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September 2, 2014

*VIA ELECTRONIC FILING*

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor North
P.O. Box 3265
Harrisburg, PA 17105-3265

**Re: Petition of PPL Electric Utilities Corporation For Approval of a Distribution System Improvement Charge - Docket Nos. P-2012-2325034, etc.**

Dear Secretary Chiavetta:

Enclosed for filing please find the Reply Exceptions of PPL Electric Utilities Corporation for the above-referenced proceeding.

Copies will be provided as indicated on the Certificate of Service.

Respectfully submitted,

David B. MacGregor

DBM/jl
Enclosures

cc: Honorable Kandace F. Melillo
Certificate of Service

## CERTIFICATE OF SERVICE

***Docket No. P-2012-2325034***

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

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Date: September 2, 2014

Jessica R. Rogers

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

| | | |
|---|---|---|
| Petition of PPL Electric Utilities Corporation | : | |
| For Approval of a Distribution System | : | Docket Nos. P-2012-2325034 |
| Improvement Charge | : | |
| | : | |
| Office of Consumer Advocate | : | C-2012-2346390 |
| Alan D. Whitehouse | : | C-2013-2345750 |
| Pamela Mosconi | : | C-2013-2346375 |
| John E. Hoag | : | C-2013-2345729 |
| James Weaver | : | C-2013-2351090 |

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# REPLY EXCEPTIONS OF PPL ELECTRIC UTILITIES CORPORATION

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Date: September 2, 2014

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## I. INTRODUCTION

PPL Electric Utilities Corporation ("PPL Electric" or the "Company") files this Reply to Exceptions in response to the Exceptions of the Office of Consumer Advocate ("OCA"). The Exceptions of the OCA provide no basis for overruling the Recommended Decision ("RD") on the two tax issues excepted to by OCA.

OCA contends that its two proposed adjustments to the distribution system improvement charge ("DSIC") mechanism are required by Act 11 of 2012 ("Act 11") and the general provisions of Chapter 13 of the Public Utility Code that rates be just and reasonable. OCA's contentions fail to recognize that the General Assembly is empowered to establish how just and reasonable rates are to be determined. The General Assembly clearly intended in Act 11 to adopt the historic water DSIC developed by the Pennsylvania Public Utility Commission ("Commission"). That historic mechanism specifically included only certain rate components, which did not include any adjustment in the calculation of the charge for accumulated deferred income tax ("ADIT") and included a full gross-up for state income taxes. However, the DSIC mechanism adopted by the General Assembly does protect against unjust or unreasonable rates through an earnings cap, which captures any net benefits from ADIT or tax depreciation deductions that reduce state income tax expense. PPL Electric designed its DSIC in accordance with the will of the General Assembly and pursuant to the Commission's Final Implementation Order at Docket No. M-2012-2293611 ("Final Implementation Order").

The RD correctly found that OCA's tax adjustments are not required by statute, and that OCA failed to produce evidence showing that the calculation of the mechanism established by the statute, as interpreted by the Commission in its Final Implementation Order, did not result in just and reasonable rates. (RD at 29; 34-35.) Therefore, the RD rejected OCA's proposals.

For the reasons summarized below, and explained in greater detail in PPL Electric's Main Brief ("MB") and Reply Brief ("RB"), the Exceptions of OCA should be denied.

## II. REPLY TO EXCEPTIONS

### A. OCA'S CONTENTION THAT ITS ADJUSTMENTS ARE REQUIRED BY LAW IS ERRONEOUS AND SHOULD BE REJECTED.

The OCA's primary contention in its Exceptions is that in order to arrive at just and reasonable rates, this Commission must modify the DSIC mechanism to include in the calculation of the charge selective additional components. (OCA Exc., pp. 8-13.) OCA's contention is erroneous, and should be rejected.

#### 1. The General Assembly Establishes How Just and Reasonable Rates Are Determined.

The OCA argues that in order to ensure that the DSIC results in just and reasonable rates, the Commission must reject its historic water DSIC calculation, which was adopted by the General Assembly, and add OCA's selected tax adjustments. (OCA Exc., pp. 9-13) OCA's argument fails to acknowledge that the General Assembly has the authority to establish how just and reasonable rates are calculated in a way that differs from the Section 1308(d) base rate mechanism, and has exercised that authority in establishing the DSIC mechanism.

The Commonwealth Court has held that the General Assembly can authorize a surcharge mechanism that deviates from the calculation of base rates under the general rate increase provisions of Section 1308(d) of the Public Utility Code. 66 Pa.C.S. § 1308(d). *See, e.g., Popowsky v. Pa. P.U.C.*, 13 A.3d 583, 591 (Pa. Cmwlth. Ct. 2011) ("*Purchased Water Surcharge* case"); *Popowsky v. Pa. P.U.C.*, 869 A.2d 1144, 1158 (Pa. Cmwlth. Ct. 2005) ("*Wastewater DSIC* case"); *Pennsylvania Industrial Energy Coalition v. Pa. P.U.C.*, 653 A.2d 1336, 1349 (Pa. Cmwlth. Ct. 1995) ("*PIEC*"). Further, the Court has rejected the argument that a non-1308(d) proceeding requires the same evidence and analysis as a Section 1308(d) base rate proceeding. In *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmwlth. Ct. 1996) ("*Equitable*"), OCA argued that the utility was required to present all of the evidence that would be required to support a change in base rates. The Court disagreed, and stated:

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

*Id.* at 962. Thus, the very foundation of OCA's argument here, which is that certain Section 1308(d) base rate elements must be included in surcharge mechanisms in order for the resultant rates to be just and reasonable, has plainly been rejected by the Court.

