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December 11, 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 Exceptions with regard to the above-referenced matter. Copies to be served in accordance with the attached Certificate of Service.

Sincerely,

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

Kristine E. Marsilio

KEM/lww
Enclosure

cc: Hon. Marta Guhl w/enc.
Office of Special Assistants ra-OSA@pa.gov
Cert. of Service w/enc.

CERTIFICATE OF SERVICE

I hereby certify that this day I served a copy of Pennsylvania Builders Association's

Exceptions upon the persons listed below in the manner indicated in accordance with the requirements of 52 Pa. Code Section 1.54.

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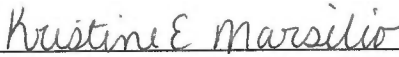
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Dated: December 11, 2018



Kristine E. Marsilio, Esq.

**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	:	

**EXCEPTIONS OF
THE PENNSYLVANIA BUILDERS ASSOCIATION**

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I. INTRODUCTION

The Pennsylvania Builders Association (“PBA”) submits that the Recommended Decision (“RD”) issued by Administrative Law Judge Marta Guhl (“ALJ Guhl”) erred in: 1) concluding that the no gross-up method is not just, reasonable and in the public interest and in accord with Pennsylvania law and Commission rules and regulations; 2) that Pennsylvania-American Water Company (“PAWC” or “the Company”) did not meet its burden of proving that it should be allowed to employ the no gross-up method with respect to Customer Advances for Construction (“Advances”) and Contributions in Aid of Construction (“Contributions” or “CIAC”); and 3) that PAWC should be allowed to choose the gross-up method that works best for the Company.

The PBA is a trade organization comprised of businesses and individuals that build and develop homes and housing developments throughout Pennsylvania. The PBA intervened in this case to support PAWC’s request to use the “no gross-up” method because of its strong belief – supported on the record here – that imposing the full tax on CIAC on the individual builder and homebuyer would negatively affect the construction and sale of homes in PAWC’s service territory and drive these important economic development drivers to other jurisdictions where these significant additional costs were more fairly socialized among all ratepayers and paid over the life of the newly added property. Because of the significant benefit accruing to the utility and the utility’s existing customers from promoting this expansion of the utility’s customer base and the benefits to the economy in the utility’s service territory, PBA respectfully urges the Commission to reject the ALJ’s adoption of the position of the Commission’s Bureau of Investigation and Enforcement’s here.

The PBA submits that the ALJ’s recommendation should be rejected because the no gross-up method – the method urged to be adopted by both PAWC and PBA – is just and

reasonable, consistent with reasonable ratemaking policy, and is in the public interest. The Commission has held that adoption of a no gross-up method is appropriate when it promotes general economic growth. The record contains substantial evidence to demonstrate that the no gross-up method promotes general economic growth by encouraging the construction of new developments in the PAWC service territory and encouraging the use of public water supply, rather than private wells or septic tanks. Existing customers will also benefit from the adoption of the no gross-up method, as it will result in more customers with whom to spread the fixed costs of maintaining PAWC's water and wastewater systems. The no gross-up method also results in a fair allocation of all costs because the initial costs of line extension (not including the tax effect) continue to be paid in full by the developer or homebuilder. Further, the record demonstrates that the no gross-up method will not result in unreasonable rates for ratepayers, as the no gross-up method imposes virtually de minimus costs on ratepayers over scores of years.

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

As such, the PBA respectfully requests that the Commission: 1) reverse the RD issued by ALJ Guhl; 2) grant the filings of PAWC at Docket Nos. R-2018-30002502 (water) and R-2018-3002504 (wastewater) related to the recovery of the income tax of Advances and Contributions; and 3) order that PAWC utilize the "no gross-up" method to recover costs associated with the taxation of Advances and CIAC. If the Commission adopt a gross-up method, however, the PBA urges the Commission to adopt the "discounted gross-up method."

