COMMONWEALTH OF PENNSYLVANIA

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December 20, 2013

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

RE: Petition of PPL Electric Utilities Corporation For Approval of a Distribution System Improvement Charge
Docket No. P-2012-2325034

Dear Secretary Chiavetta:

Attached for electronic filing is the Reply 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,

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Attachment
cc: Honorable Kandace Melillo
Certificate of Service
177031

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of PPL Electric Utilities Corporation	:		
For Approval of a Distribution System	:	Docket Nos.	P-2012-2325034
Improvement Charge	:		C-2013-2346390

REPLY BRIEF OF THE OFFICE OF CONSUMER ADVOCATE

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DATED: December 20, 2013

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Reply Brief in response to PPL Electric Utilities Corporation (PPL or Company) Main Brief (M.B.) in this matter and pursuant to the Prehearing Order of Administrative Law Judge Kandace F. Melillo (ALJ) dated July 2, 2013. The OCA's Main Brief contained a comprehensive discussion of the evidence and its position on these issues, and thus the OCA will respond only to those matters raised by PPL that were not previously addressed or that require clarification. Nevertheless, the OCA does not waive its opposition on contested issues because it does not repeat arguments here. Accordingly, the OCA incorporates the arguments and analysis contained in its Main Brief herein by reference.

II. LEGAL STANDARD

The OCA provided a full discussion of the legal standard in this matter in its Main Brief at pages 7 to 8.

III. SUMMARY OF ARGUMENT

As PPL states in its Main Brief, the purpose of the statute is to allow surcharge recovery of certain costs that are incurred by the utility. PPL states:

> 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 property that is part of the utility's distribution system. Eligible property for EDCs is defined in Section 1351 of the statute. See 66 Pa. C.S. § 1351(1).

PPL M.B. at 1 (emphasis added). This is precisely the point. One of the costs incurred is taxes, which is why Act 11 provides for recovery of pre-tax return. 66 Pa. C.S. § 1357. The Act does not, however, allow recovery of taxes that have not been incurred by the utility. 66 Pa. C.S. §§ 1351, 1353.

The DSIC calculation proposed by PPL would allow the Company to recover (1) a return on dollars that were not invested by its shareholders and (2) state taxes that are not paid by the utility. OCA St. 1 at 4-5, 9-10. This is because PPL does not recognize the tax benefits that are generated by its DSIC investment. The OCA recommends two adjustments to the calculation that will ensure that when PPL receives tax benefits from its DSIC investment, those benefits accrue to the ratepayers by reducing the revenue requirement that the DSIC rate is calculated to recover. Id.

In its Main Brief, PPL offers a myriad of flawed reasons why the DSIC revenue requirement should be calculated as if those tax benefits do not exist. PPL St. 3-R at 1-7; OCA St. 4-R at 7-8. In its testimony and Main Brief, the OCA addressed each of the Company's objections and showed how PPL can make the adjustments without undue complexity. The bottom line, however, is that without these adjustments, PPL's proposed DSIC calculation does not meet the requirements of Act 11 and the mandate of Chapter 13 that all rates be just and

reasonable, consistent with all applicable law and ratemaking principles. 66 Pa. C.S. §§ 1301, 1350-1360.

Accordingly, the OCA recommends that PPL change its tariff to reflect Accumulated Deferred Income Taxes (ADIT) as an offset to the DSIC rate base. The tariff should be modified as follows:

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

OCA St. 1 at 8. (Underline indicates new language.) In addition, the DSIC rate must also reflect the current state income taxes that PPL actually pays to the Commonwealth. The Company's calculation of pre-tax return should be adjusted to recognize that PPL will not pay state income taxes on some or all of its DSIC income due to the accelerated depreciation and, when applicable, bonus depreciation, deductions associated with DSIC plant. OCA St. 1 at 9.

IV. ARGUMENT

A. PPL's DSIC Rate Should Be Calculated to Recover Federal and State Income Taxes Paid by the Utility.

The plain language of Act 11 limits DSIC recovery to costs *incurred* by the utilities. 66 Pa. C.S. §§ 1351, 1353. Further, Act 11 was established within Chapter 13 of the Public Utility Code and its requirement that all rates be just and reasonable. 66 Pa. C.S. § 1301. As discussed on pages 11 to 29 of the OCA's Main Brief and in the testimony of OCA witness Thomas Catlin, ADIT must be recognized in calculating the rate base to which the DSIC pre-tax rate of return will apply. It is standard ratemaking practice in Pennsylvania to deduct ADIT from rate base in calculating revenue requirement so that ratepayers do not pay a return on zero cost capital in base rates. For the same reason, DSIC rates must also be calculated so that ratepayers do not pay costs that the utility does not incur, that is, a return on zero cost capital.

PPL's proposed 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. This formula does not recognize the balance of ADIT associated with DSIC-eligible plant as an offset. OCA St. 1 at 4, 7; DSIC Petition, Exh. 1 at Original Page No. 19Z.18. As a result, the formula overstates PPL's investment balance, *i.e.* it includes investment that was not funded by the utility, and allows PPL to earn a return on an overstated investment balance. OCA St. 1 at 4-5. The OCA recommends, accordingly, that PPL be required to change its tariff to reflect ADIT as an offset to the DSIC rate base. The tariff should be modified as follows:

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

OCA St. 1 at 7 (Underline indicates new language).

The federal prohibition against the flow-through of depreciation tax benefits does not apply to state taxes. The Commonwealth's highest court has held that no rate is just and

reasonable if it does not reflect actual taxes paid by the utility and, accordingly, that utilities must flow through state income tax benefits to ratepayers on a current basis. Barasch v. Pa. PUC, 507 Pa. 496, 504-05, 518, 520-22, 491 A.2d 94, 98, 101, 105-07 (1985) (Penn Power) citing 66 Pa. C.S. § 1301. This is consistent with the requirement of Act 11 that fixed costs, which include pre-tax return, recovered through the DSIC must have been "incurred" by the utility. 66 Pa. C.S. § 1351, 1353(a).

PPL used the full statutory income tax rate to calculate its DSIC rate. DSIC Petition, Exh. 1 at Original Page No. 19Z.17; PPL St. 3-S at 5-6; OCA St. 1 at 8. As discussed on pages 30 to 37 of the OCA's Main Brief, however, the amount of state income taxes that PPL will pay on DSIC revenues 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 8. Because PPL 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 incurred.

PPL has offered no evidence or argument to refute the conclusion that the failure to recognize ADIT will overstate the investment balance and allow the Company to earn a return on funds that were not supplied by investors. Nor has it disputed that use of the full statutory state income tax rate will not flow through tax benefits associated with DSIC revenue. Instead PPL provides reasons why, in its view, it is acceptable to charge customers for costs that it will not incur. PPL M.B. at 9-33.

PPL organizes its arguments into six parts in its Main Brief, which for ease of reference, the OCA will respond in seriatim.

B. The Purpose of Act 11 Is to Allow Recovery of Certain Costs Incurred between Rate Cases – the General Assembly Did Not Intend for the DSIC Calculation to Recover Costs that Will Not be Incurred.

The Company argues that the General Assembly specifically intended to continue the pre-Act 11 DSIC formula and to reject adjustments to reflect ADIT and actual state income taxes in the DSIC formula. PPL M.B. at 12-19. PPL points, first, to the language of the statute and identifies provisions that are the same or substantially similar to the prior water utility sample tariff. Id. at 13-15.