In enacting the DSIC mechanism, the General Assembly specifically chose a simple mechanism that was easy to calculate. As explained by PPL Electric, the plain language of the statute and the legislative history make it readily apparent that the General Assembly modeled the Act 11 DSIC upon the Commission's historic water DSIC, including the exact language on how to calculate the DSIC charge. (PPL Electric St. 3-R, p. 2; PPL Electric Ex. BLJ-1R; PPL Electric Ex. BLJ-2R.) The Commission's historic water DSIC did not include the proposals made here by OCA, and that historic model has been applied successfully to the water industry for sixteen years. OCA's contention that the Commission cannot continue to calculate the DSIC as it has done historically is unfounded, because the General Assembly has codified the Commission's historic calculation through Act 11.

Further, as recognized by the Commonwealth Court, the General Assembly may authorize a surcharge, "under the [Public Utility] Code, with procedures to determine the reasonableness of the charges outside of a base rate case." *PIEC*, 653 A.2d at 1350. The Commission's historic water DSIC, and the Act 11 DSIC, apply procedures to determine the reasonableness of the charge in the form of an earnings cap. The earnings cap, which is discussed in greater detail later in this Reply to Exceptions, ensures that a utility is not earning more than its authorized return, *i.e.*, more than just and reasonable rates. Importantly, the record in this case demonstrates that the earnings cap takes into account the

very same adjustments that OCA argues should be included in the initial calculation of the DSIC. (PPL Electric St. 3-R, p. 4; PPL Electric St. 3-RJ, p. 5.) In codifying the DSIC, the General Assembly has authorized a surcharge mechanism that incorporates procedures to ensure just and reasonable rates in the absence of a full Section 1308(d) analysis.

Contrary to OCA's contention in this case, the absence of the OCA's adjustments does not mean the resulting rates are unjust or unreasonable. The General Assembly has the power to authorize a surcharge mechanism that deviates from the 1308(d) calculation of base rates. In authorizing the Act 11 DSIC, the General Assembly codified the successful historic water DSIC mechanism, which has generated just and reasonable rates for sixteen years. As explained in the next sections of this Reply to Exceptions, the calculation of the DSIC charge codified by the General Assembly does not contain the adjustments proposed by the OCA. OCA's argument that its selected adjustments must be included is erroneous.

### 2. The DSIC Created by the General Assembly Does Not Include OCA's Proposed Adjustments in the Charge Calculation.

The OCA has argued that the Commission is required to include its proposed tax adjustments in the DSIC calculation in order to establish just and reasonable rates, because such adjustments would be made in a Section 1308(d) base rate proceeding. (OCA Exc., pp. 11-12.) As PPL Electric has explained, the General Assembly has the authority to establish a non-1308(d) mechanism that deviates from a traditional base rate calculation. Therefore, the issue is whether the General Assembly, in establishing the DSIC mechanism, has included, or intended to include, the OCA's adjustments. As explained in detail in PPL Electric's MB, it is clear that the General Assembly did not. (PPL Electric MB, pp. 12-19.)

The General Assembly sought to create a mechanism that would allow utilities to recover certain defined costs for the repair and replacement of aging distribution system infrastructure outside a base rate proceeding. In adopting a surcharge mechanism, it is clear that the General Assembly desired

a mechanism that was simple to calculate, in order to avoid the complexities of a full base rate proceeding, but which afforded customer protections that would ensure just and reasonable rates. As PPL Electric explained in its MB, the General Assembly found the appropriate balance in the Commission's historic water DSIC, which is simple to calculate but protects against unjust or unreasonable rates.

The General Assembly established the calculation of the DSIC charge in Section 1357 of the statute. 66 Pa.C.S. § 1357. The plain language of this section does not include the adjustments proposed by OCA. The relevant portion of Section 1357 regarding the specific calculation of the DSIC provides as follows:

> (a)(1) The initial distribution system improvement charge shall be calculated to recover the fixed cost of eligible property...
>
> (a)(3) The fixed cost of eligible property shall consist of depreciation and pretax return...
>
> (b) Depreciation Calculation. -- Depreciation shall be calculated by applying the original cost of the eligible property to the annual accrual rates employed in the utility's most recent base rate case for the plant accounts in which each retirement unit of distribution system improvement charge eligible property is recorded. The following shall apply:
>
> (1) The pretax return shall be calculated using the Federal and State income tax rates, the utility's actual capital structure and actual cost rates for long-term debt and preferred stock as of the last day of the three-month period ending one month prior to the effective date of the distribution system improvement charge and subsequent updates.

66 Pa.C.S. § 1357(a)(1), (a)(3), (b), (b)(1). As is plain from this language, and the remainder of the statute, ADIT was not included in the statutory calculation. First, Section 1357(a)(1) indicates that the DSIC will recover the fixed cost of eligible property. Eligible property for electric distribution companies is defined in Section 1351(1), and does not include ADIT. Thus, ADIT is not a category of property that should be included in the DSIC calculation. Second, Section 1357(a)(3) defines the fixed costs associated with eligible property to be recovered in the DSIC calculation, and those costs are

depreciation and pretax return. Again, this does not include ADIT. It is apparent that OCA's proposals are not included in the DSIC statute.

The plain language of the statute should be conclusive that OCA's proposed adjustments are not required. Legislative history further confirms that the General Assembly did not direct that the OCA's adjustments be part of the just and reasonable rate mechanism of the DSIC. (*See* PPL Electric Ex. BLJ-1R, Legislative Journal pp. 1909-1911.) PPL Electric has explained that the General Assembly intended to codify the exact mechanism used in the historic water DSIC, which did not include OCA's proposals. (PPL Electric Ex. BLJ-1R, Legislative Journal p. 155.) Furthermore, the General Assembly specifically rejected an amendment that would have included tax benefits, such as ADIT, in the calculation. (PPL Electric Ex. BLJ-1R, Legislative Journal pp. 1909-1911.) Thus, the legislative history further supports rejection of OCA's proposals.

Based on the plain language of the statute and the legislative history, it is readily apparent that OCA's proposed tax adjustments are not included in or required by the statutory mechanism. Therefore, OCA's contention in Exceptions that its adjustments are required by law should be rejected.

