

COMMONWEALTH OF PENNSYLVANIA



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June 21, 2017

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

RE: Petition of Metropolitan Edison Co. for Approval of a DSIC Docket Nos. P-2015-2508942, C-2016-2531040	Petition of Pennsylvania Power Co. for Approval of a DSIC Docket Nos. P-2015-2508931, C-2016-2531054
Petition of Pennsylvania Electric Co. for Approval of a DSIC Docket Nos. P-2015-2508936, C-2016-2531060	Petition of West Penn Power Co. for Approval of a DSIC Docket Nos. P-2015-2508948, C-2016-2531019

Dear Counsel:

Attached for electronic filing is the Office of Consumer Advocate's Reply Brief Addressing State Income Tax Issues in the above-referenced proceeding.

Copies have been served in accordance with the attached Certificate of Service.

Respectfully,

/s/ Erin L. Gannon  
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cc: Honorable Joel H. Cheskis, ALJ  
Certificate of Service

235846

CERTIFICATE OF SERVICE

Petition of Metropolitan Edison Co. for Approval : Docket Nos. P-2015-2508942,  
of a Distribution System Improvement Charge : C-2016-2531040

Petition of Pennsylvania Electric Co. for Approval : Docket Nos. P-2015-2508936,  
of a Distribution System Improvement Charge : C-2016-2531060

Petition of Pennsylvania Power Co. for Approval : Docket Nos. P-2015-2508931,  
of a Distribution System Improvement Charge : C-2016-2531054

Petition of West Penn Power Co. for Approval : Docket Nos. P-2015-2508948,  
of a Distribution System Improvement Charge : C-2016-2531019

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

Dated this 21<sup>st</sup> day of June 2017.

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**BEFORE THE PENNSYLVANIA  
PUBLIC UTILITY COMMISSION**

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**OCA REPLY BRIEF ADDRESSING  
STATE INCOME TAX ISSUES**

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## I. INTRODUCTION

The remaining issue in this proceeding is whether the first sentence of Act 40 of 2016 means what it says. The first sentence of Act 40 states:

(A) COMPUTATION. – If an expense or investment is allowed to be included in a public utility’s rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates.

66 Pa. C.S. § 1301.1(a). According to this plain, unambiguous language, anytime an “investment” is allowed to be included in “rates,” the related income tax deductions “shall also be included” in the calculation of current or deferred income tax expense “to reduce rates.” The DSIC is a rate and, as such, has to include income tax deductions related to DSIC investment in its calculation.

The FirstEnergy Companies assert that this sentence in Act 40 is limited to certain circumstances even though the General Assembly provided no limiting language or exceptions to this general rule in the Act. The Office of Consumer Advocate (OCA) submits that FirstEnergy’s position is not supported by the plain, unambiguous language of Act 40 or the rules of statutory construction. As discussed herein and in the OCA’s Main Brief addressing State Income Tax Issues, by its plain and unambiguous terms, Act 40, *inter alia*, requires an offset for state income tax deductions and credits be included in any Distribution System Improvement Charge (DSIC) rate charged to customers.<sup>1</sup>

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<sup>1</sup> The OCA has previously submitted Main and Reply Briefs arguing that Act 40 requires an Accumulated Deferred Income Tax (ADIT) offset to be included in any DSIC rate charged to customers to reflect federal income tax deductions. The parties’ briefs addressing ADIT were moved into this record by Commission Order entered January 19, 2017 in Docket Nos. R-2016-2537349 et al.



## II. REPLY ARGUMENT

In its Supplemental Initial Brief, FirstEnergy asserts that Act 40 does not legislatively overrule McCloskey v. Pa. PUC, 127 A.3d 860 (Pa. Commw. Ct. 2015) (McCloskey) and does not strip the Commission of its authority and discretion to determine how ADIT and state income tax deductions will be accounted for in the DSIC calculation. FE S.I.B. at 4-13. The OCA submits that, as discussed in detail in the OCA's supplemental Main Brief and infra, the Companies' arguments must be rejected, as the rules of statutory construction require that the unambiguous language in Act 40 be given effect.

