

COMMONWEALTH OF PENNSYLVANIA



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January 4, 2018

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

Re: Pa. Public Utility Commission
v.
Newtown Artesian Water Company
Docket No. R-2017-2624240

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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

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Enclosure

cc: Honorable Christopher P. Pell
Certificate of Service
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CERTIFICATE OF SERVICE

Re: Pennsylvania Public Utility Commission :
v. : Docket No. R-2017-2624240
Newtown Artesian Water Company :

I hereby certify that I have this day served a true copy of the following document, the Office of Consumer Advocate's Main Brief, 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 4th day of January 2018.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission :
 :
 v. : Docket No. R-2017-2624240
 :
 Newtown Artesian Water Company :

MAIN BRIEF OF THE
OFFICE OF CONSUMER ADVOCATE

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I. STATEMENT OF THE CASE

The Office of Consumer Advocate (OCA) hereby submits this Main Brief regarding the Distribution System Improvement Charge (DSIC) cap increase proposed by Newtown Artesian Water Company (NAWC or the Company).

A. Procedural History

Newtown Artesian Water Company provides water service to approximately 10,554 residential, commercial, industrial, public, and fire protection customers in Newtown Borough, Newtown Township, and the northern portion of Middletown Township, Bucks County, Pennsylvania. The Company provides water service in two rate areas, the Newtown Artesian Rate Area and the Indian Rock Rate Area.

On September 1, 2017, the Company filed Supplement No. 126 to Tariff Water – Pa. P.U.C. No. 9, to become effective November 1, 2017 (Supplement No. 126). In this filing, the Company seeks Pennsylvania Public Utility Commission (Commission) approval of an increase to the Company's DSIC cap that would allow the company to charge customers up to seven-and-one-half (7.5) percent of billed revenues, rather than the current cap of five (5) percent, to earn a return of and on eligible distribution system investment between base rate cases.

On September 20, 2017, the Commission's Bureau of Technical Utility Services sent an initial set of interrogatories to the Company. On September 29, 2017, the OCA filed a Formal Complaint against the proposed increase. On October 4, 2017, the Company responded to the TUS Interrogatories. On October 5, 2017, the Commission suspended the filing and instituted an investigation into the justness, reasonableness, and lawfulness of the Company's proposed and existing rates, rules, and regulations.

The OCA issued three sets of formal discovery and filed the direct and surrebuttal testimony of Jerry D. Mierzwa setting forth the OCA's position in this proceeding. At the

evidentiary hearing in Philadelphia, on December 11, 2017, the OCA conducted cross-examination and introduced evidence in support of its position in this case. Included in Appendix B is a list of testimony, schedules, and exhibits submitted by the OCA and admitted into the record.

B. Burden of Proof

NAWC bears the burden of proof to establish the justness and reasonableness of every element of the proposed increase to its DSIC cap. As set forth in Section 315(a) of the Public Utility Code:

Reasonableness of rates – In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceedings upon the complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa. C.S. § 315(a). The Commonwealth Court interprets this principle as follows:

Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial.

Lower Frederick Twp. v. Pa. PUC, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (Pa. Commw. Ct. 1980) (citations omitted). See also Brockway Glass v. Pa. PUC, 63 Pa. Commw. 238, 437 A.2d 1067 (Pa. Commw. Ct. 1981).

The Pennsylvania Supreme Court has stated that the party with the burden of proof has a formidable task to show that the Commission may lawfully adopt its position. Even where a party has established a prima facie case, the party with the burden must establish that “the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.” Burleson v. Pa. PUC, 461 A.2d 1234, 1236 (Pa. 1983) (Burleson). Thus, a utility has an affirmative burden to establish the justness and reasonableness of every component of its rate request.

The OCA carries a lesser burden in challenging the just, reasonableness and lawfulness of components of the Company's existing and proposed DSIC mechanism. See Pa. PUC v. Breezewood Telephone Co., 74 Pa. P.U.C. 431 (1991) ("Thus where a party has raised a question concerning an element at issue, the affirmative burden of proving justness and reasonableness of its claim is upon [the utility]"); see also e.g. Berner v. Pa. PUC, 382 Pa. 622, 116 A.2d 738 (1955) (Berner). In Berner, the Pennsylvania Supreme Court stated:

[T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations and that is the burden which the utility patently failed to carry.

Id., 382 Pa. at 631, 116 A.2d at 744. The Commission recognizes this standard in its rate determinations. See Pa. PUC v. Equitable Gas Co., 57 PaPUC 423, 471 (1983). See also University of Pa. v. Pa. PUC, 86 Pa. Commw. 410, 485 A.2d 1217 (Pa. Commw. Ct. 1984).

To prevail in its challenge, Pennsylvania law requires only that the OCA bear the burden of going forward. See Replogle v. Pa. Electric Co., F-06727378, 1980 Pa. PUC LEXIS 20 at *3 (Order entered Oct. 9, 1980) ("While . . . the burden of proof never shifts and always remains on the party affirming a fact in support of its case . . . the burden of going forward with the evidence may shift from party to party during the course of a proceeding."). To satisfy the burden of going forward, the OCA must merely provide evidence rebutting NAWC's original evidence. As stated in Pa. PUC v. Wellsboro Electric Co. and Citizens Electric Co. of Lewisburg, R-2014-9419774, 2014 Pa. PUC LEXIS 634 at *16-17 (Dec. 12, 2014):

If a party with the burden of proof establishes a *prima facie* case, the burden of going forward with the evidence shifts to the other party. If the other party does not rebut that evidence, the original party will prevail. If the other party rebuts the original party's evidence, the burden of going forward with the evidence shifts back to the original party, who must rebut the other party's evidence by a preponderance of the evidence. The burden of going forward with the evidence may shift from one party to another, but the burden of proof never shifts; it always remains on the original party.

In conclusion, NAWC must affirmatively demonstrate the reasonableness of every element of the DSIC, including how it is calculated, accounted for, and charged, as well as demonstrate that the proposed cap increase is just, reasonable and in compliance with applicable statutes, regulations and orders. The OCA will rebut the Company's evidence showing that it has failed to satisfy its statutory burden in the manner set forth below.

II. SUMMARY OF ARGUMENT

The issue in this proceeding is whether the Commission should allow NAWC to increase its existing DSIC cap from 5 percent to 7.5 percent. As discussed herein, the Company has not proven by a preponderance of the evidence that the proposed increase is just and reasonable, and in compliance with the applicable statutes, regulations and orders. To support its claim, the Company asserts that the DSIC cap increase will allow it to comply with its Long-Term Infrastructure Improvement Plan (LTIIIP), approved by the Commission at Docket No. P-2017-2594725, as well as reduce its base rate case filing frequency. Based on the evidence in this proceeding, however, the Company has asserted that it will comply with the LTIIIP regardless of whether the Commission approves the DSIC cap increase. Further, the Company has not filed a base rate case since March 2011 (almost seven years), has never exceeded its current DSIC cap of 5 percent, and has never utilized the fully forecasted future test year provision under Act 11 (2012).

For these reasons and as set forth below, the Commission should deny NAWC's request for a DSIC cap increase.

In addition, the OCA has identified other issues with NAWC's existing and proposed DSIC mechanism. Several issues stem from the recently enacted Act 40 of 2016, which requires utilities to reflect investment-related income tax deductions and credits in rates that recover those investments. Consistent with Act 40, the Company should include investment-related income tax

deductions and credits when it calculates the DSIC rate. For federal income tax deductions, this requires a change to the Company's tariff and the OCA also recommended that the Company maintain separate Accumulated Deferred Income Tax balances for DSIC-eligible plant. For state income tax deductions, the Company should reflect actual state income taxes paid in the state income tax rate used to calculate the pre-tax rate of return in its DSIC calculation. Likewise, NAWC should include investment-related tax deductions and credits when it calculates the overall return used to apply the DSIC earnings cap, which can reset the DSIC rate to zero.

The OCA also showed that the Company has not been using the correct cost of debt rate in its application of the earnings cap and its calculation of the DSIC rate. First, the Company improperly included short-term debt in its calculation of the rate of return used to apply the DSIC earnings cap. Second, the Company used the wrong (historic) cost of debt rate in the calculation of the DSIC rate. Specifically, it used the cost of debt established in its 2011 base rate case instead of its current cost of debt. Accordingly, the OCA recommended that the errors be corrected going forward. The OCA also recommended that NAWC provide refunds for any DSIC over-collections, with interest, resulting from use of an incorrect debt cost rate for the past four (4) years.

