

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Pennsylvania Public Utility Commission	:	R-2018-3002502
Bureau of Investigation and Enforcement	:	C-2018-3003600
	:	
v.	:	
	:	
Pennsylvania-American Water Company	:	

Pennsylvania Public Utility Commission	:	R-2018-3002504
Bureau of Investigation and Enforcement	:	C-2018-3003601
	:	
v.	:	
	:	
Pennsylvania-American Water Company	:	
Wastewater Division	:	
	:	

RECOMMENDED DECISION

Before
Marta Guhl
Administrative Law Judge

INTRODUCTION

This Recommended Decision recommends that the Commission deny Pennsylvania-American Water Company’s (PAWC or Company) request to use the no gross up method for Contributions and Advances based on the change in tax law due to the Tax Cuts and Jobs Act of 2017. The Company has not met its burden of proving that the request to use the no gross up method will result in just or reasonable rates for its customers.

Further, this Recommended Decision recommends that the Commission allow the Company to use the gross up method for government entities. Lastly, this Decision recommends

that the Commission require the Company to include Capacity Reservation Fees in the Contributions and Advances for the purposes of tax consequences.

HISTORY OF THE PROCEEDINGS

On June 5, 2018, Pennsylvania-American Water Company - Water Division (PAWC-Water) filed Tariff Supplement No. 6 to Tariff Water-PA P.U.C. No. 5 (Supplement No. 6 Water) with the Pennsylvania Public Utility Commission (Commission) at Docket No. R-2018-3002502 to become effective August 4, 2018. Supplement No. 6 Water proposes the addition of Rule and Regulation 29 – Taxes on Deposits for Construction, Customer Advances and Contributions in Aid of Construction. PAWC served a copy of Supplement No. 6 Water on the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA), and the Commission’s Bureau of Investigation and Enforcement (I&E).

On June 5, 2018, Pennsylvania-American Water Company – Wastewater Division (PAWC-WD) filed Supplement No. 6 to Tariff Wastewater PA P.U.C. No. 16 (Supplement No. 6 Wastewater) with the Commission at Docket No. R-2018-3002504 to become effective August 4, 2018. Supplement No. 6 Wastewater proposes the addition of Rule and Regulation W – Taxes on Deposits for Construction, Customer Advances and Contributions in Aid of Construction. PAWC served a copy of Supplement No. 6 Wastewater on OCA, OSBA and I&E.

On July 24, 2018, I&E filed Formal Complaints and entered the appearance of Allison C. Kaster, Esquire. The Complaints were docketed at Docket Nos. C-2018-3003600 and C-2018-3003601.

On July 25, 2018, OCA filed Notices of Intervention and Public Statements. It also entered the appearance of Christine Maloni Hoover, Esquire on its behalf.

Pursuant to the Public Utility Code, 66 Pa. C.S. § 1308(b), by Orders entered August 2, 2018, the Commission suspended the tariffs until February 4, 2019 and the matters were assigned to the Office of Administrative Law Judge for the prompt scheduling of hearings

culminating in the issuance of Recommended Decisions. The matters were assigned to Administrative Law Judge Marta Guhl.

On August 17, 2018, the Pennsylvania Builders Association (PBA) filed a Petition to Intervene in both matters related to PAWC-Water and PAWC-WD.

A telephonic prehearing conference in the PAWC-Water matter was held on Wednesday, August 29, 2018, at 2:00 p.m. The prehearing conference in the PAWC-WD matter was held on the same date at 3:00 p.m. Counsel for PAWC, I&E, OCA, OSBA, and PBA participated in both prehearing conferences. PAWC raised the issues of a Motion to Consolidate the two cases and its request for a Protective Order, which it filed with its Prehearing Conference Memoranda. I indicated I would grant the Motion to Consolidate after a written Motion was filed by the parties.

On August 30, 2018, PAWC-Water filed Supplement No. 9 to Tariff Water-PA P.U.C. No. 5 and PAWC-WD filed Supplement No. 9 to Tariff Wastewater PA P.U.C. No. 16, both of which changed the suspension period end dates to February 8, 2019.

On August 31, 2018, PAWC filed a Motion to Consolidate the rate proceedings for both the Water and Wastewater Divisions. The Company indicated in its Motion that there was no objection from the other parties. No parties filed a Response or Objection to the Motion within the timeframe allowed under 52 Pa.Code § 5.61(a)(1).

On September 21, 2018, I issued Prehearing Order No. 1, which set out the litigation schedule in these matters and also granted PBA's Petitions to Intervene. On the same date, I also issued a Protective Order since no parties had any objections to PAWC's request.

In accordance with the litigation schedule set out in Prehearing Order No. 1, PAWC submitted its direct testimony on September 24, 2018.

On October 4, 2018, I&E and PBA¹ submitted their direct testimony.

On October 11, 2018, PAWC, I&E and PBA submitted their rebuttal testimony.

On October 18, 2018, I&E and PBA submitted their surrebuttal testimony.

On October 18, 2018, counsel for I&E contacted my office via electronic mail to indicate that the parties had agreed to waive cross-examination of all witnesses in this matter and requested that the testimony in the case be moved into the record by stipulation and motion by the parties. The parties also requested that the hearing scheduled for October 23, 2018, be cancelled. There was no objection to this request and I granted the request via Prehearing Order No. 2 dated October 24, 2018.

On October 19, 2018, I issued an Order on the Motion to Consolidate, which granted the request to consolidate the cases under Docket Nos. R-2018-3002502 and R-2018-3002504, since they involved the same parties and the same issues.

On October 24, 2018, I issued a Briefing Order.

In accordance with the Briefing Order, PAWC, I&E and PBA filed their Main Briefs, on November 5, 2018.²

On November 14, 2018, the parties filed a Stipulation and Motion for Admission of the testimony and attached exhibits. I am granting the Motion for Admission through this Recommended Decision.

On November 15, 2018, PAWC, I&E and PBA filed their Reply Briefs in these matters, and the record closed on that date.³

¹ OCA and OSBA did not file any testimony in these matters.

