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VIA eFILING

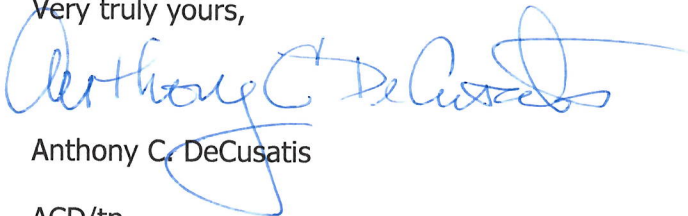
Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

**Re: Petition of Pennsylvania-American Water Company for Approval
of Tariff Changes and Accounting and Rate Treatment Related
to Replacement of Lead Customer-Owned Service Pipes
Docket No. P-2017-2606100**

Dear Secretary Chiavetta:

Enclosed for filing in the above-referenced matter are the **Exceptions of Pennsylvania-American Water Company to the Recommended Decision of Administrative Law Judge Elizabeth H. Barnes**. Copies have been served on presiding Administrative Law Judge Barnes and all parties of record as indicated on the attached Certificate of Service.

Very truly yours,



Anthony C. DeCusatis

ACD/tp
Enclosures

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

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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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|---------------------------------------|---|----------------------------------|
| PETITION OF PENNSYLVANIA- | : | |
| AMERICAN WATER COMPANY FOR | : | |
| APPROVAL OF TARIFF CHANGES AND | : | Docket No. P-2017-2606100 |
| ACCOUNTING AND RATE TREATMENT | : | |
| RELATED TO REPLACEMENT OF LEAD | : | |
| CUSTOMER-OWNED SERVICE PIPES | : | |

CERTIFICATE OF SERVICE

I hereby certify and affirm that I have this day served a copy of the **Exceptions of Pennsylvania-American Water Company to the Recommended Decision of Administrative Law Judge Elizabeth H. Barnes** on the following persons, in the matter specified in accordance with the requirements of 52 Pa. Code § 1.54:

VIA ELECTRONIC AND FEDERAL EXPRESS

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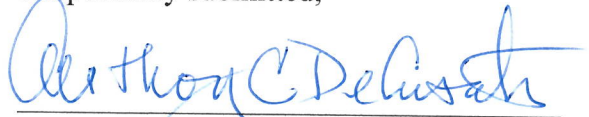
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Dated: June 4, 2018

*Attorneys for Pennsylvania-American
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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**PETITION OF PENNSYLVANIA-
AMERICAN WATER COMPANY FOR
APPROVAL OF TARIFF CHANGES AND
ACCOUNTING AND RATE TREATMENT
RELATED TO REPLACEMENT OF LEAD
CUSTOMER-OWNED SERVICE PIPES**

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DOCKET NO. P-2017-2606100

**EXCEPTIONS OF
PENNSYLVANIA-AMERICAN WATER COMPANY**

**To The Recommended Decision Of
Administrative Law Judge Elizabeth H. Barnes**

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TABLE OF CONTENTS

| | Page |
|--|------|
| I. BACKGROUND AND HISTORY OF THIS PROCEEDING | 1 |
| II. OVERVIEW | 2 |
| III. EXCEPTIONS | 5 |
| IV. ARGUMENT | 10 |
| A. The Commission May Not Mandate That PAWC Implement Its Voluntary Replacement Plan Under Terms That PAWC Does Not Accept | 10 |
| B. The York Water Order Is Not Valid Precedent In This Proceeding | 11 |
| C. PAWC Should Be Permitted To Capitalize LSP Replacements For Accounting Purposes And Recover A Return On, And A Return Of, The Capital It Invests In That Property | 13 |
| 1. The Contention That Customer-Owned Lead Service Pipes Are Not Utility Plant And Therefore May Not Earn A Return Is Contrary To Commission Precedent | 14 |
| 2. Commission Precedent Supports The Capitalization Of Investments In Customer-Owned Property | 19 |
| 3. The “Cost Sharing” Approach Recommended By The ALJ Is Unsupported And Does Not Compensate PAWC’s Investors For Their Capital Committed To Protect Public Health | 20 |
| D. The Replacement Plan As Proposed By PAWC Appropriately Dedicates Investment To Address The Potential Health Risk Posed By Lead | 24 |
| 1. The Proposal To Cap Investment In Replacement Plan - Part 2 Projects Is Unnecessary, Would Divert Funds From Eliminating The Risk Of LSP, Will Result In Asymmetrical Treatment Of Customers Facing A Lead Health Risk, And Will Impair Replacement Plan Efficiency | 24 |
| 2. The Partial Compensation Program Is Unnecessary And Takes Focus Away From Addressing The Potential Health Risk Posed by Lead | 26 |
| V. CONCLUSION | 27 |

TABLE OF AUTHORITIES

| | Page(s) |
|---|---------------|
| COURT CASES | |
| <i>HIKO Energy, LLC v. Pennsylvania Pub. Util. Comm'n</i> , 163 A.3d 1079 (Pa.Cmwlt. 2017), appeal granted, 176 A.3d 235 (Pa. 2017) | 12 |
| COMMISSION CASES | |
| <i>Petition of Columbia Gas of Pennsylvania, Inc. for Limited Waivers of Certain Tariff Rules Related to Customer Service Line Replacement</i> , Docket No. P-00072337 (Order entered May 19, 2008) | 8, 15, 17, 18 |
| <i>Petition of Peoples Natural Gas Co., LLC</i> , Docket Nos. P-2013-2344596 and C-2013-2348847 (Order entered Aug. 21, 2014) | 8 |
| <i>Petition of Peoples Natural Gas Co., LLC for Approval of its Amended Second Revised Long-Term Infrastructure Improvement Plan for its Peoples Division and Equitable Division</i> , Docket Nos. P-2013-2344596 and P-2013-2342745 (Order entered June 30, 2016) | 18 |
| <i>Petition of Peoples Natural Gas Co., LLC for Approval of its Amended Second Revised Long-Term Infrastructure Improvement Plan for its Peoples Division and Equitable Division</i> , Docket Nos. P-2013-2344596 and P-2013-2342745 (Order entered Mar. 10, 2016) | 18 |
| <i>Petition of Peoples Natural Gas Co., LLC for Approval of Limited Waivers of Certain Tariff Rules Related to Customer Service Line Replacement</i> , Docket Nos. P-2013-2346161, <i>et al.</i> (Opinion and Order entered May 23, 2013) | 8, 15, 17-19 |
| <i>Petition of The York Water Co. For an Expedited Order Authorizing Limited Waivers of Certain Tariff Provisions and Granting Accounting Approval to Record Cost of Certain Customer-Owned Service Line Replacements to the Company's Services Account</i> , Docket No. P-2016-2577404 (Order entered Mar. 8, 2017) | 6, 7, 11, 12 |