Next, the OCA showed that the Company is not charging the DSIC to private fire protection customers. This exemption is not permitted under Act 11, which requires utilities to apply the DSIC to all customers. Therefore, the OCA recommends that, going forward, the Company apply the DSIC to its private fire protection customers.

Further, the OCA showed that the Company removes accumulated depreciation from its calculation of the DSIC investment on which it earns a return, but does not reflect this in the DSIC formula contained in its tariff. Therefore, the OCA recommends that the tariff be changed to be consistent with the Company's practice.

All of these issues bear on whether the proposed increase to the DSIC cap is just, reasonable, and in compliance with the law. Further, many of the concerns raised by the OCA – the Company’s calculation of its overall return used to apply the earnings cap, calculation of its DSIC rate and failure to apply the surcharge to all customer classes – serve to overstate the DSIC rate and call into question the level of the Company’s historic and projected DSIC rates.

The OCA respectfully submits this Main Brief in support of its position.

III. ARGUMENT

A. NAWC’s Proposed Increase to the DSIC Cap

1. NAWC’s Supplement No. 126 and Supporting Information

On September 1, 2016, the Company submitted Supplement No. 126, along with supporting information required by 52 Pa. Code § 53.52. Upon suspension and investigation of the proposed supplement, the Company submitted NAWC Statement No. 1, NAWC Statement No. 1R, and NAWC Statement No. 2. In Supplement No. 126 and its testimony, the Company claims that approval of the increase to the DSIC cap will facilitate compliance with its LTIP, docketed at P-2017-2594725. NAWC St. 1 at 3. The Company also claims that approval of the increase to the DSIC cap increase will reduce its future rate base filing frequency. *Id.* at 5.

As discussed in detail below, however, NAWC has failed to support its DSIC cap increase. Further, additional reasons demonstrate that an increase to the Company’s DSIC cap is unjust and unreasonable.

2. Reasons against Increase to the DSIC Cap

a) The Company Will Not Further Accelerate Its Infrastructure Investment If the DSIC Cap Increase Is Approved

NAWC asserts that if the Commission approves the DSIC cap increase, it will facilitate compliance with the Company’s infrastructure replacement schedule and the LTIP plan. NAWC

St. 1 at 3. However, the Company has no plans to accelerate the rate at which it completes the LTIP projects if the DSIC cap increases to 7.5 percent. Tr. at 36.

The Commission has recognized the importance of accelerating infrastructure improvement when deciding whether to increase a utility's DSIC cap. Particularly with water utilities, the Commission has approved the DSIC cap increase where the utility provided evidence that the increase would accelerate infrastructure replacement. See Pa. PUC v. Aqua Pennsylvania, Inc., R-2008-2079310, 2009 Pa. PUC LEXIS 263 (July 23, 2009) (holding that an increase to the DSIC cap would allow Aqua to accelerate replacement of 1,500 miles of critical pipe) (Aqua); Petition of United Water Pennsylvania, Inc. for Approval of a Tariff Supplement to Revise its Maximum DSIC To 7.5% of Billed Revenues, P-2013-2389331, Order at 3 (Dec. 19, 2013) (determining that an increase of the DSIC cap “will enable UWPA to accelerate further its main replacement program”) (United Water); Petition of Pennsylvania-American Water Co. for Approval to Implement a Tariff Supplement to Tariff Water – Pa. P.U.C. No. 4 Revising the DSIC, P-00062241, 2007 Pa. PUC LEXIS 42 at *6, 24 (July 11, 2007) (approving an incremental increase to PAWC's DSIC cap based, *inter alia*, on PAWC's claim that the increase would support its efforts to accelerate replacement of its older small-diameter mains) (PAWC).

In contrast to PAWC, Aqua and United Water, NAWC has explicitly stated that it does not intend to accelerate further its infrastructure improvement schedule if the DSIC cap increase is granted. Rather, the Company merely claims it will be able to better comply with its approved LTIP. Tr. at 37. Indeed, its witness acknowledged that the Company will comply with its LTIP whether or not the DSIC cap is increased to 7.5 percent. NAWC St. 1R at 2-3.

Further, the Commission did not condition NAWC's compliance with the LTIP order upon approval of an increase to the DSIC cap. Rather, the LTIP order states that “Newtown's proposed

LTIIP appears to demonstrate its associated expenditures are reasonable, cost effective, and designed to ensure and maintain efficient, safe, adequate, reliable, and reasonable service to its customers.” NAWC St. 2, Att. 1 at 17. The LTIIP was approved with a DSIC cap of 5 percent.

For these reasons, merely complying with the LTIIP is insufficient to support an increase to NAWC’s DSIC cap.

b) The Intervals between NAWC’s Base Rate Filings Are Already Lengthy

The Company claims that if the Commission approves the DSIC cap increase, it will reduce the frequency of the Company’s future DSIC cap related base rate cases. NAWC St. 1 at 5. To make this argument, the Company contends that it has never filed a DSIC cap related base rate case before, so its historic filing frequency is not relevant to whether its DSIC cap should be increased. NAWC St. 1R at 5. NAWC predicts that some of its future base rate cases will be DSIC cap related, because it has started to spend more on infrastructure investment, and that it will file that type of base rate case less frequently if it has a higher DSIC cap. NAWC St. 1R at 3. This circular argument should be rejected.

For one, the decision to file a rate case is a combination of many factors and variables. As OCA witness Mierzwa stated:

As a general matter, numerous economic and financial factors together determine the frequency with which NAWC, and other utilities, file base rate increase requests and incur the costs associated with the review of those requests. While NAWC has never exceeded the 5 percent DSIC cap in any quarter, in 2009, its DSIC rates were 4.49 and 4.80 percent (effective January 1 and March 1, 2009). This was due to DSIC-eligible expenditures made during the future test year of its 2008 base rate case. It is reasonable to conclude that the Company considered those expenditures in its decision to file that base rate case. It is also reasonable to conclude that the Company has considered its planned DSIC-eligible expenditures and the level of its DSIC rate relative to the DSIC cap, among many other factors, each time it has decided to file or not to file a base rate case.

OCA St. 1SR at 4. Secondly, it is difficult to predict when a utility will file a rate case in the future. PAWC acknowledged this in its DSIC cap increase proceeding, where its witness could not say with certainty how often the utility would file base rate cases with a higher DSIC cap. The Presiding Officer quoted the witness' acknowledgment that "there are too many factors, DSIC cap being only one, that determine when a utility needs to file a general rate increase case." PAWC, 2007 Pa. PUC LEXIS 43 at *23.

Accordingly, in its review of prior requests to increase water utility's DSIC caps, the Commission has looked at the utility's known, historic filing frequency and tried to achieve a reasonable balance between the "Company's efforts to make improvements to its distribution system while encouraging the Company to make reasonably frequent base rate filings." PAWC, 2007 Pa. PUC LEXIS 42 at *32. The Commission's focus has been on whether an increase to the DSIC cap could result in a utility avoiding a rate case for an extended period. Aqua, 2009 Pa. PUC LEXIS 263 at *27-28 ("Aqua asserts that, under its current pattern of filing base rate cases approximately every two years, the 5% DSIC surcharge cap is reached in about eighteen months. Aqua reasons that the increase in the DSIC cap to 7.5% will not unduly lengthen the time between base rate cases.") The Commission repeatedly found this balance where the approval of the DSIC cap increase would encourage reasonably frequent base rate cases of approximately two to three years. PAWC, 2007 Pa. PUC LEXIS 42 at *32; see also United Water, Order at 6 ("increased pace of main replacement will necessitate a revised maximum DSIC rate of 7.5% in order to maintain a base rate case filing cycle of two to three years").

