so the Company does not incur state taxes at the full statutory rate. Id. at 13. The DSIC calculation must reflect the tax benefits associated with DSIC investment or the rate will recover costs not incurred by the Company, in violation of Act 11 and the requirement that rates be just and reasonable.

IV. ARGUMENT

A. Accumulated Deferred Income Taxes.

1. Introduction.

The Commission allowed Peoples' Act 11 DSIC tariff to go into effect on July 1, 2013 subject to resolution of the issues raised in the present litigation. Peoples' tariff provides that the rate base upon which the Company is allowed to earn a return is equal to the balance of DSIC-eligible plant less the accumulated depreciation on that plant. The rate base formula does not deduct ADIT associated with DSIC-eligible plant as a rate base offset. OCA St. 1 at 8; DSIC Petition at Tariff Supp. 11 at Original Page No. 75. ADIT is generated by the difference between the federal taxes actually paid by the Company and the federal taxes it records for ratemaking. ADIT is the cumulative balance of the deferred taxes generated over time, and it represents a zero-cost source of capital for the Company. OCA St. 1 at 8-9. By not deducting the applicable ADIT, Peoples' formula assumes that all of the plant was paid for with investor supplied capital when it was partially paid for with zero cost capital in the form of deferred taxes. The resulting DSIC requirement will, therefore, include a return as if there were no zero-cost capital.

Peoples has offered no evidence or argument to refute the conclusion that the failure to recognize ADIT can overstate the investment balance and allow the Company to earn a return on funds that were not supplied by investors. Instead, Peoples' arguments against recognizing ADIT associated with the DSIC-plant investment are that it is too complex, not intended by Act 11, and not adopted by the Commission in prior orders. Peoples also argues that ADIT is fully recognized through the earnings cap. Peoples St. 3-R at 4-6; Peoples St. 3-RJ at 2-3.

The OCA will rebut each of these arguments below. The bottom line, however, is that the rates charged to Peoples' customers must be calculated correctly -- whether they are base

rates or surcharge rates. It is not just and reasonable for a utility to earn a return on dollars that its shareholders did not invest. In order to limit recovery to costs incurred by the Company, Peoples DSIC tariff should be modified to read:

DSI = Original cost of eligible distribution system improvement projects net of accumulated depreciation *and accumulated deferred income taxes*.

OCA St. 1 at 12 (emphasis in original indicates new language).

2. ADIT Must Be Included in the DSIC Formula to Ensure that Rates Are Just and Reasonable.

As provided in its proposed tariff, Peoples' surcharge is intended to allow the utility to recover a pre-tax return rate applicable to the original cost of eligible projects net of accrued depreciation. DSIC Petition at Tariff Supp. 11 at Original Page No. 75 (Formula). Specifically, every dollar of equity return in the DSIC is "grossed up" to include federal and state income taxes at the full statutory state and federal income tax rates. *Id.* at Ninth Revised Page Nos. 3-4a; Peoples St. 3-R at 4-10. Peoples is not actually paying that level of taxes to the government, however. Peoples is allowed to take deductions for accelerated and bonus depreciation that significantly reduce the income on which it must pay income taxes. OCA St. 1 at 8-9, 11. The Internal Revenue Code prohibits Peoples from flowing through those tax reductions in rates on a current basis. OCA St. 1 at 8; I.R.C. §§ 167, 168. OCA witness Catlin explained how this law creates ADIT:

Accumulated deferred income taxes arise because certain income tax deductions such as accelerated tax depreciation and bonus tax depreciation must be normalized under the provisions on the United States Internal Revenue Code. That is, utilities such as Peoples are allowed to take tax deductions for accelerated and bonus depreciation that significantly reduce the income on which they must pay income taxes. However, under the normalization provisions of the Internal Revenue Code, those tax reductions are not allowed to be flowed through in rates on a current basis. Instead, income taxes for ratemaking purposes are calculated using book depreciation instead of tax depreciation as a deduction. The resulting difference between the taxes actually paid (taking into account accelerated and

bonus depreciation) and the income taxes for ratemaking (taking into account book depreciation) generates what is known as deferred income taxes. ADIT is simply the cumulative balance of the deferred taxes generated over time. ADIT represents a source of zero cost capital because the utility has paid less in taxes to the federal government than it has collected in rates. Under the standard ratemaking practice, the balance of ADIT is recognized as a source of zero cost capital, as it is in Pennsylvania and most other states, or included in capital structure with a zero cost.

OCA St. 1 at 8-9.

As Mr. Catlin explained, under standard ratemaking procedure, as practiced in Pennsylvania and every other state and federal regulatory jurisdiction in the country, the balance of deferred federal taxes is treated as a reduction in the utility's rate base or included in capital structure with a zero cost, so that customers do not pay a return on non-investor supplied capital.

Id. In the general ratemaking context, this issue has been addressed repeatedly and consistently.

As stated in a leading utility treatise:

Most regulatory commissions have treated accumulated income tax deferrals as a cost-free source of funds. It must be kept in mind that, for cost-of-service purposes, current and deferred federal income taxes are treated as part of the revenue requirements calculation. However, the accumulated deferred income taxes are then used to reduce rate base, to produce a cost-free source of funds to the utility ratepayer.

Robert L. Hahne, Gregory E. Aliff, Accounting for Public Utilities, § 3.02 (2) (1983). This principle is stated even more succinctly in Bonbright's Principles of Utility Rates, which states:

We never have seen a plausible defense for a claim to the enjoyment of a profit on funds not contributed by the corporate investors...there is no need to concede stockholders a return on capital contributed, in effect, either by the taxpayers or by the ratepayers.

James C. Bonbright, Albert L. Danielsen, David R. Kamerschen, Principles of Utility Rates at 288 (1988). See also, Martin T. Farris and Roy J. Sampson, Public Utilities: Regulation, Management, and Ownership at 114 (1973) ("This tax deferral is, in effect, an interest free loan to the utility, since depreciation allowances are normally reinvested in the firm").

The Pennsylvania Commission and other state and federal regulatory commissions have recognized this principle as well. For example, in a 1979 West Penn Power rate case involving the Pleasants Unit 1 Generating Station, the Commission addressed the issue of deducting ADIT from rate base as follows:

If this amount is not deducted from rate base, the stockholders will be earning a return on money they never provided...

Under West Penn's proposal, the stockholders would be permitted to retain the tax benefits on which they would earn a return; and the ratepayers would be obligated to provide a return to the stockholders on funds made available by the federal government.

We agree with the consumer advocate, that simple equity to the ratepayers, commission policy regarding treatment of accelerated depreciation benefits, and consistent treatment of such depreciation for both book and rate-making accounts, require that additional deduction in this regard be made to rate base.

Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 264-265, 53 PaPUC 410, 430-31 (1979) (West Penn). The Commission reached the identical conclusion in a case involving the PECO Salem Nuclear Plant. Pa. PUC v. Philadelphia Electric Co., 31 PUR4th 15 at 44-45, 52 PaPUC 772 at 802-03 (PECO). (The utility's treatment "runs afoul of the well-settled commission principle that tax depreciation benefits must either be flowed through to the benefit of the ratepayer, or if not, then deducted from rate base").

In adopting an adjustment to rate base to reflect ADIT, the Kansas Corporation Commission rejected a utility's argument that there should be no ADIT recognition because it was not addressed in prior orders relating to the underlying amortized operating expense. Western Resources, Inc. v. State Corp. Comm'n of Kan., 30 Kan. App. 2d 348, 365, 42 P.3d 162, 174 (Kan. Ct. of App. 2002). In its decision, which was affirmed by the appellate court, the commission stated:

As Staff indicates, including ADIT in rate base is standard to recognize for ratemaking purposes the cost-free capital provided from ratepayers related to differences between when expenses are deducted for regulatory and income tax purposes. There would be no need to specifically refer to such an adjustment in an Order. Including ADIT in rate base is a well-recognized regulatory accounting concept that is applied in a variety of situations to account for deferred income tax benefits related to rate base assets or for timing differences between when expenses are deductible for income tax purposes and financial reporting purposes.

Id.; see also, Florida Progress Corp. v. Commissioner of Internal Revenue, 114 T.C. 587, 589-90, 2000 U.S. Tax Ct. LEXIS 42 (June 30, 2000); aff'd by, Florida Progress Corp. v. Commissioner of Internal Revenue, 2003 U.S. App. LEXIS 21294 (11th Cir. 2003). The Florida Public Service Commission (FPSC) and the Federal Energy Regulatory Commission (FERC) recognize ADIT as zero cost capital so that the customers do not pay a return. Specifically:

Customers of Florida Power receive the economic benefit of all deferred income taxes for as long as they are held by Florida Power. The FERC treats deferred income tax as a reduction to the capital rate base used to calculate the approved rate of return on Florida Power's invested capital. The FPSC treats deferred income tax as zero cost capital, meaning that deferred income tax is used to fund services for the benefit of the ratepayers and no return is collected because it was the ratepayers who supplied the capital. Customers get the resulting economic benefit in reduced rates.

Id.

Consistent with standard ratemaking practice, the OCA's position is that ADIT must be recognized in calculating the rate base to which the DSIC pre-tax return rate will apply. The rate base and revenue requirement for DSIC plant additions should be calculated the same way that rate base and revenue requirement are calculated for base rate purposes. It is no more appropriate for ratepayers to pay a return on zero cost capital in rates established between base rate cases than it is in rates established in a base rate case. OCA St. 1 at 9. Indeed, as set forth more fully below, utilities with similar DSIC-type mechanisms across the country routinely and

correctly reflect ADIT as an offset to the increased rate base that would otherwise be included in rates. As Mr. Catlin explained:

The DSIC represents an approved exception to the rule against single issue ratemaking that allows the utility to recover the capital-related revenue requirement of specific plant additions that are added to plant in service between rate cases. As an allowed single issue ratemaking item, the calculation of the DSIC rate base and revenue requirement must be consistent with how the rate base and revenue requirement associated with that DSIC-eligible plant would be calculated if that plant was being recovered in a base rate case. In a base rate case, it is recognized that rate base must be reduced to reflect ADIT related to the plant, otherwise ratepayers would be paying the utility a return on funds that were not supplied by investors. The treatment of ADIT in the DSIC should be no different. That is, the DSIC rate base and revenue requirement must be reduced to reflect the balance of ADIT associated with DSIC plant. To do otherwise would allow Peoples to earn a pre-tax return on DSIC investment which is financed with zero-cost capital, not with investor supplied capital.

OCA St. 1 at 9.

3. The Impact of ADIT on Rates Can Potentially Be Significant.

The balance of ADIT associated with DSIC-eligible plant can potentially be significant.

OCA St. 1 at 11. Peoples projected that as of February 28, 2013, the total balance of ADIT associated with its DSIC-eligible investment since December 2012 would be \$2,087,632 due to bonus depreciation and accelerated tax depreciation. Id. at 10. The total balance of DSIC-generated ADIT, which Peoples projects to be more than \$2 million as of February 2013, has the potential to significantly increase when Peoples adopts the new IRS repair allowance rules. Id. at 10. OCA witness Catlin testified:

In the future, when Peoples adopts the new IRS repair allowance rules, the balance of ADIT is likely to be even larger because, based on results for other gas distribution companies such as Columbia Gas of Pennsylvania, the repair allowance deduction results in significant amounts of DSIC-eligible investment becoming immediately tax deductible.

OCA St. 1 at 10.

The OCA recognizes, however, that the Company is currently in a temporary “loss carry forward position,” *i.e.*, it has unutilized federal net operating losses and, as a result, will not be able to realize the full benefit of the available tax deductions associated with its DSIC plant immediately. OCA St. 1 at 10. Until Peoples is no longer in a loss carry forward position, the only portion of the deferred taxes for which Peoples will realize an immediate cash benefit will be the federal income taxes on the incremental income produced by DSIC. Based on the pre-tax rate of return in Peoples’ June 20, 2013 compliance filing in this docket, Peoples’ federal taxable income from the DSIC for the first quarter the DSIC is in effect will generate approximately \$41,000 of deferred federal income taxes.⁶ That balance of deferred income taxes would be available as an offset to DSIC rate base as of the end of that first quarter. *Id.* at 11. While the current cash benefit is relatively small, this amount will increase in subsequent quarters as Peoples recognizes additional DSIC income.

OCA witness Catlin explained why it is important to establish the requirement that ADIT be recognized in calculating the investment on which Peoples is entitled to earn a return:

It is important because Peoples’ loss carry forward position is temporary. Once Peoples is no longer in a loss carry forward position, it will be able to realize the full cash benefit of the bonus depreciation and accelerated depreciation deductions associated with its DSIC plant additions. As noted previously, those deductions will be significant and the DSIC established in this proceeding must put in place a provision to account for the ADIT associated with the DSIC plant now and in the future.

Id. Explicitly recognizing ADIT in the DSIC formula will ensure that when Peoples does have taxable income and realizes a cash benefit from the ADIT funds, the DSIC rate base will be reduced so that ratepayers will not be required to pay a return on those taxpayer-supplied funds.⁷

⁶ Mr. Catlin explained: “The state income tax benefits of these deductions are flowed through for ratemaking, so only federal deferred income taxes are generated.” OCA St. 1 at 10, n2.