² OCA and OSBA filed letters indicating that they would not be filing Main Briefs in these matters.

³ OCA and OSBA filed letters indicating that they would not be filing Reply Briefs in these matters.

The record consists of the transcript of the prehearing conferences on August 29, 2018, the testimony of the witnesses of PAWC, I&E and PBA and attached exhibits, and the briefs of PAWC, I&E and PBA. For the reasons set forth below, I recommend that the Commission adopt the proposals of I&E related to PAWC's Supplemental Tariffs No. 6 for both Water and Wastewater.

FINDINGS OF FACT

1. On February 12, 2018, the Commission issued a Secretarial Letter at Docket No. M-2018-2641242 initiating a proceeding (the TCJA Proceeding) to determine the effects of the Tax Cuts and Jobs Act (TCJA) on the tax liabilities of Commission-regulated public utilities.

2. As part of the Secretarial Letter, the Commission requested that certain utilities, including PAWC, provide verified responses to data requests concerning the effect of the TCJA on their tax liabilities.

3. 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 (CAC), customer contributions in aid of construction (CIAC) and customer deposits for construction (CDC) (collectively, "Contributions and Advances").⁴

4. 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.⁵

5. On June 5, 2018, PAWC filed Supplement No. 6 to Tariff Water-PA P.U.C. No. 5 and Supplement No. 6 to Tariff Wastewater PA P.U.C. No. 16.

⁴ PAWC Exhibit No. 3 provides a copy of the relevant portion of the Company responses.

⁵ 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).

6. By its Orders entered August 2, 2018, the Commission suspended the matters for a period of six months, or until February 4, 2019, pursuant to Section 1308(b) of the Public Utility Code, 66 Pa.C.S.A. § 1308(b).

7. 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.

8. 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 for the matters until February 8, 2019.

9. Existing customers benefit by having new customers added to the system.⁶

10. Prior to the Tax Reform Act of 1986, CIAC and CAC were not taxable so cost recovery was not an issue. I&E St. No. 1, p. 4.

11. CIAC and CAC became taxable under the Tax Reform Act of 1986. I&E St. No. 1, p. 4.

12. After the Tax Reform Act of 1986, the Commission initiated an investigation to determine who should pay the tax and adopted the gross-up method for the water and wastewater industry finding that the contributor, not existing customers, should bear the total cost in *Re Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, 70 Pa. PUC 44, (Order entered June 14, 1989). I&E St. No. 1, p. 4.

13. PAWC received Commission approval to deviate from the gross-up methodology for construction made by political subdivisions or other governmental entities.

⁶ See, e.g., I&E St. No. 1-R, p. 4.

Pa. Pub. Util. Comm 'n v. Pennsylvania-American Water Company, Docket No. P-890376 (Order entered November 3, 1989). I&E St. No. 1, p. 5.

14. The Small Business Job Protection Act of 1996, Pub.L. No. 104-188, 110 Stat. 1755 , restored the taxable exclusion for CIAC and CAC; however, the exclusion was eliminated by the recent passage of the TCJA. I&E St. No. 1, pp. 5-6.

15. All jurisdictional water and wastewater companies used the gross-up method when CIAC and CAC were taxable. I&E St. No. 1, p. 11.

16. In 1996, when CIAC and CAC were no longer taxable, The York Water Company received Commission approval to use the no gross-up method. I&E St. No. 1, p. 11.

17. Competition exists in the gas industry because electricity is standard in nearly all residences and can be used as an alternative to natural gas. I&E St. No. 1, p. 10.

18. In addition to electric service, other alternatives to natural gas exist such as geothermal, wood, propane and oil. I&E St. No. 1, p. 10.

19. The average cost to install both a septic system and well is \$20,000 to \$50,000 per lot. I&E St. No. 1-SR, p. 8.

20. Septic systems and private wells can impact lot size and may decrease developers' profitability. I&E St. No. 1-SR, p. 9.

21. Approval of Supplement No. 6 Water and Supplement No. 6 Wastewater will increase costs for PAWC customers. I&E St. No. 1, p. 16.

22. Capacity Reservation Fees are CIAC. I&E St. No. 1-SR, p. 26.

DISCUSSION

A. Legal Standard

The purpose of this investigation is to establish rates for PAWC's customers that are just and reasonable pursuant to Section 1301 of the Public Utility Code.⁷ Section 1301 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(a). 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. Pub. Util. Comm'n*, 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. Pub. Util. Comm'n*, 437 A.2d 1067, 1070 (Pa.Cmwlth. 1981).

The issue is whether PAWC's rates will comport with the just and reasonable requirement if its current customers are required to pay the tax for Contributions and Advances by using the no gross up method for tax purposes.

B. Burden of Proof

The public utility bears the burden of proof to establish the justness and reasonableness of its requested rate increase. As set forth in Section 315(a) of the Public Utility Code, 66 Pa.C.S. § 315(a):

Reasonableness of rates – In any proceeding upon the motion of the commission, involving any proposed or existing rate of any public utility, or in any proceedings upon the complaint involving

⁷ 66 Pa.C.S. § 1301.

any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

...

66 Pa.C.S. § 315(a)

The Commonwealth Court has stated:

Section 315(a) of the Public Utility Code, 66 Pa.C.S. § 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial.^[8]

The Pennsylvania Supreme Court has stated that the party with the burden of proof has a formidable task to show that the Commission may lawfully adopt its position. Even where a party has established a prima facie case, the party with the burden of proof must establish that “the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.”⁹ Furthermore, it is well-established that the “degree of proof before administrative tribunals as well as before most civil proceedings is satisfied by establishing a preponderance of the evidence.”¹⁰ Additionally, the evidence must be substantial and legally credible, and cannot be mere “suspicion” or a “scintilla” of evidence.¹¹ Thus, a utility has an affirmative burden to establish the justness and reasonableness of its rate request.