### 3. OCA's Contention That the Just and Reasonable Standard Requires that its Adjustments be Adopted Ignores the Distinction Between a Surcharge and a Base Rate Mechanism.

OCA contends that its proposed adjustments to the DSIC mechanism must be included in the calculation of a surcharge in order for DSIC rates to be "just and reasonable." (OCA Exc., pp. 9-13.) OCA's contentions were properly rejected by the RD.

As explained in PPL Electric's MB and RB, and as recognized in the RD, the DSIC surcharge is not required to include OCA's two additional components in order for rates to be just and reasonable. (PPL Electric MB, pp. 19-24; PPL Electric RB, pp. 3-8; RD, p. 29.) The RD correctly reached this conclusion based, in part, on the decision rendered by the Supreme Court of the United States in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) ("*Duquesne*"). OCA contends that the RD's reliance on the *Duquesne* decision is misplaced. OCA's contention is incorrect.

OCA attempts to distinguish the holding in *Duquesne* by arguing that the case was a takings case under the Fifth and Fourteenth Amendments. However, OCA overlooks the import of the Court's conclusion, which was that a rate cannot be declared unjust or unreasonable by looking in isolation at one or two base rate components that are not directly included in the calculation. The Court's finding states that:

> 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.

(internal citation omitted) (*Duquesne* at 314.) The Supreme Court further stated that "the States [are] free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." (*Duquesne* at 316.) This language is clearly relevant to the Commission's consideration of this issue. Rather than confirm that there is a single mechanism that establishes just and reasonable rates, or even that there are specific components that must be included in all rate making mechanisms, the Supreme Court acknowledged that the true test of just and reasonable rates is whether the end result of the rates is just and reasonable. Thus the Court in *Duquesne* reaches a result similar to the result reached by the Commonwealth Court in *Equitable, supra* pp. 2-3 – that the legislative body has the authority to develop a ratemaking mechanism that does not incorporate every aspect of a base rate case, so long as the end result is just and reasonable.

OCA seeks to undermine the holding reached by the Supreme Court by arguing that the failure to consider individual adjustments would make "rate proceedings effectively meaningless." (OCA Exc., p. 11.) OCA's argument is misleading. The OCA once again ignores the distinction between the Section 1308(d) base rate mechanism and a surcharge mechanism. Surcharge mechanisms are not subject to a full panoply of adjustments, unlike the scope of the proceedings in a general rate case. Surcharge mechanisms are subject to the adjustments specified in the statute creating them, and the terms of that statute are established by the General Assembly. Thus, the analysis of what may be included within the DSIC mechanism will have absolutely no impact on the Commission's or the

Court's consideration of Section 1308(d) proceedings, which will continue to include an analysis of all individual revenue, expense and rate base adjustments as required by law and precedent.

OCA's argument that certain additional adjustments are necessary in order for rates to be just and reasonable is undermined by its stated position in its Exceptions, and throughout this proceeding, that it does not seek to include all adjustments associated with a Section 1308(d) proceeding and does not seek a full tax analysis. (OCA Exc., p. 11.) Particularly, OCA does not seek to include adjustments that would be beneficial to utilities. OCA's logic is inconsistent and unfairly selective. Base rates include numerous individual adjustments which are not reflected in the DSIC. OCA does not contend that the absence of these other base rate adjustments would result in unjust and unreasonable rates, yet asserts that its two adjustments are required in order for DSIC rates to be just and reasonable. Such position is unsupportable.

OCA's further assertion that its proposals merely relate to other components already included in the DSIC calculation is untenable. (OCA Exc., p. 11.) As explained in detail in PPL Electric's MB and RB, and as recognized in the RD, there is no mention of ADIT in the statutory language and the General Assembly rejected a proposal to include in Act 11 an adjustment for tax benefits. (PPL Electric St. 3-R, p. 2; PPL Electric Ex. BLJ-1R.) Further, OCA has not disputed PPL Electric's argument that the Act 11 DSIC was based on the historic water DSIC formula, which did not include the specific adjustments identified by OCA in this proceeding. The OCA's claim that its tax effects are somehow already part of the DSIC mechanism, and not selective additions to the rate calculation, is erroneous.

OCA fails to acknowledge that the calculation of a surcharge mechanism can and should be different from the complete rate analysis undertaken in a Section 1308(d) proceeding. The RD correctly concluded that OCA's additional adjustments are not required.

### 4. The Evidence in This Proceeding Does Not Support OCA's Argument that PPL Electric's DSIC is Calculated Incorrectly According to Statute.

OCA relies on Act 11's use of the phrase "costs incurred" in an effort to circumvent the clear fact that its proposals are not set forth in the plain language of Section 1357, and are not supported by the legislative history. (OCA Exc., pp. 8-9; 11; 12; 22.) OCA argues that its proposal adjusts for costs that are not "incurred" by a utility, because otherwise the Company would recover investment on plant that was not funded by the Company or its shareholders. (OCA Exc., pp. 9; 11.) There is no evidence in this proceeding showing that PPL Electric uses non-shareholder capital to fund DSIC eligible projects. When PPL Electric invests in DSIC eligible property, it uses shareholder capital to make the necessary investments. Whether it will subsequently receive incremental deferred tax benefits is not known until after a tax return is filed. (PPL Electric St. No. 4-R, p. 5.) OCA assumes in its argument that any resulting incremental ADIT benefits associated with DSIC plant – plant originally fully funded by shareholder capital – will be flowed back into more DSIC eligible plant. There is no evidence in this proceeding that OCA's assumption is true. The Company can use the incremental ADIT in a variety of ways.[1] For example, any net growth in the ADIT balance may be used to finance future investment in non-DSIC plant, thereby reducing the earnings erosion due to the lag in reflecting such plant in rates. OCA has failed to support its argument with record evidence, and its argument should be rejected. Furthermore, as explained later in this Reply to Exceptions, any growth in the ADIT balance will be captured by the earnings cap portion of the DSIC rate.[2]

OCA also applies its "cost incurred" argument to its proposal to exclude the state income tax gross-up. (OCA Exc., p. 27.) However, the evidence in this proceeding demonstrated that OCA's

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[1] ADIT is a separate ratemaking adjustment to rate base, not unlike customer deposits, or cash working capital; it is not plant or a part of plant balances. *See Pa. P.U.C. v. Columbia Gas of Pennsylvania*, Inc., 1990 Pa PUC LEXIS 164, *17 (1990)(Recommended Decision). The General Assembly chose to define what components would be reflected in the surcharge calculation, specifically referencing property placed in service and depreciation, and chose not to include ADIT. However, the General Assembly did include an earnings cap, which takes into consideration the ADIT associated with all plant in service.

