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November 5, 2018

## VIA eFILING

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

**Re: Pennsylvania Public Utility Commission v. Pennsylvania-American  
Water Company – Water Division  
Docket No. R-2018-3002502**

**Pennsylvania Public Utility Commission v. Pennsylvania-American  
Water Company – Wastewater Division  
Docket No. R-2018-3002504**

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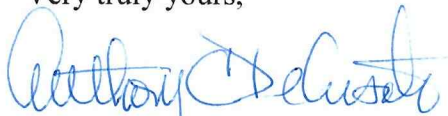
Dear Secretary Chiavetta:

Enclosed for filing is the **Main Brief of Pennsylvania-American Water Company** (“Main Brief”) in the above-referenced matters.

As evidenced by the Certificate of Service, a copy of the Main Brief has been served upon Administrative Law Judge Marta Guhl, and all parties of record.

Should you have any questions, please do not hesitate to contact me at 215.963.5034.

Very truly yours,



Anthony C. DeCusatis

Enclosures

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

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Respectfully submitted,



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Dated: November 5, 2018



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## I. STATEMENT OF THE CASE

### A. Background And Procedural History

The Tax Cuts and Jobs Act<sup>1</sup> (“TCJA”), which was enacted on December 22, 2017, changed the Federal income tax law to make customer advances for construction, customer contributions in aid of construction and customer deposits for construction (collectively, “Contributions and Advances”) taxable income to water and wastewater utilities that receive such payments. As a consequence, water and wastewater utilities incur, and must pay, Federal income tax on such payments in the year they are received. Because the Pennsylvania Corporate Net Income Tax is based on Federal taxable income, the change in the Federal tax law made Contributions and Advances taxable income for Pennsylvania corporate income tax purposes as well.

On February 12, 2018, the Pennsylvania Public Utility Commission (“Commission”) issued a Secretarial Letter at Docket No. M-2018-2641242 initiating a proceeding (the “TCJA Proceeding”) to determine the effects of the TCJA on the tax liabilities of Commission-regulated public utilities. As part of the Secretarial Letter, the Commission requested that certain utilities, including Pennsylvania-American Water Company (“PAWC” or the “Company”), provide verified responses to data requests concerning the effect of the TCJA on their tax liabilities. As part of its response, PAWC explained that, upon the effective date of the TCJA, Contributions and Advances would be treated as taxable income. The Company further stated that it planned to adopt the “no gross-up” method for billing and accounting for Contributions and Advances and also provided a detailed discussion of the “no gross-up” method. Although the Commission issued orders specific to PAWC’s Water and Wastewater Divisions as a result of the TCJA

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<sup>1</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017).

Proceeding, the orders did not address the Company's proposed treatment of Contributions and Advances.<sup>2</sup>

To clarify how taxable Contributions and Advances would be handled, on June 5, 2018, PAWC filed Supplement No. 6 to Tariff Water-Pa. P.U.C. No. 5 ("Supplement No. 6 Water") and Supplement No. 6 to Tariff Wastewater-Pa. P.U.C. No. 16 ("Supplement No. 6 Wastewater"). Copies of the filings were served on the Bureau of Investigation and Enforcement ("I&E"), the Office of Consumer Advocate ("OCA") and the Office of Small Business Advocate ("OSBA"). The Commission assigned Docket Nos. R-2018-3002502 and R-2018-3002504 to the Company's water and wastewater filings, respectively.

On July 24, 2018, I&E filed formal Complaints at each of the above-referenced dockets. On July 25, 2018 and August 14, 2018, respectively, the OCA filed Notices of Intervention and Public Statements and the OSBA filed Notices of Appearance and Public Statements in each of the above-referenced dockets. On August 17, 2018, the Pennsylvania Builders Association ("PBA") filed Petitions to Intervene at both dockets.

By its Opinions and Orders entered August 2, 2018, at each of the above-referenced dockets, the Commission deemed the Company's filings to have been made under Section 1308(a) of the Public Utility Code and initiated investigations of the identical tariff rule changes proposed in Supplement No. 6 Water and Supplement No. 6 Wastewater, respectively. Accordingly, the supplements were suspended for a period of six months, or until February 4, 2019, pursuant to Section 1308(b) of the Public Utility Code.