However, as the Commonwealth Court has explained: “While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.”¹² Therefore, while the ultimate burden of proof does not shift from the utility, a

⁸ *Lower Frederick Twp. v. Pa. Pub. Util. Comm’n*, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980) (citations omitted). See also, *Brockway Glass v. Pa. Pub. Util. Comm’n*, 63 Pa. Commw. 238, 437 A.2d 1067 (1981).

⁹ *Burleson v. Pa. Pub. Util. Comm’n*, 461 A.2d 1234, 1236 (Pa. 1983).

¹⁰ *Lansberry v. Pa. Pub. Util. Comm’n*, 578 A.2d 600, 602 (Pa.Cmwlth. 1990).

¹¹ *Lansberry*, 578 A.2d at 602.

¹² *Allegheny Center Assocs. v. Pa. Pub. Util. Comm’n*, 570 A.2d 149, 153 (Pa.Cmwlth. 1990).

party proposing an adjustment to a ratemaking claim bears the burden of presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment.¹³

C. PAWC's Proposal—Adoption of No Gross Up Method

1. 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.

(PAWC Main Brief at 4).

Under the approach proposed by the Company, Contributions and Advances paid by an applicant would not be increased (or "grossed-up")¹⁴ 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

¹³ See, e.g., *Pa. Pub. Util. Comm'n v. PECO Energy Co.*, Docket No. R-891364, 1990 Pa. PUC LEXIS 155 (Order entered May 16, 1990); *Pa. Pub. Util. Comm'n v. Breezewood Telephone Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45 (Order entered January 31, 1991).

¹⁴ 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 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.¹⁵ (PAWC Main Brief at 4-5).

2. PAWC Position

PAWC argues that there have been major changes in the utilities market and the Commission should 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.¹⁶ (PAWC Main Brief at 8).

PAWC states that no party disputes that existing customers benefit by having new customers added to the system.¹⁷ Further, the Company asserts that it has presented evidence that, under its main extension provisions for both water and wastewater, non-bona fide customers¹⁸ 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 actually providing a benefit to existing customers.¹⁹ 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.²⁰ (PAWC Main Brief at 8-9).

PAWC argues that the cost borne by new customers and/or developers to connect to the Company’s water distribution and wastewater collection systems will increase. PAWC asserts that Commission policies that increase the cost of connecting to such systems can change

¹⁵ 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.

¹⁶ 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.

¹⁷ See, e.g., I&E St. No. 1-R, p. 4.

¹⁸ Non-bona fide customers are potential future customers based on future development within the Company’s system.

¹⁹ PAWC St. No. 1, pp. 7-8 & PAWC Exh. No. 5.

²⁰ PAWC St. No. 1, p. 8.

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.²¹ 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.²² PAWC contends that 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. (PAWC Main Brief at 9).

PAWC asserts that 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 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.^[23]

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.²⁴ (PAWC Reply Brief at 2-3).

²¹ 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).

²² *Id.*

²³ PAWC St. No. 1, p. 8.

²⁴ *Id.*

PAWC notes that I&E did not dispute the Company's calculation of the benefit that adding new customers will produce. PAWC argues that it 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. Instead, PAWC contends that the issue is the justness and reasonableness of the rate that will be charged to applicants requesting extensions of the Company's facilities. PAWC maintains it only needs to show that its proposal is "just and reasonable." PAWC asserts that the Commission must consider the total effect of the rate at issue.²⁵ PAWC argues that the evidence in this proceeding shows that the overall effect of its 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. (PAWC Reply Brief at 3-4).

Moreover, PAWC argues that based on the competitive nature of the market now, it should be allowed to use the no gross up method like the gas utilities, which was allowed under the original TRA-86 Order²⁶. The Company notes that the Commission allowed gas utilities to utilize the no gross up method because of the competitive nature of the industry which PAWC asserts is the case in the water and wastewater industries now. (PAWC Reply Brief at 4).

PAWC argues that the Commission's continued acceptance of the no gross-up method by gas utilities indicates that the Commission has 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-2018-264124²⁷, where it set forth its proposal and explained why it was reasonable. PAWC notes that while the Commission issued both generic and utility-specific orders in the TCJA proceeding providing detailed instructions for reflecting other changes in the tax law made

²⁵ *McCloskey v. Pa. Pub. Util. Comm'n*, 127 A.3d 860, 868 (Pa.Cmwlth. 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).

²⁶ *Re Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, 70 Pa. PUC 44, (Order entered June 14, 1989) (the TRA-86 Order).

²⁷ PAWC Main Brief., pp. 1-2; PAWC St. No. 1-R, pp. 6-7.

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).²⁸ (PAWC Reply Brief at 5).

PAWC also argues that consistency and uniformity can be achieved by authorizing the no gross-up method for all water and wastewater utilities. PAWC states that all major water and wastewater utilities favor the no gross-up method for Contributions and Advances.²⁹ PAWC also asserts the Commission considered the opinions of the utilities in determining the appropriate method to utilize in the TRA-86 Order.³⁰ 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. (PAWC Reply Brief at 5).

Further, PAWC states that 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. PAWC notes that under I&E’s proposal, municipal providers will be given an advantage, and “territory shopping” would likely occur. PAWC contends that the no gross-up method would at least level the playing field for investor-owned water and wastewater utilities. (PAWC Reply Brief at 6).

PAWC argues that adopting I&E’s favored method would not create “consistency and uniformity” among investor-owned utilities.³¹ PAWC notes that for a single development, a developer could end up paying a gross-up for water infrastructure and no gross-up for gas infrastructure. (PAWC Reply Brief at 6).

PAWC maintains that York Water Company had an existing tariff provision³² 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. PAWC notes that the Commission was aware of

²⁸

Id.

²⁹ PAWC St. No. 1-R, pp. 6-7; PBA Main Brief., pp. 11-12.

³⁰ PBA Main Brief at 11-12.

³¹ PAWC St. No. 1-R, p. 4.