II. BACKGROUND

Advances and Contributions refer to money or property that a developer, or potential customer, contributes or advances for the development of main and service line extensions to expand utility services to new customers or locations. The Tax Reform Act of 1986 provided that Advances and Contributions were to be considered taxable income to regulated utilities. The taxability of Advances and Contributions raises the issue of how utilities will recover this expense. While utilities have various options for recovery, generally the options fall into one of two categories: 1) a “no gross-up” method, or 2) a “gross-up” method.

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

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

On August 18, 1988, the Commission instituted a generic investigation to examine the proper accounting and ratemaking treatment of the income taxes imposed on Advances and Contributions. After receiving Comments from regulated utilities and other interested parties, the Commission issued its Final Order in that investigation on June 14, 1989. *Investigation of Accounting and Ratemaking Associated with Contributions in Aid of Construction and Customer*

Advances, Docket No. I-880083, Opinion and Order (June 14, 1989) (“the TRA-86 Order” or “the 1989 CIAC Order”). In the *1989 CIAC Order*, the Commission held that the CIAC issue requires a uniform but flexible policy that “creates neither unreasonable rates nor financial burden, that assigns cost to those who will reap benefits and at the same time helps maintain an environment in the Commonwealth that is conducive to economic development and the growth of commerce.” *1989 CIAC Order* at 57. The Commission concluded that adoption of the no gross-up method is appropriate if the no gross-up method will provide a “public benefit” in the form of economic development. *See 1989 CIAC Order* at 24.

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

III. PROCEDURAL HISTORY

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

The Commission’s Bureau of Investigation and Enforcement (“I&E”) filed a Formal Complaint on July 24, 2018, and the Office of Consumer Advocate (“OCA”) filed a Notice of Intervention on July 25, 2018.

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

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

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

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

On November 26, 2018, ALJ Guhl issued the RD, in which she held that PAWC's proposed no gross-up method is not just, reasonable, and in the public interest and is not in accord with Commission rules and regulations and the Public Utility Code. RD Conclusions at ¶ 5. ALJ Guhl further concluded that PAWC failed to meet its burden of proof. RD Conclusions at ¶ 6. ALJ Guhl held that "The Company should be allowed to choose the gross up method laid

out in the TRA-86 Order by the Commission that works best for it and its current customers.” RD at 31.

A Secretarial Letter was issued on December 5, 2018, directing parties to file Exceptions no later than December 11, 2018 and Reply Exceptions no later than December 17, 2018. The PBA submits these Exceptions in accordance with the Secretarial Letter issued in this proceeding.

IV. EXCEPTION

- A. **Exception No. 1: The RD erred in concluding that the no gross-up method is not just, reasonable and in the public interest and in accord with Pennsylvania law and Commission rules and regulations. RD Conclusions at ¶ 5.**

While ALJ Guhl acknowledged that there have been changes to the water and wastewater industries since the Commission last addressed the issue of the tax methods for Contributions and Advances in the TRA-86 Order, ALJ Guhl, nonetheless, concluded that the no gross-up method is not just, reasonable and in the public interest and in accord with Pennsylvania law and Commission rules and regulations. RD at 29, 32. ALJ Guhl’s conclusion is based entirely on a flawed interpretation of an order that is almost 30 years’ old – the Commission’s TRA-86 Order – and the unsupported conclusion that the Commission’s *analysis* in that Order is still applicable today. *See* RD at 30-31.

Contrary to ALJ Guhl’s conclusion, the TRA-86 Order does not establish that the no gross-up method is not just, reasonable, and in the public interest, and in accord with Pennsylvania law and the Commission’s rules and regulations. Rather, in the TRA-86 Order, the Commission specifically acknowledged that there may be circumstances that warrant adoption of the no gross-up method. *See 1989 CIAC Order* at 22. As an example of a situation in which sharing of costs may be appropriate, the Commission provided that many water utility extension projects involve the construction of upgraded mains and other such “backbone facilities” that

benefit current customers, as well as the contributor and new customers. The Commission further held that cost sharing may also be appropriate, even if the new plant is not directly used to the benefit of existing ratepayers, if a new user will provide a “public good” that will benefit the existing community at large. The Commission broadly defined these “public goods,” holding that they could take the form of increased jobs for the area or even *general economic development*. *Id.* The Commission concluded: “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. In other words, the TRA-86 Order specifically establishes 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: “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,

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 24.¹

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.