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<sup>2</sup> See Tax Cuts and Jobs Act of 2017 – Pennsylvania American Water Company, Docket No. R-2018-3000724 (Order entered May 17, 2018); Tax Cuts and Jobs Act of 2017 – Pennsylvania American Water Company – Wastewater Division, Docket No. R-2018-3000725 (Order entered May 17, 2018).

On August 8, 2018, the Company filed Supplement No. 8 to Tariff Water-Pa. P.U.C. No. 5 and Supplement No. 8 to Tariff Wastewater-Pa. P.U.C. No. 16 to suspend Supplement No. 6 Water and Supplement No. 6 Wastewater, respectively, until February 4, 2019. Additionally, on August 30, 2018, the Company filed Supplement No. 9 to Tariff Water-Pa. P.U.C. No. 5 and Supplement No. 9 to Tariff Wastewater-Pa. P.U.C. No. 16 to voluntarily extend the suspension periods, at each of the above-referenced dockets, until February 8, 2019.

On August 29, 2018, contiguous telephonic Prehearing Conferences were held before Administrative Law Judge Marta Guhl (“ALJ Guhl”) at 2:00 PM and 3:00 PM with respect to the proceedings at Docket Nos. R-2018-3002502 and R-2018-3002504, respectively. At the Prehearing Conferences, procedural schedules were adopted, with all parties’ agreement, that anticipated the consolidation of the separately-docketed water and wastewater proceedings. *See* Prehearing Order # 1 (September 21, 2018). Also at the Prehearing Conferences, all parties indicated that they either supported, or did not oppose, consolidation of the two dockets. ALJ Guhl, therefore, asked that the Company file a Motion for Consolidation pursuant to 52 Pa. Code § 5.81(a).

On August 30, 2018, PAWC filed a Motion to Consolidate the water and wastewater proceedings. On October 19, 2018, ALJ Guhl issued an Order consolidating the proceedings for hearings and adjudication.

Written direct, rebuttal and surrebuttal testimony was submitted by the Company, I&E, and PBA on the dates previously established for each submission.

The evidentiary hearing scheduled for October 23, 2018 was cancelled because the parties waived cross-examination of their respective witnesses and ALJ Guhl did not have any questions for the witnesses. Pursuant to Prehearing Order #2, the parties are filing a Stipulation and Motion for Admission of testimony and exhibits. PAWC submits this Main Brief in support

of its Supplement No. 6 Water and Supplement No. 6 Wastewater and to address the issues raised by I&E.

## **B. Summary Of PAWC's Proposal**

PAWC filed Supplement No. 6 Water and Supplement No. 6 Wastewater to reflect its adoption of the "no gross-up" method. In particular, PAWC proposed a change to the Company's water and wastewater tariffs to include the following provision:

The Company will pay income taxes on any deposit, advance, contribution of other like amounts received from an applicant which shall constitute taxable income to the Company as defined by the Internal Revenue Code. Such income taxes shall be segregated in a deferred account for inclusion in rate base in a future rate case proceeding. Such income tax associated with a deposit, advance or contribution will not be charged to the specific depositor/contributor of the capital.

Under the approach proposed by the Company, Contributions and Advances paid by an applicant would not be increased (or "grossed-up"<sup>3</sup>) for the Federal and state income taxes payable on those amounts (a full gross-up) or for the time-value of money difference between the tax payable by the Company upon receipt of a contribution or advance and the future depreciation deductions it will receive with respect to the property funded by the contributions or advance. Amounts refunded by the Company would also not be subject to a gross-up. The tax paid by the Company would be recorded as a tax asset, would reduce accumulated deferred

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<sup>3</sup> A "gross up" calculates the amount of money a utility must receive from an applicant so that, after paying federal and state income taxes on that amount, the remainder is equal to the net-of-tax Contribution or Advance. Consequently, there is a "tax-on-tax" effect from a full gross-up. To illustrate, assume a Contribution of \$100 is required. At the composite federal/state tax rate of 28.89%, \$140 would have to be received so that, after payment of federal and state income taxes, the remainder equals \$100:  $\$140 - (\$140 \times .2889) = \$100$ . Thus, although the composite tax rate is 28.89%, \$40 must be added to so that the after-tax Contribution will equal \$100.

income taxes, and would “reverse” over the depreciable life of the asset funded by the Contribution or Advance.<sup>4</sup>

## **II. SUMMARY OF THE ARGUMENT**

The TCJA has increased the overall cost of connecting new customers to the Company’s water and wastewater systems by making Contributions and Advances taxable income. PAWC’s proposal to implement the no gross-up method for Contributions and Advances strikes an appropriate balance of costs and benefits to existing and new customers.

