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December 12, 2013

***VIA ELECTRONIC FILING***

Rosemary Chiavetta, Secretary  
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**Re: Petition of Peoples Natural Gas Company LLC for Approval of a Distribution System Improvement Charge - Docket No. P-2013-2344596**

**Office of Consumer Advocate v. Peoples Natural Gas Company LLC  
Docket No. C-2013-2348847**

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Dear Secretary Chiavetta:

Enclosed for filing is the Main Brief of Peoples Natural Gas Company LLC in the above-referenced proceeding. Copies of this correspondence will be provided as indicated on the Certificate of Service.

Respectfully submitted,

Michael W. Hassell

MWH/jl  
Enclosures

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

**CERTIFICATE OF SERVICE**  
**(Docket Nos. P-2013-2344596 and C-2013-2348847)**

I hereby certify that a true and correct copy of the foregoing has been served upon the following persons, in the manner indicated, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

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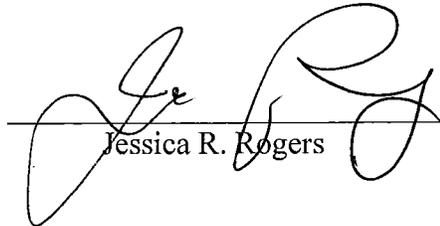
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**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Petition of Peoples Natural Gas Company LLC :  
for Approval of a Distribution System : P-2013-2344596  
Improvement Charge :

Office of Consumer Advocate :  
v. : C-2013-2348847  
Peoples Natural Gas Company LLC :

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**MAIN BRIEF OF  
PEOPLES NATURAL GAS COMPANY LLC**

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**TO ADMINISTRATIVE LAW JUDGES MARY D. LONG AND JEFFREY WATSON:**

Of Counsel:

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Date: December 12, 2013

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## **I. BACKGROUND**

On February 14, 2012, Governor Corbett signed into law Act 11 of 2012 (“Act 11”), which amends Chapters 3, 13 and 33 of the Public Utility Code. As relevant to this proceeding, Act 11 authorizes electric distribution companies (“EDCs”), natural gas distribution companies (“NGDCs”), water utilities, wastewater utilities and city natural gas distribution operations to establish a distribution system improvement charge (“DSIC”). Prior to the adoption of Act 11, water utilities charged a DSIC pursuant to Section 1307(g) of the Public Utility Code, which was repealed by Act 11.

Act 11 provides utilities with the ability to implement a DSIC to recover reasonable and prudent costs incurred to repair, improve or replace certain eligible distribution property that is part of the utility’s distribution system. Eligible property for natural gas distribution companies is defined in § 1351 of the statute. *See* 66 Pa.C.S. § 1351(2). As a precondition to the initial implementation of a DSIC, each utility must file and obtain approval of a Long-Term Infrastructure Improvement Plan (“LTIIP”) that is consistent with the provisions of § 1352 of the statute. *See* 66 Pa.C.S. § 1352(a).

On April 5, 2012, the Pennsylvania Public Utility Commission (“Commission”) held a working group meeting for discussion and feedback from stakeholders regarding its implementation of Act 11. The purpose of the meeting was to address certain key implementation issues in advance of the issuance of a Tentative Implementation Order. On May 10, 2012, the Commission issued its Tentative Implementation Order addressing and incorporating input from the stakeholder meeting at Docket No. M-2012-2293611. The Commission solicited comments from interested parties. Comments were filed by many interested parties, including Peoples Natural Gas Company LLC (“Peoples” or “the Company”) and the Office of Consumer Advocate (“OCA”) on May 31, 2012.

On August 2, 2012, the Commission issued its Final Implementation Order establishing procedures and guidelines necessary to implement Act 11. The Final Implementation Order adopts the requirements established in Act 11, provides additional standards that each utility must meet in developing an LTIP and DSIC, and gives guidance to utilities for meeting the Commission's standards. The Final Implementation Order also included a model form of DSIC tariff (the "model tariff").

## **II. PROCEDURAL HISTORY**

On January 23, 2013, Peoples filed a LTIP pursuant to Section 1352 of the Public Utility Code, 66 Pa. C.S. § 1352. On January 31, 2013, pursuant to Section 1353, Peoples filed a Petition for Approval of a Distribution System Improvement Charge ("DSIC"). 66 Pa. C.S. § 1353.

On February 12, 2013, the OCA filed Comments on the LTIP. On February 19, 2013, Pennsylvania Independent Oil & Gas Association ("PIOGA") filed a Petition to Intervene. On February 20, 2013, the OCA filed an Answer, Notice of Intervention and Formal Complaint and Public Statement. Also on February 20, 2013, the Office of Small Business Advocate ("OSBA") filed an Answer, Notice of Intervention, Public Statement, and Notice of Appearance.

On March 4, 2013, Peoples filed an Answer to the OCA's Complaint. On March 22, 2013, Peoples filed a letter indicating that it was delaying the filing of its updated DSIC rate and tariff until the Commission had issued an order in the LTIP and DSIC proceedings. On April 8, 2013, Peoples filed a letter clarifying certain statements made in its LTIP and DSIC petitions and their supporting documents.

By Order entered May 23, 2013, the Commission approved Peoples' LTIP and DSIC. The Commission approved the DSIC subject to refund, pending final resolution of issues raised in the parties' filings and identified in the Commission's Order.<sup>1</sup>

On June 20, 2013, Peoples filed its compliance filing, as directed by the Commission in its May 23 Order. Peoples' DSIC became effective July 1, 2013.

A prehearing conference was held on June 21, 2013 before Administrative Law Judges Mary D. Long and Jeffrey Watson (the "ALJs"), where a procedural schedule was established. Pursuant to the procedural schedule, parties filed direct, rebuttal, surrebuttal, and rejoinder testimony. On November 6, 2013, the parties contacted the ALJs to inform them that a partial settlement had been reached regarding cost recovery associated with customer-owned service lines, other identified costs, gathering system improvements, and language included in the Company's DSIC tariff regarding competitive customers. A hearing was held on November 12, 2013 in order to admit the pre-filed testimony into the evidentiary record. Main Briefs for the parties are due on December 12, 2013 and Reply Briefs are due on January 9, 2013. Along with their Main Briefs, on December 12, 2013, the parties will file a Proposed Stipulation of Certain Issues and supporting statements.

### **III. LEGAL STANDARD**

As the petitioner or moving party, Peoples has the burden of proof in this matter. Section 332(a) of the Public Utility Code requires the proponent of a rule or order "to bear the ultimate burden of persuading the Commission, by a preponderance of substantial evidence, that the relief

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<sup>1</sup> The issues identified by the Commission included DSIC recovery of costs for replacement of customer-owned service lines, as well as other identified costs, the impact of accumulated deferred income taxes, and the calculation of state income taxes. No party submitted testimony to challenge DSIC recovery of costs for replacement of customer-owned service lines. As indicated in this brief, the parties reached a partial stipulation addressing a number of issues. Thus, of the issues identified by the Commission in its May 23 Order, only ADIT and calculation of state income taxes have been reserved for litigation. See Proposed Stipulation of Certain Issues filed December 12, 2013.

sought is proper and justified under the circumstances." 66 Pa.C.S. § 332(a); *Motheral, Inc. v. Duquesne Light Co.*, 2001 Pa. PUC LEXIS 4 at 9; citing *Se-Ling Hosiery v. Margulies*, 70 A.2d 854 (Pa. 1954). A "preponderance of the evidence" means that one party must present evidence which is more convincing by even the smallest amount, than the evidence presented by an opposing party. See *Se-Ling Hosiery*. Substantial evidence is "relevant evidence that a reasonable mind may accept as adequate to support a conclusion: more is required than a mere trace of evidence or a suspicion of the existence of a fact sought to be established." *Murphy v. Pa Department of Public Welfare, White Haven Center*, 480 A.2d 382 (Pa. Cmwlth. 1984).