[2] As the Final Implementation Order recognized, the earnings cap is one of the customer protections in Act 11 and is an integral part of the DSIC rate. (Final Implementation Order, p. 39; PPL Electric MB, pp. 23-24.)

proposal to use state tax depreciation deductions on new DSIC eligible plant to eliminate the state tax gross-up would double-count available tax deductions. This would deprive PPL Electric of the recovery of pretax return costs authorized by Act 11. OCA's state income tax proposal fails its own "cost incurred" standard.[3]

OCA has failed to support its argument that PPL Electric's DSIC does not conform to the requirements of Act 11. OCA did not present evidence showing that PPL Electric funds DSIC projects with incremental ADIT. OCA presented no evidence to refute PPL Electric's evidence that the state income tax proposal advanced by OCA would result in double-counting of PPL Electric's tax benefits. For the reasons explained in greater detail in PPL Electric's RB, OCA's argument regarding the "costs incurred" language in Act 11 must fail. (PPL Electric RB, pp. 12-13.)

**5. The Earnings Cap Ensures that Rates are Just and Reasonable.**

OCA's argument that DSIC rates would be unjust and unreasonable without its tax adjustments ignores the important role of the earnings cap. As PPL Electric has explained, the General Assembly developed a mechanism that included consumer protections to ensure that rates would be just and reasonable. The earnings cap not only ensures that the resulting rates are just and reasonable, it takes into account the very same tax effects that OCA raises in this proceeding.

Initially, it is important to emphasize that the earnings cap provisions are an integral component of the DSIC rate. In Pennsylvania, a rate is defined as more than just the individual components of the mechanism, but rather the entire mechanism and all rules and regulations associated with it. The statutory definition of a rate is:

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

[3] As explained further in this Reply to Exceptions, OCA's proposal to double-count tax deductions also is inconsistent with OCA's "actual taxes paid" argument.

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

The earnings cap prohibits a utility from utilizing a DSIC if it is in an over-earning position; that is, its actual return is greater than its authorized return. As designed by the Commission in its historic water DSIC, and subsequently adopted by the General Assembly in Act 11, the earnings cap prohibits PPL Electric from utilizing the DSIC if it is earning a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under the DSIC. (PPL Electric St. 3-R, p. 4.) The earnings cap is based on the rate of return authorized in the utility's most recent Section 1308(d) base rate proceeding or in the Commission's quarterly earnings reports. In this instance, the earnings cap would be based on the return on equity allowed in PPL Electric's 2012 base rate proceeding.[4] In the quarterly earnings reports, the Company's calculation of rate base includes the current book amount of ADIT and adjustments for state income tax. (PPL Electric St. 3-RJ, p. 5.)

The earnings cap is applied to determine whether a utility is overearning its allowed rate of return, as calculated in the utility's most recent Section 1308(d) rate proceeding or the Commission's quarterly earnings report, as applicable. If a utility is, in fact, overearning, then it will not be allowed to charge customers the DSIC. If a utility obtains significant ADIT or state tax benefits, then those will be reflected in the quarterly earnings report and will increase the Company's achieved rate of return. Thus, in order for PPL Electric to get the benefit of a DSIC, it must be in an under-earning position after taking into consideration the very tax matters that the OCA is concerned about. (PPL Electric St. 3-R, p. 4.) The earnings cap provides the DSIC with a mechanism to ensure that rates are just and reasonable, and do not produce a profit above Commission-authorized levels.

[4] The arguments made by PPL Electric related to the earnings reports would apply equally to the results of a more recent rate case or to the use of the Commission determined rate of return.

OCA's failure to recognize that the General Assembly specifically embraced this mechanism as part of the consumer protections that will ensure just and reasonable rates is a critical flaw in its argument. The General Assembly has designed the DSIC rate, and the fact that the mechanism did not incorporate OCA's selective adjustments, or other adjustments such as additional uncollectible accounts expense, does not mean the resulting rates are unjust or unreasonable.

**6. Conclusion**

The OCA presented the same arguments in this proceeding that it presented before the Commission in its comments to the Final Implementation Order. In the Final Implementation Order, the Commission held that:

> [T]he DSIC is intended to be a straightforward mechanism which is easy to calculate, easy to audit and which does not require a full rate case analysis. Inclusion of an ADIT adjustment would be inconsistent with that goal and would likely invite litigation over its calculation. Moreover, we note that the water DSIC, used successfully for over 15 years, did not include an ADIT adjustment. And, in any event, consumers remain protected against over earnings by the earnings cap under Section 1358(b)(3) which captures the revenue impact of all other adjustments and insures that the DSIC does not result in unreasonable rates.
>
> Therefore, the Commission declines to adopt the OCA proposal to include, in the DSIC calculation, an adjustment for accumulated deferred income taxes. The adjustment, which was not previously used in the DSIC by the water industry, would add unnecessary complexities to the DSIC and, accordingly, will not be included in the model tariff.

Final Implementation Order at p. 39 (internal citations omitted). The evidence in this proceeding has shown that the Commission's reasoning in its Final Implementation Order is correct. The OCA has failed to produce evidence to show that the mechanism created by the General Assembly, based on the calculation of the historic water DSIC, must include the adjustments proposed by OCA in this proceeding. As the RD correctly identified, "it is the end result which must be analyzed" for the purpose of determining just and reasonable rates. (RD, p. 29.) The Commission should adopt the RD, and reject the OCA's proposals, as the OCA's proposals are not required or necessary to produce just and reasonable DSIC rates.

