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November 15, 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**

Dear Secretary Chiavetta:

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

As evidenced by the Certificate of Service, a copy of the Reply 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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I. INTRODUCTION

Pennsylvania-American Water Company (“PAWC” or the “Company”) files this Reply Brief in response to the Main Brief of the Pennsylvania Public Utility Commission (“Commission’s”) Bureau of Investigation & Enforcement (“I&E”) regarding the Company’s proposal 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”).

As more fully explained in the Company’s Main Brief (pp. 1-5), the Tax Cuts and Jobs Act¹ (“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 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”) to reflect its adoption of the “no gross-up” method for Contributions and Advances. Under the approach 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. PAWC’s proposal is supported by the Pennsylvania Builders Association (the “PBA”) and opposed by I&E. The Office of Consumer Advocate and the Office of Small Business Advocate intervened in this case but have not taken a position on this issue.

To a large extent, the arguments advanced by I&E regarding PAWC’s no gross-up proposal were fully addressed in the Company’s Main Brief and an extensive reanalysis is

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

unnecessary. Consequently, this Reply Brief will address the principal errors and omissions in I&E's Main Brief related to its proposal that the Company gross up Contributions and Advances.

II. ARGUMENT

A. **Contrary To I&E's Contentions, The No Gross-Up Method Does Not Result In "Unjust And Unreasonable" Rates, Does Not "Shift" A "Financial Burden" To Existing Customers, And Does Not Create A "Subsidy" Of New Customers By Existing Customers**

In its Main Brief, I&E claims that the no gross-up method will result in unjust and unreasonable rates.² I&E further contends that the Company has made only "vague allegations" that existing customers benefit from adding new customers to the system and that the Company has failed to show that the gross-up method would be a deterrent to developers and new customers.³

I&E improperly focuses only on the allocation of tax expense while ignoring the overall effect of the Company's no gross-up proposal. In its Main Brief, the Company explained that its proposal will provide a net benefit for customers.⁴ Existing customers would not subsidize developers or new customers if the no gross-up method is employed; in fact, new customers produce a significant benefit, as PAWC witness John R. Cox explained:

As shown on PAWC Exhibit No. 5, a new average residential water customer provides net revenue sufficient to fund \$4,839 in rate base. Under the applicable provisions of the Company's water tariff, the Company's investment in the facility extension that might be needed to add that customer would be \$2,632. The net benefit to the Company and its existing customers is \$2,797, which includes the effect of the depreciation deductions on the new plant funded by CAC/CIAC. Based on that amount, the Company and its existing customer could receive up to \$9,681 in contributed property and absorb the income taxes on that amount and still break-even. Any contribution less than that amount is a net benefit

² I&E Main Br., pp. 17-20.

³ *Id.*, pp. 4-5, 21-25.

⁴ PAWC Main Br., pp. 8-9.

to the Company and its existing customers, because existing fixed costs that otherwise would be borne by existing customer are spread over a larger customer base, and the new customers are paying a level of fixed costs that exceeds the amount of rate base installed to serve them.⁵

As Mr. Cox also explained, 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.⁶

I&E did not dispute the Company's calculation of the benefit that adding new customers will produce. Instead, it contends that a gross-up method should be imposed notwithstanding that benefit because the added cost of the gross-up method will not be a "deterrent" to developers' constructing, or customers buying, new homes. In short, I&E contends that the gross-up method should be adopted unless PAWC can prove that the gross-up method will result in fewer homes being built – with a correspondingly lower level of the overall benefits Mr. Cox identified. Thus, I&E argues that it is acceptable to burden new service applicants with additional costs even if Contributions and Advances without a "gross-up" adequately compensate the Company (and its existing customers) so long as the added burden does not reduce the total number of new customers likely to be added.

I&E has it wrong. PAWC does not have the burden to produce evidence that I&E's preferred gross-up method would be a "deterrent" to developers constructing, and new customers buying, new homes. The issue is justness and reasonableness of the rate – i.e., the Contribution or Advance⁷ – that will be charged to applicants requesting extensions of the Company's facilities. The Company need only show that its proposal is "just and reasonable." And, in

⁵ PAWC St. No. 1, p. 8.

⁶ *Id.*

⁷ Contributions and Advances are clearly within the definition of a "rate" set forth in 66 Pa.C.S. § 102.

applying that standard, the Commission must consider the *total effect* of the rate at issue.⁸ The evidence in this proceeding shows that, when viewed in its entirety – i.e., without focusing on just one cost element, as I&E has done – the overall effect of the Company’s proposal will properly compensate the Company and its existing customers for the costs associated with extending facilities to serve new customers and, in fact, will likely produce substantial overall benefits to existing customers.