If a petitioner has met its burden by a preponderance of evidence and met its *prima facie* case, the fact finder must then determine whether a respondent has submitted evidence of co-equal value or weight in order to counter or refute the applicant's case. If a respondent has provided co-equal evidence in response to the applicant's case, the burden of proof cannot be deemed to have been satisfied unless the party bearing the burden presents additional evidence causing its position to be supported by a preponderance of the evidence. Thus, with competing evidence, a petitioner must meet its burden of proof by a preponderance of evidence, based on the overall weight of the evidence.

Importantly, however, many of the issues presented in this case relate, in whole or in part, to the proper interpretation and application of a statute, *i.e.*, Act 11. These issues are ultimately questions of law to be decided under the applicable rules of statutory interpretation and construction set forth in 1 Pa.C.S. § 1921, *et. seq.* Resolution of these issues is based on which party's interpretation of the applicable statute is correct and consistent with the intent of the General Assembly.

#### **IV. SUMMARY OF ARGUMENT**

In this case, the OCA has proposed that the computation of Peoples DSIC should include an adjustment to DSIC-eligible plant for Accumulated Deferred Income Tax (“ADIT”), and should not include a gross-up for state income taxes. These proposals are not supported by Act 11 or record evidence in this proceeding. OCA’s proposals to include an ADIT adjustment and to eliminate the state income tax gross-up contradict the plain language of Act 11. In addition, such proposals are directly contrary to the stated intent of the General Assembly. Legislative history demonstrates that the General Assembly intended that the DSIC provisions in Act 11 continue the prior methodology for calculating water DSICs, which have been in effect for over 16 years. The evidence in this proceeding, uncontested by OCA, is that the Commission has not reflected either of OCA’s proposals in its prior implementation of the water DSIC. Further, the legislative history clearly shows that the General Assembly rejected a proposal to amend the water DSIC mechanism to include tax benefits in the DSIC calculation. OCA’s proposal does not conform to the General Assembly’s intent in their enactment of Act 11.

In addition to being inconsistent with the intent of the General Assembly, OCA’s proposal regarding an ADIT adjustment would not conform to the Commission’s Final Implementation Order, and is unnecessary. The Commission’s Final Implementation Order instructed that the DSIC was to be a simple mechanism that is easy to audit. Including an adjustment for ADIT would complicate the calculation of the DSIC rate. An ADIT adjustment is unnecessary because the earnings cap provides adequate protection for consumers from concerns that excluding an ADIT adjustment would result in Peoples overearning its allowed return. Case law is clear that the reasonableness of rates must be judged based upon the return produced by the total rates charged by the utility, and not based upon the allowance or disallowance of individual cost items.

OCA's proposal to exclude the state income tax gross-up in the DSIC formula is based upon a position that incremental tax deductions associated with DSIC-eligible plant would eliminate state tax expense. OCA defends its proposal by claiming it is consistent with the "actual taxes paid" doctrine. This is not correct. As the Company demonstrated, it pays taxes based on total net income. OCA's position is fundamentally unfair, and would result in a double counting of tax deductions available to Peoples. In order to obtain accurate results, a full state income tax calculation would need to be conducted, which is inconsistent with the intent to have a simple surcharge mechanism. In addition, the "actual taxes paid" doctrine can be modified by the General Assembly. To the extent this doctrine even applies outside a base rate case, it is clear that the General Assembly rejected the use of the doctrine for purposes of calculating the DSIC charge. Instead, the General Assembly determined to address any concern that available tax deductions would result in Peoples overearning its allowed return through the application of the earnings cap.

For the reasons explained in this Main Brief, Peoples requests that the ALJs approve the calculation mechanism for the Company's DSIC as filed, and reject the OCA's proposed modifications.

## **V. ARGUMENT**

### **A. ACT 11 SHOULD BE INTERPRETED TO REQUIRE ALL UTILITIES TO CALCULATE THEIR DSICS IN THE SAME MANNER AS THE WATER DSIC.**

The primary issue in this proceeding concerns OCA's proposals to modify the DSIC calculation to: (1) deduct from the DSIC-eligible property balance an amount for ADIT and (2) to eliminate from the calculation of pre-tax return any gross-up for state income taxes due to asserted incremental tax deductions on DSIC-eligible plant. As a matter of law, such proposals

must be rejected as contrary to the intent of the Pennsylvania General Assembly in enacting Act 11.

The primary objective in statutory interpretation in the Commonwealth of Pennsylvania is to discern the intent of the General Assembly. The Statutory Construction Act of 1972 (“Statutory Construction Act”) provides that “the object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly.” 1 Pa.C.S. § 1921. As the courts have noted, “it is incumbent that the reviewing court endeavor to ascertain the intent of the Legislature.” *Commonwealth v. Cox*, 603 Pa. 223, 283, 983 A.2d 666, 703 (2009). In order to ascertain the intent of the General Assembly, the ruling body should first look at the plain language of the statute. *Commonwealth v. Segida*, 604 Pa. 103, 108, 985 A.2d 871, 874 (2009). When the language of the statute is free from all ambiguity, the letter of the statute is to be followed. 1 Pa.C.S. § 1921(b). However, if the words are not explicit, then intent may be gleaned from the contemporaneous legislative history. 1 Pa.C.S. § 1921(c)(7). Legislative history may include previous drafts of house bills, as well as statements made by legislators during the time of the statute’s enactment. *See Commonwealth v. Wilson*, 529 Pa. 268, 602 A.2d 1290 (1992) (Court relied on statements made by legislature during the enactment process and recorded in the Legislative Journal to determine legislative intent). Applying the language of the statute and the legislative history associated with its enactment, the Commission should conclude as a matter of law that the General Assembly intended that the DSIC mechanism previously adopted for water utilities should continue and apply to all utilities that qualify to implement a DSIC. Based upon the legislative intent, the Commission should further conclude that OCA’s proposed tax modifications to the DSIC formula are contrary to Act 11 and must be rejected.

The plain language of the DSIC provision makes clear the General Assembly intended to adopt the DSIC formula, previously used by water utilities, and to reject the tax modification

proposed by OCA. The statute enacted by the General Assembly embraces all of the concepts originally applicable to the water DSIC. As explained by Peoples witness Wachter, and as is evident by a comparison of the DSIC provisions in Act 11 and the prior water utility model DSIC tariff, Act 11 adopted the water DSIC formula. Peoples St. No. 1-R, pp. 10-11; Peoples Exhibit APW-1R. For example, provisions related to computation of the DSIC contained in Section 1357 and the customer protection provisions contained in Section 1358 are substantially the same as, and in many cases identical to, the model water DSIC tariff.<sup>2</sup> Since its inception, and for the following 16 years, the water utility DSIC formula did not contain either the ADIT adjustment or the state income tax adjustment proposed by OCA, and no language was added in the adoption of Act 11 to incorporate either of these changes. The adoption by the General Assembly of the historical water DSIC mechanism, as a specific defined exception to the traditional base rate mechanism under Section 1308(d), demonstrates that OCA's proposal to include new adjustments should be rejected. *Popowsky v. Pa. P.U.C.*, 869 A.2d 1157, 1160 (Pa. CmwltH Ct. 2005) ("*Wastewater DSIC*").

The OCA cannot deny that its tax adjustments are omitted from the plain language of Act 11. The Pennsylvania Supreme Court has held that in determining legislative intent it is not appropriate to "supply omissions in the statute, especially where it appears that the item may have been intentionally omitted." *Mt. Village v. Bd. of Supervisors*, 582 Pa. 605, 874 A.2d 1, 22

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<sup>2</sup> As just one example, Section 1357(b)(1) provides as follows:

The pretax return shall be calculated using the Federal and State income tax rates, the utility's actual capital structure and actual cost rates for long-term debt and preferred stock as of the last day of the three-month period ending one month prior to the effective date of the distribution system improvement charge and subsequent updates.

