

COMMONWEALTH OF PENNSYLVANIA



OFFICE OF CONSUMER ADVOCATE

555 Walnut Street, 5th Floor, Forum Place
Harrisburg, Pennsylvania 17101-1923
(717) 783-5048
800-684-6560

FAX (717) 783-7152
consumer@paoca.org

June 6, 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
Exceptions in the above-referenced proceeding.

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

Respectfully submitted,

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

Erin L. Gannon
Assistant Consumer Advocate
PA Attorney I.D. #83487

Attachment

cc: Honorable Susan D. Colwell
Office of Special Assistants at ra-OSA@pa.gov
Certificate of Service

184404.doc

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 EXCEPTIONS OF THE OFFICE
OF CONSUMER ADVOCATE

Erin L. Gannon
Assistant Consumer Advocate
PA Attorney I.D. #83487

Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. #50026

Counsel for:
Tanya J. McCloskey
Acting Consumer Advocate

Office of Consumer Advocate
555 Walnut Street,
5th Floor, Forum Place
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Reply to the Exceptions of Little Washington Wastewater Company (LWWC or Company). The OCA urges the Public Utility Commission (Commission) to adopt the Administrative Law Judge's well-reasoned positions contained in the Recommended Decision and supported by the OCA below.

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.

For the reasons below, and those contained in the ALJ's Recommended Decision, the OCA's Main Brief and the OCA's Reply Brief, the Exceptions of LWWC should be rejected.

II. REPLIES TO EXCEPTIONS

Reply to LWWC Exception No. 1: The ALJ Followed the Commission's Directive to Review and Determine Whether LWWC Should Be Required to Include ADIT in Its DSIC Calculation. R.D. at 17-23; OCA M.B. at 18; OCA R.B. at 7-8.

Federal income tax benefits associated with DSIC plant investment generate zero-cost funds that partially pay for that plant investment, *i.e.* not all of the plant investment must be financed or paid for by shareholders. OCA St. 1 at 5. The express language of the statute limits DSIC recovery to costs incurred by utilities. 66 Pa. C.S. §§ 1351, 1353. Accordingly, the DSIC calculation must reflect the tax benefits associated with DSIC investment or the rate will recover costs not incurred by the Company, in violation of Act 11 and the requirement that rates be just and reasonable. OCA St. 1 at 4-5.

The ALJ recommended that LWWC be directed to modify its DSIC calculation to include the ADIT adjustment. R.D. at 23. LWWC excepts to this recommendation on the basis that the adjustment was already addressed and rejected by the Commission in its Final Implementation Order. LWWC Exc. at 6-7, citing Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order (Aug. 2, 2012). Following the issuance of the Final Implementation Order, however, the Commission entered an order in this proceeding, specifically referring issues related to the impact of ADIT associated with DSIC investments and the calculation of the state income tax component of the DSIC revenue requirement for "further disposition." R.D. at 18-19; Petition of Little Washington Wastewater Co. For Approval of a DSIC, Docket No. P-2013-2366873, Order at 33-34, 44-45 (Sept. 12, 2013) (September Order).

The ALJ explained:

[t]he Commission assigned this issue to OALJ after it issued the Final Implementation Order. From a procedural standpoint, the Commission could have simply decided this issue as well, as the Final Implementation Order determines the answer in what appears to be a conclusive manner. Because the Commission

could have dismissed the OCA complaints in both cases based solely on its prior determination in the Final Implementation Order, as it decided the other issues in the case, but declined to do so, I can only conclude that the Commission decided to revisit this issue and seeks a thorough analysis which may or may not lead to a different result. Accordingly, I will interpret the Commission's assignment of this issue to OALJ as a directive to evaluate the arguments independent of the Commission's Final Implementation Order.

R.D. at 19¹; 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 further support of the ALJ's decision to conduct an independent analysis, the OCA notes that Final Implementation Order is not a binding norm that has the force of law. Chapter 14 Implementation, 2005 PaPUC LEXIS 20, *18-20, quoting Hardiman v. Commonwealth, 550 A.2d 590 (Pa. Commw. Ct. 1988); 45 Pa. C.S. § 501.² The Final Implementation Order did not

¹ The OCA agrees with the ALJ's conclusion but filed an exception to clarify one statement within the ALJ's discussion. OCA Exc. at 5-6. The OCA does not agree that the Commission could have dismissed the OCA complaints in both cases based solely on its prior determination in the Final Implementation Order, *i.e.* without an evidentiary record. Id. The OCA's position is that the Final Implementation Order is in the nature of a policy statement and not a binding norm that has the force of law. Id.; OCA R.B. at 7-8.

