

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission	:	R-2017-2624240
Office of Consumer Advocate	:	C-2017-2626954
	:	
v.	:	
	:	
Newtown Artesian Water Company	:	

RECOMMENDED DECISION

Before
Christopher P. Pell
Deputy Chief Administrative Law Judge

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I. INTRODUCTION

This Decision recommends that the Commission deny the Company's request to increase its Distribution System Improvement Charge (DSIC) cap to 7.5% of the amount billed to customers. NAWC's DSIC is presently capped at 5% of billed revenue. This Decision further recommends: that the Company reflect federal and state income tax deductions in the calculation of its DSIC rate; that the Company include a federal tax normalization adjustment in all future Financial Earnings Reports filed with the Commission; that the Company exclude short term debt when calculating its DSIC earnings cap and DSIC rate; that the Company use the actual cost of long-term debt from its most recent Financial Earnings Report to calculate the DSIC earnings cap and the DSIC rate; that the Company be required to provide verified debt cost for the years 2013, through 2017, in its next 1307(e) reconciliation proceeding in order to determine to what extent, if any, there was a DSIC overcollection/undercollection during that period; that the Company begin applying its DSIC to private fire customers; and that the Company modify its tariff to reflect accumulated depreciation and accumulated deferred income taxes in its DSI¹ definition.

II. HISTORY OF THE PROCEEDING

On September 1, 2017, Newtown Artesian Water Company (Newtown Artesian, NAWC or Company), Utility Code 212070, filed Supplement No. 126 To WATER-PA. P.U.C. No. 9 (Supplement No. 126) to become effective November 1, 2017. Supplement No. 126 proposes to increase NAWC's existing Distribution System Improvement Charge (DSIC) cap from 5% to 7.5%.

On September 29, 2017, the Office of Consumer Advocate (OCA) filed a Public Statement, a Notice of Appearance on behalf of Christine Maloni Hoover, Esq., and Erin L. Gannon, Esq., and a formal Complaint. The Complaint was docketed at C-2017-2626954.

¹ DSI is defined by the Commission as the "original cost of eligible distribution system improvement projects net of accrued depreciation." *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611, *Final Implementation Order* at 53. (Order entered August 2, 2012).

By Order entered October 5, 2017, the Pennsylvania Public Utility Commission (Commission) instituted an investigation into the lawfulness, justness, and reasonableness of the rates, rules, and regulations contained in NAWC's proposed Supplement No. 126 To WATER-PA. P.U.C. No. 9. The Commission ordered that the Company's proposed Supplement No. 126 To WATER-PA. P.U.C. No. 9 be suspended by operation of law until May 1, 2018, unless otherwise directed by Order of the Commission. The Commission further ordered that the investigation shall include consideration of the lawfulness, justness, and reasonableness of the existing rates, rules, and regulations of NAWC. The matter was assigned to the Office of Administrative Law Judge for the prompt scheduling of hearings culminating in the issuance of a Recommended Decision.

In accordance with the Commission's October 5, 2017, Order, the matter was assigned to Deputy Chief Administrative Law Judge Christopher P. Pell.

A Prehearing Conference was held on November 8, 2017. Counsel for NAWC and OCA participated.

By Prehearing Order dated November 17, 2017, I identified the parties of record and established the procedural schedule and the procedures applicable to this proceeding.

On November 6, 2017, Newtown Artesian served the following Direct Testimony: the Direct Testimony of Harold Walker, III, NAWC Statement No. 1; and the Direct Testimony of George Forsyth, NAWC Statement No. 2.

On November 20, 2017, OCA served the Direct Testimony of Jerome D. Mierzwa, OCA Statement No. 1.

On November 29, 2017, Newtown Artesian served the Rebuttal Testimony of Harold Walker, III, NAWC Statement No. 1R.

On December 6, 2017, OCA served the Surrebuttal Testimony of Jerome D. Mierzwa, OCA Statement No. 1-SR.

On December 6, 2017, I emailed the parties the cross-examination matrix for the hearings in this proceeding. I directed the parties to complete the cross-examination matrix and return it to me by the close of business on December 7, 2017. The parties completed the matrix as requested.

The evidentiary hearing was held as scheduled on December 11, 2017. During the hearing, NAWC presented the rejoinder testimony of Harold Walker, III, and made Mr. Walker available for cross-examination by the OCA. NAWC Witness George Forsyth was excused from appearing at the hearing as OCA did not request to cross-examine him, and also because I did not have any questions for him. OCA also presented its Witness, Jerome D. Mierzwa, for cross-examination. NAWC and OCA both moved to have their Witnesses' testimony and exhibits entered into the record. As there were no objections, all testimony and exhibits were admitted into the record during the hearing.

In accordance with my November 17, 2017 Prehearing Order, the parties filed Main Briefs on January 4, 2018 and Reply Briefs on January 16, 2018.

The record in this proceeding consists of the transcripts of the prehearing conference and the evidentiary hearing, and the statements and exhibits sponsored by the parties during the December 11, 2017 hearing. The record closed on January 16, 2018 after I received the parties' Reply Briefs.

III. FINDINGS OF FACT

A. General

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, Bucks County. NAWC St. No. 2 at 1-2; NAWC Exhibit 1, Supporting Information for Supplement No. 126 at 1-2 and 5.

2. NAWC's water distribution system includes approximately 130 miles of mains, 1,000 hydrants, 3,200 valves and 10,300 meters. NAWC Exhibit 1, Supporting Information for Supplement No. 126 at 2.

3. NAWC has had an approved DSIC mechanism in its tariff since 1998 and since that time has replaced 24,606 feet of primarily older undersized main, accounting for more than 3.5% of its total distribution system pipe.

4. The Company's DSIC is capped at 5%. NAWC St. 1 at 2.

B. NAWC's Request to Increase the DSIC Cap.

5. 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.

6. For the years 2014, 2015, and 2016, the Company averaged \$478,513 in annual DSIC eligible expenses. NAWC St. 2, Att. 1 at 12.

7. NAWC's LTIIIP related capital improvement program expenditures are projected to be approximately \$4,251,000 between 2017 and 2021. NAWC St. No. 1 at 3; NAWC St. 2, Att. 1 at 12; NAWC St. No. 1R at 3.

8. For the LTIIIP period (2017-2021), NAWC projected that it would average \$850,200 in annual DSIC eligible expenses. NAWC St. 2, Att. 1 at 2.

9. The LTIIIP projected that the State Street Main Replacement would cost \$650,000 in 2017. NAWC St. 2, Att. 1 at 9.

10. The Commission did not condition NAWC's compliance with the LTIP upon approval of an increase to the DSIC cap. NAWC St. 2, Att. 1 at 17.

11. NAWC subsequently revised its State Street Main Replacement cost projection, indicating that the project was scheduled to be completed by year end 2017 at a cost of \$400,000. NAWC St. No. 2 at 2.

12. On September 1, 2016, NAWC submitted Supplement No. 126 to Tariff Water-Pa. P.U.C. No. 9 and supporting information required by 52 Pa.Code § 53.52.

13. Supplement No. 126 proposes an increase to the DSIC cap from 5% to 7.5% of billed revenue. NAWC Exhibit 1, Supplement No. 126, Second Revised Page No. 29.

14. NAWC does not have plans to accelerate the rate at which it completes the LTIP projects if the DSIC cap is increased to 7.5%. Tr. at 36.

15. If the Commission approves NAWC's requested DSIC cap increase, it will not reach the 7.5% cap for approximately 2 to 3 years. Tr. at 36.

16. NAWC will comply with its LTIP even if its request to increase the DSIC cap is denied. NAWC St. 1R at 2-3.

17. NAWC has never reached the 5% DSIC cap since it implemented a DSIC. OCA St. 1 at 5.

18. NAWC has not filed a base rate increase request since 2011. OCA St. 1 at 5.

19. If the Commission approves NAWC's requested DSIC cap increase, the frequency of DSIC cap related base rate cases will be reduced. NAWC St. No. 1 at 5; NAWC Exh. I at 5.

C. Act 40 Issues.

20. A DSIC rate is a surcharge mechanism for the recovery of the costs related to the repair, improvement, and replacement of eligible property outside of a rate case. NAWC M.B. at 15.

21. NAWC does not account for accumulated deferred income taxes (ADIT) in its DSIC calculation. NAWC M.B. at 17.

22. 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. OCA M.B. at 20; OCA Sch. JDM-4, DSIC Supporting Calculations.

23. Tax deductions have reduced the income on which NAWC must pay income taxes. OCA M.B. at 20; OCA Sch. JDM-1; NAWC St. 1R, Att. 1, Sch. B.

24. The Internal Revenue Code prohibits NAWC from flowing through federal tax reductions in rates on a current basis. I.R.C. §§ 167, 168.

25. Under standard ratemaking procedures, the balance of 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. OCA M.B. at 21.

26. Federal tax loss carry-forward is an investment-related income tax deduction. OCA St. 1 at 7-8, 12.

27. NAWC, in its first revised Financial Earnings Report for the 12-month Period Ended June 30, 2017, made an adjustment to eliminate investment-related income tax deductions in its presentation of federal income tax expenses. OCA St. 1, Sch. JDM-1, Sch. A.

28. NAWC reflected an increase of \$277,343 to its per book returns to increase expenses for federal income taxes. OCA St. 1 at 8.

29. NAWC filed a second revised Financial Earnings Report on November 28, 2017 that eliminated all but \$22,440 of its original adjustment. NAWC St. 1R, Att. 1 Sch. A.

30. Pennsylvania law requires that state income tax deductions must be reflected in its rates on a current basis. OCA St. 1 at 11.

D. Cost Of Debt

31. In NAWC's quarterly DSIC filing, effective November 1, 2017, the Company used a 6.09% 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.

32. NAWC's cost of long-term debt from its second revised Financial Earnings Report for the 12-month Period Ended June 30, 2017 is 5.47%. NAWC St. 1R, Att. 1, Sch. F.

33. NAWC did not have a 6.09% actual cost of long-term debt at any time during the previous 4 years. OCA St. 1, Sch. JDM-5.

34. NAWC used the incorrect cost of long-term debt for every quarter since 2013. NAWC St. 1 at 10.

35. NAWC 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. 39.

36. NAWC also included short-term debt in the debt cost rates reported in its first Financial Earnings Report for the 12-month Period Ended June 30, 2017. NAWC St. 1R at 7-8; OCA St. 1SR at 8-9.

37. When NAWC filed its second revised Financial Earnings Report for the 12-month Period Ended June 30, 2017, it excluded the cost of short-term debt from its overall cost of debt calculation. NAWC. St. 1R, Att. 1, Sch. F.

38. NAWC agreed, going forward, to exclude short-term debt in calculating the DSIC earnings cap and the DSIC rate. Tr. at 38.

E. Private Fire Protection & Accumulated Depreciation

39. NAWC does not charge the DSIC to private fire protection customers. OCA St. 1 at 12.

40. 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.

41. NAWC calculates DSI as the original cost minus accumulated depreciation. OCA St. 1, Sch. JDM-4, DSIC Calculation.

42. 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 (Order Entered September 15, 2016).

IV. DISCUSSION

A. Applicable Legal Standards

1. Burden Of Proof

The public utility bears the burden of proof to establish the justness and reasonableness of its requested rate increase. As set forth in Section 315(a) of the Public Utility Code, 66 Pa.C.S. § 315(a):

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.

The Commonwealth Court has stated:

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.²

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 of proof 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.”³ Furthermore, it is well-established that the “degree of proof before administrative tribunals as well as before most civil proceedings is satisfied by establishing a preponderance of the evidence.”⁴ Additionally, the evidence must be substantial and legally credible, and cannot

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

³ *Burleson v. Pa. Pub. Util. Comm’n*, 461 A.2d 1234, 1236 (Pa. 1983).

⁴ *Lansberry v. Pa. Pub. Util. Comm’n*, 578 A.2d 600, 602 (Pa.Cmwlth. 1990).

be mere “suspicion” or a “scintilla” of evidence.⁵ Thus, a utility has an affirmative burden to establish the justness and reasonableness of its rate request.

However, as the Commonwealth Court has explained: “While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.”⁶ Therefore, while the ultimate burden of proof does not shift from the utility, a party proposing an adjustment to a ratemaking claim bears the burden of presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment.⁷ Furthermore, a party that raises an issue that is not included in a public utility’s general rate case filing bears the burden of proof regarding that issue.⁸

2. Act 11 Statutory Provisions

Act 11 of 2012, effective April 16, 2012, (Act 11) amended Chapters 3, 13 and 33 of the Public Utility Code (Code). 66 Pa.C.S. chs. 3, 13, 22. Act 11, in part, establishes a DSIC mechanism that allows certain utilities, including electric distribution companies; natural gas distribution companies (NGDCs); city natural gas operations; and water and wastewater companies, with distribution or collection systems, upon Commission approval, to recover the costs related to the repair, improvement, and replacement of eligible property outside of a rate case. 66 Pa.C.S. §§ 1350-1360.

Section 1351 of the Code sets forth the definitions for “eligible property” for each utility type, including water utilities:

For water utilities, eligible property shall include:

⁵ *Id.*

⁶ *Allegheny Center Assocs. v. Pa. Pub. Util. Comm’n*, 570 A.2d 149, 153 (Pa.Cmwlth. 1990).

