

COMMONWEALTH OF PENNSYLVANIA



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October 2, 2017

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

RE: Petition of Metropolitan Edison Co.
for Approval of a DSIC
Docket Nos. P-2015-2508942,
C-2016-2531040

Petition of Pennsylvania Power Co.
for Approval of a DSIC
Docket Nos. P-2015-2508931,
C-2016-2531054

Petition of Pennsylvania Electric Co.
for Approval of a DSIC
Docket Nos. P-2015-2508936,
C-2016-2531060

Petition of West Penn Power Co.
for Approval of a DSIC
Docket Nos. P-2015-2508948,
C-2016-2531019

Dear Counsel:

Attached for electronic filing are the Office of Consumer Advocate's Reply Exceptions in the above-referenced proceeding.

Copies have been served in accordance with the attached Certificate of Service.

Respectfully,

/s/ Erin L. Gannon

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cc: Honorable Joel H. Cheskis, ALJ
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Certificate of Service

CERTIFICATE OF SERVICE

Petition of Metropolitan Edison Co. for Approval : Docket Nos. P-2015-2508942,
of a Distribution System Improvement Charge : C-2016-2531040

Petition of Pennsylvania Electric Co. for Approval : Docket Nos. P-2015-2508936,
of a Distribution System Improvement Charge : C-2016-2531060

Petition of Pennsylvania Power Co. for Approval : Docket Nos. P-2015-2508931,
of a Distribution System Improvement Charge : C-2016-2531054

Petition of West Penn Power Co. for Approval : Docket Nos. P-2015-2508948,
of a Distribution System Improvement Charge : C-2016-2531019

I hereby certify that I have this day served a true copy of following document, the Office of Consumer Advocate's Reply Exceptions, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Petition of Metropolitan Edison Co. for Approval of a Distribution System Improvement Charge	:	Docket Nos.	P-2015-2508942, C-2016-2531040
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	:		
	:		
Petition of West Penn Power Co. for Approval of a Distribution System Improvement Charge	:	Docket Nos.	P-2015-2508948, C-2016-2531019

**REPLY EXCEPTIONS OF
THE OFFICE OF CONSUMER ADVOCATE**

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Dated: October 2, 2017

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Reply to the Exceptions of Metropolitan Edison Company (Met-Ed), West Penn Power Company (West Penn), Pennsylvania Electric Company (Penelec) and Pennsylvania Power Company (Penn Power) (collectively referred to as the Companies or FirstEnergy) filed on September 20, 2017. The FirstEnergy Companies argue that modification of their DSIC calculation to reduce the DSIC rate to reflect ADIT and state income tax deductions and credits is not required. The plain language of Act 40 of the Public Utility Code refutes this. In their Exceptions, the Companies seek to create ambiguity where there is none, in order to argue that the statute should be interpreted differently. The Presiding Officer found no merit in their efforts and determined that Section 1301.1 of the Public Utility Code requires the Companies to modify their computation of current or deferred income tax expense in the DSIC to reduce the rate to account for related federal and state income tax deductions and credits. The OCA urges the Public Utility Commission (Commission) to adopt the Administrative Law Judge's determination.

II. REPLY EXCEPTIONS

Reply to FE Exception No. 1: The ALJ Correctly Determined that the Companies Bear the Burden of Proving that Their DSIC Riders Are Just and Reasonable and in Conformity with Act 40. R.D. at 14-16; FE Exc. at 10-11; OCA M.B. at 5; OCA Exc. at 3-6.