A. The Language in Act 40 Is Clear and Unambiguous and Must Be Given Its Full Effect.

In its Supplemental Initial Brief, FirstEnergy discusses the DSIC calculation contained in Section 1357 of the Public Utility Code, 66 Pa. C.S. § 1357. FE S.I.B. at 9-11. According to FirstEnergy, because Section 1357 does not include any term in the DSIC formula that would reflect ADIT or state income tax deductions, this is evidence that the General Assembly did not intend to require their reflection in the DSIC formula when it passed Act 40.

FirstEnergy's argument, however, ignores the plain, unambiguous language of Act 40, which states, in relevant part:

(A) COMPUTATION. – If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates.

66 Pa. C.S. § 1301.1(a). The DSIC is a rate that recovers utility investment and income tax expense related to that investment.<sup>2</sup> 66 Pa. C.S. §§ 101, 1351. Act 40 requires, therefore, that

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<sup>2</sup> See discussion in the OCA's Main Brief addressing State Income Tax Issue (OCA S.M.B.) on pages 10 to 12. See also OCA St. 1 at 110; OCA St. 1S at 1-2. FirstEnergy does not dispute that the DSIC is a "rate" as that term is defined in the Public Utility Code. See FE I.B. at 29.

the DSIC calculation include the income tax deductions and credits related to the same investment.

The Companies' position hangs on an interpretation of Act 11 that was adopted by the Commission and the Commonwealth Court. Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order (Aug. 2, 2012) (Final Implementation Order; Petition of Columbia Gas of Pa., Inc. for Approval of a Distribution System Improvement Charge, Docket No. P-2012-2338282, Opinion and Order (May 22, 2014) (Columbia Gas); McCloskey at 867. It is no longer relevant that the Commission and Commonwealth Court found that Act 11 did not require ADIT or state income tax deductions in the DSIC calculation, however, because Act 40 has been subsequently enacted. Act 40 eliminates any Commission discretion regarding the treatment of federal and state income tax deductions in the DSIC – it requires them to be included.

This is not the first time the General Assembly has amended a statute and legislatively overruled decisions of the judiciary.<sup>3</sup> See, e.g., Commonwealth v. State Conference of State Police Lodges of the Fraternal Order of Police, 525 Pa. 40, 575 A.2d 94 (1990), superseded by statute, 71 Pa. C.S. § 5955. Indeed, both parties are in agreement that Act 40 itself overrules Pennsylvania Supreme Court precedent in regards to the Consolidated Tax Adjustment (CTA). Had the General Assembly wished not to disturb the Commission's DSIC orders and McCloskey, it could have specifically excluded the DSIC computation from the mandates of Act 40 or it could have limited the effect of the first sentence of Act 40 to base rates

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<sup>3</sup> In 2005, the Commonwealth Court found the Commission could not approve a DSIC mechanism for wastewater utilities. Popowsky v. Pa PUC, 869 A.2d 1157, 1160 (Pa. Commw. Ct. 2005). In 2012, the General Assembly enacted Act 11, which allowed all utilities, including wastewater, to establish a DSIC. 66 Pa. C.S. §§ 1350, et seq.

only, or to CTA's specifically.<sup>4</sup> Instead, the General Assembly required related income tax deductions to be included in the computation of income tax expense to reduce all utility rates.

The Companies also make the companion argument that reflecting state income tax deductions in the DSIC formula is inconsistent with the provision of Section 1357 that addresses the use of state income tax rates in the pretax return (effective versus statutory rate). FE S.I.B. at 10-12, 14-16. As discussed in Section 2.b, *infra*, this argument relies on a false dichotomy – it is possible to use the statutory income tax rate and reflect income tax deductions and, thereby give effect to both Section 1301.1 and 1357. OCA St. 1SR-Supp. at 3; OCA S.I.B. at 12-16.