NAWC is far beyond the three-years the Commission discussed in PAWC and United Water. NAWC filed base rate cases in 1998, 2005, 2008 and 2011. OCA St. 1 at 5. If the Company files a base rate case in 2018, it will have averaged 5 years between base rate filings. If the

Commission approves the DSIC cap increase, the Company projects that it will not reach the 7.5 percent cap for two to three years. Tr. at 36. NAWC claims that an increase to its DSIC cap will reduce the need for future DSIC cap-related base rate filings. Tr. at 33. NAWC last filed a base rate case in March of 2011. If the Company does not file a base rate case until it reaches the 7.5 percent cap, or in two to three years, *i.e.* the beginning of 2020 or 2021, NAWC would avoid base rate review for nine or ten years. That is well beyond the filing frequency that the Commission indicated was appropriate in prior cases and does not support NAWC's request to increase the DSIC cap.

c) The Company's DSIC Rate Has Never Reached the 5 Percent Cap

The Company argues that the fact that NAWC has never exceeded its 5 percent cap is superfluous. NAWC St. 1R at 5. Whether or not the Company has reached the 5 percent cap is relevant, however, as shown by the Commission's decisions in Aqua, PAWC and United Water. In those cases, the Commission took into account the utility's historic, current, and future DSIC rate. For example, the Commission stated in Aqua that:

Aqua has historically reached the cap in about eighteen months or less after it was reset to 0% following a base rate proceeding. For instance, Aqua's expenses exceeded the 5% cap in the fourth quarter of 2005 (5.26%), the second quarter of 2006 (7.21%), and the second quarter of 2008 (6.03%). Aqua's most recent base rate case went into effect on August 1, 2008, and Aqua anticipates reaching the current 5% DSIC surcharge cap by September 1, 2009

Aqua, 2009 Pa. PUC LEXIS 263 at *20; see also PAWC, 2007 Pa. PUC LEXIS 42 at *6 (noting that PAWC surpassed its DSIC cap limit and was at 6.36% on Jan. 1, 2007, several months before the Commission made its decision); United Water, Petition at 5 (observing that the surcharge reached the 5 percent cap in January 2002 and remained there until September 2006 and then reached the cap again in October 2009 until March 2010.)

NAWC has never reached the DSIC cap since it implemented a DSIC. OCA St. 1 at 5. This makes the Company's situation similar to that of Columbia Gas. The Commission denied that utility's petition to increase its DSIC cap, in part, because Columbia Gas had never reached its 5 percent cap. Petition of Columbia Gas of Pennsylvania, Inc. for a Waiver of the DSIC Cap of 5% of Billed Distribution Revenues and Approval to Increase the Maximum Allowable DSIC to 10% of Billed Distribution Revenues, P-2016-2521993, Order at 53 (Dec. 22, 2016) (Columbia Gas Waiver).

d) The Company Has Overstated or Misstated Its Historic and Projected DSIC Rate

NAWC has claimed that it will reach the 5 percent cap by the end of 2017 due to increased spending under the LTIP. NAWC St. 1 at 3. The record shows, however, that the projected spending for 2017 was overestimated in the LTIP. There, NAWC projected that the State Street Main Replacement project would cost \$650,000 in 2017. NAWC St. 2, Att. 1 at 9. In this proceeding, the Company's witness adjusted NAWC's projected spending for that project to \$400,000. NAWC St. 2 at 2. This \$250,000 reduction represents almost 25 percent of the Company's total projected LTIP spending for 2017. It is equally possible that NAWC's actual spending will be less than projected spending in other years of the LTIP. The likelihood that actual spending will differ from projected is one reason the Commission has focused on a utility's historic (known) DSIC rates in determining whether an increase to the DSIC cap is warranted. As discussed above, Aqua, PAWC and Suez showed a pattern of consistently reaching their DSIC cap. NAWC's DSIC rates have never reached the existing 5 percent DSIC cap. Moreover, the OCA has shown that NAWC's historic and current DSIC rates may not have been correctly calculated. This bears directly on the justness and reasonableness of an increase to the DSIC cap.

The first problem relates to the long-term debt rate used in the DSIC calculation. In the Company's quarterly DSIC filing, effective November 1, 2017, it used a 6.09 percent cost of long-term debt as calculated in the 2011 base rate case, docketed at R-2011-2230259, to calculate the pre-tax rate of return component of the DSIC formula. OCA St. 1, Sch. JDM 4, DSIC Supporting Calculations. By statute, however, the Company must use its most recent cost rates for long-term debt and preferred stock for the calculation of the pre-tax rate of return. Section 1357(b)(1) states:

The pretax return shall be calculated using the federal and state income tax rates, the utility's actual capital structure and actual cost rates for long-term debt and preferred stock as of the last day of the three-month period ending one month prior to the effective date of the distribution system improvement charge and subsequent updates.

66 Pa. C.S. § 1357(b)(1) (emphasis added). In practice, the Commission has directed utilities to utilize the cost rates from their most recent annual or quarterly financial earnings report to satisfy this statutory requirement. Implementation of Act 11 of 2012, M-2012-2293611, Supplemental Implementation Order at 6-7 (Sept. 15, 2016) (Supp. Implementation Order). Accordingly, NAWC erred by using a historic cost of debt.

The Company's long-term cost of debt from its most recent quarterly financial earnings report is 5.47 percent. NAWC St. 1R, Att. 1, App. A. When the erroneous 6.09 percent is replaced with the 5.47 actual (current) cost of long-term debt, it produces a lower DSIC rate. OCA St. 1 at 9-10. The OCA's witness showed that, for every quarter since 2013, the Company made the same error in the calculation of its DSIC rate. Id. at 10; OCA Sch. JDM-5.

In the course of this proceeding, it was also discovered that the Company included short-term debt in the debt cost rates reported in its quarterly earnings report. OCA St. 1SR at 9. This error impacts the application of the DSIC earnings cap. If the Company's rate of return exceeds the allowed level for DSIC purposes, the DSIC must be reset to zero. Short-term debt also should be excluded from pre-tax return component of the DSIC rate. OCA St. 1 at 9. Going forward, the

Company committed to exclude short-term debt in calculating both parts of the DSIC mechanism. Tr. at 38.

The OCA identified another error in NAWC's application of the DSIC. The Company does not charge the DSIC to private fire protection customers. OCA St. 1 at 12. The omission of this customer class means that the eligible costs were recovered from a smaller number of customers and, therefore, the rate was overstated.

Looking at all of this information cumulatively, shows that NAWC has not provided the Commission with an accurate picture of its historic or projected DSIC rates. The Company has not demonstrated that a 7.5 percent DSIC cap is warranted and the Commission should deny the DSIC cap increase.

e) The Company Already Has Several Regulatory Mechanisms at Its Disposal to Reduce Regulatory Lag

The Commission has determined that an increase to the DSIC cap is unnecessary when a Company effectively utilizes other regulatory mechanisms to address its main replacement efforts. Columbia Gas Waiver, Order at 50. Three regulatory mechanisms are already available to NAWC, to reduce regulatory lag, lower risk and decrease the need for base rate filings.

First, NAWC has a Purchased Water Adjustment Clause (PWAC) through which it automatically recovers approximately one-third of its annual operating expenses without filing a base rate case. OCA St. 1 at 6. Second, the Company can utilize a fully forecasted future test year, which allows for prospective inclusion of distribution system improvement costs in rate base. Id. Third, NAWC has a DSIC in place that allows it to recover up to 5 percent of its eligible distribution system investment between base rate cases.

3. Legal Standard for a DSIC Cap Increase

In support of its proposed DSIC cap increase, the Company also argues that a DSIC cap of 7.5 percent for a water utility is presumptively fair and reasonable considering the language of 66 Pa. C.S. § 1358(a)(2). Tr. at 30. The OCA submits, however, that there is no right or presumption of reasonableness.

Section 1358(a)(2) states that, “[a] distribution system improvement charge granted to a water utility under former section 1307(g) or this subchapter may not exceed 7.5% of the amount billed to customers.” 66 Pa. C.S. § 1358(a)(2). Based on this language, the statute does not guarantee a water utility a DSIC cap of 7.5 percent, rather it merely sets the ceiling for the DSIC rate the Commission may authorize for a water utility. When seeking an increase in the DSIC cap up to 7.5 percent, a water utility must still comply with Section 1301 of the Public Utility Code, by showing that the proposed rate increase is just, reasonable, and in compliance with applicable statutes, regulations and orders. 66 Pa. C.S. § 1301; see PAWC, 2007 Pa. PUC LEXIS 43 at *18-19; Aqua, 2009 Pa. PUC LEXIS 263 at *25; United Water, Order at 6.

If the General Assembly were to create an automatic right or presumption, it would have done so expressly, given the importance of the DSIC cap. This is no more evident in the original implementation of the DSIC, where the Commission recognized that the 5 percent DSIC cap is the primary consumer safeguard against abuse of the DSIC. See Petition of Philadelphia Suburban Water Co. for Approval to Implement a Tariff Supplement Establishing a DSIC, P-00961036, Order (Aug. 22, 1996). Therefore, the applicable statutory standard for an increase to the DSIC cap is the same applied for all rate increases – whether the proposed rate increase is just, reasonable and in compliance with the law.