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

result from an adjudication; it is a policy statement setting forth how the Commission intends to interpret Act 11 in future adjudications and rulemakings. The current adjudicated proceeding, thus, is the OCA's first opportunity to demonstrate through record evidence that ADIT is a necessary component of LWWC's DSIC calculation. The ALJ is not bound to reach the same conclusion as the Commission did in its Final Implementation Order.

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 Exc. at 6-7; Petition of Columbia Gas of Pa., Inc. for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2338282, Order (May 22, 2014) (Columbia Order). In every DSIC proceeding filed pursuant to Act 11, the Commission has entered an order specifically referring the OCA's proposed tax adjustments for "further disposition."³ For the same reasons discussed above, the presiding officer in each utility's DSIC proceeding is not constrained to reach the same result as the Final Implementation Order and will conduct an independent evaluation of the law and evidence. R.D. at 18-19.

Next, LWWC argues that the ADIT adjustment and the portions of the Recommended Decision addressing it should be rejected because the adjustment is not required by the plain language of Act 11, is too complex and is not necessary to ensure just and reasonable rates.

forth how the Commission intends to interpret Chapter 14 in future adjudications and rulemakings.

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

³ See, e.g., Columbia Order at 46; 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); September Order at 33-34, 44-45.

LWWC Exc. at 6-7. The OCA will rebut each of these substantive arguments in its reply to LWWC Exceptions 2 through 4, infra.

Finally, LWWC argues that the ALJ's recommendation is not consistent with the historic water DSIC, which does not include an ADIT adjustment. LWWC Exc. at 7. The ALJ correctly found, however, there is no requirement in the statute that new DSIC plans comport with the existing water DSICs. R.D. at 23; OCA R.B. at 15-18; see Columbia Order at 15-16 ("there is no evidence that the General Assembly intended that the Commission be required to automatically adopt all aspects of the formula used by water utilities"). Rather, 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.

Id. This provision 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.

For all of these reasons, LWWC's exception should be denied.

Reply to LWWC Exception No. 2: The ALJ Correctly Determined That the Plain Language of Act 11 Requires That the Calculation of the DSIC Include Recognition of ADIT. R.D. at 20-23; OCA M.B. at 11-34; OCA R.B. at 5, 9-11.

LWWC excepts to the ALJ's conclusion that "plain language" supports the ADIT adjustment, LWWC Exc. at 8, citing R.D. at 22. The Company reasons that, because the statute does not specifically mention ADIT (or actual state income taxes), the statute does not require LWWC to recognize ADIT in its DSIC calculation. LWWC Exc. at 8, citing Columbia Order at 35. The ALJ rejected this argument because the statute does specify that only costs "incurred" by the utility shall be recovered through the surcharge. R.D. at 21-22; 66 Pa. C.S. §§ 1351, 1353. The ALJ stated:

LWWC's formula, which does not include an adjustment for ADIT, charges ratepayers for taxes which have not been incurred.

The wording in the statute provides further support for the OCA position:

§ 1353. Distribution system improvement charge

(a) Authority.-Except as provided under this subchapter, after January 1, 2013, a utility may petition the commission, 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).

The "timely recovery of the reasonable and prudent costs incurred" cannot be read to include the recovery of taxes which have not been paid. Nowhere in the legislation is there approval of the creation of a "source of interest-free funds, provided by ratepayers and not investors." Rate Case and Audit Manual Prepared by NARUC Staff Subcommittee on Accounting and Finance (2003) at 24. Every statute shall be construed, if possible, to give effect to all its provisions. 1 Pa. C.S. § 1921(a); OCA RB at 9. Applying the "plain language" argument advanced by LWWC supports the inclusion of the ADIT adjustment, not its exclusion.

R.D. at 21-22. As stated by the ALJ, the plain language of Act 11 requires that the DSIC rate be calculated to recover only costs incurred by LWWC. 66 Pa. C.S. §§ 1351, 1353. This is not accomplished if the DSIC calculation recovers a return on dollars that were not invested by shareholders and state taxes that were not paid by the utility. OCA St. 1 at 4-6; OCA St. 1-S at 1-2. The OCA's adjustments for ADIT and actual state income taxes are necessary to meet the explicit requirement of Act 11 that only costs incurred shall be recovered through the charge. R.D. at 21-23; OCA M.B. at 11-34; OCA R.B. at 5, 9-11.