This language is virtually identical to the following provision of the Commission's model water DSIC tariff, which provided:

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 three-month period ending one month prior to the effective date of the DSIC and subsequent updates.

Peoples Exhibit APW-1R.

(Pa. 2005), citing *Kusza v. Maximonis*, 363 Pa. 479, 70 A.2d 329, 331 (Pa. 1950). As Peoples will explain below, the General Assembly's omission from the DSIC formula of an adjustment related to purported tax benefits was intentional. The fact that neither of OCA's modifications appear in the language of the statute should be taken as a clear demonstration that the General Assembly intended that neither modification be included in the DSIC mechanism adopted in Act 11.<sup>3</sup>

If there were any uncertainty with regard to the intent of the General Assembly in the statutory provisions, and there is not, it would be resolved in Peoples' favor based upon a review of the legislative history associated with Act 11. The legislative history makes it readily apparent that the General Assembly specifically considered, and rejected, the OCA's tax-related proposals. Peoples witness Andrew Wachter provided legislative history relevant to this issue in his rebuttal testimony, including excerpts from the House Journal, wherein the implementation of the DSIC was discussed. The House Journal documents indicate that an amendment was proposed that would have modified the calculation of the DSIC. The sponsor of the proposed amendment emphasized that the intent of her change was to "offset" the charge by incorporating "tax benefits" in the final DSIC calculation. *See* Peoples Exhibit APW-3R, Legislative Journal p. 1909. This amendment was rejected by the General Assembly. *Id.* at p. 1911. Therefore, no reflection of purported tax benefits, such as ADIT or the elimination of the state tax gross-up, was intended to be incorporated in the final version of Act 11. Explained another way, the omission of OCA's proposed tax modifications from the statute was intentional, and should not be added to the statute through a subsequent interpretation that is clearly inconsistent with the intent of the General Assembly.

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<sup>3</sup> The language of the statute refers to using the applicable state income tax rate. 66 Pa C.S. § 1357(b)(1). This language is identical to the language used in the water DSIC. The statutory tax rate has always been used in the application of the water utility DSIC. Peoples St. No. 3-R, pp. 7-8.

In addition, the legislative history makes it clear that the General Assembly relied on the water DSIC mechanism, as it had been implemented by the Commission, as the foundation for the DSIC mechanism authorized in Act 11. The legislative history indicates House Bill 1294, which eventually became Act 11, was specifically amended, to “memorialize in statute the current PUC . . . procedure and process used to evaluate water utility requests for a DSIC.” *Id.* at p. 155. (emphasis added). The General Assembly’s specific reference to the historical water DSIC makes the Commission’s treatment of ADIT and state income taxes in water DSICs relevant to determining how to apply Act 11 in this proceeding.

The water DSIC was first implemented by the Commission in 1997. As indicated in Peoples Exhibit APW-1R, when the Commission implemented the DSIC it provided the water utilities with model tariff language. The model tariff language did not provide for an ADIT adjustment to be included in calculating the DSIC. Peoples St. No. 1-R, p. 10. Further, witnesses for the Company and for the OCA agree that no water utility in the state of Pennsylvania has included ADIT in calculating its DSIC. *Id.*; Peoples Exhibit APW-2R. In addition, witnesses for the Company and OCA also agree that all water utilities have done a gross-up for state income tax using the full statutory tax rate as part of their calculation of DSIC rates. Peoples St. No. 1-R, pp. 9-10, 12; Peoples St. No. 3-R, pp. 7-8. The prior history of water utility DSICs was directly referenced by the General Assembly when it enacted Act 11. Therefore, in accordance with the provisions of Section 1921(c)(7) of the Statutory Construction Act, the DSIC provisions of Act 11 must be interpreted consistent with the Commission’s past practice with the water DSIC.<sup>4</sup>

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<sup>4</sup> Section 1921(c)(8) of the Statutory Construction Act further provides that the intention of the General Assembly may be ascertained by considering legislative and administrative interpretations of a statute. The Commission previously interpreted the provisions of the predecessor water DSIC statute to not include OCA’s proposed tax offsets, and the legislature reaffirmed this determination in adopting the DSIC.

OCA Witness Catlin asserts that, in determining how to apply Act 11, the Commission should look at DSIC mechanisms developed in other states, either through statute or state utility commission orders. OCA Statement No. 1-S, pp. 1-2. This assertion does not comport with proper statutory interpretation. The Statutory Construction Act does not generally provide for consideration of an issue by another jurisdiction as a basis for determining legislative intent. In *Elder v. Orluck*, 511 Pa. 402, 515 A.2d 517, 522 (1986), the Court noted that it was not appropriate to consider another jurisdiction's statute where there was no indication that the General Assembly based Pennsylvania legislation on legislation adopted in other jurisdictions. The OCA has not argued, and cannot argue, that the General Assembly relied upon any other jurisdiction in developing the DSIC provisions in Act 11. It is clear that the General Assembly based the DSIC provisions of Act 11 upon the Pennsylvania water DSIC, which, as explained above, does not include the modifications proposed by OCA.<sup>5</sup>

The rules of statutory interpretation in Pennsylvania are clear, and require the Commission to interpret the DSIC provisions of Act 11 consistent with the intent of the General Assembly. The evidence presented by Peoples has shown that the OCA's recommendations with regard to deducting ADIT from DSIC eligible plant balances and disallowing any state income tax gross-up are inconsistent with the legislative intent of the General Assembly when it enacted Act 11. Further, the OCA's argument that the Commission should look to other states rather than adhere to the clear directives from the General Assembly is inconsistent with the rules of statutory interpretation, and should be rejected.

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<sup>5</sup> Section 1927 of the Statutory Construction Act provides that statutes uniform with those of other states shall be interpreted and construed to effect their general purpose to make laws uniform among jurisdictions. However, as discussed in section V.B.4 of this brief, there is no uniformity among jurisdictions on DSIC-type provisions. Therefore, this provision is inapplicable. See *Allegheny County Sportman's League v. Rendell*, 860 A.2d 10 (Pa. 2004).

The legislative intent in adopting Act 11 was to adopt the water utility DSIC mechanism, and to reject proposals to incorporate tax-based modifications to the mechanism. Under the rules of statutory interpretation, OCA's proposals to revise the DSIC mechanism must be rejected.

**B. OCA'S PROPOSAL TO MODIFY THE DSIC FORMULA WITH AN ADIT ADJUSTMENT UNNECESSARILY COMPLICATES THE FORMULA.**

**1. Introduction**

ADITs are created as a result of normalization of certain deductions for federal income tax purposes. Certain items of income and expense incurred by most utilities are treated very differently for regulatory (i.e., book) purposes than they are for tax purposes. For purposes of this proceeding, the differences that matter are those items of income or expense that are reflected in rate-setting and on the tax return at different times. Peoples St. No. 3-R, p. 4. These are commonly referred to as "timing" or "temporary" differences. *Id.* With respect to these items, the same aggregate quantity of dollars ultimately gets reflected for both purposes – just at different times. One major component of the tax calculation is accelerated depreciation. *Id.* at p. 9. Depreciation deductions will not remain unchanged over time. *Id.* On the contrary, due to accelerated depreciation, as to plant that was reflected in a prior base rate proceeding, certain tax depreciation deductions will decline between years. *Id.* For example, the federal tax laws permit a 50% bonus depreciation deduction in the first year of an asset's tax life. *Id.* at p. 10. The excess of federal tax depreciation deductions over book depreciation deductions reduces income taxes paid to the federal government. *Id.* at p. 4. However, the tax reduction may not be passed through to customers, but may be deducted from rate base. The excess, when multiplied by the federal tax rate, determines the ADIT associated with an asset for each tax year. In a Section 1308(d) base rate proceeding, the then current balance of ADIT on all tax vintages is deducted from rate base.