⁷ *See, e.g., Pa. Pub. Util. Comm’n v. PECO Energy Co.*, Docket No. R-891364, *et al.*, 1990 Pa. PUC LEXIS 155 (Order entered May 16, 1990); *Pa. Pub. Util. Comm’n v. Brezewood Telephone Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45 (Order entered January 31, 1991).

⁸ *Pa. Pub. Util. Comm’n et al. v. Columbia Gas of Pennsylvania, Inc.*, R-2010-2215623 at 28 (Opinion and Order dated October 14, 2011).

- (i) Utility service lines, meters and hydrants installed as in-kind replacements for customers.
- (ii) Mains and valves installed as replacements for existing facilities that have worn out, are in deteriorated condition or are required to be upgraded to meet under 52 Pa. Code Ch. 65 (relating to water service).
- (iii) Main extensions installed to eliminate dead ends and to implement solutions to regional water supply problems that present a significant health and safety concern for customers currently receiving service from the water utility.
- (iv) Main cleaning and relining projects.
- (v) Unreimbursed costs related to highway relocation projects where a water utility must relocate its facilities.
- (vi) Other related capitalized costs.

66 Pa.C.S. § 1351.

As a precondition to the implementation of a DSIC, Act 11 requires that a utility must file a long-term infrastructure improvement plan (LTIP) with the Commission and specifies the information to be included in the LTIP. 66 Pa.C.S. § 1352.

Section 1353(a) of the Code specifically provides as follows:

(a) Authority—Except as provided under this subchapter, after January 1, 2013, a utility may petition the commission, or the commission, after notice and hearing may approve the establishment of a distribution system improvement charge to provide for the timely recovery of the reasonable and prudent costs incurred to repair, improve or replace eligible property in order to ensure and maintain adequate, efficient, safe, reliable and reasonable service.

66 Pa.C.S. § 1353(a).

Section 1358 of the Code provides various customer protections. Section 66 Pa.C.S. § 1358(a)(2), establishes a general rate cap. Under this section, a DSIC granted to a water utility under former section 1307(g) . . . or this subchapter may not exceed 7.5% of the amount billed to customers. Under certain circumstances, Section 1358(b) requires that a DSIC rate be reset to zero. After a reset, only fixed costs of new eligible property not previously

reflected in base rates may be reflected in a quarterly DSIC update. The DSIC rate is reset to zero if new base rates are established. 66 Pa.C.S. § 1358(b)(1). For investor-owned utilities, reset is also required 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 DSIC. 66 Pa.C.S. § 1358(b)(3).

Section 1358(c) of the Code, 66 Pa.C.S. § 1358(c), provides that, absent an express limitation on existing ratemaking authority, the Commission retains its full and existing ratemaking authority. Accordingly, the Commission has the full power and authority under the Code to examine, investigate, and audit any and all aspects regarding the data, operation, and implementation of the DSIC to the same extent that it would review a non-DSIC rate matter. In exercising its ratemaking authority, Section 1301 of the Code, mandates that the Commission determine “[e]very rate made, demanded, or received by any public utility ... shall be just and reasonable, and in conformity with regulations or orders of the commission.” This mandate applies to the DSIC rate in this proceeding. 66 Pa.C.S. § 1301. Finally, Section 1358(e) requires that all DSICs shall be subject to audits by the Commission and annual reconciliation based on a period consisting of the twelve months ending December 31 of each year. 66 Pa.C.S. § 1358(e)(1)(i), (ii).

On August 2, 2012, the Commission entered its Order in *Implementation of Act 11 of 2012*, Docket Number M-2012-2293611 (*Final Implementation Order*), which established procedures and guidelines necessary to implement Act 11 and included a Model Tariff for DSIC filings.

B. NAWC's Request To Increase The DSIC Cap

1. NAWC's Currently Approved DSIC Mechanism And Long Term Infrastructure Improvement Plan.

NAWC is a public utility subject to the regulatory jurisdiction of the Commission. NAWC owns and operates a water system serving 10,554 customers in Newtown Borough, Newtown Township, and the northern portion of Middletown Township, Bucks County. Its water distribution system includes approximately 130 miles of mains, 1,000 hydrants, 3,200 valves and 10,300 meters. (NAWC MB at 5).

NAWC has had an approved DSIC mechanism in its tariff since 1998 and since that time has replaced 24,606 feet of primarily older undersized main, accounting for more than 3.5% of its total distribution system pipe. For the past 20 years, the DSIC has permitted the Company to address its aging infrastructure replacement needs, allowing the Company to provide its customers with safe, reliable, and cost-effective water service. (NAWC MB at 5).

The DSIC has been capped at 5% of billed revenue since it became effective in 1998. NAWC's current DSIC percentage, which was placed into effect on November 1, 2017, with Supplement No. 125, is 4.26%. The DSIC is applied to all customer bills with the exception of fire protection. (NAWC MB at 5).

The DSIC is used, with Commission approval and as allowed by the General Assembly, to recover depreciation and pre-tax return on DSIC eligible property between rate cases. NAWC maintains that Company investment in DSIC eligible depreciable property facilitates the continued provision of reasonable and adequate service. (NAWC MB at 5-6).

On March 21, 2017, NAWC filed a petition asking the Commission to approve its Long-Term Infrastructure Improvement Plan (LTIIP).⁹ By Order entered July 12, 2017, the Commission approved NAWC's petition and LTIIP. The Commission summarized its

⁹ *Petition of The Newtown Artesian Water Company for Approval of its Long-Term Infrastructure Improvement Plan*, Docket No. P-2017-2594725 (Order entered July 12, 2017).

conclusions as follows directing NAWC to comply with the infrastructure replacement schedule and elements of its LTIIIP:

The Commission reviewed the eight required elements for Newtown's Petition for Approval of their LTIIIP and any resulting Petition comments. Newtown's proposed LTIIIP 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.

The Commission finds Newtown's Long-Term Infrastructure Improvement Plan and manner in which it was filed conforms to the requirements of Act 11 and our Final Implementation Order. The plan, as approved herein, is designed to maintain safe, adequate and reliable service and, as such, Newtown shall be required to comply with the infrastructure replacement schedule and elements of that plan.¹⁰

(NAWC MB at 6-7).

NAWC maintains that its projected LTIIIP related capital improvement program expenditures are significant in dollar terms totaling \$4,251,000 for 2017 through 2021. With a present rate base value of \$10,398,000, the LTIIIP projected expenditures equal 41% of the Company's existing rate base. The expenditures are detailed in the Order entered July 12, 2017. All of the LTIIIP expenditures are DSIC eligible. (NAWC MB at 7; NAWC RB at 6).

NAWC notes that it is moving forward with its LTIIIP program. The Company's State Street main replacement project is in progress and scheduled to be completed by year end 2017 at a cost of about \$400,000. NAWC anticipates that when the State Street project is completed and reflected in the Company's DSIC calculation, along with the Company's ongoing meter replacement plan efforts for the current period, its DSIC, which is presently 4.26%, will exceed 5%. NAWC maintains that additional LTIIIP program expenditures projected for 2018 through 2021, will increase the DSIC even further above 5%. (NAWC MB at 7; NAWC RB at 6).

¹⁰ *Id.* at 17.

Additionally, NAWC projects that within the projected five-year LTIP period all cast iron pipe (CIP) and asbestos cement pipe (ACP) more than 100 years old will be replaced. NAWC projects further that, thereafter, all remaining CIP and ACP mains will be replaced within 40 years, which represents an acceleration when compared to the roughly 72-year replacement rate that was found in March 2017 in the Focused Management and Operations Audit of NAWC at Docket No. D-2016-2559577. NAWC asserts that the Company's system will be safer and more reliable as a result of the replacement of CIP and ACP, as CIP and ACP are more susceptible to breaks, leaks and corrosion. (NAWC RB at 6).

For these reasons, NAWC seeks an increase to the DSIC CAP. NAWC's Supplement No. 126 proposes increasing the DSIC cap from 5.0% to 7.5% of billed revenue. The change from 5% to 7.5% is the only tariff change proposed in Supplement No. 126. NAWC asserts that the tariff change will have no immediate impact on a customer's bill, and that the increase in the DSIC cap will not impact bills until the DSIC calculation goes above 5% of billed revenue. NAWC maintains that even then, increases in the DSIC would be incremental as new DSIC eligible investment is completed and placed in service and included in a DSIC quarterly update. NAWC further maintains that the proposed tariff change has no impact on expenses. Lastly, NAWC asserts that, rather than force the Company into a base rate filing, an increase to the DSIC Cap to 7.5% is just and reasonable, and that Supplement No. 126 should be allowed to go into effect as filed on May 1, 2018. (NAWC MB at 6).

2. NAWC's Request To Increase The DSIC Cap To 7.5%.

NAWC maintains that compliance with the Company's infrastructure replacement schedule and LTIP plan elements will be facilitated by increasing the DSIC cap to the statutory maximum of 7.5%. It will do this by allowing the Company to recover the fixed costs (depreciation and pre-tax return) of completed DSIC eligible LTIP projects until they are ultimately reflected in base rates in the Company's next base rate case. Increasing the DSIC cap also will provide the Company with the resources to continue the accelerated replacement of aging infrastructure and to comply with evolving regulatory requirements including compliance with the Commission approved LTIP. (NAWC MB at 8).

The Company's LTIP, which was approved by the Commission in its Order entered July 12, 2017, at P-2017-2594725, reflects an acceleration of infrastructure investment in compliance with Act 11. At page 14 of the Order, the Commission concluded as follows:

“Upon review of Newtown’s LTIP and all supplemental information filed, the Commission finds that the requirements of element six of the Final Implementation Order, the manner in which replacement of aging infrastructure will be accelerated and how repair, improvement or replacement will maintain safe and reliable service, have been fulfilled.”

(NAWC RB at 7).

NAWC argues that the acceleration of infrastructure investment accepted by the Commission at P-2017-2594725 for the LTIP is substantial support for the proposed increase to the DSIC cap. NAWC additionally argues that a further acceleration is not required for the Company's 2.5% increase to its DSIC cap, and that the Order entered July 2, 2017 does not, in any way, preclude NAWC from increasing its DSIC cap to the statutory maximum of 7.5%.

(NAWC RB at 7).

NAWC contends that, while a further acceleration of infrastructure replacement is not required and the Company intends to meet its LTIP commitment, increasing the DSIC cap will facilitate compliance with the LTIP's timing. In the absence of the cap increase, the Company asserted that LTIP timing could be impacted due to the financial resources necessary and delays associated with more frequent rate cases that will arise without increasing the DSIC cap. Facilitating compliance with an LTIP is a recognized statutory justification for a DSIC.¹¹ Accordingly, NAWC submits that compliance with its Commission approved LTIP and approved accelerated replacement of aging infrastructure is appropriate justification for the Company's increase to its DSIC cap, and that the Company's proposed increase to the DSIC cap is just and reasonable and in compliance with the Public Utility Code. (NAWC RB at 7-8).

¹¹ See Section 1353(b)(2) of the Public Utility Code, 66 Pa. C.S. § 1353(b)(2).

Additionally, NAWC believes that the benefits of this increase are not one-sided. Increasing the DSIC cap will also benefit customers by reducing the frequency of base rate cases. Delaying the filing of base rate cases reduces rate case expense and the Commission has consistently recognized a reduction in base rate cases (with their attendant increased rate case expense) as a benefit of DSIC cost recovery and a reason for increasing the DSIC cap. NAWC believes that it is likely that the frequency of DSIC cap related base rate cases will be cut in half as a result of increasing the DSIC cap to 7.5%. The Company submits that further increasing the interval between base rate cases should be encouraged, not discouraged. The Company further submits that, rather than force the Company into a base rate filing, an increase in the DSIC cap to 7.5% is just and reasonable and in compliance with the Public Utility Code. (NAWC RB at 8-9).

Additional customer benefits include a decline in the number of main breaks and service interruptions, increased fire protection and an improvement in water quality through replacement, lining, cleaning and tie-ins. The value of accelerated infrastructure improvement in accordance with the approved LTIP is substantial, benefiting customers today and well into the future. (NAWC MB at 8-9).

NAWC asserts that the aforementioned benefits will occur without impeding existing customer safeguards. The General Assembly has included legislated safeguards within the DSIC process to ensure that the DSIC is appropriately monitored and that ratepayers are adequately protected. Safeguards assure that NAWC's DSIC is reflecting only DSIC eligible projects and that NAWC is not over-earning. Ultimately, the DSIC represents only the dollar-for-dollar recovery of prudent expenses incurred for improving reliability to customers. (NAWC MB at 9).

The DSIC eligible projects projected as part of the Commission approved LTIP will further the continued provision of reasonable and adequate service. NAWC maintains that it is entirely appropriate that the DSIC cap be increased so that they may be reflected in the DSIC calculation. Increasing the DSIC cap will enable the Company to meet its five-year LTIP on time and without undue delays. (NAWC MB at 9).