As summarized by the Presiding Officer, this proceeding arises from the Companies' submission of petitions for approval of a DSIC. R.D. at 15. The FirstEnergy Companies filed petitions seeking approval of their respective long-term infrastructure improvement plans and those petitions were approved on February 11, 2016. On February 16, 2016, each of the

Companies then filed a proposed tariff supplement or petition to implement a DSIC rider into their respective tariffs with an effective date of July 1, 2016. The ALJ explained the status of the Petition filing:

Issues arising from these filings form the initial basis of this proceeding. *See*, June 9th Orders, *supra*. The companies' DSIC proceedings were approved by the Commission subject to the resolution of certain outstanding issues. Subsequently, in disposing of the companies' base rate proceedings, the Commission referred the OCA's claim regarding the calculation of [ADIT] in the companies' DSIC riders to this proceeding. Jan. 19th Order at 39. As such, the underlying DSIC proceeding, in which the companies, as the petitioners, have the burden is not final and issues pertaining to the companies' DSIC arise from the underlying rate proceeding in which the companies also have the burden of proof.¹

R.D. at 15. This summation is fully consistent with applicable law.

The FirstEnergy Companies argue that the rate at issue is the entire DSIC Rider; the OCA agrees that all components of the DSIC rate are subject to review in this proceeding. FE Exc. at 10-11. The Companies state further that the Riders are no longer "proposed" because the Commission has determined they conform to the Model Tariff. *Id.* at 11. This does not end the discussion, however. First, the Order approving the Company's DSIC Riders is not a "final" order because it did not dispose of all claims in the matter.² The Companies acknowledge that the June 9 Orders referred matters to the OALJ for disposition (FE Exc. at 3), for which a final order has not yet been entered.

Second, the Companies bear the burden of proof whether the DSIC Riders are proposed or existing. Section 315 of the Public Utility Code provides that in any proceeding upon the motion of the Commission, involving "any proposed or existing rate of any public utility, or in

¹ The citations within the quoted paragraph are: Petition of Metropolitan Edison Co. for Approval of a DSIC, Docket Nos. P-2015-2508942, et al. (Order entered June 9, 2016) (June 9 Orders) and Pa. PUC v. Metropolitan Edison Co., Docket Nos. R-2016-2537349, et al. (Order entered Jan. 19, 2017) (Jan. 19 Order)).

² See Pa. R.A.P. 341.

any proceedings upon complaint involving 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.”³ Here, the Companies filed Petitions to implement a DSIC rate and tariff rider in order to increase rates. At the direction of the Commission, the Petition was assigned to the Office of Administrative Law Judge for final disposition.⁴ June 9 Orders at 20-21. The Companies are the proponent of Commission action, *i.e.* the Companies seeking a final order approving their DSIC Riders. They cannot evade this by arguing that the OCA should “really” be challenging the Commission’s Final Implementation Order.⁵ FE Exc. at 6, 11. That order does not dispose of the OCA’s challenge to the calculation of income tax deductions and credits in any individual utility’s DSIC, which is why the OCA raised and litigated the issue in those individual DSIC implementation cases. Likewise, the OCA did not seek judicial review of the Final Implementation Order, the OCA sought review of the individual orders approving utility’s DSIC calculations.⁶ Now, post-Act 40, the OCA has challenged the FirstEnergy Companies’ calculation of the DSIC Rider in the implementation proceeding initiated by those Companies.

Moreover, the Commission has specifically determined that this is the appropriate proceeding for that challenge. In its Jan. 19 Order, the Commission stated that the OCA’s challenge to the FirstEnergy DSIC calculation should be addressed in this proceeding “in the

³ 66 Pa. C.S. § 315 (emphasis added); Pa. PUC v. Aqua Pennsylvania, Inc., 2004 Pa. PUC LEXIS 39 at *8-9 (Order entered Aug. 5, 2004) (Section 315 reveals a legislative intent that the utility carries the burden of proving the justness and reasonableness of both proposed and existing rates). As discussed by the ALJ, and below, the DSIC is a rate. R.D. at 9 (Finding of Fact no. 7).

⁴ As discussed below, at the direction of the Commission, the merits of DSIC matters raised in the base rate proceeding were not addressed and were assigned to the Petition docket for final disposition. Jan. 19 Order at 38-40, 42.

⁵ Implementation of Act 11 of 2012, Docket No. M-2012-2293611 (Final Implementation Order entered Aug. 2, 2012) (Final Implementation Order).