While ALJ Guhl appears to be hung-up on the circumstances nearly thirty years ago,² any evidence demonstrating what may have affected, or not affected, the development of housing in

¹ In the RD, ALJ Guhl also provides as follows: “[T]he 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.” RD at 30. 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.

² For example, ALJ Guhl provides, “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.” RD at 30. The PBA submits that such a “then vs. now” approach confuses the issues and takes the focus away from what is important – the now.

the distant past is immaterial to the issue of how the no gross-up method will impact economic development today. 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 that the *1989 CIAC Order* establishes the appropriate standard for adopting the no gross-up method, the PBA submits that, if that Order is going to continue to be used, the standards set forth therein 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 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 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.

As explained in detail in Exception No. 2, the record contains sufficient evidence to support a holding that a no gross-up method is appropriate for water and wastewater utilities today. 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

ALJ Guhl also provides, "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. *Id.* It should be noted that it would be impractical to require evidence demonstrating that development would have been greater thirty years ago, but for the Commission's approval of a gross-up method for water and wastewater utilities. Evidence of what "would have" or "could have" been is unattainable and would amount to nothing more than speculation.

³ See Exception No. 2(c), *infra*.

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 RD erred in concluding that the no gross-up method is not just, reasonable and in the public interest and in accord with Pennsylvania law and Commission rules and regulations. RD Conclusions at ¶ 5.

B. Exception No. 2: The RD erred in concluding that PWSA did not meet its burden of proving that it should be allowed to employ the no gross-up method with respect to Advances and Contributions. RD Conclusions at ¶ 6.

While ALJ Guhl acknowledged that existing customers benefit by having new customers added to the system, ALJ Guhl, nonetheless, concluded that PWSA did not meet its burden of proving that it should be allowed to employ the no gross-up method with respect to Advances, CIAC, and customer deposits for construction. RD at 6, 32. Contrary to ALJ Guhl's conclusion, PAWC has met its burden of proof, as the record contains substantial evidence demonstrating: 1) the no gross-up method will provide a benefit in the form of economic development; 2) the no gross-up method will benefit existing ratepayers, as it will result in more customers with whom to spread the cost of maintaining PAWC's water and wastewater systems; 3) the no gross-up method is the preferred method for large water utilities today; and 4) the no gross-up method will not result in unreasonable costs to existing ratepayers.

a. The record contains substantial evidence demonstrating that the no gross-up method will provide a benefit in the form of economic development.

ALJ Guhl's conclusion that PAWC failed to meet its burden of proof is based entirely on a number of statements that are inconsistent with the record evidence and/or confuse the issues in this proceeding. For example, ALJ Guhl asserts that "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." RD at 30. This statement is simply untrue. Contrary to ALJ Guhl's

holding, the record contains substantial evidence to support the finding 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. Moreover, the record shows the real likelihood of economic detriment under the gross-up method to PAWC, its customers, and the Commonwealth's economy.

For example, the record contains the Direct, Rebuttal and Surrebuttal Testimonies of Mr. Daniel 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 the construction of new businesses and residential developments usually require the development of access to water and sewer services, which may include construction of water and wastewater main and service line extensions. Once constructed, the new businesses and developments will assist in bringing new jobs and resources to the surrounding communities. PBA St. 1 at 5.