The OCA notes that the General Assembly provided a more specific standard for non-water utilities, which must show that a proposed increase to the DSIC cap is necessary “to ensure and

maintain adequate, efficient, safe, reliable and reasonable service.” 66 Pa. C.S. § 1358(a)(1). The Commission has considered whether an increase would ensure and maintain adequate, efficient, safe, reliable and reasonable service as part of its overall review of the just and reasonableness of water utility DSIC cap increases, both before and after Act 11. PAWC, 2007 Pa. PUC LEXIS 43 at *19-21; Aqua, 2009 Pa. PUC LEXIS 263 at *11-13; United Water, Order at 3, 5.

4. Conclusion

In summary, NAWC must show that the DSIC cap increase is just and reasonable under Section 1301 of the Public Utility Code. The Company has failed to meet that standard for the following reasons: (1) the Company has shown no evidence that it intends to further accelerate its infrastructure investment if its DSIC cap is increased; (2) it has failed to show the need to reduce its base rate filing frequency; (3) it has never reached the current 5 percent cap; (4) it has miscalculated its current and historic DSIC rates; and (5) it has other regulatory mechanisms at its disposal, which will allow the Company to reduce regulatory lag and timely recover its expenditures. For these reasons, the Commission should deny NAWC’s proposed DSIC cap increase.

B. The OCA’s Recommendations

The OCA has identified several errors in how NAWC calculates and applies its DSIC mechanism. These errors bear directly on whether the DSIC cap increase is just and reasonable, as well as the justness, reasonableness, and lawfulness of NAWC’s existing rates, rules, and regulations. As stated in the Commission’s Order suspending Supplement No. 126 for investigation:

That this investigation shall include consideration of the lawfulness, justness, and reasonableness of the existing rates, rules, and regulations of Newtown Artesian Water Company.

Pa. PUC v. Newtown Artesian Water Co., R-2017-2624240, Suspension Order at 2 (Oct. 5, 2017)
(Suspension Order).

The OCA has demonstrated that aspects of the Company’s DSIC mechanism do not comply with the Public Utility Code and Commission orders. The following corrections to the Company’s DSIC mechanism are necessary:

Issue	Recommended Correction
NAWC does not include federal and state income tax deductions and credits in the DSIC rate (pp. 17-22, <u>infra</u>).	Deduct ADIT from eligible investment costs in its calculation of DSIC revenue requirement; Revise the tariff to include ADIT in the DSIC formula; Maintain separate ADIT balances; and Adjust the state income tax rate in its gross-up for the DSIC pre-tax rate of return, to reflect its actual tax liability.
NAWC does not include federal and state income tax deductions and credits in its earnings cap. In its most recent financial earnings report, the Company removed federal income tax deductions from the return calculation used to reset the DSIC rate (pp. 22-24, <u>infra</u>).	Include federal and state income tax deductions in the earnings cap calculation. Calculate future financial earnings reports in the same manner as the revised November 28, 2017 report.
NAWC included short-term debt in its cost of debt and overall return calculations in its financial earnings reports. (pp. 24, <u>infra</u>)	Going forward, exclude short-term debt from the cost of debt utilized to apply the DSIC earnings cap and calculate the DSIC rate.
NAWC used a historic cost of debt rate to calculate its DSIC earnings cap and the DSIC rate (pp. 24-26, <u>infra</u>).	Going forward, use the actual (current) cost of long-term debt from its most recent financial earnings report to apply the DSIC earnings cap and calculate the DSIC rate. Recalculate the DSIC rate for the prior 4 years, excluding short-term debt and using the current cost of long-term debt.

Issue	Recommended Correction
NAWC used a historic cost of debt rate to calculate its DSIC earnings cap and the DSIC rate (pp. 24-26, <u>infra</u>).	Issue refunds, with interest, if customers were overcharged during the past four years, due to the Company’s use of an incorrect cost of debt rate.
NAWC does not charge the DSIC to private fire protection customers (pp. 27-29, <u>infra</u>).	Begin charging the DSIC to all private fire protection customers.
NAWC’s current tariff does not reflect that the Company removes accumulated depreciation in its calculation of the DSIC rate (pp. 29, <u>infra</u>).	Modify the DSIC formula in the tariff to show that “DSI” is net of accumulated depreciation (as well as ADIT).

The OCA submits that the Commission should adopt these recommendations to remedy the identified errors and ensure that the DSIC is accurately calculated and charged going-forward.

1. Application of Act 40 to the Company’s DSIC Mechanism

In 2012, Act 11 was signed into law. Act 11, *inter alia*, permitted certain utilities, including electric utilities, to petition the Commission for approval to implement a DSIC. See 66 Pa. C.S. § 1353(a). In one of the first cases before the Commission seeking approval of a DSIC under Act 11, the OCA asserted that the utility should be required to recognize federal and state income tax benefits recovered through the DSIC and generated by the investment in replaced infrastructure. The Commission rejected the OCA’s assertions. See Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution System Improvement Charge, P-2012-2338282, Opinion and Order (May 22, 2014) (Columbia Gas’ Initial DSIC). The OCA appealed the Commission’s determination, and on appeal the Commission asserted that “in enacting Act 11, the General Assembly envisioned a simple and straightforward process of establishing rates for the DSIC surcharge that would be easy to calculate and audit” McCloskey v. Pa. PUC, 127 A.3d 860, 867 (Pa. Commw. Ct. 2015) (McCloskey). In upholding the Commission’s decision and discretion to determine the components required for calculation of the DSIC rate, the Commonwealth Court stated:

Had the General Assembly wanted to ... curtail the Commission's discretion to allow utilities to continue to utilize this practice, the General Assembly could have explicitly incorporated such a prohibition or placed a limit on the Commission's discretion at the time it enacted Act 11. However, the General Assembly declined to take such action when the statute was drafted or enacted.

McCloskey, 127 A.3d 860, 870-71.

Shortly after the Commonwealth Court's determination in McCloskey, the General Assembly passed Act 40 of 2016, and the Governor signed Act 40 into law. Specifically regarding the computation of utility rates, Act 40 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 OCA submits that Act 40 now requires the inclusion of federal and state income tax deductions in the DSIC rate charged to customers because the related investment is being included in the DSIC rate.¹ OCA St. 1 at 11. In addition, the OCA submits that Act 40 also requires that federal and state income tax deductions be included in the rate of return used to apply the DSIC earnings cap, because the related investment is included in the return calculation. OCA St. 1 at 7-8, 12.

NAWC witness Walker claims that the Commission and the Commonwealth Court have previously rejected similar claims made by the OCA that ADIT and state income tax deductions should be reflected in the calculation of DSIC rates. NAWC St. 1R at 8-9. Mr. Walker also mentions the Commission's DSIC Final Implementation Order and Model Tariff. Id. at 12-13. As discussed, however, those determinations were made prior to August 11, 2016, the date Act 40

¹ The OCA is currently litigating this issue, which is awaiting decision before the Commission. See Petitions of Metropolitan Edison Co., Pennsylvania Electric Co., Pennsylvania Power Co., and West Penn Power Co. for Approval of a DSIC, Office of Consumer Advocate v. Metropolitan Edison Co., P-2015-2508942, C-2016-2531040, *et al.* (FirstEnergy DSIC).

took effect. Section 1301.1(c)(2) states that Act 40 shall apply to all cases where the final order is entered after its effective date. It is well-established that when enacting legislation, it is presumed that the General Assembly is familiar with existing law. See e.g. Commw. v. Ramos, 623 Pa. 420, 428, 83 A.3d 86, 91 (Pa. 2013). It, therefore, must be presumed that in passing Act 40, the General Assembly was aware of the recent Commonwealth Court order finding it unnecessary to account for state income tax deductions in calculating the DSIC. Act 40 requires that utilities include all “related income tax deductions and credits” in their computation of their DSIC charges, which therefore, requires the inclusion of state income tax deductions in their computations. The General Assembly did not limit the application of Act 40 and, therefore, it must be presumed that Act 40 applies to all “rates” as defined in the Public Utility Code, of which the DSIC is one.² As such, Act 40 requires a different treatment of federal and state income taxes than that previously approved by the Commission in Columbia Gas’ Initial DSIC.

