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November 15, 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 Reply Brief with regard to the above-referenced matter. Copies to be served in accordance with the attached Certificate of Service.

Sincerely,

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 Reply 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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Dated: November 15, 2018

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	R-2018-3002502
	:	
Pennsylvania-American Water Company	:	
Pennsylvania Public Utility Commission	:	
	:	
v.	:	R-2018-3002504
	:	
Pennsylvania-American Water Company Wastewater Division	: :	

REPLY BRIEF OF THE PENNSYLVANIA BUILDERS ASSOCIATION

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I. INTRODUCTION

The Main Brief of the Commission's Bureau of Investigation and Enforcement ("I&E") is based entirely on a flawed interpretation of the Commission's 1989 Order regarding Contributions in Aid of Construction ("CIAC" or "Contributions") and Customer Advances ("Advances")[1] and its antiquated analysis, wherein it fails to evaluate the issue in light of present day circumstances. I&E tries to paint this faulty picture that the use of the gross-up method for water and wastewater utilities is a long-standing practice in Pennsylvania, currently being employed on an industry-wide basis, and that the record evidence in this case does not support a change to this current, well-established approach.

In reality, however, water and sewer utilities have not been required to pay a tax on Contributions and Advances since 2006. In fact, water and wastewater utilities were only required to pay a tax on Contributions and Advances for a brief span of approximately 20 years. During that time period, utilities recovered the tax expense of CIAC and Advances consistent with a Commission Order that was issued nearly 30 years ago (the *1989 CIAC Order*). Importantly, in the *1989 CIAC Order*, the Commission based its conclusions on the then-existing economic circumstances, while also considering the method favored by utilities within a particular industry at the time. In short, I&E's Main Brief ignores the indisputable facts that nearly 12 years have passed since any Pennsylvania water or wastewater utility has been subject to a taxable CIAC and that the Commission's *1989 CIAC Order* was based on obsolete economic

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1 *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*").

considerations. Any contention that economic circumstances have not changed in 30 years is simply unreasonable and inconsistent with the record evidence in this case.

Even 30 years ago, approval of the gross-up method for water and wastewater utilities was not the hard-and-fast rule that I&E attempts to portray. In fact, the Commission specifically held that it shall "authorize a great deal of flexibility" to water and sewer industries and left open the opportunity for these utilities to deviate from the use of the gross-up method. *1989 CIAC Order* at 25-26. The Commission even approved the use of the no gross-up method for York Water Company and for Pennsylvania American Water Company ("PAWC" or the "Company") with respect to Contributions and Advances from government entities.[2] Moreover, the Commission's approval of the no gross-up method for natural gas and electric industries demonstrates that the Commission did not consider the no gross-up method to be inherently unreasonable and inconsistent with Commission policy. Rather, as discussed, the Commission based its conclusions on then-existing economic considerations.

Having not been subject to a taxable CIAC for nearly 12 years, water and wastewater utilities are now, appropriately, revisiting the issue of cost recovery. While the PBA does not dispute the standard established in the *1989 CIAC Order*, the PBA submits that the standard must be analyzed in light of present circumstances. The reestablishment of taxable CIAC for water and wastewater utilities, as well as the recent filings by several Pennsylvania water/wastewater utilities seeking approval of the no gross-up method,[3] provides the perfect opportunity for the

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2 *See* York Water Company, Tariff Water – Pa. P.U.C. 14, Rule 3.11.8 Taxes on Deposits for Construction & Customer Advances, page 15; *see also Pa. PUC v. Pennsylvania American Water Co.*, Docket No. P-890376, Order (Nov. 3, 1989).

3 As explained in PBA's Main Brief, 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

Commission to revisit this issue. Taking a quote from the Commission's *1989 CIAC Order*, the Commission's goal in this proceeding should be to allow PAWC to utilize a method 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. As explained in PBA's Main Brief and discussed in more detail, below, the no gross-up method achieves this goal. To the contrary, the goal should not be to merely rely on an obsolete analysis that no longer applies in light of current economic considerations.

