

COMMONWEALTH OF PENNSYLVANIA



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April 8, 2014

Rosemary Chiavetta, Secretary
PA Public Utility Commission
Commonwealth Keystone Bldg.
400 North Street
Harrisburg, PA 17120

Re: Petition of Little Washington Wastewater Company
for Approval of a Distribution System Improvement Charge
Docket No. P-2013-2366873

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Reply Brief in the above-referenced proceeding.

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

Respectfully submitted,

A handwritten signature in cursive script that reads "Erin L. Gannon".

Erin L. Gannon
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Attachment

cc: Honorable Susan D. Colwell
Certificate of Service
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Little Washington Wastewater Co. :
For Approval of a Distribution System : Docket Nos. P-2013-2366873
Improvement Charge : C-2013-2369886

REPLY BRIEF OF THE OFFICE
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DATED: April 8, 2014

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Reply Brief in response to Little Washington Wastewater Company's (LWWC or Company) Main Brief (M.B.) in this matter and pursuant to the Scheduling Order of Administrative Law Judge Susan D. Colwell (ALJ) dated October 8, 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 LWWC 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 5 to 6.

III. SUMMARY OF ARGUMENT

As LWWC states in its Main Brief, Act 11 provides for surcharge recovery of certain costs that are incurred by the utility. LWWC states:

Act 11 of 2012 (“Act 11” or “Act”) provides wastewater companies and other utilities with the ability to implement a Distribution System Improvement Charge (“DSIC”) to recover reasonable and prudent costs incurred to repair, improve or replace eligible property.

LWWC M.B. at 1 (emphasis added); see also LWWC M.B. at B-2. 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 Distribution System Improvement Charge (DSIC) calculation proposed by LWWC 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 4-8. This is because LWWC 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 LWWC 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. at 5-7; OCA St. 1-S at 1-2.

In its Main Brief, LWWC offers a myriad of flawed reasons why the DSIC revenue requirement should be calculated as if those tax benefits do not exist. LWWC M.B. at 8-23. In its testimony and Main Brief, the OCA addressed each of the Company’s objections and showed how LWWC can make the adjustments without undue complexity. OCA St. 1 at 5-8; OCA St. 1-S at 1-3. The bottom line, however, is that without these adjustments, LWWC’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 LWWC be required to 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 6. (Underline indicates new language.) In addition, the DSIC rate must also reflect the current state income taxes that LWWC actually pays to the Commonwealth. The Company's calculation of pre-tax return should be adjusted to recognize that LWWC 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 6-7.

IV. ARGUMENT

A. LWWC's DSIC Rate Should Be Calculated To Properly Reflect The Taxes Associated With The DSIC Plant.

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 requirements that all rates be just and reasonable. 66 Pa. C.S. § 1301. As discussed in 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. OCA M.B. at 11-34; OCA St. 1 at 4-6; OCA St. 1-S at 1-2. 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. OCA M.B. at 10-13; OCA St. 1 at 4-5. 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.

LWWC's proposed tariff provides that the rate base upon which the Company is allowed to earn a return is equal to the balance of the 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 to DSIC rate base. OCA St. 1 at 4-6; LWWC St. 1S, App. A (Revised Tariff Supp. 85) at 10DSIC2. As a result, the formula overstates LWWC's investment balance, *i.e.* it includes investment that was not funded by the utility, and allows LWWC to earn a return on an overstated investment balance. OCA St. 1 at 4-6. The OCA recommends, accordingly, that LWWC 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 and accumulated deferred income taxes.

OCA St. 1 at 6 (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, 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).

LWWC used the full statutory income tax rate to calculate its DSIC rate. Revised Tariff Supp. 85 at 10DSIC2; LWWC St. 1R at 4; OCA St. 1 at 8. As discussed on pages 21 to 24 of the OCA's Main Brief, however, the amount of state income taxes that LWWC will pay on DSIC revenues will be affected by tax deductions related to the DSIC investment, in particular the accelerated depreciation and bonus depreciation. OCA St. 1 at 8-9. Because LWWC 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.

