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June 5, 2017

VIA eFILING

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
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Harrisburg, PA 17105

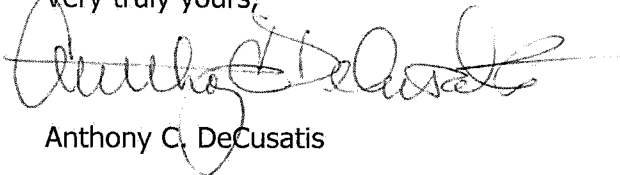
Re: Petitions of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company for Approval of a Distribution System Improvement Charge Docket Nos. P-2015-2508942, *et al.*
Office of Consumer Advocate v. Metropolitan Edison Company, *et al.* Docket Nos. C-2016-2531040, *et al.*

Dear Secretary Chiavetta:

Enclosed for filing, on behalf of **Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company**, please find their **Supplemental Initial Brief** (the "Brief") in the above-referenced proceedings.

A copy of this Brief will be served on Administrative Law Judge Joel Cheskis and those parties identified on the attached Certificate of Service.

Very truly yours,



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Enclosures

c: Per Certificate of Service (w/encls.)

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITIONS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY, PENNSYLVANIA POWER COMPANY AND WEST PENN POWER COMPANY FOR APPROVAL OF A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE	:	**Docket Nos. P-2015-2508942, *et al.***
OFFICE OF CONSUMER ADVOCATE	:	**Docket Nos. C-2016-2531040, *et al.***
v.	:	
METROPOLITAN EDISON COMPANY, *ET AL.*	:	

CERTIFICATE OF SERVICE

I hereby certify and affirm that I have this day served a copy of the **Supplemental Initial Brief** on the following persons in the matter specified in accordance with the requirements of 52 Pa. Code § 1.54:

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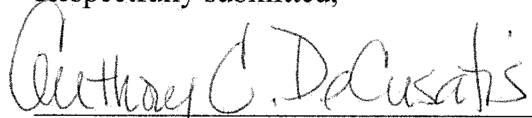

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Dated: June 5, 2017

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITIONS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY, PENNSYLVANIA POWER COMPANY AND WEST PENN POWER COMPANY FOR APPROVAL OF A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE	:	**Docket Nos. P-2015-2508942 P-2015-2508936 P-2015-2508931 P-2015-2508948**
OFFICE OF CONSUMER ADVOCATE	:	
v.	:	**Docket Nos. C-2016-2531040 C-2016-2531060 C-2016-2531054 C-2016-2531019**
METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY PENNSYLVANIA POWER COMPANY WEST PENN POWER COMPANY	:	

SUPPLEMENTAL INITIAL BRIEF

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June 5, 2017

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I. INTRODUCTION

A. Background And History Of The Proceeding[1]

Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power") and West Penn Power Company ("West Penn") (individually, a "Company" and, collectively, the "Companies") submit this Supplemental Initial Brief to supplement their Initial and Reply Briefs filed on September 30 and October 14, 2016, respectively, in their consolidated base rate proceedings.[2] In their earlier briefs, the Companies addressed the issue that had been expressly reserved for decision by the Pennsylvania Public Utility Commission pursuant to the terms of the Joint Petitions for Partial Settlement ("Joint Petitions") that resolved all other issues in those cases (hereafter, the "Settlements"). In its Opinion and Order entered January 19, 2017, approving the Settlements, the Commission transferred the reserved issue to this proceeding together with relevant portions of the record in the base rate cases, the Companies' and Office of Consumer Advocate's ("OCA") briefs on the reserved issue,[3] the OCA's Exceptions and the Companies' Replies to those Exceptions.

In summary, the reserved issue is whether the enactment of Act 40 of 2016 ("Act 40"), which added Section 1301.1 to the Pennsylvania Public Utility Code,[4] requires the Commission

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[1] A detailed procedural history is set forth in the Companies' Further Prehearing Conference Memorandum filed on March 2, 2017 and in the Commission's Opinion and Order on reconsideration and clarification at Docket Nos. R-2016-2537349, *et al.* entered on May 18, 2017. Consequently, a detailed procedural history is not being repeated here.

[2] *Pa. P.U.C. v. Metropolitan Edison Co.*, Docket Nos. R-2016-2537349, *et al.*; *Pa. P.U.C. v. Pennsylvania Electric Co.*, Docket Nos. R-2016-2537352, *et al.*; *Pa. P.U.C. v. Pennsylvania Power Co.*, Docket Nos. R-2016-2537355, *et al.*; *Pa. P.U.C. v. West Penn Power Co.*, Docket Nos. R-2016-2537359, *et al.* The Companies' base rate cases and all complaints against the Companies' proposed rates were consolidated for hearings and decision by the Prehearing Order issued on June 22, 2016 in those cases.

[3] The Companies and the OCA each submitted their detailed Proposed Findings of Fact, Conclusions of Law and Proposed Ordering Paragraphs on the reserved issue as appendices to their Initial and Main Briefs, respectively,

[4] Hereafter, all references to a "Section" are to sections of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 101 *et seq.*, unless otherwise indicated.

to revise the formula for calculating quarterly charges under the Distribution System Improvement Charge ("DSIC") set forth in the Model Tariff for the DSIC that the Commission approved in its Final Implementation Order.[5] (It is not disputed that the Companies' DSIC Riders conform to the terms of the Model Tariff, as the Commission expressly found and determined in the June 9, 2017 Orders approving their respective DSIC Riders.[6])

Section 1301.1 precludes the Commission from making consolidated tax adjustments ("CTAs") in determining the federal income tax included in a utility's revenue requirement. It also specifies how the additional income produced by that change should be invested for a period of five years after the effective date of Act 40. The OCA, through its witness, Ralph C. Smith, contended that Section 1301.1 should be interpreted to require the Commission to revise the DSIC to include a new element in the DSIC formula to deduct from the original cost of DISC-eligible property the accumulated deferred income taxes ("ADIT") that may accrue with respect to quarterly additions of such property.[7] The Companies submitted the rebuttal testimony of Richard A. D'Angelo, FirstEnergy's Manager, Rates and Regulatory Affairs – Pennsylvania, rebutting Mr. Smith's averments,[8] and also addressed the reserved issue in their Initial and Reply Briefs.

As previously explained, in the Companies' base rate proceeding, Mr. Smith proposed his interpretation of Section 1301.1 in conjunction with his recommendation that ADIT should be deducted from the original cost of eligible property in calculating the DSIC. Consequently,

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5 *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611 (Aug. 2, 2012) ("Final Implementation Order"), pp. 30-31 and Appendix A (Model Tariff) to that Order.

6 *See, e.g.*, Met-Ed's June 9, 2016 Order at Docket No. P-2015-2508942 (p. 7) ("Met-Ed's proposed DSIC Rider is consistent with the Model Tariff . . .").

7 *See* OCA Statement No. 1, pp. 108-110.

8 Companies' Statement No. 2-R, pp. 40-43. Mr. D'Angelo explained that Section 1301.1 does not apply to the DSIC and, even if it did, it does not eliminate or diminish the Commission's discretion and authority to determine how ADIT and other income tax effects should be recognized in the DSIC rate adjustment formula.

neither Mr. Smith, in his testimony, nor the OCA, in its Main or Reply Briefs, addressed how, if at all, the DSIC formula should – or could – be revised to reflect Pennsylvania state income tax deductions and credits if Mr. Smith's interpretation of Section 1301.1 were adopted by the Commission. For that reason, after the reserved issue was referred to this proceeding, the OCA asked for the opportunity to supplement the record for the limited purpose of explaining how, in its estimation, the DSIC formula might be revised to reflect the effect on state income taxes of its interpretation of Act 40 and Section 1301.1.