⁷ When the Company is in a loss carry forward position, the loss carry forward offsets any amounts of ADIT the Company does not have income to use. OCA St. 1 at 10-11. The net effect is that the ADIT does not exist until

This is consistent with Section 1353, which provides for recovery of costs “incurred” by the utility. 66 Pa.C.S. § 1353. Accordingly, the definition of DSI shown on Tariff Supplement No. 11, Original Page No. 75 should be modified to read:

DSI= Original cost of eligible distribution system improvement projects net of accrued depreciation *and accumulated deferred income taxes*.

OCA St. 1 at 12. (Emphasis indicates new language).

In summary, Peoples’ loss carry forward position is temporary. OCA St. 1 at 11. The DSIC formula established in this proceeding should establish the correct formula for the calculation of investment on which Peoples is entitled to earn a return. Then, when Peoples is no longer in a loss carry forward position, the tariff will provide for the appropriate adjustment to DSIC rate base and revenue requirement.

4. Rates Must Be Calculated Correctly Whether They Are Recovered Through Surcharges or Base Rates.

Peoples witness Warren argues that the projection for the ADIT is an added complexity that is not needed. Peoples St. 3-R at 5-6. The Company’s specific concerns are that the calculation would require full base rate case state income tax analysis and that there is difficulty in projecting Peoples’ tax status at any time other than the end of the tax year. Peoples St. 3-R at 6. The Company also argues that its tariff includes an earnings cap, which makes the correction to rate base unnecessary. Peoples St. 1-RJ at 3. For the reasons discussed below, the OCA submits that these arguments do not justify approval of a surcharge that will allow the Company to charge ratepayers for a return on non-investor supplied funds.

the loss carry forward is eliminated by having taxable income. This is not a reason to ignore the ADIT; it just means that recognition of ADIT will not reduce the DSIC rate base at this time. Id.

a. Reflecting ADIT in the DSIC Calculation Is Not Overly Complicated.

Peoples witnesses Warren and Wachter argue that the DSIC should be simple and that the ADIT would add complexity and be a source of controversy. Peoples St. 1-R at 10; Peoples St. 3-R at 6; Peoples St. 1-RJ at 2. The inclusion of ADIT, however, is not overly complex. Rather, it is a necessary correction that is universally accepted as an essential element of just and reasonable rates. The fact is that utilities in Georgia, Kansas, Kentucky, Maine, Maryland (pending), Massachusetts, Missouri, Nebraska, New Jersey, Rhode Island, and Utah calculate ADIT balances associated with incremental investment for their DSIC-type cost recovery mechanisms.⁸ OCA St. 1-S at 6-7. As Mr. Catlin discusses, this demonstrates that recognizing ADIT is not too complicated and is common practice for the calculation of rates that recover infrastructure costs. Id.

Peoples witness Wachter specifically contends that the surcharge mechanism was not designed to mirror a base rate calculation. Peoples St. 1-RJ at 2. The major element of taxes associated with DSIC property, however – state and federal income taxes – is already included in the DSIC. DSIC Petition at Tariff Suppl. 11 at Ninth Revised Page Nos. 3-4a. Deducting ADIT does not “add” anything more to the calculation, it only serves to correctly and fairly value the rate base on which the utility is entitled to earn a return. OCA witness Catlin testified:

Finally, it is important to recognize that the DSIC serves as an interim base rate increase that allows Peoples to begin recovering a return of and on new plant investment without filing a full general rate case. By proposing to ignore ADIT and flow-through of tax deductions for state income purposes, Peoples is

⁸ In re Atlanta Gas Light Co.’s Pipeline Replacement Program, 2009 GaPUC LEXIS 245, * 10; Kan. Stat. Ann. § 66-2202; Application of Columbia Gas of Ky., Inc. for an Adjustment in Rates, 2009 KyPUC LEXIS 1140, *49 (Kentucky Order); Ky. Rev. Stat. Ann. § 278.509; CMR 65-407-675; Mo. Rev. Stat. § 393.1009; R.R.S. Neb. § 66-1866; Annual Filing of South Jersey Gas Co. to Adjust its Capital Investment Recovery Tracker, 2011 NJPUC LEXIS 67, * 35; In re Narragansett Elec. Co. d/b/a National Grid, 2011 RIPUC LEXIS 22, * 8; In the Matter of the Application of Questar Gas Co. to Increase Distribution Non-Gas Rate and Charges, 2010 UTPUC LEXIS 133, * 42-43.

proposing to follow a different set of rules for calculating the return and income taxes associated with DSIC-eligible plant than it would have to follow if those same investments were recovered in base rates as part of a general rate case. There is no sound basis for recognizing incremental plant and incremental accumulated depreciation, but not recognizing incremental ADIT when calculating rate base for DSIC purposes. The rate base used in setting base rates in the Company's general rate cases reflects the ADIT associated with the plant included in base rates; it does not include the ADIT associated with DSIC-eligible plant, so the ADIT associated with DSIC-eligible plant should be recognized in determining rate base for DSIC purposes.

OCA St. 1-S at 2.

Reflecting ADIT for DSIC-eligible plant will not transform the DSIC review process into a full rate case analysis. The statute still provides that the surcharge may take effect in as few as 10 days. 66 Pa. C.S. § 1357(d)(3). The adjustments proposed by the OCA will not recognize, *inter alia*, the overall increase in the net plant in the applicable plant categories, offsetting O&M savings associated with incremental investment, and any other offsetting changes that occur between base rate cases. Contrary to the Company's arguments, recognition of ADIT is consistent with the purpose of the DSIC, which is to permit "timely recovery of the reasonable and prudent costs incurred to repair, improve or replace eligible property." 66 Pa. C.S. § 1353. Return on the utility's investment is included as a cost; however, there is no provision for the recovery of costs that are not "incurred" by Columbia because they are funded through taxpayer-supplied ADIT. *Id.*; see also 66 Pa. C.S. § 1351.

Peoples witness Warren also raises a concern with projecting the net loss carry forward position prior to the end of a tax year. Peoples St. 3-R at 6. Identifying the Company's tax status is no different for DSIC purposes than it is for ratemaking in general. If a question arises, the Company's taxable income for a given year is provided in its annual tax return. Act 11 also recognizes that there will be over- and under-recovery through the surcharge and provides for reconciliation, recoupment and refund. 66 Pa. C.S. §1358(d), (e). The Act specifically provides

for the use of estimates. 66 Pa. C.S. § 1357(d). Given the reconcilable nature of the DSIC, the alleged challenges with projecting the net loss carry forward is not a reason to ignore the ADIT altogether.

As discussed in Section IV.A.2 above, the DSIC rate, like every rate approved by the Commission must be just and reasonable. In order to comply with the express limitation of Act 11 that costs recovered through the surcharge are incurred by the utility, the DSIC rate base must be adjusted for applicable ADIT.

b. The Earnings Cap Does Not Prevent the DSIC from Being Overstated.

