COMMONWEALTH OF PENNSYLVANIA

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August 21, 2014

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

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

Dear Secretary Chiavetta:

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

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

Respectfully submitted,

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Attachment
cc: Honorable Kandace F. Melillo
Office of Special Assistants
Certificate of Service
188916

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

EXCEPTIONS OF THE OFFICE OF CONSUMER ADVOCATE

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I. INTRODUCTION

The Distribution System Improvement Charge (DSIC) is not a surcharge under Section 1307 of the Public Utility Code, 66 Pa. C.S. § 1307. Rather Act 11 repealed prior legislation and created a new mechanism within Chapter 13 that provides for the limited recovery of certain costs that are incurred by the utility. 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 costs that have not been incurred by the utility. 66 Pa. C.S. §§ 1351, 1353. When the Company invests in its infrastructure replacement and repair, that investment can generate tax benefits, which should be reflected in the DSIC calculation. Otherwise, the DSIC collects costs that have not been incurred by the utility. OCA St. 1 at 4-8.

In its testimony and briefs, the OCA showed how PPL Electric Utilities Corporation (PPL or the Company) can adjust its surcharge calculation to ensure that when PPL receives tax benefits from its DSIC investment, those benefits are properly reflected as an offset to the utility's investment – without undue complexity. The bottom line, however, is that if these adjustments are not made, PPL's proposed DSIC calculation does not meet the requirements of Act 11 and the mandate of Chapter 13 that all rates be just and reasonable, consistent with applicable law and ratemaking principles. 66 Pa. C.S. §§ 1301, 1350-1360.

On July 25, 2014, the Office of Administrative Law Judge issued the Recommended Decision (R.D.) of ALJ Kandace F. Melillo (ALJ Melillo). ALJ Melillo recommended approving PPL's proposed DSIC calculation without the necessary modifications proposed by the OCA, specifically that PPL (1) change its tariff to reflect Accumulated Deferred Income Taxes (ADIT) as an offset to the DSIC rate base[1] and (2) adjust the pre-tax return to recognize

[1] The tariff should be modified as follows to account for ADIT:

that PPL will not pay state income taxes on some or all of its DSIC income due to deductions associated with DSIC plant. R.D. at 1

The OCA respectfully submits the following Exceptions to the Recommended Decision of ALJ Melillo relating to federal ADIT and state income taxes.

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

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

II. EXCEPTIONS

OCA Exception No. 1: The ALJ Erred In The Determination Of The Legal Standard To Be Applied. (R.D. at 26-29 ; OCA M.B. at 11-16; OCA R.B. at 5-16).

In the R.D., ALJ Melillo held that the Commission has the requisite authority to determine whether an ADIT adjustment should be included in the DSIC mechanism for PPL. R.D. at 27. Further, the ALJ also held that the plain language of the statute provides authority and discretion to the Commission to determine the method of calculating the DSIC provisions of Act 11. Id. The ALJ erred, however, by accepting the arguments that inclusion of ADIT is too complex, the earnings cap provision renders ADIT inclusion unnecessary and that inclusion of ADIT is not required in order to find the resulting DSIC rate to be just and reasonable. R.D. at 27-29.

The OCA submits that the ALJ's conclusions are incorrect for several reasons. The statute prohibits recovery of costs not incurred; failing to include ADIT would result in rates that are not just and reasonable; reflecting actual taxes associated with DSIC investment is not too complex; and, the earnings cap will not preclude the DSIC from being overstated. The OCA discusses each of these below.

A. The Plain Language Of Act 11 Limits DSIC Recovery To Costs Incurred.

While the ALJ is correct that the General Assembly vested the Commission with discretion as to how it calculates various elements of the surcharge, that authority is 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. R.D. at 27-28; 66 Pa. C.S. §§ 1301, 1351, 1353.

To be consistent with the requirement that the DSIC recover only costs "incurred" by the utility (66 Pa. C.S. §§ 1351, 1353), the surcharge calculation must include ADIT so the utility

does not earn a return on non-investor supplied capital and must reflect the effective tax rate rather than the full statutory state income tax rate. This is consistent with the existing jurisprudence of Chapter 13, which holds that just and reasonable rates must reflect actual taxes paid and, conversely, rates that do not reflect actual taxes paid cannot be just and reasonable for purposes of Section 1301. Barasch v. Pa. PUC, 491 A.2d 94 at 107 (Pa. 1985) (Penn Power).