In their Further Prehearing Conference Memorandum filed on March 2, 2017, the Companies explained that they would not object to the submission of supplemental testimony limited to the contingent issue delineated above, namely, how, if at all, the DSIC formula for calculating quarterly DSIC charges should be revised to reflect state income tax deductions and credits in the event the OCA's position on the reserved issue is adopted by the Commission. Accordingly, the parties agreed to the procedural schedule set forth in Scheduling Order No. 2 issued on March 6, 2017. Pursuant to that schedule, the OCA submitted the Supplemental Direct Testimony of Mr. Smith on March 21, 2017; the Companies submitted the Supplemental Rebuttal Testimony of Charles V. Fullem on April 13, 2017;[9] the OCA submitted the Surrebuttal Testimony of Mr. Smith on May 1, 2017; and the Companies' submitted the Rejoinder Testimony of Mr. Fullem on May 5, 2017. The parties waived cross-examination of Messrs. Smith and Fullem, and a telephonic hearing was held on May 12 to admit the supplemental testimony and accompanying exhibits into the evidentiary record.

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[9] Mr. Fullem is the Director, Rates and Regulatory Affairs – Pennsylvania, for FirstEnergy Service Company.

B. The Reserved Issue – Overview

In *McCloskey v. Pa. P.U.C.*,[10] the Commonwealth Court held that the Commission did not abuse the discretion afforded it under the Public Utility Code to set just and reasonable rates when it determined that: (1) incremental ADIT associated with quarterly additions of "eligible property" need not be included in calculating quarterly adjustments of the DSIC: and (2) state income taxes on DSIC income may be recovered at the applicable statutory rate.[11] In so doing, the Court rejected the OCA's contention that the Commission-approved DSIC adjustment clause ignores the impact of ADIT and various state income tax deductions and credits. To the contrary, the Court held that the DSIC, viewed in its entirety, properly takes ADIT and state income tax deductions and credits into account because cumulative ADIT (i.e., ADIT related to *all* of a utility's property) as well as *all* state income tax deductions and credits that a utility may properly claim on its state income tax return are fully reflected in the calculation of a utility's achieved rate of return on equity that is performed, and filed, each quarter. The utility's achieved rate of return on equity, in turn, is compared, each quarter, to the utility's allowed rate of return on equity to determine if the utility has exceeded its DSIC "earnings cap"[12] and, if so, the utility must reduce its DSIC to *zero*. The Court explained that its affirmance of the Model Tariff followed established Pennsylvania appellate court precedent holding that there is no "single way" to determine just and reasonable rates; that the Commission is "'vested with

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[10] 127 A.3d 860 (Pa. Cmwlth. 2015) ("*McCloskey*"). This case was an appeal from a Commission Order approving a DSIC for Columbia Gas of Pennsylvania, Inc. ("Columbia"). Similar issues were also decided against the OCA in an unreported opinion issued the same day in the OCA's appeal from a Commission Order approving a DSIC for Little Washington Wastewater Company ("Little Washington"). *McCloskey v. Pa. P.U.C.*, No. 1358 C.D. 2014 (Nov. 3, 2015) ("*McCloskey-Little Washington*").

[11] 127 A.3d at 870-871.

[12] *See* 66 Pa.C.S. § 1358(b)(3).

discretion to decide what factors it will consider'" in establishing a rate, [13] and that the *entire* adjustment clause (including the "earnings cap") constitutes the "rate" that must be assessed for justness and reasonableness.[14]

In the Companies' base rate proceeding, Mr. Smith and the OCA contended that the enactment of Section 1301.1(a) requires the Commission to adopt the very same proposed revision to the DSIC formula the Commonwealth Court rejected in *McCloskey* and *McCloskey-Little Washington*.[15] As previously explained, Act 40[16] added Section 1301.1(a) to the Public Utility Code for the express purpose of eliminating the use of CTAs in calculating utility base rates.[17] Nonetheless, Mr. Smith and the OCA submitted that Section 1301.1(a): (1) applies to the formula for calculating the DSIC incorporated in the Model Tariff; and (2) retroactively eliminates the Commission's discretion to determine how ADIT and state income tax deductions and credits should be recognized in establishing a just and reasonable DSIC adjustment clause. Mr. D'Angelo, in his rebuttal testimony, and the Companies, in their Initial and Reply Briefs,

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[13] 127 A.3d at 868, quoting *Popowsky v. Pa. P.U.C.*, 669 A.2d 1029, 1040 (Pa. Cmwlth. 1995). *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 313 (1989) (Rejecting the argument advanced by appellants in that case that "subsidiary elements" of a ratemaking methodology may be "examined piecemeal.")

[14] 127 A.3d at 867 (Accepting the Commission's position that "the DSIC charge and the limiting provisions of the customer protections under Act 11 must be considered together." The "earnings cap" is one of the "customer protections" embedded in the DSIC Model Tariff.) *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2338282 (Final Order entered May 22, 2014), p. 22 ("However, the ALJs stated that, '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.'") quoting R.D. issued Mar. 6, 2014), p. 45. *See also* 66 Pa.C.S. § 102 (defining a "rate" as including "any rules, regulations, practices, classifications or contracts affecting any . . . charge.").

[15] OCA Statement No. 1, pp. 108-110.

[16] Act 40 was enacted on June 12, 2016 to become effective in sixty days (i.e., by August 11, 2016) for "all cases where the final order is entered after the effective date of this section."

[17] *See* Public Hearing In Re: House Bill 1436, Pennsylvania House of Representatives, Consumer Affairs Committee, Sept. 29, 2015 ("H.B. 1436 Public Hearing"), Tr. at 4-5 (Opening Statement of Chairman Robert Godshall): "House Bill 1436 would eliminate the consolidated tax approach and adopt a standalone approach used by a majority of the states and the Federal Energy Regulatory Commission." *See also House of Representatives Legislative Journal*, Feb. 8, 2016, p. 117 (Remarks of Robert Godshall, Chairman, Consumer Affairs Committee (". . . this section applies to base rate cases . . ."). Copies of the Public Hearing transcript and the House Legislative Journal are attached as Appendices A and B, respectively, to the Companies' Initial Brief.

explained why both of the OCA's contentions are erroneous. Specifically, Act 40 does not apply to the DSIC and, even if it did, it could not retroactively revoke the discretion afforded the Commission to determine how ADIT and state income tax deductions and credits should be accounted for in the DSIC adjustment clause. These arguments are set forth at length in the Companies' Initial (pp. 11-39) and Reply (pp. 6-15) Briefs and, therefore, only a brief summary is provided herein.

Act 40 does not apply to the DSIC for three reasons. First, Act 40 does not mention the DSIC or otherwise indicate that the amendments it was making to the Public Utility Code altered the method of calculating the DSIC that had been approved by the Commission and affirmed by the Commonwealth Court.[18] To the contrary, Act 40 was explicitly designed to eliminate the use of CTAs.[19] Nothing within the four corners of Act 40, or in its legislative history, suggests it would alter the elements of the DSIC formula prescribed in Section 1357 or deprive the Commission of its discretion to determine *how* ADIT and state income tax deductions and credits should be accounted for in designing DSIC tariffs.[20]

Second, contrary to the OCA's attempt to interpret Act 40 in a manner that conflicts with its express purpose, the legislative history of Act 40 is clear that Section 1301.1 was intended to apply *only* to *base* rates established under Section 1308 and not to adjustment clauses such as the DSIC.[21] The lead sponsor of H.B. 1436 – the bill that became Act 40 – stated that "this section applies to *base* rate cases" and "would only go into effect when a utility comes in for a *base* rate

[18] Companies' Initial Brief, pp. 18-22.

[19] *See* Companies' Statement No. 2-R, pp. 40-41 and Companies' Initial (pp. 19-20) and Reply (pp. 7-11) Briefs.

[20] *See* 1 Pa.C.S. § 1921(c) (Legislative intent may be ascertained from the "occasion and necessity for the statute," the "circumstances under which it was enacted," the "object to be attained," the "contemporaneous legislative history," and "legislative and administrative interpretations" bearing on the relevant statute.)

[21] Companies' Initial (pp. 22-27) and Reply (pp. 7-11) Briefs.

case."[22] Additional evidence from the text of Act 40 itself,[23] as well as its legislative history, supports this conclusion.[24] The DSIC is a "sliding scale of rates or other method for the automatic adjustment of rates"[25] that is based on the same authority granted under Section 1307.[26] As such, the DSIC is not a "base rate" and, therefore, Section 1301.1 does not apply to it.

