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November 5, 2018

Via Electronic Filing

Rosemary Chiavetta, Secretary
PA Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Re: Pennsylvania Public Utility Commission v. Pennsylvania-American Water Company
Docket Nos. R-2018-3002502 and R-2018-3002504

Dear Secretary Chiavetta:

Enclosed for electronic filing please find Pennsylvania Builders Association's Main Brief with regard to the above-referenced matter. Copies to be served in accordance with the attached Certificate of Service.

Sincerely,

A handwritten signature in cursive script that reads "Kristine E. Marsilio".

Kristine E. Marsilio

KEM/lww
Enclosure

cc: Hon. Marta Guhl w/enc.
Cert. of Service w/enc.

CERTIFICATE OF SERVICE

I hereby certify that this day I served a copy of Pennsylvania Builders Association's Main Brief upon the persons listed below in the manner indicated in accordance with the requirements of 52 Pa. Code Section 1.54.

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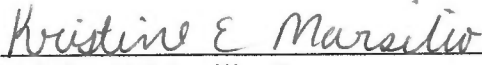
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Dated: November 5, 2018



Kristine E. Marsilio, Esq.

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission

v.

Pennsylvania-American Water Company

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R-2018-3002502

Pennsylvania Public Utility Commission

v.

Pennsylvania-American Water Company
Wastewater Division

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R-2018-3002504

**MAIN BRIEF OF THE
PENNSYLVANIA BUILDERS ASSOCIATION**

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I. INTRODUCTION

Customer Advances (“Advances”) and Contributions in Aid of Construction (“CIAC” or “Contributions”) refer to money or property that a developer, or potential customer, contributes or advances for the development of main and service line extensions to expand utility services to new customers or locations. The Tax Reform Act of 1986 provided that advances and contributions were to be considered taxable income to regulated utilities. On August 18, 1988, the Commission instituted a generic investigation to examine the proper accounting and ratemaking treatment of the income taxes imposed on Advances and Contributions. After receiving Comments from regulated utilities and other interested parties, the Commission issued its Final Order in that investigation on June 14, 1989. *Investigation of Accounting and Ratemaking Associated with Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, Opinion and Order (June 14, 1989) (“1989 CIAC Order”). In the *1989 CIAC Order*, the Commission held that the CIAC issue requires a uniform but flexible policy that “creates neither unreasonable rates nor financial burden, that assigns cost to those who will reap benefits and at the same time helps maintain an environment in the Commonwealth that is conducive to economic development and the growth of commerce.” *1989 CIAC Order* at 57. The Commission concluded that adoption of the no gross-up method is appropriate if the no gross-up method will provide a benefit in the form of economic development. *See 1989 CIAC Order* at 24.

In 1996, water and sewer utilities became exempt from taxable CIAC as a result of the passage of the Small Business Job Protection Act. The Federal Tax Cuts and Jobs Act (“TCJA”), signed into law on December 22, 2017, eliminated the exemption for water and sewer utilities from recognizing CIAC as federal taxable income. Pursuant to Pennsylvania’s Corporate Net Income Tax, CIAC are now recognized as state taxable income as well.

After nearly 30 years of water and wastewater utilities being exempt from taxable CIAC, the reestablishment of this requirement raises the issue of how these utilities will recover this expense. While utilities have various options for recovery, generally the options fall into one of two categories: 1) a “no gross-up” method, or 2) a “gross-up” method.

Under the “no gross-up” method, (also called the “utility finance” or “socialization” method), the utility pays the tax and then adds that amount to its rate base, allowing the utility to earn a return on the amount, which decreases as the asset is depreciated. Essentially, the utility finances the payment of the tax expense and gets reimbursed through rates over the life of the CIAC asset.

Under a “gross-up” method, the tax, or a portion thereof, is recovered by the developer or potential customer by “grossing up” the CIAC to reflect the amount of tax that the utility will be required to pay. Under this method, the asset is also depreciated for tax purposes. As the asset is depreciated, the utility will either remit the savings resulting from the annual depreciation back to the developer as those savings are realized, *or* the discounted present value of those future savings will be netted out of the original gross-up amount (the “discounted gross-up method”).