Consistent with the water DSIC, Peoples' DSIC calculation does not include an additional ADIT adjustment to DSIC-eligible plant in determining the plant balance to be reflected in the DSIC calculation. The OCA has proposed that the Commission require Peoples to include a reduction based on ADIT. As explained in section V.A of this brief, this proposal is inconsistent with the legislative intent of Act 11 and must be rejected. In addition, such a proposal is inconsistent with the General Assembly's and Commission's intent to adopt a simple surcharge mechanism. Furthermore, such provision is unnecessary because the ADIT offset is already considered in the customer safeguard provisions to ensure customers are not charged unreasonable rates.

**2. OCA's Proposed ADIT Adjustment is Contrary to the Intent of Having a Simple Surcharge Mechanism**

OCA proposes to modify the DSIC charge calculation to include a new component, ADIT computed on an incremental basis, as an offset to DSIC plant. Such proposal is contrary to the intent that the DSIC be a simple surcharge mechanism.

It is important to recognize that the DSIC is an automatic adjustment surcharge mechanism. Such mechanisms are authorized by the General Assembly as exceptions to traditional base rate filings. *Popowsky v. Pa P.U.C.*, 13 A.3d 583, 591 (Pa. Cmwlth. Ct. 2011) ("*Purchased Water Surcharge*"); *Wastewater DSIC*, 869 A.2d 1157; *Pennsylvania Industrial Energy Coalition v. Pa P.U.C.*, 653 A.2d 1336, 1349 (Pa. Cmwlth. Ct. 1995) ("*PIEC*"). As such, the General Assembly is empowered to establish the scope of surcharges. As the Court recognized in *Wastewater DSIC*,

To be sure, the General Assembly has the authority to exempt utilities from making the used and useful demonstration before recovering its capital expenditures. As noted, by amendment to Section 1307, the legislature has expressly authorized water utilities to recoup these expenses by surcharge.

869 A.2d at 1158. As the Court recognized, the General Assembly has the authority to establish the terms of surcharge mechanisms as exceptions to traditional ratemaking procedures. In the case of the DSIC, the General Assembly defined the components to be used in calculating the charge, chose to adopt the long-established water DSIC mechanism, and did not incorporate ADIT as an adjustment. Such determination by the General Assembly is controlling as to the design of the surcharge calculation.

The Commission directly addressed this issue in its Final Implementation Order. In its comments to the Tentative Implementation Order, OCA argued that the DSIC calculation should include an adjustment for ADIT to recognize the difference between the utilities' tax depreciation and book depreciation on plant additions reflected in the DSIC. In response, the Commission held:

[T]he 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.

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.

Final Implementation Order at p. 39 (internal citations omitted). It is quite apparent from this language that the Commission did not intend to include an adjustment for ADIT. In its resolution of this issue, the Commission provided three reasons that it did not include an adjustment for ADIT in the DSIC calculation. The first is that the DSIC mechanism was intended to be straightforward and easy to calculate. The second, which has already been

addressed in this brief, is that the water DSIC historically did not include ADIT. The third is that ADIT is already accounted for as one of the adjustments captured in the earnings cap analysis.

OCA's proposal to include in the DSIC an offset to plant for ADIT would violate the concept of a straightforward and easy to calculate surcharge mechanism. The purpose of a surcharge mechanism is to establish a simple adjustment mechanism that does not require examination of every component that would be considered in a full base rate case proceeding. *See, e.g., Dorothy Gill v. The Bell Telephone Company of Pennsylvania*, C-00935402 (April 22, 1994) (The State Tax Adjustment Surcharge, a § 1307 mechanism, was adopted to provide a simple, expeditious mechanism to recover certain utility expenses). In contrast, base rate case calculations have many complexities, and reflect all of the changes in revenues, expenses, plant additions and offsetting rate base deductions. In an analogous context, the Commonwealth Court has recognized that non-base rate cases do not require submission of the full extent of revenues, expenses, rate base and rate of return as is required in a general base rate case. In *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmwlth. Ct. 1996) ("*Equitable*"), the Court considered an appeal from a Commission Order that authorized a non-general rate increase to recover costs associated with a change in accounting for post-retirement benefits other than pensions. OCA argued that the utility was required to present all of the evidence that would be required to support a change in base rates. The Court disagreed, and stated:

"In response to such an argument, we would agree with the PUC that the statutory and regulatory scheme do not make the same full-blown standards applicable. If such a high standard applied, there would be no significant difference between non-general rate filings under Section 1308(b) and general rate filings under Section 1308(d). To the contrary, because of the modest nature of non-general rate filings, as required by the statute, we believe the PUC may determine whether the public utility's rates are just and reasonable based on the general information required under 52 Pa. Code § 53.52(b). That the non-general rate filing may be contested does not increase *Equitable's* evidentiary burden or limit the PUC's discretion."

*Id.*, at 962.

In *PIEC*, the Commonwealth Court reiterated that surcharge mechanisms are exceptions to traditional base rate mechanisms, holding:

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 cost 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.

653 A.2d at 591 (emphasis added). Similarly here, the DSIC is a legislatively established alternative to base rate determinations under Section 1308(d), and it would defeat the purpose of Act 11's DSIC surcharge provisions to incorporate ADIT adjustments into the rate calculation. This is because the determination of ADIT is not a simple calculation. There are several reasons for the complexity.

First, as acknowledged by OCA witness Catlin and as further explained by Peoples witness Warren, whether and to what extent Peoples has any ADIT balance not already reflected in base rates depends in part upon its overall tax position. OCA St. No. 1, p. 11; Peoples St. No. 3-R, p. 4. ADIT is generated by tax depreciation deductions that exceed book depreciation deductions. Peoples St. No. 3-R, p. 4. However, in recent years Peoples has generated tax deductions that exceed its income, resulting in net operating losses for tax purposes. *Id.* As a result, Peoples has not been able to benefit from all available accelerated depreciation deductions and has substantial tax loss carryforwards. As a consequence, deductions have not produced any incremental cash for the Company which would have augmented its ADIT balance. The result, as conceded by Mr. Catlin, is that effectively no ADIT adjustment can be included at this time, due to prior and ongoing tax losses. OCA St. No. 1, pp. 10-11. This situation can recur in the future at any time, depending upon available tax deductions under federal law, thereby complicating the determination of ADIT. OCA's own concession in this proceeding, that

essentially no ADIT offset is proper at this time, demonstrates that the adjustment is not easy to calculate, and could invite litigation over the utility's past, present, and future income tax status.

The complications of computing ADIT offsets is further demonstrated by OCA's proposal in this case. OCA computes a \$41,000 ADIT offset based upon projected revenues to be received under the DSIC. OCA St. No. 1, p. 11. However, if ADIT is reflected in the rate calculation, the revenues received under the DSIC would be reduced, thereby reducing OCA's calculated ADIT offset. The iterative process of determining rates based upon ADIT produced from such rates is the antithesis of an easy to calculate charge.

The determination of ADIT for purposes of quarterly DSIC filings is further complicated by the seasonal nature of the gas utility business and the differing deductions available. Projecting Peoples' net operating loss carryover production or utilization (in order to determine an ADIT balance change) at any point prior to the end of a tax year is complex, and a potential source of controversy. Peoples St. No. 3-R, p. 9. The Company will not know its taxable income (or loss) until it knows all depreciation deductions, as well as the applicable deductions (*i.e.*, bonus depreciation and/or accelerated depreciation) available for the mix of plant additions actually installed. *Id.* at p. 6. However, the DSIC is calculated on a quarterly basis. Peoples Exhibit APW-1S. Thus, any determination of ADIT would involve estimates that would require subsequent true ups. To inject estimates into the DSIC plant balance used in the calculation would be contrary to the use of known, historic balances envisioned by the statute.<sup>6</sup> This is inconsistent with the "straightforward" calculation intended for the DSIC.