Third, Act 40 expressly provides: "This section shall apply to all cases where the final order is entered after the effective date of this section."[27] The DSIC formula the OCA proposes to revise was approved in the Final Implementation Order as part of the Model Tariff that Section 1353(b) required the Commission to adopt. The Final Implementation Order was entered on August 2, 2012, and the DSIC formula it approved was affirmed by the Commonwealth Court in *McCloskey* and *McCloskey-Little Washington* on November 3, 2015.[28] The Final Implementation Order was the "final order" that established the DSIC "rate" now challenged by the OCA. As such, Section 1301.1 does not apply to that "rate."[29] Moreover,

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22 House of Representatives Legislative Journal, Feb. 8, 2016, p. 117 (Remarks of Robert Godshall, Chairman, House Consumer Affairs Committee) (emphasis added). *See* Companies' Initial (pp. 25-26) and Reply (p. 11) Briefs and Companies' Statement No. 2-R, pp. 41-42.

23 *See* Companies' Initial (pp. 26-27) and Reply (pp. 7-10) Briefs.

24 *See* Companies Initial Brief, pp. 25-26.

25 66 Pa.C.S. § 1357(c).

26 66 Pa.C.S. § 1358(e)(2). This section requires the reconciliation of revenues and costs "in accordance with section 1307(e)."

27 As previously noted, the effective date is August 11, 2016.

28 As previously noted, the OCA appealed from two Commission Orders that approved DSIC tariffs conforming to the Model Tariff. These two appeals were the "test cases" for challenging the terms of the Model Tariff.

29 *See* Companies' Statement No. 2-R, p. 42 and Companies' Initial (pp. 27-31) and Reply (p. 12) Briefs.

even the Commission Orders approving the Companies' DSIC Riders, which found that they conform to the Model Tariff, were also entered prior to the effective date of Act 40.[30]

Furthermore, even if Act 40 applied to the Model Tariff – which it clearly does not – Act 40 did not retroactively revoke or diminish the discretion afforded the Commission, and affirmed in *McCloskey*, to determine how ADIT should be reflected in the DSIC.[31] As previously explained, cumulative ADIT related to all of a utility's plant in service and all state income tax deductions and credits are fully reflected in the quarterly calculation of a utility's achieved rate of return on equity used to determine whether it may charge a DSIC or, alternatively, must reduce the charge to zero if its "earnings cap" is exceeded.[32] The DSIC formula does not ignore the impact on the DSIC of ADIT and state income tax deductions and credits and, therefore, does not violate Section 1301.1(a) as the OCA contends. To the contrary, the Commission's Model Tariff accounts for ADIT and state income tax deductions and credits – just not in the manner the OCA prefers. Simply stated, Act 40 did not strip the Commission of its discretion to choose the method for reflecting ADIT and state income tax deductions and credits in the DSIC adjustment mechanism – a method that the Commonwealth Court has previously determined is just and reasonable.[33]

II. THE CONTINGENT ISSUE ADDRESSED IN THE SUPPLEMENTAL TESTIMONY

As explained in Section I, *supra*, the reserved issue is whether Act 40, by adding Section 1301.1, fundamentally altered Sections 1357 and 1358, which delineate the terms of a DSIC, to

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30 As previously explained, the Orders approving the Companies' DSIC Riders were entered on June 9, 2016. Act 40 was enacted on June 12, 2016 to become effective in sixty days (i.e., by August 11, 2016) for all cases where the final order is entered after the effective date of that section. 66 Pa.C.S. § 1301.1(c)(2).

31 *See* Companies' Statement No. 2-R, pp. 40-41 and Companies' Initial (pp. 32-39) and Reply (pp. 12-15) Briefs.

32 *See* Companies' Initial Brief, pp. 33-35 and 38-39.

33 *See* Companies' Initial (pp. 35-39) and Reply (pp. 14-15) Briefs.

require that the Commission reflect ADIT and state income tax deductions and credits attributed to incremental additions of eligible property in calculating quarterly adjustments of the DSIC. For the reasons summarized in Section I.B., *supra*, and set forth at length in the Companies' Initial and Reply Briefs, Section 1301.1 does not require any change to the DSIC formula embodied in the Model Tariff.

If the Administrative Law Judge and the Commission adopt the Companies' position that Act 40 does not require any change in the DSIC formula, then there is no need to address the contingent issues of how the formula would have to be revised to reflect ADIT and state income tax deductions and credits in calculating quarterly adjustments of the DSIC.[34] In the Companies' base rate cases, the OCA's witness proposed that, if the OCA's interpretation of Act 40 were adopted, then ADIT should be recognized in the DSIC formula by estimating the ADIT associated with the quarterly additions of eligible DSIC property and deducting that amount from the original cost of eligible property. Mr. Smith did not, however, offer a proposal for recognizing the effects of state income tax deductions and credits on the quarterly calculation of the DSIC if the OCA's interpretation of Act 40 were adopted. Accordingly, as previously explained, that contingent issue was addressed in the Supplemental Testimony presented by the OCA and the Companies.

Before addressing how the OCA proposes to reflect state income tax deductions and credits if its interpretation of Act 40 were adopted, it is important to examine the statutory language of Section 1357, which describes the components of the DSIC formula. Significantly,

[34] Federal income tax effects of certain tax timing differences, such as accelerated forms of depreciation, are "normalized" for ratemaking purposes, which results in deferred taxes being recorded. Under normalization accounting, accumulated deferred income taxes (ADIT) are deducted from rate base because they are assumed to represent a source of non-investor supplied capital. The state tax effects of tax timing differences, such as accelerated depreciation, are not "normalized," but, instead are flowed-through directly to customers in calculating state income tax expense.

Section 1357, which delineates how the DSIC is to be calculated, does not include any term in the DSIC formula that would reflect either ADIT or state income tax deductions and credits. In addition to the obvious problem this creates for implementing the OCA's proposal, the existing statutory language is itself clear evidence of the legislative intent that neither ADIT nor state income tax deductions and credits must be reflected in calculating quarterly adjustments of the DSIC rate.[35]

Sections 1357(a)(1) and (3) provide that the "[DSIC] charge shall be calculated to recover the fixed cost of eligible property," which "shall consist of depreciation and pretax return." "Eligible property" is to be included in the DSIC calculation of quarterly charges at its "original cost,"[36] and there is no provision in Section 1357 for deducting ADIT or any other amounts from "original cost."

"Return" is specifically defined; must be calculated using the "utility's actual capital structure;" consists of the "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" and the "cost of equity" (Section 1357(b)(1) and (2)). The "cost of equity shall be the equity return rate approved in the utility's most recent fully litigated base rate proceeding" if a final order was issued not more than two years prior and, otherwise, the equity return rate calculated in the Commission's most recent Quarterly Report on the Earnings of Jurisdictional Utilities (Section 1357(b)(2)-(3)). The taxable

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35 As discussed in Section I, *supra*, both cumulative ADIT and all applicable state income tax deductions and credits are fully accounted for in the detailed calculation of a utility's achieved rate of return on equity used to determine whether it may charge a DSIC or, alternatively, must reduce the charge to zero if its "earnings cap" is exceeded. *See* Section 1358(b)(3).

36 *See* 66 Pa.C.S. § 1357(b)

components of the "pretax return" are to be stated at their "pretax" levels "using the federal and State Income tax rates" (Section 1357(b)(1)).

The Commission-approved Model Tariff's formula (which the Companies' adopted in their respective DSIC Riders) adheres to the directions given by Section1357, described above. And, as noted, Section 1357 does not contemplate that either ADIT or state income tax deductions and/or credits are to be reflected in the calculation of quarterly charges. As a consequence, neither Section 1357 nor the Commission's Model Tariff provides any direction as to how, if at all, ADIT could be factored into the calculation of the original cost of eligible property or how state income tax deductions and/or credits could be factored into the calculation of the "pretax return" as that term is defined and described by Section 1357.