Through this case, Pennsylvania American Water Company (“PAWC”) seeks to affirm and memorialize how the income tax on Advances and Contributions will be calculated and recovered in rates in light of the recent changes in Federal law. Specifically, the PAWC seeks Commission approval to adopt the no gross-up method of recovery.

The Pennsylvania Builders Association (the “PBA”) fully supports the adoption of the no gross-up method. PAWC’s proposal is just and reasonable, consistent with reasonable ratemaking policy, and is in the public interest. The no gross-up method provides a public benefit, as it is “conducive to economic development and the growth of commerce.” The no gross-up method encourages the construction of new developments in the PAWC service territory and encourages

the use of public water supply, rather than private wells or septic tanks. Existing customers will also benefit from the adoption of the no gross-up method, as it will result in more customers with whom to spread the cost of maintaining PAWC's water and wastewater systems.

While PAWC's request to institute the "no-gross up" method should be approved, should the Commission reject this position and adopt the gross-up method, the PBA urges the Commission to adopt the "discounted gross-up method." Adoption of a discounted gross-up method, as opposed to a full gross-up method, will result in a lower, upfront cost charged to developers, which may help to reduce the potential, significant consequences that the gross-up method may have on economic development and will be easier to administer.

As such, and as explained in more detail below, the PBA respectfully requests that the Pennsylvania Public Utility Commission (the "Commission"): 1) grant the filings of PAWC at Docket Nos. R-2018-30002502 (water) and R-2018-3002504 (wastewater) related to the recovery of the income tax of Advances and Contributions; and 2) order that PAWC utilize the "no gross-up" method to recover costs associated with the taxation of Advances and CIAC. However, if the Commission adopt a gross-up method, the PBA urges the Commission to adopt the "discounted gross-up method."

II. PROCEDURAL HISTORY

On June 5, 2018, PAWC filed Supplement No. 6 to its Tariff Water-Pa P.U.C. No. 5 and Supplement No. 6 to its Tariff Wastewater-Pa P.U.C. No. 16 (collectively, "Supplement No. 6"), both to become effective August 4, 2018. In its filings, PAWC sought to affirm and memorialize how the income tax of Customer Advances and Contributions in Aid of Construction ("CIAC") will be calculated and recovered in rates in light of recent changes in Federal law.

The Commission's Bureau of Investigation and Enforcement filed a Formal Complaint on July 24, 2018, and the Office of Consumer Advocate filed a Notice of Intervention on July 25, 2018.

By Order dated August 2, 2018, Supplement No. 6 was suspended by operation of law until February 4, 2019, unless otherwise directed by Order of the Commission. The Commission assigned this matter to the Office of Administrative Law Judge, which was further assigned to Administrative Law Judge Marta Guhl ("ALJ Guhl").

Telephonic Prehearing Conferences in these matters were held on August 29, 2018, at which time a procedural schedule was established. On August 31, 2018, PAWC filed a Motion to Consolidate the water and wastewater proceedings.

Pursuant to the procedural schedule in this proceeding, PAWC served Direct Testimony on September 24, 2018. The PBA and the Commission's Bureau of Investigation and Enforcement (I&E") served Direct Testimony on October 4, 2018. On October 11, 2018, PAWC, the PBA, and I&E served Rebuttal Testimony, and on October 18, 2018, the PBA and I&E served Surrebuttal Testimony. ALJ Guhl granted PAWC's Motion to Consolidate by way of Order dated October 19, 2018.

The parties agreed to waive cross-examination of all witnesses in this matter, and requested that the testimony be moved into the record by stipulation and motion of the parties. Accordingly, ALJ Guhl cancelled the evidentiary hearing in this proceeding by Order dated October 24, 2018. Also on October 24, 2018, ALJ Guhl issued a Briefing Order, requiring the parties to file Main Briefs no later than November 5, 2018 and Reply Briefs no later than November 15, 2018. In accordance with ALJ Guhl's Briefing Order, the PBA submits this Main Brief.