LWWC also contends that the legislative history does not warrant factoring ADIT into the Company's DSIC calculation. LWWC Exc. at 8, citing LWWC M.B. at 13-14 and LWWC R.B. at 8. The ALJ correctly observed that the actual words of the statute, which are clear, do not require further investigation. R.D. at 20; 1 Pa. C.S. § 1921(b). Even if the legislative history is considered, however, it does not support LWWC's arguments. First, the amendment referenced by LWWC did not address the OCA's tax adjustments. OCA R.B. at 10. The referenced pages from the House Legislative Journal relate to an amendment proposed to limit DSIC recovery to "net increases" in eligible property. 2011 Pa. Legisl. Journal – House 1909 (Oct. 3, 2011); see also Columbia Order at 18 ("we agree with the OCA that there is no indication that the General Assembly specifically considered and rejected the OCA's tax related proposals"). Second, as discussed *supra*, the language in Section 1358(a)(2) demonstrates that the General Assembly did not intend for the Commission to automatically apply the DSIC calculation historically used by water utilities. OCA R.B. at 15-18; see also Columbia Order at 18 ("we cannot conclude, based on the evidence in this proceeding, that that the General Assembly intended that the Commission automatically adopt the DSIC formula historically used by water utilities"); see also 2011 H.B. 1294, A.2783 (repealing 66 Pa. C.S. § 1307(g)).

In conclusion, Act 11 allows LWWC to recover eligible costs incurred between base rate cases. 66 Pa. C.S. §§ 1351, 1353. The plain language of the statute does not allow the DSIC calculation to recover costs that will not be incurred. Id. Failure to recognize ADIT will overstate the investment balance and allow the Company to earn a return of funds that were not supplied by investors, *i.e.* not incurred. Accordingly, the ALJ correctly concluded that LWWC's proposed DSIC formula is not just and reasonable without adjusting the calculation to reflect ADIT. LWWC's exception should be rejected.

Reply to LWWC Exception No. 3: The ALJ Correctly Found That the Earnings Cap Alone Cannot Ensure that the DSIC Will Be Just and Reasonable. R.D. at 23, 25; OCA M.B. at 17; OCA R.B. at 18-21.

On pages 9 to 11 of its Exceptions, LWWC excepts to the ALJ's conclusion that LWWC has failed to meet its burden of proving that its DSIC formula is just and reasonable without the ADIT adjustment. R.D. at 23. LWWC contends that the earnings cap captures the revenue impact of all other adjustments including the current book amount of ADIT and ensures that the DSIC will not result in unreasonable rates. LWWC Exc. at 10. Further, the Company argues that individual expense adjustments do not bear on the "justness and reasonableness" of rates; it is adequate if the total effect of the rate is just and reasonable. Id., citing Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) (Duquesne). For the reasons discussed below, both arguments are flawed and do not provide support for the Company's exception.

The ALJ did not accept LWWC's assertion that the earnings cap compensates for the Company's failure to reflect its actual federal income tax expense in the DSIC calculation. R.D. at 23, 25. The ALJ correctly concluded that the earnings cap will accomplish what it is intended to accomplish: to prevent a utility from charging a DSIC when its reported quarterly earnings exceed the rate of return authorized in its last base rate case or in the Commission's Quarterly Earnings Report. R.D. at 28, citing 66 Pa. C.S. § 1357(b)(2)-(3). Reflecting ADIT in the earnings report is not the equivalent of reflecting ADIT in rates. 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 17. LWWC may not have excess earnings on a total company basis for reasons wholly unrelated to the DSIC. For example, LWWC might be under-earning due to an increase in postage expense or management retirement bonuses. In this example, the earnings cap would not prevent the utility from charging ratepayers a return on funds that were not supplied by investors. OCA M.B. at 17; OCA R.B. at 18-19; OCA St. 1-S at

3; see R.D. at 25. This is only prevented if the investor-supplied funds are removed from the surcharge rate base by reflecting ADIT in the DSIC formula.

LWWC argues that it should not be required to reflect ADIT because the reasonableness of rates is based on the overall return produced by the utility's total rates and it is not relevant that customers are charged a return on investor-supplied funds or phantom taxes. LWWC Exc. at 10. In LWWC's view, application of Duquesne means that its DSIC formula will produce a just and reasonable rate as long as the Company is not overearning. Id. at 10. The Company's alarming version of utility ratemaking would make the just and reasonable 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.⁴ 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:

⁴ 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 Barasch v. Pa. PUC, 507 Pa. 561, 570, 493 A.2d 653, 657 (1985) (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) (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); Barasch v. Pa. PUC, 507 Pa. 496, 515, 491 A.2d 94, 103 (1985) (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).