A. The OCA's Recommendation

The full formula for calculating quarterly adjustments to the DSIC that has been approved by the Commission is as follows:[37]

$$\mathbf{DSIC} = \frac{\mathbf{((DSI * PTRR)+Dep+e) \times 1 / (1-T)}}{\mathbf{PQR}}$$

Where:

DSI = Original cost of eligible distribution system improvement projects net of accrued depreciation.

PTRR = Pre-tax return rate applicable to DSIC-eligible property.

Dep = Depreciation expense related to DSIC-eligible property.

e = Amount calculated (+/-) under the annual reconciliation feature or (C) Commission audit, as described below.

PQR = Projected quarterly revenues for distribution service (including all applicable clauses and riders) from existing customers, excluding customers served under the Company's Rate Schedule [as applicable, by Company], plus

37 Companies' St. No. 1-RJ, p. 3.

revenue from any customers which will be acquired by the beginning of the applicable service period.

T = Pennsylvania gross receipts tax rate in effect during the billing month, expressed in decimal form.

In the DSIC formula the Commission adopted in the Model Tariff, the Commission recognized the need to apply a revenue conversion factor to the weighted average equity return component to calculate the *pre-tax* return rate or PTRR.[38] The revenue conversion factor for a single level of income tax (either federal or state) is: **1/(1 - tax rate).**[39]

The Model Tariff expressly provides that the allowed rate of return on equity must be "grossed up" by the **statutory** federal and state income tax rates to determine the PTRR.[40] Consequently, the revenue conversion factor used in calculating the PTRR must reflect the composite federal and state statutory income tax rates (recognizing that state income tax is deductible for federal income tax purposes). The revenue conversion factor is 1.709211797, which is calculated using the following formula: **Revenue Conversion Factor = 1/1 - (.35 x (1 - 0.0999)) + 0.0999**, where .35 (35%) is the statutory federal income tax rate and 0.0999 (9.99%) is the statutory state income tax rate. Thus, in the DSIC formula, the weighted average cost rate of common equity is multiplied by 1.709211797 to calculate a pre-tax weighted average cost rate of common equity.[41] As previously explained, the Model Tariff, which exactly tracks the elements of the DSIC formula set forth in Section 1357, contains no provision either in the calculation of the PTRR or otherwise, for the inclusion of state income tax deductions or credits

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[38] A pre-tax rate of return is the rate of return a utility would have to earn so that, after paying state and federal income taxes, it achieves the after-tax return approved by the Commission.

[39] Companies' St. 1-R (Supp), p. 6.

[40] Final Implementation Order, pp. 30-31 and Appendix A (Model Tariff, Section 2.B.2 – Definition of Pre-Tax Return)(Requiring pre-tax return to be calculated at "*statutory* state and federal income tax rates" (emphasis added).)

[41] Companies' St. 1-R (Supp), pp. 6-7.

– which are accounted for in calculating the "earnings cap," not in each quarterly adjustment of the DSIC.

To implement the OCA's proposed interpretation of Act 40 with respect to state income tax deductions, Mr. Smith recommended changing the way the pre-tax weighted average rate of return on equity (a component of PTRR in the DSIC formula shown above) is calculated.[42] Specifically, he recommended that the revenue conversion factor used to "gross up" the allowed equity return to a pre-tax level reflect the "actual amount of state income taxes that will be paid on DSIC income."[43] In his Supplemental Direct Testimony, Mr. Smith described his proposed revision on a conceptual basis, but did not identify any specific changes to the DSIC formula. Mr. Smith also did not provide a calculation using the Companies' own data (previously supplied in their DSIC filings) to show how his concept might be implemented consistent with the Commission's directive that a rate adjustment clause should not require a full base-rate revenue requirement computation.

Notably, in the Final Implementation Order, the Commission stated that "the 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."[44] Mr. Smith's concept has none of these characteristics; rather, it would add to the calculation and auditing of the DSIC exactly the kind of complication the Commission worked hard to avoid when it developed the DSIC formula set forth in the Final Implementation Order. Indeed, as Mr. Fullem explained, there is no practical

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42 *See* OCA St. 1-Supp, p. 2.

43 *Id.*

44 Final Implementation Order, p. 39. In *McCloskey*, the Commonwealth Court agreed with the Commission's assessment that the DSIC need not replicate a full base rate revenue requirement calculation and, in fact, such rate adjustment clauses are intended to be precisely the kind of "straightforward mechanism" the Commission described. 127 A.3d at 87-871.

way to implement Mr. Smith's proposal consistent with the guidelines the Commission established for the DSIC:[45]

> Mr. Smith's recommendation cannot be implemented in the manner he describes. The revenue conversion factor is calculated using tax rates, not dollars of tax expense, and the latter cannot be substituted for the former, which is evident from the terms of the revenue conversion factor formula I provided previously. In addition, Mr. Smith has not addressed how dollars (tax expense) would be – or could be – restated as a percentage to conform to the variable that actually exists in the formula for the revenue conversion factor.

Faced with Mr. Smith's lack of specificity, Mr. Fullem addressed the possibility (which Mr. Smith finally affirmed in his Supplemental Surrebuttal Testimony) that Mr. Smith intended the revenue conversion factor to reflect an "effective" state income tax rate to gross-up the return component of the DSIC formula.[46] Mr. Fullem also explained the defects inherent in the "effective tax rate" approach:[47]

> If, however, Mr. Smith intends that the revenue conversion factor applied to the weighted average equity cost rate should reflect an "effective" state tax rate on DSIC income, then his recommendation is contrary to both the Commission's Model Tariff, which specifies that "statutory" tax rates must be used, and Section 1357(b)(1), which does not mention the use of an "effective" tax rate but, instead, states that "the pre-tax return shall be calculated using the Federal and State income tax rates."

Mr. Fullem explained further that, if the state income tax rate used in calculating the quarterly DSIC adjustment is to be applied to a variable that already represents state taxable income, then the "statutory" tax rate and the "effective" tax rate would be the same.[48] However, the "effective" tax rate, as typically understood, can differ from the statutory rate because the

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[45] Companies' St. 1-R (Supp), p. 7.

[46] *Id.*

[47] *Id.*

[48] Companies' St. 1-R (Supp), pp. 7-8.

effective tax rate is typically derived by dividing the actual income taxes paid (in this instance, state income taxes) by net income before income taxes as determined for financial reporting purposes.[49] The effective tax rate, thus defined, would differ from the statutory state tax rate if the taxable income calculated for state income tax purposes is different from pre-tax net income calculated for financial reporting purposes. This would be the case where, for example, depreciation for financial reporting (and regulatory purposes) differs from the depreciation deductions taken, pursuant to state law, for state income tax purposes.[50] Thus, Mr. Smith's approach would require a three-step process: first, deductions attributable to adding DSIC-eligible property (principally, accelerated forms of depreciation) would have to determined and calculated; second, book depreciation, which is reflected (and already deducted for tax purposes) under the Model Tariff's DSIC formula, must be subtracted from the projected tax depreciation; and third, the resulting net deduction would have to be converted from a dollar amount to a revenue conversion factor stated as a percentage and applied to the after-tax weighted average return rate to "gross-up" that rate to a pre-tax level.[51] Obviously, that process is a far cry from the "straightforward mechanism" the Commission has always envisioned the DSIC to be. As Mr. Fullem explained, "there is not a practical way to implement Mr. Smith's recommendation, and attempts to do so would embroil the Commission in the kind of comprehensive revenue requirement analysis it has previously held is not required for calculating the [quarterly] DSIC."[52]

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49 Companies' St. 1-R (Supp), p. 8.

50 *Id.*

51 *See* Companies' St. 1-R (Supp), p. 10; Companies' St. 1-RJ, pp. 4-5.