The Company maintains that the fact that the Company's DSIC, in the past, has been rolled back and restarted before reaching the 5% cap has no bearing on the reasonableness of the Company's present request. The Company has a Commission approved LTIP that calls for investment totaling \$4,251,000 for 2017 through 2021 and equals 41% of the Company's existing rate base. Both in dollar terms and on a percentage basis, NAWC maintains that the Company's LTIP commitment is significant. NAWC asserts that when the current State Street project is completed and reflected in the Company's DSIC calculation, along with the Company's ongoing meter replacement plan efforts for the current period, NAWC's DSIC, which is presently 4.26%, will exceed 5%. Irrespective of whether its DSIC has ever exceeded 5% in the past, NAWC maintains that its DSIC is set to exceed 5% in the next quarter. (NAWC RB at 9-10).

Regarding the OCA's assertion that the State Street Replacement project was overestimated in the LTIP, NAWC maintains that the Company explained in its LTIP petition that DSIC expenditures may rise or fall in an individual year. In 2017, the State Street Replacement project was completed under budget, which would seem to be a worthwhile result. Going forward, other LTIP projects may be completed on budget or under or over budget. However, the Company argues that the fact that one project was under budget provides no basis for denying the DSIC cap increase or suggesting that the Company has presented an inaccurate picture of its projected DSIC rate. (NAWC RB at 10).

The Company asserts that, unlike gas companies which must petition the Commission for a waiver of a 5% DSIC cap pursuant to Section 1358(a)(1), a water utility is allowed a DSIC that does not exceed 7.5% pursuant to Section 1358(a)(2). The Public Utility Code does not require a water utility to petition the Commission for a DSIC cap of 7.5%. (NAWC RB at 10).

Regarding OCA's assertion that NAWC miscalculated the Company's DSIC, the Company maintains that the inclusion of short term debt in DSIC calculations actually benefitted customers. However, going forward, the Company acknowledged that it will revise the debt cost rate and remove short term debt from the DSIC calculation. NAWC maintains that

these changes will not have a material impact on the DSIC calculation going forward, and that the OCA cites no testimony that suggests otherwise. (NAWC RB at 10).

NAWC notes that the Company has a Commission approved LTIP that calls for investment totaling \$4,251,000 for 2017 through 2021 and equals 41% of the Company's existing rate base. Both in dollar terms and on a percentage basis, NAWC asserts that the Company's LTIP commitment is significant, outweighing any minor change to the DSIC percentage that might occur as a result of the revisions to the debt cost rate, the exclusion of short term debt and charging of the DSIC to private fire protection customers as proposed by the OCA. NAWC posits that, rather than force the Company into a base rate filing, an increase in the DSIC cap to 7.5% is just and reasonable and in compliance with the Public Utility Code. (NAWC RB at 10).

To the extent that the OCA has argued that the Company already has several regulatory mechanisms at its disposal to reduce regulatory lag, NAWC asserts that these other mechanisms do not disqualify the Company from increasing its DSIC cap to 7.5%. The Company's purchased water adjustment clause has no bearing on main replacement efforts. The fully projected future test year was enacted as part of Act 11 coincident with Section 1358, which expressly allows a DSIC cap of 7.5%, and, thus, could not possibly disqualify the Company from a DSIC cap of 7.5%. Similarly, the existing DSIC cap of 5.0% does not disqualify the Company from a DSIC cap of 7.5%. Section 1358(a)(2) expressly allows a DSIC cap of 7.5% and the Commission has allowed three other Pennsylvania water utilities to increase their DSIC cap to 7.5%. (NAWC RB at 12).

3. OCA's Position.

a. NAWC Will Not Further Accelerate Its Infrastructure Investment If The DSIC Cap Increase Is Approved.

OCA maintains that although NAWC asserted that Commission approval of an increase to its DSIC cap will facilitate compliance with the Company's infrastructure replacement schedule and the LTIP plan, the Company has no plans to accelerate the rate at

which it completes the LTIIIP projects if the DSIC cap increases to 7.5%.¹² OCA notes that 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.¹³ (OCA MB at 6-7).

OCA asserts that, in contrast to PAWC, Aqua and United Water, NAWC has explicitly stated that it does not intend to further accelerate 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 LTIIIP. Moreover, its Witness acknowledged that the Company will comply with its LTIIIP whether or not the DSIC cap is increased to 7.5%. (OCA MB at 7).

OCA further argues that the Commission did not condition NAWC's compliance with the LTIIIP order upon approval of an increase to the DSIC cap. Rather, the LTIIIP order states that "Newtown's proposed LTIIIP 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." The LTIIIP was approved with a DSIC cap of 5%. Accordingly, OCA concludes that merely complying with the LTIIIP is insufficient to support an increase to NAWC's DSIC cap. (OCA MB at 7-8).

Additionally, OCA maintains that the fact that a utility plans to spend more money under an LTIIIP cannot establish that an increase to the DSIC cap is just, reasonable and lawful. OCA asserts that projected LTIIIP costs and DSIC recovery must be distinct, to give

¹² Tr. at 36.

¹³ 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*).

effect to the 5% DSIC cap protection. The Commission has recognized the distinction in orders approving various utility LTIPs. It stated:

nor is the inclusion of [arguably DSIC-eligible] property in the LTIP dispositive of whether the cost of that project will be afforded DSIC recovery. The issues of eligibility and cost recovery, for all property claimed as DSIC-eligible, are to be addressed and resolved in the subsequent DSIC petition and calculation.¹⁴

Accordingly, OCA believes that an increase to the DSIC cap should not be granted solely because the Company projects spending will increase under its LTIP. (OCA RB at 7-8).

OCA maintains that the 5% DSIC cap is a safeguard, arguably the most important safeguard, because the Commission determined that if set at a level low enough to prevent long-term evasion of base rate review, it functions to protect the traditional ratemaking process.¹⁵ OCA believes that the Commission should not jettison that protection in this case, where the Company has failed to show that the increase is just and reasonable. (OCA RB at 9).

b. The Lengthy Intervals Between NAWC'S Base Rate Filings

The OCA notes the Company's 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. 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. However, 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. OCA maintains that this argument should be rejected. (OCA MB at 8).

¹⁴ See, e.g., *Petition of Peoples Natural Gas Co. LLC for Approval of its Long-Term Infrastructure Improvement Plan*, P-2013-2344596, Order at 43 (May 23, 2013); *Petition of Equitable Gas Co. for Approval of its Long-Term Infrastructure Improvement Plan*, P-2013-2342745, Order at 26 (July 16, 2013).

¹⁵ See, e.g., *Petition of Philadelphia Suburban Water Co. for Approval to Implement a Tariff Supplement Establishing a DSIC*, P-00961036, 1996 Pa. PUC LEXIS 211 at *15-16 (Aug. 22, 1996) (PSWC 1996).

OCA maintains that the decision to file a rate case is a combination of many factors and variables. Moreover, it is difficult to predict when a utility will file a rate case in the future. OCA notes that 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."¹⁶ (OCA MB at 8-9).

OCA notes that 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."¹⁷ 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.¹⁸ 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.¹⁹ (OCA MB at 9).

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. 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% cap for two to three years. NAWC claims that an increase to its DSIC cap will reduce the need for future DSIC cap-related base rate filings. 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% cap, or in two to three years, *i.e.* the beginning of 2020 or 2021, NAWC would avoid base rate review for nine or

¹⁶ *PAWC*, 2007 Pa. PUC LEXIS 43 at *23.

¹⁷ *PAWC*, 2007 Pa. PUC LEXIS 42 at *32.

¹⁸ *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.")

¹⁹ *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").

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. (OCA MB at 9-10).

c. NAWC's DSIC Rate Has Never Reached The 5% Cap

Although the Company has argued that the fact that NAWC has never exceeded its 5% DSIC cap is superfluous, the OCA maintains that whether or not the Company has reached the 5% cap is relevant, 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, 2009.²⁰

(OCA MB at 10).

OCA notes that NAWC has never reached the DSIC cap since it implemented a DSIC. 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% cap.²¹ (OCA MB at 11).

d. NAWC Has Overstated Or Misstated Its Historic And Projected DSIC Rate

NAWC has claimed that it will reach the 5% cap by the end of 2017 due to increased spending under the LTIP. OCA counters that the record shows that the projected

²⁰ *Aqua*, 2009 Pa. PUC LEXIS 263 at *20.

²¹ *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*).

spending for 2017 was overestimated in NAWC's LTIP. There, NAWC projected that the State Street Main Replacement project would cost \$650,000 in 2017. In this proceeding, the Company's Witness adjusted NAWC's projected spending for that project to \$400,000. This \$250,000 reduction represents almost 25% of the Company's total projected LTIP spending for 2017. OCA believes that 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 OCA noted previously, Aqua, PAWC and Suez showed a pattern of consistently reaching their DSIC cap. NAWC's DSIC rates have never reached the existing 5% DSIC cap. Moreover, the OCA argues 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. (OCA MB at 11).

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% 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 argues that by statute 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.²²

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.²³ (OCA MB at 12).

²² 66 Pa. C.S. § 1357(b)(1) (emphasis added).

²³ *Implementation of Act 11 of 2012*, M-2012-2293611, *Supplemental Implementation Order* at 6-7 (Order entered Sept. 15, 2016) (*Supplemental 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%.²⁴ When the erroneous 6.09% is replaced with the 5.47% actual (current) cost of long-term debt, it produces a lower DSIC rate. The OCA's Witness showed that, for every quarter since 2013, the Company made the same error in the calculation of its DSIC rate. (OCA MB at 12).

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 argues that 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. OCA further argues that short-term debt also should be excluded from the pre-tax return component of the DSIC rate. Going forward, the Company committed to exclude short-term debt in calculating both parts of the DSIC mechanism. (OCA MB at 12-13).

The OCA identified another error in NAWC's application of the DSIC. The Company does not charge the DSIC to private fire protection customers. The OCA maintains that 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. (OCA MB at 13).

Looking at all of this information cumulatively, OCA argues 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% DSIC cap is warranted and the Commission should deny the DSIC cap increase. (OCA MB at 13).

e. NAWC 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

²⁴ NAWC St. 1R, Att. 1, App. A.

replacement efforts.²⁵ OCA maintains that there are three regulatory mechanisms already available to NAWC, to reduce regulatory lag, lower risk and decrease the need for base rate filings. (OCA MB at 13).

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. Second, the Company can utilize a fully forecasted future test year, which allows for prospective inclusion of distribution system improvement costs in rate base. Third, NAWC has a DSIC in place that allows it to recover up to 5% of its eligible distribution system investment between base rate cases. (OCA MB at 13).

4. Discussion and Conclusions

In the present case, NAWC has proposed increasing NAWC's existing DSIC cap from 5% to 7.5%. NAWC bases its request on the assertion that compliance with the Company's existing infrastructure replacement schedule and LTIP plan will be facilitated by increasing the DSIC cap to the statutory maximum of 7.5%. In response, the OCA has argued that, as noted by the Company, increasing the DSIC cap to 7.5% will only facilitate compliance with NAWC's LTIP, and that the Company does not intend to further accelerate its LTIP projects or investment with the approval of the increase.

Although Act 11 does provide a mechanism for a water utility's DSIC cap to be increased from 5% to 7.5%, it is not an automatic entitlement and does come with limitations. In executing Act 11, the Commission issued an implementation order and specifically noted the consumer safeguards relating to the rate cap for water utilities as follows:

Section 1358 – Customer Protections

Section 1358 establishes a number of customer protections. There are seven components to this discussion.

²⁵ *Columbia Gas Waiver*, Order at 50.

2. Water Rate Cap

Section 1358(a)(2) provides that a DSIC previously granted under Section 1307(g) or subsequently granted under Act 11 to a water utility may not exceed 7.5%. *See* 66 Pa. C.S. § 1358(a)(2). This section recognizes that the Commission has previously granted, upon petition, DSIC caps up to 7.5% for certain water utilities.²⁶

The Commission further explained that:

Those water utilities had operated for many years under a 5% DSIC cap, had accelerated their rate of infrastructure replacement, and had demonstrated that an increase over the then-current DSIC cap was necessary and in the public interest.²⁷

It is significant that the Commission noted that water utilities who were previously granted a waiver up to 7.5% had demonstrated that they had accelerated their rate of infrastructure replacement and that an increase over the then-current DSIC cap was “necessary and in the public interest.” Therefore, in order for NAWC’s request to be granted, the company must demonstrate that it has accelerated its rate of infrastructure replacement and also demonstrate that the increase to the DSIC cap is necessary and in the public interest. As explained below, NAWC has failed to establish that its request to increase DSIC cap from 5% to 7.5% is necessary.

NAWC has not presented any evidence to establish that it will accelerate its rate of infrastructure replacement. Rather, if approved, NAWC Witness Walker indicated that the increased DSIC cap will simply allow it to comply with its currently approved LTIP:

Q: If the DSIC cap is approved, does the company intend to further accelerate the LTIP improvements?

A: They will not necessarily accelerate them. However, it will facilitate the ability to make such large investments over five years. Without the cap, the company is going to be spending resources. Going to be submitting a lot of money

²⁶ *Final Implementation Order*, Docket M-2012-2293611 at 42 (Order entered August 2, 2012).