If the General Assembly intended for the Commission to duplicate the sample water tariff for all utilities, without change, it could have stated that the existing water tariff should be utilized for all utilities. Or it could have simply amended Section 1307(g) to apply to all utilities, which would be more consistent with PPL's argument for business as usual. In the past, bills introduced in support of a DSIC for gas and electric utilities simply proposed to add subsections to 66 Pa. C.S. § 1307. 2002 Pa. H.B. 2754, Printer's No.; 2003 Pa. H.B. 1841, Printer's No. 3852.

Instead, the General Assembly repealed Section 1307(g) and expressly provided, for water utilities only, that existing orders and practices can stand but also gave the Commission authority to amend or revoke any of its orders and other actions related to a DSIC granted under Section 1307(g):

> 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).

The Company fails to recognize that while adopting some aspects of the Commission's model water tariff in Act 11, the General Assembly did not duplicate the status quo. For

example, under Section 1307(g), there was no statutory limit on how far back the Commission could allow utilities to reach in claiming plant investment through the surcharge. Act 11 limits the period to the ninety days ending one month prior to the effective date of the surcharge. 66 Pa. C.S. § 1357(a)(1)(ii). Section 1307(g) imposed no requirement that the utility recover the DSIC from all customer classes or that the charge be equal for all customer classes, but this requirement is included in Act 11. Cf. 66 Pa. C.S. §§ 1357(d)(1), 1358(d)(1). With regard to the DSIC cap for water utilities, the Commission had determined that Section 1307(g) granted it the authority to establish the cap "at either 5% or 7.5% or, conceivably, at a higher percentage." Petition of Pennsylvania-American Water Co., 2007 PaPUC LEXIS 42, *17-18. The General Assembly specifically eliminated the Commission's discretion to approve a higher percentage cap for water utilities as follows:

> A distribution system improvement charge granted to a water utility under former section 1307(g) (relating to sliding scale of rates; adjustments) or this subchapter may not exceed 7.5% of the amount billed to customers.

66 Pa. C.S. § 1358(a)(2).

Act 11 thus did not simply make applicable the Commission's prior Orders and Tariffs for water utilities under Section 1307(g) to all other utilities, and nothing in Act 11 prevents the Commission from applying appropriate ratemaking standards in adopting a DSIC calculation that carries out the requirements of Act 11 as well as the just and reasonable rate requirements of Chapter 13. 66 Pa. C.S. §§ 1301, 1353, 1353(b)(1).

Next, PPL says that the language of the statute omits mention of adjustments for ADIT and state income taxes. PPL M.B. at 13-14. This is correct. The plain language of Act 11 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(a), 1357(c). The Company is wrong to interpret the omission of these specific adjustments in the statute to mean that the adjustments cannot be made. To do so would result in PPL recovering costs through the DSIC that it did not incur. This is not consistent with the plain language of the statute and would not give effect to the requirement that costs be "incurred" by the utility. 66 Pa. C.S. § 1351, 1353(a). The rules of statutory construction provide:

Every statute shall be construed, if possible, to give effect to all its provisions.

1 Pa. C.S. § 1921(a).

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 – be just and reasonable. 66 Pa. C.S. §§ 1301, 1308, 1353; Northern Tier Solid Waste Auth. v. Dep't of Revenue, 860 A.2d 1173 (Pa. Commw. Ct. 2004) ("statutes are to be construed in harmony with the existing law and as part of a general and uniform system of jurisprudence") (Northern Tier). The Pennsylvania Supreme Court has determined that just and reasonable rates must reflect actual taxes paid and, conversely, that rates that do not reflect actual taxes paid cannot be just and reasonable for purposes of Section 1301. Penn Power at 521. The statute must, therefore, allow adjustments to properly calculate applicable taxes related to DSIC-eligible investment.[1]

Moreover, by PPL's logic, the Company cannot recover gross receipts tax through the DSIC because it is not specifically identified in the statute. Yet, on page 19Z.18 of its proposed DSIC tariff, PPL adds gross receipts tax (GRT) to the DSIC formula as follows:

[1] 1 Pa. C.S. § 1921(c)(6) ("the intention of the General Assembly may be ascertained by considering, among other matters... [t]he consequences of a particular interpretation"); 1 Pa. C.S. § 1922 ("In ascertaining the intention of the General Assembly in the enactment of a statute the following presumptions, among others, may be used... [t]hat the General Assembly does not intend a result that is absurd, impossible of execution or unreasonable).

DSIC = ((DSI x PTRR)+Dep+e) x 1/(1-T)

Exh. BLJ-2 at Original Page No. 19Z.18. PPL defines "T" as "Pennsylvania gross receipts tax rate in effect during the billing month, expressed in decimal form." Id. OCA witness Catlin did not oppose this change to the DSIC formula because he recognized that PPL will pay GRT on its DSIC revenues. OCA St. 1-S at 2. The Company will "incur" gross receipt taxes when it recovers revenue to "repair, improve or replace DSIC-eligible property" (66 Pa. C.S. §§ 1351, 1353) and OCA agrees that those taxes should be part of the DSIC calculation, even though they are not specifically identified in the statute. The Company will not incur federal and state taxes at the full statutory rates, however, and the reductions attributable to DSIC investment should be part of the DSIC calculation even though they are not specifically identified in the statute. The OCA notes, further, that the gross receipts taxes are sizable, 5.9% of the total revenue requirement. Petition of PPL Elec. Util. Corp. for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2325034, Order (May 23, 2013) (May 23 Order) at 9.

PPL also suggests that the Commonwealth Court's holding in Popowsky v. Pa PUC means that there can be no adjustments to the DSIC that are not specifically identified in the statute.[2] 869 A.2d 1157, 1160 (Pa. Commw. Ct. 2005) (Popowsky 2005); PPL M.B. at 14-15. It does not. The issue in that case was whether the Commission had authority to allow surcharge recovery of capital costs outside of a base rate case. The Court determined that the General Assembly's passage of Section 1307(g) showed that the Commission did not have authority to allow surcharge recovery of capital costs by non-water utilities under Section 1307(a). Popowsky 2005 at 1159-60. In other words, the inclusion of a specific matter in the statute implied the exclusion of another matter. Id. Here, we have a statute that provides for a DSIC

[2] As explained, *supra*, this argument is not correct. However, if it were, this interpretation would prohibit making an adjustment for gross receipts taxes because the statute includes no provision for such an adjustment.

that recovers specific costs incurred by the utility and the OCA has shown how the proposed calculation must be made in order to recover those specific costs.

PPL also cites to Mt. Village regarding intentional omissions. PPL M.B. at 14 (citing Mt. Village v. Board of Supervisors, 582 Pa. 605, 874 A.2d 1 (2005). The Commonwealth Court's holding there was that attorneys were not "consultants" for purposes of charging review fees because the statute specified that the review would be done in accordance with requirements for engineers, land surveyors, geologists, and landscape architects. Id. at 619, 874 A.2d 1 at 9 ("we cannot supply omissions in the statute, especially where it appears that the item may have been intentionally omitted"). In this case, the plain language of the statute provides that only costs incurred may be recovered in the DSIC rate. Federal and state income taxes are specifically included in the statute. The OCA's recommendations do not "add" anything to the DSIC formula outlined by the General Assembly; they properly apply the components to make them consistent with the requirements of the Act and Section 1301.