II. BURDEN OF PROOF

The PBA does not dispute that PAWC has the burden of proof in this case. For clarification, however, the Commission has held that while the burden of proof remains with the utility, the burden of going forward, or the burden or persuasion, shifts to the other parties to rebut a prima facie case. *See e.g. PA PUC v. PGW*, Docket No. R-00061931, et. al., Opinion and Order at 18 (Sept. 13, 2007). The PBA submits that PAWC has met its initial burden of establishing a prima facie case that the "no gross-up" method is reasonable and in the public interest; but I&E has failed to meet its burden of persuasion to rebut PAWC's prima facie case. Accordingly, PAWC should be found to have met its burden of proof of showing that its

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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. I&E has indicated that it is currently challenging the use of the no gross-up method by York Water Company in its current rate case at Docket No. R-2018-3000019. I&E M.B. at 12. 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).

proposed tariff filing establishing the use of the no gross-up method is just, reasonable and in the public interest.

III. ARGUMENT

a. The Commission's *1989 CIAC Order* (or "*TRA-86 Order*") supports the adoption of the no gross-up method by PAWC, as it will promote competition and economic growth.

Throughout its Main Brief, I&E consistently misrepresents the Commission's *1989 CIAC Order* and inappropriately concludes that the Commission's analysis in that Order is still applicable today. To support its position that a gross-up method is appropriate for water and wastewater utilities, I&E relies heavily on the Commission's quote that "[l]ogic would dictate that where a contributor is a developer [...] and all of the dollars contributed are committed to plant that will be used solely to provide utility services to that developer and his future potential clients, the increased tax cost should generally rest with the developer and eventually the new lot owners." *See* I&E M.B. at 7, 22. I&E contends that absent limited "special circumstances" discussed by the Commission on page 22 of the *1989 CIAC Order*, water and wastewater utilities are not permitted to utilize the no gross-up method. *See* I&E M.B. at 24-25. Contrary to the Commission's holding, I&E contends that general economic development allegations do not justify the use of the no gross-up method. *Id.* at 25.

I&E takes the Commission's holding out of context and completely ignores the Commission's approval of the no gross-up method on an industry-wide basis when it serves to promote competition and economic development. The Commission's discussion of the logical approach and special circumstances that warrant approval of the no gross-up method sets the stage for the Commission to conclude: "If we accept the premise that costs should be shared in

some circumstances and that costs should be fully assignable to developers in others, we can then proceed to examine the various circumstances of the separate utility industry groups and the various methodologies advanced in this Investigation." *1989 CIAC Order* at 22. The Commission broadly defined these "special circumstances," holding that they could take the form of a "public good" that will benefit the community at large, including increased jobs for the area or even *general economic development*. *Id.* In other words, the Commission specifically found that both the no gross-up method and the gross-up methods may be appropriate, depending on the particular circumstances.

The Commission then went on to analyze the appropriate methodology on an industry by industry basis, finding the no gross-up method to be appropriate for electric, natural gas, and telecommunications utilities. Acknowledging the competitive nature of the electric and natural gas industries and the ability of consumers to readily switch between electric and natural gas for heating, cooking and cooling, the Commission concluded that "For these reasons, our CIAC/CAC methodology should be comparable across these two industries in order to allow a level playing field in the competition to provide energy services." *1989 CIAC Order* at 24. In approving adoption of the no gross-up method for electric and natural gas companies, the Commission stated that because these industries "have the potential to provide a 'public benefit' in the form of economic development, a methodology that promotes such growth should be available." *Id.* The Commission based its telecommunications holding on many of the same factors. *Id.* at 26.