52 Companies' St. 1-R (Supp), p. 10 and n. 5.

In his Supplemental Surrebuttal Testimony, Mr. Smith attempted to redress his earlier failure to show how his recommendation could be implemented by offering an illustrative calculation.[53] However, Mr. Smith's revised position simply raises more problems, as Mr. Fullem explained in pointing out the defects in Mr. Smith's belated attempt to implement his conceptual proposal. First, Mr. Smith's calculations clearly embody an "effective tax rate" approach:

> Although Mr. Smith shows the "statutory" state income tax rate of 9.99% being used in the table on page 4, he applies it to "taxable income" that reflects an assumed level of state income tax deductions. Consequently, what Mr. Smith proposes results, nonetheless, in the use of an "effective" state income tax rate, not the "statutory" tax rate in the DSIC formula. In that regard, his proposal is contrary to the Commission's Model Tariff, which requires the use of "statutory" federal and state income tax rates based on the Commission's interpretation of the requirements of Section 1357(b)(1) of the Public Utility Code, which states that "the pre-tax return shall be calculated using the Federal and State income tax rates."

Second, Mr. Smith's calculation, which is clearly based on hypothetical figures that bear no necessary relationship to actual data used in calculating the Companies' initial DSIC rates, are nonetheless accompanied by a description that is demonstrably incorrect, as Mr. Fullem also explained.[54] Specifically, Mr. Smith claims that the impact of state income tax deductions, such as state-allowed tax depreciation related to the DSIC-eligible plant, needs to be taken into account to reduce taxable income in the DSIC calculation. In the simplified hypothetical example Mr. Smith uses, he shows $50,000 of taxable income remaining after reflecting what he refers to as "all related state tax deductions."[55] Unless Mr. Smith implicitly assumes – although he did not actually say so – that "all related state tax deductions" should be restricted to

[53] *See* OCA St. 1SR-Supp, pp. 4 and 6-7.

[54] Companies' St. 1-RJ, pp. 2-3.

[55] OCA St. 1SR-Supp, p. 4, lines 12-13.

deductions related to placing DSIC-eligible plant in service, then his calculation is incorrect for two reasons:

Initially, it would be wrong to include any tax deductions that might accrue due to increases in operating and maintenance ("O&M") expenses related to DSIC-eligible property because O&M expenses are **not** recovered in the DISC; since the expenses are not in the calculation, the associated deductions should not be there either.[56]

Additionally, Mr. Smith's proposal, as he has explained it, would double-count the deduction for book depreciation.[57] Depreciation expense related to DSIC-eligible property is already included as part of the revenue requirement recovered through the DISC (i.e., in the term "Dep"). The formula clearly shows that depreciation expense is **not** grossed up for state or federal taxes. The fact that depreciation expense is not grossed up for state and federal taxes means that the Commission's Model Tariff already recognized that book depreciation expense is an off-setting deduction for federal and state income tax purposes (and, therefore, the formula already gives customers credit for a deduction in an amount equal to the depreciation recognized as an allowable expense in the DSIC calculation). Therefore, in Mr. Smith's simplified example (as shown on pages 4 through 7 of his Supplemental Surrebuttal Testimony), if he included the depreciation expense recovered through the DSIC to determine the "effective" tax rate he later uses to compute the revenue conversion factor, then his state tax depreciation deduction up to the amount of book depreciation expense already included in DSIC revenue requirement is counted twice. Simply stated, the DSIC revision as articulated by Mr. Smith is wrong in this respect as well.

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[56] Companies' St. 1-RJ, pp. 2-3.

[57] Companies' St. 1-RJ, p. 3.

Finally, and perhaps most importantly, the illustrative calculation provided by Mr. Smith actually proves that there is **not** a practical way to implement Mr. Smith's recommendation, as Mr. Fullem explained:

> Exhibit KMS-3 for each of the Companies provided the data that were the inputs for calculating an initial DSIC quarterly charge; this data included the original cost of the DSIC-eligible plant by type of plant. Although Mr. Smith might have tried using this data and his proposed methodology to attempt to calculate an "effective" state tax rate, a revenue conversion factor based on that "effective" tax rate, and the resulting pre-tax rate of return, he chose instead to create a very simplified hypothetical example in which he assumed values that are not derived from, or necessarily related to, any actual data or realistic scenarios for the Companies. In doing so, Mr. Smith *assumed away* the most complicated and difficult part of the process of applying his methodology to a real-world situation. *The fact that an accurate, understandable example showing how to implement Mr. Smith's recommendation based on actual data was not provided supports my position that there is not a practical way to implement Mr. Smith's recommendation, and an attempt to do so would entangle the Commission in the kind of detailed revenue requirement analysis it has previously held is not required for calculating just and reasonable charges under an adjustment clause such as the DSIC.*[58]

B. Summary: The OCA's Recommendation Cannot Be Implemented And Should Not Be Adopted, Which Is A Further Reason To Reject The OCA's Interpretation Of Act 40

The simplistic – and hypothetical – calculation provided in Mr. Smith's Supplemental Surrebuttal Testimony cannot be translated into a workable revision to the DSIC formula reflecting state income tax deductions and credits, as Mr. Smith erroneously contends. The fact that Mr. Smith's recommendation cannot, as practical matter, be implemented is a further reason for rejecting the OCA's fundamental position on the reserved issue. As previously explained, attempting to actually implement the OCA's proposal creates fundamental conflicts with the

[58] Companies' St. 1-RJ, pp. 4-5 (emphasis added).

express statutory language of Section 1357. Sections 1357(b)(1) and (2) specify the elements of the DSIC formula – none of which provide for deducting ADIT from the original cost of eligible plant or for adjusting the statutory state tax rate to reflect state income tax deductions and credits. The Model Tariff, as approved in the Final Implementation Order, which specifies the use of statutory tax rates and expressly rejected deducting ADIT from the original cost of eligible property in calculating the DSIC, is consistent with the terms of Section 1357, and should not be revised in the manner the OCA proposes.

Furthermore, given the specific and explicit terms for calculating the DSIC set forth in Section 1357(b), there is no valid basis in accepted rules of statutory interpretation to conclude that the general and high-level language of Act 40 – which does not even mention the DSIC – should be applied to fundamentally alter the specific and detailed delineation of the elements of the DSIC calculation set forth in Section 1357(b).[59] In short, the inability to convert the OCA's interpretation of Act 40 into a practical revision to the DSIC formula that could actually be implemented consistent with the "straightforward" nature of rate adjustment clauses provides additional support for the Companies' position that Act 40 was never intended to apply to the DSIC – just as the lead sponsor of the bill that become Act 40 explicitly stated: "[T]his section [1301.1] applies to base rate cases" and "would go into effect when a utility comes in for a base rate case."[60]

III. CONCLUSION

For all the reasons discussed above and in the Companies' Initial and Reply Briefs, the Administrative Law Judge should issue a Recommended Decision, and the Commission should

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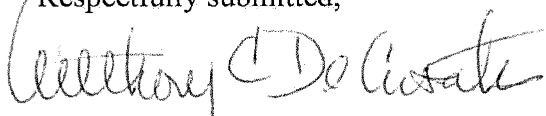
[59] *See, e.g.*, 1 Pa.C.S. § 1933 (the specific is given precedence over the general in statutory interpretation).

[60] See Companies' Initial Brief, p. 26 and n. 73.

enter a final order, finding and determining that Act 40 does not apply to the DSIC and, even if it did, Act 40 neither overruled *McCloskey* and *McCloskey-Little Washington* nor revoked the Commission's discretion to determine that cumulative ADIT and all applicable state income tax deductions and credits are properly taken into account in the earning cap analysis required by the Model Tariff (and incorporated in the DSIC Rider for each of the Companies). Accordingly, the OCA's proposed revision to the DSIC formula should be rejected, and it should not be necessary to address the contingent issue pertaining to the recognition of state income tax deductions and credits discussed in the Supplemental Testimony of the OCA. As also explained above, there is no practical means to implement the DSIC formula revisions to recognize state income tax deductions and credits proposed by the OCA, which is further strong evidence that the OCA's fundamental position regarding the application of Act 40 to the DSIC is erroneous.