Turning to the legislative history, PPL argues that the General Assembly specifically considered and rejected the OCA's tax-related proposals. PPL M.B. at 15. In fact, the General Assembly considered a different proposal. As discussed in the OCA's Main Brief, the referenced pages from the House Legislative Journal relate to an amendment proposed to limit DSIC recovery to "net increases" in eligible property. Id.; PPL Exh. BLJ-1R; 2011 Legisl. Journal – House at 1909 (Oct. 3, 2011). 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 plant 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, PPL ignores the response of Representative Reichley in opposition to the proposed amendment. 2011

Legsl. Journal – House at 1910. With regard to that amendment, he 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 a 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).

PPL also argues that the legislative history shows that the bill was amended to memorialize the current PUC procedure and process used for water utilities. PPL M.B. at 15-16. The statement was made in the context of describing Senate amendments to the bill and distinguishing them from the House version. Representative Godshall explained 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). As discussed in the OCA's Main Brief, 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.

PPL goes further to say that the fact that the General Assembly referenced the prior history of water utility DSICs means that it reaffirmed the Commission's interpretations of a predecessor water DSIC statute to not include the OCA's proposed tax offsets. PPL M.B. at 16, n.5 citing 1 Pa. C.S. § 1921(c)(8). First, the Commission interpreted a *different* statute, one that was repealed by the statute in question. Second, to the OCA's knowledge, the exclusion of ADIT or recognition of actual state income taxes in the DSIC calculation approved for water utilities was never addressed by the Commission. The OCA is addressing here the exclusion of these adjustments from the new DSIC calculation approved for utilities under Act 11. Third, the General Assembly specifically provided in Act 11 that the Commission's past practices with regard to water utilities with existing DSICs might be amended or revoked under the new legislation. 66 Pa. C.S. § 1358(a)(2).

Finally, the Company argues that the General Assembly intended for the DSIC to be an exception to traditional base rate procedures an-d that adjustments required by accepted ratemaking principles would not apply. PPL M.B. at 16-18. In support, PPL cites two decisions where the Commonwealth Court recognized the General Assembly's authority to allow recovery of expenses under Section 1307(a) where recovery would otherwise be impermissible single-issue or retroactive recovery, respectively. Pennsylvania Indus. Energy Coalition v. Pa. PUC, 653 A.2d 1336, 1349 (Pa. Commw. Ct. 1995), aff'd per curiam, 543 Pa. 307, 670 A.2d 1152 (Pa. 1996) (PIEC); Popowsky v. Pa. PUC, 13 A.3d 583, 591 (Pa. Commw. Ct. 2011) (Newtown Artesian). PPL also cites Popowsky 2005 where the Court recognized that the General Assembly could exempt utilities from making a used and useful demonstration prior to recovery

of capital costs in rates. While the OCA agrees that the General Assembly has authority to allow utilities to depart from certain ratemaking rules, Act 11 does not exempt PPL from calculating its DSIC rate to recover actual taxes paid.[3] The statute does not prohibit the Commission from approving a DSIC calculated to recover only those costs incurred by PPL. To the contrary, the General Assembly did not authorize the Commission to approve a DSIC that recovers costs that are not actually incurred by the utility. Section 1353(a) of Act 11 states:

> after January 1, 2013, a utility may petition the commission for, or the commission, after notice and hearing, may approve the establishment of a distribution system improvement charge to provide for the 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(a) (Emphasis added). This limitation on cost recovery is repeated in the General Assembly's definition of a DSIC:

> "Distribution system improvement charge." A charge imposed by a utility to recover the reasonable and prudent costs incurred to repair, improve or replace eligible property that is part of the utility's distribution system.

66 Pa. C.S. § 1351. It is, thus, consistent with the language of Act 11 – and Section 1301 as it has been interpreted by the Courts – that the Commission approve a DSIC rate that is calculated to recover only costs that were actually incurred by PPL.

C. Recognition of ADIT and Effective State Income Taxes Is Necessary, Consistent with Timely Recovery of Costs Incurred by PPL, and Not That Complex.

1. The Commission's Act 11 Final Implementation Order Did Not Result from an Adjudication, and, Therefore, Is Not Binding.

PPL begins its argument by stating that the Commission directly addressed the OCA's proposed tax adjustments in its Final Implementation Order. PPL M.B. at 19-20. In fact, the

[3] The OCA points out that Act 11, unlike Section 1307(g), does provide some measure of prudence review of the projects the utilities' propose to recover through the DSIC through the long-term infrastructure plans. 66 Pa. C.S. § 1352. Section 1307(g) did not require long-term plans or annual asset optimization plans. Id.; 66 Pa. C.S. § 1356.

OCA did not raise and the Commission did not address the state income tax adjustment in its Final Implementation Order beyond the mention that federal and state income tax rates are included in the pretax return calculation. In re: Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order at 31 (Aug. 2, 2012) (Final Implementation Order); 66 Pa. C.S. § 1357(b)(1). PPL's arguments regarding the Commission's position on the OCA's tax adjustments are, thus, limited to ADIT.

PPL argues that the Commission has already rejected the OCA's proposed ADIT adjustment. PPL M.B. at 19-20. In fact, the Commission specifically referred issues related to the impact of ADIT for further disposition in this proceeding. May 23 Order at 37. The Final Implementation Order did not result from an adjudication; it was a policy statement setting forth how the Commission intends to interpret Act 11 in future adjudications and rulemakings. See Chapter 14 Implementation, 2005 PaPUC LEXIS 20, *18-20 (defining the legal effect of similar orders issued to implement Chapter 14 of the Public Utility Code).[4] As PPL points out in its Main Brief, the Commission identified three concerns in its Act 11 Final Implementation Order, based on which it declined to include ADIT in the model DSIC tariff. Final Implementation Order at 39. Accordingly, the current adjudicated proceeding is the OCA's opportunity to

[4] As stated by the Commission in its Chapter 14 Order in a similar context:

> Since the Implementation Orders are not adjudications, they should not be construed to have created "binding norms" that have the force of law. If they are so interpreted, then the Implementation Orders would be illegal because they are in the nature of unpromulgated regulations. See, e.g., Hardiman v. Commonwealth, 550 A.2d 590 (Pa. Commw. Ct. 1988).
>
> A statement of policy is defined in the Commonwealth Documents Law as: any document, except an adjudication or a regulation, promulgated by an agency which sets forth substantive or procedural personal or property rights, privileges, immunities, duties, liabilities or obligations of the public or any part thereof, and includes, without limiting the generality of the foregoing, any document interpreting or implementing any statute enforced or administered by such agency.
>
> 45 Pa. C.S. § 501 ("Statement of Policy") (Emphasis added). These Implementation Orders fit within this definition. Accordingly, the Commission agrees with the argument of the PGW that the Implementation Orders at issue constitute policy statements setting forth how the Commission intends to interpret Chapter 14 in future adjudications and rulemakings.

Chapter 14 Implementation, 2005 PaPUC LEXIS 20, *18-20.

develop a record responding to those concerns and to demonstrate through record evidence that ADIT and the effective state income tax rate are necessary components of PPL's DSIC calculation.