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. 66 Pa. C.S. § 315(a). 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 Barasch v. Pa. PUC, 507 Pa. 496, 515, 491 A.2d 94, 103 (1985) (Penn Power) (“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”).

For all of these reasons, the ALJ correctly determined that 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. R.D. at 23, 25. 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. R.D. at 66 Pa. C.S. §§ 1351, 1353; supra at 8-10. 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. LWWC’s exception to the ALJ’s determination should be denied.

Reply to LWWC Exception No. 4: The ALJ Correctly Found That Reflecting ADIT in the DSIC Calculation Is Not Overly Complicated. R.D. at 19-23; OCA M.B. at 15-16; OCA R.B. at 13-15.

The presiding ALJ concluded that complexity is not a legal excuse for non-compliance with the requirements of Act 11 and the actual taxes paid doctrine, and that LWWC did not establish that the ADIT adjustment is overly complex. R.D. at 19-23. LWWC excepts to these conclusions, arguing that tax adjustments should be dealt with in the base rate process because they are too complicated for the purpose of the DSIC. LWWC Exc. at 11-13. The problem with the Company's position is that the purpose of the DSIC is not to make it easy for LWWC to recover costs, if those costs are not actually incurred. The stated purpose of the statute is to permit "timely recovery" of the reasonable and prudent costs incurred to repair, improve or replace eligible property." 66 Pa. C.S. § 1353(a). To that end, the ALJ found that the goal of simplifying the process for recovering distribution improvement costs is already achieved by allowing utilities to recover eligible costs through a single-issue surcharge. R.D. at 20. The ALJ stated:

It is true that the entire DSIC mechanism is meant to "simplify" the process that is used in a base rate case. As Act 11 represents the creation of single-issue ratemaking, this goal is already accomplished.

Id.

LWWC's exception implies that the recognition of ADIT would make the DSIC process more like a base rate process than a single-issue process. LWWC Exc. at 12-13. As explained by the ALJ, this is not the case.⁵ More important, however, it is not relevant whether the process

⁵ For example, the statute provides that the surcharge may take effect in as few as 10 days – whether or not it is contested – compared to the base rate process, under which a litigated rate increase may not take effect for up to nine months from filing. 66 Pa. C.S. §§ 1308(a), 1308(d), 1357(d)(3). In contrast to the adjusted DSIC formula proposed by the OCA, base rate review would require recognition of, *inter alia*, the overall increase in the net plant in the applicable plant categories, offsetting O&M savings associated with incremental investment, and any other offsetting changes that occur between base rate cases. R.D. at 22.

is more like the process used for Section 1307(g.1) state tax adjustments, for example, or a Section 1308 base rate process. 66 Pa. C.S. §§ 1307(g.1), 1308. The process is dictated by Act 11. Act 11 allows recovery of certain costs, specifically including federal and state income taxes, which are incurred by the utility. 66 Pa. C.S. §§ 1353, 1357(b)(1). The process, thus, includes any component necessary to ensure that the DSIC recovers only costs incurred. ADIT is an unavoidable component of a calculation that recovers only costs incurred. R.D. at 21-23; OCA M.B. at 15-16; OCA R.B. at 14-15. The ALJ properly concluded, thus, that it is not an option to ignore ADIT in order to achieve a desired level of simplicity. The ALJ stated:

While recognizing that one of the goals of the DSIC mechanism is to simplify the process in order to obtain the necessary funds for infrastructure improvement more quickly than a full-blown litigated base rate case would provide, it is quite clear that, in the development and implementation of the ratemaking process, there has not been dismissal of a step which ensures accuracy because it is just too hard. The ratemaking process is a detailed and complex process because it has to be in order to come to the correct result: rates must be just and reasonable. Nowhere in the statute does it state that rates must be easy to compute.

R.D. at 19. The ALJ also found that the limitation in Act 11 to costs “incurred” is consistent with the actual taxes paid doctrine. R.D. at 21. The actual taxes paid doctrine is further reason why ADIT must be part of the DSIC formula. She stated:

While the legislature did create the DSIC mechanism to allow a shorter time for recovery of costs, the legislature did not overrule this basic principle [actual taxes paid]. LWWC’s formula, which does not include an adjustment for ADIT, charges ratepayers for taxes which have not been incurred.