Peoples' proposed DSIC includes an earnings cap, which determines whether Peoples is allowed to impose a DSIC surcharge. Specifically, it provides:

The DSIC will also 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 show that the Company would 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.

DSIC Petition at Tariff Suppl. 11 at Original Page No. 76; 66 Pa. C.S. § 1358(b)(3). Peoples witness Wachter suggests that the earnings cap exists as a means to compensate for the fact that tax deductions and ADIT are not flowed to customers through the DSIC. Peoples St. 1-RJ at 3. The earnings cap will prevent a utility from charging a DSIC when its reported quarterly earnings exceed the rate of return authorized in its last base rate case or in the Commission's Quarterly Earnings Report. *Id.*; 66 Pa. C.S. §§ 1357(b)(2)-(3). Those earnings reports, however, are not subject to the type of review and scrutiny that occur in a rate case and the question of whether or not a utility is "overearning" may be a product of a myriad of factors unrelated to the DSIC. The earnings cap does not prevent utilities from overstating the surcharge revenue

requirement and improperly charging ratepayers a return on funds that were not supplied by investors. OCA St. 1-S at 3.

c. Summary.

Peoples has provided no reasonable basis to create a lesser standard of ratemaking for the recovery of capital addition costs through surcharge rates than for the recovery through base rates. Failure to recognize ADIT is not justified by the “complexity” of this calculation (which is being made by numerous other utilities with DSIC-type mechanisms across the Nation) and it is not corrected by the earnings cap. As in the many other states that have addressed this issue, there is simply no question that it is appropriate and necessary to offset the cost of DSIC-eligible plant additions with the accumulated deferred income taxes associated with that plant.

5. Peoples’ Argument that the Statute Does Not Support the Inclusion of ADIT in the DSIC Is Misplaced.

Peoples witness Wachter argues that the General Assembly expressed intent that there should be no offset for taxes. Peoples St. 1-RJ at 2. Mr. Wachter does not reference any provision of the statute in support of his claim, only the legislative history. Pennsylvania’s rules of statutory interpretation provide that legislative history is considered only when the legislative intent is not clear. 1 Pa. C.S. § 1921(b). (“When the words of statute are clear and free from all ambiguity, the letter of it is not be disregarded under the pretext of pursuing its spirit”).

The legislative intent is clear from the statute. Act 11 was established within Chapter 13 of the Public Utility Code and its requirement that all rates be just and reasonable.⁹ The statute specifies that only costs “incurred” by the utility shall be recovered through the surcharge. 66 Pa. C.S. §§ 1351, 1353. There is no proscription against recognition of ADIT within Act 11. To

⁹ 1 Pa.C.S. § 1932 (statutes relating to the same things “shall be construed together, if possible, as one statute”). See, Popowsky 2005.

the contrary, the General Assembly stated plainly that it expected the Commission to address many aspects of the DSIC mechanism. 66 Pa. C.S. § 1358(c) (“nothing under this subchapter shall be construed as limiting the existing ratemaking authority of the Commission”); 66 Pa. C.S. § 1357(c) (“rates of the utility to provide for recovery of the depreciation and pretax return fixed costs of eligible property, as approved by the commission”)(emphasis added); 66 Pa. C.S. §1358(a)(2) (The Commission may amend or revoke practices and procedures of a water utility operating under a distribution system improvement charge prior to the effective date of Act 11). It is, thus, consistent with the language of Act 11 and Section 1301 that the Commission approve a DSIC that is calculated to recover only costs incurred by Peoples.

Further, the legislative history does not support the Company’s position that because the statute does not specify that ADIT be deducted from rate base that the Company does not need to deduct ADIT in its DSIC calculation. Mr. Wachter references a statement that the DSIC legislation sought to memorialize “in statute the current PUC procedure and process used to evaluate water utility requests for DSIC.” Peoples St. 1-R at 11. The statement was made in the context of describing Senate amendments to the bill and distinguishing them from the House version of the bill and explains that “[m]any of the Senate amendments are not substantively different than the provisions of the House-passed bill, where other Senate amendments memorialize in statute the current PUC (Public Utility Commission) procedure and process used to evaluate water utility requests for a DSIC.” 2012 Legisl. Journal- House at 155 (Feb. 7, 2012). Act 11 specifies that Commission rules and orders relating to DSICs established prior to Act 11 remain in effect only for the water utilities, while also giving the Commission authority to amend or revoke the orders. See, 66 Pa. C.S. § 1358(a)(2). Specifically, Section 1358(a)(2) states:

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.

66 Pa. C.S. § 1358(a)(2). Section 1358(a)(2) clearly shows that the General Assembly did not intend for the Commission's existing DSIC rules and procedures for the water companies to automatically apply to electric distribution companies, natural gas distribution companies, city natural gas operations or wastewater companies.

Company witness Wachter states that “[o]pponents to the amendments cited the complexities that would result, as well as the protections that were already included in the DSIC act.” Peoples St. 1-R at 11. The pages attached to Mr. Wachter’s testimony relate to an amendment proposed to limit DSIC recovery to “net increases” in eligible property. Peoples St. 1-R, Exh. APW-3R; 2011 Legisl. Journal-House at 1909 (Oct. 3, 2011); see also, Peoples St. 1-RJ at 2. In other words, rate increases should not be permitted under a DSIC unless there was an overall increase in the “net” plant in the applicable categories, *e.g.*, accumulated depreciation and retirements. Here, the issue is the appropriate calculation of taxes related to the plant that is being recovered in the DSIC rate. In addition, Peoples ignores the response of Representative Reichley to the proposed amendment. Id. at 1910. With regard to that amendment, Representative Reichley opined that the details of the DSIC implementation should be left to the Commission:

And while the approach being offered by [Rep. Mundy] seems to be rather straightforward and simplistic, in reality this inclusion of accumulated depreciation, which is fairly complex and highly technical issue, is one best left to the Public Utility Commission for evaluation when determining any alternative rate mechanism being proposed, not for the legislature to start monkeying around and throwing our 2 cents in when in reality the experts need to be dealing with this.

Id. (emphasis added). Thus, to the extent that this discussion of accumulated depreciation is relevant to the calculation of taxes, the legislative history is consistent with the plain language of Act 11, which allows the Commission to implement the specific rate mechanisms for recovery of eligible costs incurred by the utilities, subject to the overriding requirement that the rates must comply with all provisions of the Public Utility Code and the courts' interpretations, Commission regulations, case precedent and ratemaking principles that bear upon it. 66 Pa. C.S. §§ 1301, 1351, 1353.

6. Nothing in the Model Tariff or Tariffs Approved Prior to Act 11 Limits the Commission's Authority to Correct for ADIT Going Forward.