TABLE OF AUTHORITIES

| | Page(s) |
|---|---------|
| STATUTES AND REGULATIONS | |
| 25 Pa. Code §§ 109.1101 through 109.1108..... | 2 |
| 66 Pa.C.S. § 1351..... | 1, 5 |
| 66 Pa.C.S. § 1357..... | 1, 5 |
| OTHER AUTHORITIES | |
| Cawley, James H. and Norman James Kennard, <i>A Guide To Utility Ratemaking Before The Pennsylvania Public Utility Commission</i> (2018)..... | 16 |

I. BACKGROUND AND HISTORY OF THIS PROCEEDING

This proceeding was initiated on May 22, 2017, when Pennsylvania-American Water Company (“PAWC” or the “Company”) voluntarily petitioned the Pennsylvania Public Utility Commission (“PUC” or “Commission”) to approve its plan (“Replacement Plan”) to replace customer-owned lead Service Pipes (“LSPs”)¹ and recover the associated costs (the “Petition”). In the Petition, PAWC requested that the Commission: (1) approve the tariff revisions set forth in the Supplement to Tariff No. 4, provided as PAWC Exhibit No. 1 to the Petition, which will allow the Company to replace LSPs at its sole cost; (2) authorize the Company to capitalize costs incurred to replace LSPs (“LSP Replacement Costs”) and to record such costs in Account No. 333 – Services for accounting purposes; and (3) affirm that the Company’s investment in capitalized LSP Replacement Costs constitutes “eligible property” for water utilities as defined in 66 Pa.C.S. § 1351 and, therefore, pursuant to 66 Pa.C.S. § 1357, PAWC is entitled to recover a return on, and a return of, such costs through its Distribution System Improvement Charge (“DSIC”).

PAWC’s Petition includes a Replacement Plan with two parts. First, PAWC proposes to proactively remove and replace, with the customer’s consent, LSPs that are encountered when it replaces its mains and Service Lines (“Replacement Plan – Part 1”).² Second, PAWC proposes to remove and replace LSPs when requested to do so by a customer subject to verifying that the

¹ Rules 2.11 and 2.12, respectively, set forth at page 16 of PAWC Tariff Water-Pa. P.U.C. No 4 (“Tariff No. 4”), define a “Service Line” as “[t]he Company-owned piping and appurtenances which run between and are connected to the Company’s main and its street service connection,” and a “Service Pipe” as “[t]hat part of the water line not owned by the Company” that “begins at the Company-owned street service connection and continues into the structure on the premise[s] to be supplied.” Therefore, throughout these Exceptions, the terms “Service Line” and “Service Pipe” are employed in the manner they are defined in Rules 2.11 and 2.12 of Tariff No. 4.

² When PAWC replaces a main, it typically replaces its Service Lines that are attached to that main at the same time. There may also be locations where PAWC, for sound operational reasons, will replace its Service Lines even though it is not replacing its mains. In both of the aforementioned scenarios, PAWC would replace all of the lead Service Pipes it encounters pursuant to its Replacement Plan – Part 1.

customer, in fact, has a LSP (“Replacement Plan – Part 2”). Under Replacement Plan – Part 2, the Company proposes to coordinate customer-requested replacements. Customer requests will be grouped by geographic location, and replacements will be undertaken when the number of customer requests in a given location allows the Company to realize reasonable economies of scale by doing those replacements as a single project. PAWC proposes to set a budget cap of \$6.0 million per year on the amounts expended to replace LSPs pursuant to Part 1 and Part 2 of the Replacement Plan.

The Replacement Plan will help PAWC remove conditions that could expose customers to lead in their drinking water and will help maintain compliance with applicable drinking water regulations. PAWC complies with the Lead and Copper Rule³ (“LCR”) by implementing a number of measures, including effective corrosion control treatment of the water it supplies. The Company has demonstrated that replacing LSPs in conjunction with the Company’s main replacement program is the most cost-effective, efficient, and responsible way to continue PAWC’s main replacement program, while avoiding the health and safety concerns associated with partial lead service line replacements. In addition, proactively replacing LSPs is a prudent and cost-effective way to obtain a higher level of assurance that a source of potential water-borne lead exposure will be eliminated.

II. OVERVIEW

On May 15, 2018, the Commission issued the Recommended Decision of Administrative Law Judge Elizabeth H. Barnes (the “ALJ”). The Recommended Decision, consistent with the

³ 25 Pa. Code §§ 109.1101 through 109.1108.

evidence introduced into the record in this case by the Company and the other parties,⁴ acknowledges the merit in PAWC's proposal to replace customer-owned LSPs that are encountered when replacing its mains and Service Lines as a prudent and efficient means to proactively eliminate potential sources of lead exposure through drinking water and, thus, protect and promote public health and safety.⁵ Indeed, the ALJ recommends that the Commission authorize the Company to revise its Tariff to authorize it to replace customer-owned LSPs.⁶

Despite her recommendation that the Commission authorize the Company to move forward with the replacement of customer-owned LSPs as an initiative that is both prudent and in the public interest, the ALJ rejected the Company's proposal that the investments it makes to replace customer-owned LSPs be treated the same as the capital it invests in other projects to assure safe and reliable service to its customers. Specifically, the Company asked the Commission to affirm that it could capitalize its investment in replacing LSPs; record that investment in an appropriate capital account; amortize or depreciate its investment over a reasonable estimate of its service life; and recover the cost of capital PAWC incurs (i.e., earn a return) on the debt and equity capital it dedicates to making those investments.

Instead, the ALJ recommended accepting proposals made by witnesses for the Office of Consumer Advocate ("OCA") and the Bureau of Investigation and Enforcement ("I&E") that would require the Company to defer the costs it incurs to replace LSPs, amortize those costs over a period of up to ten years beginning in its next base rate case,⁷ and deny PAWC any recognition

⁴ See, e.g., PAWC St. No. 1, pp. 8-14 (describing the prudence of the Replacement Plan); OCA St. No. 1, pp. 11-13 (summarizing the best practices in the industry and agreeing the PAWC's lead-control program should include the full replacement of lead service lines).

⁵ See, e.g., R.D., p. 30.

⁶ R.D., p. 30.

⁷ The ALJ does not recommend a particular amortization period, but rather states that the amortization period should be established in PAWC's next rate base proceeding. R.D., p. 2.

of the cost of capital it unquestionably would bear to carry that investment from the time it is made until it is recovered. As the Company's witness demonstrated, the OCA/I&E proposal would impose upon the Company uncompensated capital costs approximating \$1.5 million and \$2.3 million (based on a five-year or ten-year amortization, respectively) for *each year's investment*.⁸ Over the duration of the Replacement Plan the Company's uncompensated costs would total approximately \$15 million and \$23 million depending on the amortization period. The OCA/I&E proposal is comparable to the Company making a loan of \$60 million for a period of up to ten years at zero interest rate. Under those circumstances, the Company would never recover its costs for a program the objective of which has been lauded by other parties and, for that reason, takes exception to the ALJ's cost-recovery recommendation. And, in that regard, the Company wants to make clear that, given the magnitude of the uncompensated costs the ALJ's cost-recovery recommendation would impose, it would not be in a position to move forward with its voluntary Replacement Plan if that recommendation is adopted by the Commission.