Recently, the OCA raised the same issue in a consolidated DSIC proceeding initiated by the four FirstEnergy Companies. FirstEnergy DSIC, P-2015-2508942, C-2016-2531040, *et al.*, Recommended Decision (Aug. 31, 2017). There, the presiding Administrative Law Judge adopted the OCA’s position, stating:

² The DSIC is a rate. The Public Utility Code specifically defines “Rate” as follows:

Every individual, or joint fare, toll, charge, rental, or other compensation whatsoever of any public utility . . . made, demanded, or received for any service within this part, offered, rendered, or furnished by such public utility

66 Pa. C.S. § 102 (emphasis added). The Public Utility Code defines “Distribution system improvement charge” as follows:

A charge imposed by a utility to recover the reasonable and prudent costs incurred to repair, improve or replace eligible property that is part of the utility’s distribution system.

66 Pa. C.S. § 1351 (emphasis added).

The OCA, therefore, is correct that the companies must modify their DSIC calculation to include federal and state income tax deductions generated by DSIC investment. Doing so is what the General Assembly directed when enacting Act 40, regardless of McCloskey. No further analysis is required. The discretion previously afforded to the Commission in McCloskey is no longer present in light of the enactment of Act 40. The companies' arguments to the contrary are without merit and should be rejected.

Id. at 25.

For NAWC to include federal and state income tax deductions related to placing DSIC-eligible plant in service in its DSIC rate and its application of the DSIC earnings cap, the OCA showed the need for the following changes to the Company's existing mechanism:

- Modify its existing DSIC tariff to include accumulated deferred income taxes and accumulated depreciation in the definition of "DSI";
- Maintain separate ADIT balances for DSIC-eligible plant;
- Reflect actual state income taxes paid in the state income tax rate used to calculate pre-tax rate of return in the DSIC calculation; and
- Include related income tax deductions in the calculation of overall rate of return used to apply the DSIC earnings cap.

OCA St. 1 at 10-11. The specific changes are discussed in the following sections.

a) Reflection of Federal and State Income Tax Deductions in the Calculation of the DSIC Rate

NAWC's DSIC is intended to allow the utility to recover a *pre-tax* return rate applicable to the original cost of eligible projects net of accrued depreciation. 66 Pa. C.S. § 1357(a)(3). Specifically, every dollar of equity return in the DSIC is "grossed up" to include federal and state income taxes at the full statutory state and federal income tax rates. See OCA Sch. JDM-4, DSIC Supporting Calculations. NAWC is not actually paying that level of taxes to the government, however. Tax deductions have reduced the income on which NAWC must pay income taxes. See, e.g., OCA Sch. JDM-1, Sch. A; NAWC St. 1R, Att. 1, Sch. B. The Internal Revenue Code prohibits NAWC from flowing through federal tax reductions in rates on a current basis. I.R.C. §§ 167, 168.

Thus, under standard ratemaking procedure, the balance of deferred taxes (ADIT) is treated as a reduction in the utility's rate base, so that customers do not pay a return on non-investor supplied capital.³ For DSIC purposes, the OCA's position is that ADIT must be recognized in calculating the eligible costs to which the DSIC pre-tax return rate will apply, so that customers do not pay NAWC a return on zero cost capital. This ensures that ratepayers will not pay a return on capital that NAWC did not invest.

To reflect ADIT in the DSIC calculation, the definition of eligible distribution system improvement project costs (DSI) shown on page 28 of NAWC's DSIC tariff should be modified to read "DSI = original cost of eligible distribution system improvement projects net of accumulated deferred income taxes." (emphasis indicates new language.) OCA St. 1 at 11. To facilitate this calculation, the OCA recommended that NAWC begin maintaining separate ADIT balances for DSIC eligible plant, because it does not currently do so. Id.

³ For example, in a 1979 West Penn Power rate case involving the Pleasants Unit 1 Generating Station, the Commission addressed the issue of deducting ADIT from rate base as follows:

If this amount is not deducted from rate base, the stockholders will be earning a return on money they never provided. . . .

Under West Penn's proposal, the stockholders would be permitted to retain the tax benefits on which they would earn a return; and the ratepayers would be obligated to provide a return to the stockholders on funds made available by the federal government.

We agree with the consumer advocate, that simple equity to the ratepayers, commission policy regarding treatment of accelerated depreciation benefits, and consistent treatment of such depreciation for both book and rate-making accounts, require that additional deduction in this regard be made to rate base.

Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 264-65, 53 PaPUC 410, 430-31 (1979). The Commission reached the identical conclusion in a case involving the PECO Salem Nuclear Plant. Pa. PUC v. Philadelphia Elec. Co., 31 PUR4th 15 at 44-45, 52 PaPUC 772 at 802-03 (1978) (The utility's treatment "runs afoul of the well-settled commission principle that tax depreciation benefits must either be flowed through to the benefit of the ratepayer, or if not, then deducted from rate base").

State income tax deductions are handled differently than federal income tax deductions because the IRS prohibition against the flow-through of federal tax reductions does not apply to state taxes. Pennsylvania law requires that state income tax deductions must be reflected in rates on a current basis.⁴ As explained by OCA witness Mierzwa, this can be accomplished by using an effective state income tax rate to calculate the DSIC pre-tax rate of return. OCA St. 1 at 11. The effective state income tax rate reflects the Company's actual state income taxes paid where the Company's state income tax liability is reduced by tax deductions. Mr. Mierzwa provided this illustration:

If, for example, deductions exceed the state taxable income that will be generated by the DSIC, NAWC will pay no state income taxes on DSIC revenues and the Company's pre-tax rate of return should be grossed-up to account for federal income taxes and no state income taxes.

Id. No tariff change is necessary to make this change to the DSIC calculation because the gross-up for pre-tax return is not detailed in the Company's tariff. It appears in the workpapers attached to NAWC's DSIC updates. See, e.g., OCA Sch. JDM-4, DSIC Computation.

b) Reflection of Federal and State Income Tax Deductions in the Application of the Earnings Cap (Federal Income Tax Payment Adjustment)

Federal and state income tax deductions should also be included in NAWC's calculation of its overall rate of return used to determine whether the DSIC should be reset. OCA St. 1 at 7-8, 12. The DSIC earnings cap is in Section 1358(b)(3), which states:

The distribution system improvement charge shall be reset at zero if, in any quarter, data filed with the commission in the utility's most recent annual or quarterly earnings report show that the utility will earn a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under the distribution system improvement charge.

⁴ See, e.g., Pittsburgh v. Pa. PUC, 182 Pa. Super. 551, 577-79, 128 A.2d 372 at 384 (Pa. Super. Ct. 1956); Barasch v. Pa. PUC, 507 Pa. 496, 504-05, 521-22, 491 A.2d 94, 101, 105-07 (Pa. 1985); Pa. PUC v. Metropolitan Edison Co., 60 PaPUC 349, 398 (1985).

66 Pa. C.S. § 1358(b)(3). The earnings cap reduces the DSIC rate to zero, where the utility's overall rate of return is greater than the allowable return used to calculate the DSIC. Federal tax loss carry-forward is an investment-related income tax deduction. OCA St. 1 at 7-8, 12. Consistent with Act 40, then, that deduction should be included in NAWC's calculation of its overall rate of return used to reset the DSIC rate. In its most recent financial earnings report, however, the Company made an adjustment to eliminate that deduction in its presentation of federal income tax expense. OCA St. 1, Sch. JDM-1, Sch. A. As a result, even though the Company did not incur any federal income tax expense and federal income tax expenses did not reduce its return, NAWC reflected an increase of \$277,343 to its per book returns to increase expenses for federal income taxes. OCA St. 1 at 8. The Company's adjustment served to lower its overall rate of return, which it uses to determine whether it exceeds the earnings cap and must zero out the DSIC rate. The Company's exclusion of federal income tax deductions is inconsistent with Act 40, which requires that investment-related income tax deductions be included in the calculation of income tax expense in rates that recover that investment. OCA St. 1 at 12; 66 Pa. C.S. § 1301.1.

The Company filed a revised financial earnings report on November 28, 2017 that eliminated all but \$22,440, or more than 90 percent, of its original adjustment. NAWC St. 1R, Att. 1, Sch. A. As stated by OCA witness Mierzwa, the remaining amount of the adjustment is not material. OCA St. 1SR at 8. With regard to future financial earnings reports, however, the OCA recommended that any adjustment for federal income taxes be calculated in the same manner as the November 28, 2017 report. Id. Consistent with Act 40, investment-related income tax deductions should be included in the calculation of overall rate of return used to apply the DSIC earnings cap.