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

In today's world, the cost of building a home is very high, and there is much economic competition in the development of new housing these days. Every

added cost impacts the affordability for potential purchasers. As such, developers will consider all costs, including a tax imposed on CIAC, in determining where to construct new developments. **Based on my discussions and interactions with the members of the PBA, developers will consider alternatives if they are faced with having to front unreasonable costs, including the grossed-up CIAC tax, without reasonable certainty of recovery.**

PBA St. 1-R at 2 (emphasis added). Mr. Durden explained that, today, developers have many alternatives, including the use of wells and septic tanks, as well as geographic alternatives. The record evidence demonstrates that the use of wells and septic tanks is a viable option for developers. According to the National Association of Home Builders (“NAHB”), even without the potential added cost of a grossed-up CIAC, 15% of new single family homes that were built in the Mid- Atlantic region in 2017 had wells and 20% had septic systems.⁴ PBA St. 1-R at 4. Mr. Durden stated, “[C]ommon sense dictates that utilization of the public water supply provides a benefit to the Commonwealth generally, because it reduces the numbers of private wells/septic systems that can more easily become polluted and or cause damage or become a nuisance to neighboring properties.” PBA St. 1-R at 3.

ALJ Guhl’s statement that she was unpersuaded by the PBA’s arguments because the record reflects that connecting to the public water and wastewater was overwhelmingly favored in 2017 misses the point. *See* RD at 30. Public water and wastewater may have been favored in 2017 when developers were not required to pay a gross-up on CIAC. These statistics, however, demonstrate that wells and septic tanks are, in fact, viable options for developers, and ones that may be used more often should the Commission approve the gross-up method. Mr. Durden testified that based on his long experience in the industry and his discussions with homebuilders,

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/>.

this figure is likely to rise if developers are faced with having to pay the grossed-up CIAC tax.⁵ PBA St. 1-R at 3. There was no evidence submitted contradicting these assertions.

Mr. Durden also testified that developers have geographic alternatives, which are more likely and potentially more problematic. PBA St. 1-R at 4. Mr. Durden explained that these geographic alternatives may include the development: 1) in areas where there is an existing service line; and/or 2) in other states that utilize the no gross-up method, such as New York; 3) and/or in other service territories in Pennsylvania in which the Commission has authorized the use of the no gross-up method, such as that of York Water Company or municipal and authority-owned water/wastewater companies (which are not subject to tax). *Id.* With the continued development of municipal water systems, these non-tax alternatives will pose an increased competitive threat to systems such as PAWC's, if it is denied the ability to socialize these tax costs.

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

While ALJ Guhl appeared to rely on the Commission's efforts towards a uniform approach to refute concerns of territory shopping,⁶ uniformity does not eliminate the concern that

⁵ ALJ Guhl makes findings related to the average cost to install septic systems and wells. RD Findings at ¶¶ 19-20. These findings are based entirely on the testimony of I&E witness Mr. Brenton Grab. It should be noted that Mr. Grab's testimony was based entirely on a review of various, uncited websites. I&E St. 1 S-R at 8. It should also be noted that 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. Nevertheless, even accepting these findings, I&E makes no argument, and ALJ Guhl makes no findings, that the installation of wells and septic tanks will be a more expensive for developers than paying the CIAC gross-up. As such, ALJ Guhl's findings related to the cost to install wells and septic tanks does not refute the testimony of Mr. Durden that developers will consider installing wells and septic tanks in lieu of paying a grossed-up CIAC tax.

developers will seek to develop in areas where there is an existing service line, in other states that utilize the no gross-up method, such as New York and Missouri,⁷ in municipal territories where there is no tax gross up, or to simply sit on the sidelines and wait for conditions to become less expensive. Further, given the various gross-up options permitted in the TRA-86 Order, uniformity may not eliminate territory shopping within the Commonwealth, as developers may benefit from certain forms of the gross-up method compared to others. *See* Exception 3, *infra*. Thus, regardless of efforts towards uniformity, there is record evidence demonstrating that developers will look elsewhere if the gross-up method is approved.