The ALJ has also recommended deviating from the terms of the Company's unitary proposal to voluntarily and proactively address customer LSPs by requiring the Company to compensate customers who previously replaced their LSP outside of its Replacement Plan and by imposing impractical and unrealistic "caps" on the cost of LSP replacements under Part 2 of the Replacement Plan. These recommendations are also the subject of the Company's Exceptions, as explained hereafter.

To a large extent, the errors in the ALJ's recommendations to which the Company takes exception have been addressed in the Company's Initial and Reply Briefs filed on March 1 and 15, respectively, and PAWC urges the Commission to review those Briefs. Consequently, these

⁸ PAWC St. No. 2-R, p. 14; PAWC Exhibit No. JRC-1R.

Exceptions will focus upon the major errors and omissions underlying the ALJ's recommendations on those issues addressed herein.

III. EXCEPTIONS

The Company respectfully notes the following Exceptions to the Recommended Decision:

1. **PAWC May Not Be Directed To File A Tariff Supplement To Implement A Voluntary Program On Terms That PAWC Does Not Accept.** Exception is taken to the recommendation in the Ordering Paragraphs (R.D., p. 34) that PAWC "be directed to file a Tariff Supplement to Tariff Rule No. 5 consistent with the body of the Commission's final decision" in this proceeding.⁹ The proposed Replacement Plan is the Company's voluntary initiative to proactively eliminate customers' potential risk of exposure to lead from customer-owned LSPs. PAWC is not currently in violation of the LCR or under any legal obligation to implement the Replacement Plan. PAWC proposed the Replacement Plan subject to the authorization of certain accounting and rate recovery treatment. In particular, PAWC requested that the Commission: (1) authorize the Company to capitalize LSP Replacement Costs and to record such costs in Account No. 333 – Services for accounting purposes; and (2) affirm that the Company's investment in capitalized LSP Replacement Costs constitutes "eligible property" for water utilities as defined in 66 Pa.C.S. § 1351 and, therefore, pursuant to 66 Pa.C.S. § 1357, PAWC is entitled to recover a return on, and a return of, such costs through its DSIC.¹⁰ While the Commission may grant PAWC permission to file a tariff supplement to implement the Replacement Plan with modifications, it may not

⁹ PAWC notes that language elsewhere in the Recommended Decision (outside of the Ordering Paragraphs) says that PAWC should be granted permission to file a tariff supplement. *See* R.D. at 1, 32.

¹⁰ Petition, pp. 1-2.

compel the Company to implement a voluntary program with terms that the Company does not accept.

2. The York Water Proceeding¹¹ Is Not Precedent, As The Settlement In That Case Expressly Provides. Moreover, The Facts Surrounding York Water's Adoption Of Its Replacement Program In Response To Its Violation Of Safe Drinking Water Standards Were Materially Different From The Voluntary, Proactive Program Proposed By PAWC. The ALJ's Error Was Compounded By Allowing The Possible Consequences For York Water Company To Color And Influence Her Recommendation Regarding PAWC's Petition, Which Should Have Been Based On The Facts In This Case. Exception is taken to the recommendation that the *York Water Order* is controlling precedent and, therefore, all of the same provisions that were adopted by settlement in that case must be imposed on PAWC. Based on that erroneous recommendation, the ALJ further recommended that the Commission: (1) deny PAWC the opportunity to recover a return on and a return of investments made to replace customer-owned LSPs; and (2) require PAWC to compensate customers who had replaced their own LSPs outside of the Replacement Plan.

The ALJ emphasized her reliance on the *York Water Order* as the basis for her recommendations at multiple places in the Recommended Decision. For example, the ALJ avers (R.D., pp. 14-15) that this case is "comparable" to the York Water Company proceeding and, on that basis, recommends (R.D., p. 21) "classifying the incurred cost [for LSP replacements] as a deferred regulatory asset to be amortized consistent with the Commission's decision at York Water." Also, the ALJ inappropriately looked to factors outside the four corners of this case to

¹¹ See *Petition of The York Water Co. For an Expedited Order Authorizing Limited Waivers of Certain Tariff Provisions and Granting Accounting Approval to Record Cost of Certain Customer-Owned Service Line Replacements to the Company's Services Account*, Docket No. P-2016-2577404 (Order entered Mar. 8, 2017) (the "*York Water Order*").

caution the Commission (R.D., p. 23) that, if it approves PAWC's Petition without modification "York Water would then be permitted to file a petition" asking the Commission to consider amending the *York Water Order* to allow York Water to "capitalize" its unrecovered replacement costs.

The settlement approved by the *York Water Order* was expressly conditioned upon the Commission's approval *not* constituting a precedential decision. Unlike this case, York Water had triggered the LCR and was facing penalties if it did not promptly begin replacing both the company-owned and customer-owned segments of lead service lines. York Water's acquiescence to record the costs of replacing customer-owned lead service lines as a "regulatory asset" and to partially compensate customers who replaced their own lead service lines does not dictate the scope of the Company's Replacement Plan or the accounting and ratemaking treatment of the Company's LSP Replacement Costs. In sum, the *York Water Order* should not be considered even persuasive authority – let alone a valid precedent – in this case.

3. LSP Replacement Costs Are Investments Made To Provide Safe And Adequate Water Service. Exception is taken to the recommendation (R.D., p. 21) that the Commission find that the cost of replacing a customer-owned LSP is "akin to an extraordinary cost normally classified as a regulatory asset as opposed to a capitalized cost recovered through PAWC's DSIC."

Long-standing ratemaking principles hold that utilities are entitled to recover their cost of capital on a wide range of investments necessary to fulfill their statutory service obligations and promote public health and safety. There is also clear precedent for capitalizing utility investments in the property of others. First, the Commission has already allowed two gas companies to replace customer-owned service lines made of vulnerable material, capitalize the replacement costs in their

mains account and recover their associated costs, with a return, in base rates and through the DSIC between base rate cases.¹² In addition, PAWC currently capitalizes costs to restore property owned by others, including roadways and customer premises (e.g., sidewalks, driveways and lawns), to its original condition whenever such property is damaged or its serviceability is impaired by the Company's infrastructure replacement and rehabilitation projects.