Thus, despite I&E's attempt to establish the contrary, the "special circumstances" that warrant approval of the no gross-up method are hardly limited and specific instances. Rather,

the clear holding of the Commission in 1989 is that adoption of a no gross-up method is appropriate when it promotes general economic growth. *Id.* at 24.[4]

Regarding water and wastewater utilities, the Commission, at the time, concluded, that competition was not as vital a force and "[e]conomic development, while an important consideration, is not as sensitive to water utility pricing as it is to energy costs. Therefore, a "gross-up" methodology is more appropriate." *1989 CIAC Order* at 25. This analysis was conducted by the Commission nearly 30 years ago and was based on then-existing economic considerations. Additionally, the Commission left open ample room for water and wastewater utilities to be flexible in their approach and specifically provided them with the opportunity to deviate from the gross-up method. *Id.* at 25-26.

Having not been subject to a taxable CIAC for nearly 12 years, water and wastewater utilities are now, appropriately, revisiting the issue of cost recovery. Appropriate recovery

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[4] In support of its position, I&E also places much emphasis on the need for consistency and uniformity. I&E M.B. at 10-11, 17. While it is the PBA's position that the ***no gross-up method*** should be employed on a universal basis, the PBA finds it necessary to clarify the issue. While the Commission held that some degree of consistency and uniformity was necessary, the Commission found that such an approach was particularly critical for the electric and natural gas industries in light of the competitive nature of the two industries and the ability of consumers to readily switch between the two. *See 1989 CIAC Order* at 24. On the other hand, regarding the water and wastewater industries, the Commission stressed the importance of permitting a great deal of flexibility *at the time* and noted that competition within the industry was not as vital a force *at the time*. *1989 CIAC Order* at 25 ("Given the varying degrees of sophistication in the water and sewer industry we shall authorize a great deal of flexibility."). Consistent with this finding, the Commission approved the no gross-up method for York Water Company and for PAWC with respect to Contributions and Advances from government entities. *See* FN 2, *supra*.

Today, it is the PBA's position that competition is a "vital force" in the water and wastewater industries and that the Commission should thoroughly consider alternatives to public water supply, as well as geographic alternatives, in its determination of whether to approve the no gross-up method. Because of these competitive alternatives, as well as the numerous utilities currently seeking approval of a no gross-up method, the Commission should approve a no gross-up method on an industry-wide basis (much as the Commission did with natural gas, electric, and telecommunications utilities nearly 30 years ago). Nevertheless, should the Commission find that competition and economic development considerations do not support approval of the no gross-up method on an industry-wide basis, the Commission should still afford PAWC flexibility in its proposal to utilize the no gross-up method, based on the record evidence supporting PAWC's proposal in this case.

should be analyzed in light of present economic development considerations. As explained in detail in the PBA's Main Brief, the record contains ample evidence to support a holding that a no gross-up method is appropriate. PBA witness Mr. Daniel Durden explained in detail how 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. See PBA St. 1-R at 2-5. Mr. Durden also explained that existing customers will 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. *Id.* at 5-6. As such, the Commission's *1989 CIAC Order* supports the adoption of the no gross-up method by PAWC, as it will promote competition and economic growth.

b. The record contains sufficient evidence to support findings that the no gross-up method provides benefits in the form of economic development by encouraging the construction of new developments in the PAWC service territory and encouraging the use of public water supply.

Throughout its Main Brief, I&E makes a number of inconsistent statements related to the evidence presented by the PBA. One the one hand, I&E makes the unsubstantiated argument that the PBA's claims regarding developers' potential use of wells and septic tanks and geographic alternatives are "not realistic" and "unsupported by the record." *See e.g.* I&E M.B. at 5, 14, 21-23. On the other hand, I&E relies on the testimony of PBA witness Mr. Durden regarding geographic alternatives to support its position that a uniform approach is necessary. I&E M.B. at 11-12. On one hand, I&E asserts, "The fact is simply that developers do not want to pay the tax associated with their water and wastewater projects and want this cost to be subsidized by existing PAWC customers." I&E M.B. at 6. On the other hand, I&E asserts that developers face no risk of increased expenditures, as they will merely pass the grossed-up CIAC

tax on to new customers. I&E M.B. at 22. Regardless of I&E's assertions, the record contains substantial evidence to support the findings that the no gross-up method provides benefits in the form of economic development by encouraging the construction of new developments in the PAWC service territory and encouraging the use of public water supply. Moreover, the record shows the real likelihood of economic detriment under the gross-up method to PAWC, its customers, and the Commonwealth's economy.