⁶ Docket Nos. 1012 C.D. 2014, 1358 C.D. 2014, 1686 C.D. 2014, 1688, 1965 C.D. 2014, 777 CD 2015, 938 C.D. 2015, 1305 C.D. 2015, 1306 C.D. 2015.

context of all issues directly related to the DSIC,” consistent with its previous consideration of the issue pre-Act 40. Jan. 19 Order at 38-39. The Commission cited Petition of Columbia Gas of Pa., Inc. for Approval of a DSIC, Docket No. P-2012-2338282 (Order entered May 22, 2014) (Columbia Gas) as an example. In Columbia Gas, the Commission distinguished the burden of going forward and applied the burden of proof to the utility seeking approval of its DSIC Rider.⁷ Consistent with Columbia Gas, the burden of proof in the instant DSIC proceeding is properly assigned to the utility. As such, the Companies bear the burden of proving with substantial and legally credible evidence that all elements of its DSIC Rider are just, reasonable and in conformity with applicable law, “precluding all reasonable inferences to the contrary.”⁸ The OCA carries no burden in this regard.

Third, while the burden of proof (specifically, the burden of persuasion) remains with the proponent,⁹ if another party makes an alternative proposal, the burden of going forward can shift.¹⁰ Here, the OCA has proposed a change to the FirstEnergy Companies’ method for calculating the DSIC Rider to comply with Act 40. Thus, the burden of going forward will shift to the OCA if the proponents of Commission action, *i.e.* the Companies seeking a final order approving their DSIC Riders, make a *prima facie* case that their method for calculating the DSIC Rider complies with Act 40.¹¹ FirstEnergy has argued that the Commission’s June 9 Order

⁷ See Columbia Gas at 7-8, 58.

⁸ Burleson v. Pa. PUC, 461 A.2d 1234, 1236 (Pa. 1983); Lansberry v. Pa. PUC, 578 A.2d 600, 602 (Pa. Commw. 1990).

⁹ This burden never shifts from the utility. See Pa. PUC v. Breezewood Tel. Co., 1991 Pa. PUC LEXIS 45 at *9-10 (Order entered Jan. 31, 1991) (Breezewood) (citing Pa. PUC v. PECO, Docket No. R-891364 at 42, 53-54 (Order entered May 16, 1990)).

¹⁰ Pa. PUC v. Superior Water Co., Inc., 2009 Pa. PUC LEXIS 1055 at *18 (Order entered Feb. 5, 2009) (Superior) (citing Breezewood at *10).

¹¹ “[T]he proponent of a rule or order has the burden of proof.” 66 Pa. C.S. § 332(a); Hurley v. Hurley, 754 A.2d 1283 (Pa.Super. 2000).

finding that its DSIC Rider complies with the Model Tariff proves that its method for calculating the DSIC Rider does not need to be changed in response to Act 40. FE Exc. at 11. The Commission will determine whether that evidence is sufficient to make a *prima facie* case. If so, then the burden of going forward will shift to the OCA.

The challenger's burden of going forward is satisfied by presenting some evidence or analysis of the reasonableness of the proposal.¹² The standard is not a preponderance of the evidence but "coequal, leaving the proof in equilibrium."¹³ Here, the OCA has met that burden by presenting testimony by its witness Ralph C. Smith and analysis showing that the DSIC in its current form does not account for federal deferred income taxes and state income tax deductions generated by DSIC investment as required by recently enacted Section 1301.1. The OCA identified one method to implement that change for federal income tax purposes and two methods to implement that change for state income tax purposes. OCA M.B. at 10-15; OCA S.M.B. at 12-16; OCA S.R.B. at 5-9; OCA St. 1 at 110; OCA St. 1-Supp. at 2-3; OCA St. 1SR-Supp. at 3-9. The fact finder determined that the OCA provided substantial record evidence in support of its proposals. R.D. at 31-33. Indeed, even though the ALJ applied the wrong burden and a more stringent burden (burden of proof) to the OCA, he found that the OCA met its burden. See OCA Exc. at 5-6; R.D. at 15-16, 31, 33. As such, the burden of going forward shifts back to FirstEnergy to rebut the OCA's evidence by a preponderance of the evidence.¹⁴

The ALJ rejected the arguments and evidence advanced by the FirstEnergy Companies against changing the DSIC Rider to include ADIT and state income tax deductions in the

¹² Superior at *18 (citing Breezewood at *10).