LWWC 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 the use of the full statutory state income tax rate will allow the Company to charge ratepayers for state income taxes that it will not incur. Instead, LWWC provides reasons why, in its view, it is acceptable to charge customers for costs that it will not incur. LWWC M.B. at 8-23. As discussed in the OCA's

Main Brief and below, LWWC's reasons are wholly without merit. For ease of reference, the OCA addresses the Company's arguments in the same order presented in LWWC's Main Brief.¹

B. The Commission's Act 11 Final Implementation Order Did Not Result From An Adjudication And, Therefore, Is Not Binding.

LWWC argues that ADIT should not be recognized in the DSIC calculation because the proposal was already addressed and rejected by the Commission. LWWC M.B. at 9. Rather, as explained on pages 20 and 21 of the OCA's Main Brief, the Commission specifically referred issues related to the impact of ADIT associated with DSIC investments for "further disposition" in its September 12 Order instituting the present proceeding. Petition of Little Washington Wastewater Company For Approval of a DSIC, Docket No. P-2013-2366873, Order at 33-34, 44-45 (Sept. 12, 2013) (September 12 Order); see Petition of Philadelphia Gas Works for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2337737, Order at 10 (May 9, 2013) (approving a final tariff for Philadelphia Gas Works that differs materially from the model tariff).

In its Act 11 Final Implementation Order, the Commission identified three concerns, based on which it declined to include ADIT in the model DSIC tariff. Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order at 39 (Aug. 2, 2012) (Final Implementation Order). The Final Implementation Order did not result from an adjudication, however; 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

¹ LWWC makes an argument regarding the General Assembly's reliance on the water DSIC in two places in its brief. LWWC M.B. at 13-14, 17-18. The OCA will address this argument in Section IV.D, *infra*, (only).

Public Utility Code)²; Final Implementation Order at 2-3. The current adjudicated proceeding, thus, is the OCA's first opportunity to develop a record responding to those concerns and to demonstrate through record evidence that ADIT is a necessary component of LWWC's DSIC calculation.

LWWC raises a second, similar argument, that the OCA's recommendations have been addressed and rejected in the DSIC proceeding of another utility, Columbia Gas of Pennsylvania. LWWC M.B. at 10-12; Petition of Columbia Gas of Pa., Inc. for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2338282, R.D. (Feb. 25, 2014) (Columbia RD). The Company points out that the OCA's testimony in that proceeding was substantively similar to its testimony here. Id. at 12. The presiding officers and Commission will render their decision in each DSIC proceeding based on the record developed in the case before them. Exceptions and Reply Exceptions are now before the Commission in the Columbia case. With those provisos, the OCA points out that in their Recommended Decision in Columbia, the Presiding Officers rejected several of the same arguments presented by LWWC in this

² 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.

proceeding. Columbia RD at 14-24. The OCA will address the ALJs' findings in the relevant sections below.

C. Accumulated Deferred Income Taxes

1. The Stated 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.

LWWC claims that recognition of ADIT in the DSIC calculation is contrary to the plain language of Act 11 and its legislative intent. LWWC M.B. at 12-14. The Company argues that the language of the statute omits mention of adjustments for ADIT. LWWC M.B. at 13, citing 66 Pa. C.S. § 1357. LWWC is partly 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 incorrect, however, 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 LWWC 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.

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, LWWC argues that the General Assembly chose not to amend Act 11 to incorporate “tax benefits” as an offset in the final DSIC calculation. LWWC M.B. at 11-12. In fact, the General Assembly considered a different proposal. The referenced pages from the House Legislative Journal relate to an amendment proposed to limit DSIC recovery to “net increases” in eligible property. LWWC M.B. at 12 (citing 2011 Pa. Legisl. Journal – House 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, LWWC ignores the response of Representative Reichley in opposition to the proposed amendment. 2011 Legisl. Journal – House at 1910 (Oct. 3, 2011). 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.