Id., citing Penn Power, 506 Pa. at 515, 491 A.2d at 103 (“Where an expense is not actually incurred, be it for taxes or otherwise, it is improper to include it in the rates charged to the ratepayers); 66 Pa. C.S. § 1301.

Furthermore, the Company's arguments for simplicity give no recognition to the fact that Act 11 addresses recovery of a capital cost rather than an expense. 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).

For all of these reasons, the ALJ correctly determined that complexity is not a legal excuse for non-compliance with the requirements of Act 11 and the actual taxes paid doctrine.

The ALJ also correctly determined that the evidence does not support LWWC's arguments that tax adjustments are too complicated for the DSIC mechanism. R.D. at 19, 22-23. While LWWC quotes from the Columbia DSIC proceeding, LWWC provides no direct evidence that the ADIT adjustment is complex, only that it does not consider it necessary. LWWC Exc. at 12, citing Columbia Order at 36. LWWC does argue that tax matters require separate calculations and have a greater likelihood of litigation. LWWC Exc. at 12-13; LWWC St. 1-REJ at 2. Identifying the Company's tax status is no different for DSIC purposes, however, than it is for ratemaking in general. If a question arises, LWWC's taxable income for a given year is provided in its annual tax return. 26 I.R.C. §§ 63, 6012, 6072. Moreover, as a general matter, 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 correction to the DSIC formula. Act 11 provides for reconciliation and gives the Commission authority to

allow the Company to recover its proposed DSIC rate while the matter is litigated. 66 Pa. C.S. § 1358(d)(2), (e).

In summary, 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. LWWC's exception should be denied.

Reply to LWWC Exception No. 5: The ALJ's Recommendation to Reflect Actual State Income Taxes in the DSIC Formula Is Consistent with Act 11 and the Actual Taxes Paid Doctrine. R.D. at 25-26; OCA M.B. at 21-24; OCA R.B. at 21-25.

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; OCA R.B. at 21-22. 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. R.D. at 25-26. Accordingly, the ALJ properly concluded that the state income tax rate used to calculate DSIC revenue requirement should reflect the state income tax expense actually paid. As a result, the effective state income tax rate may be less than the full statutory rate. *Id.*; OCA R.B. at 22. The ALJ summarized her recommendation that LWWC correct the gross-up for state income taxes to ensure that ratepayers are charged only for state income taxes actually paid as follows:

LWWC will not pay state income taxes on the full amount of its equity return, and accordingly, the state income tax rate used to calculate DSIC revenue requirement should reflect the state income tax expense actually paid. Nothing in the statute or in the Final Implementation Order states otherwise. In fact, as discussed above, the DSIC legislation approves establishment of a DSIC to provide for the timely recovery of the "reasonable and prudent costs incurred" between base rate cases. If a cost is not incurred, it cannot be "recovered." 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. OCA RB at 6.

Therefore, to prevent utilities from overstating the surcharge revenue requirement and improperly charging ratepayers for state income taxes that the utility will not pay, the Commission should require the flow-through of state income tax deductions associated with the DSIC plant. The OCA Complaint is sustained.

R.D. at 25-26.

LWWC excepts to the ALJ's recommendation. LWWC Exc. at 14-16. The Company argues that using the full statutory rate is consistent with the plain language of the statute and

that reflecting actual state income taxes is too complex and unnecessary because of the earnings cap.⁶ Id. The ALJ considered and rejected each of these arguments for the following reasons.

First, the plain language of 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. R.D. at 25; 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 Solid Waste Auth. v.

⁶ LWWC also argues that the Commission has already addressed the OCA’s proposed tax adjustments in the Columbia Order. LWWC Exc. at 14-15. While this argument is addressed in the OCA’s Reply to LWWC Exception No. 1, supra, the OCA notes that LWWC has the burden to show that use of the full statutory state income tax rate in its own DSIC calculation will produce just and reasonable rates. R.D. at 26; 66 Pa. C.S. § 1315(a); 66 Pa. C.S. § 315(a). LWWC also argues that the state income tax adjustment is not consistent with the Final Implementation Order. 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).

Dep't. of Revenue, 860 A.2d 1173 (2004); 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.