For the sake of argument, however, even if Act 11 were interpreted to prohibit recognition of state income tax deductions, Act 40 was enacted later and prevails because the words of the statute are unambiguous.<sup>5</sup> 1 Pa. C.S. § 1921(b). Pursuant to 1 Pa. C.S. § 1921(b), the courts must accept that when the General Assembly selects the words to use in a statute, it has chosen them purposefully, and courts cannot change those words to reflect their own public policy concerns. See e.g. Commonwealth v. Scolieri, 571 Pa. 658, 661, 813 A.2d 672, 673-74 (2002). As discussed in the OCA's Reply Brief dated October 14, 2016, the language in Act 40 regarding its purpose states that it provides, "for ratemaking purposes" how to compute income tax expense in utility rates. OCA R.B. at 6-7. In calculating base rates, this means that a

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<sup>4</sup> As explained in the OCA's Main Brief at pages 11 to 12, it is well-established that when enacting legislation, it is presumed that the General Assembly is familiar with existing law. See, e.g., Commonwealth v. Ramos, 623 Pa. 420, 428, 83 A.3d 86, 91 (2013). It, therefore, must be presumed that in passing Act 40, the General Assembly was aware of the Commission's Final Implementation Order adopting the Model DSIC Tariff and McCloskey, upholding the Commission's decision that ADIT need not be included in utilities' computations of DSIC rates.

<sup>5</sup> "Unambiguous words control construction.--When the words of a statute are clear and free from all ambiguity, the letter of it is not to be disregarded under the pretext of pursuing its spirit." 1 Pa. C.S. § 1921(b).

consolidated tax adjustment can no longer be used. In calculating the DSIC, this means that federal and state income tax deductions must be added to the rate formula.

FirstEnergy states that, even if the requirements of Section 1301.1 apply to the DSIC, state income tax deductions are accounted for in the earnings cap and, therefore, do not need to be included in the calculation of the DSIC rate itself. FE S.I.B. at 13. This is incorrect because Act 40 mandates that these deductions “shall also be included in the computation of current or deferred income tax expense to reduce rates.” 66 Pa. C.S. § 1301.1. The earnings cap does not reduce the DSIC rate; it can only prevent a utility from charging a DSIC when its reported quarterly earnings exceed a certain rate of return. 66 Pa. C.S. § 1357(b)(2)-(3). The earnings cap does not prevent utilities from charging a DSIC rate that is calculated as if the utility received no income tax deductions. This can only be accomplished if the flow-through of the state income tax deductions associated with DSIC plant is accounted for in determining the state income taxes that are included in the DSIC pre-tax rate of return.

Further, FirstEnergy ignores the impact of Act 40 on the earnings cap protection of the DSIC. With Act 40, consumers will lose the benefit of the consolidated tax savings adjustment when calculating whether a utility is overearning. FR S.I.B. at 2, 6. Act 40 will work to the Companies’ benefit in this regard. When Act 40 is read in its entirety, the General Assembly balances the impact of this change by requiring that “related tax deductions and credits” also be included in the calculation to reduce rates.

B. It Is Required, and Possible, to Include Related State Income Tax Deductions in the Calculation of the DSIC Rate.

The OCA identified two ways to recognize the impact of the deductions related to the state income taxes recovered through the DSIC. OCA St. 1-Supp. at 2-3; OCA St. 1SR-Supp. at 3-4, 6-7, 8-9. Both methods accomplish the same thing; they reduce the DSIC by the amount the

utility's state income tax decreases as a result of state income tax deductions related to the DSIC-eligible property. OCA S.M.B. at 12-15; OCA St. 1SR-Supp. at 3-4. The main difference is the first method uses FirstEnergy's existing DSIC formula and changes the tax multiplier used to calculate the pre-tax rate of return (PTRR).<sup>6</sup> OCA St. 1 at 6-7; OCA St. 1SR-Supp. at 2, 8-9. The second separates out the calculation of the allowance for state income tax expense that includes the related income tax deductions and credits.