2. The Commission Is Not Bound to the Language of Its Model Tariff or the Sample Tariff Approved for Water Utilities.

The Commission is not bound to the language of its model tariff or the sample tariff approved for water utilities in 1996. As to the first, the Commission may choose to modify the language of the model tariff attached to the Final Implementation Order in accordance with its final resolution of this proceeding. This was the case for Philadelphia Gas Works. In that utility's DSIC proceeding, the Commission approved a final tariff for PGW that differs from the PGW model tariff attached to the Final Implementation Order – even though that 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, P-2012-2337737, Order at 10 (May 9, 2013). With regard to the water utility tariff, the Commission was never bound to the language of the sample water tariff adopted in 1996; it always had discretion to review and approve changes where warranted by the facts and circumstances. This point was made by the Commission in a 2003 Order where a water utility sought to expand the types of costs recovered through its surcharge:

> We agree with the ALJ and emphasize that the fact that the Commission has not approved a DSIC to recover costs for distribution system improvement projects other than those in the Sample DSIC tariff does not diminish our discretion to review each request for DSIC recovery based on the facts and circumstances presented.

Petition of Columbia Water Co., Docket No. P-00021979, Order at 11 (Apr. 17, 2003). To the OCA's knowledge, the exclusion of ADIT from the DSIC calculation approved for water utilities was never challenged. The OCA is challenging, however, the exclusion of ADIT from the new

DSIC calculation approved for utilities under Act 11. One of the reasons is that, as discussed in the OCA's Main Brief, the tax benefits that are now available to PPL and other utilities were substantially smaller or did not exist when the Commission first adopted a water DSIC tariff in 1996. OCA M.B. at 21-22; OCA St. 1-S at 3; Tr. 60-61; Re Pennsylvania-American Water Co., 84 PaPUC 415 (1996). Also, the surcharge will be applied to more customer bills - natural gas, electric and wastewater. 66 Pa. C.S. § 1351. Moreover, some customers will pay a DSIC on multiple utility bills.

3. The ADIT Adjustment Is Not Too Complex and Is Consistent With the Intentions of the General Assembly and the Commission.

PPL asserts that incorporation of an ADIT adjustment would violate the goals of the General Assembly and the Commission, because the intention was to create a "straightforward and easy to calculate surcharge mechanism." PPL M.B. at 20. In support of its position, PPL asserts that non-base rate cases do not require submission to the full extent of revenues, expenses, rate base, and rate of return as is required in a general rate base case. PPL M.B. at 21. First of all, it should be noted that the purpose of the statute was not to make it easy for PPL to recover costs, regardless of whether those costs are actually incurred. Rather, 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). Contrary to PPL's assertion, it would defeat the purpose of the Act 11 DSIC surcharge provisions not to incorporate ADIT adjustments into rate calculations, because a failure to do so would result in the recovery of costs not incurred by the Company. The bottom line is that rates must be calculated correctly, regardless of whether they are recovered through a surcharge or base rates. The failure to recognize ADIT will overstate the investment balance and allow PPL to earn a return on funds that were not supplied by investors, resulting in a rate that is unjust and

unreasonable in violation of Section 1301 of the Public Utility Code and Commission Orders. See gen'ly 66 Pa. C.S. § 1301; Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 53 PaPUC 410 (1979); Pa. PUC v. Philadelphia Elec. Co., 31 PUR4th 15, 52 PaPUC 772 (1978).

The Company argues that a lesser ratemaking standard should apply for costs recovered by surcharge. PPL M.B. at 20-21. Specifically, PPL contends that excluding ADIT from the DSIC calculation is analogous to the Court's recognition that utilities are not required to reflect all changes in revenues, expenses, rate base and rate of return in a non-general base rate case that would be required for a general base rate case. PPL M.B. at 21 citing Popowsky v. Pa. PUC, 683 A.2d 958 (Pa. Commw. 1996) (Equitable). The issue in Equitable, however, was whether an increase in one item of expense (compliance accounting changes) could be considered in isolation, without specific evidence regarding other changes in revenue/expense and rate base/rate of return since base rates were last established, including offsetting savings in other categories of expenses. Id. at 960. In direct contrast, here, the OCA does not propose to broaden the scope of the DSIC. OCA St. 1 at 5. By statute, the incremental DSIC property and federal income taxes are already part of the calculation. 66 Pa. C.S. § 1357(b)(1); OCA St. 1 at 4-5. The issue here is that the DSIC formula proposed by PPL will overstate the investment on which the Company is entitled to earn a return. ADIT must be included in the calculation to correctly and fairly value the surcharge rate base by removing plant investment that was not funded by the Company. OCA St. 1 at 5.

This would certainly not, as suggested by the Company, be the equivalent of full base rate review. PPL M.B. at 20-21. There will still be no consideration, inter alia, of accumulated depreciation associated with plant investment already included in base rates, offsetting O&M

savings associated with incremental investment, and any other offsetting changes that occur between base rate cases. 66 Pa. C.S. § 1357(a).

PPL also relies on the Gill case for the premise that surcharges should be simple and straightforward. PPL M.B. at 20; Gill v. The Bell Tele. Co. of Pa., 1994 PaPUC LEXIS 115 (denying pro se complainant's protest against any surcharges and/or taxes on her telephone bill) (Gill). The language cited by PPL is dicta from the Initial Decision in the context of the ALJ's discussion of a utility's legal authority to recover state taxes. Gill at *12-13. The OCA's position is consistent with Gill because recognition of ADIT is consistent with having a surcharge that recovers one type of cost – the eligible new plant investment incurred by PPL between rate cases – without examination of every component that would be considered in a full base rate proceeding. The Gill case is distinguished from the present case, however, for an important reason. State taxes are an easily identifiable expense that is beyond a utility's control. See Popowsky v. Pa. PUC, 869 A.2d 1144, 1161 (Pa. Commw. Ct. 2005) (PAWC 2005). In contrast, Act 11 authorizes recovery of a capital cost. The Commonwealth Court has recognized that recovery of capital costs is inherently more complex than recovery of an expense:

> a Section 1307(a) surcharge "flows through only expenses and changes to those expenses without including any profit or other recovery." By contrast, improvements to physical facilities leave a utility with a more valuable capital asset.

PAWC 2005 at 1155 (citing Pennsylvania Indus. Energy Coalition v. Pa. PUC, 653 A.2d 1336, 1341 (Pa. Commw. Ct. 1995)). Essentially, PPL wants to ignore the distinction between recovery of an expense and a capital cost. The degree of simplicity that PPL seeks is not possible in a calculation of the pre-tax return that will be recovered through the DSIC rate. ADIT is a necessary and unavoidable component of a calculation that produces a just and reasonable rate that meets the requirements of Act 11. It is one thing to permit PPL to earn a

return on its investment in new plant between base rate cases; it is another thing to permit PPL to earn a return on taxpayer-supplied funds that are universally excluded from rate base as a matter of basic ratemaking fairness.

Moreover, PPL overstates the difficulty of calculating ADIT. The fact that the utilities in all of the many states cited by the OCA in its Main Brief deduct ADIT from the surcharge rate base demonstrates that recognizing ADIT is not too complicated. OCA St. 1-S at 2-3. First, PPL contends that ADIT is too complicated because, "whether and to what extent PPL has any ADIT balance not already reflected in base rates depends in part upon its overall tax position." PPL M.B. at 21. This is because, 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 4-5, 7. The net effect is that the ADIT does not arise until the loss carry forward is eliminated by having taxable income. Id. This is not reason to ignore the ADIT, however. OCA witness Catlin explained how PPL can make the ADIT adjustment without undue complexity. See OCA St. 1 at 6; OCA M.B. at 19-22. Although recognition of ADIT will not reduce the DSIC rate base at this time, the DSIC formula established in this proceeding, should correctly calculate the investment on which PPL is entitled to earn a return. OCA St. 1 at 7. Then, when PPL is no longer in a loss carry forward position, the tariff will provide for the appropriate adjustment to DSIC rate base and revenue requirement. It should also be noted that PPL's argument as to the complexity of calculating ADIT has no bearing on its ability to calculate state income taxes on its DSIC income.