Almost thirty years ago, the Commission found that water and wastewater utilities should implement a gross-up method while other utilities, such as gas utilities, were permitted to use the no gross-up method. A key basis for the different treatment was the different competitive environment in which the utilities operated. Significantly, although the competitive environment for gas utilities has changed (and narrowed) dramatically, the Commission continues to permit gas utilities to utilize a no gross-up method.

The Commission is not bound to follow the industry-specific conclusions of its earlier orders now that circumstances have changed. The Company has submitted evidence in this proceeding that its no gross-up proposal will provide a net benefit for customers. Additionally, the no-gross up method is consistent with the Commission’s policy of discouraging the proliferation of small water and wastewater systems and encouraging further regionalization by existing viable water and wastewater utilities. For these reasons, Supplement No. 6 Water and Supplement No. 6 Wastewater should be approved.

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<sup>4</sup> See PAWC St. No. 1, p. 5. PAWC provided a detailed explanation of its proposed methodology in response to the Commission’s data requests on the effects of the TCJA at Docket No. M-2018-2641242. PAWC Exhibit No. 3 provides a copy of the relevant portion of the Company responses.

### III. ARGUMENT

#### A. The Commission Should Approve PAWC's Proposed Tariff Changes To Implement The No Gross-Up Method

##### 1. The Commission Has Previously Approved The Use Of The No Gross-Up Method For Other Utilities

The Commission addressed the appropriate treatment of taxes on Contributions and Advances in an Order that followed the Tax Reform Act of 1986 (the "TRA-86 Order").<sup>5</sup> Different utility types were separately analyzed in the TRA-86 Order, and the Commission did not approve the same methodology for each type of utility service. Gas utilities, for example, were permitted to use the no gross-up method for Contributions and Advances. Water and wastewater utilities, however, were required to select one of three gross-up methodologies for Contributions and Advances.<sup>6</sup> The TRA-86 Order also provided that a water or wastewater utility could seek Commission approval to depart from the three gross-up methodologies.<sup>7</sup> Several months following the TRA-86 Order, the Commission approved the no gross-up method for use by PAWC with respect to Contributions and Advances from government entities.<sup>8</sup> The Commission has also previously accepted the no gross-up method for use by York Water

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<sup>5</sup> *Re Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, 70 Pa. P.U.C. 44, (Order entered June 14, 1989) (the "TRA-86 Order").

<sup>6</sup> PAWC would note that while it should be permitted to use the no gross-up method, of the gross-up methods identified in the TRA-86 Order, only the net present value gross-up method does not suffer from the significant practical, computational, and administrative problems that the "full" gross-up method (CIAC Method 2) would create. Additionally, the full gross-up method should be eliminated because it would cause new customers to overpay on a net present value basis (I&E St. No. 1, p. 16, lines 6-7; I&E Exh. No. 1, Schedule 2, p. 2 and Schedule 3, p. 2).

<sup>7</sup> Following the enactment of the Small Business Jobs Protection Act in 1996, the Internal Revenue Code was revised to provide that Contributions and Advances received by water and wastewater utilities would no longer be treated as taxable income to the recipients. *See* I&E St. No. 1, pp. 5-6. Contributions and Advances received by other utilities continued to be treated as taxable income. As previously explained, the TCJA restored the pre-1996 tax treatment, and Contributions and Advances received by water and wastewater utilities are now treated as taxable income.

<sup>8</sup> *See Pa. P.U.C. v. Pennsylvania-American Water Co.*, Docket No. P-890376 (Order entered Nov. 3, 1989) (the "PAWC TRA-86 Order"). A copy of the PAWC TRA-86 Order has been provided as PAWC Exhibit No. 4.