³² *See* The York Water Company, Tariff Water-Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction.

this provision when it was approved. PAWC argues that if its (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. (PAWC Reply Brief at 7).

PAWC also contends that the New York Public Service Commission (NY PSC) analysis³³ 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 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. (PAWC Reply Brief at 7-8).

Lastly, PAWC maintains that 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.³⁴ PAWC asserts 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. PAWC argues that 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. (PAWC Reply Brief at 9).

3. PBA Position

The PBA supports PAWC's proposal in this matter. PBA argues that PAWC'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. (PBA Main Brief at 6).

³³ 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.

³⁴ See 52 Pa. Code § 69.721.

The PBA argues that 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 PBA submits that the evidence of record in this proceeding demonstrates that adoption of the no gross-up method is appropriate. The PBA argues that water and sewer utilities provide a public benefit in the form of economic development and benefit the community at large.³⁵ (PBA Main Brief at 7-8).

Specifically, PBA notes that its witness, Mr. Daniel 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.³⁶ (PBA Main Brief at 8).

The PBA also states that 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.³⁷ The PBA argues through its witness' testimony 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.³⁸ PBA contends that developers have many alternatives, including the use of wells and septic tanks, as well as geographic alternatives. PBA argues that 15% of new single-family homes that were built in the Mid- Atlantic region in 2017 had wells and 20% had septic systems.³⁹ PBA asserts that this figure is likely to rise if developers are faced with having to pay the grossed-up CIAC tax.⁴⁰ (PBA Main Brief at 9).

³⁵ 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 TRA-86 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.”).

³⁶ PBA St. 1 at 5.

³⁷ PBA St. 1 at 4.

³⁸ PBA St. 1 at 4-5.

³⁹ PBA St. 1-R at 4. 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/>.

⁴⁰ PBA St. 1-R at 3.

The PBA also notes that developers have geographic alternatives, which are more likely and potentially more problematic.⁴¹ The PBA contends 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 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).⁴² (PBA Main Brief at 9-10).

The PBA maintains that many developers 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.⁴³ The PBA argues that the no gross-up method provides a public benefit in the form of economic development. (PBA Main Brief at 10).

The PBA asserts that 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 \$1,000.⁴⁴ The PBA argues that 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. (PBA Main Brief at 10-11).

The PBA states that existing customers will benefit from the advances in infrastructure and extensions to facilities that are funded through CIAC.⁴⁵ The PBA argues that the impact on individual ratepayers is both very modest and spread out over the life of the new facilities. Moreover, PBA maintains that the costs associated with taxable CIAC will be offset by the additional revenue generated from the additional customers that have access to the system.⁴⁶ The PBA argues 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

⁴¹ PBA St. 1-R at 4.

⁴² *Id.*

⁴³ PBA St. 1-SR at 6.

⁴⁴ PBA St. 1-R at 4-5. *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>.

⁴⁵ *See* PAWC St. 1 at 7-9; PBA St. 1 at 4; I&E St. 1-R at 4.

⁴⁶ *See* PAWC St. 1 at 7-9; PBA St. 1 at 4.

those new facilities will pay the regular rate for water and wastewater service, which will produce additional revenue for the Company. The PBA asserts that existing ratepayers benefit by being able to share the cost of water and wastewater services with a larger group of ratepayers.⁴⁷ The PBA explains that the tax expense that PAWC incurs will be recovered over the life of the property, which is generally a better result.⁴⁸ The PBA contends that 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. The PBA states that socializing the cost in the manner described above is appropriate from a policy standpoint.⁴⁹ (PBA Main Brief at 11).

The PBA argues that 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.⁵⁰ The PBA notes that 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.⁵¹ (PBA Main Brief at 11-12).

Further, the PBA notes that 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 PBA argues that the “special circumstances” that warrant approval of the no gross-up method are hardly limited and specific instances. The PBA notes that the analysis was conducted by the Commission nearly 30 years ago and was based on then-existing economic considerations. Additionally, the PBA maintains that the Commission left open room for water

⁴⁷ PBA St. 1-SR at 3.

⁴⁸ PBA St. 1 at 4.

⁴⁹ PBA St. 1-R at 6.

⁵⁰ York Water Company, *Tariff Water – Pa. P.U.C. 14, Rule 3.11.8 Taxes on Deposits for Construction & Customer Advances* at 15.

⁵¹ *Pa. Pub. Util. Comm’n v. Suez Water Pennsylvania, Inc.*, Docket No. R-2018-3000834 (Recommended Decision entered October 31, 2018).

and wastewater utilities to be flexible in their approach and specifically provided them with the opportunity to deviate from the gross-up method. (PBA Reply Brief 5-6).

The PBA also asserts that developers will consider all costs when determining if and where to construct new developments.⁵² The PBA notes that as the gross-up amount increases, the number of potential buyers priced out of the market increases as well. The PBA presents the example that 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. (PBA Reply Brief at 9).

Further, the PBA contends that adoption of the no gross-up method will not result in unreasonable rates for PAWC's existing customers. The PBA notes that 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,⁵³ who will pay the expenses over the lives of the respective properties. The PBA asserts that when considering 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. (PBA Reply Brief at 11-12).

4. I&E Position

I&E argues that the Commission undertook a comprehensive review of who should bear the added costs associated with the taxable status of CIAC and CAC in the late 1980s and determined that developers or new customers should be responsible for those costs rather than be subsidized by existing water and wastewater customers. I&E asserts that the Company has failed to demonstrate why the Commission should reverse this long-standing

⁵² PBA St. 1-R at 2.

⁵³ <https://amwater.com/paaw/about-us>.

position and approve the no gross-up method as requested in Supplement No. 6 Water and Supplement No. 6 Wastewater. (I&E Main Brief at 6).