PPL also raises the concern that there could be litigation over the utility's past, present, and future income tax status. PPL M.B. at 22. 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. PPL St. 4-R at 5. It is always possible that there will be litigation over some portion of the Company's DSIC formula. Act 11 specifies that the DSIC rate is subject to audit and complaint. 66 Pa. C.S. §§ 1301, 1358(e)(1)(i), (f). The potential for litigation is not a basis to ignore a necessary change in the DSIC. Moreover, the Commission may still allow the Company to recover its proposed DSIC rate subject to refund while the matter is litigated. 66 Pa. C.S. § 1357(d)(3).

Next, PPL asserts that in some calendar quarters it may report taxable income or loss that may not be representative of the full tax year and that it might need to subsequently true-up the DSIC plant balance used for those quarters. PPL M.B. at 22. It argues that using estimates is contrary to the use of known, historic balances envisioned by Section 1357. PPL M.B. at 22-23. Section 1357 addresses the requirement that plant additions be in service prior to recovery in rates. 66 Pa. C.S. § 1357. The recognition of ADIT has no bearing on this requirement. ADIT relates to the calculation of the Company's return on the cost of those plant additions and operates to prevent the DSIC rate from including return on plant additions that were not funded by the Company. OCA St. 1 at 4-5. Further, Section 1357 recognizes that estimates are part of the DSIC formula:

> The distribution system improvement charge shall be calculated by dividing one-fourth of the annual fixed costs associated with all eligible property under the distribution system improvement charge by the projected revenue for the quarterly period during which the distribution system will be collected.

66 Pa. C.S. § 1357(d) (Emphasis added). The DSIC estimates are subject to reconciliation, refund and recoupment. 66 Pa. C.S. §§ 1358(d)(2), (e); DSIC Petition at Tariff Supp. 194 at Original Page No. 180. Accordingly, PPL can true up its DSIC calculations to reflect the actual ADIT balances at the same time it prepares its annual reconciliation for each calendar year.

Given the reconcilable nature of the DSIC, the alleged inability to calculate the exact ADIT on a quarterly basis is not a reason to ignore ADIT altogether.

Finally, PPL argues that declines in the ADIT balance may offset any new ADIT balances created from new DSIC-eligible plant, particularly for plant subject to the repair allowance deduction or a bonus depreciation deduction. PPL M.B. at 23. The Company's argument is not correct because the ADIT balance will only decline if PPL does not continue to add new plant. There is no indication that PPL will not add new plant. Moreover, if PPL does not repair, replace or improve plant, it is not eligible to recover any costs through the DSIC. 66 Pa. C.S. § 1350-1360.

4. The Earnings Cap Does Not Prevent The DSIC Rate From Being Overstated.

PPL asserts that the earnings cap compensates for failing to reflect its actual federal and state income tax expense in the DSIC calculation. PPL M.B. at 23-24. The earnings cap will prevent the Company 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. 66 Pa. C.S. § 1357(b)(2)-(3). Earnings reports are not subject to the type of review and scrutiny that occur in a rate case, however, and the question of whether or not a utility is "overearning" may be a product of a myriad of factors unrelated to the DSIC. 52 Pa. Code §§ 71.1 *et seq.*; see OCA M.B. at 23. As discussed in the OCA's Main Brief, if PPL is under earning due to an increase in expense that is wholly unrelated to the DSIC – postage or management retirement bonuses, for example - the earnings cap would not prevent the utility 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; OCA M.B. at 22. To ensure that ratepayers are not required to pay a return on non-investor supplied capital, the ADIT associated with DSIC-

eligible plant must be deducted from the DSIC rate base. The earnings cap will also not prevent ratepayers from being charged state taxes on DSIC income that are not being paid by PPL. That result will only be avoided if the flow-through of the state income tax deductions associated with DSIC plant is accounted for in determining the state income taxes that are included in the DSIC pre-tax rate of return.

D. The Mismatch Is Due to Single-Issue Recovery of Pre-tax Return and Depreciation.

On page 25 of its Main Brief, PPL argues that the OCA's adjustments are flawed because the Company does not pay income tax expense on particular plant additions or particular revenues generated from plant additions; rather the Company pays taxes based on its deductions associated with all of its plant in service. PPL M.B. at 25; PPL St. 4-R at 5. As discussed in the OCA's Main Brief, it is correct that DSIC revenues and costs are part of the Company's overall taxable income for federal and state income tax reporting purposes. OCA M.B. at 32-33; OCA St. 1-S at 6. However, Act 11 allows PPL and other utilities to isolate the costs associated with DSIC-eligible plant and separately recover those costs. It would be inconsistent and inappropriate to calculate state income taxes associated with DSIC-eligible plant without flowing through the tax deductions associated with the same plant. Moreover, while PPL argues that calculating incremental tax deductions is not how it pays taxes, the OCA notes that it does not claim that it is not *able* to calculate tax deductions associated with the incremental plant additions on an annual basis – because those amounts are already calculated in conjunction with the calculation of the tax deductions associated with DSIC-eligible plant for federal income tax purposes. PPL St.4-R at 2-3, 6.

The Company argues that recognizing PPL's federal and state income tax expense for DSIC eligible property without recognizing changes in the Company's total ADIT and state

income taxes that have occurred since its last base rate case is inappropriate. PPL M.B. at 25-26. The Company – not the OCA – has created the mismatch, however, by proposing a surcharge that recovers pre-tax return and depreciation on a single cost that has increased since its last base rate case, without recognizing other changes, including *inter alia* plant balances that are declining due to accrued depreciation. PPL has isolated the costs associated with DSIC-eligible plant. The adjustments recommended by the OCA make the valuation of those costs as correct and fair as possible, within the constraints of an inherently one-sided calculation.

PPL argues that adjusting the DSIC formula to reflect its actual taxes associated with its DSIC investment results in a double-counting of the repairs and depreciation deductions. PPL M.B. at 25-26. The OCA recognizes that the repair deduction is a one-time deduction in the year of construction. Id., n.7. PPL has provided no support, however, for the assumption that the repairs deduction included in base rates fully accounts for the repair deduction associated with new DSIC-eligible plant additions and that additional repair allowance benefits will not occur.

With regard to accelerated tax depreciation deductions, PPL M.B. at 26, n.7, there is no double-counting because the deductions are fully incremental to the accelerated tax depreciation associated with plant previously recognized in base rates. OCA St. 1 at 9. Thus, if the Company's state tax deductions are lower than the amount assumed in calculating 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. Id. at 5-7, 9. If PPL does not repair, replace or improve plant, it is not eligible to recover any costs through the DSIC. 66 Pa. C.S. § 1350. If the Company continues to repair, replace or improve plant, accelerated depreciation deductions will not decline. In fact, the Commission has found that PPL projects a continued increase in the amount it invests each year throughout the 2013 to 2017 period.

Petition of PPL Elec. Util. Corp. for Approval of its Long-Term Infrastructure Improvement Plan, Docket No. P-2012-2325034, Order at 10, 13 (Jan. 10, 2013) (January 10 Order).