III. APPLICABLE LEGAL STANDARDS

Section 1302 of the Public Utility Code provides that every rate made, demanded, or received by a public utility must be just and reasonable and in conformity with Commission rules and regulations. 66 Pa. C.S. § 1301. Rates charged by regulated public utilities reflect, among other things, annual taxes paid both to the federal and state governments. *See* 66 Pa.C.S. § 1301.1. All regulated utilities are required to file with the Commission their tariffs showing all rates established, collected or enforced. 66 Pa. C.S. § 1302. The public utility has the burden to show that all rates are just and reasonable. 66 Pa. C.S. § 315. The Commission has broad discretion and authority in determining what expenses incurred by a utility may be charged to the ratepayers. *Barasch v. Pa. Public Utility Commission*, 507 Pa. 561, 566, 493 A.2d 653, 655 (1985). Once approved, the tariff provisions are legally binding on both the utility and its customers. *Brockway Glass Co. v. Pa. Public Utility Commission*, 437 A.2d 1067, 1070 (Pa. Cmwlth. 1981).

In its *1989 CIAC Order*, the Commission set the standard for how utilities were to recover the tax expense associated with Advances and Contributions. The Commission held that the CIAC issue requires a uniform but flexible policy that "creates neither unreasonable rates nor financial burden, that assigns cost to those who will reap benefits and at the same time helps maintain an environment in the Commonwealth that is conducive to economic development and the growth of commerce." *1989 CIAC Order* at 57. The Commission concluded that adoption of the no gross-up method was appropriate if the no gross-up method will provide a benefit in the form of economic development, stating:

[Regarding utility industries] which have the potential to provide a 'public benefit' in the form of economic growth, a methodology that promotes such growth should be available. Such a methodology is necessary, therefore, even if existing ratepayers share in the costs associated with the new plant. [A method] in which deferred taxes associated with a contribution or advance are added to rate base fulfills both requirements of promoting competition and economic

growth. It requires only the base contribution or advance and shares the burden of taxes with current ratepayers who may also share in the “public benefits” inherent in the increased economic growth.

Id. at 24. The Commission further held that “there may be room for the sharing of the additional tax costs even though the new plant is not directly used to the benefit of existing ratepayers.”

As an example of a situation in which sharing of costs may be appropriate, the Commission provided that many water utility extension projects involve the construction of upgraded mains and other such “backbone facilities” that benefit current customers, as well as the contributor and new customers. The Commission held that cost sharing may also be appropriate if a new user will provide a “public good” that will benefit the existing community at large, including current ratepayers. The Commission explained that a “public good” could take the form of increased jobs for the area, or even general economic development. *1989 CIAC Order* at 22. As such, it is appropriate for PAWC to adopt the no gross-up method if doing so will provide a benefit in the form of economic development and/or a benefit to the existing community at large.

IV. ARGUMENT

a. PAWC’s Proposal

The Company’s proposal to adopt the “no gross-up method” to recover the tax expense associated with Contributions and Advances should be approved by the Commission. Pursuant to the Company’s proposal, PWAC will absorb the tax, and then spread the cost to all customers through the ratemaking process. PAWC has proposed to record the income taxes in a segregated, deferred account for inclusion in rate base in a future rate case proceeding, which will reduce its Accumulated Deferred Income Tax (“ADIT”) liabilities in future base rate cases. Under the Company’s proposal, PAWC will treat the facilities funded by CIAC as depreciable assets, although the Company will not record this future tax depreciation when calculating tax expense in future base rate cases. As explained by PAWC witness Mr. John R. Cox in his Direct Testimony,

the future tax depreciation will cause the deferred tax asset to reverse over the tax life of the depreciable asset and increase net ADIT liabilities, as the additional tax depreciation is realized. The future tax depreciation will provide a benefit to PAWC in the form of depreciation deductions. In other words, the Company will be compensated for the time lag between its payment of income taxes on CIAC and the future recovery of those amounts when depreciation deductions are recognized by the increase in rate base that results from treating the deferred amount as a deferred tax asset that offsets ADIT. The timing difference will be normalized by reflecting the deferred amount in rate base. PAWC St. No. 1 at 5, PAWC Exh. No. 3; *see also* PBA St. 1 at 3-4.

b. The no gross-up method is just and reasonable, consistent with reasonable ratemaking policy, and is in the public interest.