In response, First Energy argues that it may not be possible to add offsets for state income tax deductions into the DSIC calculation provided in Section 1357 and the Commission's model tariff. FE S.I.B. at 11-16. The Companies' first reason is that the statute and model tariff specify that the "statutory" income tax rates should be used. FirstEnergy's second reason is that the OCA's methods would double-count state income tax deductions. Last, the Companies maintain that including offsets for state income tax benefits may require more steps than the Commission intended when it developed the existing DSIC formula. In the following sections, each claim is examined and shown to pose no obstacle to compliance with Section 1301.1.

FirstEnergy raises these false hurdles to give credence to its arguments regarding statutory construction. FE S.I.B. at 19. It is not necessary or appropriate, however, to consider evidence outside the plain meaning of the words of Section 1301.1 to determine legislative intent. Commonwealth v. Rushing, 627 Pa. 59, 70, 99 A.3d 416, 423 (2014); Bayada Nurses Inc. v. Commonwealth Dept. Labor and Indus., 607 Pa. 527, 551-54, 8 A.3d 866, 880-81 (2010); PPL Elec. Utils. Corp. v. Pa. PUC, 912 A.2d 386, 400-01 (2006). The plain meaning of Section 1301.1 is unambiguous. It requires that, anytime an "investment" is allowed to be included in

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<sup>6</sup> The mechanics of the PTRR calculation are not included in the FirstEnergy Companies' DSIC tariff riders. They are provided in the calculations supporting each Company's quarterly DSIC updates. See OCA Exh. LA-ME-1 (PTRR calculation from Met-Ed June 20, 2016 DSIC compliance filing).

“rates,” the related income tax deductions “shall also be included” in the calculation of current or deferred income tax expense “to reduce rates.” 66 Pa. C.S. § 1301.1.

1. Effective Tax Rate

The Companies contend that Section 1357(b)(1) prohibits use of an effective tax rate (the first method discussed above). FE S.I.B. at 12, 14-16. The cited provision of Act 11 states that “the pre-tax return shall be calculated using the Federal and State income tax rates.” 66 Pa. C.S. § 1357(b)(1). Using an effective tax rate in the DSIC calculation, however, does not change the applicable statutory state income tax rate. Just as calculating an average tax rate or a marginal tax rate does not change the applicable statutory tax rate. OCA S.M.B. at 14-15; OCA St. 1-Supp. at 3-4. The statutory state income tax rate is still “used” in the calculation of pre-tax return. This is best exemplified by the fact that both methods identified by the OCA for reflecting deductions produce the same DSIC rate, even though one does not adjust the statutory state income tax rate. OCA St. 1-Supp. at 3; OCA M.B. at 14-15. There is, thus, no inconsistency in using the statutory income tax rate pursuant to Section 1357(b)(1) and reducing the DSIC rate to reflect state income tax deductions pursuant to Section 1301.1.

2. Double-Counting

FirstEnergy’s arguments regarding double-counting are likewise misleading. The Companies point out that the existing DSIC formula already gives customers credit for a deduction in an amount equal to the depreciation recognized as an allowable expense in the DSIC calculation. FE S.I.B. at 17. As a result, if the deductions included in the depreciation expense were also included in the revenue conversion factor, there would be a double-count. Id. That much is correct but it is not what the OCA proposed.

There are additional state income tax deductions related to DSIC investment that are not included in the existing calculation of the DSIC rate (in the depreciation expense).<sup>7</sup> FE Exh. 1 at 1-2; OCA St. 1-Supp. at 5; see OCA M.B. at 15-16. The OCA’s recommended adjustments to the formula are intended to capture the impact of these additional state income tax deductions only. See OCA St. 1SR-Supp. at 5-6. The OCA explained that there will be no double-count if the revenue conversion factor is calculated to reflect the impact of tax deductions that are not already included in the depreciation expense component of the formula. Id.; see n.8, infra. As an alternative, the OCA has also pointed out that a separate calculation for related income tax impacts could be incorporated into the DSIC formula and calculated in a manner that does not double-count any deductions already included in the depreciation expense. OCA St. 1-Supp. at 8-9.