B. Circumstances Have Changed Since 1989, And The Commission Should Not, Therefore, Simply Impose Its Directives From The TRA-86 Order

As explained in the Company’s Main Brief, the Commission permitted gas utilities to use the no gross-up method as part of the TRA-86 Order⁹ based on the heightened competitive circumstances of gas utilities relative to water and wastewater utilities.¹⁰ Since that Order was issued, there have been significant changes to the nature of gas utility service in the Commonwealth and to the natural gas commodity market. As a result of restructuring in 1999, gas utilities are no longer sellers of natural gas. In addition, the availability of abundant low-cost Marcellus shale gas has changed the market dynamics for heating fuel.¹¹ Although the heightened competitive concerns cited by the Commission no longer exist, it has continued to allow gas utilities to utilize the no gross-up method for the last nearly 20 years.¹²

⁸ *McCloskey v. Pennsylvania Pub. Util. Comm’n*, 127 A.3d 860, 868 (Pa.Cmwth. 2015) (“The United States Supreme Court in *Duquesne Light Company* acknowledged that there were many ways to achieve rates that were just and reasonable, and went on to find that the disallowance of a single element was not the appropriate standard for determining whether rates were just and reasonable; however, a determination regarding whether rates were just and reasonable must involve a look at the total effect of the rates.”) citing *Duquesne Light Co. v. Barasch*, 448 U.S. 299 (1989).

⁹ *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”).

¹⁰ PAWC Main Br., pp. 6-7.

¹¹ *Id.*, p. 7.

¹² *Id.*

The Commission's continued acceptance of the no gross-up method by gas utilities indicates, contrary to I&E's position, that the Commission has now recognized its merit. Moreover, the Company discussed the Commission's acceptance of the no gross-up method for gas utilities in its verified responses to the Commission's data requests in the TCJA proceeding at Docket No. M-2018-2641242,¹³ where it set forth its proposal and explained why it was reasonable. While the Commission issued both a generic and utility-specific orders in the TCJA proceeding providing detailed instructions for reflecting other changes in the tax law made by the TCJA, it did not express any concerns about the Company's proposal to adopt the no gross-up method (or similar proposals by other water utilities).¹⁴

C. Contrary To I&E's Contentions, "Consistency And Uniformity" Do Not Dictate The Use Of A Gross-Up Method

I&E contends that PAWC's proposal will "disrupt the industry-wide use of the gross-up method" and prevent needed "consistency and uniformity" in the industry.¹⁵ Consistency and uniformity, however, can be achieved by authorizing the no gross-up method for all water and wastewater utilities. All major water and wastewater utilities favor no gross-up of Contributions and Advances.¹⁶ In addition, as PBA correctly noted in its Main Brief, the Commission considered the opinions of the utilities in determining the appropriate method to utilize in the TRA-86 Order.¹⁷ Notably, at the time the TRA-86 Order was issued, the water industry generally supported some form of gross-up, and, as the Commission explained, it took the industry's views into consideration in developing the policy it favored at that time.

¹³ PAWC Main Br., pp. 1-2; PAWC St. No. 1-R, pp. 6-7.

¹⁴ *Id.*

¹⁵ I&E Main Br., pp. 9-10.

¹⁶ PAWC St. No. 1-R, pp. 6-7; PBA Main Br., pp. 11-12.

¹⁷ PBA Main Br., pp. 11-12.

Adopting I&E’s proposal would not produce “consistency and uniformity” because municipal water and wastewater providers do not pay tax and, therefore, do not gross-up any Contributions or Advances. I&E has expressed concern about an “unfair advantage for certain companies”¹⁸ and has touted its methodology as a means to prevent “territory shopping”¹⁹ but, under its proposal, municipal providers will be given an advantage, and “territory shopping” – to the detriment of PUC-jurisdictional water and wastewater utilities – would likely occur. The no gross-up method would at least level the playing field for investor-owned water and wastewater utilities.

Finally, adopting I&E’s favored method would not create “consistency and uniformity” among investor-owned utilities.²⁰ For a single development, a developer could end up paying a gross-up for water infrastructure and no gross-up for gas infrastructure.

D. Contrary To I&E’s Contentions, The Existing York Water Company Tariff, The Commission’s Approval Of The No Gross Up Method For Gas Utilities And The NY PSC’s Order Authorizing The No Gross-Up Method For Water Utilities Support The Company’s Position

I&E tries to minimize the importance of The York Water Company’s (“York”) existing tariff provision²¹ that adopts the no gross-up method because I&E asserts that provision was only adopted after the 1996 tax law changes revoked the taxability of Contributions and Advances. However, I&E is overlooking a very important point. York had an existing tariff provision already in effect adopting the no gross-up method at the time the Commission issued both its generic and utility-specific orders in the TCJA proceeding. It should not simply be assumed that the existence of a previously-approved tariff provision adopting the no gross-up method was lost

¹⁸ I&E Main Br., p. 17.