Act 11 was established within Chapter 13 of the Public Utility Code and its requirement that all rates be just and reasonable.[2] 66 Pa. C.S. § 1301. The statute specifies that only costs "incurred" by the utility shall be recovered through the surcharge. 66 Pa. C.S. §§ 1351, 1353. There is no proscription against recognition of ADIT within Act 11. To the contrary, the General Assembly stated plainly that it expected the Commission to address many of aspects of the DSIC mechanism. 66 Pa. C.S. § 1358(c) ("nothing under this subchapter shall be construed as limiting the existing ratemaking authority of the Commission"); 66 Pa. C.S. § 1357(c) ("rates of the utility to provide for recovery of the depreciation and pretax return fixed costs of eligible property, as approved by the commission") (emphasis added); 66 Pa. C.S. § 1358(a)(2) (The Commission may amend or revoke practices and procedures of a water utility operating under a distribution system improvement charge prior to the effective date of Act 11). It is, thus, consistent with the language of Act 11 and Section 1301that the Commission approve a DSIC rate that is calculated to recover only costs incurred by PPL.

B. The Elements Included In Rates Must Be Just And Reasonable.

The ALJ concludes that no adjustment for federal ADIT or state income taxes is necessary because (only) the overall effect of the rate is to be considered when determining whether the rate is just and reasonable, and not the individual components. R.D. at 29, quoting

[2] 1 Pa. C.S. § 1932 (statutes relating to the same things "shall be construed together, if possible, as one statute).

Columbia Order. The ALJ adopts the reasoning that under the United States Supreme Court's decision in Duquesne Light Company v. Barasch, 488 U.S. 299 (1989) (Duquesne), as long as the overall end result of a rate order is just and reasonable, then the Commission need not reflect specific rate adjustments such as the ADIT or state taxes proposed by OCA in this proceeding. There are two problems with this interpretation.

First, the Court's discussion in Duquesne addressed the ratemaking standards applicable to the Court's review of a constitutional taking issue. Its discussion of Hope was made in the same context. Duquesne did not establish the standard for the determination of just and reasonable rates under the Public Utility Code. Duquesne at 310, quoting Hope. Two statements by the Court in Duquesne demonstrate this point:

> Today we reaffirm these teachings of Hope Natural Gas: "...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."

Duquesne at 310 (quoting Hope Natural Gas Co., 320 U.S. 591, 605 (1944) (Hope)) (emphasis added). The Court also stated:

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

Duquesne at 316 (emphasis added).

The issue here is the interpretation of the Public Utility Code and whether, under the Pennsylvania law, a specific rate authorized by statute is just and reasonable if it allows recovery of costs that are not incurred by the utility.[3]

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[3] See, e.g., Barasch v. Pa. PUC, 493 A.2d. 653, 657 (Pa. 1985) (UGI) ("When the PUC approves hypothetical expenses not actually incurred, it commits an error of law"); Barasch v. Pa. PUC, 491 A.2d

Here, the incremental DSIC property and federal and state income taxes for DSIC-eligible plant are already part of the calculation – the OCA does not propose to recognize offsetting savings in other categories of expenses. 66 Pa. C.S. § 13 (b) (1); OCA St. 1 at 8-10. The DSIC formula proposed by PPL, however, 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 removing plant investment that was not funded by the Company. OCA St. 1 at 8-10.

The second problem with the ALJ's conclusion that individual expense adjustments do not bear on the "justness and reasonableness" of rates, is that it would make rate proceedings effectively meaningless. There is an entire body of Commission Orders and judicial opinions construing Section 1301 of the Public Utility Code on revenue, expense, and rate base adjustments ranging from consolidated taxes to rate case expense to hypothetical capital structure to state income tax expense.[4] If all of these decisions regarding just and reasonable rates are ignored, the judgment of the Commission regarding the ratemaking provisions of the Public Utility Code would be effectively conclusive upon the reviewing court.

94, 103, 107 (Pa. 1985) (Penn Power) (finding the Commission could only find rates "just and reasonable" if those rates are based on actual taxes paid).

[4] Bell Tel. Co. v. Pa. PUC, 47 Pa. Commw. 614, 619-22, 408 A.2d 917, 921-22 (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); UGI, 507 Pa. at 570, 493 A.2d at 657 (approving a consolidated tax adjustment because "[i]t is a violation of base ratemaking 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 Twp. 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 at 444 (Commission acted within its power by disallowing utility's actual income tax claim on the basis that the underlying capital structure was not just and reasonable.); Penn Power, 507 Pa. 496 at 515, 491 A.2d at 103 (normalization of state income tax expense is contrary to the requirement that rates approved by the Commission must be "just and reasonable"; it is improper to include any expense not actually incurred in the rates charged to ratepayers).