I&E notes that prior to the Tax Reform Act of 1986, CIAC and CAC were not taxable, so cost recovery was not an issue. However, under the Tax Reform Act of 1986, CIAC and CAC became taxable and I&E's predecessor, the Office of Trial Staff (OTS), filed a Petition requesting that an Investigation be initiated to address the appropriate accounting and ratemaking treatment of CIAC and CAC. I&E states that in response to the OTS Petition the Commission initiated an *Investigation of Accounting and Ratemaking Associated with Contributions in Aid of Construction and Customer Advances*, at Docket No. I-880083, and named all jurisdictional fixed utilities as respondents.⁵⁴ Six different ratemaking methods for CIAC and two for CAC were investigated. OTS supported only those methods that did not change the revenue requirement because OTS argued that existing ratepayers should not be required to subsidize the construction of new plant for new customers and developers. (I&E Main Brief at 6-7).

By Order entered June 1, 1989, (Investigation Order or TRA-86 Order)⁵⁵, I&E states that the Commission addressed this issue on an industry-by-industry basis and adopted the gross-up method for water and wastewater utilities stating, "a 'gross-up' methodology is more appropriate. The contributor bears the total cost, including taxes of the plant because he also will reap its full benefit."⁵⁶ The Commission further opined:

Logic would dictate that where a contributor is a developer who may pass costs on to lot purchasers 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. Current customers would have no vested interest in such a contribution and would not benefit from it. As such, they should not be responsible for the related income taxes. ^[57]

⁵⁴ TRA-86 Order, p. 5.

⁵⁵ *Investigation of Accounting and Ratemaking Associated with Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083 (Order entered June 14, 1989); see, I&E Exh. No. 1, Sch. 1.

⁵⁶ TRA-86 Order, p. 25.

⁵⁷ TRA-86 Order, p. 22.

I&E states that at the conclusion of the Investigation the Commission ordered all jurisdictional water and wastewater utilities to file the appropriate tariff supplements necessary to employ a gross-up method. (I&E Main Brief at 7).

I&E notes that after the Commission's Investigation Order, PAWC filed a Petition requesting permission to deviate from the gross-up methodology for construction made by political subdivisions or other governmental entities.⁵⁸ I&E states that at the time, PAWC argued that requiring political subdivisions and governmental entities to pay the Federal Income Tax is contrary to public policy and that it is not in the public interest to require the gross-up method where the contributor is a political subdivision or other governmental entity.⁵⁹ I&E also notes that the Commission agreed, stating "In the Opinion and Order [of June 14, 1989] we recognized that there are 'special circumstances' where there may be room for a sharing of additional tax costs, even though the new plant is not directly used to the benefit of existing ratepayers."⁶⁰ (I&E Main Brief at 8).

In the decade after Contributions and Advances became taxable, I&E contends that water and wastewater ratepayers did not subsidize contributors because pursuant to the TRA-86 Order those utilities were required to utilize the gross-up method and, only upon demonstrating "special circumstances," were permitted to deviate from that method. I&E notes that the Small Business Job Protection Act of 1996 restored the taxable exclusion for CIAC and CAC so developers and new customers no longer had to pay the income tax. I&E states that this exclusion was recently eliminated by the TCJA, which mandates that CIAC and CAC be taxable to water and wastewater utilities. I&E maintains that while the taxable status of Contributions and Advances in the water and wastewater industries has changed, the issue of who pays has not changed. I&E asserts that the Commission thoroughly analyzed this issue in the TRA-86 Order and approved the gross-up method for all jurisdictional water and wastewater utilities because it correctly determined that current customers should not be required to subsidize new customers. I&E argue that now that CIAC and CAC are once again taxable under the TCJA, water and

⁵⁸ *Pa. PUC v. Pennsylvania-American Water Company*, Docket No. P-890376 (Order entered November 3, 1989).

⁵⁹ *Id.* at 3.

⁶⁰ *Id.* at 2.

wastewater ratepayers should continue to be insulated from these costs. I&E maintains that the taxable status of Contributions and Advances changed under the TCJA but the fundamental principle that the contributor, not current water and wastewater customers, should bear the cost remains sound. (I&E Main Brief at 8-9).

I&E argues that reliance on York Water Company (York Water) is unfounded because it is an outlier. I&E notes that York Water correctly utilized the gross-up method during the period that Contributions and Advances were taxable between the TRA-86 Order and when the taxable exclusion was restored in the Small Business Job Protection Act of 1996. In fact, York Water implemented a gross-up methodology prior to the entry of the TRA-86 Order. This is evidenced by the fact that the TRA-86 Order addressed York Water and noted that it had already filed a tariff supplement recognizing the gross-up method to charge developers for taxes related to CIAC and CAC. I&E witness Brenton Grab testified that York Water only switched to the no gross-up method in 1996 when CIAC and CAC were no longer taxable. I&E notes that York Water is currently an outlier, which highlights the importance of consistency in the water and wastewater industry now that CIAC and CAC are once again taxable under the TCJA. I&E argues that territory shopping will not occur if all jurisdictional water and wastewater utilities utilize the same accounting methodology. I&E notes that York Water currently has a pending base rate case, at Docket No. R-2018-3000019, where this issue is being addressed as I&E believes that the Commission's goal to ensure uniformity in the water and wastewater industry through use of the gross-up method remains sound. (I&E Main Brief at 10-12).

I&E disagrees with PAWC and the PBA as the TRA-86 Order made it clear that this issue would be decided on an industry-by-industry basis; therefore, the fact that the TRA-86 Order permitted the no gross-up method for the gas industry fails to support its adoption for PAWC. I&E notes that the Commission's TRA-86 Order recognized the need to review this issue on an industry-by-industry basis, which resulted in the Commission adopting the gross-up methodology for water and wastewater utilities and the no gross-up methodology for gas utilities.⁶¹ I&E argues that the different utility industries and their customers have varying needs and circumstances that may necessitate methodologies that differ. (I&E Main Brief at 12-13).

⁶¹ TRA-86 Order, p. 23.