Even assuming that the gross-up method will not affect the development and construction of new projects because, theoretically, developers may attempt to pass these costs on to potential purchasers, the record contains substantial evidence demonstrating that the gross-up method will still impact economic development. As explained by Mr. Durden, 9,374 households will be priced out of the market for a median-priced new home in Pennsylvania if the price of a new home increases by \$1,000.⁸ PBA St. 1-R at 4-5. Mr. Durden testified:

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

PBA St. 1-R at 5.

⁶ *See* RD at 30 ("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.").

⁷ *See In the Matter of the Proposed Missouri-American Water Company 2nd Revised Tariff Sheet No. R 65*, File No. WT-2019-0054, Notice That Tariff Will be Allowed to go Into Effect (Dec. 5, 2018).

⁸ *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>.

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. As such, the record contains substantial evidence demonstrating that the no gross-up method will provide a benefit in the form of economic development.

- b. The record contains substantial evidence demonstrating that the no gross-up method will benefit existing ratepayers, as it will result in more customers with whom to spread the cost of maintaining PAWC's water and wastewater systems.**

PAWC witness Mr. Cox, PBA witness Mr. Durden, and I&E witness Mr. Grab, all acknowledge that existing customers will benefit from the advances in infrastructure and extensions to facilities that are funded through CIAC. *See* PAWC St. 1 at 7-9; PBA St. 1 at 4; I&E St. 1-R at 4. Mr. Durden explained that under the no gross-up method, developers will still pay the cost of installing the equipment necessary to serve new customers. New ratepayers being served by those new facilities will pay the regular rate for water and wastewater service, which will produce additional revenue for the Company. This Company would not get this additional revenue if not for the contribution. In this manner, existing ratepayers benefit by being able to share the cost of water and wastewater services with a larger group of ratepayers. PBA St. 1-SR at 3. Additionally, the record demonstrates 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. *See* PAWC St. 1 at 7-9; PBA St. 1 at 4. In response to ALJ Guhl's assertion that "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," as discussed, there is record evidence demonstrating that developers will look elsewhere if the gross-up method is approved (regardless of efforts towards a uniform approach), which would surely limit the number of new customers that could join the system. As such, the record contains substantial evidence demonstrating that the no gross-up method will

benefit existing ratepayers, as it will result in more customers with whom to spread the cost of maintaining PAWC's water and wastewater systems.

c. The no gross-up method is the preferred method for large water utilities today.

Importantly, in the *1989 CIAC Order*, the Commission also considered the opinions of the utilities in determining the appropriate method to utilize per industry. *See 1989 CIAC Order* at 24-25. Today, the no gross-up method appears to be the preferred method for large water utilities. In addition to PAWC, Aqua Pennsylvania, Inc. has also recently proposed to utilize the no gross-up method for both its water and wastewater services at Docket Nos. R-2018-3003558 and R-2018-3003561, respectively. Additionally, York Water Company has already received Commission approval to utilize the no gross-up method and has incorporated the relevant language in its tariff. York Water Company, Tariff Water – Pa. P.U.C. 14, Rule 3.11.8 Taxes on Deposits for Construction & Customer Advances, page 15. While Suez Water Pennsylvania, Inc. initially proposed to utilize a gross-up method, it has agreed to propose the method adopted by the Commission in this proceeding, indicating that uniformity among water utilities is its greater concern. *See Joint Petition for Approval of Settlement or Rate Proceeding*, Docket Nos. R-2018-3000834, *et. al.* at ¶ 1 (Oct. 10, 2018); *see also Rebuttal Testimony of James C. Cagle*, Docket Nos. R-2018-3000834, *et. al.* (Aug. 17, 2018).

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

d. The record contains substantial evidence demonstrating that the no gross-up method will not result in unreasonable costs to existing ratepayers.

In the RD, ALJ Guhl found that adoption of the no gross-up method will increase costs for PAWC customers. RD Finding at ¶ 21. While technically true, the effect will be virtually undetectable to the average customers, and adoption of the no gross-up method will not result in unreasonable rates for PAWC's existing customers. 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. Mr. Durden explained that under the Company's proposal, the tax expense that PAWC incurs will be recovered over the life of the property, which is generally a better result. PBA St. 1 at 4.