PPL also alleges that the only way to take into account the changing mix of current state tax deductions is to undertake a full state tax calculation as part of each DSIC. PPL M.B. at 26. As a practical matter, however, tax deductions generated from the repair allowance and accelerated tax depreciation on DSIC-eligible plant are likely to be far in excess of the taxable income produced by the DSIC. OCA St. 1 at 5-7. If, as PPL has indicated, the Company continues to increase its pace of replacement compared to historic replacement, the tax deductions associated with that replacement will increase. See January 10 Order at 10, 13.

Again, the Company is seeking a separate stream of income while its base rates continue to reflect the original undepreciated rate base. That is the mismatch created by allowing single-issue recovery of a capital cost. The OCA's adjustments serve to make the DSIC formula proposed by PPL as reasonable and correct as possible.

E. The Just and Reasonable Rate Requirement of the Public Utility Code Requires More Than A Constitutional End Result Analysis.

PPL correctly states the OCA's position that, without its two tax adjustments, "the DSIC will overstate the Company's costs in violation of the standard ratemaking practices." PPL M.B. at 27, citing OCA St. 1 at 5; OCA St. 1-S at 2. More specifically, OCA has contended that the Company's proposed DSIC formula would allow it to recover federal and state income taxes it will not pay due to tax benefits generated by DSIC plant and revenues, in violation of the "just and reasonable" requirement of Section 1301 of the Public Utility Code as that provision has been applied by the Pennsylvania Supreme Court. Penn Power (citing 66 Pa. C.S. § 1301); see also Barasch v. Pa. PUC, 507 Pa. 561, 493 A.2d 653 (1985) (UGI); 66 Pa. C.S. § 1353.

Citing Duquesne Light Co. v. Barasch, PPL argues that the reasonableness of rates is based on the overall return produced by the utility's total rates and not individual adjustments to expense items. PPL M.B. at 27-29 (citing 488 U.S. 299 (1989) (Duquesne)). As Act 11 provides an earnings cap, PPL opines that that there can only be two results: (1) it cannot charge a DSIC or (2) any DSIC that it does charge will be just and reasonable under the Duquesne standard. Id. at 29. PPL's alarming version of utility ratemaking must be rejected. First, the constitutional standard for judicial review set forth in Duquesne is not the relevant standard for determining the justness and reasonableness of PPL's DSIC calculation. Second, under PPL's theory, every ratemaking adjustment has no meaning and no ratemaking decision would be reviewable. Third, as discussed in Section IV.C.4, *supra*, the earnings cap is not the panacea that PPL suggests.

First, PPL has confused the standard applied in Duquesne with the standard that applies to this proceeding. In Duquesne, the Court addressed the standard for judicial review of the constitutional question whether the rates were confiscatory, *i.e.* whether the impact of negative allowances rises to the level of confiscation for purposes of the Fifth and Fourteenth amendments. Duquesne at 305-08, 312. Here, the issue is interpretation of the Public Utility Code and whether, under Pennsylvania law, a specific rate authorized by statute is just and reasonable if it allows a return on non-investor supplied funds and recovers state income taxes that are not paid by the utility. The Company's quotations from Duquesne demonstrate this point:

> 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.

PPL M.B. at 28 quoting Duquesne at 314 (discussing Hope Natural Gas Co., 320 U.S. 591 at 605 (1944) (emphasis added).

> 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 28-29 quoting Duquesne at 316 (emphasis added). When PPL quoted the Court's observation about errors cancelling out countervailing errors to support its argument that individual expense adjustments do not bear on the justness and reasonableness of rates, it omitted some critical context:

> The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect.

Duquesne at 314 (quoted in part PPL M.B. at 28).

In Duquesne, the OCA argued and the United States Supreme Court agreed that Section 1315 of the Public Utility Code does not "take" property in violation of the Fifth Amendment to the Constitution simply because it disallows recovery of capital investments that are incurred by the utility but are not "used and useful." Duquesne at 301. Here, the issue is interpretation of the Public Utility Code and whether, under Pennsylvania law, a specific rate authorized by statute is just and reasonable if it allows recovery of costs that are not incurred by the utility.

Second, PPL's theory that individual expense adjustments do not bear on the "justness and reasonableness" of rates makes that standard effectively meaningless. There is an entire body of Commission Orders and judicial opinions construing Section 1301 of the Public Utility Code on expense adjustments ranging from consolidated taxes to rate case expense, hypothetical

capital structure and state income tax expense.[5] If all of these decisions regarding just and reasonable rates are ignored, the judgment of the Commission regarding the ratemaking provisions of the Public Utility Code would be effectively conclusive upon the reviewing court. Keystone Water Co. v. Pa. PUC, 477 Pa. 594, 609-10, 385 A.2d 946, 954 (1976).

Further, without the standards that have been developed by the Commission and the Pennsylvania appellate courts under the Public Utility Code, the litigation of base rate cases would have no specific consideration of any factors – with only the end result relevant to the ruling. This, the OCA submits, would be inconsistent with the requirement of Section 703(e) that the Commission's determinations be supported by specific findings:

> After the conclusion of the hearing, the commission shall make and file its findings and order with its opinion, if any. Its findings shall be in sufficient detail to enable the court on appeal, to determine the controverted question presented by the proceeding, and whether proper weight was given to the evidence.

66 Pa. C.S. § 703(e). Likewise, the Commonwealth Court has construed Section 315(a) of the Public Utility Code to require utilities to support the individual expenses underlying proposed and existing rates. The Court stated:

> Because 66 Pa. C.S. § 315(a) explicitly places upon a utility the burden of proving the reasonableness of its rates, logic compels the conclusion that Carnegie must prove the reasonableness of those expenses which form the basis for its rates.

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[5] Bell Tel. Co. v. Pa. PUC, 47 Pa. Commw. 614, 619-622, 408 A.2d 917, 921-922 (1979) (the Commission may properly exclude a portion of a utility's tax expense where there is evidence that the utility has not been afforded its fair share of benefits from filing a consolidated tax return with a parent corporation); see also UGI, 507 Pa. at 570, 493 A.2d at 657 (approving a consolidated tax adjustment because "[i]t is a violation of basic rate-making principles to charge ratepayers for theoretical expenses which in practice the utility bears no liability. This is true no matter the category of expense."); Butler Township Water Co. v. Pa. PUC, 81 Pa. Commw. 40, 45-46, 473 A.2d 219, 222 (1984) (approving Commission's adjustment to rate case expense for the unrealized portion of utility's normalized expense in subsequent case instituted before the period of normalization); Carnegie Nat'l Gas Co. v. Pa.PUC, 61 Pa. Commw. 436, 444, 433 A.2d 938, 942 (1981) (Carnegie) (Commission acted within its power by disallowing utility's actual income tax expense claim on the basis that the underlying capital structure was not just and reasonable); Penn Power at 515, 491 A.2d at 103 (normalization of state income tax expense is contrary to the requirement that rates approved by the Commission must be "just and reasonable"; it is improper to include any expense not actually incurred in the rates charged to ratepayers).

Carnegie, 61 Pa. Commw. at 444, 433 A.2d 938 at 942; see also Penn Power at 515 ("As the expert body, the Pennsylvania Public Utility Commission must make determinations about the propriety of proposed rates as part of its duty to see that rates are 'just and reasonable.' 66 Pa. Cons. Stat. § 1301").