I&E maintains that the reason the Commission approved the no gross-up method for the gas industry was that gas utilities operate in an energy competitive environment and have the potential to provide a “public benefit” in the form of economic development.⁶² However, for water and wastewater utilities, the Commission approved the gross-up method, since the same considerations did not apply.⁶³ The Commission stated that for the water and wastewater industry “competition within the industry is not as vital a force as it is in the energy-based industries. Economic development, while an important consideration, is not as sensitive to water utility pricing as it is to energy costs.”⁶⁴ (I&E Main Brief at 12-13).

I&E argues that PAWC fails to recognize that there are still many alternatives to natural gas such as electric, geothermal, wood, propane and oil, that simply do not exist for water and wastewater service. I&E maintains that there is still competition in the natural gas industry, whether the natural gas commodity is bundled with other natural gas services or not. (I&E Main Brief at 13-14).

I&E argues that PAWC has not demonstrated that competition is any more vibrant in the water and wastewater industry than it was thirty years ago. I&E contends that if competition in the gas industry is less vibrant now as PAWC argues, it may be appropriate for gas utilities, like water and wastewater utilities, to use the gross-up method. (I&E Reply Brief at 5-6).

I&E also asserts that only a small percentage of new single-family homes in the Middle Atlantic Region in 2017 were built with wells and septic systems. I&E contends that connecting to public water and wastewater was overwhelmingly favored since 85% of the single-family homes built in 2017 used public water and 80% of the homes built in 2017 used public wastewater.⁶⁵ Specifically, I&E witness Grab indicated that the average cost to install both a septic system and well is \$20,000 to \$50,000 per lot.⁶⁶ Additionally, Mr. Grab noted that septic

⁶² TRA-86 Order, pp. 23-24.

⁶³ TRA-86 Order, p. 25.

⁶⁴ TRA-86 Order, p. 25.

⁶⁵ I&E St. No. 1-SR, p. 7

⁶⁶ I&E St. No. 1-SR, p. 8.

systems and wells potentially impact lot size which may decrease developers' profitability.⁶⁷ (I&E Main Brief at 14-15).

I&E also argues that reliance on the New York Public Service Commission's recent adoption of the no gross-up method for water and wastewater utilities is misplaced as it does not prioritize consistency and uniformity in the water utility industry. I&E also notes that the NY PSC also allows water utilities to continue to use the gross-up method so that different water companies utilize different methods based on the size and revenue of the company which is inconsistent with the Commission's stated goals in the TRA-86 Order.⁶⁸ (I&E Main Brief at 16-17).

I&E maintains that approval of the no gross-up method in PAWC's Supplement No. 6 Water and Supplement No. 6 Wastewater will increase costs for existing PAWC customers. This cost shifting was rejected in the Commission's TRA-86 Order as the Commission recognized that the financial burden should be placed on contributors and new customers. I&E contends that in the TRA-86 Investigation, OTS examined the impact on rates under the six different CIAC accounting methodologies and assumed that the plant to be constructed would be valued at \$1,000. I&E states that under this assumption, NPV effect of the no gross-up method, identified as Method 3, on current ratepayers was \$281.50. OTS argued that its NPV analysis demonstrated that adding taxes to rate base through the no gross-up method (Method 3) is a "very costly alternative for ratepayers."⁶⁹ I&E explains that the Company's no gross-up proposal had an NPV of \$931,000, which would be recovered from all customers, while the three gross-up methodologies either decreased rates (CIAC Method 2) or did not affect customer rates (CIAC Modified Method 2 and CIAC Method 5).⁷⁰ The same was true for the wastewater service. I&E notes that an annual CIAC estimate of \$500,000 resulted in an NPV of \$93,000 with the no gross-up method and the three gross-up methodologies either decreased rates or did not affect customer rates.⁷¹ (I&E Main Brief at 19-20).

⁶⁷ I&E St. No. 1-SR, p. 9.

⁶⁸ I&E St. No. 1, p. 12.

⁶⁹ TRA-86 Order, p. 16.

⁷⁰ I&E St. No. 1, p. 16; I&E Exhibit No. 1, Sch. 2, pp. 2-3.

⁷¹ I&E St. No. 1, p. 16, I&E Exhibit No. 1, Sch. 3, pp. 2-3.

Further, while I&E does not dispute that adding new customers benefits existing customers, PAWC provided no evidence that I&E's recommended gross-up method actually deters new development or new customers from joining the system.⁷² I&E argues that there is no record evidence that charging the tax associated with CIAC and CAC to the contributor will prevent or decrease new customer growth. I&E maintains that the gross-up method was used from 1989 until the tax exemption became effective in 1996 and no support was provided that development stagnated during that time due to developers being required to pay the tax. I&E asserts that "the number of houses supposedly priced out of the market by a hypothetical \$1,000 increase is only 0.19% (9,374/4,966,122) of all houses in Pennsylvania in 2016."⁷³ (I&E Main Brief at 21-22).

I&E argues that while the PBA makes general claims that "water and sewer utilities provide a public benefit in the form of economic development and benefit the community at large", it provided no specific evidence showing how existing PAWC customers will benefit which was required in the Commission's TRA-86 Order.⁷⁴ I&E notes that if PAWC can demonstrate that specific extension projects will actually benefit the community, that is the type of "special circumstance" that would potentially warrant approval of the no gross-up method and a sharing of those costs. I&E asserts that absent this showing, developers should continue to bear the tax responsibility as contemplated in the TRA-86 Order. (I&E Reply Brief at 9-10).

D. Request to use Discounted Gross-Up Method (OTS Method No. 5)

1. PBA Position

The PBA also argues that the Commission should require utilities to utilize the discounted gross-up method. The PBA maintains that 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

⁷² I&E St. No. 1-R, p. 4.

⁷³ I&E St. No. 1-R, p. 11.

⁷⁴ PBA MB, pp. 7-8.

developers, which may help to reduce the potential consequences to economic development. (PBA Main Brief at 13).

The PBA notes that it will also be easier to administer and track. The PBA contends that 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. (PBA Main Brief at 13).