Company.<sup>9</sup>

In treating gas utilities differently than water and wastewater utilities, the TRA-86 Order focused on the differences in the competitive circumstances in which the utilities operated. At that time, gas utilities were subject to competitive forces related to alternatives to use of the natural gas commodity they sold. The Commission found that competitive forces for water and wastewater were less significant: “competition within the industry is not as vital a force as it is in the energy based [electric and gas] industries.”<sup>10</sup>

Since the TRA-86 Order, there have been dramatic changes to the natural gas commodity market and the nature of gas utility service, but the Commission has continued to permit gas utilities to utilize the no gross-up method for Contributions and Advances.<sup>11</sup> The gas industry has been deregulated in Pennsylvania since 1999.<sup>12</sup> Gas utilities no longer are sellers of the natural gas commodity and, therefore, no longer face the “competitive forces” the Commission relied upon in the TRA-86 Order. Gas utilities only furnish distribution service (and supplier-of-last resort service, which is simply a pass-through, not a profit center and not a “competitive” service). In addition, since 1989, the availability of abundant low-cost Marcellus shale gas has changed the market dynamics for heating fuel. For new construction, potential home buyers may view natural gas as a necessary heating source given its current low cost and its low cost relative to the alternatives.<sup>13</sup>

Despite these significant changes, I&E contends that the industry-specific analysis completed almost 30 years ago in the TRA-86 Order remains relevant and should continue to

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<sup>9</sup> See The York Water Company, Tariff Water- Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction.

<sup>10</sup> See TRA-86 Order, p. 57.

<sup>11</sup> See, e.g., Columbia Gas of Pennsylvania, Inc. Tariff Gas – Pa. P.U.C. No 9, Rule 8.2.5 Taxes on Deposits for Construction & Customer Advances, page 49a.

<sup>12</sup> 66 Pa.C.S. § 2204(a) (implementing customer choice for retail customers of natural gas distribution companies).

<sup>13</sup> PAWC St. No. 1, p. 7; PAWC St. No. 1-R, pp. 3-4.

serve as the basis for treating water and wastewater utilities differently than gas utilities. I&E witness Grab argues that the competitive aspect of natural gas service remains strong and “[n]atural gas is tantamount to an optional accessory when a developer is evaluating improvement costs.”<sup>14</sup>

The Company submits that I&E is understating the changes in the market and the nature of gas utility service in the hopes that the Commission will accept the conclusions of the TRA-86 Order and decline to engage in a new analysis of the appropriate treatment of Contributions and Advances in the competitive circumstances that exist today. PAWC notes that the New York Public Service Commission recently engaged in such an analysis and concluded that it would no longer require the gross-up of Contributions and Advances for large water utilities.<sup>15</sup>

## **2. Contributions And Advances Would Continue To Provide Net Benefits To Customers Under The No Gross-Up Method**

No party disputes that existing customers benefit by having new customers added to the system.<sup>16</sup> I&E witness Grab, however, contends that use of the “no gross-up” method for Contributions and Advances will result in the tax imposed on Contributions and Advances being “subsidized by existing customers” which is “unfair to existing customers as they should not have to pay costs associated with servicing new customers.”<sup>17</sup>

The Company has presented evidence that, under its main extension provisions for both water and wastewater, non-bona fide customers that pay Contributions or Advances are not being “subsidized” by existing customers. To the contrary, the Company’s analysis shows that even if Contributions and Advances of up to \$9,681 are paid, new non-bona fide water customers are

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<sup>14</sup> I&E St. No. 1, p. 10.

<sup>15</sup> See *Proceeding on Motion of the Comm’n on Changes in Law that May Affect Rates*, Case No. 17-M-0815 (Order issued Aug. 9, 2018), pp. 32-33.

<sup>16</sup> See, e.g., I&E St. No. 1-R, p. 4.