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

> After the conclusion of the hearing, the commission shall make and file its findings and order with its opinion, if any. Its finding 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. Carnegie Nat'l Gas Co. v. Pa. PUC, 61 Pa. Commw. 436, 433 A.2d 938 (1981). 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 conclusions that Carnegie must prove the reasonableness of these expenses which form the basis for its rates.

Carnegie at 444; see also Barasch v. Pa. PUC, 491 A.2d 94, 103 (Pa. 1985) (Penn Power) ("As the expert body, the 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. C.S. § 1301").

The OCA's specific adjustments to properly calculate applicable taxes related to DSIC-eligible investment are discussed further below, but the ALJ erred in the determination of the legal standard to be applied to this case. The exclusion of ADIT and the inclusion of the full statutory rate in the calculation of the DSIC would mean that costs that were not actually incurred will be included in the DSIC. This is contrary to Section 1353(a) of Act 11. 66 Pa. C.S. § 1353(a). While the Commission has discretion regarding the calculation of the DSIC, the

Commission must give meaning to the language of Act 11 and must adhere to traditional ratemaking requirements as set forth in Pennsylvania law.

OCA Exception No. 2: The ALJ Erred By Not Requiring PPL To Include ADIT In The DSIC Calculation. (R.D. at 26-29; OCA M.B. at 11-29; OCA R.B. at 5-33).

The ALJ found no basis to reach a different result than the Commission reached in the Columbia Order and denied the OCA's proposal to include an ADIT adjustment in PPL's DSIC formula. R.D. at 29. In Columbia the Commission relied on Duquesne for the conclusion that the total effect of rates, rather than the formula is dispositive and that the earnings cap ensures the effect of the DSIC rate will be just and reasonable. R.D. at 26-29, citing Columbia Order at 35-37. The ALJ's conclusion in this proceeding fails to recognize the fact that the statute does not allow for recovery of costs not actually incurred by the utility.[5] Further, as discussed below, the earnings cap does not ensure the rate will only recover costs actually incurred by the utility.

A. The Evidence Supports Inclusion Of ADIT In The DSIC Calculation.

Throughout this proceeding, in response to concerns regarding the perceived complexity of including ADIT, the OCA has pointed out that water and gas utilities in other jurisdictions routinely include ADIT in their infrastructure surcharge. OCA St. 1-S at 2-3; OCA M.B. at 18-19. The OCA looked to these other states not as the basis for interpreting Act 11, as argued by PPL, but to show that ADIT is inextricably tied to valuing the surcharge rate base correctly and that it can, in fact, be readily calculated. Id.; PPL M.B. at 31. As noted on pages 21 to 22 of the OCA's Main Brief, PPL witness Torok testified on behalf of a Kentucky utility that was annually

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5 See OCA Exception No. 1, *supra*.

calculating ADIT related to plant recovered in its infrastructure surcharge.[6] In re: An Adjustment of the Gas Rate of the Union Light, Heat and Power Co., 246 PUR4th 1, 29, 31-32 (KyPSC 2005) (Union Light).

In addition to Kentucky, Commissions in many other states have routinely approved infrastructure investment recovery mechanisms that reflect ADIT in the surcharge calculation even though their authorizing statutes do not explicitly address ADIT.[7] OCA St. 1-S at 3. Indeed, as noted in the OCA's Main Brief, the recognition of ADIT associated with surcharge plant investment is treated as a matter of course. In other states, recognition of accumulated deferred income taxes has been incorporated in the statutes implementing DSIC-type mechanisms.[8]

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

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

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

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

Indeed, PPL has not pointed to a single state where this issue was even questioned by the utility implementing the surcharge.

PPL also argued that other states do not have an earnings cap, suggesting that is why they account for ADIT. PPL M.B. at 32. The earnings cap does not prevent a utility from overstating its actual taxes in the DSIC revenue requirement, however, so they are not interchangeable. Some of the states have revenue caps and other protections, yet all use the ADIT offset.[9]

Interestingly, PPL criticized the OCA for not advocating to include other major rate components which are included in DSIC-type mechanisms in other states, but not specifically included in Act 11. PPL M.B. at 32-33. This is directly contrary to PPL's insistence that even the components that are specifically included in Act 11 should not be calculated correctly because it would be simpler to overstate them. Id. at 23, 26, 29. While the OCA has not proposed to expand the components of the DSIC, the OCA recognizes that the General Assembly left the task of determining the details of calculating a DSIC that would comply with Act 11 and the Public Utility Code to the Commission. Section 1357(c) provides:

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

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

66 Pa. C.S. § 1357(c); see also 2011 Legsl. Journal – House at 1910. It is for that reason that the OCA did not oppose PPL's proposal to recover gross receipts taxes in the DSIC even though gross receipts taxes are not included in the model tariff. OCA St. 1-S at 2.