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. Durden, an individual with vast experience in the building industry. Since October 2014, Mr. Durden has served 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. Prior to that, Mr. Durden served for seventeen years as General Counsel for the National Association of Home Builders. Mr. Durden testified that "based on his experiences and interactions with members of the PBA, developers will consider alternatives if faced with having to front unreasonable costs, including the gross-up CIAC tax, without reasonable certainty of recovery." PBA St. 1-R at 2. Mr. Durden explained that these "alternatives" included, not only geographical alternatives, but also the use of wells and septic tanks. PBA St. 1-R at 4. Mr. Durden also relied on statistics from the National Association of Home Builders ("NAHB") to demonstrate that, contrary to I&E's assertion, the use of wells and septic tanks is a viable alternative, and one that is likely to be used more if the Commission approves the gross-up method. PBA St. 1-R at 3. Mr. Durden also relied upon statistics from the NAHB to demonstrate that the cost of the tax from Contributions and Advances may price potential buyers out of the market. PBA St. 1-R at 4-5.

While I&E attempted to refute the testimony of Mr. Durden through the testimony of Mr. Brenton Grab, Mr. Grab's testimony is unpersuasive. Mr. Grab, who is employed by I&E as a Fixed Utility Financial Analyst, has no experience in the development and building industry. *See* I&E St. 1 at 1 and Appendix A. As such, his testimony related to the health and cost considerations of wells and septic tanks, as well as the effect of those considerations on developers, does not carry the same weight as the testimony presented by an expert in the industry, which is corroborated by statistics provided by the NAHB. Moreover, it should be noted that Mr. Grab's general testimony on the topic does not establish that wells and septic tanks will be a more expensive alternative, nor does it rebut any concerns raised by the PBA related to geographic alternatives. I&E's attempt to diminish the percentage of home buyers priced out of the market per $1,000 increase (I&E M.B. at 22) is also ineffective and fails to consider the potential large-scale impact. In today's world, developers will consider all costs when determining if and where to construct new developments. PBA St. 1-R at 2. So, even if I&E does not consider home buyers priced out of the market to be a serious economic concern, the record evidence demonstrates that developers will consider those increased costs seriously, which may impact economic development. Additionally, I&E's assumption that the grossed-up CIAC will only total $1,000 is unsupported. As the gross-up amount increases, the number of potential buyers priced out of the market increases as well. In other words, a $2,000 grossed-up CIAC doubles the percentage quoted by I&E of potential buyers that are priced out of the market, a $3,000 grossed-up CIAC triples the percentage, and so on.

I&E also asserts that there is no support that development stagnated during the time period when water and wastewater utilities were required to utilize the gross-up method and that the PBA has failed to provide evidence that economic benefits are more prevalent now. I&E

M.B. at 21, 23. Such statements are entirely immaterial. The PBA is not attempting to speculate as to what may have affected, or not affected, the development of housing nearly thirty years ago. The PBA has demonstrated that, *today*, under present circumstances, developers will consider all costs when determining where to construct new developments and any increased cost is a concern. PBA St. 1-R at 3. "Because of tight market conditions, developers may not be in a position to pass on these increased costs to the homebuyer. If faced with having to front unreasonable costs, including the gross-up CIAC, developers will consider alternatives, including alternatives to public water and wastewater and geographic alternatives, or forgo the development altogether." *Id.*

I&E's asserts that developers simply do not want to pay the tax. I&E M.B. at 6. Certainly, the PBA is trying to emphasize that a grossed-up CIAC could have a huge, negative impact on developers, PAWC, and its customers, and the construction of new developments. For that reason, developers do not want to incur the tax. Nonetheless, if the desire of the developers was the only consideration here, surely, PAWC would have no reason to support the no gross-up method, and the OCA would not remain silent on the issue.