Respectfully submitted,



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Dated: June 5, 2017

APPENDIX A

Supplemental Proposed Findings of Fact, Conclusions of Law and Ordering Paragraphs

SUPPLEMENTAL PROPOSED FINDINGS OF FACT[1]

1. On January 19, 2017, the Pennsylvania Public Utility Commission ("Commission") entered its Opinion and Order ("January 19, 2017 Order") in the Companies' base rate cases at Docket Nos. R-2016-2537349, *et al.*

2. The January 19, 2017 Order granted Joint Petitions for Partial Settlements ("Joint Petitions") filed on October 14, 2016, and approved the terms and conditions of the base rate increase settlements set forth therein. The Joint Petitions reserved for briefing and decision one issue (the "Reserved Issue"), which pertains to the formula for calculating the distribution system improvement charge ("DSIC") set forth in the Companies' DSIC Riders.

3. The Reserved Issue is whether the enactment of Act 40 of 2016, which added Section 1301.1 to the Public Utility Code, requires the Commission to revise the formula for calculating quarterly DSIC charges set forth in the Model Tariff for the DSIC that the Commission approved for use by utilities in its Final Implementation Order.[2]

4. In its January 19, 2017 Order, the Commission concluded that it would not decide on its merits as part of the Companies' base rate cases the issue reserved from the settlement of those cases and, instead, referred the Reserved Issue to this proceeding. Pursuant to Ordering Paragraph No. 4 of the January 19, 2017 Order, the Commission also transferred to this proceeding "the relevant part of the record" in the Companies' base rate cases including the

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1 The Companies' Proposed Findings of Fact on the Reserved Issue, which were appended to their Initial Brief, are incorporated herein by reference as if set forth at length.

2 *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611 (Aug. 2, 2012) ("Final Implementation Order"), pp. 30-31 and Appendix A.

OCA's Exceptions, the Companies' Replies, the OCA's Main and Reply Briefs, the Companies' Initial and Reply Briefs, OCA Statement No. 1 and the Companies' Statement No. 2-R.[3]

5. The Reserved Issue was fully briefed in the OCA's Main Brief and the Companies' Initial Brief (both filed on September 30, 2016) and the OCA's and Companies' Reply Briefs (both filed on October 14, 2016) that were submitted to Administrative Law Judge Mary D. Long in the Companies' base rate cases. The OCA and the Companies each provided their Proposed Findings of Fact, Conclusions of Law and Ordering Paragraphs[4] with respect to the Reserved Issue as appendices to their Main and Initial Briefs, respectively.

6. The referral to this case of the Reserved Issue together with the relevant parts of the record and the briefs, exceptions and reply exceptions in the Companies' base rate case provide the complete and sufficient basis for the Administrative Law Judge to address and decide, in a Recommended Decision, the Reserved Issue referred to this proceeding.

7. Following the referral to this proceeding, the OCA pointed out in letters to the Administrative Law Judge and the parties that: (1) the Reserved Issue was discussed on the record and in briefs submitted in the base rate case principally in terms of how federal accumulated deferred income taxes ("ADIT") would be reflected in the calculation of quarterly DSIC charges if the OCA's position were adopted by the Commission; (2) the OCA contends that, in addition to revisions to the DSIC formula to reflect federal ADIT, further revisions would

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3 On February 3, 2017, the OCA filed a Petition for Reconsideration or Clarification ("Petition") for the limited purpose of requesting the Commission to revise Ordering Paragraph No. 4 to specifically include OCA Statement No. 1-SR because the OCA believes that pages 33-36 of that statement are relevant to the reserved issue. On February 10, 2017, the Companies responded to the Petition with a letter stating that they had no objection to the Commission clarifying its January 19, 2017 Order as the OCA requested. The Commission granted the OCA's request in its Opinion and Order entered on May 18,2017 ("Order on Clarification"). The Order on Clarification includes a detailed procedural history.

4 Hereafter referred to as the "September 30 Proposed Findings of Fact, Conclusions of Law and Ordering Paragraph."

also be needed to reflect state income tax deductions and credits, if the OCA's position on the Reserved Issue were adopted; and (3) revisions related to state income tax implications were not set forth on the record in the base rate case. Accordingly, the OCA proposed the submission of supplemental testimony to set forth and discuss the parties' positions on how state income tax deductions and credits should be reflected in the DSIC formula if the OCA's position were to prevail.

8. The Companies did not object to the submission of supplemental testimony and exhibits if they were limited to the contingent state income tax issue, namely, how the DSIC formula for calculating quarterly DSIC charges might be revised to reflect state tax deductions and credits in the event the OCA's position on the Reserved Issue is adopted by the Commission (hereafter, the "Supplemental Issue").[5]

9. A further Prehearing Conference was held on March 6, 2017 at which a procedural schedule was adopted. The procedural schedule was set forth in Scheduling Order No. 2 issued the same day.

10. Pursuant to the approved schedule, the OCA submitted the Supplemental Direct Testimony of Mr. Ralph C. Smith on March 21, 2017; the Companies submitted the Supplemental Rebuttal Testimony of Charles V. Fullem on April 13, 2017; the OCA submitted the Surrebuttal Testimony of Mr. Smith on May 1, 2017; and the Companies' submitted the Rejoinder Testimony of Mr. Fullem on May 5, 2017. The parties waived cross-examination of Messrs. Smith and Fullem, and a telephonic hearing was held on May 12 to admit the supplemental testimony and accompanying exhibits into the evidentiary record.

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[5] Companies' Further Prehearing Memorandum, filed March 2, 2017, p. 4.

11. The schedule provided for the filing and service of Supplemental Initial and Reply Briefs on June 5 and June 21, 2017.

12. The Supplemental Issue would have to be addressed only if the OCA's interpretation of the Reserved Issue is adopted.

13. Neither Section 1357 of the Public Utility Code, which delineates the components of the DSIC formula, nor the Commission's Final Implementation Order, which adopted the DSIC formula as part of its Model Tariff for the DSIC, address the Supplemental Issue because neither Section 1357 nor the Final Implementation Order include any element in the DSIC formula for state income tax deductions or credits.[6]

14. The Final Implementation Order (pp. 30-31) provides that DSIC charges are to be calculated using "statutory state and federal income tax rates."

15. The full formula for calculating quarterly adjustments to the DSIC that has been approved by the Commission is as follows:[7]

$$\text{DSIC} = \frac{((\text{DSI} * \text{PTRR})+\text{Dep}+e) \times 1 / (1-T)}{\text{PQR}}$$

Where:

DSI = Original cost of eligible distribution system improvement projects net of accrued depreciation.

PTRR = Pre-tax return rate applicable to DSIC-eligible property.

Dep = Depreciation expense related to DSIC-eligible property.

e = Amount calculated (+/-) under the annual reconciliation feature or (C) Commission audit, as described below.

6 *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 3-8, 30 and 38-40.

7 Companies' St. No. 1-RJ, p. 3.

PQR = Projected quarterly revenues for distribution service (including all applicable clauses and riders) from existing customers, excluding customers served under the Company's Rate Schedule [as applicable, by Company], plus revenue from any customers which will be acquired by the beginning of the applicable service period.

T = Pennsylvania gross receipts tax rate in effect during the billing month, expressed in decimal form.

16. In the DSIC formula adopted in the Model Tariff, the Commission recognized the need to apply a revenue conversion factor to the weighted average equity return component to calculate the *pre-tax* return rate or PTRR. (A pre-tax rate of return is the rate of return a utility would have to earn so that, after paying state and federal income taxes, it achieves the after-tax return approved by the Commission.) The revenue conversion factor for a single level of income tax (either federal or state) is: **1/(1 - tax rate).**[8]

17. The Model Tariff provides that the allowed rate of return on equity must be "grossed up" by the statutory federal and state income tax rates to determine the PTRR.[9] Therefore, the revenue conversion factor used in calculating the PTRR reflects the composite federal and state statutory income tax rates (recognizing that state income tax is deductible for federal income tax purposes).

18. The revenue conversion factor is 1.709211797, which is calculated using the following formula: **Revenue Conversion Factor = 1/1 - (.35 x (1 - 0.0999)) + 0.0999**, where .35 (35%) is the statutory federal income tax rate and 0.0999 (9.99%) is the statutory state income tax rate.[10] Therefore, in the DSIC formula, the weighted average cost rate of common

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[8] Companies' St. 1-R (Supp), p. 6.