The evidence of record in this proceeding demonstrates that the no gross-up method proposed by PAWC is just and reasonable, consistent with reasonable ratemaking policy, and is in the public interest. In the *1989 CIAC Order*, the Commission provided that the issue of CIAC requires a flexible policy that assigns costs to those who reap benefits and maintains an environment that is conducive to economic development. The *1989 CIAC Order* set the standard that the no gross-up method is appropriate if it will provide a benefit in the form of economic development and/or benefit the existing community at large. *Id.* at 22, 24, 57. As water and wastewater utilities have been exempt from taxable CIAC for nearly thirty years, it is appropriate for the Commission to evaluate whether the adoption of the no gross-up method by water and wastewater utilities today is appropriate under the standard established in the *1989 CIAC Order*.

The PBA submits that the evidence of record in this proceeding demonstrates that adoption of the no gross-up method is appropriate. Today, certainly, water and sewer utilities provide a public benefit in the form of economic development and benefit the community at

large.¹ To support the PBA's position that adoption of the no gross-up method provides a public benefit and is essential for economic development, the PBA filed the Direct, Rebuttal and Surrebuttal Testimonies of Mr. Daniel Durden, an expert with vast experience in the building community who currently serves as the Chief Executive Officer of the PBA, a trade association primarily representing the interests of the residential builder community, its producers, suppliers, and consumers.² PBA St. 1 at 1. In his testimony, Mr. Durden explained how water and sewer service is essential for economic development and described how economic development will be impeded should the Commission adopt a gross-up method.

Specifically, Mr. Durden explained that the construction of new businesses and residential developments may require the development of access to water and sewer services, which may include construction of water and wastewater main and service line extensions. Once constructed, the new businesses and developments will assist in bringing new jobs and resources to the surrounding communities. PBA St. 1 at 5.

Mr. Durden further explained the serious consequences to economic development should the Commission adopt a gross-up method. Under a gross-up method, the income tax consequences of CIAC would fall upon developers or others requesting service line extensions in one large payment up front. PBA St. 1 at 4. Mr. Durden testified that requiring developers to pay the grossed-up CIAC would place an extreme financial burden on them and may serve as a deterrent for developers to undertake such projects. PBA St. 1 at 4-5. Mr. Durden further explained:

¹ Even in 1989, the Commission recognized that water and sewer utilities also provided such a benefit, albeit, the Commission did not give that factor the weight that it should be given today. *See 1989 CIAC Order at 22, 25* ("Many water utility extension projects involve the construction of upgraded mains and other such backbone facilities that benefit current customers to an extent, as well as the contributor and new customers.").

² Mr. Durden has served as the Chief Executive Officer of the PBA since October 2014. Prior to that, Mr. Durden served for seventeen years as General Counsel for the National Association of Home Builders.

In today's world, the cost of building a home is very high, and there is much economic competition in the development of new housing these days. Every added cost impacts the affordability for potential purchasers. As such, developers will consider all costs, including a tax imposed on CIAC, in determining where to construct new developments. Based on my discussions and interactions with the members of the PBA, developers will consider alternatives if they are faced with having to front unreasonable costs, including the grossed-up CIAC tax, without reasonable certainty of recovery.

PBA St. 1-R at 2. Mr. Durden explained that, today, developers have many alternatives, including the use of wells and septic tanks, as well as geographic alternatives. As explained, the use of wells and septic tanks is a viable option for developers. Even without the potential added cost of a grossed-up CIAC, 15% of new single family homes that were built in the Mid- Atlantic region in 2017 had wells and 20% had septic systems.³ PBA St. 1-R at 4. Based on Mr. Durden's long experience in the industry and his discussions with homebuilders, this figure is likely to rise if developers are faced with having to pay the grossed-up CIAC tax. Mr. Durden stated, "[C]ommon sense dictates that utilization of the public water supply provides a benefit to the Commonwealth generally, because it reduces the numbers of private wells/septic systems that can more easily become polluted and or cause damage or become a nuisance to neighboring properties." PBA St. 1-R at 3.