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

The ALJ denied the OCA's proposal to include ADIT in the DSIC calculation, based on the arguments advanced by PPL and the Commission's decision in Columbia. R.D. at 26-29. The OCA submits that PPL's arguments are without merit. PPL's proposed DSIC calculation will require customers to pay a return on capital that is not supplied by the utility's investors and should not be authorized.

B. Calculating A Capital Cost Surcharge Is Not Too Complex.

PPL argued that incorporation of an ADIT adjustment would violate the goals of the General Assembly and the Commission, because the intention was to create a "straightforward and easy to calculate surcharge mechanism." PPL M.B. at 20. In support of its position, PPL asserts that non-base rate cases do not require submission to the full extent of revenues,

expenses, rate base, and rate of return as is required in a general rate base case. PPL M.B. at 21. The ALJ apparently relied on the Company's arguments in concluding that the OCA's ADIT adjustment would add unnecessary complexity to the DSIC calculation. R.D. at 29.

First of all, it should be noted that the purpose of the statute was not to make it easy for PPL to recover costs, regardless of whether those costs are actually incurred. Rather, the stated purpose of the charge authorized by Act 11 is to provide an alternative to base rate filings that will provide for timely recovery of eligible costs incurred by the utility. 66 Pa. C.S. §§ 1351, 1353(a). Contrary to PPL's assertion, it would defeat the purpose of the Act 11 DSIC surcharge provisions not to incorporate ADIT adjustments into rate calculations, because a failure to do so would result in the recovery of costs not incurred by the Company. The bottom line is that rates must be calculated correctly, regardless of whether they are recovered through a surcharge or base rates. The failure to recognize ADIT will overstate the investment balance and allow PPL to earn a return on funds that were not supplied by investors, resulting in a rate that is unjust and unreasonable in violation of Section 1301 of the Public Utility Code and Commission Orders. See gen'ly 66 Pa. C.S. § 1301; Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 53 PaPUC 410 (1979); Pa. PUC v. Philadelphia Elec. Co., 31 PUR4th 15, 52 PaPUC 772 (1978).

The Company essentially argues that a lesser ratemaking standard should apply for costs recovered by surcharge. PPL M.B. at 20-21. Specifically, PPL contends that excluding ADIT from the DSIC calculation is analogous to the Court's recognition that utilities are not required to reflect all changes in revenues, expenses, rate base and rate of return in a non-general base rate case that would be required for a general base rate case. PPL M.B. at 21 citing Popowsky v. Pa. PUC, 683 A.2d 958 (Pa. Commw. 1996) (Equitable). The issue in Equitable, however, was whether an increase in one item of expense (compliance accounting changes) could be

considered in isolation, without specific evidence regarding other changes in revenue/expense and rate base/rate of return since base rates were last established, including offsetting savings in other categories of expenses. Id. at 960. In direct contrast, here, the OCA does not propose to broaden the scope of the DSIC. OCA St. 1 at 5. By statute, the incremental DSIC property and federal income taxes are already part of the calculation. 66 Pa. C.S. § 1357(b)(1); OCA St. 1 at 4-5. The issue here is that the DSIC formula proposed by PPL will overstate the investment on which the Company is entitled to earn a return. ADIT must be included in the calculation to correctly and fairly value the surcharge rate base by removing plant investment that was not funded by the Company. OCA St. 1 at 5.

This procedure would certainly not, as suggested by the Company, be the equivalent of full base rate review. PPL M.B. at 20-21. There will still be no consideration, *inter alia*, of accumulated depreciation associated with plant investment already included in base rates, offsetting O&M savings associated with incremental investment, and any other offsetting changes that occur between base rate cases. 66 Pa. C.S. § 1357(a).