PAWC infrastructure construction activities disturb customer-owned LSPs and, thereby, impair the serviceability of that property by creating an increased risk of potential lead exposure, as explained in detail in the Company's Initial (pp. 11-14) and Reply (pp. 2-3) Briefs. Thus, LSP Replacement Costs incurred to avoid performing "partial" service lines replacements, which replace the Company-owned portion while leaving the customer's disturbed portion in place, are not distinguishable in any legally cognizable fashion from the restoration of roads, highways or customer property that is damaged by the Company's construction activities. The costs of the latter are properly capitalized to an appropriate property account, and the Company's investment in replacing customer-owned LSP should be afforded the same treatment. Moreover, there is no dispute that the Company's investments to replace customer-owned LSP are made to ensure that customers continue to receive safe and adequate service and to proactively address conditions that have the potential to adversely affect human health and safety.

4. The Commission Should Not Impose A Cost Recovery Cap On Replacement Plan - Part 2 Projects Or Require A Customer Contribution Based On The Cost Of An

¹² *Petition of Columbia Gas of Pennsylvania, Inc. for Limited Waivers of Certain Tariff Rules Related to Customer Service Line Replacement*, Docket No. P-00072337 (Order entered May 19, 2008) ("Columbia Gas Order"), pp. 4-6; *Petition of Peoples Natural Gas Co., LLC for Approval of Limited Waivers of Certain Tariff Rules Related to Customer Service Line Replacement*, Docket Nos. P-2013-2346161, *et al.* (Opinion and Order entered May 23, 2013) ("Peoples Gas Order"), pp. 5-6. Subsequent to the *Peoples Gas Order*, the Commission approved a settlement in which Peoples Natural Gas Company, LLC ("Peoples"), the OCA and other parties agreed that "investments in the replacement of customer-owned service lines will be reflected in the Company's DSIC." *Petition of Peoples Natural Gas Co., LLC*, Docket Nos. P-2013-2344596 and C-2013-2348847 (Order entered Aug. 21, 2014), pp. 5-6 and 42-43.

Individual LSP Replacement. Exception is taken to the recommendation (R.D., pp. 25-26) that the Commission either (1) “deny PAWC cost recovery for Part 2 expenditures that exceed \$3,500 per unit, or the average replacement cost associated with Part 1 projects conducted through the completion date of a given Part 2 project, whichever is greater”; or (2) “require a customer to provide the difference between: a) the cost of replacing the customer’s specific Part 2 lead service line, and b) \$3,500, or the average replacement cost associated with Part 1 projects conducted through the completion date of a given customer’s Part 2 project, whichever is greater.”

The \$3,500 average replacement cost developed by the Company is a composite figure that reflects various Service Pipe diameters and lengths. As such, there will be instances where the Company’s replacement costs are greater than the average unit-cost estimate and other instances where such costs will be less than \$3,500. The Company’s total expenditures on LSP replacements (Part 1 and Part 2) are already bounded by the \$6.0 million budgetary allotment under which Part 1 replacements will have first priority of expenditures. The approach recommended by the ALJ would impose the “average” per-unit Part 1 replacement cost as the upper limit for Part 2 replacements. This would mean that the Company could proceed with replacements that cost the same as, or less than, the “average,” but the Company could not proceed with replacements that exceed the average without shouldering, or seeking a customer contribution for, those costs that are largely driven by site-specific conditions. That treatment is improperly asymmetrical and, therefore, unfair. Also, it could lessen the efficiencies of the Company’s work if it is unable to replace all affected customer-owned LSPs at once.

5. The Partial Compensation Program Is Unnecessary And Would Divert Funds From Eliminating Existing LSPs To Providing A Financial Benefit To Customers Who Had Already Eliminated The Risk Of LSPs. This Recommendation, If Adopted, Would Also

Require The Company To Needlessly Incur Administrative Costs And Expend Resources And, Thereby, Detract From The Company's Ability To Implement Its Replacement Plan Efficiently And Expeditiously. Exception is taken to the recommendation (R.D., pp. 28-29) that the Commission adopt "the OCA's proposal to institute a partial reimbursement program for PAWC customers that replaced their lead Service Pipe within the past four years similar to the one done in *York Water*." The Replacement Plan properly focuses the budgetary allotment on removing and replacing LSPs that remain in service and continue to pose a health risk, while avoiding unnecessary administrative costs and the unnecessary diversion of managerial, administrative and contractor resources.

IV. ARGUMENT

A. The Commission May Not Mandate That PAWC Implement Its Voluntary Replacement Plan Under Terms That PAWC Does Not Accept

The Company *voluntarily* proposed an up to \$60 million Replacement Plan to proactively remove and replace customer-owned LSPs to eliminate a potential source of lead exposure.¹³ PAWC has a well-established history of LCR compliance and, in fact, has not triggered the LCR action level requirements in any portion of its system in the past thirty years.¹⁴ The Replacement Plan was proposed subject to the authorization of certain accounting and rate recovery treatment to ensure that the Company fully recovered Replacement Plan costs, including the cost of debt and equity capital on its investments.

After recommending that the Commission adopt significant changes to cost recovery and Replacement Plan scope, which are addressed elsewhere in these Exceptions, the ALJ further

¹³ PAWC St. No. 1, pp. 8-12.

¹⁴ PAWC St. No. 1, p. 7.

recommends that PAWC “*be directed* to file a Tariff Supplement to Tariff Rule No. 5 consistent with the body of the Commission’s final decision” in this proceeding.¹⁵ PAWC submits that the Commission may not compel the Company to implement a voluntary program with terms that the Company does not accept. In addition, and as previously explained in these Exceptions, given the magnitude of the uncompensated costs the ALJ’s cost-recovery recommendation would impose, PAWC would not be in a position to implement the voluntary Replacement Plan if that recommendation is adopted by the Commission.

B. The York Water Order Is Not Valid Precedent In This Proceeding

The ALJ improperly invites the Commission to view the *York Water Order* as controlling precedent that supports her recommendation to: (1) deny PAWC the opportunity to recover a return on and a return of investments made to replace customer-owned LSPs; and (2) require PAWC to compensate customers who had replaced their own LSPs outside of the Replacement Plan. For example, after averring that this case is “comparable” to the York Water case, the ALJ recommends “classifying the incurred cost [for LSP replacements] as a deferred regulatory asset to be amortized consistent with the Commission’s decision at *York Water*”¹⁶ and adopting “a partial reimbursement program for PAWC customers that replaced their lead Service Pipe within the past four years similar to the one done in York Water.”¹⁷

The ALJ also improperly looks outside the record evidence in this case and cautions the Commission that if it approved PAWC’s Petition without modification “York Water would then

¹⁵ R.D., p. 34 (emphasis added). PAWC notes that language elsewhere in the Recommended Decision (outside the Ordering Paragraphs) says that PAWC should be granted permission to file a tariff supplement. See R.D. at 1, 32.

¹⁶ R.D., pp. 14-15, 21.