Peoples witnesses Warren and Wachter argue that reflecting ADIT as an offset to rate base is inconsistent with the Final Implementation Order and the water utility tariffs approved by the Commission. Peoples St. 3-R at 5-6; Peoples St. 1-RJ at 2. As OCA witness Catlin explained, however, recognition of ADIT is necessary to correctly calculate the surcharge rate base on which utilities can earn a return. OCA St. 1 at 9. Mr. Catlin testified:

the DSIC rate base and revenue requirement must be reduced to reflect the balance of ADIT associated with DSIC plant. To do otherwise would allow Peoples to earn a pre-tax return on DSIC investment which is financed with zero-cost capital, not with investor supplied capital.

Id. The evidentiary record developed in this proceeding demonstrates the need for this correction. Moreover, the corrected calculation recognizes the experience and developments in other states in refining the DSIC formula that was created in Pennsylvania 16 years ago.

The Commission's Final Implementation Order and model tariff were developed based on one working group meeting and two rounds of written comments by interested parties, without the benefit of an evidentiary record. Final Implementation Order at 2-3. This proceeding is one of the Commission's first opportunities to review a proposed DSIC by an

investor-owned utility under Act 11. In its May 23 Order, the Commission allowed Peoples' DSIC to go into effect but specifically referred issues related to the impact of ADIT associated with DSIC investments for further disposition.¹⁰ May 23 Order at 65. The Commission is not bound to the language of its model tariff; it may choose to modify that language in accordance with its final resolution of this proceeding. This was the case for PGW. There, the Commission approved a final tariff for PGW that differs from the model tariff – even though the model tariff was developed for that one utility specifically. Final Implementation Order at Model Tariff; Petition of Philadelphia Gas Works for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2337737, Order at 10 (May 9, 2013).

With regard to the water utility tariffs approved prior to the passage of Act 11, Mr. Catlin pointed out two important differences between the situation now and when Pennsylvania established the first water DSIC in the country more than 16 years ago:

We have the benefit of that time and experience in Pennsylvania and nationwide to use in crafting the DSIC pursuant to Act 11. We also have different circumstances, i.e., new IRS repair allowance rules and bonus depreciation, which increase the importance of properly calculating the DSIC.

OCA St. 1-S at 2.

As noted, Pennsylvania was the first state to implement a DSIC mechanism for any type of utility. Since that time, however, legislatures, commissions and utilities in at least 11 other states have authorized or implemented infrastructure investment surcharges that deduct ADIT from the surcharge rate base either by statute, regulation, or simply as a routine matter of course. OCA St. 1-S at 1-2. (Maine and Missouri (water), Georgia, Kansas, Kentucky, Maryland (pending), Massachusetts, Missouri, Nebraska, New Jersey, Rhode Island, and Utah (gas)). In

¹⁰ As discussed in the following section, the Commission also referred the calculation of the state income tax component of the DSIC revenue requirement to the OALJ for further disposition. May 23 Order at 65.

each of those states, ratepayers are protected from paying a return on zero cost capital resulting from ADIT between rate cases, just as they are protected when base rates are set. Id.

Commissions in Maine, Massachusetts, Georgia, Kentucky, New Jersey, Rhode Island and Utah have approved infrastructure investment recovery mechanisms that reflect ADIT in the surcharge calculation without a specific statutory requirement to do so.¹¹ CMR 65-407-675; In re Atlanta Gas Light Co.'s Pipeline Replacement Program, 2009 GaPUC LEXIS 245, *10; Kentucky Order at *49; Annual Filing of South Jersey Gas Co. to Adjust its Capital Investment Recovery Tracker, 2011 NJPUC LEXIS 67, *35; In re Narragansett Elec. Co. d/b/a National Grid, 2011 RIPUC LEXIS 22, *8; In the Matter of the Application of Questar Gas Co. to Increase Distribution Non-Gas Rate and Charges, 2010 UTPUC LEXIS 133, *42-43. Indeed, these ADIT offsets are not even questioned in these decisions; they are treated as a routine matter and taken as a matter of course.

In this proceeding, the Commission has the benefit of an evidentiary record, which demonstrates the need to correctly calculate surcharge revenue requirement and the impact of ADIT on ratepayers, as well as the collective experience of other states that have implemented a DSIC-type mechanism, to ensure that the DSIC established for Peoples does not permit the Company to charge ratepayers a return on non-utility supplied investment.

7. Conclusion.

The DSIC is intended to be an exception to the prohibition against single-issue ratemaking; however, that single issue must be calculated fairly and correctly. To make the DSIC calculation correct (to allow recovery only for costs actually incurred by the utility), the rate base on which the pretax return is calculated must reflect an offset for accumulated deferred

¹¹ Other states have incorporated recognition of accumulated deferred income taxes in statutes implementing DSIC-type mechanisms. Mo. Rev. Stat. § 393.1009; Kan. Stat. Ann. § 66-2202; R.R.S. Neb. §§66-1866.

income taxes. If the balance of ADIT is not recognized, Peoples will be allowed to earn a return on DSIC plant by incorrectly assuming that all of that plant was paid for with investor supplied capital when, in fact, it was partially paid for with zero cost capital in the form of deferred taxes. The calculation of investment on which Peoples is entitled to earn a return for DSIC purposes should be the same as how the balance would be calculated for purposes of base rates. That is, the eligible balance should equal plant less accumulated depreciation on that plant less ADIT associated with that plant.

B. State Income Taxes.

The OCA has also identified a correction that must be made to Peoples' calculation of state income taxes in the DSIC revenue requirement determination. The Company developed its pre-tax rate of return by grossing up the equity component of its overall return to account for both state and federal income taxes at the full statutory rates. DSIC Petition at Tariff Supp. 11 at Original Page No. 74; Peoples St. 1-S, Exh. APW-1S at 4; Peoples St. 3-R at 7-10; OCA St. 1 at 13-14. The amount of state income taxes that Peoples will pay on DSIC revenues, however, will be affected by tax deductions related to the DSIC investment, in particular the accelerated depreciation and, when applicable, bonus depreciation. OCA St. 1 at 13.¹² Because Peoples will not pay state income taxes on the full amount of its equity return, these deductions should be taken into account in determining state taxable income and state income tax expense. The state income tax rate used to calculate DSIC revenue requirement should reflect the state income tax expense actually paid.

With respect to state income tax deductions in Pennsylvania, the law is clear. That is, state income tax deductions must be reflected in rates on a current basis, consistent with the

¹² In base rate proceedings, Peoples flows through the benefit of accelerated depreciation and bonus depreciation for state income tax purposes. OCA St. 1 at 13. Historically, Pennsylvania has recognized 50 percent bonus depreciation but not 100 percent bonus depreciation. OCA St. 1-S at 8.