²⁷ *Id.* at FN 5.

making numerous rate filings. Each rate filing is worth about half of a year of LTIIIP investment. So you put a couple of rate filings together, you've wiped out essentially an entire year of investment of LTIIIP. Now, that's not going to say they're not going to still make the investment. It's just whether or not they'll make it according to the schedule that is within the LTIIIP Plan.

Q: So if the DSIC cap is approved, it will further allow them to comply with this LTIIIP schedule that's already been ordered?

A: Yes.

Tr. 36-37.

I am also persuaded by OCA's argument that the Commission did not condition NAWC's compliance with its recently approved LTIIIP upon approval of an increase to the DSIC cap. In the Order approving NAWC's LTIIIP, the Commission stated:

Newtown's proposed LTIIIP appears to demonstrate its associated expenditures are reasonable, cost effective, and designated to ensure and maintain efficient, safe, adequate, reliable, and reasonable service to its customers.

The Commission finds Newtown's Long-Term Infrastructure Improvement Plan and manner in which it was filed conforms to the requirements of Act 11 and our Final Implementation Order. The plan, as approved herein, is designed to maintain safe, adequate and reliable service and, as such, Newtown shall be required to comply with the infrastructure replacement schedule and elements of that plan.²⁸

NAWC maintains that the acceleration of infrastructure investment accepted by the Commission when it approved the Company's LTIIIP is substantial support for the proposed increase, and that a further acceleration is not required to increase the DSIC cap. Based on the *Final Implementation Order*, I must disagree. Merely complying with the LTIIIP, rather than

²⁸ *Petition of The Newtown Artesian Water Company for Approval of its Long-Term Infrastructure Improvement Plan*, Docket No. P-2017-2594725 (Order entered July 12, 2017).

accelerating infrastructure improvement, is not sufficient to warrant an increase of the DSIC cap to 7.5%.

Additionally, the Company has failed to demonstrate that the increase to the DSIC cap is necessary and in the public interest. Although the Company stated that it has pipe in need of replacement in the near future, and that increasing the DSIC cap rate will have the added benefit of a decline in the number of main breaks and service interruptions, increased fire protection and improvement in water quality, the Company has not offered anything to show that compliance with its LTIP with a 5% DSIC cap is insufficient to achieve these goals. Moreover, NAWC has not presented any evidence to establish that its infrastructure is unsafe or unreliable.

I will note that the Company has argued that increasing the DSIC cap will benefit customers by reducing the frequency of base rate cases. The Company asserts that delaying the filing of base rate cases reduces rate case expense, and that the Commission has consistently recognized a reduction in base rate cases as a benefit of DSIC cost recovery and a reason for increasing the DSIC cap. However, this argument is unconvincing since the Company has not filed a base rate case in nearly seven years, the last occurring in 2011.²⁹ As noted by OCA Witness Mierzwa:

First, it is not clear that the frequency of NAWC's base rate filings should be reduced. NAWC filed base rate cases in 1998, 2005, 2008 and 2011. If the Company files a base rate case in 2018, it will have averaged 5 years between base rate filings. NAWC Witness Walker indicates that increasing the DSIC to 7.5 percent could increase the time between rate cases to 7.5 years. There is value to base rate proceedings, which provide the opportunity for simultaneous review of all aspects of a utility's revenues, expenses and capital costs for the same period of time.

Second, the current 5-year period between base rate cases is substantially longer than the periods at issue when the Commission approved an increase in the DSIC cap for Pennsylvania-American Water Company ("PAWC," Docket No. P-00062241) and Aqua Pennsylvania, Inc. ("Aqua" Docket No. R-2008-2079310). When these increases were approved by the Commission, PAWC was filing base rate cases every one to two years and argued that a 7.5

²⁹ NAWC St. 1-R at 5.

percent DSIC cap would reduce filings to every three years. Aqua was filing base rate cases every two years and had a history of reaching the cap in 18 months or less after its DSIC was reset to zero following a base rate case.³⁰

Based on the infrequency of NAWC's historical base rate filings, NAWC's argument is without merit.

It is also important to note that NAWC has never exceeded its 5% DSIC cap. As an explanation for why the Company is asking for the increase to their DSIC, NAWC Witness Walker indicated as follows:

The Company is moving forward with its infrastructure replacement schedule and LTIP plan elements and estimates it will exceed their current maximum DSIC surcharge percentage rate with the LTIPP plan improvements it completes by the end of the year.³¹

Although the Company believes that the fact that the Company's DSIC has never reached the 5% cap has no bearing on the reasonableness of the present request, I agree with the OCA that whether or not the Company has reached the 5% DSIC cap is relevant. As noted by OCA Witness Mierzwa, if the Company has never exceeded its 5% DSIC cap, then the 5% DSIC cap has been adequate to recover the costs associated with the Company's DSIC-eligible investment.³² The Company's projected estimate of maxing out the DSIC cap, especially when the DSIC has been incorrectly determined (as discussed later in this decision) is not sufficient justification for increasing the DSIC cap to 7.5%.

Although NAWC's determination to improve its infrastructure is laudable, the Company has failed to present evidence to demonstrate that it has accelerated its rate of infrastructure replacement and also that an increase to the DSIC cap is necessary and in the

³⁰ OCA St. 1 at 5.

³¹ NAWC St. 1 at 3.

³² OCA St. No. 1-SR at 6.

public interest. Accordingly, I shall recommend that NAWC's request for an increase to the DSIC cap from 5% to 7.5% be denied.

C. The OCA's Recommendations

The OCA argues that it has identified several errors in how NAWC calculates and applies its DSIC mechanism, and that 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.³³

OCA maintains that, through this language, the Commission directly placed at issue NAWC's existing and proposed DSIC mechanism, and that the OCA's evidence regarding whether NAWC calculates its DSIC properly or conforms to the law is relevant and material to the issues in this proceeding. (OCA MB at 15-16; OCA RB at 13).

The OCA believes that there are several aspects of the Company's DSIC mechanism that do not comply with the Public Utility Code and Commission orders. The OCA believes that the evidence it has presented demonstrates that the Company has miscalculated its DSIC and not properly charged all customers. The OCA submits that the Commission should adopt its recommendations to remedy the identified errors and ensure that the DSIC is accurately calculated and charged going-forward. (OCA MB at 16-17; OCA RB at 13).

In response, NAWC submits that the OCA is unnecessarily complicating this case and the issue of whether NAWC should be allowed to increase its DSIC cap to 7.5%. Section 1358 of the Public Utility Code provides that a water utility DSIC may not exceed 7.5%.

³³ *Pa. PUC v. Newtown Artesian Water Co.*, R-2017-2624240, Suspension Order at 2 (Oct. 5, 2017) (*Suspension Order*).

NAWC has filed a tariff supplement proposing to do no more than increase its DSIC cap to the statutory maximum. (NAWC MB at 14).

NAWC asserts that OCA Witness Mierzwa's recommendations, by and large, do not address the issue of whether NAWC should be allowed to increase its DSIC cap to 7.5%; rather they raise "red herring" issues. NAWC further asserts that the OCA has the burden of proof in regard to these issues, and that the OCA has failed to meet its burden. NAWC maintains that the OCA has failed to demonstrate any nexus between NAWC's simple request for a DSIC cap of 7.5% and Mr. Mierzwa's many recommendations, and that the recommendations of the OCA should be rejected. (NAWC MB at 14).

1. Application Of Act 40 To NAWC'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.³⁴ 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 ..."³⁵ 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

³⁴ 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*).

³⁵ *McCloskey v. Pa. PUC*, 127 A.3d 860, 867 (Pa. Commw. Ct. 2015) (*McCloskey*).

time it enacted Act 11. However, the General Assembly declined to take such action when the statute was drafted or enacted.³⁶

(OCA MB at 17-18).

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.³⁷

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. 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 MB at 18; OCA RB at 15-16).

OCA notes that both parties agree that Act 40 itself overrules Pennsylvania Supreme Court precedent regarding the consolidated tax adjustment. OCA maintains that if 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 only, or to consolidated income tax adjustments specifically. Instead, the General Assembly required related income tax deductions to be included in the computation of income tax expense to reduce all utility rates. (OCA RB at 17).

³⁶ *Id.* at 870-71

³⁷ 66 Pa. C.S. § 1301.1(a).

OCA notes that NAWC Witness Walker claims that the Commission and the Commonwealth Court have previously rejected similar claims made by the OCA that Accumulated Deferred Income Taxes (ADIT) and state income tax deductions should be reflected in the calculation of DSIC rates.³⁸ Mr. Walker also mentions the Commission’s DSIC *Final Implementation Order* and Model Tariff.³⁹ OCA maintains that those determinations were made prior to August 11, 2016, the date Act 40 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.⁴⁰ 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. Section 1301.1 does not provide an exception to the requirement that “related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates” whenever an expense or investment is permitted to be included in a utility’s rates.⁴¹ 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*. (OCA MB at 18-19; OCA RB at 15).

The OCA maintains that legislative history is not relevant in this case, indicating that it is only when the words of a statute are not explicit that factors extraneous to the statutory language may be consulted to ascertain the General Assembly’s intent in enacting the statute.⁴² The OCA submits that NAWC’s reliance on any testimony relating to House Bill 1436 to explain

³⁸ NAWC St. 1R at 8-9.

³⁹ *Id.* at 12-13.

⁴⁰ *See e.g. Commw. v. Ramos*, 623 Pa. 420, 428, 83 A.3d 86, 91 (Pa. 2013).

⁴¹ *See* 66 Pa. C.S. § 1301.1(a).

⁴² *See Pa. Associated Builders & Contrs., Inc. v. Commw. Dept. of General Servs.*, 593 Pa. 580, 592, 932 A.2d 1271, 1278 (2007). *See also Commw. Office of the Governor v. Donahue*, 59 A.3d 1165, 1168 (Pa. Commw. Ct. 2013).

the “express purpose” of Act 40 is not appropriate in the absence of such language of “express purpose” in the Act itself. As discussed, Act 40 states that it applies to all utility rates, for all ratemaking purposes. (OCA RB at 15).

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 maintains that there is a 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 MB at 20).

In response, NAWC maintains that Act 40 has no bearing on NAWC’s proposed increase of the DSIC cap to 7.5%. Act 40 addresses consolidated income tax expense for base rate purposes. Consolidated taxes are not relevant to NAWC since it is not a holding company nor a subsidiary of a holding company. NAWC is a stand-alone company. This proceeding, moreover, is not a base rate proceeding. A DSIC rate is a surcharge mechanism for the recovery of the costs related to the repair, improvement, and replacement of eligible property outside of a rate case. Surcharges are not part of a base rate proceeding. (NAWC MB at 15).

NAWC further notes that while it is aware of the decision in the *First Energy DSIC* proceeding⁴³ addressing Act 40 and apparently applying Act 40 to the DSIC calculations of electric utilities outside the context of a base rate case proceeding, the Recommended Decision remains pending before the Commission. The Company argues that unless and until the Commission adopts the Recommended Decision in that matter and then applies it to water utilities, Act 40 has no application NAWC’s DSIC mechanism. NAWC’s DSIC mechanism is in accordance with statutory and decisional law as discussed below. (NAWC MB at 15-16).

⁴³ *FirstEnergy DSIC*, P-2015-2508942, C-2016-2531040, *et al.*, Recommended Decision (Aug. 31, 2017).

NAWC asserts that the Commission may decline to adopt the ALJ's Recommended Decision in the *FirstEnergy DSIC* proceeding because the Decision is inconsistent with contemporaneous legislative history. According to NAWC, the legislative history demonstrates that the purpose of the Act was the elimination of the consolidated tax adjustment. Representative Robert Godshall, the Chairman of the House Consumer Affairs Committee and lead sponsor of H.B. 1436, explained the scope and application of Section 1301.1 in remarks on the House floor by stating that "this section applies to *base rate cases*" and "would only go into effect when a utility comes in for a *base rate case*."⁴⁴ In testimony before the Committee, Commission Chairman Brown testified that "[t]he proposed bill introduces legislation that requires a public utility's federal income tax expense to be calculated on a 'stand-alone' basis ... *when establishing base rates* for the regulated public utility"⁴⁵ (NAWC MB at 16; NAWC RB at 14-15).

Lastly, NAWC maintains that the issue at hand is only whether NAWC should be permitted to increase the DSIC cap to 7.5% as allowed by statute. NAWC further maintains that Act 40 has no relevance to the issue of whether the Commission should approve Supplement No. 126 and allow NAWC to increase its DSIC cap to 7.5%. (NAWC MB at 16-17).

⁴⁴ Pennsylvania House Legislative Journal, 2016 Reg. Sess. No. 7, at 117 (emphasis added), *available at* <http://www.legis.state.pa.us/WU01/LI/HJ/2016/0/20160208.pdf>.

⁴⁵ Prepared Testimony of Gladys M. Brown, Chairman, Pennsylvania PUC (Sept. 28, 2015), at 4, *available at* http://www.legis.state.pa.us/WU01/LI/TR/Transcripts/2015_0229_0004_TSTMNY.pdf. *See also* Public Hearing In Re: House Bill 1436, Pennsylvania House Consumer Affairs Committee (Sept. 29, 2015), Tr. at 41 (acknowledging receipt of testimony from Commission Chairman Brown for inclusion into the record), *available at* http://www.legis.state.pa.us/WU01/LI/TR/Transcripts/2015_0229T.pdf.