Third, the General Assembly's inclusion of an earnings cap in Act 11 does not obviate the need for DSIC rates to be calculated to recover (only) the actual costs incurred by the utility. Even if the Company were correct – and it is not – that the just and reasonable standard does not mandate that rates reflect actual taxes paid, the plain language of Act 11 limits DSIC recovery to costs incurred by the utility. 66 Pa. C.S. §§ 1351, 1353. For the reasons already discussed in Section IV.C.4, PPL may not have excess earnings on a total company basis for reasons wholly unrelated to the DSIC, in which case the earnings cap would not prevent PPL's DSIC formula from overstating the surcharge revenue requirement. OCA St. 1-S at 3; OCA M.B. at 22.

F. The Actual Taxes Paid Doctrine Applies to the Calculation of the DSIC.

The Pennsylvania Supreme Court has held that no Commission approved rate is just and reasonable under Section 1301 of the Public Utility Code unless it is based on actual taxes paid by the utility. Penn Power, 507 Pa. at 521, 491 A.2d at 107 (citing Pittsburgh v. Pa. PUC, 182 Pa. Super. 551, 577-79, 128 A.2d 372, 384 (1956) (Pittsburgh I). 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 ("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).

PPL makes three arguments why it should be permitted to charge customers for taxes that it will not pay. PPL M.B. at 29-31. First, the Company argues that it does not calculate the taxes it pays based on individual items of plant or revenue and thus, it is not possible to reflect the actual taxes paid on the DSIC plant or revenue. Id. at 30. The fallacy of this position is that the Company does not propose a DSIC rate that recovers taxes on a total company basis. Instead, it proposes to recover only the taxes associated with the incremental DSIC plant or revenue. As discussed in Section D, *supra*, PPL has isolated the taxes associated with DSIC-eligible plant. The adjustments recommended by the OCA are necessary to correctly value those taxes.

Second, PPL argues that that the actual taxes paid doctrine does not apply to surcharges and, specifically, to the DSIC. PPL M.B. at 30. The General Assembly, Courts and Commission did not, it argues, intend for the DSIC to require full rate case analysis but rather that it be a simple mechanism. Id. PPL ignores that the actual taxes paid doctrine reflects the Court's interpretation of Section 1301 of the Public Utility Code, which applies to every rate approved by the Commission. 66 Pa. C.S. § 1301. While the doctrine was developed in base rate proceedings, it is no more lawful or appropriate for ratepayers to pay phantom income taxes in surcharge rates than in base rates.

As discussed above, PPL wants to pretend that surcharge recovery of return on capital investment is no different from surcharge recovery of an expense. The calculation of pre-tax profit is inherently more complex, however, than the simple tracking of an increase in an item of expense. See Sections IV. C, D, E, *supra*. While PPL is entitled to a return on its investment in distribution system improvements, it is not entitled to recover taxes on the DSIC plant or revenue that it will not pay.

Reflecting ADIT and the effective state income tax rate related to 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 accumulated depreciation on 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. The issue is limited to the appropriate calculation of the specific plant (and related taxes) that is being recovered in the DSIC rate.

Third and finally, PPL argues that, if the actual taxes paid doctrine does apply to surcharges, the General Assembly rejected application of the doctrine to the DSIC. PPL M.B. at 31. PPL's claim is contradicted by the plain language of the statute, which says that costs must be "incurred" by the utility in order to be recovered through the surcharge. 66 Pa. C.S. §§ 1351, 1353.

Even without that language, however, nothing within Act 11 expressly rejects the adjustment of the DSIC to reflect actual taxes paid. The rules of statutory construction provide that statutes are to be construed in harmony with existing law and as part of a general and uniform system of jurisprudence. See 1 Pa. C.S. § 1932; Erie Sch. Dist. Appeal, 39 A.2d 271, 155 Pa. Super. 564 (1944); Northern Tier. Specifically, the Commonwealth Court has stated that all provisions of Chapter 13 of the Public Utility Code must be read together. Popowsky 2005 at 1159. Thus, as part of Chapter 13 and its requirement that all rates be just and reasonable, Act 11 must be implemented consistent with its mandates and the applicable law, unless the Act expressly provides otherwise.

PPL argues instead that the Act impliedly rejects the actual taxes paid doctrine by providing a detailed formula for calculation of the DSIC that intentionally omits tax benefit adjustments. PPL M.B. at 31. The Company attempts to separate the tax benefits as distinct from the taxes themselves, which they are not. The tax benefits associated with DSIC investment and revenues exist because of the DSIC investment and revenue. OCA St. 1 at 5-6, 8, 11. The statute specifically provides for recovery of federal and state income taxes and the OCA has shown how the proposed calculation must be adjusted to recover those taxes in accordance with Act 11 and Section 1301.

As noted in Section IV.B, *supra*, if PPL's position were accepted, this would mean that there could be no adjustment for gross receipts taxes because the statute mentions income taxes only. 66 Pa. C.S. § 1357(b)(1). The removal of gross receipts taxes from PPL's DSIC calculation would have a greater effect than ignoring the necessary adjustments to reflect actual tax liability.

PPL claims that the OCA's proposed adjustments would "violate the mandate that surcharges be simple mechanisms" as set forth by the courts and the Commission. PPL M.B. at 31. The surcharge cases that PPL relies on (Gill and Equitable) involve expenses under Section 1307(a) rather than capital costs under Sections 1350 to 1360. See Section IV.C, *supra*; see Popowsky 2005 at 1155. While the Commission has expressed intent that the DSIC be a straightforward and simple mechanism, that intent can only be exercised in matters over which the Commission has discretion.[6] Penn Power, 507 Pa. at 521, 491 A.2d at 107; 66 Pa. C.S. §

[6] In Penn Power the Pennsylvania Supreme Court stated:

> Although we have held that the power to fix "just and reasonable rates" imports flexibility to a complicated regulatory function by a specialized decision-making body, we do not believe that the appropriate ratemaking treatment of deferred taxes is a matter within the unbridled discretion of the Commission.

Penn Power at 521 citing Pa. PUC v. Pennsylvania Gas and Water Co., 492 Pa. 326, 424 A.2d 1213 (1980).

1301. Also, the OCA has discussed above and in its Main Brief the manner in which PPL overstates the complexity of calculating the OCA's tax adjustments. See Section IV.C., *supra*; OCA M.B. at 19-22.

More to the point, however, the mandate regarding the DSIC is set forth in the statute (rather than by the courts or the Commission), and it is to provide for "timely recovery" of eligible costs "incurred" by the utility. 66 Pa. C.S. §§ 1353(a). Deducting ADIT will not impact the timeliness of PPL's recovery because the statute provides that the surcharge may take effect in as few as 10 days and be updated every three months to recover the Company's plant investment in the prior quarter. 66 Pa. C.S. § 1357(d)(3), (a)(1)(ii), (a)(2). Even if the calculation is contested, the rates can be put into effect subject to refund or recoupment, as was done in the case sub judice.[7] May 23 Order at 8, 19-20.

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).

G. That Every Other State Cited in this Proceeding Deducts ADIT from Surcharge Rate Base Provides Further Evidence of the Necessity and Feasibility of the Adjustment.

PPL's final argument is that the OCA's examples of DSIC calculations in other states are not relevant because the rules of statutory construction do not provide for other jurisdictions' consideration of an issue as evidence of legislative intent. PPL M.B. at 31.