“actual taxes paid” doctrine. Id. at 13-15. The Pennsylvania Superior Court addressed this principle:

The commission in 1932 very properly held that the utility was not entitled to an allowance on account of a tax which it had not been called upon to pay and which there was then no evidence that it would be required to pay. Our statement is applicable to the present situation, where the utility has not been called upon to pay the tax which it saved by reason of the use of accelerated depreciation, and where there is no evidence that it will ever be called upon to do so within the reasonably foreseeable future.

Pittsburgh v. Pa. PUC, 182 Pa. Super. 551, 577-579, 128 A.2d 372, 384 (1956) (Pittsburgh I).

The Pennsylvania Supreme Court rendered the seminal decision regarding the flow-through of income tax benefits in Barasch v. Pa. PUC, where it determined that the Commission could only find rates “just and reasonable” if those rates are based on the actual taxes paid. 507 Pa. 496, 521, 491 A.2d 94, 107 (1985) (Penn Power). While the Court recognized that federal “normalization” rules prohibited the immediate flow-through of federal tax benefits, the Court required the utility to flow through state income tax benefits to ratepayers on a current basis.

Penn Power, 507 Pa. at 504-05, 518, 520-22, 491 A.2d at 98, 101, 105-107. It held:

We believe that the Pennsylvania version of the “actual taxes paid” doctrine, as developed in Pittsburgh I and II and the Commission in its earlier cases, accurately interprets the statutory requirement and rates be “just and reasonable,” found in 66 Pa. C.S. § 1301.

Id. at 521-22, 491 A.2d at 107. See also, Barasch v. Pa. PUC, 507 Pa. 561, 493 A.2d 653 (1985). (UGI) (when the PUC approves hypothetical expenses not actually incurred, it commits an error of law); see also, Popowsky v. Pa. PUC, 695 A.2d 448, 455 (Pa. Commw. Ct. 1997).

Consistent with Penn Power, this Commission has recognized that flow-through of the benefits associated with utilizing accelerated depreciation in the calculation of state income taxes is “mandated.” Pa. PUC v. Metropolitan Edison Co., 60 PaPUC 349, 398 (1985). Moreover, as stated by the Commission:

[UGI] stands for the proposition that the Commission does not have the authority to permit the inclusion of hypothetical expenses not incurred, and more specifically, establishes the “actual taxes paid” doctrine, prohibiting a utility from collecting “phantom taxes.”

Pa. PUC v. Jackson Sewer Corp., 2001 PaPUC LEXIS 53, * 47 (citing UGI).

In base rate cases, Peoples correctly flows through the state income tax benefits of accelerated depreciation and bonus depreciation. OCA St. 1 at 13; OCA St. 1-S at 8. The OCA submits, however, that as a matter of Pennsylvania law, the Company must calculate the state income tax revenue requirement for the DSIC plant additions in the same manner. OCA St. 1-S at 8. It is no more lawful or appropriate for ratepayers to pay phantom state income taxes in rates established between base rate cases than it is in rates established in a base rate case. Id. The requirement of just and reasonable rates applies to *every* rate approved by the Commission. 66 Pa. C.S. § 1301. Reflecting actual state income taxes paid in the DSIC is also consistent with Act 11, which limits recovery to costs incurred by the Company. 66 Pa. C.S. §§ 1351, 1353(a).

Peoples witness Warren raises four principal objections to making an adjustment to state income taxes in the pre-tax gross-up: (1) the water utilities do not do so; (2) the statutory state income tax rate is the most common meaning of the term “tax rate”; (3) the Commission intended that the statutory tax rate should be used, as evidenced by the language used in the Final Implementation Order and because it is less complicated than reflecting utility-specific taxes; and (4) it is not proper to calculate the state tax liability on a “sequestered” basis. Peoples St. 3-R at 7-8.

In response to Mr. Warren’s first argument – that no water utilities have flowed through state tax benefits in their DSICs (Peoples St. 3-R at 8), the OCA points out that existing water utility DSICs were authorized by prior legislation. Moreover, in Act 11, the General Assembly specified that Commission rules and orders relating to pre-Act 11 DSICs remain in effect only

for those water utilities with existing DSIC mechanisms and recognized that the Commission could amend or revoke the practices and procedures. 66 Pa. C.S. § 1358(a)(2). Peoples' DSIC is one of the first for an investor-owned natural gas distribution utility under the new legislation and one of the first for which an evidentiary record has been developed addressing the need to correctly reflect the impact of tax deductions related to the DSIC investment on the surcharge revenue requirement. See, Petition of Columbia Gas of Pa., Inc. for Approval of a Distribution System Improvement Charge, 303 PUR4th 298 (PaPUC 2013); Petition of PPL Elec. Util. Corp. for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2325034, Order (May 23, 2013).

As to Mr. Warren's second argument that the General Assembly meant "statutory tax rate" rather than the utility's actual or effective tax rate in 66 Pa. C.S. § 1357(b)(1) (Peoples St. 3-R at 7), this argument must fail. Mr. Warren's interpretation of the term is not consistent with the language of the Act itself, which explicitly limits DSIC recovery to costs actually incurred by the utility. 66 Pa. C.S. §§ 1351, 1353. Further, it must be presumed that the General Assembly intended for DSICs established pursuant to Act 11 to comply with the existing requirement of Section 1301 that every rate – whether established in a Section 1308 base rate proceeding or a Section 1350 surcharge – must be just and reasonable. 66 Pa. C.S. §§ 1301, 1308, 1353; Northern Tier, 860 A. 2d 1173 ("statutes are to be construed in harmony with the existing law and as part of a general and uniform system of jurisprudence"). The Pennsylvania Supreme Court has determined that just and reasonable rates must reflect the actual taxes paid and, conversely, that rates that do not reflect the actual taxes paid cannot be just and reasonable for purposes of Section 1301. Penn Power, 507 Pa. at 521, 491 A.2d at 107.

Peoples also contends that the Commission's Final Implementation Order evidences its intent that the statutory state income tax rate should be used rather than reflecting the utilities' effective taxes. Peoples St. 3-R at 7-8. The Order does not address the issue, however, and the model tariff does not specify that the statutory rate be applied without adjustment for the effective tax rate.¹³ Final Implementation Order, App. A. Consistent with the Commission's holding in Jackson Sewer, appellate law and Act 11's requirement that the DSIC recover only costs incurred, rates cannot include phantom taxes. Where a utility is not paying the full statutory tax rate on DSIC income, it must make an adjustment to properly reflect the effective tax rate as part of its calculation of the gross-up for pre-tax return. OCA St. 1 at 13-15. See, Jackson Sewer at 47; Penn Power; UGI; 66 Pa. C.S. §§ 1351, 1353. While Peoples argues that it would be easier not to calculate a utility-specific tax rate (Peoples St. 3-R at 7-8), that is not the purpose of Act 11. The stated purpose of the charge authorized by Act 11 is to provide an alternative to base rate filings that will provide for timely recovery of eligible costs "incurred" by the utility. 66 Pa. C.S. §§ 1351, 1353(a).