## B. THE OCA'S CONTENTION THAT FAILURE TO INCLUDE ADIT WILL RESULT IN UNJUST AND UNREASONABLE RATES IS INCORRECT, AND SHOULD BE REJECTED.

In the previous section of this Reply to Exceptions, PPL Electric explained that OCA errs in contending that its two selective adjustments to the DSIC charge calculation are required by law. PPL Electric further explained that the General Assembly chose to establish a simple mechanism that provides protection against unjust or unreasonable rates through an earnings cap. In its second Exception, OCA has presented additional argument in an effort to support its proposal to include ADIT in the charge calculation. As explained below, OCA's proposal on ADIT is complicated and unnecessary, and properly was rejected by the RD.

### 1. OCA Failed to Provide Relevant Evidence to Meet its Burden in this Proceeding.

OCA argues in its Exceptions that the record evidence produced by OCA supports adoption of its proposal to include ADIT in the DSIC calculation. (OCA Exc. pp. 13-16.) However, the evidence recited by OCA in support of this argument provides no meaningful support for inclusion of ADIT, and was correctly rejected in the RD.

The only evidence OCA points to in its Exceptions to support its proposed adjustment for ADIT is the approach used by utilities in other states. Reliance on other states is irrelevant as a matter of statutory construction, and provides no support for OCA's position. The Statutory Construction Act does not generally provide for consideration of an issue by another jurisdiction as a basis for determining legislative intent. In *Elder v. Orluck*, 511 Pa. 402, 515 A.2d 517, 522 (1986), the Court noted that it was not appropriate to consider another jurisdiction's statute where there was no indication that the General Assembly based Pennsylvania legislation on legislation adopted in other jurisdictions. The OCA does not dispute this legal standard. However, OCA attempts to skirt the rule by claiming that it offers these other states as evidence that ADIT is "inextricably tied to valuing the surcharge rate base correctly." (OCA Exc., p. 13.) In plain language, OCA argues that it is not offering these other

states as a basis for interpreting Act 11, but merely as a basis for showing that the DSIC must include ADIT because other states include ADIT. In short, OCA is doing exactly what is prohibited by the rules of statutory construction. There is no meaningful conclusion to be drawn from OCA's reliance on other jurisdictions.

Even if the practices in other states were relevant to the interpretation of Act 11, and they are not, the rate mechanisms cited by the OCA are fundamentally different from the Pennsylvania DSIC and offer no meaningful guidance to support the OCA's position. Of the states referenced by the OCA, many do not have mechanisms in place for electric utilities.[5] Morever, none of the states OCA has cited in this proceeding have an earnings cap. *See, e.g.,* MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013); KAN. STAT. ANN. §§ 66-2202-2204 (2013); KY. REV. STAT. ANN. § 278.509 (2013); MO. REV. STAT. § 393.1009 (2013); NEB. REV. STAT. §§ 66-1802, 1865-1867 (2012); R.I. GEN. LAWS § 39-1-27.7.1 (2013).[6] As discussed previously in Section II.A.5 of this Reply to Exceptions, the earnings cap plays a critical role in ensuring that the Act 11 DSIC produces just and reasonable rates.

Further, these states account for a variety of other adjustments as part of their calculation, including uncollectible accounts, real property, other taxes, operation and maintenance savings, purchased gas costs, and fully projected plant additions, to name only a few, which are not included in the Pennsylvania DSIC.[7] Rather than supporting the OCA's position in this proceeding, the practices in other states show that there is no absolute formula for calculating a surcharge mechanism, and that many different possible forms may result in just and reasonable rates. The OCA's argument that its tax proposals must be included because some other states include them is undermined by the OCA's

[5] *See, e.g., In re Atlanta Gas Light Co.'s Pipeline Replacement Program*, 2009 Ga. PUC LEXIS 245 (Ga. P.U.C. 2009) ("*Atlanta Gas*"); *Petition of Bay State Gas Co. for Approval by the Dep't of Pub. Utils. of its Proposed Calendar Year 2009 Targeted Infrastructure Reinvestment Factor for Effect November 1, 2010*, 2012 Mass. PUC LEXIS 160, D.P.U. 10-52 (Mass. Dept. of Telecomms. and Energy Oct. 30, 2012)("*Bay State 2010*").

[6] OCA continues to mistakenly argue that other states have an earnings cap similar to the earnings cap provided by the General Assembly in Act 11. (OCA Exc., Fn. 9.) This is not accurate. What OCA mistakenly identifies as an earnings cap in other states is comparable to the 5% revenue cap, which limits the amount that can be recovered through the DSIC. The earnings cap, however, operates to completely prohibit the use of the DSIC if the utility is in an overearning position. Perhaps this misunderstanding about how the earnings cap operates explains OCA's mistaken insistence that a utility could obtain unjust and unreasonable rates through the DSIC.

[7] *See, e.g., Bay State 2010*; MD. CODE ANN., PUB. UTIL. COS. § 4-210 (2013).

failure to similarly advocate to include other major rate components, which are included in other states but not included in Pennsylvania.

OCA argues that "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." (OCA Exc., p. 14.) This places an erroneous burden on PPL Electric, to present evidence that is irrelevant to the determination of whether the General Assembly in Pennsylvania included ADIT in the Act 11 DSIC. The evidence PPL Electric presented shows that the General Assembly adopted the same calculation that the Commission had used for the water DSIC, which does not include OCA's adjustments. (PPL Electric St. 3-R, pp. 3-4.) The evidence also shows that the earnings cap ensures that rates are just and reasonable. (PPL Electric St. 3-R, p. 4.) OCA has produced no evidence that PPL Electric would earn more than its allowed rate of return, or any other evidence to show that its adjustments are required in order to ensure that DSIC rates are just and reasonable. Therefore, OCA has not met its evidentiary burden in this proceeding, and its adjustments should be rejected.