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.⁴⁶ 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.⁴⁷ OCA maintains that NAWC is not actually paying that level of taxes to the government. Tax deductions have reduced the income on which NAWC must pay income taxes.⁴⁸ The Internal Revenue Code prohibits NAWC from flowing through federal tax reductions in rates on a current basis.⁴⁹ Thus, under standard ratemaking procedure, the balance of 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. 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. (OCA MB at 20-21).

OCA maintains that section 1357 of the Public Utility Code addresses the elements of the DSIC computation: fixed costs, depreciation and pretax return.⁵⁰ OCA further maintains that it would be incorrect to interpret the omission of these specific adjustments in the statute to mean that the adjustments cannot be made. The Court and Commission did not take that position in *McCloskey* and *Columbia Gas*. Rather, they determined that the Commission had discretion whether or not to require the utility to include ADIT in the DSIC calculation based on the Commission's determination that, without the adjustment, the overall rate was just and reasonable.⁵¹ Further, in *Columbia Gas*, the Commission stated:

⁴⁶ 66 Pa. C.S. § 1357(a)(3).

⁴⁷ See OCA Sch. JDM-4, DSIC Supporting Calculations.

⁴⁸ See, e.g., OCA Sch. JDM-1, Sch. A; NAWC St. 1R, Att. 1, Sch. B.

⁴⁹ I.R.C. §§ 167, 168.

⁵⁰ 66 Pa. C.S. § 1357(a)-(b).

⁵¹ *McCloskey* at 871; *Columbia Gas* at 35-37.

Additionally, we agree with the OCA that there is no indication that the General Assembly specifically considered and rejected the OCA's tax related proposals.⁵²

Moreover, OCA notes that the Commission has allowed every electric utility with a DSIC to add gross receipts tax (GRT) to the DSIC formula.⁵³ (OCA RB at 17-18).

To reflect ADIT in the DSIC calculation, OCA maintains that 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.) To facilitate this calculation, the OCA recommends that NAWC begin maintaining separate ADIT balances for DSIC eligible plant, because it does not currently do so. (OCA MB at 21; OCA RB at 19).

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.⁵⁴ 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. 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

⁵² *Columbia Gas* at 18.

⁵³ See, e.g., *Petition of PPL Electric Utilities Corp. for Approval of a DSIC*, P-2012-2325034, Order at 6-7 (Apr. 9, 2015) (*PPL*); *Petition of Metropolitan Edison Co. for Approval of a DSIC*, P-2015-2508942, Order at 10-11 (June 9, 2016); *Petition of Duquesne Light Co. for Approval of a DSIC*, P-2016-2540046, Order at 28-29, 38 (Sept. 15, 2016).

⁵⁴ 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).

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.⁵⁵

OCA indicates that 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.⁵⁶ (OCA MB at 22; OCA RB at 19).

OCA maintains that using an effective tax rate in the DSIC calculation does not change the applicable statutory state income tax rate. Instead, it acknowledges that, while the statutory state income tax rate applies, NAWC's actual tax liability is a lesser amount due to state income tax deductions. The statutory state income tax rate is still "used" in the calculation of pre-tax return. There is, according to OCA, 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. (OCA RB at 19).

NAWC responds that the OCA's recommendation is contrary to decisional law. Following the enactment of Subchapter B, the Commission specifically rejected the OCA's attempt to include its ADIT and income tax proposals in the DSIC calculation. The Commission explained in its *Final Implementation Order* entered August 2, 2012 that "the DSIC is intended to be a straightforward mechanism which is easy to calculate, easy to audit and which does not require a full rate case analysis;" that "[i]nclusion of an ADIT adjustment would be inconsistent with that goal and would likely invite litigation over its calculation;" and that statutory tax rates would be used in the DSIC calculation.⁵⁷ (NAWC MB at 17-18).

NAWC maintains that the decision in *McCloskey* undermines the entirety of OCA Witness Mierzwa's recommendation as *McCloskey* holds that utilities are not required to include an ADIT adjustment in their DSIC calculations and that utilities are permitted to include statutory state and federal income tax rates in those calculations. NAWC asserts that Act 40

⁵⁵ OCA St. 1 at 11.

⁵⁶ See, e.g., OCA Sch. JDM-4, DSIC Computation.

⁵⁷ *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611, *Final Implementation Order* at 31, 38 and 39; NAWC St. No. 1R at 10 and 12.

concerns base rate cases and consolidated taxes, neither of which is involved in this proceeding, and *McCloskey* remains the law. NAWC submits that the ADIT and income tax calculations proposed by Mr. Mierzwa are not part of the DSIC computation under Subchapter B of Chapter 13 of the Public Utility Code. (NAWC MB at 18-19; NAWC RB at 15-16).

Additionally, NAWC asserts that the OCA has also failed to demonstrate any nexus between its recommendation and the Company's request to increase its DSIC cap to 7.5%. The interpretation of Act 40 and a decision as to whether Act 40 applies to DSIC proceedings are simply not necessary to resolve this proceeding which asks only that the Commission allow NAWC to increase its DSIC cap to 7.5%. The Commission should reject the OCA's recommendation. (NAWC MB at 19).

b. Reflection Of Investment-Related Income Tax Deductions In The Application Of The Earnings Cap (Federal Income Tax Payment Alignment).

The OCA maintains that 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. 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.⁵⁸

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 asserts that, consistent with Act 40, 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.⁵⁹ As a

⁵⁸ 66 Pa. C.S. § 1358(b)(3).

⁵⁹ OCA St. 1, Sch. JDM-1, Sch. 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. 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. OCA posits that 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.⁶⁰ (OCA MB at 22-23).

The OCA's Witness objected to this adjustment because, in his opinion, that was an improper adjustment that is not consistent with Commission policy and practices. OCA asserts that it appears that TUS agreed, because the Company was directed to revise the \$277,343 adjustment.⁶¹ The OCA notes that the Company filed a revised financial earnings report on November 28, 2017 that eliminated all but \$22,440, or more than 90%, of its original adjustment.⁶² According to OCA Witness Mierzwa, the remaining amount of the adjustment is not material.⁶³ 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.⁶⁴ 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. (OCA MB at 23; OCA RB at 21).

Additionally, OCA asserts that there is a clear nexus between this recommendation and NAWC's request to increase the DSIC cap. OCA maintains that NAWC's adjustment changed the overall rate of return in its financial earnings report, which is one of the two inputs used to determine whether the DSIC earnings cap is triggered.⁶⁵ Whether the federal income tax adjustment is proper, therefore, is relevant to whether NAWC's existing DSIC Rider, as applied by the Company, is just and reasonable under Section 1301. It is also relevant to

⁶⁰ 66 Pa. C.S. § 1301.1.

⁶¹ NAWC St. 1R at 6-7.

⁶² NAWC St. 1R, Att. 1, Sch. A.

⁶³ OCA St. 1SR at 8.

⁶⁴ *Id.*

⁶⁵ 66 Pa. C.S. § 1358(b)(3).

whether the DSIC cap should be increased. If the Company makes improper adjustments to its financial earnings reports that cause NAWC to charge a positive DSIC when the rate should be reset to zero, allowing NAWC to increase its DSIC rate above 5% would put customers at risk for incrementally larger overcollections. Moreover, the OCA believes that its recommendation for how NAWC presents federal income tax expenses in future earnings reports and applies the DSIC earnings cap is consistent with its recommendation that NAWC include investment-related income tax deductions in the calculation of its DSIC rate, as it believes it would be logical to be consistent and reflect the tax deductions in both places. (OCA RB at 21-22).

Accordingly, 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. (OCA MB at 24).

In response, NAWC argues that Act 40 applies to a “public utility’s rates,”⁶⁶ and that the earnings cap is not a “public utility rate.” Rather, it is a quarterly submission required of utilities under 52 Pa. Code Chapter 71. The Chapter has a stated purpose of “establishing uniform and industry-wide financial reporting requirements designed to improve the Commission’s ability to monitor on a regular basis the financial performance and earnings of the ... public utilities subject to Commission jurisdiction.”⁶⁷ NAWC maintains that Act 40 has no application to Chapter 71 financial reporting. (NAWC MB at 19-20; NAWC RB at 16).

Nevertheless, and irrespective of the foregoing, NAWC asserts that it already includes a federal tax normalization adjustment in its Chapter 71 financial reporting. NAWC Witness Walker explained that the refiled Financial Report for the 12-months ended June 30, 2017, submitted by NAWC at the direction of TUS, included a federal tax normalization adjustment. The Company believes that the refiled Financial Report is acceptable to Commission Staff. (NAWC MB at 20; NAWC RB at 16).

⁶⁶ 66 Pa. C.S. § 1301.1(a).

⁶⁷ 52 Pa. Code § 71.1.

NAWC maintains that the OCA has failed to support its recommendation concerning the reflection of investment related income tax deductions in the earnings cap, and that it also failed to demonstrate any nexus between its recommendation and the Company's request to increase its DSIC cap to 7.5%. NAWC believes that the Commission should reject the OCA's recommendation. (NAWC MB at 20; NAWC RB at 17).

2. Prospective Changes To Cost Of Debt Utilized To Apply The Earnings CAP And Calculate The DSIC Rate.

a. Exclusion Of Short-Term Debt

OCA notes that 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."⁶⁸ In other words, short-term debt should not be included. OCA further notes that when it 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.⁶⁹ The OCA notes that the Company had been using the wrong (historic) cost of debt to calculate the DSIC rate and the DSIC earnings cap. OCA's Witness Mierzwa provided calculations showing that when correcting the Company's rate of return used to apply the DSIC earnings cap by removing the federal income tax adjustment and correcting the DSIC rate by using the current cost of long-term debt, the Company appeared to exceed the allowable rate of return, *i.e.* the earnings cap reset provision was triggered.⁷⁰ In the rebuttal phase of testimony, Company Witness Walker identified a second problem with NAWC's cost of debt calculations – the Company had included short-term debt.⁷¹ (OCA MB at 24; OCA RB at 23).

On November 28, 2017, the Company filed a second revised financial earnings report that removed short-term debt from the overall cost of debt used to apply the DSIC earnings cap (and eliminated most of the federal income tax adjustment).⁷² Based on the

⁶⁸ 66 Pa. C.S. § 1357(b)(1).

⁶⁹ OCA St. 1, Sch. JDM-1.

⁷⁰ OCA St. 1 at 8-9; 66 Pa. C.S. § 1358(b)(3).

⁷¹ NAWC St. 1R at 7-8; OCA St. 1SR at 8-9.

⁷² NAWC St. 1R, Att. 1., App. A.

corrected data, the Company was not exceeding its DSIC allowed return and it is no longer an issue in this case.⁷³ (OCA RB at 24).

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 notes that 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."⁷⁴ 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. NAWC's Witness accepted this recommendation.⁷⁵ (OCA MB at 24; OCA RB at 24).

NAWC maintains that, going forward, the Company will remove short term debt from both its Financial Report submission pursuant to 52 Pa. Code Chapter 71 and its DSIC calculation. The continued exclusion of short term debt will depend on the directives of the Commission and its Bureau of Technical Utility Services.⁷⁶ (NAWC RB at 17).

b. Use Of Current Debt Cost

In the Company's most recent quarterly DSIC update, effective November 1, 2017, it used a 6.09% cost of debt to calculate its DSIC earnings cap and the pre-tax rate of return used to determine the DSIC rate.⁷⁷ This 6.09% is the same cost of debt calculated in the Company's 2011 base rate case, docketed at R-2011-2230259.⁷⁸ OCA notes that the Company has used this 6.09% cost of debt in every quarterly DSIC filing dating back to at least November 2013. (OCA MB at 24-25; OCA RB at 25).

⁷³ OCA. St. 1SR at 9.

⁷⁴ 66 Pa. C.S. § 1357(b)(1).

⁷⁵ NAWC St. 1R at 7-8, 14; Tr. at 37-38.

⁷⁶ Tr. 38 – 39.

⁷⁷ OCA St. 1, Sch. JDM-4, DSIC Supporting Calculations.

⁷⁸ *Id.*

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 MB at 25; OCA RB at 25).

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.⁷⁹ According to the Company's most recent, revised financial earnings report, its current cost of debt is 5.47%.⁸⁰ OCA notes that at no time during the last four years was the current cost of debt 6.09%.⁸¹ OCA Witness Mierzwa attempted to calculate the impact of this error on the historic DSIC rate, and 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.⁸² 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. Regardless of this, OCA maintains 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. The OCA recommends, therefore, that NAWC's DSIC should be recalculated and refunds issued as appropriate. (OCA MB at 25-26).

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."⁸³ At the evidentiary hearing, Mr. 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.⁸⁴ OCA maintains that the use of the current cost

⁷⁹ 66 Pa. C.S. § 1357(b)(1); *Supp. Implementation Order* at 5-6.

⁸⁰ NAWC St. 1R, Att.1, App. A.

⁸¹ OCA St. 1, Sch. JDM-5.

⁸² OCA St. 1, Sch. JDM-5.

⁸³ NAWC St. 1R at 14.

⁸⁴ Tr. at 39.

rates is required by statute, and that the Company should be directed by the Commission to make its calculations using the current long term debt cost rates. (OCA MB at 26; OCA RB at 24-26).