¹⁷ R.D., p. 29.

be permitted to file a petition requesting that the Commission: (1) amend its Order approving this Settlement only as it pertains to the rate treatment of such costs to the extent not already collected in rates through the amortization; and (2) permit York Water to capitalize the Phase 1 replacement costs and/or Phase 2 replacement costs to its services account on a going-forward basis to the extent not already collected in rates through the amortization.”¹⁸

It is a long-standing policy of the Commission to not consider settlements as precedent.¹⁹ The express terms of the settlement approved in the *York Water Order* provide that it may not be used as precedent. Additionally, the circumstances in the York Water case were decidedly not “comparable” to this proceeding. As explained earlier in these Exceptions, PAWC has proposed the Replacement Plan as a voluntary and proactive effort. York Water, by contrast, had triggered the LCR and was facing penalties if it did not meet certain regulatory deadlines that required it to promptly begin to replace company-owned and customer-owned lead service lines. In short, time was of the essence. York Water’s willingness to acquiesce to a particular cost recovery method under the exigencies of its case – and recognizing that such acquiescence was part of a matrix of inter-related compromises on all sides – is neither precedential, probative nor even persuasive as to what the proper cost recovery mechanism should be in this case. Furthermore, each case must be decided based on its facts, and the facts in this case are different from those in the York Water

¹⁸ R.D., p. 23.

¹⁹ See, e.g., *HIKO Energy, LLC v. Pennsylvania Pub. Util. Comm’n*, 163 A.3d 1079, 1102–03 (Pa. Cmwlth. 2017), appeal granted, 176 A.3d 235 (Pa. 2017) (stating that “the PUC previously explained that it ‘vigorously, and without equivocation, reject[s] considering a settlement as precedent, as to any subsequent issue, in any proceeding.’ *Pa. Pub. Util. Comm’n v. The Bell Tel. Co. of Pa.*, No. R–811819 (Nov. 10, 1988), 1988 Pa. PUC LEXIS 572 at *19 (emphasis in original). Thus, ‘the [PUC’s] approval of a settlement does not establish legal precedent, because parties frequently waive their legal rights regarding certain issues in a settlement.’ *Customer Assistance Programs: Funding Levels & Cost Recovery Mechanisms*, No. M-00051923, (Oct. 19, 2006), 2006 WL 6610966 (Pa.P.U.C.) at *11.”).

case. Allowing PAWC to recover its cost of capital under its voluntary plan does not mean that the Commission needs to do the same for York Water.

C. PAWC Should Be Permitted To Capitalize LSP Replacements For Accounting Purposes And Recover A Return On, And A Return Of, The Capital It Invests In That Property

As described in the Company's Initial Brief (p. 6), under the Replacement Plan, PAWC proposes to capitalize LSP Replacement Costs up to the annual budget cap of \$6.0 million and include such investment in the Company's rate base in a subsequent base rate case or the Company's existing DSIC for property placed in service between base rate cases. As shown by the undisputed calculations explained in PAWC's Initial Brief (pp. 14, 17, 27), under the Company's proposed accounting and ratemaking treatment, the LSP Replacement Costs would have a negligible effect on customers' bills for water service (i.e., an annual increment of less than 10 cents per month). The Company's Initial (pp. 16-17, 24-25) and Reply (pp. 6-7) Briefs also explained that such proposed accounting and ratemaking treatment is appropriate because PAWC's investment in replacing customer-owned LSPs relates to property physically connected to the Company's Service Lines and eliminates a source of potential customer exposure to lead in drinking water.

Despite emphasizing that proactive investments in customer-owned LSPs are needed to protect the public health,²⁰ I&E and the OCA both oppose the Company's cost recovery proposal, asserting that any LSP replacement costs incurred by PAWC should be deferred through a regulatory asset and amortized without a return or carrying charge.²¹ I&E witnesses Cline and

²⁰ See, e.g., I&E Main Br., p. 8 ("Because the health concerns related to lead are severe, I&E believes that a proactive rather than reactive response is in the best interest of all customers... Therefore, the proposed tariff revision is likely the most expeditious way to address this public health concern as it removes lead pipes for customers who may be unable or unwilling to do so because of monetary constraints.").

²¹ I&E Main Br., pp. 2, 5-6; OCA Main Br., pp. 14-18.

Wilson, as well as OCA witness Rubin, argued that PAWC should not be permitted to recover the cost of capital it must commit to replace customers' LSPs because Service Pipes are customer-owned property. They also argued that York Water agreed to adopt a regulatory asset cost recovery method in the settlement of its Petition to replace lead customer-owned service lines and it would be improper for the Commission to allow a utility to earn a "profit" on investments to protect customers from serious health risks posed by lead exposure.²² The ALJ echoes these arguments in the Recommended Decision, concluding that deferral and amortization is appropriate because LSP Replacement Costs are not utility plant but rather investments "for the benefit of the pipe owner and not the general customer base"²³ and that the Company would be mindful of lower-cost approaches to address the replacement of LSPs when it had "no profit motive."²⁴

These arguments were fully addressed, and refuted, in PAWC's Initial (pp. 16-30) and Reply (pp. 6-18) Briefs. PAWC will emphasize a few key points below to explain why the reasoning of the ALJ, OCA and I&E fails to justify disregarding PAWC's actual cost of capital in establishing a legally valid method of cost recovery for LSP replacements.

1. The Contention That Customer-Owned Lead Service Pipes Are Not Utility Plant And Therefore May Not Earn A Return Is Contrary To Commission Precedent

The ALJ, I&E and OCA all assert that PAWC should not be allowed to recover its cost of capital because it is replacing customer-owned property.²⁵ This argument is totally undercut by prior Commission precedent. As explained in the Company's Initial (pp. 18-21) and Reply (pp.

²² See I&E St. Nos. 1, pp. 7-10; 1-SR, pp. 7-11; 2, pp. 2-4 & 2-R, pp. 4-8; OCA St. Nos. 1, pp. 10-23 & 1-SR, pp. 4-8.

²³ R.D., p. 14.

²⁴ R.D., p. 24.

²⁵ R.D., pp. 13-25; I&E Main Br., pp. 10-15; OCA Main Br., pp. 18-23.

9-10) Briefs, the Commission has already allowed two gas companies to replace customer-owned service lines made of vulnerable material, capitalize the replacement costs in their mains account and recover their associated costs, with a return, in base rates and through the DSIC between base rate cases. Consequently, there is no legal impediment to a utility recovering its cost of capital when, in replacing its own property, it must invest in the replacement or restoration of adversely-affected customer-owned property. And, as the Commission recognized in the gas cases, the replacement of customer-owned service lines in conjunction with utility main replacement work facilitates main replacements and, in that way, provides system-wide benefits to all customers of the utility.²⁶ The same is true here.

Despite the holdings in the *Columbia Gas* and *Peoples Gas* cases, the ALJ, I&E and OCA assert that the Commission should ignore the capital costs of funds PAWC will dedicate to the Replacement Plan because customer-owned LSPs serve only one customer and, therefore, are not dedicated to “public” use or service.²⁷ However, the same is true for gas service lines, and the Commission determined that costs to replace gas service lines made of vulnerable material (even if they did not pose an imminent threat to safety) should be included in rate base and be recoverable through the DSIC. There are several additional reasons why the contentions concerning a single customer benefit are unavailing.