PPL further relied on the Gill case for the premise that surcharges should be simple and straightforward. PPL M.B. at 20; Gill v. The Bell Tele. Co. of Pa., 1994 PaPUC LEXIS 115 (denying pro se complainant's protest against any surcharges and/or taxes on her telephone bill) (Gill). The language cited by PPL is dicta from the Initial Decision in the context of the ALJ's discussion of a utility's legal authority to recover state taxes. Gill at *12-13. The OCA's position is consistent with Gill because recognition of ADIT is consistent with having a surcharge that recovers one type of cost – the eligible new plant investment incurred by PPL between rate cases – without examination of every component that would be considered in a full base rate proceeding. The Gill case is distinguished from the present case, however, for an

important reason. State taxes are an easily identifiable expense that is beyond a utility's control. See Popowsky v. Pa. PUC, 869 A.2d 1144, 1161 (Pa. Commw. Ct. 2005) (PAWC 2005). In contrast, Act 11 authorizes recovery of a capital cost. The Commonwealth Court has recognized that recovery of capital costs is inherently more complex than recovery of an expense:

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

PAWC 2005 at 1155 (citing Pennsylvania Indus. Energy Coalition v. Pa. PUC, 653 A.2d 1336, 1341 (Pa. Commw. Ct. 1995)). Essentially, PPL wants to ignore the distinction between recovery of an expense and a capital cost. The degree of simplicity that PPL seeks is not possible in a calculation of the pre-tax return that will be recovered through the DSIC rate. ADIT is a necessary and unavoidable component of a calculation that produces a just and reasonable rate that meets the requirements of Act 11. It is one thing to permit PPL to earn a return on its investment in new plant between base rate cases; it is another thing to permit PPL to earn a return on taxpayer-supplied funds that are universally excluded from rate base as a matter of basic ratemaking fairness.

Moreover, PPL overstated the difficulty of calculating ADIT. The fact that the utilities in all of the many states cited by the OCA in its Main Brief deduct ADIT from the surcharge rate base demonstrates that recognizing ADIT is not too complicated. OCA St. 1-S at 2-3. First, PPL contends that ADIT is too complicated because, "whether and to what extent PPL has any ADIT balance not already reflected in base rates depends in part upon its overall tax position." PPL M.B. at 21. This is because, when the Company is in a loss carry forward position, the loss carry forward offsets any amounts of ADIT the Company does not have income to use. OCA St. 1 at 4-5, 7. The net effect is that the ADIT does not arise until the loss carry forward is eliminated by

having taxable income. Id. This is not reason to ignore the ADIT, however. OCA witness Catlin explained how PPL can make the ADIT adjustment without undue complexity. See OCA St. 1 at 6; OCA M.B. at 19-22. Although recognition of ADIT will not reduce the DSIC rate base at this time, the DSIC formula established in this proceeding, should correctly calculate the investment on which PPL is entitled to earn a return. OCA St. 1 at 7. Then, when PPL is no longer in a loss carry forward position, the tariff will provide for the appropriate adjustment to DSIC rate base and revenue requirement. It should also be noted that PPL's argument as to the complexity of calculating ADIT has no bearing on its ability to calculate state income taxes on its DSIC income.

PPL also raised the concern that there could be litigation over the utility's past, present, and future income tax status. PPL M.B. at 22. Identifying the Company's tax status is no different for DSIC purposes than it is for ratemaking in general. If a question arises, the Company's taxable income for a given year is provided in its annual tax return. PPL St. 4-R at 5. It is always possible that there will be litigation over some portion of the Company's DSIC formula. Act 11 specifies that the DSIC rate is subject to audit and complaint. 66 Pa. C.S. §§ 1301, 1358(e)(1)(i), (f). The potential for litigation is not a basis to ignore a necessary change in the DSIC. Moreover, the Commission may still allow the Company to recover its proposed DSIC rate subject to refund while the matter is litigated. 66 Pa. C.S. § 1357(d)(3).

Next, PPL asserted that in some calendar quarters it may report taxable income or loss that may not be representative of the full tax year and that it might need to subsequently true-up the DSIC plant balance used for those quarters. PPL M.B. at 22. It argues that using estimates is contrary to the use of known, historic balances envisioned by Section 1357. PPL M.B. at 22-23. Section 1357 addresses the requirement that plant additions be in service prior to recovery in

rates. 66 Pa. C.S. § 1357. The recognition of ADIT has no bearing on this requirement. ADIT relates to the calculation of the Company's return on the cost of those plant additions and operates to prevent the DSIC rate from including return on plant additions that were not funded by the Company. OCA St. 1 at 4-5. Further, Section 1357 recognizes that estimates are part of the DSIC formula:

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

66 Pa. C.S. § 1357(d) (Emphasis added). The DSIC estimates are subject to reconciliation, refund and recoupment. 66 Pa. C.S. §§ 1358(d)(2), (e); DSIC Petition at Tariff Supp. 194 at Original Page No. 180. Accordingly, PPL can true up its DSIC calculations to reflect the actual ADIT balances at the same time it prepares its annual reconciliation for each calendar year. Given the reconcilable nature of the DSIC, the alleged inability to calculate the exact ADIT on a quarterly basis is not a reason to ignore ADIT altogether.