LWWC points out that, in the Columbia RD, the ALJs found that the plain language of Act 11 and its legislative history do not specifically include the ADIT adjustment proposed by the OCA. LWWC M.B. at 14 citing Columbia RD at 48. The Company ignores that the ALJs also rejected the utility's argument that Act 11 or its legislative history exclude the OCA's recommended adjustments for ADIT and effective state income taxes. R.D. at 18-24. Specifically, the ALJs held:

The fact that neither of the OCA's modifications appear in the language of the statute is not dispositive of the issue of whether the General Assembly intended for the modifications proposed by the OCA to be included in the DSIC mechanism adopted in Act 11.

Id. at 18. They stated further:

Although the sponsor of the proposed amendment intended to offset the change by incorporating "tax benefits", there is no evidence that the intent of the legislature in rejecting the proposed amendment was to specifically exclude additional ADIT on DSIC plant as an offset to eligible plant to be reflected in the DSIC.

...

Although the General Assembly's 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, nothing in the legislative history suggests that the Commission should be constrained to follow the exact procedures utilized in water DSIC proceedings.

Id. at 20.

Although its Main Brief does not address the issue, in its Proposed Conclusions of Law, LWWC contends that the rules of statutory construction do not provide for consideration of other jurisdictions' statutes as evidence of legislative intent. LWWC M.B. at B-2-B-3. 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 even though their authorizing statutes do not specifically address ADIT.³ OCA St. 1-S at 2-3; OCA M.B. at 12-15, 19-20. 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. OCA M.B. at 19. In other states, recognition of accumulated deferred income taxes has been incorporated in the statutes implementing DSIC-type mechanisms.⁴ The OCA looked to these other states not as the basis for interpreting Act 11, but to show that ADIT is inextricably tied to valuing the surcharge rate base correctly and that it can, in fact, be readily calculated. OCA M.B. at 12-15, 19-20.

It is also significant that, although DSIC type mechanisms are now somewhat common for natural gas and electric utilities around the Nation, LWWC 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, LWWC has not pointed to a single state where this issue was even questioned by the utility implementing the surcharge.

³ 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; Code Me. R. 65-407-675 § 6; 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.

⁴ Mo. Rev. Stat. § 393.1009; Kan. Stat. Ann. § 66-2202; R.R.S. §§ 66-1866.

In conclusion, the purpose of Act 11 is to allow LWWC to recover eligible costs incurred between base rate cases. The General Assembly did not intend for the DSIC calculation to recover costs that will not be incurred. LWWC's arguments are not consistent with the plain language of Act 11 and must be rejected.

2. The ADIT Adjustment Is Consistent With The Intentions Of The General Assembly And The Commission To Establish A Straightforward Mechanism.

LWWC claims that including ADIT in the calculation of the DSIC rate base is contrary to the Commission's intent to establish a simple surcharge mechanism. LWWC M.B. at 15-17. LWWC avers that including ADIT is complicated and that having a complicated DSIC calculation would defeat the purpose of the DSIC, which is to be a simple and easy mechanism for cost recovery. Id. at 15-16. The purpose of the statute is not to make it easy for LWWC to recover costs, however, particularly if those costs are not actually incurred. 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. Deducting ADIT will not impact the timeliness of LWWC's recovery because the statute provides that the surcharge may take effect in as few as 10 days. 66 Pa. C.S. § 1357(d)(3). 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*.⁵ September 12 Order at 33-34, 43-44.

The Company acknowledges that ADIT and tax effects of flow through timing differences of DSIC eligible investment are not represented in LWWC's current base rates, but

⁵ The Commission similarly put other Act 11 DSIC into effect subject to refund or recoupment. Petition of Columbia Gas of Pa., Inc. for Approval of a DSIC, Docket No. P-2012-2338282, Order at 46 (Mar. 14, 2013); Petition of PPL Elec. Util. Corp. for Approval of a DSIC, Docket No. P-2012-2325034, Order at 19-20 (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 Peoples Natural Gas Co., LLC for Approval of a DSIC, Docket No. P-2013-2344596, Order at 64 (May 23, 2013); Petition of Peoples Natural Gas Co., LLC - Equitable Division For Approval of a DSIC, Docket No. P-2013-2342745, Order at 30, 35, 42-43 (July 16, 2013); 66 Pa. C.S. § 1358(d).