First, there are many differences in the nature and cost of utility plant used to serve particular customers in different locations. For example, some customers live at elevations that require booster pumping while others live great distances from sources of supply and treatment

²⁶ See *Columbia Gas Order*, p. 5 (“The OCA agrees that by granting the waivers, Columbia will be able to efficiently and timely coordinate replacement of the service lines which will *minimize disruptions of service to all of Columbia’s customers*.”(emphasis added)).

²⁷ R.D., p. 14; I&E Main Br., pp. 10-11; OCA Main Br., pp. 18-19.

and use more of the distribution system to obtain service. All of these factors result in the cost to serve individual customers or groups of customers varying materially from each other and from the average. In fact, many of those existing cost differences could actually exceed LSP replacement costs. The Commission, nonetheless, uses average system-wide costs to develop rates and does not attempt to reflect variations in costs between and among individuals within a single class.²⁸

Second, *Company-owned* Service Lines also serve only one customer rather than the “public” generally. However, no one disputes that the Company’s expenditure to replace its Service Line – which is functionally part of a single property unit that, together with the customer’s Service Pipe, creates the service connection from the main to the customer’s premises – represents a public utility investment needed to furnish service to customers, should be capitalized, and may be included in rate base. In addition, and as discussed in Section IV.C.2 of these Exceptions, PAWC regularly makes investments to restore the property of an individual customer, and such investments are also capitalized.

Third, and directly contrary to the contentions of the ALJ, OCA and I&E, the Replacement Plan will provide benefits to individuals who do not own the LSP as well as system-wide benefits to all customers. The Replacement Plan is not restricted to residential customers, and therefore LSP Replacement Costs may be incurred to reduce potential lead exposure risk at a daycare, school or restaurant, clearly benefiting more than just the customer-owner. Additionally, while PAWC has not triggered the LCR, by removing the entire lead service line from active operation, a source

²⁸ Cawley, James H. and Norman James Kennard, *A Guide To Utility Ratemaking Before The Pennsylvania Public Utility Commission* (2018), p. 142 (“Each individual customer imposes a different combination of costs on the system, and the cost to serve is unique to each. Ideally each customer should be on a separate tariff reflecting those costs, but such a solution is administratively infeasible. Thus, customers . . . are grouped together as a customer class, and tariffs are designed to recover the cost of serving the class.”).

of lead will be removed, further reducing the potential for exposure to lead in the drinking water supplied to customers, and supporting the Company's continued compliance with the LCR. In fact, as OCA witness Rubin has testified,²⁹ comprehensive replacement of company-owned and customer-owned segments of lead service lines will likely become a legal requirement soon – perhaps as early as 2018. Avoiding the incrementally greater costs (and potential penalties) that would result if PAWC did not act proactively to do what Mr. Rubin has reasonably determined the law will soon require is a system-wide benefit to all customers. Additionally, as explained in PAWC's Initial Brief (pp. 23-24), the Replacement Plan will avoid contractor delays and inefficiencies (which would materially increase the cost of PAWC's infrastructure improvement program) that would undoubtedly result if that work had to wait for individual customers to replace their LSP at their own cost in coordination with the Company's main replacements. Those cost efficiencies for main replacement projects clearly are a public benefit for all customers.

Finally, the ALJ attempts to distinguish the cost recovery findings of the *Columbia Gas Order* and *Peoples Gas Order* on two additional grounds: (1) the gas companies owned some service lines up to the customers' meters, and PAWC does not; and (2) the gas cases involved "emergency replacement" of vulnerable service lines, while the Company's LSPs are "less of an immediate threat."³⁰ Neither serves as a proper basis to prevent PAWC from recovering its costs of capital for the Replacement Plan. First, mixed utility/customer ownership of service lines was not dispositive to the cost recovery approved in either gas case. In the portion of the *Peoples Gas Order* addressing the service line replacement petition, Altoona and Johnstown (the cities where Peoples owned service lines) were simply noted as part of the background discussion.³¹ In

²⁹ OCA St. No. 1, pp. 5-12.

³⁰ R.D., p. 19.

³¹ *Peoples Gas Order*, p. 6.

approving the petition, the Commission did not rely upon equity concerns between Altoona/Johnstown customers and other customers, but rather the public interest served by replacing customer-owned service lines when replacement was required as a result of the Company's main replacement and upgrade plan.³² In the *Columbia Gas Order*, the Commission stated that it was "troubled" by Columbia not owning and maintaining the new gas lines in light of safety issues, such as customer-owned lines not being properly mapped and marked, and noted general "equitable concerns" when some customers owned lines and some did not.³³ However, citing the language of Section 1510 of the Public Utility Code, the Commission granted Columbia's request to replace customer service lines but not take ownership of them.³⁴ Consistent with the *Peoples Gas Order*, the Commission found the replacement of the customer-owned service lines at the utility's expense was in the public interest because the replacements were prompted by Columbia's main replacement and upgrade program.³⁵ The public interest finding was not based on equity concerns between customer groups.

The "immediacy" of the public health threat caused by vulnerable gas lines is also not a proper basis for distinguishing this case from the circumstances in the *Columbia Gas Order* and *Peoples Gas Order*. Citing to the Main Brief of I&E, the ALJ summarizes her reasoning as follows: "a vulnerable natural gas line represents a clear and present danger to not only the consumer/customers but also to his/her neighbors; whereas, a lead customer-owned service pipe is less of an immediate threat to public health and safety as it affects only the consumers at the

³² *Peoples Gas Order*, pp. 9-10.

³³ *Columbia Gas Order*, pp. 4-5.

³⁴ *Columbia Gas Order*, p. 5.

³⁵ *Id.*

dwelling.”³⁶ This argument is belied by I&E’s own admission throughout its Main Brief (pp. 2, 5, 7-9) that lead exposure through drinking water is a “significant” public health concern. Moreover, as explained in PAWC’s Initial Brief (p. 20), the adverse impact on human lives of lead exposure is well-recognized, as the Commission has previously indicated in the York Water proceeding. In addition, and as discussed earlier, the Replacement Plan is not restricted to residential customers, and therefore LSP Replacement Costs may be incurred to reduce lead exposure risk at a public place such as a daycare, school or restaurant. Finally, in the *Peoples Gas* case, the Commission extended its approval of rate base/DSIC rate treatment to *all* customer service lines made of vulnerable material, even if those lines passed the requisite pressure test and did not pose an imminent risk of failure.³⁷

2. Commission Precedent Supports The Capitalization Of Investments In Customer-Owned Property

The Recommended Decision did not address the Company’s discussion of why its proposal to recover Replacement Plan costs is consistent with the manner in which restoration costs are currently recovered. As explained in its Initial (pp. 22-24) and Reply (pp 15-16) Briefs, the Company routinely capitalizes costs for property that the Company does not own that is impacted by its infrastructure construction activities. For example, costs to restore roadways and customer premises (e.g., sidewalks, driveways and lawns) to their original condition are capitalized and booked to the Company’s property account for its underlying capital project even though the road,

³⁶ R.D., p. 19.