In response, NAWC indicates that, going forward the Company will use the cost of long term debt in its DSIC calculation that is acceptable to Commission Staff. (NAWC MB at 22; NAWC RB at 17-18).

3. Recalculation Of The DSIC Rate For The Cost Of Debt And Refunds.

OCA has recommended that customers should receive a refund for any overcharges resulting from the Company's use of the incorrect (historic) debt cost rate. OCA notes that the NAWC Witness Walker did not agree with this recommendation for two reasons. Mr. Walker's first objection was on the grounds that refunds are outside the scope of this proceeding.⁸⁵ Mr. Walker's second objection was on the grounds that "[a]ll overcollections and undercollections are handled through the annual 1307(e) reconciliation process."⁸⁶ (OCA MB at 26-27).

Regarding Mr. Walker's objection that refunds are outside the scope of this proceeding, OCA responds that this argument ignores that NAWC's DSIC is a surcharge and is subject to audit and reconciliation.⁸⁷ 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:

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.⁸⁸

⁸⁵ NAWC St. 1R at 7.

⁸⁶ NAWC St. 1R at 14.

⁸⁷ 66 Pa. C.S. § 1358(e).

⁸⁸ 66 Pa. C.S. § 1312.

Moreover, the OCA notes that the Commission made clear in its Suspension Order that NAWC's existing rates are an issue in this proceeding.⁸⁹ 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. (OCA MB at 26-27).

Regarding Mr. Walker's objection that overcollections and undercollections are handled through the 1307(e) reconciliation process, the OCA indicates that it 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. (OCA MB at 27).

To the extent that the Company claims that the OCA did not complete its refund analysis because the OCA Witness failed to remove short-term debt from his recalculation of the Company's DSIC rate for the past four years, OCA maintains that this is a misleading portrayal of the evidence. The OCA notes that it submitted Schedule JDM-5, along with its direct testimony, on November 20, 2017, which calculated the percentage difference between the DSIC rate that was actually charged to customers due to NAWC's failure to use the cost of debt from its most recent quarterly financial earnings reports for the past four years, and the corrected DSIC rate for those quarters. Eight days after this submission, the Company filed its second revised Financial Earnings Report for the 12-month period Ended June 30, 2017.⁹⁰ The Company revealed that it had erroneously included short-term debt in its cost of long-term debt for the previous financial earnings report and that the second revised report corrected this error.⁹¹ Due to the Company's error, the OCA's refund analysis – based on the incorrect data – was not correct. Since the OCA learned about the error within a week of the date its responsive testimony was due and the discovery period had already ended, the OCA maintains that it was not able to obtain the necessary breakdown of data to update its refund analysis. OCA notes that

⁸⁹ Suspension Order at 2.

⁹⁰ NAWC St. 1R, Att. 1, App. A.

⁹¹ *Id.*

the Company agreed to correct the long-term cost of debt error going forward. OCA posits that the Company will not know the net effect these changes (removal of short term debt from DSIC rate calculations and update the cost of debt to match the most recently filed financial earnings report) will have on the DSIC rates charged to customers, unless the Commission adopts the OCA's recommendation and requires NAWC to make the calculations. Then, if appropriate, the Commission should require the Company to issue refunds. (OCA RB at 26-27).

To the extent that the Company argues that the OCA's refund recommendation is beyond the scope of this proceeding because their recommendation is based on past DSIC rates rather than existing rates, which would be contrary to the Commission's directive that this rate investigation would include consideration of the lawfulness, justness and reasonableness of the Company's existing rates, the OCA maintains that "existing rates" for DSIC purposes is not limited to a specific rate charged in a particular quarter. OCA asserts that it has been shown that the errors are in the Company's existing methods for calculating the DSIC rate, and that the Company has used the same, erroneous methods for at least four years, *i.e.* including short-term debt and using historic instead of actual long-term debt cost rates. Moreover, OCA argues that Section 1312 authorizes refunds "in any proceeding involving rates."⁹² OCA maintains that, since this is a rate proceeding, Section 1312 applies. The statute provides that if the Commission determines that any rate received by a utility was unjust or unreasonable, in violation of any regulation or order, or in excess of the applicable rate contained in an existing and effective tariff, the Commission has the power to require the utility to refund the amount of any excess paid within four years, with interest.⁹³ (OCA RB at 27-28).

To the extent that the Company argues that it was not afforded due process because the OCA did not provide a refund averment or claim in its Formal Complaint, the OCA notes that in its Formal Complaint it asked the Commission to investigate NAWC's existing DSIC rates and asked for broad relief in the event that the investigation showed those rates were not just and reasonable. Moreover, OCA notes: that it identified the issue of, and request for, refunds in the Direct Testimony of its Witness; that the Company responded to the OCA's

⁹² 66 Pa. C.S. § 1312.

⁹³ 66 Pa. C.S. § 1312(a).

request for refunds in Rebuttal Testimony; that refunds were raised again by OCA in Surrebuttal Testimony; that during the evidentiary hearings in this matter, NAWC's counsel asked the OCA's Witness substantive questions regarding his refund calculation;⁹⁴ and that the Company provided substantive and procedural arguments addressing refunds in its Main Brief. OCA argues that NAWC's due process argument is rebutted by the evidence and should be rejected. (OCA RB at 28-29).

The OCA also points out that the Commission's regulations expressly allow for amendment of pleadings to conform to the evidence. 52 Pa. Code § 5.92. Specifically, amendments to the pleadings may occur by consent:

When the parties introduce issues at a hearing not raised by the pleadings whether by express or implied consent of the parties, the issues shall be treated in all respects as if they had been raised in the pleadings.⁹⁵

OCA maintains that the Commission has found implied consent where an opposing party fails to object to the introduction of evidence or claims and substantially litigates the matter; the opposing party has consented to treat the issue as if it had been raised in the pleadings. (OCA RB at 29).

OCA asserts that the evidence shows that consent was implied in this proceeding. At no time prior to filing its Main Brief did the Company raise a due process objection regarding refunds. Furthermore, the Company substantially litigated the issue by responding to the refund recommendation in rebuttal testimony, cross-examination of the OCA's Witness, and briefing the issue.⁹⁶ Accordingly, OCA maintains that NAWC gave implied consent to amend the OCA's Complaint to conform to the evidence, that there has been no violation of NAWC's due process, and that the refund claim is properly before the Commission for consideration. (OCA RB at 29-30).

⁹⁴ Tr. at 56-57.

⁹⁵ 52 Pa. Code § 5.92(a).

⁹⁶ NAWC St. 1R at 7-8, Tr. at 34-35, 56-58; NAWC M.B. at 22-24.

OCA further asserts that the refund recommendation is material and relevant to the Commission's consideration whether an increase to the DSIC cap is just and reasonable. The OCA notes that the Company's existing DSIC rates, rules and regulations are part of the investigation of its proposed DSIC rates, rules and regulations and maintains that if NAWC's existing DSIC rates were not correctly calculated, then the Commission has authority under the Public Utility Code to direct the Company to provide refunds.⁹⁷ NAWC cannot rely on incorrectly calculated DSIC rates to support an increase to the DSIC cap. If NAWC has overcharged customers through the DSIC without making them whole, charging those customers an even higher DSIC rate cannot be just and reasonable. (OCA RB at 30).

For its part, the Company maintains that OCA Witness Mierzwa's refund analysis was determined to be incomplete by his own admission. While he adjusted the DSIC calculation to reflect the most recently reported debt cost rate, Mr. Mierzwa failed to remove the short-term debt that the Company had been including in the DSIC calculation over the past four years. NAWC maintains that the Company's inclusion of short term debt benefited customers by *lowering* the return included in the DSIC calculation. NAWC Witness Walker identified this error in his rebuttal testimony describing Mr. Mierzwa's incomplete refund calculation as "meaningless." NAWC notes that, while Mr. Mierzwa acknowledged in his surrebuttal testimony that Mr. Walker was correct in respect to the elimination of short term debt to complete the analysis,⁹⁸ Mr. Mierzwa did not recalculate his Schedule JDM-5.⁹⁹ (NAWC MB at 22-23).

Additionally, the Company asserts that the revisions removing short term debt and revising the long-term debt cost rate are offsetting. The Company believes that revising the offsetting adjustments may show an under-collection due to the Company rather than overcollection due to customers. (NAWC RB at 18).

⁹⁷ 66 Pa. C.S. §§ 1312(a), 1307(e), 1358(e).

⁹⁸ OCA St. No. 1-SR at 9.

⁹⁹ Tr. 55 – 56.

NAWC maintains that the debt cost rate used by NAWC in its DSIC calculations was documented by the Company, reviewed by the Bureau of Audits and accepted by the Commission. All overcollections and potential DSIC refunds, if any, are handled through the annual 1307(e) reconciliation process. The Company notes that it has always followed and will continue to follow the annual reconciliation process. For this reason, the Company asserts that there is no reason for the Commission to give further consideration to Mr. Mierzwa's claims of an historic overcollection. (NAWC MB at 23).

NAWC also maintains that Mr. Mierzwa's recommendation concerning DSIC refunds is beyond the scope of this proceeding, noting that in the Order entered October 5, 2017, the Commission instituted an investigation into the lawfulness, justness, and reasonableness of the rates, rules, and regulations contained in Supplement No. 126, and that the investigation shall include consideration of the lawfulness, justness, and reasonableness of existing rates, rules, and regulations. NAWC asserts that Mr. Mierzwa's refund recommendation is not based on either a proposed or an existing rate. It, rather, is based entirely on past DSIC rates and, consequently, is beyond the scope of the proceeding. (NAWC MB at 23; NAWC RB at 18).

NAWC further maintains that the OCA presented no refund averment or claim in its Complaint, and that the failure to plead the claim is a violation of due process. NAWC asserts that it had no notice of the refund claim until the OCA served Mr. Mierzwa's direct testimony. NAWC further asserts that OCA failed to demonstrate any nexus between its refund recommendation and the Company's request to increase its DSIC cap to 7.5%. Lastly, NAWC maintains that if this matter had been properly pleaded and adequately noticed, the parties would not be speculating as to the impact of removing short term debt and revising the long-term debt cost rate in the DSIC for prior periods. (NAWC MB at 23-24; NAWC RB at 18).

4. Application Of The DSIC To Private Fire Protection Customers

NAWC does not charge the DSIC to private fire protection customers.¹⁰⁰ OCA maintains that 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. OCA further maintains that it requires a change going forward – NAWC should apply the DSIC to the private fire protection class. NAWC 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.¹⁰¹ OCA asserts that the Company has no legal basis, however, for its position. (OCA MB at 27-28).

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).¹⁰²

The OCA notes that there is a statutory exception for public fire protection customers, which limits their rates to recover their full cost of service.¹⁰³ No such limitation applies to private fire protection customers. (OCA MB at 28; OCA RB at 31).

The OCA further argues that the fact that NAWC's private fire protection customers are not metered does not support their exclusion from the DSIC. NAWC Witness Walker indicated that one of the benefits of NAWC's DSIC-eligible investment is increased fire protection.¹⁰⁴ 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 noted by OCA Witness Mierzwa, while NAWC's flat rate customers are limited to the private

¹⁰⁰ NAWC St. 1R at 9, 15.

¹⁰¹ *Id.*

¹⁰² 66 Pa. C.S. § 1358(d)(1).

¹⁰³ 66 Pa. C.S. § 1328(a).

¹⁰⁴ NAWC St. 1 at 5.

and public fire protection classes, the same is not true for other water utilities. PAWC provided unmetered rates for residential customers in four of its rate zones and charged those unmetered customers a DSIC. (OCA MB at 28; OCA RB at 30-31).

The OCA asserts that this recommendation is material and relevant to this proceeding because failure to apply the DSIC rate to private fire protection customers means that eligible DSIC costs were recovered from a smaller number of customers and, all else being equal, the DSIC rate was overstated.¹⁰⁵ In addition, NAWC is contravening a statute by not charging all customer classes.¹⁰⁶ The OCA believes that this is relevant to whether the Company's proposed, higher DSIC rates are just and reasonable. (OCA RB at 31).

The OCA maintains that 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. For these reasons, the OCA asserts that the Company should begin charging the DSIC to all private fire protection customers. (OCA MB at 28-29; OCA RB at 30).

NAWC notes that it does not charge the DSIC to either public or private fire protection service customers. Citing the Company's tariff language, which identifies a DSIC exemption for public fire protection service but not private fire protection service, OCA Witness Mierzwa recommends that NAWC begin charging the DSIC to private fire protection customers.¹⁰⁷ NAWC maintains that private and public fire protection service customers are similarly situated irrespective of the tariff language. Both are non-metered, flat rate customers.¹⁰⁸ The Company has always interpreted its tariff to exempt both public and private fire protection service from the DSIC and not charged the DSIC to private fire protection service customers and notes that the Company's practice of not billing the DSIC to private fire protection customers has not been amended or revoked by the Commission. NAWC submits that the Commission should not upset this long-standing practice and, instead, should reject Mr.

¹⁰⁵ 66 Pa. C.S. § 1357(d)(2); see, e.g., OCA Sch. JDM-4, DSIC Supporting Calculations.