argues that a lesser ratemaking standard should apply because the costs are being recovered through a surcharge. LWWC M.B. at 15-16. Specifically, LWWC 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. Id. (citing Popowsky v. Pa. PUC, 683 A.2d 958 (Pa. Commw. Ct. 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. There are two critical distinctions between the issue in Equitable and the issue here. First, Act 11 addresses recovery of a capital cost. The Commonwealth Court has recognized that recovery of capital costs includes additional components:

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.

Popowsky v. Pa. PUC, 869 A.2d 1144, 1155 (Pa. Commw. Ct. 2005) (Popowsky 2005) (citing Pennsylvania Indust. Energy Coalition v. Pa PUC, 653 A.2d 1336, 1341 (Pa. Commw. Ct. 1995) (PIEC)).

Stated otherwise, it cannot be ignored that the DSIC rate recovers capital costs versus a straightforward utility expense. The degree of simplicity that LWWC seeks is not possible in a calculation of pre-tax profit that will be recovered through the DSIC rate. It is not just and reasonable for LWWC to earn a return on zero cost taxpayer-supplied funds that are universally excluded from rate base as a matter of basic ratemaking fairness. ADIT is a necessary and

unavoidable component of a calculation that produces a just and reasonable rate that meets the requirements of Act 11 and Section 1301.

Second, in direct contrast to Equitable, the OCA does not propose to broaden the scope of the DSIC. By statute, the incremental DSIC property and federal income taxes for DSIC-eligible plant are already part of the calculation. 66 Pa. C.S. § 1357(b)(1). The issue here is that the DSIC formula proposed by LWWC will overstate the DSIC-eligible 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 reducing investment to account for the amount that was not funded by the Company. OCA St. 1 at 4-6.

This would certainly not, as suggested by the Company, be the equivalent of “full blown” base rate review and does not entail a review of other categories of expenses. LWWC M.B. at 15-16. There will be no consideration, *inter alia*, of depreciation associated with plant investment already included in base rates, offsetting O&M savings, or any other offsetting changes that occur between base rate cases. 66 Pa. C.S. § 1357(a). As such, LWWC’s reliance on the Commonwealth Court’s decision in Equitable is misplaced.

3. The General Assembly Did Not Simply Extend The Prior Water DSIC Legislation To Other Utilities In Act 11 And Did Not Prevent The Commission From Applying Appropriate Ratemaking Standards.

LWWC argues that the General Assembly and the Commission relied on the water DSIC, which has not included an ADIT adjustment, in enacting and implementing Act 11 and, thus, there is no reason or need for LWWC to include the adjustment in its DSIC calculation. LWWC M.B. at 13-14, 17-18. The flaw in LWWC’s position is that failure to recognize ADIT will overstate the investment balance and allow LWWC to earn a return on funds that were not supplied by investors. Again, this obvious flaw explains why utilities in every state cited by the

OCA in its Main Brief deduct ADIT from the surcharge rate base whether or not the requirement is spelled out in a statute. OCA M.B. at 19; see OCA St. 1 at 5; OCA St. 1-S at 2-3.

If the Pennsylvania General Assembly intended to duplicate the model water tariff for all utilities – without change – it could have stated that the existing water model tariff should be utilized for all utilities or it could have simply amended Section 1307(g) to apply to all utilities. Either of these options would be more consistent with LWWC’s argument for continuing the DSIC status quo. 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, but that did not occur here. 2002 Pa. H.B. 2754, Printer’s No. 4278; 2003 Pa. H.B. 1841, Printer’s No. 3852.

Instead, however, 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). 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).