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[7] The Commission similarly put other Act 11 DSICs into effect subject to refund or recoupment. Petition of Columbia Gas of Pa. for Approval of a DSIC, Docket No. P-2012-2338282, Order at 31 (Mar. 14, 2013); Petition of Peoples Natural Gas Co., LLC for Approval of a DSIC, Docket No. P-2013-2346161, Order at 65 (May 23, 2013); Petition of Peoples TWP, LLC for Approval of a DSIC, Docket No. P-2013-2346156, Order at 63-64 (May 23, 2013); Petition of Equitable Gas Co. for Approval of a DSIC, Docket No. P-2013-2342745, Order at 43 (July 16, 2013); Petition of Little Washington Wastewater Co. for Approval of a DSIC, Docket No. P-2013-2366873, Order at 44 (Sept. 12, 2013); 66 Pa. C.S. § 1358(d).

Throughout this proceeding, in response to concerns regarding the perceived complexity of including ADIT, the OCA has pointed out that water and gas utilities in other jurisdictions routinely include ADIT in their infrastructure surcharge. OCA St. 1-S at 2-3; OCA M.B. at 18-19. The OCA looked to these other states not as the basis for interpreting Act 11, as argued by PPL, but to show that ADIT is inextricably tied to valuing the surcharge rate base correctly and that it can, in fact, be readily calculated. Id.; PPL M.B. at 31. As noted on pages 21 to 22 of the OCA's Main Brief, PPL witness Torok testified on behalf of a Kentucky utility that was annually calculating ADIT related to plant recovered in its infrastructure surcharge.[8] In re: An Adjustment of the Gas Rate of the Union Light, Heat and Power Co., 246 PUR4th 1, 29, 31-32 (KyPSC 2005) (Union Light).

In addition to Kentucky, Commissions in many other states have routinely approved infrastructure investment recovery mechanisms that reflect ADIT in the surcharge calculation even though their authorizing statutes do not explicitly address ADIT.[9] OCA St. 1-S at 3. Indeed, as noted in the OCA's Main Brief, the recognition of ADIT associated with surcharge plant investment is treated as a matter of course. In other states, recognition of accumulated deferred income taxes has been incorporated in the statutes implementing DSIC-type mechanisms.[10]

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[8] The OCA mentions this utility and proceeding specifically because it was the only other state utility proceeding in which PPL witness Torok states that he has previously testified. At the time, Mr. Torok was Vice President of Tax for the utility's parent corporation. PPL St. 4-R at 2; Union Light at 6.

[9] 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; In re Atlanta Gas Light Co.'s Pipeline Replacement Program, 2009 GaPUC LEXIS 245, *10; 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.

[10] Mo. Rev. Stat. § 393.1009; Kan. Stat. Ann. § 66-2202; R.R.S. Neb. §§ 66-1866.

PPL points out that the specific mechanism for recovery differs in each state. PPL M.B. at 32. The fact is, however, that utilities in at least 12 jurisdictions are able to include ADIT in the surcharge calculation and do so as a matter of course. This is further indication that calculating ADIT is not too complex and is not in any way inconsistent with the use of a single-issue capital addition surcharge. It is also significant that, although DSIC type mechanisms are now somewhat common for natural gas and electric utilities around the Nation, PPL has not pointed to a single state or utility in its testimony or Main Brief that includes new plant investment in rate surcharges without making the obvious and necessary reduction for ADIT. Indeed, PPL has not pointed to a single state where this issue was even questioned by the utility implementing the surcharge.

PPL also argues that other states do not have earnings caps, suggesting that is why they account for ADIT. PPL M.B. at 32. The earnings cap does not prevent a utility from overstating its actual taxes in the DSIC revenue requirement, however, so they are not interchangeable. Section IV.C.4, *supra*. Some of the states have revenue caps and other protections, yet all use the ADIT offset.[11]

Interestingly, PPL criticizes the OCA for not advocating to include other major rate components which are included in DSIC-type mechanisms in other states, but not specifically included in Act 11. PPL M.B. at 32-33. This is directly contrary to PPL's insistence that even the components that <u>are</u> specifically included in Act 11 should not be calculated correctly

[11] Missouri's statute provides for recognition of ADIT as well as a cap on annual revenues that can be obtained through the surcharge. Mo. Ann. Stat. §§ 393.1003, 393.1009 (On an annualized basis, the surcharge may not produce in excess of ten percent of the utility's base revenue level approved in its most recent general rate proceeding). Kansas' statute contains both provisions also. Kan. Stat. Ann. §§ 66-2202, 66-2203 ("The commission may not approve a GSRS to the extent it would produce total annualized GSRS revenues exceeding 10% of the natural gas public utility's base revenue level approved by the commission in the natural gas public utility's most recent general rate proceeding.) Bay State Gas Company in Massachusetts has an infrastructure surcharge with a revenue cap and offsets for reduced Operations & Maintenance expense for leak repairs. <u>Petition of Bay State Gas Co.</u>, 2012 Mass. PUC LEXIS 160, *7. Columbia Gas of Kentucky also reduces its surcharge for savings for main maintenance. <u>Kentucky Order</u> at *49-50.

because it would be simpler to overstate them. Id. at 23, 26, 29. While the OCA has not proposed to expand the components of the DSIC, the OCA recognizes that the General Assembly left the task of determining the details of calculating a DSIC that would comply with Act 11 and the Public Utility Code to the Commission. Section 1357(c) provides:

> Utilities may file tariffs establishing a sliding scale of rates or other method for the automatic adjustment of the rates of the utility to provide for recovery of the depreciation and pretax return fixed costs of eligible property, as approved by the commission, that are completed and placed in service between base rate proceedings.

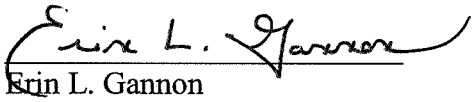
66 Pa. C.S. § 1357(c); see also 2011 Legsl. Journal – House at 1910. It is for that reason that the OCA did not oppose PPL's proposal to recover gross receipts taxes in the DSIC. OCA St. 1-S at 2; Section IV.B, *supra*.

As discussed on pages 12 to 16 of the OCA's Main Brief, it is standard ratemaking practice in every state and federal regulatory jurisdiction in the country that customers should not pay a return on capital that is not supplied by the utility's investors. In Pennsylvania, the balance of deferred federal taxes is treated as a reduction in the utility's rate base. OCA St. 1 at 5. Accordingly, for the DSIC rate to correctly reflect the utility's return, the calculation of DSIC rate base must reflect ADIT. The failure to recognize the ADIT offset would result in a rate that is unjust and unreasonable in violation of Section 1301 of the Public Utility Code and Commission orders. See gen'ly 66 Pa. C.S. § 1301; Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 53 PaPUC 410 (1979); Pa. PUC v. Philadelphia Elec. Co., 31 PUR4th 15, 52 PaPUC 772 (1978). This is consistent with Act 11's limitation of DSIC recovery to costs that are "incurred" by the utility. 66 Pa. C.S. §§ 1351, 1353(a).

V. CONCLUSION

For all of the foregoing reasons, as well as those set forth in the OCA's Main Brief, PPL Electric Utilities Corporation's proposed initial DSIC tariff must be revised. The Company should be directed to change its tariff and DSIC calculation consistent with the OCA's recommendations.

Respectfully submitted,



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Dated: December 20, 2013
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CERTIFICATE OF SERVICE

Petition of PPL Electric Utilities Corporation	:	
For Approval of a Distribution System	:	Docket No. P-2012-2325034
Improvement Charge	:	

I hereby certify that I have this day served a true copy of the foregoing Reply 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:

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