[9] Final Implementation Order, pp. 30-31 and Appendix A (Model Tariff, Section 2.B.2 – Definition of Pre-Tax Return)

[10] Companies' St. 1-R (Supp), pp. 6-7.

equity is multiplied by 1.709211797 to calculate a pre-tax weighted average cost rate of common equity.

19. The Model Tariff contains no provision in the calculation of the PTRR (or elsewhere) for including ADIT state income tax deductions or credits. The Commission has previously found that such income tax effects are accounted for in calculating the "earnings cap" of the DSIC.[11]

20. In the Final Implementation Order, the Commission stated that "the 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."[12]

21. To implement the OCA's proposed interpretation of Act 40, OCA witness Smith recommended changing the way the pre-tax weighted average rate of return on equity (a component of PTRR in the DSIC formula shown above) is calculated.[13]

22. Mr. Smith recommended that the revenue conversion factor used to "gross up" the allowed equity return to a pre-tax level reflect the "actual amount of state income taxes that will be paid on DSIC income."[14]

23. Mr. Smith did not initially identify any specific changes to the DSIC formula and did not provide a calculation using the Companies' own data to implement his proposal.[15]

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[11] Final Implementation Order, p. 39; *see* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 5, 8, 30-33.

[12] Final Implementation Order, p. 39.

[13] OCA St. 1-Supp, p. 2.

[14] OCA St. 1-Supp.

[15] *Id.*

24. Company witness Fullem testified that there was no practical way to implement Mr. Smith's concept consistent with the Commission's directive that the DSIC should be easy to calculate, easy to audit and which does not require a full rate case analysis.[16]

25. Mr. Fullem explained further that Mr. Smith's concept would, as a practical matter, require the revenue conversion factor to reflect an "effective" state income tax rate to gross-up the return component of the DSIC formula.[17]

26. Mr. Fullem opined that Mr. Smith's approach is contrary to the Commission's Model Tariff, which requires the use of "statutory" tax rates, and Section 1357(b)(1), which does not authorize the use of an "effective" federal or state tax rate.[18]

27. Mr. Fullem testified that, if the state income tax rate used in calculating the quarterly DSIC adjustment is to be applied to state taxable income, then the "statutory" tax rate and the "effective" tax rate would be the same.[19]

28. Mr. Fullem testified that an "effective" tax rate, as generally understood, can differ from the statutory rate because it is typically derived by dividing the actual income taxes paid (state income taxes, in this instance) by net income before income taxes as determined for financial reporting purposes.[20]

29. Mr. Fullem explained that an "effective tax rate" would differ from the statutory state tax rate if the taxable income calculated for state income tax purposes is different from pre-

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[16] Companies' St. 1-R (Supp), p. 7.

[17] *Id.*

[18] *Id.*

[19] Companies' St. 1-R (Supp), pp. 7-8.

[20] Companies' St. 1-R (Supp), p. 8.

tax net income calculated for financial reporting purposes.[21] Mr. Fullem explained further that such a difference would be introduced where, for example, depreciation for financial reporting (and regulatory purposes) differs from the depreciation deductions taken, pursuant to state law, for state income tax purposes.[22]

30. As explained by Mr. Fullem, Mr. Smith's approach would require a three-step process: (1) deductions attributable to adding DSIC-eligible property (principally, accelerated forms of depreciation) would have to determined and calculated; (2) book depreciation, which is reflected (and already deducted for tax purposes) under the Model Tariff's DSIC formula, must be subtracted from the projected tax depreciation; and (3) the resulting net deduction would have to be converted from a dollar amount to a revenue conversion factor stated as a percentage and applied to the after-tax weighted average return rate to "gross-up" that rate to a pre-tax level.[23]

31. Mr. Fullem opined that "there is not a practical way to implement Mr. Smith's recommendation, and attempts to do so would embroil the Commission in the kind of comprehensive revenue requirement analysis it has previously held is not required for calculating the [quarterly] DSIC."[24]

32. In his Supplemental Surrebuttal Testimony, Mr. Smith offered an illustrative calculation of how he believes his recommendation might be implemented.[25]

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[21] *Id.*

[22] *Id.*

[23] Companies' St. 1-R (Supp), p. 10; Companies' St. 1-RJ, pp. 4-5.

[24] Companies' St. 1-R (Supp), p. 10 and n. 5.

[25] *See* OCA St. 1SR-Supp, pp. 4 and 6-7.

33. Mr. Smith averred that the impact of state income tax deductions, such as state-allowed tax depreciation related to the DSIC-eligible plant, needs to be taken into account to reduce taxable income in the DSIC calculation. [26]

34. In the hypothetical example Mr. Smith used, he shows an assumed level of taxable income remaining after reflecting what he refers to as "all related state tax deductions," which are also assumed values (not actual Company data).[27]

35. In his Supplemental Rejoinder Testimony, Mr. Fullem testified that Mr. Smith's illustrative calculation embodied an "effective tax rate" approach.[28]

36. Mr. Fullem also testified that Mr. Smith's description of his calculation reveals two defects.[29]

37. First, Mr. Fullem testified that it would be wrong to include any tax deductions that might accrue due to increases in operating and maintenance ("O&M") expenses related to DSIC-eligible property because O&M expenses are not recovered in the DISC and, because the expenses are not in the calculation, the associated deductions should not be there either.[30]

38. Second, Mr. Fullem testified that Mr. Smith's proposal, as Mr. Smith explained it, would double-count the deduction for book depreciation because: (1) book depreciation expense related to DSIC-eligible property is already included as part of the revenue requirement recovered through the DISC (i.e., in the term "Dep"); (2) under the DSIC formula, book depreciation expense is not grossed up for state or federal taxes; (3) not grossing-up book

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26 OCA St. 1SR-Supp, p. 4.

27 OCA St. 1SR-Supp, p. 4, lines 12-13.

28 Companies' St. No. 1-RJ, pp. 1-2.

29 Companies' St. No. 1-RJ, pp. 1-2.

30 Companies' St. 1-RJ, pp. 2-3.

depreciation expense for state and federal taxes means that the Commission's Model Tariff has recognized that book depreciation expense is an off-setting deduction for federal and state income tax purposes and has already given customers credit for that deduction.[31] Mr. Fullem testified that if, in Mr. Smith's example (shown on pages 4 through 7 of his Supplemental Surrebuttal Testimony), he included the depreciation expense recovered through the DSIC to determine the "effective" tax rate he later uses to compute the revenue conversion factor, his state tax depreciation deduction (up to the amount of book depreciation expense already included in DSIC) is counted twice.[32]

39. Mr. Fullem also opined that Mr. Smith's use of a hypothetical scenario, and not the actual data the Companies submitted to calculate their initial DSIC, supported a finding that there is not a practical way to implement Mr. Smith's proposal:[33]

> Although Mr. Smith might have tried using this data and his proposed methodology to attempt to calculate an "effective" state tax rate, a revenue conversion factor based on that "effective" tax rate, and the resulting pre-tax rate of return, he chose instead to create a very simplified hypothetical example in which he assumed values that are not derived from, or necessarily related to, any actual data or realistic scenarios for the Companies. In doing so, Mr. Smith *assumed away* the most complicated and difficult part of the process of applying his methodology to a real-world situation.[34]

40. The illustrative calculations provided by Mr. Smith and the Supplemental Rejoinder Testimony of Mr. Fullem[35] establish that there is not a practical way to implement Mr.

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[31] Companies' St. 1-RJ, p. 3.

[32] *Id.*

[33] Companies' St. 1-RJ, pp. 4-5.

[34] *Id.* (Emphasis added.)

[35] Companies' St. 1-RJ, pp. 4-5.

Smith's recommendation consistent with the Commission's prior finding and determination that the "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."[36]

41. The fact that Mr. Smith's recommendation cannot, as practical matter, be implemented is a further reason for rejecting the OCA's interpretation of Act 40 as applying to the DSIC, as more fully explained in the Conclusions of Law, *infra*.

42. Because the OCA's interpretation of Act 40 is rejected for the reasons set forth in the Companies' Initial and Reply Briefs and the Companies' September 30 Proposed Findings of Fact and Conclusions of Law and Supplemental Proposed Findings of Fact and Conclusions of Law, it is not necessary to decide the Supplemental Issue.