**2. Inclusion of ADIT Would Complicate the DSIC Unnecessarily.**

OCA asserts that the inclusion of ADIT will not complicate the DSIC calculation. (OCA Exc., pp. 16-21.) However, OCA's position in this case confirms the complicated nature of ADIT. OCA has acknowledged that in certain circumstances it is not appropriate to make an ADIT adjustment, where generated tax deductions exceed the utility's income, resulting in tax losses. (OCA Exc., pp. 19-20.) PPL Electric has been in such a position, as conceded by OCA's witness. (OCA St. 1, p. 7.) As a result, PPL Electric has not been able to benefit from all available accelerated depreciation deductions, and has substantial tax loss carryforwards. Therefore, PPL Electric cannot take tax deductions, or receive the benefit of ADIT, on new plant additions until these tax loss carryforwards have been utilized. (PPL Electric St. No. 4-R, pp. 7-8; OCA St. 1, p. 7.) The result, as conceded by OCA, is that

an ADIT adjustment will not always be appropriate for inclusion in the DSIC. (OCA Exc., pp. 19-20; OCA St. No. 1, p. 7.)

OCA argues that the tax loss carry forward position is only temporary, and should not be a basis for concluding that ADIT adjustments are complicated. However, this argument ignores that the tax loss carry forward is ongoing, and can recur at any time, depending on the Company's earnings and the available tax deductions under federal law. (PPL Electric MB, pp. 21-24.) Thus, the tax loss issue is not necessarily a one-time or temporary event. Moreover, OCA ignores entirely the issue of changing and decreasing deferred tax balances in base rates. The Company's total deferred tax balance that is reflected in a base rate proceeding changes yearly, and tax deductions on new plant can be offset by declining deferred tax offsets on plant already reflected in base rates. (PPL Electric St. 4-R, pp. 3-6.) ADIT is a dynamic element that is constantly shifting based on available tax deductions, the mix of plant in service, and the Company's current tax position. These dynamic changes cannot be accurately captured in the simple formula used to compute the DSIC charge, and are not reflected in OCA's proposed adjustment.

OCA has argued that difficulties in providing accurate projections of incremental ADIT may be overcome through the annual reconciliation process. (OCA Exc., p. 21.) This assertion cuts directly against OCA's argument that ADIT is not overly complicated, as the OCA acknowledges that the Company cannot accurately calculate ADIT until the end of the calendar year.[8] Further, the reconciliation provided for in the statute is intended to be simple and straightforward, and not include the likelihood of significant changes in the charge to customers due to changes in the Company's tax position.

[8] OCA raises a new argument that PPL Electric's ADIT balance will not decline, because PPL Electric intends to continue to repair and replace DSIC eligible plant. (OCA Exc., p. 21.) OCA's argument ignores that there could be any number of unforeseen events that cause a significant change in PPL Electric's tax position, including a change in the tax deductions available under federal law.

### 3. A Higher Standard of Review is Not Appropriate for Capital Costs.

OCA argues that a higher level of review should apply in this case than in other surcharge proceedings, because capital costs are involved. (OCA Exc. p. 19.) OCA relies on language from the *Wastewater DSIC* case, *supra* p. 2, to contend that recovery of capital costs are "inherently more complex than recovery of an expense." However, OCA misstates the Court's decision. In that case, Pennsylvania American Water Company sought to implement a DSIC for its wastewater operations under authority of Section 1307(a) of the Public Utility Code. 66 Pa.C.S. § 1307(a). The Court concluded that Section 1307(a) was limited to recovery of expenses. However, the Court did not hold that only a complex surcharge mechanism, which included every base rate element, was required for capital cost recovery. Indeed, the Court held:

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

869 A.2d at 1158. As the Court recognized, the General Assembly has the authority to establish the terms of surcharge mechanisms as exceptions to traditional ratemaking procedures. Specifically, in the *Wasterwater DSIC* case, the Court recognized that the General Assembly had expressly authorized a simple mechanism to recover capital costs, but had limited the application of that mechanism to water companies. The General Assembly's authority to authorize rate treatment for capital costs that deviates from the full rate mechanism used in a Section 1308(d) proceeding is readily apparent. OCA's argument that the DSIC mechanism requires a higher standard of review because it impacts capital costs is not supported by the very case it cites for that principle.

### 4. The Earnings Cap Captures the Effect of ADIT.

OCA contends that the earnings cap should not be considered in determining whether ADIT is appropriate in the DSIC formula. As explained in Section II.A.5, above, OCA fails to acknowledge the importance of the earnings cap in capturing the complexities of ADIT changes, and in ensuring that the

DSIC rate is just and reasonable. ADIT changes are part of the earnings cap calculation, and are therefore included in the determination of the total effect of the DSIC rate. If increases in ADIT are substantial, the impact can be that the utility will overearn its authorized return, which will be reflected in the DSIC earnings cap and will result in the DSIC being suspended.

OCA argues that because the quarterly earnings report takes into consideration many adjustments, aside from the two selective tax adjustments identified by OCA in this proceeding, it is therefore invalid as an adequate customer protection. (OCA Exc., p. 22.) This contention is incorrect. The General Assembly rationally decided to include the earnings cap in recognition that the DSIC charge calculation did not include all of the components considered in a base rate case. The quarterly earnings report captures a wide variety of individual adjustments which would be considered in a base rate proceeding, and captures both upward and downward impacts. As a result, the earnings reports provide a more complete, ratemaking type analysis of a utility's earnings. However, instead of relying on the more complete analysis of the quarterly earnings report, OCA seeks selective incremental adjustments in this proceeding. The evidence shows that OCA's incremental adjustments do not accurately reflect the impact of tax benefits on the Company's overall rate of return, and would certainly lead to inaccurate results that do not comport with actual taxes paid. (PPL Electric St. No. 4-R, pp. 3-8; MB at pp. 25-26; *see also* Section II.C.1 below.) The use of the quarterly earnings report, which captures the actual impact of tax benefits associated with DSIC-eligible property on the Company's rate of return, is the more appropriate method to ensure that rates are just and reasonable, rather than the incomplete incremental adjustments proposed by OCA.