### 3. Additional Steps

FirstEnergy argues that it is not practical to include income tax deductions in the DSIC calculation because it would require a “full rate case analysis” that is not consistent with the “straightforward” forward nature of a rate adjustment clause. FE S.I.B. at 15, 18. Act 11 established an adjusting rate that requires more detailed calculations than simple expense surcharges because it recovers the return of and on eligible capital investment. 66 Pa. C.S. §§ 1350, et seq. Now, under Act 40, the calculation of the DSIC rate must include the deductions associated with the same capital investment. While the process described by the OCA and Company witnesses to include state income tax deductions in no way requires a “full rate case

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<sup>7</sup> The record demonstrates that depreciation on DSIC-eligible property for state income taxes, *i.e.* the state income tax deduction for depreciation, will exceed the book depreciation on the DSIC-eligible property that is included in the existing DSIC rate calculation. The state tax depreciation rate is the MACRS for 20-year plant plus an additional 3/7ths (or 42.68%), which is greater than the book depreciation rate. See FE Exh. 1 at 1-2; see e.g., Metropolitan Edison Exh. KMS-3, Sch. 4. There is, thus, an incremental amount of state income tax deductions for tax depreciation that is required by Act 40 to be recognized to reduce the DSIC rate but is not recognized by the Companies’ existing calculation.

analysis,” that is not relevant. The General Assembly has required a DSIC calculation that includes income tax deductions related to the investment recovered in the rate. 66 Pa. C.S. § 1301.1.

The Companies do not argue that they are not able to calculate the required offset, only that it would require three additional steps.<sup>8</sup> FE S.I.B. at 15. The OCA points out that if the Company’s informed estimates are different than the actual adjustment for state income tax deductions, Act 11 provides for reconciliation.<sup>9</sup> 66 Pa. C.S. §§ 1358(d)(2), (e). Moreover, the additional steps will not change the timeliness of the Companies’ recovery of DSIC-eligible investment. The surcharge can still take effect in as few as 10 days. 66 Pa. C.S. § 1357(d)(3) . If the calculation is contested, the rates can be put into effect, subject to refund or recoupment, as was done in the case *sub judice*. Petition of Metropolitan Edison Co., et al., Docket Nos. P-2015-2508942 et al., Order at 20-21 (June 9, 2016).

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<sup>8</sup> FirstEnergy witness Fullem summarized the “effective tax rate” method as requiring the utility to (1) calculate the deductions associated with adding DSIC-eligible property, (2) subtract book depreciation and (3) convert the dollar amount to a revenue conversion factor. FE St. 1-R (Supp) at 10; FE St. 1-RJ at 4-5; FE S.I.B. at 15. OCA witness Smith demonstrated that converting the dollar amount to a revenue conversion factor is basic math. See OCA St. 1SR-Supp. at 5-7.

\$4,995 actual state income tax (after fully reflecting all related state income tax deductions) divided by the \$100,000 pre-tax income (e.g., equity return prior to fully reflecting the state tax depreciation deductions) equals an “effective” tax rate of 4.995 percent.

...

$1/1 - (.35 \times (1 - 0.04995)) + 0.04995$ , where .35 is the federal income tax rate and 0.04995 is the effective state income tax rate that reflect the state income tax deductions.

Id. at 5 n.1, 7 n.2.

<sup>9</sup> This is the same process used for the Companies’ estimate of revenues in the DSIC formula. 66 Pa. C.S. § 1357(d), (e).



### III. CONCLUSION

Based on the foregoing and for the reasons articulated in the OCA's Main Brief addressing state income tax deductions and the OCA's Briefs and Exceptions addressing federal income tax deductions (transferred to this proceeding), the FirstEnergy Companies should be directed to include federal and state income tax deductions and credits related to DSIC-eligible investment in their DSIC rate calculations.

In addition, FirstEnergy's proposed findings of fact and conclusions of law should be rejected to the extent they are inconsistent with these recommendations.

Respectfully submitted,



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