Finally, the determination of any ADIT deductions is complicated by the fact that, as to plant already reflected in base rates, or plant reflected in a DSIC, the ADIT balance may decline because tax depreciation deductions have reached the point where book depreciation deductions

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<sup>6</sup> Under Section 1357, the DSIC is to include plant additions actually placed in service.

for an asset exceed tax deductions. This is particularly the case for plant that is subject to accelerated depreciation such as bonus depreciation deduction, which can turn around within a few years of the creation of the ADIT. Peoples St. No. 3-R, p. 10. Such ADIT balance reductions can offset, in whole or in part, any new ADIT balances created from new DSIC-eligible plant.

OCA's proposal is clearly contrary to the simple mechanism envisioned by the General Assembly and the Commission. OCA's proposal should be rejected.

### **3. The Earnings Cap Provisions Ensure Customers Are Not Charged Unreasonable Rates**

OCA has argued in its testimony that without the ADIT adjustment the DSIC will result in the Company receiving an overstated return. OCA St. No. 1, p. 8. Essentially, OCA contends that without the ADIT adjustment, the DSIC will not produce just and reasonable rates. OCA's contention is in error.

It is important to emphasize that the DSIC mechanism established by Act 11 does not ignore ongoing changes in the total ADIT balance. As the Commission recognized in its Final Implementation Order, the impact of ADIT is already factored into the DSIC through the calculation of the earnings cap. The earnings cap prohibits Peoples from exceeding its allowable rate of return. The Company's DSIC will be reset to zero if the data included in the most recent Annual or Quarterly Earnings report filed with the Commission shows that Peoples is earning a rate of return higher than the allowable rate of return used in the DSIC calculation. Peoples St. No. 1-R, pp. 12-13. The Company's calculation of rate base for earnings report purposes includes the current book amount of ADIT. *Id.* at p. 13. Thus, in order for Peoples to get the benefit of a DSIC, it must be in an under-earning position after taking into consideration the very tax matters that the OCA is concerned about. Peoples St. No. 1-RJ, p. 3. Since earnings are reviewed quarterly, the earnings cap adequately addresses the concern associated with ADIT for

plant additions under the DSIC, without the complication of incorporating an adjustment in each quarterly DSIC filing.

The earnings cap provisions are an important component of the DSIC rate. 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. The statutory definition of a rate is:

Every individual, or joint fare, toll, charge, rental or other compensation whatsoever of any public utility...made, demanded, or received for any service within this part, offered, rendered, or furnished by such public utility...and any rules, regulations, practices, classifications or contracts affecting any such compensation, charge, fare, toll, or rental.

66 Pa.C.S. § 102. Thus, the very definition of a rate requires that the entirety of the rate is to be considered, and not individual components. For the DSIC, this means that the earnings cap must be part of the consideration.

OCA contends that a rate can be declared unjust or unreasonable by looking in isolation at one or two base rate components that are not included in the calculation. Such a position is contrary to OCA's successful position in *Duquesne Light Co. v. Barasch*, 488 US 299 (1989) ("*Barasch*"). In *Barasch*, a utility contended that it was unconstitutionally unjust and unreasonable for rates to exclude recovery of the cost of a canceled nuclear power plant. In that case, the United States Supreme Court analyzed how a judicial body may determine just and reasonable rates. The Court noted that in determining just and reasonable rates, "the economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result." *Id.* at 314. *See also Permian Basin Area Rate Cases*, 390 US 747, 790 (1968) ("[N]either law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders"). Thus, the Court acknowledged that there are many ways to achieve rates that are just and reasonable. The Supreme Court held:

[W]e reaffirm these teachings of [*FPC v. Hope Natural Gas Co.*, 320 US 591, 602 (1944)]: "[I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry. . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *Id.* at 602. This language, of course, does not dispense with all of the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is so low as to be confiscatory: whether a particular rate is "unjust" or "unreasonable" will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return.

*Id.* at 314. The Court went on to find that the disallowance of a single element is not the appropriate standard for determining whether rates are just and reasonable. This is due, in part, to the fact that "errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding." *Id.* at 314. Finally, in rejecting that there is a single theory of valuation that produces just and reasonable rates, the Court held:

[C]ircumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

*Id.* at 316. The conclusions to be drawn from *Barasch* are readily apparent. There is no single way to arrive at just and reasonable rates; however, any determination regarding whether rates are just and reasonable must look at the total effect of rates.

The courts of Pennsylvania have reached similar determinations regarding what constitutes a just and reasonable rate. In *Equitable*, 683 A.2d 958, the Commonwealth Court considered an appeal from a Commission Order that authorized a non-general rate increase in a 1308(b) proceeding. The Company did not undertake the full calculation associated with a base rate proceeding under 1308(d). The Court held that the Commission could determine whether a

non-general rate increase was just and reasonable based upon findings concerning the utility's rate of return and offsetting savings, without analyzing every individual expense component.

The OCA's argument in this proceeding is strikingly similar to the argument rejected by the Supreme Court in *Barasch*. The OCA has argued that the principles of 1308(d) base rate calculations require the inclusion of incremental ADIT, while ignoring the overall impact of the rate. As determined by the Supreme Court, a single disallowance does not result in confiscatory rates. The Court looked to the entirety of the utility's return to conclude whether the rate was confiscatory. Here, the OCA has asked the Commission in this case to choose selective additional rate adjustments to add to the DSIC, based on its argument that without these particular adjustments the rate will be unjust or unreasonable. The Supreme Court specifically acknowledged that this balancing of allowances and disallowances is the very reason adjudicative bodies must not look at individual components of the rate in determining whether rates are just and reasonable. *Barasch* at 314. The appropriate inquiry is whether the total effect of the surcharge results in unjust and unreasonable rates. The Commission and the General Assembly have addressed that very issue with the use of the earnings cap.

In assessing whether the DSIC rate is just and reasonable, the charge and the limiting provisions of customer protections must be considered together. *See* 66 Pa.C.S. § 102. In particular, the Commission and the General Assembly have identified that the earnings cap plays a critical role in ensuring that the total effect of DSIC rates is just and reasonable. The earnings cap compares the return produced from the utility's current quarter's earnings, as reflected in its Quarterly Earnings Report, to the Commission's allowed rate of return. In so doing, the earnings cap takes into consideration the many moving parts identified in a 1308(d) proceeding, including the very same components (ADIT and accelerated tax depreciation deductions used to calculate state income taxes) that the OCA challenges. Peoples St. No. 1-RJ, p. 3. The earnings cap

examines whether the utility's rates are just and reasonable, as measured by the utility's return on equity. The DSIC may not be charged if the utility is overearning the authorized return. Such determination is consistent with *Barasch* and *Equitable* by assessing whether overall rates are just and reasonable. OCA's contention that its specific ADIT adjustment is necessary to establish rates that are just and reasonable should be rejected.

**4. OCA's Assertion That Changed Circumstances Justify a Modification of the DSIC Formula Should be Rejected**

The OCA has argued that changed circumstances exist which make the inclusion of ADIT, outside of the earnings cap, appropriate at this time. This argument is flawed. While changes have occurred since the initial water DSIC in tax law, which has produced changes in tax benefits available to taxpayers, those changes occurred prior to the enactment of Act 11. Thus, the tax changes were known to the General Assembly before it adopted Act 11. Peoples St. No. 1-RJ, p. 2. Further, there is clear indication in the legislative history that the General Assembly was aware of the very tax benefits which the OCA seeks to address here. In response to the recognized tax benefits, the General Assembly determined that it was appropriate to continue to use the water DSIC, and denied an amendment that would have acknowledged the changed circumstances that the OCA relies upon. The OCA cannot support its proposal by relying on changed circumstances.