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

As discussed, the ALJ erred to the extent she accepted PPL's arguments as to the complexity of calculating the ADIT for inclusion in the DSIC.

C. <u>The Earnings CAP Does Not Prevent The DSIC Rate From Being Overstated.</u>

PPL asserted that the earnings cap compensates for failing to reflect its actual federal and state income tax expense in the DSIC calculation. PPL M.B. at 23-24. The earnings cap will prevent the Company from charging a DSIC when its reported quarterly earnings exceed the rate of return authorized in its last base rate case or in the Commission's Quarterly Earnings Report. 66 Pa. C.S. § 1357(b)(2)-(3). The ALJ agreed with the Company that inclusion of ADIT in the DSIC is not necessary due to the earnings cap. R.D. at 28-29.

The OCA submits that 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.*; <u>see</u> OCA M.B. at 23. As discussed in the OCA's Main Brief, if PPL is under earning due to an increase in expense that is wholly unrelated to the DSIC – postage or management retirement bonuses, for example - the earnings cap would not prevent the utility from overstating the surcharge revenue requirement and improperly charging ratepayers a return on funds that were not supplied by investors. OCA St. 1-S at 3; OCA M.B. at 22. To ensure that ratepayers are not required to pay a return on non-investor supplied capital, the ADIT associated with DSIC-eligible plant must be deducted from the DSIC rate base. The earnings cap will also not prevent ratepayers from being charged state taxes on DSIC income that are not being paid by PPL. That result will only be avoided if the flow-through of the state income tax deductions associated with DSIC plant is accounted for in determining the state income taxes that are included in the DSIC pre-tax rate of return.

OCA Exception No. 3: <u>The ALJ Erred By Not Requiring PPL To Reflect Its Actual State Income Taxes In The DSIC Calculation.</u> (R.D. at 34-35; OCA M.B. at 30-37: OCA R.B. at 29-33).

The ALJ erred in her Recommended Decision by permitting PPL to develop its pre-tax rate of return by grossing up the equity component of its overall return to account for both federal and state income taxes at the full statutory rates. R.D. at 34-35. As discussed *supra* regarding ADIT, the Internal Revenue Code provides that federal income tax benefits cannot be flowed through in rates on a current basis, which generates ADIT. OCA St. 1 at 4-6. In contrast, Pennsylvania law requires that state income tax deductions must be reflected in rates on a current basis, consistent with the "actual taxes paid doctrine." <u>Id.</u> at 8-10. The Pennsylvania Supreme Court rendered the seminal decision regarding the flow-through of income tax benefits in <u>Penn Power</u> where it determined that the Commission could only find rates "just and reasonable" if those rates are based on the actual taxes paid. <u>Penn Power</u>, 491 A.2d at 107. The Court required the utility to flow through state income tax benefits to ratepayers on a current basis. <u>Id.</u> at 491 A.2d at 98, 101, 105-107. It held:

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

<u>Id.</u> at 491 A.2d at 107. Weeks later, the Court affirmed this position in the context of consolidated taxes, finding that 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. <u>Barasch v. Pa. PUC</u>, 493 A.2d 653 (1985) (<u>UGI</u>) ("When the PUC approves hypothetical expenses not actually incurred, it commits an error of law"); <u>see also</u> <u>Popowsky v. Pa PUC</u>, 695 A.2d 448, 455 (Pa. Commw. Ct. 1997).

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

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

Pa. PUC v. Jackson Sewer Corp., 2001 Pa. PUC LEXIS 53, *47.

PPL used the full statutory rate to calculate its DSIC rate. OCA St. 1 at 8-9. PPL's approach, however, is not allowed by Pennsylvania law, which – as discussed above – requires that state income tax deductions must be reflected in rates on a current basis, consistent with the "actual taxes paid" doctrine. Nor is PPL's approach allowed under Act 11, which limits recovery to costs incurred by the Company. 66 Pa. C.S. §§ 1351, 1353(a). To correct the DSIC calculation, the flow-through of the state income tax deductions associated with DSIC plant must be accounted for in determining the state income taxes that should be included in the DSIC pre-tax rate of return.