43. If, notwithstanding the rejection of the OCA's interpretation of Act 40, a decision on the Supplemental Issue were necessary, then calculation of the revenue conversion factor used to "gross-up" the equity return component of the Pre-Tax Rate of Return would have to follow (with respect to the state income tax portion of that calculation) the complicated three-step process described by Mr. Fullem and set forth in Paragraph No. 30, *supra*.

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[36] Final Implementation Order, p. 39.

PROPOSED CONCLUSIONS OF LAW

1. Considering the absence of any reference to DSIC-related sections of the Public Utility Code in Act 40 or in its legislative history, and applying Pennsylvania's statutory construction law (1 Pa.C.S. §§ 1921 *et seq.*), Section 1301.1 does not apply to the calculation of quarterly charges under the formula for the DSIC incorporated in the Model Tariff pursuant to Sections 1357 and 1358 and in the Companies' DSIC Riders, which conform to the Model Tariff.[37]

2. Section 1301.1 applies only to base rates established under Section 1308 and, therefore, does not apply to the DSIC adjustment mechanism or to any other "sliding scale of rates" or "method for the automatic adjustment" of rates.[38]

3. Section 102 provides that a "rate" includes "any rules, regulations, practices, classifications or contracts affecting any . . . charge."[39]

4. The entire DSIC adjustment mechanism set forth in the Model Tariff (and in the DSIC Riders that conform to the Model Tariff), including, without limitation, the formula for quarterly charges and the earnings cap provision, is a "rate." *See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge*, Docket No. P-2012-2338282 (Final Order entered May 22, 2014), p. 22 ("However, the ALJs stated that '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.'") quoting R.D.

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[37] The legal analysis underlying this Conclusion of Law is discussed in the Companies' Initial (pp. 15-22) and Reply (pp. 6-7) Briefs.

[38] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 20-29. The legal analysis underlying this Conclusion of Law is discussed in the Companies' Initial (pp. 22-27) and Reply (pp. 7-12) Briefs.

[39] Section 102 and cases interpreting that provision to include the entirety of the DSIC adjustment clause are discussed in the Companies' Initial Brief (pp. 27-31).

issued Mar. 6, 2014), p. 45. *See also McCloskey* v. Pa. P.U.C., 127 A.3d 860, 869 (Pa. Cmwlth. 2015) ("*McCloskey*").[40]

5. Even if Section 1301.1 applies to more than base rates, it does not apply to the DSIC because the Final Implementation Order was the "final order" approving the relevant "rate" and was entered before the effective date of Section 1301.1.[41]

6. Even if the Opinions and Orders entered on June 9, 2016, approving the Companies' DSIC Riders were deemed necessary to make the Final Implementation Order final as to the Companies, that condition was satisfied prior to the effective date of Section 1301.1.[42]

7. Even if Section 1301.1 applied to the DSIC adjustment mechanism, it does not legislatively overrule *McCloskey* nor does it eliminate or diminish the Commission's discretion, affirmed in *McCloskey*, to determine *how* ADIT and state income tax deductions and credits may be accounted for in the DSIC adjustment mechanism. [43]

8. Even if Section 1301.1 applied to the DSIC, *McCloskey* remains valid and controlling precedent on the issues reserved by the OCA, including the Supplemental Issue.[44]

9. Even if Section 1301.1 applied to the DSIC adjustment mechanism, it does not legislatively overrule *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmlwth. 1996) ("*Equitable*"), which was expressly relied upon by the Commonwealth Court in *McCloskey*.[45]

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[40] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 31-32; *see also* Companies' Initial Brief (pp. 27-31), which discusses the underlying legal analysis.

[41] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 33-34.

[42] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 35. The legal analysis underlying this Conclusion of Law was discussed in the Companies' Initial Brief (pp. 31).

[43] The legal analysis underlying this Conclusion of Law was discussed in the Companies' Initial (pp. 32-39 and Reply (pp. 12-15).

[44] *Id.*

10. *Equitable* remains valid and controlling precedent on the issue reserved by the OCA and establishes that the earning cap is a lawful means of accounting for ADIT and state income tax deductions and credits in the DSIC.[46]

11. The earnings cap properly accounts for ADIT and state income tax deductions and credits in the DISC adjustment mechanism.[47]

12. Revising the DSIC formula to include a term deducting ADIT, reflecting ADIT as non-investor supplied capital in the pretax return component of the DSIC formula, or using state income tax deductions and credits to calculate an "effective tax rate" for use in the revenue conversion factor is not necessary to comply with Section 1301.1 even if Section 1301.1 applied to the DSIC.[48]

13. Revising the DSIC formula to include a term deducting ADIT, reflecting ADIT as non-investor supplied capital in the pretax return component of the DSIC formula, or using state income tax deductions and credits to calculate an "effective tax rate" for use in the revenue conversion factor is not necessary to assure that the DSIC adjustment mechanism is a just and reasonable rate.[49]

14. Sections 1357(b)(1) and (2) specify the elements of the DSIC formula. Nothing in those sections provides for deducting ADIT from the original cost of eligible plant, reflecting ADIT as non-investor supplied capital in the pretax return component of the DSIC formula, or adjusting the statutory state tax rate to reflect state income tax deductions and credits in

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[45] The Commonwealth Court's *Equitable* decision is discussed in the Companies' Initial Brief, pp. 35-39.

[46] *Id.*

[47] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 5-8. The legal analysis underlying this Conclusion of Law is discussed in the Companies' Initial (pp. 32-39) and Reply (pp. 12-15) Briefs.

[48] *Id.*

[49] *Id.*

calculating the revenue conversion factor. Consequently, the OCA's proposed methods for reflecting ADIT and state income tax deductions and credits in the DSIC formula are not authorized by Section 1357 or any other provision of Subchapter B of Chapter 13 of the Public Utility Code, which delineates all of the terms of the DSIC and the method of calculating the DSIC.[50]

15. The Model Tariff for the DSIC, as approved in the Final Implementation Order, specifies the use of statutory tax rates and expressly rejected deducting ADIT from the original cost of eligible property in calculating the DSIC. The Model Tariff is consistent with, and fully conforms to, the terms of Section 1357, and should not be revised in the manner the OCA proposes.[51]

16. The terms for calculating the DSIC set forth in Section 1357(b) are specific, detailed and explicit. Therefore, there is no valid basis in accepted rules of statutory interpretation to conclude that the general and high-level language of Act 40 – which does not even mention the DSIC – should be applied to fundamentally alter the specific, detailed and explicit delineation of the elements of the DSIC calculation set forth in Section 1357(b).[52] For that reason, the inability to convert the OCA's interpretation of Act 40 into a practical revision to the DSIC formula that could actually be implemented consistent with the "straightforward" nature of rate adjustment clauses provides substantial additional support for the Companies' position that Act 40 was never intended to apply to the DSIC – just as the lead sponsor of the bill

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[50] *Id.*

[51] *See* Companies' September 30 Proposed Findings of Fact, Paragraph Nos. 38-40. The legal analysis underlying this Conclusion of Law is set forth in the Companies' Supplemental Initial Brief, Section II.B.

[52] *See, e.g.*, 1 Pa.C.S. § 1933 (the specific is given precedence over the general in statutory interpretation).

that become Act 40 explicitly stated: "[T]his section [1301.1] applies to base rate cases" and "would go into effect when a utility comes in for a base rate case."[53]

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[53] *See* Companies' Initial Brief, p. 26 and n. 73.

PROPOSED ORDERING PARAGRAPHS

1. The OCA's proposed revisions to the Companies' DSIC Riders – and by extension, to the Model Tariff – should be rejected because Section 1301.1 does not apply to the DSIC Riders and, even if it did, *McCloskey* remains valid and controlling precedent that affirms the Commission's discretion to determine how ADIT and state income tax deductions and credits may be accounted for in the DSIC rate mechanism.

2. Because the OCA's fundamental position on the Reserved Issue is rejected, it is not necessary to address the Supplemental Issue.

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