In his fourth argument, Mr. Warren claims that it is improper to calculate state income taxes on a "sequestered" basis as though the rest of the Company did not exist. Peoples St. 3-R at 9. It is correct that DSIC revenues and costs are part of the Company's overall taxable income for state income tax reporting purposes. OCA St. 1-S at 7. The fact is, however, the DSIC mechanism provides for an isolation of all of the individual costs associated with DSIC eligible plant. As OCA witness Catlin testified:

Act 11 allows Peoples, Peoples TWP, and other gas and electric companies to isolate the costs associated with DSIC eligible plants and separately recover those costs. It would be inconsistent and inappropriate to calculate state income taxes

¹³ That is why the OCA did not recommend that the language in People's proposed tariff be modified with respect to this issue, just that the utility make the adjustment as part of its calculation of the gross-up for pre-tax return. OCA St. 1 at 6-7.

without recognizing the flow-through of the tax deductions associated with that plant.

OCA St. 1-S at 7. The Company is seeking a separate stream of income through a single issue surcharge. Thus, to the extent there are changes to other components of the Company's overall state income tax position that are not considered in the DSIC formula, that mismatch is driven by the utility.

The OCA also points out that it is not necessary to know the Company's overall tax position in order to flow-through state income taxes in the DSIC rate. Id. OCA witness Catlin explained:

The offset to state income taxes for the flow-through of accelerated depreciation is dependent only on the taxable income produced by the DSIC and the accelerated depreciation deductions associated with DSIC-eligible plant.

OCA St. 1-S at 7. While it is necessary to know if the Company is in an overall tax loss position for purposes of reflecting ADIT in the calculation of DSIC rate base, the Company's concern about reductions in state tax depreciation due to accelerated depreciation is not related to the DSIC itself. Peoples St. 3-R at 9. If the Company's state tax deductions are lower than the amount assumed in calculating state tax expense for base rate purposes, those deductions are associated only with the plant that is included in base rates and the Company has the option to seek a change in base rates. OCA St. 1 at 13-14.

Finally, the OCA will respond to the argument by Company witness Wachter that the earnings cap and other customer safeguards in Act 11 consider the effects of tax depreciation deductions, and therefore, that the actual state income taxes paid by Peoples do not need to be flowed through in the DSIC. Peoples St. 1-R at 6. As discussed in Section IV.A.4.b, the earnings cap can only prevent a utility from charging a DSIC when its reported quarterly earnings exceed the rate of return authorized in its last base rate case or in the Commission's

Quarterly Earnings Report. Id.; 66 Pa. C.S. § 1357(b)(2)-(3). The earnings cap does not prevent utilities from overstating the surcharge revenue requirement and improperly charging ratepayers for state income taxes not actually paid by the utility. OCA St. 1-S at 3.

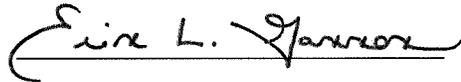
In summary, the Commonwealth's highest court has held that no rate is just and reasonable if it does not reflect the actual taxes paid by the utility. Act 11 also imposes the requirement that fixed costs, which include pre-tax return, recovered through the DSIC must have been "incurred" by the utility. Peoples' state income tax expense for DSIC revenues will be affected by applicable tax deductions for accelerated depreciation and bonus depreciation related to the DSIC investment. To make the DSIC calculation correct (and to allow recovery only for costs actually incurred by the utility), Peoples' pre-tax rate of return must recognize the flow-through of state income tax deductions associated with the investments that are recovered through the DSIC. The effect is to reduce the total quarterly DSIC revenue requirement for the surcharge that took effect on July 1, 2013 from \$188,356 to \$175,332.¹⁴ OCA St. 1 at 14; Peoples Exh. APW-1S at 3. This has the impact of reducing the initial DSIC rate from 0.35 percent to 0.33 percent. Id. Peoples' pre-tax rate of return in the DSIC calculation must recognize the flow-through of state income tax deductions associated with the investments that are recovered through the DSIC.

¹⁴ The quarterly return requirement is reduced from \$164,235 to \$151,210. OCA St. 1 at 14; Peoples Exh. APW-1S at 3.

V. CONCLUSION

For the reasons set forth in this Main Brief, Peoples Natural Gas Company's proposed initial DSIC tariff and rate must be revised. The Company should be directed to change its tariff and DSIC calculation consistent with the OCA's recommendations and refund the excess revenues charged due to the gross-up of the pre-tax rate of return at the full state income tax rate. The OCA's recommendation reduces the DSIC rate that took effect on July 1, 2013 from 0.35% to 0.33%.

Respectfully Submitted,



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DATE: December 12, 2013
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Peoples Natural Gas Company, :
LLC for Approval of a Distribution System : Docket No. P-2013-2344596 and
Improvement Charge : C-2013-2348847

Proposed Findings of Fact, Conclusions of Law and Ordering Paragraphs

Proposed Findings of Fact

Jurisdiction

1. The OCA's Formal Complaint, docketed at C-2013-2348847, was filed against a proposed rate.

ADIT

2. In its May 23 Order, the Commission allowed Peoples' DSIC to go into effect but specifically referred issues related to the impact of the Accumulated Deferred Income Taxes (ADIT) associated with DSIC investments "for further disposition." May 23 Order at 65.

3. ADIT balances are generated by the difference between federal taxes actually paid by the Company and the federal taxes it recorded for ratemaking. OCA St. 1 at 8. Under Commission ratemaking practice, ADIT is reflected as an offset to rate base in determining the revenue requirement. Id. at 8-9. ADIT represents a source of zero cost capital to the utility. Id. at 9.

4. The rate base formula in Peoples' initial DSIC tariff does not recognize the balance of ADIT associated with DSIC-eligible plant as an offset to DSIC rate base. Id. at 9-10.

5. Peoples' proposed calculation can overstate the DSIC investment balance and allow Peoples to earn a return on funds that were not invested by shareholders. OCA St. 1 at 8-9.

6. Peoples estimated the balance to federal ADIT associated with its DSIC-eligible investment as of February 28, 2013 to be \$2,087,632 due to bonus depreciation and accelerated tax depreciation. OCA St. 1 at 10.

7. Based on the pre-tax rate of return in Peoples' June 20, 2013 compliance filing in this docket, Peoples' federal taxable income from the DSIC for the first quarter the DSIC is in effect will generate approximately \$41,000 of deferred federal income taxes. OCA St. 1 at 11. That balance of deferred income taxes would be available as an offset to DSIC as of the end of the first quarter the DSIC is in effect. This amount will increase in subsequent quarters as Peoples realizes additional DSIC income. Id.