³⁷ *Petition of Peoples Natural Gas Co., LLC for Approval of its Amended Second Revised Long-Term Infrastructure Improvement Plan for its Peoples Division and Equitable Division*, Docket Nos. P-2013-2344596 and P-2013-2342745 (Order entered Mar. 10, 2016), pp. 24-25; *see also* *Petition of Peoples Natural Gas Co., LLC for Approval of its Amended Second Revised Long-Term Infrastructure Improvement Plan for its Peoples Division and Equitable Division*, Docket Nos. P-2013-2344596 and P-2013-2342745 (Order entered June 30, 2016) (approving Peoples’ second revised LTIP to include replacement of all “at risk” customer owned service lines).

sidewalk, driveway or lawn that PAWC restores remains the property of the municipality or customer. I&E disagrees that LSP Replacement Costs are analogous to restoration costs, asserting that the latter are an “essential, unavoidable cost that is directly associated with the installation, repair or replacement of Company-owned property.”³⁸ Applying I&E’s own standard, however, LSP Replacement Costs qualify for inclusion in rate base. As explained in PAWC’s Initial Brief, when replacing Company-owned Service Lines, the Company adversely impacts the adjacent customer-owned LSPs by creating conditions that could promote the leaching of lead into the water passing through the pipes and increases the risk of potential exposure to lead.³⁹ Therefore, the potential elevated risk of lead exposure on the customer’s property that is impacted by PAWC’s construction activities should be addressed by the Company, which can only be done by replacement of the customer-owned LSPs. Likewise, it is appropriate to book the cost of remediating the adverse impact to the customer’s property to the Company’s capital project that caused the potential increase in risk of lead exposure – just as PAWC does with road restoration and with repairs to customer property damaged by other aspects of infrastructure improvement work.

3. The “Cost Sharing” Approach Recommended By The ALJ Is Unsupported And Does Not Compensate PAWC’s Investors For Their Capital Committed To Protect Public Health

OCA and I&E claimed that the Company should not recover its cost of debt and equity capital (which they chose to characterize as “profit”) on its investments in LSP replacements. I&E recommended that any LSP replacement costs incurred by PAWC be deferred through a regulatory

³⁸ I&E Main Br., p. 12 (quoting OCA St. No. 1-SR, p. 5).

³⁹ PAWC Initial Brief, p. 23.

asset and amortized over a period of ten years without a return or carrying charge.⁴⁰ Similarly, OCA proposed that the Commission authorize the Company to establish a regulatory asset and determine the ratemaking treatment of those deferred costs in its next rate case but preclude recovery of a return or other carrying charge in this case.⁴¹ Both I&E and the OCA believe that PAWC shareholders should bear a significant portion of the cost burden of LSP replacements by forgoing a return on their investment.⁴² The ALJ agreed with OCA and I&E on this issue, recommending that the cost be treated as a deferred regulatory asset to be amortized over a period to be established in PAWC's next base rate proceeding. The ALJ further reasoned that the Company "should still have a financial incentive to replace customer-owned lead pipes" and that "with no profit motive" the Company would have no disincentive to use lower-cost approaches that proved workable.⁴³ The Commission should reject this "cost-sharing" approach as unreasonable and contrary to well-established principles of ratemaking.

First, the amortization method of cost recovery does not compensate the Company for committing its capital for LSP replacements for extended periods of time (ten years in I&E's proposal) before that expense is recovered in rates. The recommended disallowance of a return on the unamortized balance of PAWC's investment in LSP replacements would require the Company to obtain debt and equity financing to support its annual investment of \$6.0 million each year of the Replacement Plan, but would force it to bear the costs it unquestionably incurs to deploy that capital. As explained by PAWC witness Cox, the present value of the revenue streams from a

⁴⁰ I&E St. Nos. 2, pp. 2-4 & 2-SR, pp. 4-8.

⁴¹ OCA St. No. 1, pp. 13-18, 20-23.

⁴² I&E St. Nos. 2, p. 4 & 2-SR, pp. 6-7; OCA St. Nos. 1, pp. 15-18, 22-23 & 1-SR, pp. 7-8.

⁴³ R.D., p. 24. The ALJ also states (R.D., p. 20) that she was unaware of any other states that require water utilities to receive a return on 100% of their costs of replace customer owned LSPs. PAWC notes that Indiana recently passed legislation (H.B. 1519) that permits public water utilities to seek to include customer lead service improvements as eligible infrastructure improvements for purposes of their infrastructure improvement charges.

five-year and ten-year amortization of an assumed LSP replacement cost of \$2,500 per customer (the same value modeled by OCA witness Rubin) with an annual investment of \$6.0 million per year results in time value losses of approximately \$1.5 million and \$2.34 million, respectively. Furthermore, the Company would experience an uncompensated loss of those magnitudes for each year's investment over the ten-year duration of its Replacement Plan.⁴⁴

The need to compensate utilities for committing their capital to pay expenses between the time expenses are incurred to furnish service and the time a utility recovers those expenses in revenues from customers is well-established. That ratemaking concept is embodied in the cash working capital allowance that is calculated, and included in rate base, in every utility base rate case. The cash working capital allowance recognizes that when a utility expends funds, even for the payment of an expense, before that expense is recovered in rates, there is a cost to the utility equal to its pre-tax average cost of capital.⁴⁵ Clearly, the ALJ's recommendation that would amortize the Company's investment over a prospective, multi-year period but disregard the capital carrying cost on the unrecovered balance is unreasonable and contrary to well-established principles of ratemaking.

The ALJ agrees with the arguments of I&E and OCA that LSP Replacement Costs are "atypical and non-recurring" and the Commission has historically required such costs to be excluded from cash working capital calculations and amortized over a multi-year period without carrying charges.⁴⁶ This argument fails for several reasons. First, a program requiring regular annual expenditures of \$6.0 million for ten years is not "atypical and non-recurring." Moreover,

⁴⁴ PAWC St. No. 2-R, p. 14; PAWC Exhibit No. JRC-1R. While the ALJ correctly notes that these values are estimates (R.D., pp. 23-24), the fact that the exact time value loss is not known does not make the ALJ's cost recovery approach consistent with well-established principles of ratemaking.

⁴⁵ PAWC St. No. 2-R, pp. 11-13.