In a footnote, LWWC contends that the House Bill underlying 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 14 n.34, citing 2012 Pa. Legisl. Journal – House 155 (Feb. 7, 2012). The referenced statement, however, was made in the context of describing Senate amendments to the Bill to distinguish them from the House version. 2012 Pa. Legisl. Journal – House 155. 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.” Id. at 155-56. As can be seen, nothing in the referenced statement indicates that all procedures for water utilities were to be memorialized in the Bill.

The OCA’s position is consistent with the ALJs findings in the Columbia DSIC proceeding. The ALJs stated there:

The language of Act 11 does not set forth a specific requirement that the water DSIC model be followed in the instant case. As the OCA suggests, if this was intended, the General Assembly could have simply amended Section 1307(g) to include these other utilities, which it did not. See 66 Pa. C.S. § 1307(g) (1996). In addition, there are provisions in the Act where water utilities remain subject to different treatment. For instance, as the OCA explains, the General Assembly provided a specific DSIC cap of 5% of distribution rates for wastewater, electric distribution and natural gas distribution companies (EDCs and NGDCs), and city natural gas operations in Section 1358(a)(1), whereas the cap for water companies is set at 7.5% in Section 1358(a)(2). See 66 Pa. C.S. §§ 1358(a)(1), 1358(a)(2). Additionally, Act 11 states that Commission rules and orders relating to DSICs established prior to Act 11 would 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).

Columbia RD at 20-21.

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).

LWWC also argues that the Commission should not include an ADIT adjustment because, prior to Act 11, it had not done so. LWWC M.B. at 17-18. The Company ignores that the water DSICs were authorized by 66 Pa. C.S. § 1307(g), a statute that was repealed by the

statute at issue in this proceeding. Further, 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 ADIT or recognition of actual state income taxes from the new DSIC calculation approved for utilities under Act 11. The issue is particularly important, now, because the surcharge will be applied to more customer bills - natural gas, electric and wastewater - and for some customers that will mean paying a DSIC on multiple utility bills. 66 Pa. C.S. § 1351.

In conclusion, the purpose of Act 11 is to allow LWWC to recover eligible costs incurred between base rate cases. The General Assembly did not intend for the DSIC calculation to recover costs that will not be incurred. LWWC's arguments are not consistent with the plain language of Act 11 and must be rejected.

4. The Earnings Cap Does Not Prevent The DSIC Rate From Being Overstated Where It Charges Ratepayers A Return On Funds That Were Not Supplied By The Company.

LWWC asserts that the earnings cap compensates for its failure to reflect its actual federal income tax expense in the DSIC calculation. LWWC M.B. at 18-20. The Company argues that the earnings cap captures the revenue impact of all other adjustments, including the OCA's ADIT adjustment and insures that the DSIC does not result in unreasonable rates. *Id.* at 19. 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 16-17. The earnings cap does not prevent utilities from overstating the surcharge revenue requirement and improperly charging ratepayers a return on funds that were not supplied by investors. As discussed in the OCA's Main Brief, if LWWC 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 M.B. at 16-17; OCA St. 1-S at 2.

Citing Duquesne Light Co. v. Barasch, LWWC 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. LWWC M.B. at 19-20 (citing 488 U.S. 299 (1989) (Duquesne)). The premise of LWWC's position is that, as Act 11 provides an earnings cap, there can only be two results: (1) the cap will prevent the Company from charging a DSIC or (2) any DSIC that it does charge will be just and reasonable under the Duquesne standard. Id. LWWC'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 LWWC's DSIC calculation. Second, under LWWC's theory, every ratemaking adjustment has no meaning and no ratemaking decision would be reviewable. Third, the earnings cap is not the panacea that LWWC suggests. The OCA addresses each reason in detail below.

First, LWWC 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 of 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. The Court stated:

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 314 (discussing Hope Natural Gas Co., 320 U.S. 591, 605 (1944) (emphasis added)). Here, there is no utility property being taken and no disallowance, as this is about costs never even

incurred by the utility. Moreover, the present proceeding is about the 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.

Second, LWWC'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 to hypothetical capital structure to state income tax expense. 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 – if LWWC's theory were adopted. 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 the 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 these expenses which form the basis for its rates.