In support of its argument that ADIT should be included in the DSIC calculation, the OCA also points to the practice of utilities in other states. As a primary matter, this is not an appropriate tool for statutory interpretation. As explained previously, the practices of other states, unless specifically identified by the General Assembly in the legislative history, are irrelevant to a determination of how a Pennsylvania statute should be construed. In addition, of the states referenced by the OCA which have natural gas DSIC-like mechanisms, none of the states cited have an earnings cap. *See In re Atlanta Gas Light Co.'s Pipeline Replacement*

*Program*, 2009 Ga. PUC LEXIS 245 (Ga. P.U.C. 2009); KAN. STAT. ANN. §§ 66-2202-2204 (2013); KY. REV. STAT. ANN. § 278.509 (2013); *Petition of Bay State Gas Co. for Approval by the Dep't of Pub. Utils. of its Proposed Calendar Year 2009 Targeted Infrastructure Reinvestment Factor for Effect November 1, 2010*, 2012 Mass. PUC LEXIS 160, D.P.U. 10-52 (Mass. Dept. of Telecomms. and Energy Oct. 30, 2012)(“*Bay State 2010*”); MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013); MO. REV. STAT. § 393.1009 (2013); NEB. REV. STAT. §§ 66-1802, 1865-1867 (2012); *In re Petition of Pivotal Util. Holdings, Inc. d/b/a Elizabethtown Gas to Extend Its Util. Infrastructure Enhancement Program and Revise Its Util. Infrastructure Enhancement Rate*, 2011 N.J. PUC LEXIS 112 (N.J. B.P.U. 2011); R.I. GEN. LAWS § 39-1-27.7.1 (2013); *In re Application of Questar Gas Co. to Increase Distribution Non-Gas Rate and Charges and Make Tariff Modifications*, 2010 Utah PUC LEXIS 133 (Utah P.S.C. 2010)). Further, these states account for a variety of other adjustments as part of their calculation, including uncollectible accounts, real property, other taxes, operation and maintenance savings, and purchased gas costs, to name only a few, which are not included in the Pennsylvania DSIC. *See, e.g., Bay State 2010*; MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013). Rather than support the OCA’s position in this proceeding, the reliance on other states shows that there is no absolute formula for calculating a surcharge mechanism, and that many different possible forms may result in just and reasonable rates. The OCA’s argument that ADIT must be included because other states include it is undermined by the OCA’s failure to similarly advocate to include other major rate components, which are included in other states but not included in Pennsylvania. OCA’s reliance on the DSIC-eligible rate mechanisms in other jurisdictions to justify a selective change to the Pennsylvania DSIC mechanism is without merit and should be rejected.

**C. THE STATE TAX GROSS-UP INCLUDED IN THE PEOPLES DSIC IS APPROPRIATE.**

The OCA has proposed that the state income tax gross-up included in Peoples' DSIC calculation be disallowed. Specifically, the OCA argues that the amount of state income tax that will be paid on the income produced by the DSIC should be reduced to zero. OCA reaches this result by reflecting incremental flow-through tax deductions for accelerated depreciation on DSIC-eligible plant additions. As explained previously in Section V.A of this brief, OCA's proposal is contrary to the intent of the General Assembly in enacting the statute. OCA's proposal also should be rejected because it violates the Commission's determination in its Final Implementation Order, and because it creates inaccurate tax results.

As explained previously in this brief, historically the water DSIC included the same state tax gross-up proposed by Peoples as part of the DSIC. The historical approach applied by the Commission to the water DSIC is determinative to this inquiry because the legislative history indicates that it was the intent of the General Assembly to embrace the procedure and process used for the water DSIC. In addition, the Commission's Final Implementation Order, consistent with the historical DSIC approach, did not adjust the state tax gross-up in its discussion of taxes. As previously noted, the Commission intended the DSIC to be a straightforward mechanism which is easy to calculate. Including a full and accurate calculation of state taxes would require the Company to provide a full rate making calculation, which could potentially require recalculating the Company's other tax liabilities and deductions. Peoples St. No. 3-R, p. 9.

OCA's incremental deduction proposal also should be rejected because it would incorporate inaccurate tax adjustments into the DSIC. As explained by Peoples witness Warren, it is improper to try to isolate and compute state tax liabilities on an incremental basis. *Id.* The Company's tax posture is computed on an overall basis, and it would be incorrect to ignore overall taxes and the tax allowance reflected previously in base rates. Due to accelerated

depreciation, as to plant that was reflected in a prior base rate proceeding, state tax depreciation deductions will progressively decline. *Id.* Elimination of the state income tax gross-up through an “incremental” deduction approach improperly ignores state tax depreciation and accelerated depreciation deductions that were reflected in the Company’s prior base rate case. *Id.* at p. 10. At least some of the tax deductions that were previously available will no longer be available to the Company. *Id.* In addition, under accelerated depreciation procedures, the amount of the depreciation deduction on each tax vintage declines over time. *Id.* at pp. 9-10. Treating deductions in base rates as if they continue into the future unchanged, while claiming that deductions associated with new plant in the DSIC should be viewed as “incremental,” results in a double counting of deductions, thereby significantly overestimating the deductions available to the Company.

The OCA has argued that the state income tax gross-up should be excluded based on the “actual taxes paid” doctrine. OCA St. No. 1, p. 13. Simply described, the actual taxes paid principle permits a utility to only charge rates which reflect its actual tax expense that reflects actual deductions for any given year. *See Barasch v. Pa P.U.C.*, 491 A.2d 94 (Pa. 1985) (“*Barasch*”). The OCA’s reliance on this argument should be rejected for three reasons. First, as explained above, the tax adjustments proposed by the OCA do not and logically cannot reflect actual taxes paid. The OCA’s proposed incremental approach ignores that base rates reflect certain tax deductions that are no longer available to the Company for plant included in rate base, and as a result, would double count those deductions.

Second, the actual taxes paid doctrine has only been applied in base rate proceedings. As discussed previously, the General Assembly did not intend for a DSIC proceeding to be a full base rate proceeding under Section 1308(d), but rather a simplified automatic adjustment clause

proceeding. The OCA's reliance on actual taxes paid is an improper proposal to inject Section 1308(d) base rate issues into an automatic adjustment clause proceeding.

Finally, even if the "actual taxes paid doctrine" were relevant to this case, and it is not, it is a judicial construct and therefore can be modified by the General Assembly. *Barasch* at 104. To the extent that this judicial doctrine could have had any application to the DSIC, the General Assembly rejected that application in Act 11 where it provided a formula for calculation of the DSIC and intentionally omitted the OCA's proposed adjustments while embracing the Commission's historic water DSIC calculation.

As demonstrated by the foregoing, OCA's "incremental" approach is fundamentally unfair. The only way to correct such unfairness would be to undertake a full state tax calculation as part of each DSIC. Only in this way can the changing mix of current state tax deductions be taken into account. However, a full state tax calculation is directly contrary to the General Assembly's and the Commission's intent that the DSIC be calculated in a simple, straight forward manner.

As explained in section V.B.3 of this brief, the DSIC mechanism does factor in benefits from state tax depreciation deductions. Tax depreciation deductions allowed for Pennsylvania net income tax purposes are reflected in the calculation of the Company's earnings reports. Peoples St. No. 1-R, p. 13. Thus, if Peoples is overearning its authorized return as a result of tax depreciation deductions or other benefits, it is not permitted to charge the DSIC.