8. Currently, the Company is in a "loss carry forward position," *i.e.* it has unutilized federal net operating losses, due to bonus depreciation and accelerated tax depreciation, and Peoples will not be able to take the tax deductions attributable to the DSIC plant until some future time when it does have taxable income. OCA St. 1 at 10-11.

9. Peoples' loss carry forward position is temporary. OCA St. 1 at 11.

10. The model tariff and the Commission's Final Implementation Order were developed based on one working group meeting and two rounds of written comments by interested parties, without the benefit of an evidentiary record. Final Implementation Order at 2-3.

11. Other commissions have also approved infrastructure investment recovery mechanisms that reflect ADIT in the surcharge calculation without a specific statutory requirement. OCA St. 1-S at 1-2; Western Resources, Inc. v. State Corp. Comm'n of Kan., 30 Kan. App. 2d 348, 42 P.3d 162 (Kan. Ct. of App. 2002); Florida Progress Corp. v. Commissioner of Internal Revenue, 114 T.C. 587, 2000 U.S. Tax Ct. LEXIS 42 (June 30, 2000), aff'd by, Florida Progress Corp. v. Commissioner of Internal Revenue, 2003 U.S. App. LEXIS 21294 (11th Cir. 2003). See also, CMR 65-407-675; In re Atlanta Gas Light Co.'s Pipeline Replacement Program, 2009 GaPUC LEXIS 245, *10; Annual Filing of South Jersey Gas Company to Adjust its Capital Investment Recovery Tracker, 2011 NJPUC LEXIS 67, *35; In re Narragansett Elec. Co. d/b/a National Grid, 2011 RIPUC LEXIS 22, *8; In the Matter of the Application of Questar Gas Company to Increase Distribution Non-Gas Rate and Charges, 2010 UTPUC LEXIS 133, *42-43.

13. The earnings cap does not prevent utilities from overstating the surcharge revenue requirement and improperly charging ratepayers a return on funds that were not supplied by investors. OCA St. 1-S at 3.

14. Act 11 specifies that only costs "incurred" by the utility shall be recovered through the DSIC. 66 Pa. C.S. §§ 1351, 1353.

15. Act 11 specifies that Commission rules and orders relating to DSICs established prior to Act 11 remain in effect only for the water utilities, while also giving the Commission authority to amend or revoke the orders. 66 Pa. C.S. § 1358(a)(2).

State Taxes

16. The Company developed its pre-tax return by grossing up the equity component of its overall return to account for both state and federal income taxes at the full statutory rates.

OCA St. 1 at 13.

17. Currently, Peoples will pay no state income taxes on DSIC revenues because the tax deductions for accelerated depreciation far exceed the state taxable income that will be generated by the DSIC. OCA St. 1 at 13.

18. Recognizing the flow-through of accelerated depreciation for state income tax purposes in the DSIC pre-tax rate of return, the DSIC rate effective April 1, 2013 is reduced from 0.35 percent to 0.33 percent. OCA St. 1 at 14.

19. State income tax deductions must be reflected in rates on a current basis, consistent with the “actual taxes paid” doctrine. OCA St. 1 at 14-15.

20. Reflecting actual state income taxes paid in the DSIC is consistent with Act 11, which limits recovery to costs “incurred” by the Company. 66 Pa. C.S. §§ 1351, 1353(a).

Proposed Conclusions of Law

Jurisdiction

1. The Commission has jurisdiction over the subject matter of and the parties to this proceeding. 66 Pa. C.S. § 1102 (a)(2), 1103(a).

Burden of Proof

2. Section 332(a) of the Public Utility Code provides that the proponent of a rule or order from the Commission has the burden of proof. 66 Pa. C.S. § 332(a).

3. Peoples has not met its burden of proving that its DSIC rate is calculated to produce just and reasonable rates pursuant to Chapter 13. 66 Pa. C.S. § 1301.

4. Peoples has not met its burden of proving that its failure to offset rate base with ADIT related to the DSIC-eligible plant to correctly calculate the DSIC rate base on which it is entitled to earn a return produces just and reasonable rates, meets the requirement of Act 11 that the DSIC recover costs incurred by the utility, or complies with longstanding precedent in Pennsylvania and nationwide that ratepayers should not pay a return on funds that were not supplied by investors. 66 Pa. C.S. §§ 1301, 1350 et seq.; Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 53 PaPUC 410 (1979); Pa. PUC v. Philadelphia Electric Co., 31 PUR4th 15, 52 PaPUC 772 (1978).

5. Peoples has not met its burden of proving that its failure to reflect actual state taxes paid in determining DSIC revenue requirement is consistent with the actual taxes paid doctrine and the requirement of Act 11 that the DSIC recover costs incurred by the utility. 66 Pa. C.S. §§ 1031, 1350 et seq.; Barasch v. Pa. PUC, 507 Pa. 496, 491 A.2d 94 (1985).

Proposed Ordering Paragraphs

IT IS HEREBY ORDERED THAT:

1. Peoples is directed to modify its tariff, containing the revised language below, to be effective on ten days' notice:

DSI=Original cost of eligible distribution system improvement projects net of accrued depreciation and accumulated deferred income taxes.

2. Peoples is directed to modify its pre-tax rate of return in the DSIC calculation to recognize the flow-through of state income tax benefits associated with the investments that are recovered through the DSIC. The effect is to reduce the DSIC rate that took effect on July 1, 2013 from 0.35 percent to 0.33 percent. Revenues collected pursuant to that tariff will be refunded based on the Commission's resolution in this Order.

3. The Complaint of the Office of Consumer Advocate is sustained.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Peoples Natural Gas Company,	:		
LLC for Approval of a Distribution System	:	Docket No.	P-2013-2344596 and
Improvement Charge	:		C-2013-2348847

Testimony
of the
Office of Consumer Advocate

1. OCA Statement No. 1 – Direct Testimony of Thomas S. Catlin dated August 6, 2013 (admitted into the record on November 12, 2013).
2. OCA Statement No. 1-S – Surrebuttal Testimony of Thomas S. Catlin dated October 3, 2013 (admitted into the record on November 12, 2013).
3. OCA Exhibit TSC-1 – Accompanying the Direct Testimony of Thomas S. Catlin (admitted into the record on November 12, 2013).

CERTIFICATE OF SERVICE

RE: Petition of Peoples Natural Gas Company :
LLC for Approval of a Distribution : Docket No. P-2013-2344596
System Improvement Charge :

I hereby certify that I have this day served a true copy of the Main Brief of the Office of Consumer Advocate upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code §1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 12th day of December 2013.

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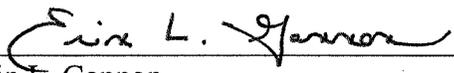
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