Carnegie Nat'l Gas Co. v. Pa. PUC, 61 Pa. Commw. 436, 444, 433 A.2d 938, 942 (1981); 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”).

Finally, 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, LWWC 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 LWWC’s DSIC formula from overstating the surcharge revenue requirement. OCA M.B. at 16-17; OCA St. 1-S at 2.

5. Summary

As discussed on pages 9 to 16 of the OCA’s Main Brief, 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).

D. State Income Taxes

LWWC used the full statutory income tax rate to calculate its DSIC rate. Revised Tariff Supp. 85 at 10DSIC1; OCA St. 1 at 6-7; see also OCA M.B. at 21-24. However, LWWC will not pay state income taxes on its DSIC income. This is because the deductions for the repair allowance and accelerated depreciation far exceed the state taxable income that will be generated

by its DSIC. OCA St. 1 at 6-7. LWWC's approach is not allowed by Pennsylvania law, which requires that state income tax deductions must be reflected in rates on a current basis, consistent with the "actual taxes paid" doctrine.⁶ To make the DSIC calculation correct (to allow recovery only for costs actually incurred by the utility), the flow-through of the state income tax deductions associated with DSIC plant must be accounted for in determining the state income taxes that are included in the DSIC pre-tax rate of return. OCA St. 1 at 7.

1. It Is Consistent With Pennsylvania Law To Apply The Effective, Rather Than Statutory, State Income Tax Rate.

As discussed in the OCA's testimony and Main Brief, the state income taxes that LWWC will pay on DSIC revenues are affected by tax deductions related to the DSIC investment, in particular the accelerated depreciation and, when applicable, bonus depreciation. OCA St. 1 at 8-9; OCA M.B. at 21. Because LWWC will not pay state income taxes on the full amount of its equity return, these deductions should be taken into account in determining state taxable income and state income tax expense. The state income tax rate used to calculate DSIC revenue requirement should reflect the state income tax expense actually paid and, accordingly, the effective state income tax rate may be less than the full statutory rate. Id.

The Company argues, however, that the plain language of the statute shows that the pretax return for DSIC purposes is to be calculated using the statutory state income tax rate

⁶ 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)). 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 rates."

Pa. PUC v. Jackson Sewer Corp., 2001 PaPUC LEXIS 53, *47 citing Barasch v. Pa. PUC, 507 Pa. 61, 493 A. 2d 653 (1985) (UGI) ("When the PUC approves hypothetical expenses not actually incurred, it commits an error of law"); see also Popowsky v. Pa. PUC, 695 A.2d 448, 455 (Pa. Commw. Ct. 1997).

rather than the effective income tax rate. LWWC M.B. at 20. The statute does not specify that “statutory” tax rates must be used, nor does it prohibit the Commission from approving a DSIC calculated to recover only those costs incurred by LWWC. 66 Pa. C.S. §§ 1350, et seq. 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.

Moreover, statutes are to be construed in harmony with the existing law and as part of a general and uniform system of jurisprudence. 1 Pa. C.S. § 1932; Popowsky 2005 (all provisions of the Code that relate to ratemaking must be read together); Northern Tier; Erie Sch. Dist. Appeal, 155 Pa. Super. 564, 39 A.2d 271 (1944). It must be presumed that the General Assembly intended for DSICs established pursuant to Act 11 to comply with the existing requirement of Section 1301 that every rate – whether established in a Section 1308 base rate proceeding or a Section 1350 surcharge – must be just and reasonable. 66 Pa. C.S. §§ 1301, 1308, 1353. The Pennsylvania Supreme Court has determined that just and reasonable rates must reflect the actual taxes paid and, conversely, that rates that do not reflect the actual taxes paid cannot be just and reasonable for purposes of Section 1301. Penn Power, 507 Pa. at 521,

491 A.2d at 107; 66 Pa. C.S. § 1301; see OCA M.B. at 21-23. It is, thus, consistent with the language of Act 11 and Section 1301 as it has been interpreted by the Courts and the Commission to approve a DSIC rate that is calculated to recover only the state income tax expense actually incurred by LWWC.