The ALJ denied the OCA's state income adjustment based on the Commission's decision in Columbia. R.D. at 34-35. Instead, the R.D. accepts a DSIC calculation that will charge customers as if the Company were paying state income taxes at the full statutory rate when the Company is not paying taxes at that rate. The ALJ supports this decision using three arguments accepted by the Commission in the Columbia Order. As the OCA demonstrated in its Main Brief at 23-27 and its Reply Brief at 22-27, in this proceeding, these arguments are flawed.

The first argument the ALJ relies upon is that the only way to determine actual taxes paid for state income tax purposes is to conduct a full rate case analysis, which is not easy to calculate

or audit. R.D. at 34-35. The Commission also found that calculating actual taxes paid could subject the utility to litigation regarding state income tax liability. R.D. at 34-35, citing Columbia Order. This overstates the difficulty of identifying the Company's tax position and ignores that the DSIC is reconcilable if the Company's quarterly position is different than its position at the end of the tax year. Finally, the ALJ accepts the argument that the earnings cap reflects state income tax deductions and, thus, will ensure that PPL's DSIC rates are just and reasonable. Id. at 35.

As discussed previously, the earnings cap does not ensure that only the actual amount of state income taxes paid will be recovered in the DSIC rate because the Company's earnings are affected by factors unrelated to the DSIC. This argument also contains the same legal infirmities as the argument regarding the Duquesne case as discussed in Exception No. 1, *supra*. Before addressing the substantive arguments, the OCA wishes to make clear its position. The OCA does not recommend that the calculation of pre-tax return should always eliminate all state income taxes from the gross-up. It is the OCA's position that the state income tax rate used to calculate the DSIC revenue requirement should reflect the state income tax expense actually paid.

A. Calculating Current State Income Tax Is Required In Order To Achieve A DSIC Rate That Is Just And Reasonable.

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, 491 A.2d at 107, citing Pittsburgh v. Pa. PUC, 128 A.2d 372, 384 (1956) (Pittsburgh I). Moreover, as stated by the Commission:

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

Pa. PUC v. Jackson Sewer Corp., 2001 PaPUC LEXIS 53, *47 citing UGI ("When the PUC approves hypothetical expenses not actually incurred, it commits an error of law"); see also Popowsky v. Pa. PUC, 695 A.2d 448, 455 (Pa. Commw. Ct. 1997). PPL makes three arguments why it should be permitted to charge customers for taxes that it will not pay. PPL M.B. at 29-31. In the R.D., the ALJ accepts PPL's position and recommends adoption of a DSIC calculation that will charge customers as if the Company were paying state income taxes at the full statutory rate when the Company is not paying taxes at that rate. R.D. at 34-35.

As to the Company's first argument, PPL argued that it does not calculate the taxes it pays based on individual items of plant or revenue and thus, it is not possible to reflect the actual taxes paid on the DSIC plant or revenue. Id. at 30. The fallacy of this position is that the Company does not propose a DSIC rate that recovers taxes on a total company basis. Instead, it proposes to recover only the taxes associated with the incremental DSIC plant or revenue. As discussed previously, PPL has isolated the taxes associated with DSIC-eligible plant. The adjustments recommended by the OCA are necessary to correctly value those taxes.

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

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

Reflecting ADIT and the effective state income tax rate related to DSIC-eligible plant will not transform the DSIC review process into a full rate case analysis. The statute still provides that the surcharge may take effect in as few as 10 days. 66 Pa. C.S. § 1357(d)(3). The adjustments proposed by the OCA will not recognize, *inter alia*, the overall increase in the accumulated depreciation on net plant in the applicable plant categories, offsetting O&M savings associated with incremental investment, and any other offsetting changes that occur between base rate cases. The issue is limited to the appropriate calculation of the specific plant (and related taxes) that is being recovered in the DSIC rate.

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

Even without that language, however, nothing within Act 11 expressly rejects the adjustment of the DSIC to reflect actual taxes paid. The rules of statutory construction provide that statutes are to be construed in harmony with existing law and as part of a general and uniform system of jurisprudence. See 1 Pa. C.S. § 1932; Erie Sch. Dist. Appeal, 39 A.2d 271, 155 Pa. Super. 564 (1944). Specifically, the Commonwealth Court has stated that all provisions

of Chapter 13 of the Public Utility Code must be read together. Popowsky 2005 at 1159. Thus, as part of Chapter 13 and its requirement that all rates be just and reasonable, Act 11 must be implemented consistent with its mandates and the applicable law, unless the Act expressly provides otherwise.