For the reasons discussed above, contrary to I&E's assertion, the record contains sufficient evidence to support findings that the no gross-up method provides benefits in the form of economic development by encouraging the construction of new developments in the PAWC service territory and encouraging the use of public water supply.

c. Adoption of the no gross-up method will provide a benefit to PAWC's customers and will not result in unreasonable rates.

Adoption of the no gross-up method will not result in unreasonable rates for PAWC's existing customers. I&E makes a number of inaccurate and misleading statements related to the

issue of customer rates and benefits to existing customers. First, I&E asserts that the Commission approved the gross-up method for water and wastewater utilities because it determined that "current customers should not be required to subsidize new customers." I&E M.B. at 9. I&E's statement is misleading. As discussed, the *1989 CIAC Order*, in fact, established that a no gross-up method is appropriate if it will provide a "public benefit" in the form of economic development. Furthermore, I&E's repeated claim that the no gross-up method results in current customers having to pay the costs is not completely accurate and fails to recognize the financial benefit that these customers will receive from new customers being added to the system. As explained by PBA witness Mr. Durden:

> [A]s I understand the Company's proposal, PAWC would initially finance the tax and it would be included in the utility's rate base. PAWC would be entitled to earn a return, or a percentage, of the deferred tax asset from its entire customer base. The return on the deferred tax asset would be paid off by all of PAWC's customers, including the customers that were responsible for the CIAC, over the entire life of the property as the property is depreciated (which in the case of water facilities is likely to be decades). Payment on the tax would decline as the tax deductions from depreciation are realized. Thus, the tax effect is reflected in rates at the same pace as the benefits that will accrue from adding these new customers – over the life of the facilities. While new customers will pay a portion of the return of the deferred tax asset, new customers will also receive the benefit of being able to share in the price of maintaining the water and wastewater system.

PBA St. 1-R at 3-4; see also PBA St. 1-R at 5-6. Therefore, the tax effect will actually be reflected in rates over the life of the facilities being installed.

As noted by I&E, the Company compared the net present value ("NPV") of the effect on water customers based on an annual CIAC estimate of $5 million and concluded that the no gross-up proposal had an NPV of $931,000. For wastewater customers, the annual CIAC estimate was $500,000, resulting in an NPV of $93,000. According to PAWC's website, PAWC

provides water and wastewater service to approximately 2.4 million people,[5] who will pay the expenses over the lives of the respective properties. When you consider that the annual NPV estimates for both water and wastewater divisions total just over $1,000,000, to be recovered by approximately 2.4 million people, paid on a monthly basis, over a 25-40 year period, such an expense has virtually no impact on customers – less than 2 mills per customer. "To the contrary, under the gross-up method, a developer would be required to pay the entirety of the tax (plus the tax on the tax) in year 1 for property that may have a 25-40 year life." PBA St. 1-R at 6.

So, contrary to I&E's assertion, adoption of the no gross-up method will provide a benefit to PAWC's ratepayers and will not result in unreasonable rates.

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5 https://amwater.com/paaw/about-us.

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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Date: November 15, 2018

Proposed Findings of Fact, Conclusions of Law, and Ordering Paragraphs

The Pennsylvania Builders Association adopts PAWC's proposed findings of fact, conclusions of law, and ordering paragraphs, with the following additions to the findings of fact:

1. If the Company is required to gross-up Contributions and Advances as I&E proposes, developers may consider alternatives to public water and wastewater, such as the use of wells and septic tanks, as well as geographic alternatives, including developing: 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 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).

2. If the Company is required to gross-up Contributions and Advances as I&E proposes, PAWC estimates that the annual Net Present Value for both water and wastewater divisions total just over $1,000,000. When you consider that the annual NPV estimates for both water and wastewater divisions total just over $1,000,000, to be recovered by approximately 2.4 million people, paid on a monthly basis, over a 25-40 year period, such an expense has virtually no impact on customers