<sup>17</sup> *Id.*, p. 15, lines 1-5.

actually providing a benefit to existing customers.<sup>18</sup> For wastewater customers, the benefit is even larger because the Company does not fund any portion of the facility extension for non-bona-fide applicants.<sup>19</sup>

### **3. Other Public Policy Considerations Favor The No Gross-Up Method**

If the Company is required to gross-up Contributions and Advances as I&E proposes, the cost borne by new customers and/or developers to connect to the Company's water distribution and wastewater collection systems will increase. Commission policies that increase the cost of connecting to such systems can change the economic dynamic and make alternatives to public water and wastewater, such as individual on-lot wells and septic systems or small water/wastewater systems, more attractive to potential customers.<sup>20</sup> PAWC notes that, as detailed in 52 Pa. Code § 69.721, the Commission believes that further consolidation of water and wastewater systems may result in greater environmental and economic benefits to customers.<sup>21</sup> The Commission should consider the important public policy implications, like this one, in determining whether to increase the cost of new customers connecting to existing water and wastewater systems.

### **4. The Company's Capacity Reservation Fees Are Materially Different From Traditional Contributions And Advances, And Should Also Not Be Subject To Gross Up**

I&E contends that use of the no gross-up method for Capacity Reservation Fees is improper because it results in a subsidy by existing ratepayers that "does not benefit the Company and existing ratepayers."<sup>22</sup> I&E fails to recognize, however, that Capacity Reservation

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<sup>18</sup> PAWC St. No. 1, pp. 7-8 & PAWC Exh. No. 5.

<sup>19</sup> PAWC St. No. 1, p. 8.

<sup>20</sup> PAWC St. No. 1-R, p. 5; *see also* PBA St. No. 1, pp. 4-6 (discussing the potential consequences of the additional financial burden from the gross-up method for developers or others seeking a line extension).

<sup>21</sup> *Id.*

<sup>22</sup> I&E St. No. 1, pp. 16-18.

Fees are materially different from traditional Contributions and Advances. Although booked as contributions, Capacity Reservation Fees do not result in any new expenditure or newly-incurred cost for the Company in contrast to what occurs when a main extension must be made to serve new customers. Applicants pay such fees to reserve wastewater treatment capacity on the Company's system. The Capacity Reservation Fees directly benefit existing customers by reducing the amount of revenue requirement existing customers would otherwise have to bear.<sup>23</sup> For these reasons, even if the Commission finds that a gross-up method must be used for traditional Contributions and Advances, it would not be appropriate to require a gross-up of Capacity Reservation Fees.<sup>24</sup>

**5. The Commission Should Reaffirm Its Prior Determination That Contributions and Advances Received From Government Entities Should Not Be Subject To A Gross-Up**

As explained in Section III.A.1, *supra*, following the enactment of TRA-86, which required Contributions and Advances to be treated as taxable income, PAWC requested express Commission approval to not gross-up Contributions and Advances received from government entities because doing so would be consistent with the public policy to facilitate government initiatives that promote “public health, environmental quality, and economic development.”<sup>25</sup> The Commission granted PAWC its requested approval, and PAWC adopted tariff revision to implement the Commission's decision.<sup>26</sup>

For the reasons set forth previously, the Commission should grant PAWC's request to adopt its proposed tariff revision to adopt the no gross-up method for all Contributions and

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<sup>23</sup> PAWC St. No. 1, pp. 8-9; PAWC St. No. 1-R, p. 6.

<sup>24</sup> The Company also notes that, unlike traditional Contributions and Advances, Capacity Reservation Fees are specific rates set forth in the Company's wastewater tariff that were reviewed and approved in a base rate case. These rates should not be changed outside of a rate case. *See* PAWC St. No. 1, p. 9.

<sup>25</sup> PAWC TRA-89, *supra*, p. 6.

<sup>26</sup> *Id.*

Advances whether or not they are paid by government or non-governmental entities. In any event, if PAWC's primary proposal is not approved in its entirety, the Commission should, nonetheless, expressly reaffirm its earlier determination that the no gross-up method will continue to apply to Contributions and Advances received from governmental entities.

**6. If the Commission Were To Disapprove PAWC's Requested Tariff Revisions And Mandate The Use Of A Gross-Up Method, Its Decision Should Apply Prospectively Only**

As previously explained, the Commission should approve the Company's proposed tariff revisions and, in any event, should not revoke its decision in the PAWC TRA-86 Order that no gross-up should be required for Contributions and Advances received from governmental entities. If the Commission were to mandate the use of a gross-up method for any Contributions and Advances, the Commission's Order should not apply to Contributions and Advances received pursuant to Extension Agreements executed before the entry of its Order.