Mr. Durden also testified that developers have geographic alternatives, which are more likely and potentially more problematic. PBA St. 1-R at 4. Mr. Durden explained that these geographic alternatives may include the development: 1) in areas where there is an existing service line; and/or 2) in other states that utilize the no gross-up method, such as New York; 3) and/or in other service territories in Pennsylvania in which the Commission has authorized the

³ This statistic was provided by the National Association of Home Builders. *See New Homes Built with Private Wells and Individual Septic Systems in 2017*, National Association of Home Builders (Oct. 4, 2018), available at <http://eyeonhousing.org/2018/10/new-homes-built-with-private-wells-and-individual-septic-systems-in-2017/>.

use of the no gross-up method, such as that of York Water Company or municipal and authority-owned water/wastewater companies (which are not subject to tax). *Id.*

Additionally, Mr. Durden testified that, historically, many developers simply “sit on the sidelines” and do not develop a given plot of land when conditions become too expensive, just as an investor will choose not to purchase additional stock when the market is overvalued. PBA St. 1-SR at 6. When this situation arises, those seeking a home “will have no choice but to choose among older, aging homes, built to less stringent, less sustainable codes and using aging infrastructure like water and wastewater lines.” *Id.* As such, it is apparent that the no gross-up method provides a public benefit in the form of economic development.

Through the testimony of its witness Brenton Grab, I&E has attempted to minimize the potential serious consequences of the gross-up method, arguing that developers will merely pass these costs along to the purchasers. *See* I&E St. 1 at 14. Assuming as true, for purposes of this argument, Mr. Grab’s assertion, the grossed-up CIAC will be an added cost for potential purchases, which will also impact economic development. As explained by Mr. Durden, 9,374 households will be priced out of the market for a median-priced new home in Pennsylvania if the price of a new home increases by \$1,000.⁴ PBA St. 1-R at 4-5. Mr. Durden testified:

Fewer buyers results in reduced sales of median-priced homes. Reduced sales either means a reduction in the development of median-priced homes, *or* a risk for developers that they will be unable to recover the full cost from the purchaser. These are the exact kinds of circumstances that will result in developers considering the alternatives that I previously discussed. In short, Mr. Grab’s assertion that these prices will merely be passed along demonstrates the serious impact that the [gross-up] method could have on economic development.

⁴ *See Households Priced-Out by Higher House Prices and Interest Rates*, National Association of Home Builders, available at <https://www.nahb.org/en/research/housing-economics/housings-economic-impact/households-priced-out-by-higher-house-prices-and-interest-rates.aspx>.

PBA St. 1-R at 5. Approval of the no gross-up method eliminates the serious potential consequences that the gross-up method could have on economic development in PAWC's service territory and the public generally.

Also, as acknowledged by PAWC witness Mr. Cox, PBA witness Mr. Durden, and I&E witness Mr. Grab, existing customers will benefit from the advances in infrastructure and extensions to facilities that are funded through CIAC. *See* PAWC St. 1 at 7-9; PBA St. 1 at 4; I&E St. 1-R at 4. The impact on individual ratepayers is both very modest and spread out over the life of the new facilities -- scores of years. Moreover, the costs associated with taxable CIAC will be offset by the additional revenue generated from the additional customers that have access to the system. *See* PAWC St. 1 at 7-9; PBA St. 1 at 4. Mr. Durden explained that under the no gross-up method, developers will still pay the cost of installing the equipment necessary to serve new customers. New ratepayers being served by those new facilities will pay the regular rate for water and wastewater service, which will produce additional revenue for the Company. This Company would not get this additional revenue if not for the contribution. In this manner, existing ratepayers benefit by being able to share the cost of water and wastewater services with a larger group of ratepayers. PBA St. 1-SR at 3. Mr. Durden also explained that under the Company's proposal, the tax expense that PAWC incurs will be recovered over the life of the property, which is generally a better result. PBA St. 1 at 4. To the contrary, under the gross-up method, developers would be required to pay the entirety of the tax (plus the tax on the tax) in the first year for property that may have a 25-40 year life. As such, socializing the cost in the manner described above is appropriate from a policy standpoint. PBA St. 1-R at 6.