PPL argues instead that the Act impliedly rejects the actual taxes paid doctrine by providing a detailed formula for calculation of the DSIC that intentionally omits tax benefit adjustments. PPL M.B. at 31. The Company attempts to separate the tax benefits as distinct from the taxes themselves, which they are not. The tax benefits associated with DSIC investment and revenues exist because of the DSIC investment and revenue. OCA St. 1 at 5-6, 8, 11. The statute specifically provides for recovery of federal and state income taxes and the OCA has shown how the proposed calculation must be adjusted to recover those taxes in accordance with Act 11 and Section 1301. If the ALJ's position was accepted on this issue, this would mean that there could be no adjustment for gross receipts taxes because the statute mentions income taxes only. 66 Pa. C.S. § 1357(b)(1). The removal of gross receipts taxes from PPL's DSIC calculation would have a greater effect than ignoring the necessary adjustments to reflect actual tax liability.

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

the Commission has discretion.[10] Penn Power, 507 Pa. at 521, 491 A.2d at 107; 66 Pa. C.S. § 1301. Also, the OCA has discussed above and in its Main Brief the manner in which PPL overstates the complexity of calculating the OCA's tax adjustments. See OCA M.B. at 19-22.

The requirement of just and reasonable rates applies to every rate approved by the Commission. 66 Pa. C.S. § 1301. Reflecting actual state income taxes paid in the DSIC is also consistent with Act 11, which limits recovery to costs incurred by the Company. 66 Pa. C.S. §§ 1351, 1353(a). The ALJ's acceptance of PPL's arguments in this area (R.D. at 34-35) creates a recommended decision that is inconsistent with the Public Utility Code and prevailing appellate case law in this area.

B. 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.

The ALJ also concludes that if PPL is overearning its authorized return, then the Company will not be permitted to charge the DSIC. Therefore, the ALJ finds that it makes it unnecessary to reflect actual taxes paid in the DSIC formula. R.D. at 34-35. 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. 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 2. That result will

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

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

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

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 incomes taxes that are included in the DSIC pre-tax rate of return.

As a matter of Pennsylvania law, the Company must flow through the state income tax benefits of accelerated depreciation and the repairs deduction in calculating the state income tax revenue requirement for DSIC plant additions. 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. Penn Power, 507 Pa. at 504-05, 518, 520-22, 491 A.2d at 98, 101, 105-07, 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).

It is no more lawful or appropriate for ratepayers to pay phantom state income taxes in rates established between base rate cases than it is in rates established in a base rate case. The requirement of just and reasonable rates applies to every rate approved by the Commission. 66 Pa. C.S. § 1301. Reflecting actual state income taxes paid in the DSIC is also consistent with Act 11, which limits recovery to costs incurred by the Company. 66 Pa. C.S. §§ 1351, 1353(a).

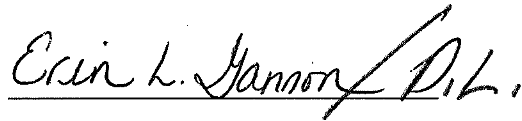
While the Commission has expressed the intent that the DSIC be a straightforward and simple mechanism (R.D. at 26-29), that intent can only be exercised in matters over which the Commission has discretion. The Commission has no discretion to ignore the requirement to flow through state income tax benefits in the DSIC rate because the flow-through of state income tax benefits is a requirement of just and reasonable rates under Pennsylvania law. Penn Power, 507 Pa. 504-05, 518, 520-22, 491 A.2d at 98, 101, 105-07; 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, consistent with the language of Act 11 and Section 1301 as it has been interpreted by the Courts and the Commission. 66 Pa. C.S. § 1353(a).

III. CONCLUSION

For the reasons set forth above, and for the reasons set forth in the OCA's Main Brief and Reply Brief, the OCA respectfully submits that the ALJ erred in her recommendation to approve PPL's initial tariff and rate as proposed. The OCA requests that the Commission direct the Company to change its tariff and DSIC calculation consistent with the OCA's recommendations and refund the excess revenues charged due to the gross-up of the pre-tax rate of return at the full state income tax rate and the failure to deduct ADIT from rate base.

Respectfully Submitted,



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DATED: August 21, 2014
189202

CERTIFICATE OF SERVICE

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

I hereby certify that I have this day served a true copy of the foregoing 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 21st day of August 2014.

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