As explained in Section I.A., *supra*, as part of its verified response to the Commission's February 12, 2018 Order in the TCJA Proceeding, the Company set forth in detail its plan to employ the no gross-up method. While the Commission addressed other TCJA implementation issues, it made no determination with respect to the Company's proposal regarding taxable Contributions and Advances nor did the Commission indicate, either directly or by implication, that, in a subsequent Order, it might retroactively prohibit PAWC from implementing its proposal.

In light of PAWC's verified response in the TCJA Proceeding and the absence of guidance from the Commission, PAWC has not required applicants for service that have made Contributions and Advances since the enactment of the TCJA to pay a gross-up (either a full

gross-up or a gross-up calculated on a net present value basis).<sup>27</sup> There are potentially adverse financial impacts for applicants and adverse practical and administrative complications for the Company if the Commission were to issue an Order imposing a gross-up requirement as proposed by I&E and make the effect of that Order retroactive to the enactment of the TCJA. Therefore, if the Commission were to decide that it will disapprove the proposal the Company first set forth in the verified response in the TCJA Proceeding and now seeks to formalize with the tariff revisions filed on June 5, 2018, that Order should apply only to Contributions and Advances received pursuant to Extension Agreements executed after the entry of the Commission's Order.

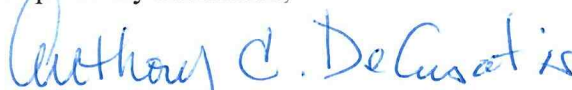
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<sup>27</sup> The Company did, however, revise its Extension Agreements to provide that applicants could be responsible for additional gross-up payments if the Commission were to subsequently issue an Order inconsistent with the Company's position.

#### IV. CONCLUSION

For the reasons set forth above, the Commission should enter an Order approving PAWC's Supplement No. 6 Water and Supplement No. 6 Wastewater and permitting the Company to utilize the no gross-up method for Contributions and Advances. If the Commission were, however, to decide to withhold that approval it should not revoke the authority granted in the PAWC TRA-86 Order to use the no gross-up method for Contributions and Advances received from governmental entities and should make its Order effective prospectively only.

Respectfully submitted,



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Dated: November 5, 2018

*Counsel for Pennsylvania-American Water Company*

# **APPENDIX A**

## **PROPOSED FINDINGS OF FACT**

1. On February 12, 2018, the Pennsylvania Public Utility Commission (“Commission”) issued a Secretarial Letter at Docket No. M-2018-2641242 initiating a proceeding (the “TCJA Proceeding”) to determine the effects of the TCJA on the tax liabilities of Commission-regulated public utilities. As part of the Secretarial Letter, the Commission requested that certain utilities, including Pennsylvania-American Water Company (“PAWC” or the “Company”), provide verified responses to data requests concerning the effect of the TCJA on their tax liabilities.
  
2. As part of its response filed in the TCJA Proceeding, PAWC explained that it planned to adopt the “no gross-up” method for billing and accounting for customer advances for construction, customer contributions in aid of construction and customer deposits for construction (collectively, “Contributions and Advances”).<sup>1</sup> Although the Commission issued orders specific to PAWC’s Water and Wastewater Divisions as a result of the TCJA Proceeding, the orders did not address the Company’s proposed treatment of Contributions and Advances.<sup>2</sup>
  
3. To clarify how taxable Contributions and Advances would be handled, on June 5, 2018, PAWC filed Supplement No. 6 to Tariff Water-Pa. P.U.C. No. 5 (“Supplement No. 6 Water”) and Supplement No. 6 to Tariff Wastewater-Pa. P.U.C. No. 16 (“Supplement No. 6 Wastewater”). The Commission assigned Docket Nos. R-2018-3002502 and R-2018-3002504 to the Company’s water and wastewater filings, respectively.

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<sup>1</sup> PAWC Exhibit No. 3 provides a copy of the relevant portion of the Company responses.

<sup>2</sup> See Tax Cuts and Jobs Act of 2017 – Pennsylvania American Water Company, Docket No. R-2018-3000724 (Order entered May 17, 2018); Tax Cuts and Jobs Act of 2017 – Pennsylvania American Water Company – Wastewater Division, Docket No. R-2018-3000725 (Order entered May 17, 2018).