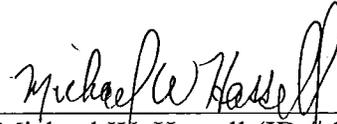
Peoples' inclusion of a state tax gross-up is consistent with the legislative intent of Act 11 and with the historic calculation of the water DSIC. Further, the OCA's proposal to remove the state tax gross-up would result in improper tax calculations which double count deductions, or would require a much more complicated and extensive calculation than the Commission intended

in its Final Implementation Order. Therefore, the OCA's proposal regarding the state tax gross-up should be rejected.

**VI. CONCLUSION**

For the foregoing reasons, Peoples Natural Gas Company LLC respectfully requests that its calculation mechanism for the Distribution System Improvement Charge be approved as filed, that the modifications proposed by the OCA be denied, and that the Stipulation of Certain Issues be approved.

Respectfully submitted,



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Date: December 12, 2013

Attorneys for Peoples Natural Gas Company LLC

# **Appendix A**

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Petition of Peoples Natural Gas Company LLC	:	
for Approval of a Distribution System	:	P-2013-2344596
Improvement Charge	:	
Office of Consumer Advocate	:	
	:	
v.	:	C-2013-2348847
	:	
Peoples Natural Gas Company LLC	:	

**PROPOSED FINDINGS OF FACT**

1. On February 14, 2012, Governor Corbett signed into law Act 11 of 2012 ("Act 11"), which amends Chapters 3, 13 and 33 of the Public Utility Code.
  
2. Act 11 authorizes electric distribution companies ("EDCs"), natural gas distribution companies ("NGDCs"), water utilities, wastewater utilities and city natural gas distribution operations to establish a distribution system improvement charge ("DSIC").
  
3. On May 10, 2012, the Commission issued its Tentative Implementation Order addressing and incorporating input from the stakeholder meeting at Docket No. M-2012-2293611.
  
4. Comments to the Tentative Implementation Order were filed by Peoples Natural Gas Company LLC ("Peoples" or "the Company") and the Office of Consumer Advocate ("OCA") on May 31, 2012.
  
5. On August 2, 2012, the Commission issued its Final Implementation Order establishing procedures and guidelines necessary to implement Act 11.
  
6. The Final Implementation Order also included a model form of DSIC tariff (the "model tariff").

7. On January 23, 2013, Peoples filed an LTIIP pursuant to Section 1352 of the Public Utility Code, 66 Pa.C.S. § 1352.

8. On January 31, 2013, pursuant to Section 1353, Peoples filed a Petition for Approval of a DSIC. 66 Pa.C.S. § 1353. As part of the Petition, Peoples included a form of DSIC tariff consistent with the model tariff, along with supporting direct testimony.

9. On May 23, 2013, the Commission entered an order approving the Company's DSIC, subject to refund.

10. On June 20, 2013, Peoples filed its compliance filing, as directed by the Commission in its May 23 Order.

11. Peoples' DSIC became effective on July 1, 2013.

12. Act 11 adopted the water DSIC formula. Peoples St. No. 1-R, p. 11; Peoples Exhibit APW-1R.

13. The General Assembly considered a proposed amendment which emphasized that the intent was to "offset" the DSIC charge by incorporating "tax benefits" in the final DSIC calculation. *See* Peoples Exhibit APW-3R, Legislative Journal p. 1909.

14. This amendment was rejected by the General Assembly. *See* Peoples Exhibit APW-3R, Legislative Journal p. 1911.

15. The legislative history indicates House Bill 1294, which eventually became Act 11, was specifically amended, to "memorialize in statute the current PUC . . . procedure and process used to evaluate water utility requests for a DSIC." *See* Peoples Exhibit APW-3R, Legislative Journal p. 155.

16. The model tariff language for the water DSIC did not provide for ADIT to be included in calculating the DSIC. Peoples St. No. 1-R, p. 10.

17. No water utility in the state of Pennsylvania has included ADIT in calculating its DSIC. Peoples St. No. 1-R, p. 10; Peoples Exhibit APW-2R.

18. All water utilities have done a gross-up for state income tax using the full statutory tax rate as part of their calculation of DSIC rates. Peoples St. No. 1-R, pp. 9-10, 12; Peoples St. No. 3-R, pp. 7-8.

19. ADITs are created as a result of normalization of certain deductions for federal income tax purposes, when certain items of income and expense incurred by most utilities are treated very differently for regulatory (i.e., book) purposes than they are for tax purposes. Peoples St. No. 3-R, p. 4.

20. For purposes of this proceeding, the differences that matter are those items of income or expense that are reflected in rate-setting and on the tax return at different times. Peoples St. No. 3-R, p. 4.

21. One major component of the tax calculation is accelerated depreciation. Peoples St. No. 3-R, p. 9.

22. Depreciation deductions will not remain unchanged over time. Peoples St. No. 3-R, p. 9.

23. Due to accelerated depreciation, as to plant that was reflected in a prior base rate proceeding, certain tax depreciation deductions will decline between years. Peoples St. No. 3-R, p. 9.

24. The federal tax laws permit a 50% bonus depreciation deduction in the first year of an asset's tax life. Peoples St. No. 3-R, p. 10.

25. The Commission directly addressed ADIT in its Final Implementation Order. Final Implementation Order at p. 39.

26. The Commission specifically excluded a separate adjustment for ADIT from the DSIC mechanism. Final Implementation Order at p. 39.

27. Whether and to what extent Peoples has any ADIT balance not already reflected in base rates depends in part upon its overall tax position. OCA St. No. 1, p. 11; Peoples St. No. 3-R, p. 4.

28. ADIT is generated by tax depreciation deductions that exceed book depreciation deductions. Peoples St. No. 3-R, p. 4.

29. However, in recent years Peoples has generated tax deductions that exceed its income, resulting in net operating loss carryovers. Peoples St. No. 3-R, p. 4.

30. As a result, Peoples has not been able to benefit from all available accelerated depreciation deductions. Peoples St. No. 3-R, p. 4.

31. Deductions have not produced any incremental cash for the Company which would have augmented its ADIT balance, and the result is that effectively no ADIT adjustment can be included at this time, due to prior and ongoing tax losses. OCA St. No. 1, p. 11.

32. The determination of ADIT for purposes of quarterly DSIC filings is further complicated by the seasonal nature of the gas utility business and the differing deductions available, because projecting Peoples' net operating loss carryover production or utilization (in order to determine an ADIT balance change) at any point prior to the end of a tax year is complex, and a potential source of controversy. Peoples St. No. 3-R, p. 9.

33. The Company will not know its taxable income (or loss) until it knows all depreciation deductions, as well as the applicable deductions (*i.e.*, bonus depreciation and/or accelerated depreciation) available for the mix of plant additions actually installed. Peoples St. No. 3-R, p. 6.

34. The DSIC is calculated on a quarterly basis. Peoples Exhibit APW-1S.

35. The ADIT balance may decline because tax depreciation deductions have reached the point where book depreciation deductions for an asset exceed tax deductions, particularly for plant that is subject to accelerated depreciation such as bonus depreciation deduction, which can turn around within a few years of the creation of the ADIT. Peoples St. No. 3-R, pp. 9-10.

36. The Commission recognized in its Final Implementation Order that the impact of ADIT is already factored into the DSIC through the calculation of the earnings cap. Final Implementation Order at p. 39.

37. The earnings cap prohibits Peoples from exceeding its allowable rate of return, because the Company's DSIC will be reset to zero if the data included in the most recent Annual or Quarterly Earnings report filed with the Commission shows that Peoples 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. Peoples St. No. 1-R, pp. 12-13.

38. The Company's calculation of rate base for earnings report purposes includes the current book amount of ADIT. Peoples St. No. 1-R, p. 13.

39. In order for Peoples to get the benefit of a DSIC, it must be in an under-earning position after taking into consideration the very tax matters that the OCA is concerned about. Peoples St. No. 1-RJ, p. 3.