The earnings cap is the correct approach precisely for the reason that it captures the potential magnitude and complexity of ADIT and other costs, without turning the formula of the DSIC into another miniature rate case, replete with the many issues associated with tax treatment that are present in a Section 1308(d) base rate proceeding. OCA's contention that the ALJs erred in considering the earnings cap should be rejected.

## C. THE EVIDENCE IN THIS PROCEEDING SHOWS THAT OCA'S PROPOSAL TO OFFSET THE STATE INCOME TAX GROSS-UP IS FUNDAMENTALLY UNFAIR, VIOLATES THE ACTUAL TAXES PAID DOCTRINE, AND SHOULD BE REJECTED.

OCA's third Exception presents additional argument concerning the proposal to offset the state income tax gross-up through incremental state tax depreciation deductions. OCA has proposed in this proceeding that the Commission discontinue the procedure used for sixteen years under the water DSIC of allowing utilities to include a full gross-up for state income taxes as part of the DSIC calculation. The record evidence in this proceeding clearly shows that OCA's proposal regarding the gross-up for state income taxes would result in double-counting of state tax depreciation deductions and is fundamentally unfair. Further, the evidence shows that the earnings cap accounts for state income tax depreciation benefits. The OCA's proposal produces inaccurate and unfair results that would complicate the DSIC mechanism, and are not required to produce just and reasonable rates. Therefore, the RD properly rejected OCA's state income tax proposal.

In support of its third Exception, OCA repeats many of the same arguments it made with regard to the legal standard and ADIT. For the purposes of this Reply to Exceptions, PPL Electric will not repeat its arguments in opposition which have been made in the prior sections. However, PPL Electric will respond to the new arguments raised by OCA in its third Exception.

### 1. OCA's State Tax Adjustment Does Not Reflect Actual Taxes Paid.

OCA argues that the DSIC mechanism must reflect "actual taxes paid," consistent with the requirements established by the Pennsylvania Supreme Court. (OCA Exc., pp. 23-25.) OCA's adjustment, however, does not reflect actual taxes paid. As explained below, OCA's proposal produces inaccurate tax results that double-count the Company's actual tax benefits. On that basis, alone, OCA's proposal must fail.

OCA argues that state income tax depreciation deductions associated with DSIC property is fully incremental, despite clear record evidence showing that this is simply not the case. (OCA Exc.,

pp. 26; 30.) As explained below, and in PPL Electric's MB and RB, OCA's proposal to calculate state income taxes for DSIC purposes based solely on incremental tax depreciation deductions associated with plant additions included in the DSIC ignores offsetting reductions in state tax depreciation deductions that are reflected in base rates. (MB at pp. 25-26; RB at pp. 16-17.) OCA's failure to recognize these offsets results in double-counting of deductions.

OCA's incremental deduction proposal would incorporate inaccurate tax adjustments into the DSIC. As explained by PPL Electric in its testimony, MB and RB, it is improper to try to isolate and compute state tax liabilities on an incremental basis. (PPL Electric St. No. 4-R, pp. 4-5; MB at pp. 25-26; RB at pp. 16-17.) The Company's tax posture is computed on an overall basis, and it would be incorrect to ignore overall taxes and the tax allowance reflected previously in base rates. Due to accelerated depreciation, as to plant that was reflected in a prior base rate proceeding, state tax depreciation deductions will progressively decline. (PPL Electric St. 4-R, pp. 3-6.) Elimination of the state income tax gross-up through an "incremental" deduction approach improperly ignores state tax depreciation and accelerated depreciation deductions that were reflected in the Company's prior base rate case. At least some of the tax deductions that were previously available will no longer be available to the Company. (PPL Electric St. 4-R, pp. 3-6.) In addition, under accelerated depreciation procedures, the amount of the depreciation deduction on each tax vintage declines over time. (PPL Electric St. 4-R, pp. 3-6.) Treating deductions in base rates as if they continue into the future unchanged, while claiming that deductions associated with new plant in the DSIC should be viewed as "incremental," results in a double counting of deductions, thereby significantly overestimating the deductions available to the Company.

OCA attempts to argue that it is unlawful for ratepayers to pay "phantom state income taxes" between base rate cases, just as if this were a base rate case. (OCA Exc., p. 30.) This argument is erroneous. As PPL Electric has shown, ratepayers are not paying phantom taxes, because PPL Electric has used shareholder funds to repair and replace plant, tax benefits associated with that plant, if any

exist, will not be known until the end of the tax year, and PPL Electric's base rates already reflect tax deductions that are no longer available to the Company. (PPL Electric MB, pp. 25-26.) Further, OCA's proposal will not approximate the actual taxes paid by PPL Electric. PPL Electric can continue its current accelerated pace of infrastructure replacement, and each year receive a single year's state tax benefit equal to the benefits built into base rates. However, under OCA's proposal, PPL Electric would receive no state tax gross-up in the DSIC, because OCA would claim the new deduction each year as an offset. This provides ratepayers with the equivalent of two state tax benefits, where the Company receives only one. (PPL Electric MB, pp. 25-26.) OCA's argument is grossly flawed.

Despite its continued protests in its Exceptions that the DSIC must incorporate actual taxes paid, OCA's proposal is clearly not reflective of the actual taxes that will be paid by PPL Electric. The DSIC, as currently calculated, more accurately reflects the tax benefits available to PPL Electric. OCA's proposal double-counts the state tax benefits available to the Company. As a result, the RD properly rejected OCA's proposal.