4. By its Opinions and Orders entered August 2, 2018, Supplement No. 6 Water and Supplement No. 6 Wastewater were suspended for a period of six months, or until February 4, 2019, pursuant to Section 1308(b) of the Public Utility Code.
5. On August 8, 2018, the Company filed Supplement No. 8 to Tariff Water-Pa. P.U.C. No. 5 and Supplement No. 8 to Tariff Wastewater-Pa. P.U.C. No. 16 to suspend Supplement No. 6 Water and Supplement No. 6 Wastewater, respectively, until February 4, 2019. Additionally, on August 30, 2018, the Company filed Supplement No. 9 to Tariff Water-Pa. P.U.C. No. 5 and Supplement No. 9 to Tariff Wastewater-Pa. P.U.C. No. 16 to voluntarily extend the suspension periods at each of the above-referenced dockets until February 8, 2019.
6. On October 19, 2018, ALJ Guhl issued an Order consolidating the proceedings for hearings and adjudication.
7. The evidentiary hearing scheduled for October 23, 2018 was cancelled because the parties waived cross-examination of their respective witnesses and ALJ Guhl did not have any questions for the witnesses. Pursuant to Prehearing Order #2, the parties will file a Stipulation and Motion for Admission of testimony and exhibits.
8. Under the “no gross-up” method proposed by the Company, Contributions and Advances paid by an applicant would not be increased (or “grossed-up”) for the Federal and state income taxes payable on those amounts (a full gross-up) or for the time-value of money difference between the tax payable by the Company upon receipt of a contribution or advance and the future depreciation deductions it will receive with respect to the property funded by the contributions or advance. Amounts refunded by the Company would also not be subject to a gross-up. The tax paid by the Company would be recorded as a tax asset, would reduce

accumulated deferred income taxes, and would “reverse” over the depreciable life of the asset funded by the Contribution or Advance.<sup>3</sup>

9. The Commission’s Bureau of Investigation and Enforcement (“I&E”) proposed that the Company gross-up Contributions and Advances.<sup>4</sup>

10. The Commission continues to permit gas utilities to utilize the no gross-up method for Contributions and Advances.<sup>5</sup>

11. The gas industry has been deregulated in Pennsylvania since 1999.<sup>6</sup> Gas utilities no longer are sellers of the natural gas commodity. Gas utilities only furnish distribution service (and supplier-of-last resort service, which is simply a pass-through, not a profit center and not a “competitive” service). In addition, since 1989, the availability of abundant low-cost Marcellus shale gas has changed the market dynamics for heating fuel. For new construction, potential home buyers may view natural gas as a necessary heating source given its current low cost and its low cost relative to the alternatives.<sup>7</sup>

12. No party disputes that existing customers benefit by having new customers added to the system.<sup>8</sup>

13. The Company has presented evidence that, even if Contributions and Advances of up to \$9,681 are paid, new non-bona fide water customers are actually providing a benefit to existing

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<sup>3</sup> See PAWC St. No. 1, p. 5.

<sup>4</sup> I&E St. No. 1, pp. 3-4.

<sup>5</sup> See, e.g., Columbia Gas of Pennsylvania, Inc. Tariff Gas – Pa. P.U.C. No 9, Rule 8.2.5 Taxes on Deposits for Construction & Customer Advances, page 49a.

<sup>6</sup> 66 Pa.C.S. § 2204(a) (implementing customer choice for retail customers of natural gas distribution companies).

<sup>7</sup> PAWC St. No. 1, p. 7; PAWC St. No. 1-R, pp. 3-4.

<sup>8</sup> See, e.g., I&E St. No. 1-R, p. 4.

customers.<sup>9</sup> For wastewater customers, the benefit is even larger because the Company does not fund any portion of the facility extension for non-bona-fide applicants.<sup>10</sup>

14. If the Company is required to gross-up Contributions and Advances as I&E proposes, the cost borne by new customers and/or developers to connect to the Company's water distribution and wastewater collection systems will increase. Commission policies that increase the cost of connecting to such systems can change the economic dynamic and make alternatives to public water and wastewater, such as individual on-lot wells and septic systems or small water/wastewater systems, more attractive to potential customers.<sup>11</sup>