LWWC also suggests that the Commission has already addressed the OCA's proposed tax adjustments in its Final Implementation Order.⁷ LWWC M.B. at 20. In fact, the OCA did not raise and the Commission did not address the OCA's concern with using a statutory state income tax rate in its Final Implementation Order beyond the mention that state income tax rates are a component of the pretax return calculation. Final Implementation Order at 31; 66 Pa. C.S. § 1357(b)(1). The current adjudicated proceeding is the OCA's first opportunity to demonstrate through record evidence that the state income tax rate used to calculate LWWC's DSIC revenue requirement should reflect the state income tax expense actually paid. See Section IV.B., *supra*.

The Company argues that using the statutory state income tax rate is easier to calculate and audit. LWWC M.B. at 21 citing LWWC St. 1R at 4. 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. The Commission has no discretion to ignore the requirement to flow through state income tax benefits in the DSIC rate because Act 11 limits DSIC recovery to costs incurred by utilities. 66 Pa. C.S. §§ 1351, 1353. In addition, flow-through of state income tax benefits is a requirement of just and reasonable rates under Pennsylvania law. Penn Power, 507 Pa. at 521, 491 A.2d at 107; 66 Pa. C.S. § 1301. The OCA's proposed correction to the gross-up for state income taxes ensures that ratepayers are

⁷ In the Columbia RD, the ALJs noted that the Commission did not specifically permit or prohibit the state income tax gross-up issue in the Final Implementation Order. Columbia RD at 63.

charged only for state income taxes actually paid, consistent with the actual taxes paid doctrine and legally-required ratemaking practice in Pennsylvania. OCA St. 1 at 8; 66 Pa. C.S. § 1353(a).

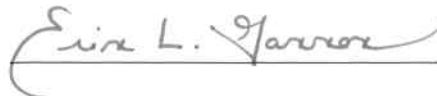
2. The Earnings Cap Does Not Prevent The DSIC Rate From Being Overstated When The Effective State Income Tax Rate Is Less Than The Statutory Rate.

As with ADIT, LWWC takes the position that it is not necessary to flow through state income tax deductions in the DSIC rate because there is an earnings cap. LWWC M.B. at 21-23. It relies on the ALJs' conclusion in the Columbia RD that the earnings cap reflects the "total effect of rates" and specifically, the actual amount of state income taxes paid, which makes it unnecessary to reflect actual taxes paid in the DSIC formula. LWWC M.B. at 22 quoting Columbia RD at 64. As discussed above, the earnings cap can only prevent a utility from charging a DSIC when its reported quarterly earnings exceed a certain rate of return. See Section IV.C.4, *supra*. 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. The earnings cap is not a substitute for adjusting the gross-up for state income taxes because it does not prevent utilities from overstating the surcharge revenue requirement and improperly charging ratepayers for state income taxes that the utility will not pay. OCA St. 1-S at 3. That result will only be avoided if the flow-through of the state income tax deductions associated with the DSIC plant is accounted for in determining the state income taxes that are included in the DSIC pre-tax rate of return.

V. CONCLUSION

For all of the foregoing reasons, as well as those set forth in the OCA's Main Brief, Little Washington Wastewater Company's proposed initial DSIC tariff and rate must be revised. The Company should be directed to change its tariff and DSIC calculation consistent with the OCA's recommendations and refund any excess revenues charged due to the gross-up of the pre-tax rate of return at the full state income tax rate and the failure to deduct ADIT from rate base.

Respectfully Submitted,



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DATE: April 8, 2014
181446

CERTIFICATE OF SERVICE

Re: Petition of Little Washington Wastewater Company
For Approval of a Distribution System Improvement Charge
Docket No. P-2013-2366873

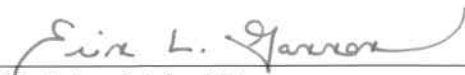
I hereby certify that I have this day served a true copy of the Office of Consumer Advocate's Reply Brief, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code §1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 8th day of April 2014.

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