¹⁰⁶ 66 Pa. C.S. § 1358(d)(1).

¹⁰⁷ OCA St. No. 1 at 12.

¹⁰⁸ NAWC St. No. 1R at 12.

Mierzwa's recommendation. NAWC argues that this is a "red herring" recommendation that is wholly unrelated to the Company's request to increase its DSIC cap to 7.5%. (NAWC MB at 24; NAWC RB at 19).

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."¹⁰⁹ The OCA notes that the Company actually calculates DSI as the original cost minus accumulated depreciation, as shown in the Company's most recent DSIC quarterly filing.¹¹⁰ 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). OCA maintains that the tariff should state:

DSI = original cost of eligible distribution system improvement projects net of accumulated deferred income taxes and accumulated depreciation.¹¹¹

(OCA MB at 29).

NAWC Witness Walker 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*.¹¹² As discussed, the tariff change would simply codify the Company's existing practice of netting accumulated depreciation. Further, OCA believes Mr. Walker's position is not correct since the Model Tariff actually defines DSI as being net of "accrued depreciation."¹¹³ (OCA MB at 29; OCA RB at 31-32).

The OCA argues that Company's failure to conform its DSIC tariff and practices is one more reason showing that an increase to the DSIC rates charged to customers is not just

¹⁰⁹ See, e.g., OCA Sch. JDM-4.

¹¹⁰ *Id.*, DSIC Computation. (deducting \$106,319 for accumulated depreciation).

¹¹¹ OCA St. 1 at 13 (emphasis indicates new language).

¹¹² NAWC St. 1R at 10, 13.

¹¹³ *Supp. Implementation Order*, App. A.

and reasonable. If NAWC's existing DSIC mechanism is not just, reasonable and lawful, then increasing DSIC rates cannot be just, reasonable and lawful. (OCA RB at 32).

The Company maintains that its existing DSIC tariff language is patterned after the Model Tariff published by the Commission in its *Supplemental Implementation Order*. NAWC notes that the existing tariff language was approved by the Commission and asserts that OCA Witness Mr. Mierzwa offers no reason, such as a statute or Commission policy, why NAWC's Commission approved tariff should be modified. NAWC maintains that no reason exists to modify the tariff. Additionally, NAWC argues that the tariff revision that the OCA is proposing is a matter of policy that, if implemented, would complicate the DSIC computation methodology. Moreover, NAWC argues that the modification desired by the OCA was rejected by the Commission and affirmed by the Commonwealth Court in *McCloskey*. (NAWC MB at 25; NAWC RB at 20).

NAWC argues that the OCA has failed to support its requested modification of Commission approved tariff language and also failed to show any nexus between its recommendation and the Company's request to increase its DSIC cap to 7.5%. NAWC submits that the Commission should reject Mr. Mierzwa's recommendation. (NAWC MB at 25; NAWC RB at 20).

6. Discussion And Conclusions

a. Consideration Of The OCA's Recommendations In This Proceeding

Before addressing the OCA's recommendations, it is first necessary to determine whether or not the OCA properly raised these concerns in this proceeding. The Company has asserted that the only issue before the Commission in this proceeding is its request to increase the DSIC cap from 5% to 7.5%. The Company believes that the recommendations suggested by OCA are unnecessarily complicating this case, and that the issues they have raised are "red herring" issues. I disagree.

In the October 5, 2017 Order in which the Commission suspended Supplement No. 126 for investigation, the Commission stated:

Investigation and analysis of this proposed tariff supplement and the supporting data indicate that the proposed changes in rates, rules and regulations may be unlawful, unjust, unreasonable, and contrary to public interest. It also appears that consideration should be given to the reasonableness of NAWC's existing rates, rules, and regulations.¹¹⁴

Accordingly, the Commission ordered that this investigation include consideration of the lawfulness, justness, and reasonableness of the existing rates, rules, and regulations of Newtown Artesian Water Company.¹¹⁵ As the recommendations raised by the OCA relate specifically to NAWC's DSIC rate, they are properly raised within the context of this proceeding and the argument raised by NAWC is without merit.

b. Application Of Act 40 To NAWC's DSIC Mechanism

The OCA has argued that Act 40 is applicable to this proceeding and 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. The Company argues in response that the OCA's recommendation is contrary to the Commonwealth Court's decision in *McCloskey*. However, this argument is without merit.

In *McCloskey*, the Commonwealth Court affirmed a decision of the Commission approving the petition for a DSIC of Columbia Gas. In the proceeding before the Commission, the Commission concluded that Columbia was not required to include an ADIT adjustment in its DSIC calculation and that Columbia was permitted to include the state income tax "gross-up" in its DSIC calculation.¹¹⁶ The OCA appealed, contending that the Commission erred as a matter of law when it approved a DSIC calculation that did not recognize ADIT tax benefits recovered through the surcharge and generated by the investment in the replaced parts of its infrastructure.¹¹⁷ The OCA argued, among other things, that Pennsylvania law and well

¹¹⁴ *Pa.PUC v. Newtown Artesian Water Co.*, R-2017-2624240, Suspension Order at 1-2.

¹¹⁵ *Id.* at 2.

¹¹⁶ *McCloskey* at 865.

¹¹⁷ *Id.* at 866.

established ratemaking policy requires that Columbia’s tax benefits be reflected in the rates paid by its ratepayers.¹¹⁸ The Commission countered that the General Assembly envisioned a simple and straightforward process of establishing rates for the DSIC surcharge that would be easy to calculate and audit.¹¹⁹

In affirming the Commission’s decision, the Commonwealth Court determined, among other things, that the United States Supreme Court has acknowledged that there are many ways to achieve rates that are just and reasonable and a determination as to whether rates were just and reasonable must involve a look at the total effect of the rates.¹²⁰ The Commonwealth Court also determined that the Commission is vested with the discretion to decide what factors it will consider in setting or evaluating a utility’s rates.¹²¹ The Commonwealth Court noted that there are earnings caps and “resets” as consumer protections and concluded that, “in the current conflict, this Court will not substitute its judgment for that of the Commission.”¹²²

Following the Commonwealth Court’s Decision in *McCloskey*, the General Assembly Enacted Section 1301.1 which became effective August 11, 2016. The enactment of Section 1301.1 occurred nearly one year after the Commonwealth Court issued its decision in *McCloskey* (November 3, 2015). The Company’s reliance on *McCloskey* for its position that utilities are not required to include an ADIT adjustment in their DSIC calculations and that utilities are permitted to include statutory state and federal income tax rates in those calculations is incorrect. Since Section 1301.1 was enacted by the General Assembly after *McCloskey*, it is applicable to the facts of this case.

Moreover, there is nothing in the Public Utility Code to suggest that Act 40 is inapplicable to this proceeding or to water utilities in particular. The language of Section 1301.1(c) provides that “[t]his section shall apply to *all cases* where the final order is entered after the effective date of this section.” 66 Pa. C.S. § 1301.1(c)(emphasis added). Act 40

¹¹⁸ *Id.*
¹¹⁹ *Id.* at 867.
¹²⁰ *Id.* at 868 (citations omitted).
¹²¹ *Id.* (citations omitted).
¹²² *Id.* at 870-871.

became effective on August 11, 2016. This investigation commenced by Commission Order entered October 5, 2017, well after the effective date of Act 40, and the final order will be entered well after the effective date of Act 40. Moreover, Section 1301.1(c) provides that it applies to “all cases”, with no exception being made for water utilities. Accordingly, I conclude that Act 40 applies in this proceeding.

c. Reflection Of Federal And State Income Tax Deductions In The Calculation of The DSIC Rate.

Regarding the OCA’s request that NAWC be required to reflect Federal and State Income Tax Deductions in the calculation of NAWC’s DSIC rate, I conclude that Section 1301.1 requires the inclusion of federal and state income tax deductions in the DSIC related charge.

Section 1301.1 provides, in pertinent part, as follows:

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. If an expense or investment is not allowed to be included in a public utility’s rates, the related income tax deductions and credits, including tax losses of the public utility’s parent or affiliated companies, shall not be included in the computation of income tax expense to reduce rates. The deferred income taxes used to determine the rate base of a public utility for ratemaking purposes shall be based solely on the tax deductions and credits received by the public utility and shall not include any deductions or credits generated by the expenses or investments of a public utility’s parent or any affiliated entity. The income tax expense shall be computed using the applicable statutory income tax rates.¹²³

The Public Utility Code defines the term “rate” in pertinent part as including “[e]very individual, or joint fare, toll, *charge*, rental, or other compensation whatsoever of any public utility . . .”¹²⁴ Lastly, the Public utility Code defines “distribution system improvement charge” as “[a] *charge* imposed by a utility to recover the reasonable and prudent costs incurred to repair, improve or

¹²³ 66 Pa. C.S. § 1301.1(a).

¹²⁴ 66 Pa. C.S. § 102 (emphasis added).

replace eligible property that is part of the utility's distribution system."¹²⁵ The DSIC, which is defined as a charge, is clearly a rate within the meaning of Section 1301.1.

The plain language of Section 1301.1 requires that the impact of any tax deductions and credits related to an expense or investment that is allowed to be included in a public utility's rates for ratemaking purposes *shall* be included in the computation of current or deferred income tax expense to reduce rates. Use of the word "shall" in statutes is generally accepted as imperative or mandatory and must be given a compulsory meaning as denoting obligation.¹²⁶ I agree with OCA that Act 40 now requires the inclusion of federal and state income tax deductions in the DSIC rate charged to customers.

Although the Company argued that Act 40 addresses consolidated income tax expense for base rate purposes, that this is not a base rate proceeding, that the DSIC rate is a surcharge mechanism for the recovery of the costs related to the repair, improvement, and replacement of eligible property outside of a rate case, and that surcharges are not part of a base rate proceeding, the language of the aforementioned code provisions are clear:

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). As previously noted, the term "rate" is defined to include charges, such as the DSIC. Although this may not be a base rate proceeding, the language is clear, and Section 1301.1 applies.

The Company also argues that the legislative history behind Act 40 demonstrates that the purpose of the Act was to eliminate the consolidated tax adjustment. However, there is nothing in the plain language of the statute to suggest this. On the contrary, Subsection (a) of Section 1301.1 says if an expense or investment is allowed to be included in a utility's rates for

¹²⁵ 66 Pa. C.S. § 1351 (emphasis added).

¹²⁶ See, Black's Law Dictionary, 6th Ed., West Publishing Co. at 1375. (As used in statutes, contracts, or the like, this word is generally imperative or mandatory.)

ratemaking purposes then the related income tax deductions and credits must also be included.¹²⁷ Subsection (a) then articulates the opposite: if the expense or investment is not allowed to be included in a utility's rates for ratemaking purposes, any related income tax deductions and credits cannot be included.¹²⁸ The third and fourth sentences in subsection (a) then articulate how those deductions and credits should be calculated.¹²⁹ This language is clear and unambiguous.

The rules of statutory construction require that “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.”¹³⁰ In this case, the language of Section 1301.1 is clear and free from all ambiguity and therefore the letter of the statute cannot be disregarded.

NAWC's reliance on legislative history as a reason to adopt its position in this proceeding is incorrect. Where the plain language of the statute is discernible, as is the case here, there is no need to look to the legislative history. As the rules of statutory construction further require, “when the words of the statute are not explicit, the intention of the General Assembly may be ascertained by considering, among other matters: (7) the contemporaneous legislative history.”¹³¹ In this case, however, the words of Section 1301.1 are explicit and, therefore, there is no need to look to the contemporaneous legislative history to ascertain the intention of the General Assembly.

The Company also argues that, although it is aware of the decision in the *First Energy DSIC* proceeding in which the ALJ determined that the companies must modify their DSIC calculations to include federal and state income tax deductions generated by DSIC investment, that decision remains pending before the Commission. The company asserts that until the Commission adopts the ALJ's Recommended Decision in that case and then applies it to water companies, Act 40 is not applicable to NAWC's DSIC mechanism.

¹²⁷ 66 Pa.C.S. § 1301.1.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ 1 Pa.C.S. § 1921(b).

¹³¹ 1 Pa.C.S. § 1921(c)(7); *see also, Yellow Cab Co. of Pittsburgh v. Pa. P.U.C.*, 501 A.2d 323 (Pa. Cmwlth 1985).

While the Company is correct that, as of the date of this decision, the *First Energy DSIC* proceeding is still pending before the Commission, for the reasons already stated, Act 40 is applicable to this proceeding. Moreover, the presiding ALJ in the *First Energy DSIC* proceeding provided a well-reasoned analysis of *McCloskey* and the evolution of Act 40 before reaching the conclusion that DSIC calculations should include federal and state income tax deductions generated by DSIC investment. Absent an order from the Commission reversing the decision in the *First Energy DSIC* proceeding, I agree with the reasoning of the ALJ in that case. Moreover, even absent the Recommended Decision in the *First Energy DSIC* proceeding, I would arrive at the same conclusion. Therefore, it will be recommended that the Company be directed to account for and reflect all federal and state income tax deductions and credits in the calculation of its DSIC going forward.

d. Reflection Of Investment-Related Income Tax Deductions In The Application Of The Earnings Cap.