⁴⁶ R.D., p. 21; *see also* I&E St. No. 2-R, pp. 7-8; OCA St. No. 1, pp. 15-16.

the OCA and I&E are simply wrong in their statement of the kinds of expenses the Commission has historically required to be amortized without reflecting carrying charges at a utility's cost of capital, as PAWC witness Cox explained⁴⁷:

The Commission requires expenses to be amortized when they are reasonable and prudently incurred, occur on a regular basis, but do not recur annually (i.e., they – or similar types of costs – recur over intervals that exceed – or are expected to exceed – one year.) The unamortized balances of those types of expenses are not included in a cash working capital allowance because the amortization is done to try to match more closely the recovery period with the actual incurrence of the expense. To illustrate, if a certain study may be required on an approximately five-year basis, the anticipated cost would be reflected by a five-year amortization. Because the utility would recover some portion of that cost in advance of when the next study is prepared and the balance after the next study is completed, on balance there is an approximate match of the timing of cost-incurrence and cost-recovery over the multi-year period encompassing the amortization. But, that is not the case here.

The Replacement Program requires expenditures of approximately \$6 million each year for ten years. A ten-year amortization does not, in any way, match cost-recovery with cost-incurrence. Instead, for the reasons I previously discussed, the Company would have to commit its funds for an extended period of time with no recognition of the capital costs of the underlying financing that the amortization method of recovery would impose.

For all these reasons, the Commission should reject the ALJ's recommendation that PAWC not be permitted to recover its cost of debt and equity capital on its investments in LSP replacements.

⁴⁷ PAWC St. No. 2-R, pp. 12-13.

D. The Replacement Plan As Proposed By PAWC Appropriately Dedicates Investment To Address The Potential Health Risk Posed By Lead

1. The Proposal To Cap Investment In Replacement Plan - Part 2 Projects Is Unnecessary, Would Divert Funds From Eliminating The Risk Of LSP, Will Result In Asymmetrical Treatment Of Customers Facing A Lead Health Risk, And Will Impair Replacement Plan Efficiency

The Recommended Decision accepts the Office of Small Business Advocate's ("OSBA") proposal to impose a spending cap on Replacement Plan - Part 2 projects. The OSBA does not oppose Replacement Plan – Part 2 within the parameters proposed by the Company, so long as PAWC does not seek rate recovery of replacement costs that exceed the greater of \$3,500 per unit or the average per-unit replacement cost under Part 1.⁴⁸ The concerns expressed by the ALJ and OSBA regarding what they characterize as "excess" replacement costs are overstated in light of the \$6.0 million budgetary allotment under which Part 1 replacements will have first priority of expenditures. PAWC has also committed to take affirmative steps to capture economies of scale to help assure that, on average, Part 2 costs do not exceed those for Part 1.⁴⁹ The Company also proposed to independently track customer-owned LSP replacement costs under both Parts of the Replacement Plan and report those costs in its quarterly DSIC filings.⁵⁰ Based on those reports, the OSBA and other parties can determine whether the average per-unit replacement costs are comparable under both Parts of the Replacement Plan. The issue of whether costs of specific investments in LSP replacements are reasonable and prudently-incurred can also be reviewed and addressed in base rate cases or DSIC filings when actual LSP replacement costs are claimed for

⁴⁸ OSBA St. Nos. 1, pp. 3-4 & 1-SR, pp. 2-3.

⁴⁹ See PAWC Initial Br., p. 14; PAWC St. No. 1-R, pp. 13-14.

⁵⁰ PAWC St. No. 1-R, p. 14.

recovery. In sum, additional cost controls on Replacement Plan – Part 2 projects are simply unnecessary.

The spending cap would also be detrimental to the purpose and administration of Part 2 of the Replacement Plan. First, the cap would make it difficult for the Company to proactively remove LSPs in areas where there is no ongoing main and Service Line replacement work by PAWC because of the additional administrative costs and project delays associated with seeking a customer contribution⁵¹. Second, the cap would result in asymmetrical treatment of customers facing a potential health risk due to an LSP, which hinders the “economies of scale” sought by the ALJ and OSBA for Part 2 replacements.⁵² The \$3,500 average replacement cost developed by PAWC reflects various LSP diameters and lengths. As such, there will be instances where the Company’s replacement costs are greater than the average unit-cost estimate and other instances where such costs will be less than \$3,500.⁵³ The recommended spending cap means that once a sufficient grouping of Part 2 replacement requests have been received, lower-cost Part 2 replacements in the area can be completed, but the Company cannot proceed with replacements that exceed the average without shouldering, or seeking a customer contribution for, the additional costs that are largely driven by site-specific conditions.⁵⁴ This will lead to customers with LSPs receiving asymmetrical treatment and the overall efficiency of Replacement Plan – Part 2 efforts will be harmed.

⁵¹ PAWC St. No. 1-R, pp. 13-14.

⁵² R.D., p. 25 (Citing Exh. OSBA-I-1(b) and OSBA Main Br., pp. 2-5).

⁵³ PAWC Initial Br., p. 6.

⁵⁴ PAWC Initial Br., p. 14.

2. The Partial Compensation Program Is Unnecessary And Takes Focus Away From Addressing The Potential Health Risk Posed by Lead

The Recommended Decision accepts the OCA's proposal to include a partial compensation program for customers who have recently replaced a customer-owned LSP at the customer's expense.⁵⁵ Specifically, the OCA recommends that the Company offer a sliding scale of reimbursement to customers who paid for their own LSP replacement between 2014 and the first quarter of 2018.⁵⁶ Citing 66 Pa.C.S. § 1304, concerning discrimination in rates, the ALJ agreed with the OCA that failure to include such a program "creates equitable concerns regarding discrimination within a class of customers."⁵⁷

The OCA's proposal should not be adopted for several reasons. First, the allotment of \$6.0 million per year for both parts of the Replacement Plan, which no party has opposed, will mitigate the impact of the Replacement Plan on customer rates. Assuming the full allotment was spent, PAWC estimates a cost of \$1.24 per year per average customer.⁵⁸ Second, the proper focus of the \$6.0 million budgetary allotment should be on LSPs that remain in service and that continue to pose a potential health risk. Third, the compensation program would add complexity to the administration of the Replacement Plan and the associated expense will have to be recovered from all customers. Finally, the Company anticipates a small number of customers would qualify for reimbursement and, in any event, there will be other customers who replaced their LSPs at their own cost prior to the four-year look-back period proposed by the OCA.⁵⁹

⁵⁵ R.D., pp. 27-29; OCA St. Nos. 1, pp. 23-24 & 1-SR, pp. 3-4.

⁵⁶ OCA St. Nos. 1, pp. 23-24 & 1-SR, pp. 3-4.

⁵⁷ R.D., pp. 27-29.

⁵⁸ PAWC Exhibit No. 2.

⁵⁹ PAWC St. No. 1-R, pp. 17-18.

V. CONCLUSION

For all the reasons discussed above and in the Company's Initial and Reply Briefs, the Company's Exceptions should be granted.

Respectfully submitted,



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