For these reasons, the OCA submits that the Commission should direct NAWC to include investment-related income tax deductions and credits when it calculates the DSIC rate and when it calculates the overall return used to apply the DSIC earnings cap.

2. Prospective Changes to Cost of Debt Utilized to Apply the Earnings Cap and Calculate the DSIC Rate

a) Exclusion of Short-Term Debt

When the OCA submitted its direct testimony, it attached NAWC's Financial Report for the 12 Month Period Ended June 30, 2017, which was the most recent financial earnings report available. OCA St. 1, Sch. JDM-1. As discussed above in Section 3(a)(ii)(4) of this Brief, the Company has been using the wrong (historic) cost of debt to calculate the DSIC rate and the DSIC earnings cap. In the rebuttal phase of testimony, however, Company witness Walker identified a second problem with NAWC's cost of debt calculations – the Company has included short-term debt. NAWC St. 1R at 7-8; OCA St. 1SR at 8-9.

OCA witness Mierzwa agreed that short-term debt should be excluded from determining NAWC's cost of debt used to apply the DSIC earnings cap and calculate the DSIC rate. OCA St. 1SR at 8-9. Section 1357(b)(1) specifies that pretax return should be calculated using “only the utility's actual capital structure and actual cost rates for long-term debt and preferred stock.” 66 Pa. C.S. § 1357(b)(1). Accordingly, the OCA recommended that in future financial earnings reports the Company make the same correction – to exclude short-term debt from the cost of debt utilized to calculate the DSIC earnings cap and the DSIC rate. OCA St. 1SR at 9. NAWC's witness accepted this recommendation. NAWC St. 1R at 7-8, 14; Tr. at 37-38.

b) Use of Current Debt Cost

In the Company's most recent quarterly DSIC update, effective November 1, 2017, it used a 6.09 percent cost of debt to calculate its DSIC earnings cap and the pre-tax rate of return used to

determine the DSIC rate. OCA St. 1, Sch. JDM-4, DSIC Supporting Calculations. This 6.09 percent is the same cost of debt calculated in the Company's 2011 base rate case, docketed at R-2011-2230259. Id. The Company has used this 6.09 percent cost of debt in every quarterly DSIC filing dating back to at least November 2013. OCA St. 1 at 10.

Pursuant to Section 1358(b)(3), however, the Company must use data from the utility's most recent earnings report when applying its DSIC earnings cap. 66 Pa. C.S. § 1358(b)(3). Correcting the cost of debt changes the Company's calculation of its overall allowable DSIC return and may impact whether or not the DSIC earnings cap is triggered and the DSIC rate must be reset to zero. OCA St. 1 at 8-9.

Further, under Section 1357(b)(1), the Company must use the cost of debt from its most recent financial earnings report to calculate its DSIC rate. 66 Pa. C.S. § 1357(b)(1); Supp. Implementation Order at 5-6. According to the Company's most recent, revised financial earnings report its current cost of debt is 5.47 percent. NAWC St. 1R, Att.1, App. A. At no time during the last four years was the current cost of debt 6.09 percent. OCA St. 1, Sch. JDM-5. OCA witness Mierzwa attempted to calculate the impact of this error on the historic DSIC rate. His calculations showed that using the current cost of debt for each quarter in the last four years reduced the DSIC rate in every quarter. OCA St. 1, Sch. JDM-5. Because the Company included short-term debt in its cost of debt in the financial earnings report that the OCA witness relied on, the calculations are not accurate.⁵ It remains, however, that the Company should not have used the debt cost rate from the 2011 base rate case in its DSIC calculations for the last four years and that the 2011 debt cost rate differed from the debt cost rates it should have used. OCA St. 1SR at 9. The OCA

⁵ OCA witness Mierzwa did not have the necessary information to make the calculations after learning about the short-term debt and had no time to obtain the information from the Company before submitting surrebuttal testimony on December 6, 2017 (seven days after NAWC submitted testimony identifying the error). Tr. at 56-57.

recommended, therefore, that NAWC's DSIC should be recalculated and refunds issued as appropriate.

NAWC witness Walker conditionally agreed with the OCA's prospective recommendation, stating that "[g]oing forward, the Company will use the cost of long-term debt which NAWC believes is acceptable to reviewing staff." NAWC St. 1R at 14. At the evidentiary hearing, Walker reiterated that, going forward, the Company would use the actual cost rates from the Company's most recent quarterly financial earnings report to calculate the DSIC earnings cap and the DSIC rate – as long as TUS approved. Tr. at 39. As discussed above, use of the current cost rates is required by statute; therefore, the Company should be directed to make its calculations using the current cost rates.

3. Recalculation of the DSIC Rate for Cost of Debt and Refunds

NAWC's witness did not agree with the OCA's recommendation that customers receive a refund for any overcharges resulting from use of the incorrect (historic) debt cost rate. NAWC St. 1R at 7, 14. Mr. Walker raised two objections. First, he argued that refunds are outside the scope of this proceeding. *Id.* He stated:

Additionally, I have been advised by counsel that this proceeding does not involve a recalculation of the DSIC for prior periods, nor is it a refund proceeding, and that NAWC will argue that the attempt of the OCA to recalculate the DSIC and request a refund directive is not before the Commission. Further, I point out, nevertheless, that the debt cost rate NAWC used in its DSIC calculations was documented by the Company, reviewed by the Bureau of Audits and accepted by the Commission.

Id. at 7. This argument ignores that NAWC's DSIC is a surcharge and is subject to audit and reconciliation.⁶ 66 Pa. C.S. § 1358(e). The Public Utility Code also provides for refunds in any rate proceeding. The DSIC is a rate and this is a rate proceeding. Section 1312(a) states:

⁶ See *Pa. PUC v. The Peoples Natural Gas Co.*, P-00032021, 2003 Pa. PUC LEXIS 488 at *27-29 (Sept. 18, 2003) (authorizing Peoples to recover undercollections resulting from accounting and computation errors in the Purchased Gas Cost surcharge rates charged to customers from 1997 through 2000). The

If, in any proceeding involving rates, the commission shall determine that any rate received by a public utility was unjust or unreasonable, or was in violation of any regulation or order of the commission, or was in excess of the applicable rate contained in an existing and effective tariff of such public utility, the commission shall have the power and authority to make an order requiring the public utility to refund the amount of any excess paid by any patron, in consequence of such unlawful collection, within four years prior to the date of the filing of the complaint, together with interest at the legal rate from the date of each such excessive payment.

66 Pa. C.S. § 1312. Further, the Commission made clear in its Suspension Order that NAWC's existing rates are an issue in this proceeding. Suspension Order at 2. The Commission has authority to require NAWC to correct its DSIC calculations for the prior four years and issue refunds, with interest, as recommended by the OCA.⁷

Second, NAWC witness Walker argues that "All overcollections and undercollections are handled through the annual 1307(e) reconciliation process." NAWC St. 1R at 14. The OCA does not object to refunds being provided through the annual DSIC reconciliation process, however, the OCA seeks a determination in this proceeding that refunds will be issued (with interest) if the Company's corrected calculations show that customers were overcharged during the past four years, due to the Company's error.

4. Application of the DSIC to Private Fire Protection Customers

As discussed earlier in this Brief, NAWC does not charge the DSIC to private fire protection customers. NAWC St. 1R at 9, 15. This failure contributes to questions about the accuracy of the Company's historic DSIC rates and provides further reason to maintain the existing DSIC cap. See, p. 13, supra. It also requires a change going forward – NAWC should apply the

Commission's Order was later modified by a settlement, which modified the total amount of the refund and refund period. See Pa. PUC v. The Peoples Natural Gas Co., P-00032021, 2004 Pa. PUC LEXIS 701 (July 23, 2004).

⁷ As discussed above, the OCA's witness determined that NAWC used an incorrect (historic) cost of debt for every quarter since 2013 and that, in every quarter, the error increased the DSIC rate. OCA St. 1 at 10; OCA Sch. JDM-5. See p. 12, supra. These calculations were made before it was shown that NAWC's earnings reports included short-term debt. See n.5, supra.

DSIC to the private fire protection class. Company witness Walker objected to this change, arguing that because private fire protection customers are non-metered, flat rate customers, similar to public fire protection customers, they should not be charged a DSIC. Id. The Company has no legal basis, however, for its position.

NAWC is required to apply the DSIC to private fire protection customers by statute.

Section 1358(d)(1) states:

That the distribution system improvement charge shall be applied equally to all customer classes as a percentage of each customer's billed revenue, consistently with subsection (a).