15. Capacity Reservation Fees are materially different from traditional Contributions and Advances. Although booked as contributions, Capacity Reservation Fees do not result in any new expenditure or newly-incurred cost for the Company in contrast to what occurs when a main extension must be made to serve new customers. Applicants pay such fees to reserve wastewater treatment capacity on the Company's system. The Capacity Reservation Fees directly benefit existing customers by reducing the amount of revenue requirement existing customers would otherwise have to bear.<sup>12</sup>

## **PROPOSED CONCLUSIONS OF LAW**

1. The Tax Cuts and Jobs Act<sup>13</sup> ("TCJA"), which was enacted on December 22, 2017, changed the Federal income tax law to make Contributions and Advances taxable income to water and wastewater utilities that receive such payments. As a consequence, water and

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<sup>9</sup> PAWC St. No. 1, pp. 7-8 & PAWC Exh. No. 5.

<sup>10</sup> PAWC St. No. 1, p. 8.

<sup>11</sup> PAWC St. No. 1-R, p. 5; *see also* PBA St. No. 1, pp. 4-6 (discussing the potential consequences of the additional financial burden from the gross-up method for developers or others seeking a line extension).

<sup>12</sup> PAWC St. No. 1, pp. 8-9; PAWC St. No. 1-R, p. 6.

<sup>13</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017).

wastewater utilities incur, and must pay, Federal income tax on such payments in the year they are received. Because the Pennsylvania Corporate Net Income Tax is based on Federal taxable income, the change in Federal tax law made Contributions and Advances taxable income for Pennsylvania corporate income tax purposes as well.

2. In an Order that followed the Tax Reform Act of 1986 (the “TRA-86 Order”),<sup>14</sup> the Commission permitted gas utilities to use the no gross-up method for Contributions and Advances. Water and wastewater utilities were required to select one of three gross-up methodologies for Contributions and Advances. In treating gas utilities differently than water and wastewater utilities, the TRA-86 Order emphasized that the competitive forces for gas utilities were more significant than for water and wastewater utilities.

3. The TRA-86 Order also provided that a water or wastewater utility could seek Commission approval to depart from the three gross-up methodologies.<sup>15</sup>

4. Several months after the TRA-86 Order, PAWC requested express Commission approval to not gross-up Contributions and Advances received from government entities because doing so would be consistent with the public policy to facilitate government initiatives that promote “public health, environmental quality, and economic development.”<sup>16</sup> The Commission granted PAWC its requested approval, and PAWC adopted tariff revisions to implement the Commission’s decision.<sup>17</sup>

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<sup>14</sup> *Re Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, 70 Pa. P.U.C. 44, (Order entered June 14, 1989) (the “TRA-86 Order”).

<sup>15</sup> *Id.*

<sup>16</sup> *See Pa. PUC v. Pennsylvania-American Water Co.*, Docket No. P-890376 (Order entered Nov. 3, 1989) (the “PAWC TRA-86 Order”), p. 3. A copy of the PAWC TRA-86 Order has been provided as PAWC Exhibit No. 4.

<sup>17</sup> *Id.*

5. The Commission has also previously accepted the no-gross up method for use by York Water Company.<sup>18</sup>

6. 52 Pa. Code § 69.721 provides that further consolidation of water and wastewater systems may result in greater environmental and economic benefits to customers.<sup>19</sup>

7. The New York Public Service Commission recently issued an order providing that it would no longer require the gross-up of Contributions and Advances for large water utilities.<sup>20</sup>

### **PROPOSED ORDERING PARAGRAPHS**

1. That Supplement No. 6 Water and Supplement No. 6 Wastewater are approved and PAWC is permitted to utilize the no gross-up method for Contributions and Advances.

2. That upon Commission approval of the tariff supplements filed by PAWC in compliance with the Commission's Order, the investigation at Docket Nos. R-2018-3002502 and R-2018-3002504, be marked closed.

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<sup>18</sup> See The York Water Company, Tariff Water- Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction.

<sup>19</sup> 52 Pa. Code § 69.721

<sup>20</sup> See *Proceeding on Motion of the Comm'n on Changes in Law that May Affect Rates*, Case No. 17-M-0815 (Order issued Aug. 9, 2018), pp. 32-33.