The record also demonstrates that, under the Company's proposal, the net present value ("NPV") of the effect on water customers based on an annual CIAC estimate of \$5 million is \$931,000. For wastewater customers, the annual CIAC estimate is \$500,000, resulting in an NPV of \$93,000. I&E Exh. No. 1. According to PAWC's website, PAWC provides water and wastewater service to approximately 2.4 million people,⁹ 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

⁹ <https://amwater.com/paaw/about-us>.

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. As such, Mr. Durden explained that socializing the cost in the manner described above is appropriate from a policy standpoint. PBA St. 1-R at 6. Thus, the record demonstrates that the no gross-up method will not result in unreasonable rates for ratepayers.

For the reasons explained above, PAWC has met its burden of proof in this proceeding. The record evidence demonstrates that the no gross-up method proposed by PAWC is just and reasonable, consistent with reasonable ratemaking policy, in the public interest, and in accord with Pennsylvania law and the Commission’s regulations. The no gross-up method provides a public benefit in the form of economic development and benefits existing customers by being able to share the cost of water and wastewater services with a larger group of ratepayers. The no gross-up method is the preferred method of large water utilities today. Further, the no gross-up method imposes virtually de minimus costs on ratepayers over scores of years. When balancing the benefits and costs, there appears to be no question that the no gross-up method is the most reasonable and in the public interest. As such, PAWC’s proposal should be adopted.

C. Exception No. 3: The RD erred in concluding that PAWC should be allowed to choose the method laid out in the TRA-86 Order that best works for it and its current customers. RD at 31.

Although ALJ Guhl stressed the importance of uniformity, she, nonetheless, concluded that: “The Company should be allowed to choose the gross-up method laid out in the TRA-86 Order by the Commission that works best for it and its customers.” RD at 31. As explained, under the gross-up method, the tax is recovered by the developer or potential customer by “grossing up” the CIAC to reflect the amount of tax that the utility will be required to pay on this

amount.¹⁰ Under this method, the asset is also depreciated for tax purposes. As the asset is depreciated, the utility will either remit the savings resulting from the annual depreciation back to the developer as those savings are realized, *or* the discounted present value of those future savings will be netted out of the original gross-up amount (the “discounted gross-up method”).

The PBA submits that the RD erred in concluding that PAWC should be allowed to choose any gross-up method laid out in the TRA-86 Order. Rather, the PBA urges the Commission to require PAWC to adopt the discounted gross-up method should the Commission determine that PAWC has not met its burden in this case. The discounted gross-up method, as opposed to a full gross-up method, will result in a lower upfront cost of the CIAC tax for developers, which may help to reduce the potential consequences to economic development. It will also be easier to administer and track. Otherwise, the utility would have to keep records of each developer initially providing the tax payment and return a refund to them as the facilities are depreciated and create a tax deduction. The far simpler and more reasonable approach is to net out the initial gross-up required for this stream of future payments, discounted to recognize the time value of money.

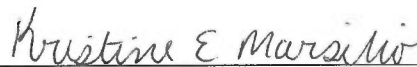
V. CONCLUSION

WHEREFORE, the Pennsylvania Builders Association respectfully requests that the Pennsylvania Public Utility Commission: 1) reverse the Recommended Decision issued by Administrative Law Judge Marta Guhl; 2) 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 for Construction and Contributions in Aid of Construction; and 3) order that PAWC utilize the “no gross-up” method to recover costs

¹⁰ Technically, the gross-up method would require the developer to pay not only the tax on the contribution, but also a tax on the tax in order to keep whole the utility that bears the tax liability.

associated with the taxation of Advances and CIAC. However, if the Commission adopt a gross-up method, the PBA urges the Commission to adopt the “discounted gross-up method.”

Respectfully submitted,



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