40. The earnings cap takes into consideration the many moving parts identified in a 1308(d) proceeding, including the very same components (ADIT and accelerated tax depreciation deductions used to calculate state income taxes) that the OCA challenges. Peoples St. No. 1-RJ, p. 3.

41. The tax changes were known to the General Assembly before it adopted Act 11. Peoples St. No. 1-RJ, p. 2.

42. Including a full and accurate calculation of state taxes would require the Company to provide a full rate making calculation. Peoples St. No. 3-R, p. 9.

43. It is improper to try to isolate and compute state tax liabilities on an incremental basis. Peoples St. No. 3-R, p. 9.

44. Due to accelerated depreciation, as to plant that was reflected in a prior base rate proceeding, state tax depreciation deductions will progressively decline. Peoples St. No. 3-R, p. 9.

45. Elimination of the state income tax gross-up through an “incremental” deduction approach improperly ignores state tax depreciation and accelerated depreciation deductions that were reflected in the Company’s prior base rate case. Peoples St. No. 3-R, p. 9.

46. At least some of the tax deductions that were previously available will no longer be available to the Company. Peoples St. No. 3-R, p. 10.

47. In addition, under accelerated depreciation procedures, the amount of the depreciation deduction on each tax vintage declines over time. Peoples St. No. 3-R, p. 9.

48. Tax depreciation deductions allowed for Pennsylvania net income tax purposes are reflected in the calculation of the Company’s earnings reports, and therefore are captured in the earnings cap. Peoples St. No. 1-R, p. 13.

## PROPOSED CONCLUSIONS OF LAW

1. Act 11 does not provide for an adjustment to DSIC-eligible plant for Accumulated Deferred Income Taxes.
2. Act 11 does not provide for an adjustment to the calculation of the state income tax gross up for incremental tax depreciation deductions.
3. The General Assembly clearly intended to adopt the water utility DSIC procedure in enacting Act 11.
4. The General Assembly clearly rejected a proposal to amend the water DSIC procedure that would have included tax benefits in the DSIC calculations.
5. The Statutory Construction Act of 1972 (“Statutory Construction Act”) provides that “the object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly.” 1 Pa.C.S. § 1921.
6. As the courts have noted, “it is incumbent that the reviewing court endeavor to ascertain the intent of the Legislature.” *Commonwealth v. Cox*, 603 Pa. 223, 283, 983 A.2d 666, 703 (2009).
7. In order to ascertain the intent of the General Assembly, the ruling body should first look at the plain language of the statute. *Commonwealth v. Segida*, 604 Pa. 103, 108, 985 A.2d 871, 874 (2009).
8. When the language of the statute is free from all ambiguity, the letter of the statute is to be followed. 1 Pa.C.S. § 1921(b).
9. If the words are not explicit, then intent may be gleaned from the contemporaneous legislative history. 1 Pa.C.S. § 1921(c)(7).

10. Legislative history may include previous drafts of house bills, as well as statements made by legislators during the time of the statute's enactment. *See Commonwealth v. Wilson*, 529 Pa. 268, 602 A.2d 1290 (1992).

11. It is not appropriate to "supply omissions in the statute, especially where it appears that the item may have been intentionally omitted." *Mt. Village v. Bd. of Supervisors*, 582 Pa. 605, 874 A.2d 1, 22 (Pa. 2005), citing *Kusza v. Maximonis*, 363 Pa. 479, 70 A.2d 329, 331 (Pa. 1950).

12. Section 1921(c)(7) of the Statutory Construction Act requires that the DSIC provisions of Act 11 be interpreted consistent with the Commission's past practice with the water DSIC.

13. It is not appropriate to consider another jurisdiction's statute where there was no indication that the General Assembly based Pennsylvania legislation on legislation adopted in other jurisdictions. *Elder v. Orluck*, 511 Pa. 402, 515 A.2d 517, 522 (1986).

14. None of the other jurisdictions cited by OCA have an earnings cap. *See In re Atlanta Gas Light Co.'s Pipeline Replacement Program*, 2009 Ga. PUC LEXIS 245 (Ga. P.U.C. 2009); KAN. STAT. ANN. §§ 66-2202-2204 (2013); KY. REV. STAT. ANN. § 278.509 (2013); *Petition of Bay State Gas Co. for Approval by the Dep't of Pub. Utils. of its Proposed Calendar Year 2009 Targeted Infrastructure Reinvestment Factor for Effect November 1, 2010*, 2012 Mass. PUC LEXIS 160, D.P.U. 10-52 (Mass. Dept. of Telecomms. and Energy Oct. 30, 2012); MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013); MO. REV. STAT. § 393.1009 (2013); NEB. REV. STAT. §§ 66-1802, 1865-1867 (2012); *In re Petition of Pivotal Util. Holdings, Inc. d/b/a Elizabethtown Gas to Extend Its Util. Infrastructure Enhancement Program and Revise Its Util. Infrastructure Enhancement Rate*, 2011 N.J. PUC LEXIS 112 (N.J. B.P.U. 2011); R.I. GEN. LAWS § 39-1-27.7.1 (2013); *In re Application of Questar Gas Co. to Increase Distribution Non-*

*Gas Rate and Charges and Make Tariff Modifications*, 2010 Utah PUC LEXIS 133 (Utah P.S.C. 2010)).

15. Other states' DSIC-like mechanisms account for a variety of other adjustments as part of their calculation, including uncollectible accounts, real property, other taxes, operation and maintenance savings, and purchased gas costs, to name only a few, which are not included in the Pennsylvania DSIC. *See, e.g., Petition of Bay State Gas Co. for Approval by the Dep't of Pub. Utils. of its Proposed Calendar Year 2009 Targeted Infrastructure Reinvestment Factor for Effect November 1, 2010*, 2012 Mass. PUC LEXIS 160, D.P.U. 10-52 (Mass. Dept. of Telecomms. and Energy Oct. 30, 2012); MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013).

16. A surcharge mechanism is authorized by the General Assembly, and is an exception to the traditional base rate filings. *Popowsky v. Pa P.U.C.*, 13 A.3d 583, 591 (Pa. Cmwlth. Ct. 2011); *Pennsylvania Industrial Energy Coalition v. Pa P.U.C.*, 653 A.2d 1336, 1349 (Pa. Cmwlth. Ct. 1995).

17. The purpose of a surcharge mechanism is to establish a simple adjustment mechanism that does not require examination of every component that would be considered in a full base rate case proceeding. *See, e.g., Dorothy Gill v. The Bell Telephone Company of Pennsylvania*, C-00935402, 1994 Pa. PUC LEXIS 115 (Order entered April 22, 1994).

18. A rate is defined as:

Every individual, or joint fare, toll, charge, rental or other compensation whatsoever of any public utility...made, demanded, or received for any service within this part, offered, rendered, or furnished by such public utility...and any rules, regulations, practices, classifications or contracts affecting any such compensation, charge, fare, toll, or rental.

66 Pa.C.S. § 102.

19. In assessing whether the DSIC rate is just and reasonable, the charge and the limiting provisions of customer protections must be considered together. *See* 66 Pa.C.S. § 102.

20. Any determination regarding whether rates are just and reasonable must look at the total effect of a utility's rates on its ability to have a fair opportunity to earn a fair rate of return on its property devoted to public service. *Duquesne Light Co. v. Barasch*, 488 US 299, 314 (1989).

21. The "actual taxes paid doctrine" is a judicial construct and therefore can be modified by the General Assembly. *Barasch v. Pa P.U.C.*, 491 A.2d 94, 104 (Pa. 1985).

## **PROPOSED ORDERING PARAGRAPHS**

It is hereby ordered that:

1. OCA's proposal to adjust the DSIC mechanism for ADIT is denied.
2. OCA's proposal to disallow the state income tax gross-up is denied.
3. That the Stipulation of Certain Issues is approved.