66 Pa. C.S. § 1358(d)(1). There is a statutory exception for public fire protection customers, which limits their rates to recover their full cost of service. 66 Pa. C.S. § 1328(a). No such limitation applies to private fire protection customers.

Furthermore, the fact that NAWC's private fire protection customers are not metered does not support their exclusion from the DSIC. Mr. Walker indicated that one of the benefits of NAWC's DSIC-eligible investment is increased fire protection. NAWC St. 1 at 5. A significant portion of NAWC's DSIC-eligible investment is in distribution mains which are necessary to provide fire protection. Thus, private fire customers receive a direct benefit from NAWC's DSIC-eligible investment, whether or not they are metered. In addition, as OCA witness Mierzwa pointed out, while NAWC's flat rate customers are limited to the private and public fire protection classes, the same is not true for other water utilities. OCA St. 1SR at 11-12. PAWC provided unmetered rates for residential customers in four of its rate zones and charged those unmetered customers a DSIC. Id.

There is no legal or factual basis to exclude private fire protection customers from the DSIC. The Company's existing and proposed tariffs do not exempt that class of customers and the

Commission has not approved their exclusion.⁸ For all of these reasons, the Company should begin charging the DSIC to all private fire protection customers.

5. Recognition of Accumulated Depreciation in the DSIC Tariff

On page 28 of NAWC's current Tariff Water-PA. P.U.C. No. 9, the Company defines DSI as "the original cost of eligible distribution system improvement projects." See, e.g., OCA Sch. JDM-4. The Company actually calculates DSI as the original cost minus accumulated depreciation, as shown in the Company's most recent DSIC quarterly filing. Id., DSIC Computation. (deducting \$106,319 for accumulated depreciation). Accordingly, the OCA recommended that the Company modify its tariff to reflect that the DSI is net of accumulated depreciation (as well as accumulated deferred income taxes, as discussed above). The tariff should state:

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

OCA St. 1 at 13 (emphasis indicates new language).⁹

NAWC witness Walker does not seem to understand the OCA's recommendation regarding accumulated depreciation. He stated that the tariff change would complicate the DSIC mechanism and that its tariff was patterned after the Model Tariff attached to the Commission's Supplemental Implementation Order. NAWC St. 1R at 10, 13. As discussed, the tariff change would simply codify the Company's existing practice of netting accumulated depreciation. Further, the Model Tariff actually defines DSI as being net of accrued depreciation, so Mr. Walker is not correct.¹⁰ Supp. Implementation Order, App. A.

⁸ See page 30 of NAWC's current tariff, which exempts public fire protection customers (only). OCA St. 1, Sch. JDM-4, Sixty-Third Rev'd Page No. 30.

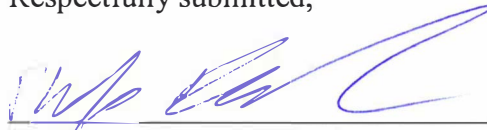
⁹ If the OCA's position on inclusion of ADIT does not prevail, then the Company will only be required to change the portion of the DSI definition related to accumulated or accrued depreciation.

¹⁰ The Model Tariff uses the term "accrued depreciation" but NAWC's DSIC workpapers use the term "accumulated depreciation." OCA Sch. JDM-4, DSIC Computation. The OCA supports either phrasing.

IV. CONCLUSION WITH REQUESTED RELIEF

As the OCA demonstrated above, NAWC has not met its burden of proof in showing that the DSIC cap increase is just and reasonable. In addition, the OCA has made specific recommendations to ensure the Company's DSIC mechanism is accurately calculated and correctly applied, consistent with the Public Utility Code and applicable Commission orders. For all the above reasons, the Office of Consumer Advocate respectfully requests that the Commission deny NAWC's proposed DSIC cap increase and adopt the OCA's recommendations.

Respectfully submitted,



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Proposed Findings of Fact

Background

1. Newtown Artesian Water Co. (NAWC or Company) is a public utility that provides water service to 10,554 customers in Newtown Borough, Newtown Township and the northern portion of Middletown Township in Bucks County. NAWC Exh. I, Resp. to Section 53.52(a)(2).
2. The Company's DSIC is capped at 5 percent. NAWC St. 1 at 2.
3. The Commission approved the Company's first Long-Term Infrastructure Improvement Plan (LTIIIP) on July 12, 2017, docketed at P-2017-2594725. NAWC St. 1 at 2
4. On September 1, 2016, the Company submitted Supplement No. 126 to Tariff Water-Pa. P.U.C. No. 9 and supporting information required by 52 Pa. Code § 53.52.

Facts Weighing Against Increasing the DSIC Cap

5. The Commission did not condition NAWC's compliance with the LTIIIP upon approval of an increase to the DSIC cap. NAWC St. 2, Att. 1 at 17.
6. The Company states that it will comply with its LTIIIP whether or not the DSIC cap is increased to 7.5 percent. NAWC St. 1R at 2-3.
7. The Company has no plans to accelerate the rate at which it completes the LTIIIP projects if the DSIC cap increases to 7.5 percent. Tr. at 36.
8. NAWC filed base rate cases in 1998, 2005, 2008 and 2011. OCA St. 1 at 5.
9. Historically, NAWC has averaged five years between filing a base rate case. OCA St. 1 at 5.
10. If the Commission approves the DSIC cap increase, the Company states that it will not reach the 7.5 percent cap for an additional two to three years. Tr. at 36.
11. If NAWC does not file a base rate case until 2020 or 2021, it will have avoided a base rate case for nine or ten years. OCA St. 1 at 5; Tr. at 36.
12. Numerous economic and financial factors together determine the frequency with which NAWC, and other utilities, must file base rate increase requests and the costs incurred in the review of those requests. OCA St. 1 at 4.
13. NAWC has never reached the 5 percent DSIC cap since it implemented a DSIC. OCA St. 1 at 5.

14. The LTIP projected that the State Street Main Replacement will cost \$650,000 in 2017. NAWC St. 2, Att. 1 at 9.
15. NAWC states that it will complete the State Street Main Replacement at a cost of \$400,000. NAWC St. 2 at 2.
16. Projected LTIP expenditures for 2017-2021 total approximately \$4,251,000. NAWC St. 2, Att. 1 at 12.
17. For the LTIP period, the Company projected that it would average \$850,200 in annual DSIC eligible expenses NAWC St. 2, Att. 1 at 12.
18. For the years 2014, 2015, and 2016, the Company averaged \$478,513 in annual DSIC eligible expenses. NAWC St. 2, Att. 1 at 12.
19. The average yearly expenses under the LTIP only represents 178% of the level of spending for the past three years. NAWC St. 2, Att. 1 at 12.
20. The Company has several regulatory mechanisms in place to reduce regulatory lag, lower risk and decrease the need for base rate filings, including a Purchased Water Adjustment Clause, a fully forecasted rate year, and a DSIC that allows recovery of up to 5 percent of eligible distribution system investment. OCA St. 1 at 6.

Act 40

21. Act 40 was signed into law on June 12, 2016 and took effect on August 11, 2016. It applies to all cases where the final order is entered into after its effective date. 66 Pa. C.S. § 1301.1(c)(2).
22. The PUC Order and Commonwealth Court Orders addressing whether utilities were required to reflect investment-related income tax deductions in the DSIC calculation under Act 11 of 2012 were decided before the effective date of Act 40. OCA St. 1 at 11.
23. NAWC's DSIC is intended to allow the utility to recover a pre-tax return rate applicable to the original cost of eligible projects net of accrued depreciation. 66 Pa. C.S. § 1357(a)(3).
24. Every dollar of equity return in the DSIC is "grossed up" to include federal and state income taxes at the full statutory state and federal income tax rates. See OCA Sch. JDM-4, DSIC Supporting Calculations.
25. Tax deductions have reduced the income on which NAWC must pay income taxes. See, e.g., OCA Sch. JDM-1; NAWC St. 1R, Att. 1, Sch. B.