¹⁹ *Id.*, p. 12.

²⁰ PAWC St. No. 1-R, p. 4.

²¹ *See* The York Water Company, Tariff Water-Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction.

on the Commission. In the TCJA proceeding, the Commission specifically directed utilities to address all of the tax law changes made by the TCJA and, as previously explained, PAWC (and other companies) set forth proposals to use the no gross-up method. In York's case, that approach was already embedded in its currently-effective tariff. Clearly, if the Company's (and other water utilities') proposal was unacceptable and a pre-existing, previously-approved tariff provision was to be countermanded, the Commission would have given some indication of its concerns in that regard in the Orders it issued in the TCJA proceeding, which it did not.

As the Company addressed in detail in Section II.B *supra*, the Commission's continued acceptance of the no gross-up method for gas utilities for almost 20 years after restructuring indicates the general merits of the no gross-up approach even in the absence of heightened competitive conditions. Although I&E has repeatedly cited to the outdated conclusion in the TRA-86 Order that economic development is "less sensitive" to water pricing than energy costs, it has provided no evidence that such a finding is accurate today.²²

Finally, I&E argues that the Commission should ignore the recent analysis performed by the New York Public Service Commission ("NY PSC")²³ because it would not result in the needed "consistency and uniformity" in the industry. As explained in Section II.C *supra*, I&E's proposal already does not achieve the consistency it desires. In addition, as PAWC explained in its testimony and Main Brief,²⁴ the NY PSC's analysis is informative because, similar to the Commission, the NY PSC required a gross-up for water utility Contributions and Advances when they were made taxable under TRA-86. After the passage of the TCJA, the NYC PSC determined that it was appropriate to consider how facts and circumstances have changed in the

²² See, e.g., I&E Main Br., p. 13; I&E St. 1-R, p. 10.

²³ See *Proceeding on Motion of the Commission on Changes in Law that May Affect Rates*, Case No. 17-M-0815 (Order issued Aug. 9, 2018), pp. 32-33.

²⁴ PAWC Main Br., p. 8; see also PAWC St. 1-R, pp. 4-5.

last 30 years. The NY PSC ultimately concluded that the no gross-up method should be mandatory for larger water utilities unless a utility could show the method would have a significant adverse effect on its finances or customers.

E. Capacity Reservation Fees Should Not Be Subject To Gross-Up

As the Company explained in its Main Brief, there is no subsidization by existing customers from using the no gross-up method for Capacity Reservation Fees. 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.²⁵ Those paying the fees are providing a benefit to existing customers equal to 100% of the fee less the taxes paid. 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.

²⁵ PAWC St. No. 1, pp. 8-9; PAWC St. No. 1-R, p. 6.

F. The Commission Should Give Due Consideration To Public Policy Concerns That Could Be Affected By Imposing The Gross-Up Method

The Commission recognizes the public interest concerns and favors policies that will not encourage on-lot wells and septic systems or the proliferation of small water and wastewater systems.²⁶ While I&E insists on some form of definitive quantitative proof that the gross-up method will encourage on-lot and small system solutions²⁷, there is no question that the gross-up method is an additional financial burden on developers that choose to connect to the distribution/collection systems of investor-owned utilities. The Commission should not encumber the process of achieving the goal of assuring that developers and new customers choose to use public water and wastewater systems.

III. CONCLUSION

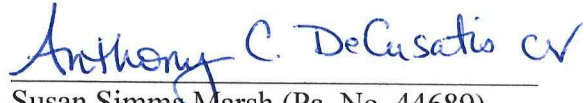
For the reasons set forth above and in PAWC's Main Brief, the Commission should enter an Order approving PAWC's Supplement No. 6 Water and Supplement No. 6 Wastewater and permitting the Company to utilize the no gross-up method for Contributions and Advances. If the Commission were, however, to decide to require the use of a gross-up method, it should: (1) utilize the net present-value approach; (2) maintain the authority granted to PAWC in the

²⁶ See 52 Pa. Code § 69.721.

²⁷ See, e.g., I&E St. No. 1-SR, p. 22.

PAWC TRA-86 Order²⁸ to use the no gross-up method for Contributions and Advances received from governmental entities; and (3) make its Order effective prospectively only.

Respectfully submitted,

Handwritten signature of Anthony C. DeCusatis in blue ink.

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²⁸ See *Pa. PUC 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.