Importantly, in the *1989 CIAC Order*, the Commission also considered the opinions of the utilities in determining the appropriate method to utilize per industry. *See 1989 CIAC Order* at 24-25. Today, the no gross-up method appears to be the preferred method for large water

utilities. In addition to PAWC, Aqua Pennsylvania, Inc. has also recently proposed to utilize the no gross-up method for both its water and wastewater services at Docket Nos. R-2018-3003558 and R-2018-3003561, respectively. Additionally, York Water Company has already received Commission approval to utilize the no gross-up method and has incorporated the relevant language in its tariff. York Water Company, Tariff Water – Pa. P.U.C. 14, Rule 3.11.8 Taxes on Deposits for Construction & Customer Advances, page 15. While Suez Water Pennsylvania, Inc. initially proposed to utilize a gross-up method, it has agreed to propose the method adopted by the Commission in this proceeding, indicating that uniformity among water utilities is its greater concern. See *Joint Petition for Approval of Settlement or Rate Proceeding*, Docket Nos. R-2018-3000834, *et. al.* at ¶ 1 (Oct. 10, 2018); see also *Rebuttal Testimony of James C. Cagle*, Docket Nos. R-2018-3000834, *et. al.* (Aug. 17, 2018).

It is well to recognize that PAWC and the other water/wastewater utilities that support the no gross-up method will recover these tax expenses regardless of which method is approved by the Commission. Their support of the no gross-up method then springs from their considered view that gross-up method will have adverse effects on the continued development and expansion of their water infrastructures and, overall, would be detrimental to the utilities and their customers. PBA believes that their view of the appropriate ratemaking policy here should be given considerable weight.

For the reasons explained above, the evidence of record in this proceeding demonstrates that the no gross-up method proposed by PAWC is just and reasonable, consistent with reasonable ratemaking policy, and is in the public interest. The no gross-up method provides a public benefit in the form of economic development, which benefits existing customers by being able to share the cost of water and wastewater services with a larger group of ratepayers and imposes virtually de minimus costs on ratepayers over scores of years. When balancing the

benefits and costs, there appears to be no question that the no gross-up method is the most reasonable and in the public interest. PAWC's proposal should be adopted.

c. Should the Commission adopt a gross-up method, it should require utilities to utilize the discounted gross-up method.

As explained, under the gross-up method, the tax is recovered by the developer or potential customer by "grossing up" the CIAC to reflect the amount of tax that the utility will be required to pay on this amount.⁵ Under this method, the asset is also depreciated for tax purposes. As the Asset is depreciated, the utility will either remit the savings resulting from the annual depreciation back to the developer as those savings are realized, *or* the discounted present value of those future savings will be netted out of the original gross-up amount (the "discounted gross-up method").

Should the Commission adopt a gross-up method, the PBA urges the Commission to require utilities to utilize the discounted gross-up method. Adoption of a discounted gross-up method, as opposed to a full gross-up method, will result in a lower upfront cost of the CIAC tax for developers, which may help to reduce the potential consequences to economic development. It will also be easier to administer and track. Otherwise, the utility would have to keep records of each developer initially providing the tax payment and return a refund to them as the facilities are depreciated and create a tax deduction. The far simpler and more reasonable approach is to net out the initial gross-up required for this stream of future payments, discounted to recognize the time value of money.

⁵ Technically, the gross-up method would require the developer to pay not only the tax on the contribution, but also a tax on the tax in order to keep whole the utility that bears the tax liability.

V. CONCLUSION

WHEREFORE, the Pennsylvania Builders Association respectfully requests that the Pennsylvania Public Utility Commission: 1) grant the filings of Pennsylvania American Water Company at Docket Nos. R-2018-30002502 (water) and R-2018-3002504 (wastewater) related to the recovery of the income tax of Customer Advances and Contributions in Aid of Construction; and 2) order that PAWC utilize the “no gross-up” method to recover costs associated with the taxation of Advances and Contributions, which will allow the Company to spread the costs to all of its customers through the ratemaking process to be recovered over the life of the facilities being added by the Advance or Contribution. Should the Commission adopt the gross-up method, the PBA urges the Commission to adopt the “discounted gross-up method.”

Respectfully submitted,



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