### 2. OCA's State Tax Adjustment Adds Unnecessary Complication to the DSIC.

OCA argues in its Exceptions that it is not advocating for a full tax analysis, and that, therefore, its proposal on state income taxes would not overly complicate the DSIC. (OCA Exc., pp. 26-29.) The only way to determine PPL Electric's actual taxes paid for state income tax purposes would be to conduct a full rate case tax analysis, which circumvents the goal of the General Assembly to establish a simple mechanism that was not a full base rate calculation.

OCA claims that "the tax benefits associated with DSIC investment and revenues exist because of the DSIC investment and revenues." (OCA Exc., p. 28.) This is factually untrue. First, and most obvious, any tax benefits exist as a result of Federal and state law. Any change in these laws could eliminate tax benefits entirely as to new plant. Second, PPL Electric's taxes are not calculated on an incremental basis. (PPL Electric St. 4-R, p. 5.) This means that, in calculating its taxes, the Company

does not distinguish new plant from plant already included in base rates. Rather, it is the total net income of PPL Electric computed on an annual, not quarterly, total Company basis that is used to calculate taxes. (PPL Electric St. 4-R, pp. 4-5.) The result of this is that the tax implications associated with new plant are offset by the tax implications associated with older vintage plant. Only a full base rate case tax analysis captures the exact amount of tax benefits available to the Company, because such an analysis would look at all plant in service. (PPL Electric St. 4-R, pp. 5-8.)

The clear evidence presented in this case shows that OCA's state income tax adjustments, which focus on incremental plant additions and ignore tax benefits already flowed through to customers, would not produce accurate results. (OCA Exc., p. 27; *see* Section II.C.1, above.) In order to determine the actual state tax adjustment, a full base rate tax analysis is required. However, as the RD properly recognized, that would be contrary to the intent of the General Assembly in adopting a simple surcharge mechanism. (RD, p. 35.) Conducting a full tax analysis would subject the DSIC to disputes over the proper calculation of state tax liability. Such litigation is specifically contrary to the Commission's intent as indicated in its Final Implementation Order. (Final Implementation Order, p. 39.) Further, the adjustment is unnecessary in order to ensure just and reasonable rates, because, as discussed below, the earnings cap reflects actual state income taxes.

### 3. The RD Correctly Concluded that the Earnings Cap Ensures Just and Reasonable Rates.

OCA asserts that the ALJ erred in relying upon the earnings cap as protection against unjust or unreasonable rates. (OCA Exc., pp. 29-30). The OCA has once again overlooked the importance of the earnings cap in accounting for the impact of state income tax benefits on the Company's rate of return. As explained previously in Section II.A.5, the earnings cap formula provides a total analysis of the Company's earnings position, including the actual amount of state income tax deductions available. (PPL Electric St. 3-RJ, p. 5.) Unlike the OCA's flawed proposal, which double-counts the Company's available tax deductions, the earnings cap formula considers the actual total deductions as part of a

package that reflects the total level of earnings for PPL Electric. The earnings cap formula captures all of the moving parts associated with the tax deductions, unlike OCA's incremental proposal. OCA appears to dispute that a formula that captures all of the moving parts associated with utility ratemaking is an appropriate method of determining whether rates are just and reasonable. (OCA Exc., p. 29.) This is merely further evidence that OCA's adjustments are not intended to arrive at a rate that reflects the actual taxes paid by the Company. OCA's proposal is unnecessary in order to ensure that actual state income tax deductions are incorporated in ensuring that DSIC rates are just and reasonable.

#### 4. OCA Continues to Ignore the Authority of the General Assembly to Establish How Just and Reasonable Rates Are Determined.

OCA asserts that the failure to include its adjustment to state income taxes is unlawful, because "actual taxes paid" are applicable to surcharge mechanisms in the same manner that they are applied to 1308(d) base rates. (OCA Exc., pp. 26-28; 30.) As a primary matter, OCA argues that "the statute specifically provides for recovery of federal and state income taxes" to conclude that, therefore, its tax benefit adjustments must be accounted for as well. (OCA Exc., p. 28.) This is clearly untrue. As described in Sections II.A.2 through 4 of this Reply to Exceptions, the OCA's tax adjustments cannot be found in the plain language of the statute. OCA's statutory argument throughout this proceeding has relied on the "costs incurred" language in the statute, as well as the OCA's construction and application of 66 Pa.C.S. § 1301, to infer that the DSIC mechanism should include ADIT and exclude the state tax gross-up. OCA's conclusion does not follow from the statutory language it identifies.

Further, OCA continues to misapprehend the authority of the General Assembly to define rate recovery through a surcharge mechanism. The actual taxes paid doctrine involves a complex set of base rate calculations to determine the tax liability of a utility. As discussed in Sections II.A.2 and 3, the General Assembly did not intend for this proceeding to be a full base rate proceeding under section 1308(d), but rather a simplified automatic adjustment clause proceeding. Further, the General Assembly is not required to incorporate every base rate ratemaking concept into a surcharge

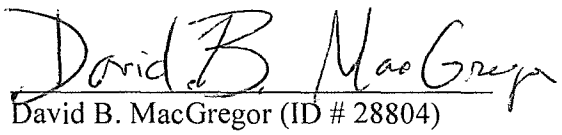
mechanism. In the case of the DSIC, the General Assembly concluded that the Commission's historic water DSIC mechanism was best suited to derive just and reasonable rates, and accounted for the complexities of actual taxes through the earnings cap. This approach is clearly more appropriate than OCA's incremental deductions approach, which double-counts state tax deductions and does not reflect "actual taxes paid."

The RD correctly concluded that OCA's state tax gross up adjustment is not required under the "actual taxes paid" principle as a matter of law. For the reasons explained above, and in PPL Electric's MB and RB, OCA's proposal should be rejected.

## III. CONCLUSION

PPL Electric Utilities Corporation respectfully requests that the Exceptions of the Office of Consumer Advocate be denied, that the Exceptions of PPL Electric Utilities Corporation be granted, and that in all other respects the Recommended Decision of Administrative Law Judge Kandace F. Melillo be adopted.

Respectfully submitted,



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