Second, the Company contends that using the statutory state income tax rate is easier to calculate and audit and would avoid litigation. LWWC Exc. at 14-15. While the Commission has expressed intent that the DSIC be a simple mechanism, that intent can only be exercised when it is consistent with the mandates of Act 11. State income tax benefits associated with DSIC investment must be recognized because Act 11 limits DSIC recovery to costs “incurred” by utilities. R.D. at 25; 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 charged only for state income taxes actually paid. R.D. at 26.

While LWWC argues that it would be easier not to calculate a utility-specific tax rate (LWWC St. 1R at 4), “[n]owhere in the statute does it state that rates must be easy to compute.”

R.D. at 19. LWWC argues that tax matters require “full rate case analysis,” which could subject the DSIC calculation to litigation regarding the Company’s state tax liability. LWWC Exc. at 15. As the OCA explained on page 16, *supra*, identifying the Company’s tax status is no different for DSIC purposes, however, than it is for ratemaking in general and can be established definitively after the Company files its annual tax return. 26 I.R.C. §§ 63, 6012, 6072. Further, it is always possible that there will be litigation over some portion of the Company’s DSIC formula. 66 Pa. C.S. §§ 1301, 1358(e)(1)(i), (f). The preference to avoid additional calculations or the possibility of litigation is not basis to ignore a necessary correction to the DSIC formula.

Third, LWWC takes the position that the existence of the earnings cap makes it unnecessary to flow through state income tax deductions in the DSIC rate. LWWC Exc. at 15. It refers to its arguments made with regard to the ADIT adjustment that the earnings cap reflects the “total effect of rates.” *Id.* at 9-11, 15. 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. R.D. at 15; see page 11, supra. Whether or not a utility is “overearning” may be a product of other factors not related to the DSIC. R.D. at 25; 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. R.D. at 25; OCA M.B. at 16-17; OCA St. 1-S at 2.

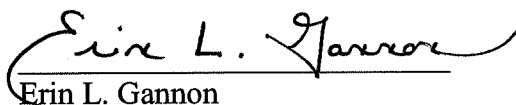
In summary, the Commonwealth’s highest court has held that no rate is just and reasonable if it does not reflect the actual taxes paid by the utility. Act 11 also imposes the requirement that fixed costs, which include pre-tax return, recovered through the DSIC must have been “incurred” by the utility. LWWC’s state income tax expense for DSIC revenues will

be affected by applicable tax deductions for accelerated depreciation and bonus depreciation related to the DSIC investment. To make the DSIC calculation correct (and to allow recovery only for costs actually incurred by the utility), the ALJ determined that LWWC's pre-tax rate of return must recognize the flow-through of state income tax deductions associated with the investments that are recovered through the DSIC. LWWC's exception to this recommendation should be rejected.

III. CONCLUSION

For all of the foregoing reasons, as well as those set forth in the OCA's Main and Reply Briefs, the OCA submits that Judge Colwell's Recommended Decision should be upheld. Little Washington Wastewater Company should be directed to change its tariff and DSIC calculation consistent with the adjustments recommended by the ALJ and to 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,



Erin L. Gannon
Assistant Consumer Advocate
PA Attorney I.D. # 83487
E-Mail: EGannon@paoca.org

Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. #50026

Counsel for:
Tanya J. McCloskey
Acting Consumer Advocate

Office of Consumer Advocate
5th Floor, Forum Place
555 Walnut Street
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152

DATE: June 6, 2014
183277

CERTIFICATE OF SERVICE

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

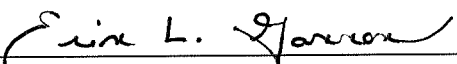
I hereby certify that I have this day served a true copy of the Reply Exceptions of the Office of Consumer Advocate upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code §1.54 (relating to service by a participant), in the manner and upon the persons listed below:

Dated this 6th day of June 2014.

SERVICE BY EMAIL AND FIRST CLASS MAIL, POSTAGE PREPAID

Mary McFall Hopper, Regulatory Counsel
Aqua America, Inc.
762 West Lancaster Avenue
Bryn Mawr, PA 19010

Thomas T. Niesen, Esquire
Thomas, Niesen & Thomas, LLC
212 Locust Street, Suite 600
P.O. Box 9500
Harrisburg, PA 17108-9500
Counsel for Little Washington Wastewater Co.


Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. #50026
Email: CHoover@paoca.org

Erin L. Gannon
Assistant Consumer Advocate
PA Attorney I.D. #83487
Email: EGannon@paoca.org

Counsel for
Office of Consumer Advocate
555 Walnut Street, 5th Floor, Forum Place
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152
*184405.doc