26. The Internal Revenue Code prohibits NAWC from flowing through federal tax reductions in rates on a current basis. I.R.C. §§ 167, 168.
27. Under standard ratemaking procedure, the balance of deferred taxes (ADIT) is treated as a reduction in the utility's rate base, so that customers do not pay a return on non-investor supplied capital. Pa. PUC v. West Penn Power Co., 32 PUR4th 245, 264-65, 53 PaPUC 410, 430-31 (1979); Pa. PUC v. Philadelphia Elec. Co., 31 PUR4th 15 at 44-45, 52 PaPUC 772 at 802-03 (1978).
28. Federal tax loss carry-forward is an investment-related income tax deduction. OCA St. 1 at 7-8, 12.
29. In the Company's first revised financial earnings report, it made an adjustment to eliminate investment-related income tax deductions in its presentation of federal income tax expense. OCA St. 1, Sch. JDM-1, Sch. A.
30. NAWC reflected an increase of \$277,343 to its per book returns to increase expenses for federal income taxes. OCA St. 1 at 8.
31. The Company filed a second revised financial earnings report on November 28, 2017 that eliminated all but \$22,440, or more than 90 percent, of its original adjustment. NAWC St. 1R, Att. 1, Sch. A.
32. State income tax deductions are handled differently than federal income tax deductions because the IRS prohibition against the flow-through of federal tax reductions does not apply to state taxes. See, e.g., Pittsburgh v. Pa. PUC, 182 Pa. Super. 551, 577-79, 128 A.2d 372 at 384 (Pa. Super. Ct. 1956); Barasch v. Pa. P.U.C., 507 Pa. 496, 504-05, 521-22, 491 A.2d 94, 101, 105-07 (Pa. 1985); Pa. PUC v. Metropolitan Edison Co., 60 PaPUC 349, 398 (1985).
33. Pennsylvania law requires that state income tax deductions must be reflected in rates on a current basis, which can be accomplished by using an effective state income tax rate to calculate the DSIC pre-tax rate of return. OCA St. 1 at 11.

Correct Cost of Debt

34. In the Company's quarterly DSIC filing, effective November 1, 2017, it used a 6.09 percent cost of long-term debt as calculated in the 2011 base rate case, docketed at R-2011-2230259, to calculate the pre-tax rate of return used to determine its DSIC rate. OCA St. 1, Sch. JDM 4, DSIC Supporting Calculations.
35. The Company's long-term cost of debt from its second revised Financial Earnings Report for the 12-month Period Ended June 30, 2017, is 5.47 percent. NAWC St. 1R, Att. 1, Sch. F.

36. The Company did not have a 6.09 percent actual cost of long-term debt at any time during the last four years. OCA St. 1, Sch. JDM-5.
37. When the erroneous 6.09 percent cost of long-term debt is replaced with the 5.47 percent actual (current) cost of long-term debt, it produces a lower DSIC rate for the current quarter. OCA St. 1 at 9-10.
38. For every quarter since 2013, that the Company made the same error in the calculation of its DSIC rate. NAWC St. 1 at 10.
39. The Company agreed to use the actual cost rates from the Company's most recent quarterly financial earnings report to calculate the DSIC earnings cap and the DSIC rate going forward, conditioned on TUS approval. Tr. at 39.
40. When the OCA submitted its direct testimony, it attached NAWC's first revised Financial Report for the 12 Month Period Ended June 30, 2017, which was the most recent financial earnings report available at that time. OCA St. 1, Sch. JDM-1.
41. The Company included short-term debt in the debt cost rates reported in its first revised Financial Earnings Report for the 12-month Period Ended June 30, 2017. NAWC St. 1R at 7-8; OCA St. 1SR at 8-9.
42. On November 28, 2019, the Company submitted a second revised Financial Earnings Report for the 12-month Period Ended June 30, 2017, excluding the cost of short-term debt from its overall cost of debt calculation. NAWC St. 1R, Att. 1, Sch. F.
43. In the future, the Company committed to exclude short-term debt in calculating the DSIC earnings cap and the DSIC rate. Tr. at 38.

Private Fire Protection

44. The Company does not charge the DSIC to private fire protection customers. OCA St. 1 at 12.
45. NAWC's witness stated that one of the benefits of its DSIC-eligible investment is increased fire protection. NAWC St. 1 at 5.
46. PAWC provided unmetered rates for residential customers in four of its rate zones and charged those unmetered customers a DSIC. OCA St. 1SR at 12.

Accumulated Depreciation

47. On page 28 of NAWC's current Tariff Water-Pa. P.U.C. No. 9, the Company defines DSI as "the original cost of eligible distribution system improvement projects." See, e.g., OCA St.1, Sch. JDM-4.

48. The Company actually calculates DSI as the original cost minus accumulated depreciation, as shown in the Company's most recent DSIC quarterly filing where it subtracted \$106,319 for accumulated depreciation. OCA St. 1, Sch. JDM-4, DSIC Calculation. OCA St. 1, Sch. JDM-4, DSIC Calculation.
49. The Model Tariff defines DSI as being net of accrued depreciation. Implementation of Act 11 of 2012, M-2012-2293611, Supplemental Implementation Order, App. A (Sept. 15, 2016).

Proposed Conclusions of Law

1. NAWC's proposed DSIC cap increase and its existing DSIC mechanism must be just, reasonable, and in conformity with regulations or orders of the Commission. 66 Pa. C.S. § 1301.
2. The burden of proving the justness, reasonableness, and lawfulness of every element of the proposed DSIC cap increase and the existing DSIC mechanism is on NAWC. 66 Pa. C.S. § 315(a); 66 Pa. C.S. § 1301.
3. The burden of proof does not shift to parties challenging a requested rate increase. Berner v. Pa. PUC, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955); Pa. PUC v. Equitable Gas Co., 57 PaPUC 423, 471 (1983); University of Pennsylvania v. Pa. PUC, 86 Pa. Commw. 410, 485 A.2d 1217 (1984).
4. NAWC has failed to prove that the proposed DSIC cap increase is just and reasonable, and it has not shown that its existing DSIC mechanism is in conformity with the law. 66 Pa. C.S. § 315(a); 66 Pa. C.S. § 1301.
5. The DSIC is a rate pursuant to the Public Utility Code. 66 Pa. C.S. § 102; 66 Pa. C.S. § 1351.
6. Act 40 requires the inclusion of federal and state income tax deductions in the DSIC rate charged to customers because the related investment is being included in the DSIC rate. 66 Pa. C.S. § 1301.1(a).
7. Act 40 requires the inclusion of federal and state income tax deductions in the calculation of the overall return used to apply the DSIC earnings cap. 66 Pa. C.S. § 1301.1(a).
8. Utilities must use the cost of debt from the Company's most recent financial earnings statement when determining the overall rate of return used to apply the DSIC earnings cap and calculating the DSIC rate. 66 Pa. C.S. §§ 1357(b)(1), 1358(b)(3); Implementation of Act 11 of 2012, M-2012-2293611, Supplemental Implementation Order at 6-7 (Sept. 15, 2016).
9. The DSIC rate must be applied to private fire protection customers; there is no exemption for that class. 66 Pa. C.S. § 1328(a); 66 Pa. C.S. § 1358(d)(1).

Proposed Ordering Paragraphs

It is hereby ORDERED THAT:

1. NAWC's proposal, contained in Supplement No. 126 to Tariff Water Pa. PUC. No. 9, to raise its Distribution System Improvement Charge cap from 5% to 7.5% is denied.
2. NAWC shall (1) deduct ADIT from eligible investment costs in its calculation of DSIC revenue requirement, (2) revise the tariff to include ADIT in the DSIC formula, (3) maintain separate ADIT balances, (4) adjust the state income tax rate in its gross-up for the DSIC pre-tax rate of return, to reflect its actual tax liability.
3. NAWC shall (1) include federal and state income tax deductions in its earnings cap calculation and (2) calculate future financial earnings reports in the same manner as the revised report submitted on November 28, 2017.
4. NAWC shall exclude short-term debt from the cost of debt utilized to calculate the DSIC earnings cap and the DSIC rate.
5. NAWC shall use the actual (current) cost of debt from its most recent financial earnings report to apply the DSIC earnings cap and calculate the DSIC rate.
6. NAWC shall (1) recalculate the DSIC rate for the prior 4 years, excluding short-term debt and using the current cost of debt and (2) issue refunds, with interest, if customers were overcharged during the past four years, due to the Company's use of an incorrect cost of debt rate.
7. NAWC shall charge the DSIC to all private fire protections customers.
8. NAWC shall modify its tariff to show that "DSI" is net of accumulated depreciation (as well as ADIT, as stated above).
9. NAWC shall file tariffs, tariff supplements, or tariff revisions, containing rates, provisions, rules, and regulations, consistent with the findings herein.
10. The Formal Complaint of the OCA at Docket No. C-2017-2626954 is sustained.