2. I&E Position

Although I&E does not specifically oppose the PBA's request, it does not believe that it is appropriate because water and wastewater utilities were authorized to use three different gross-up methods in the Commission's TRA-86 Order, not just the method preferred by PBA. I&E notes that while the Commission determined that a gross-up methodology should be utilized, there was no consensus about which gross-up method should be used. The Commission concluded that "given the varying degrees of sophistication in the water and sewer industry we shall authorize a great deal of flexibility. Therefore, we adopt a policy to allow the water and sewer utilities to select one of the following gross up methodologies: OTS Method No. 2, OTS Modified Method No. 2 or OTS Method No. 5."⁷⁵ I&E states that there is no record evidence from the PBA explaining why Method No. 5 should be used exclusively and why gross-up Method Nos. 2 and 2 Modified that were also approved in the TRA-86 Order should be rejected in this proceeding. Therefore, while I&E does not oppose the use of the PBA's preferred Method No. 5, PAWC should also be permitted to use the other two gross-up methods identified in the TRA-86 Order. (I&E Reply Brief at 11).

E. Applying the Gross Up Method Prospectively

The Company further requests that if the Commission mandates the use of I&E's recommended gross-up method in this proceeding, it should be applied prospectively and should not apply to any agreements executed before the entry of an Order. (PAWC Main Brief at 11).

⁷⁵ TRA-86 Order, pp. 25-26.

I&E does not oppose the Company's request to apply the gross-up method prospectively. However, I&E asserts that it does not believe that PAWC's decision to use the no gross-up method after the TCJA passed was appropriate. (I&E Reply Brief at 13).

F. No Gross-Up Method for Government Entities

PAWC notes that it 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."⁷⁶ The Commission granted PAWC its requested approval, and PAWC adopted a tariff revision to implement the Commission's decision.⁷⁷ PAWC argues that if its primary proposal is not approved in its entirety, the Commission should reaffirm its earlier determination that the no gross-up method will continue to apply to Contributions and Advances received from governmental entities. (PAWC Main Brief at 10).

I&E does not object to this request. (I&E Reply Brief at 12).

G. Capacity Reservation Fees

1. PAWC Position

PAWC argues that Capacity Reservation Fees are materially different from traditional Contributions and Advances. Although booked as contributions, PAWC asserts that 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. PAWC contends that applicants pay such fees to reserve wastewater treatment capacity on the Company's system. PAWC maintains that the Capacity Reservation Fees directly benefit existing customers by reducing the amount of revenue requirement existing

⁷⁶ PAWC TRA-89, *supra*, p. 6.

⁷⁷ *Id.*

customers would otherwise have to bear.⁷⁸ PAWC argues that 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.⁷⁹ (PAWC Main Brief at 10).

PAWC also notes that those paying the fees are providing a benefit to existing customers equal to 100% of the fee less the taxes paid. (PAWC Reply Brief at 8).

2. I&E Position

I&E contends that Capacity Reservation Fees are booked as CIAC; therefore, for the reasons discussed above, the new customer or developer should pay the tax rather than be subsidized by existing ratepayers. I&E argues that these fees are booked as CIAC and are taxable as contributions. For the reasons discussed above, requiring current customers to pay for these tax expenses reduces the benefit that flows to existing customers.⁸⁰ I&E asserts that the record is devoid of evidence that charging the tax associated with Capacity Reservation Fees will decrease the number of potential wastewater customers.⁸¹ (I&E Main Brief at 26).

Further, I&E contends that PAWC's insistence that this must be addressed in a subsequent base rate proceeding is unsupported by the fact that the Commission has already determined that the impact of the TCJA can be treated outside a base rate case:

While ratemaking is generally prospective in nature, an exception to this rule applies in the case of expenses that are extraordinary, substantial and nonrecurring. In this regard, we agree with the OCA that the TCJA tax savings represent "an extraordinary and substantial, non-recurring reduction in utility expenses that should be treated outside of a general rate proceeding and flowed back to ratepayers." Therefore, in the Commission's judgment, there is no legal impediment to our present consideration of the substantial tax

⁷⁸ PAWC St. No. 1, pp. 8-9; PAWC St. No. 1-R, p. 6.

⁷⁹ 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.

⁸⁰ I&E St. No. 1-SR, p. 26.

⁸¹ I&E St. No. 1-SR, p. 27.

savings from the TCJA and we need not await a base rate case filing to address its effect on the justness and reasonableness of consumer rates^[82]

(I&E Main Brief at 26-27).

I&E notes that the Commission found that existing rates were no longer just and reasonable due to the TCJA's decreased corporate tax rate and concluded that the tax savings and associated reductions in utility revenue requirements should flow back to consumers on a current basis by directing utilities who were not currently in for a base rate increase to implement a negative surcharge to recognize the TCJA changes.⁸³ While the TCJA Order was addressing the rate impact of the decreased corporate tax rate, I&E asserts that it would follow that changes relating to the changed taxable status of Contributions and Advances in the TCJA can also be made outside of a base rate case if it constitutes an extraordinary, substantial and nonrecurring expense. (I&E Main Brief at 27).

H. Analysis and Conclusions

While there have been changes to the water and wastewater industries since the Commission last dealt with the issue of the tax method for Contributions and Advances in the TRA-86 Order, I agree that PAWC has not met the burden of establishing that the Company should be allowed to use the no gross up method in this matter related to the changes in the tax law under the TCJA of 2017. I agree with I&E's position with respect to the tax method that should be employed.

Specifically, the Commission has dealt with this issue previously in its TRA-86 Order which directed that the water and wastewater utilities should use the gross up method. The Commission determined that these industries did not require the no gross up method because they did not have the same competitive market that the natural gas, electric and telecommunications industries have. While PAWC and PBA contend the markets have changed,

⁸² *Tax Cuts and Jobs Act of 2017 Temporary Rates Order*, Docket No. M-2018-2641242, p. 15 (Order entered May 17, 2018).