Regarding OCA's Request that the Commission 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, the Company has argued that Act 40 applies to a public utility's rates and that the earnings cap is not a public utility rate. The Company maintains that the earnings cap is a quarterly submission required of utilities under 52 Pa. Code Chapter 71. The Company maintains that Act 40 has no application to Chapter 71 financial reporting.

OCA maintains that the Federal tax loss carry-forward is an investment-related income tax deduction that should be included in NAWC's calculation of its overall rate of return used to reset the DSIC rate. In the Company's most recent financial earnings report submitted for the 12-months ended June 30, 2017, the Company made an adjustment to eliminate that deduction in its presentation of federal income tax expense, resulting in an increase of \$277,343 to its per books returns to increase expenses for federal income taxes, which served to lower the company's overall rate of return. TUS subsequently directed the Company to revise this adjustment and refile its report, which it did on November 28, 2017. As noted by the Company,

this had an impact on the DSIC earnings cap, which is a factor considered to determine if the DSIC should be reset to zero:

I believe it is entirely appropriate to reflect federal income taxes in the Financial Report. NAWC's revised Financial Report for the 12-months ended June 30, 2017, which Mr. Mierzwa attached to his direct testimony, included a net statutory tax adjustment. NAWC, subsequently, refiled the Financial Report on November 28, 2017, at the direction of the Bureau of Technical Utility Services. The refiled Report is attached to my rebuttal testimony as Attachment 1. The refiled Report includes a tax normalization adjustment which NAWC believes is acceptable to reviewing Staff. The Financial Report concludes that NAWC's adjusted return on common equity for the period is 9.27%, which is below the allowable DSIC threshold return of 9.75%. There is no basis for the Commission to reset NAWC's DSIC to zero as recommended by Mr. Mierzwa.¹³²

OCA has requested that, with any future adjustments for federal income taxes on financial earnings reports, the Company be directed to calculate such adjustments in the same manner as it did for the November 28, 2017 report. OCA maintains that to include investment-related income tax deductions in the calculation of overall rate of return used to apply the DSIC earnings cap is consistent with Act 40. I agree. The fact that TUS directed the Company to make this adjustment is persuasive. I am similarly persuaded by the impact that this adjustment can have on the determination to reset the DSIC to zero.

Accordingly, it will be recommended that the Company be directed to include a federal tax normalization adjustment, similar to the adjustment in the Company's November 28, 2017, revised Financial Earnings Report, in all future financial earnings reports filed with the Commission.

¹³² NAWC St. 1R at 6-7.

e. Exclusion Of Short Term Debt From Cost Of Debt And Use Of Current Long-Term Debt.

I agree with the OCA's recommendation that, in the future, NAWC should exclude short term debt from the cost of debt utilized to calculate the DSIC earnings cap and the DSIC rate. Section 1357(b)(1) provides that

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 three-month period ending one month prior to the effective date of the distribution system improvement charge and subsequent updates.¹³³

Based upon the plain wording of the statute, short term debt should not be included.

The Company has indicated that, going forward, it will remove short term debt from both its Financial Report submission pursuant to 52 Pa.Code Chapter 71 and its DSIC calculation. The Company further indicated that the continued exclusion of short term debt will depend on the directives of the Commission and TUS.¹³⁴ Accordingly, it will be recommended that NAWC exclude short term debt when calculating their DSIC earnings cap and DSIC rate. Going forward, the Company should follow the requirements of 66 Pa. C.S. § 1357(b)(1) and exclude short term debt when calculating the DSIC rate.

I also agree with the OCA's recommendation that, prospectively, NAWC should use the actual (current) cost of long-term debt from its most recent financial earnings report to calculate the DSIC earnings cap and the DSIC rate. As can be seen from Section 1357 above, the Company is required to use the cost of long-term debt from its most recent quarterly financial earnings report. Moreover, the DSIC earnings cap set out at Section 1358(b)(3) also requires the Company to use the actual (current) cost of debt:

¹³³ 66 Pa. C.S. § 1357(b)(1).

¹³⁴ NAWC RB at 17.

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.¹³⁵

As noted by OCA, correcting the cost of debt changes the Company's calculation of its overall allowable DSIC return which may impact whether or not the DSIC earnings cap is triggered, requiring the DSIC rate to be reset to zero.

The Company acknowledged that, going forward, it will use the cost of long-term debt in its DSIC calculation that is acceptable to Commission staff. Accordingly, it will be recommended that going forward, the Company use the actual cost of long-term debt from its most recent financial earnings report to calculate the DSIC earnings cap and the DSIC rate.

f. Overcollections/Refunds

Regarding the OCA's request calling for the recalculation of the DSIC rate for the cost of debt and refunds, it is clear that the Company miscalculated its DSIC rate by using the incorrect (historic) cost of debt since at least November 2013 rather than its actual (current) cost of debt. I agree that this miscalculation may have given rise to a DSIC overcollection by the Company. Moreover, although I've already addressed and recommended denying the Company's request for an increase to its DSIC cap in Section IV, B, 4 of this decision, the fact that the Company has been miscalculating its DSIC rate when it claims that it is approaching the DSIC cap also weighs heavily against granting the company's request to increase its DSIC rate.

Regarding the issuance of refunds, the Public Utility Code provides in pertinent part:

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

¹³⁵ 66 Pa. C.S. § 1358(b)(3) (emphasis added).

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 successive payment.¹³⁶

While I do not agree with NAWC that the OCA's recommendation concerning DSIC refunds is beyond the scope of this proceeding, since the Commission ordered an investigation into NAWC's existing DSIC rate, I do agree with NAWC that the issue of overcollections/refunds is more appropriately addressed through a 1307(e) reconciliation proceeding. Through the 1307(e) proceeding, the company would be required to provide verified debt cost for the years 2013 through 2017, and it could then be determined to what extent, if any, there was an overcollection/undercollection in 2013 (four years prior to the OCA's Complaint) and how that re-determined DSIC rate affected subsequent years' DSIC calculations.

The OCA has indicated that it does not object to refunds being handled in the annual DSIC reconciliation process, only that it seeks a determination in this proceeding that appropriate refunds will be granted. As stated previously, the 1307(e) proceeding is the best avenue to determine the net effect of the recalculation of the Company's DSIC rate for the previous four years. Accordingly, it will be recommended that the Company be required to provide verified debt cost for the years 2013 through 2017, in its next 1307(e) reconciliation proceeding in order to determine to what extent, if any, there was a DSIC overcollection/undercollection during that period.

g. Private Fire Protection Customers.

Regarding the OCA's recommendation that NAWC's DSIC should be applied to private fire protection customers, I note that the customer protections section of the Code provides in pertinent part that a DSIC must be applied equally to all customers:

¹³⁶ 66 Pa. C.S. § 1312(a)(emphasis added).

A distribution system improvement charge approved by the commission shall provide . . . [t]hat the distribution system improvement charge shall be applied equally to all customer classes as a percentage of each customer's billed revenue.¹³⁷

I also note that regarding rates in general, 66 Pa. C.S. § 1328(a) provides that “[a] public utility that furnishes water to or for the public shall be allowed to recover in rates the full cost of service related to public fire hydrants.” The Public Utility Code does not provide that the rates for private fire protection should be spread across customer classes. Lastly, regarding adherence to tariffs, the Code provides as follows:

No public utility shall, directly or indirectly, by any device whatsoever, or in anywise, demand or receive from any person, corporation, or municipal corporation a greater or less rate for any service rendered or to be rendered by such public utility than that specified in the tariffs of such public utility applicable thereto.

66 Pa. C.S. § 1303.

The Company has argued that, although its tariff language specifies a DSIC exemption for public fire protection but not private fire protection, it has always interpreted its tariff to exempt both public and private fire protection service from the DSIC and not charged the DSIC to private fire protection customers. The Company has asked that the Commission not upset this long-standing practice. However, the Commission is not obligated to perpetuate long-standing errors in tariff interpretation or rate application. There is no legal basis upon which to exclude private fire protection customers from NAWC's DSIC, and it is clear that the Company did not follow its own tariff when it applied the DSIC exemption to private fire protection customers. Accordingly, I will recommend that the Company begin applying its DSIC to private fire protection customers.

¹³⁷ 66 Pa. C.S. § 1358(d)(1).

h. Recognition Of Accumulated Depreciation In The DSIC Tariff

As noted by OCA, the Company currently defines DSI as “the original cost of eligible distribution system improvement projects” in its current water tariff, and the Company actually calculates DSI as the original cost minus accumulated depreciation. As a result, the OCA requests that the Company should modify its tariff to reflect accumulated depreciation and ADIT (as discussed previously) to define DSI as follows:

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

The OCA believes this would simply codify the Company’s existing practice of netting accumulated depreciation. Moreover, the OCA believes this would be correct since the Model Tariff actually defines DSI as being net of “accrued depreciation.”¹³⁸ I agree.

The Public Utility Code requires all public utilities to “file with the commission . . . tariffs showing all rates established by it and collected or enforced, or to be collected or enforced, within the jurisdiction of the commission.”¹³⁹ That provision further provides that “[e]very public utility shall keep copies of such tariffs open to public inspection under such rules and regulations as the commission may prescribe.” As a utility’s tariff is to be available for public inspection, the tariff should accurately reflect the utility’s rates, rules and regulations. Since the Company has been factoring accumulated depreciation into its DSI determination, it should be reflected in its tariff. Accordingly, it will be recommended that the Company modify its tariff to reflect accumulated depreciation in its definition of DSI. Moreover, since this decision will recommend the inclusion of federal and state income tax deductions generated by DSIC investment going forward, it will also be recommended that ADIT be reflected in the Company’s DSI definition.

¹³⁸ *Implementation of Act 11 of 2012, M-2012-2293611, Supplemental Implementation Order at Appendix A (Sept. 15, 2016).*

¹³⁹ 66 Pa. C.S. § 1302.

V. CONCLUSIONS OF LAW

1. The Commission has jurisdiction over the subject matter and the parties to this proceeding pursuant to 66 Pa.C.S. §§ 1350-1360.

2. In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon 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).

3. A party proposing an adjustment to a ratemaking claim bears the burden of presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment. *See, e.g., Pa. Pub. Util. Comm'n v. PECO Energy Co.*, Docket No. R-891364, *et al.*, 1990 Pa. PUC LEXIS 155 (Order entered May 16, 1990); *Pa. Pub. Util. Comm'n v. Brezewood Telephone Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45 (Order entered January 31, 1991).

4. Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the Commission. 66 Pa.C.S. § 1301.

5. Absent an express limitation on existing ratemaking authority, the Commission retains its full and existing ratemaking authority. 66 Pa.C.S. § 1358(c).

6. Section 1358(a)(2) provides that a distribution system improvement charge granted to a water utility . . . may not exceed 7.5% of the amount billed to customers. 66 Pa.C.S. § 1358(a)(2).

7. The burden of proving that an increase of the Company's DSIC cap from 5% to 7.5% is on Newtown Artesian Water Company. 66 Pa.C.S. § 315(a).

8. Newtown Artesian Water Company has failed to sustain its burden of proving that an increase of the DSIC cap from 5% to 7.5% is just and reasonable.

9. Act 40 requires the inclusion of federal and state income tax deductions in the DSIC rate charged to customers. 66 Pa.C.S. § 1301.1(a).

10. 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).

11. Utilities must use the cost of debt from their 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 (Order entered September 15, 2016).

12. Water Utilities must apply their DSIC charge to private fire protection customers. 66 Pa.C.S. § 1328(a), 66 Pa.C.S. § 1358(d)(1).

VI. ORDER

THEREFORE,

IT IS RECOMMENDED:

1. That Newtown Artesian Water Company's proposal, contained in Supplement No. 126 To WATER-PA. P.U.C. No. 9, to increase its DSIC cap from 5% to 7.5% of billed revenue be denied;
2. That Newtown Artesian Water Company shall account for and reflect all federal and state income tax deductions and credits in the calculation of its DSIC;
3. That Newtown Artesian shall include a federal tax normalization adjustment, similar to the adjustment in the Company's November 28, 2017 revised Financial Earnings Report, in all future financial earnings reports filed with the Commission;
4. That Newtown Artesian Water Company shall exclude short-term debt from the cost of debt utilized to calculate the DSIC earnings cap and the DSIC rate;
5. That Newtown Artesian Water Company 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. That Newtown Artesian shall, in the Company's next 1307(e) reconciliation, recalculate its DSIC rate for the 4-year period prior to the date of its filing in this matter, excluding short term debt and using the applicable verified cost of debt, and issue refunds with interest if customers were overcharged during that period;

7. That Newtown Artesian Water Company shall charge the DSIC to all private fire protection customers;

8. That Newtown Artesian Water Company shall modify its tariff to show that “DSI” is net of accumulated depreciation as well as accumulated deferred income taxes;

9. That Newtown Artesian shall file a tariff supplement or tariff revision containing rates, rules and regulations consistent with this Order;

10. That the Complaint filed by the Office of Consumer Advocate at Docket No. C-2017-2626954 is sustained; and

11. That upon acceptance and approval by the Commission of the tariff supplement or tariff revision containing rates, rules and regulations consistent with this Order, this proceeding shall be marked closed.

Date: February 6, 2018

_____/s/
Christopher P. Pell
Deputy Chief Administrative Law Judge