⁸³ *Id.* at 17-18.

there is no evidence in the record to support that the water and wastewater industries have changed such that the no gross up method is warranted. There is nothing in the record to support that the no gross up method will encourage more development or that the gross up method will discourage development. While PBA contends that developers will shop for territories with more favorable tax treatment or turn to alternatives, such as wells and septic systems, I am not persuaded by these arguments because the record reflects that connecting to public water and wastewater was overwhelmingly favored, since 85% of the single-family homes built in 2017 used public water, and 80% of the homes built in 2017 used public wastewater.⁸⁴ Further, I&E witness Grab indicated that the average cost to install both a septic system and well is \$20,000 to \$50,000 per lot.⁸⁵ Mr. Grab noted that septic systems and wells potentially impact lot size which may decrease developers' profitability. I&E also noted that there was no evidence that development was discouraged when the Commission adopted the gross up method for Contributions and Advances after the TRA-86 Order was issued. Therefore, this assessment is the most logical in this matter.

Moreover, the Company and PBA's reliance on the York Water Company case and the NY PSC decision are unfounded. York Water Company is clearly an outlier and the Commission is working towards consistency and uniformity in the water and wastewater industries as evidenced by the TRA-86 Order. If there is uniformity in the industry, then it follows that the issue of territory shopping will be eliminated because all in the industry will use the same tax treatment. The Commission will have the opportunity to address this issue in the York Water Company base rate case that is currently pending. The NY PSC decision also does not prioritize the issue of uniformity and consistency, which the Commission has done in the TRA-86 Order.

The Commission has indicated that current customers should not bear the tax burden of Contributions and Advances with the no gross up method and that these costs should be passed on to potential future customers. Again, while all parties agree that current customers

⁸⁴ I&E St. No. 1-SR, p. 7.

⁸⁵ I&E St. No. 1-SR, p. 8.

benefit from new customers in the system, there is nothing in the record to show that the Company would not be able to add new customers if the gross up method is used.

The Company should be allowed to choose the gross up method laid out in the TRA-86 Order by the Commission that best works for it and its current customers. The PBA has not provided any compelling reason that a specific method should be chosen based on its preference.

The Company should also be allowed to apply the gross up method prospectively if the Commission approves this Recommended Decision. I&E has no opposition to this request and this would allow the Company to more easily apply this change. The Company should also be allowed to apply the no gross up method to projects related to government entities as the Commission has already approved this approach in the PAWC TRA-89 Order.

Lastly, the Capacity Reservation Fees should be included in the Contributions and Advances because that is their current treatment. While PAWC argues that they are materially different and should be dealt with in a base rate case, I&E asserts that the record is devoid of evidence that charging the tax associated with Capacity Reservation Fees will decrease the number of potential wastewater customers. Moreover, the Commission determined that the consequences of the TCJA of 2017 should be dealt with in a separate proceeding and not a base rate proceeding.

CONCLUSIONS OF LAW

1. The Commission has jurisdiction over the subject matter and parties in this case. 66 Pa.C.S. § 1308(d).

2. The rates, terms and conditions contained in the Pennsylvania-American Water Company Supplemental Tariffs No. 6 for Water and Wastewater are not just, reasonable and in the public interest and are not in accord with the rules and Regulations of the Commission and the provisions of the Public Utility Code. See 66 Pa.C.S. § 315(a); 52 Pa.Code §§ 69.2703(a), (b).

3. The burden of proof in a ratemaking proceeding is on the public utility. See 66 Pa.C.S. § 315(a); *Lower Frederick Twp. v. Pa. Pub. Util. Comm'n.*, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980) (citations omitted). See also, *Brockway Glass v. Pa. Pub. Util. Comm'n.*, 63 Pa. Commw. 238, 437 A.2d 1067 (1981).

4. A party proposing an adjustment to a ratemaking claim bears the burden of presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment. See, e.g., *Pa. Pub. Util. Comm'n v. PECO Energy Co.*, Docket No. R-891364, 1990 Pa. PUC LEXIS 155 (Order entered May 16, 1990); *Pa. Pub. Util. Comm'n v. Breezewood Telephone Co.*, Docket No. R-901666, 1991 Pa. PUC LEXIS 45 (Order entered January 31, 1991).

5. The Pennsylvania-American Water Company's proposed no gross up method for customer advances for construction, customer contributions in aid of construction and customer deposits for construction is not just, reasonable and in the public interest and is not in accord with the rules and Regulations of the Commission and the provisions of the Public Utility Code. See 66 Pa.C.S. § 315(a); 66 Pa.C.S. § 1307.

6. The Pennsylvania-American Water Company has not met its burden of proof that it should be allowed to employ the no gross up method with respect to customer advances for construction, customer contributions in aid of construction, and customer deposits for construction.

ORDER

THEREFORE,

IT IS RECOMMENDED:

1. That the Motion for Admission of Testimony and Exhibits is granted and the testimony and exhibits indicated in the Stipulation for Admission of Testimony and Exhibits are entered into the record;

2. That the rates, rules and regulations contained in Pennsylvania-American Water Company's Tariff Supplement No. 6 to Tariff Water-PA P.U.C. No. 5 and Supplement No. 6 to Tariff Wastewater PA P.U.C. No. 16 not be permitted to be placed in effect;

3. That Pennsylvania-American Water Company shall not be permitted to use the no gross up method with respect to customer advances for construction, customer contributions in aid of construction, and customer deposits for construction.

4. That Pennsylvania-American Water Company shall file tariff supplements or tariff revisions containing rates, rules and regulations consistent with this Recommended Decision.

5. That the complaint of the Bureau of Investigation and Enforcement at Docket No. C-2018-3003600 be granted and marked closed

6. That the complaint of the Bureau of Investigation and Enforcement at Docket No. C-2018-3003601 be granted and marked closed.

7. That upon acceptance and approval by the Commission of the tariff supplements or tariff revisions containing rates, rules and regulations consistent with this Recommended Decision, Docket Nos. R-2018-3002502 and R-2018-3002504 be marked closed.

Date: November 26, 2018

_____/s/
Marta Guhl
Administrative Law Judge