¹³ Replogle v. Pennsylvania Electric Co., 54 Pa. PUC 528, 530 (Order entered Oct. 9, 1980) (Replogle) (citing Delaware Coach Co. v Savage, 81 F. Supp 293, 396 (1948)).

¹⁴ Wenger v. UGI Utilities, Inc. - Gas Division, 2009 Pa. PUC LEXIS 162, *14 (Order entered Sept. 18, 2009); see also Replogle at 530.

calculation of the rate. R.D. at 22-34. The OCA submits that the Commission should adopt the determination of the ALJ that FirstEnergy has failed to meet its burden of proof.

Reply to FE Exception No. 2: The ALJ Correctly Determined that Act 40 Requires a Change to the DSIC Calculation; Its Requirements Are Not Met by the Earnings Cap. R.D. at 24-27; FE Exc. at 11-15; OCA M.B. at 10-15; OCA R.B. at 7-8; OCA S.M.B. at 8-16; OCA S.R.B. at 5.

The FirstEnergy Companies contend that their current approach to setting DSIC rates includes related ADIT and state income tax effects “as an integral component of the rate-setting process,” *i.e.* the application of the earnings cap provision.¹⁵ FE R. Exc. at 13-15. As such, the Companies argue that their DSIC Riders comply with the requirements of Section 1301.1(a).¹⁶

In McCloskey v. Pa. PUC, the Commonwealth Court approved the decision of the Commission to allow Columbia Gas to not account for related ADIT and state income tax deductions in the calculation of the DSIC rate.¹⁷ The Court determined that it was within the Commission’s discretion to determine that the earnings cap serves to address the OCA’s concerns regarding the failure to reflect federal and state income tax deductions generated by DSIC investment in the DSIC calculation.¹⁸ In so doing, the Commonwealth Court noted the authority of the General Assembly to take action to remove the Commission’s discretion to allow utilities to continue to utilize this practice. It stated:

¹⁵ The premise of their argument is that in determining whether the DSIC “rate” is in conformity with the law, the entire DSIC mechanism should be considered. FE Exc. at 13-14. In this regard, the Companies argue that “rate” should be interpreted broadly. They take an inconsistent position with regard to “rate” as it is used in Section 1301.1. There, the Companies contend that “rate” should be narrowly construed to apply to “base rates” only. FE Exc. at 13, n.30. The fallacy of this position will be addressed in the OCA’s response to the Companies’ third Exception.

¹⁶ 66 Pa. C.S. § 1301.1(a).

¹⁷ McCloskey v. Pa. PUC, 127 A.3d 860 (Pa. Commw. 2015) (McCloskey).

¹⁸ Id. at 871.

Had the General Assembly wanted to prohibit this practice for DSIC mechanisms or even proscribe and curtail the Commission's discretion to allow utilities to continue to utilize this practice, the General Assembly could have explicitly incorporated such a prohibition or placed a limit on the Commission's discretion at the time it enacted Act 11.¹⁹

Six months after the Court's Order was entered in November 2015, the General Assembly took such action by enacting Act 40, codified in Section 1301.1 of the Public Utility Code.²⁰ Section 1301.1(a) provides:

If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates.²¹

The statute requires that related income tax deductions and credits must be included in the calculation of current or deferred income tax expense to reduce rates.

The FirstEnergy Companies consider this to be "micromanaging" but, as observed by the ALJ, that is the prerogative of the General Assembly. R.D. at 33-34. He stated:

The Commission has only the authority granted to it by the General Assembly and the Commission must act within, and cannot exceed, its statutory authority. City of Pittsburgh v. Pa. Pub. Util. Comm'n, 43 A.2d 348 (Pa.Super. Ct. 1945). Again, the General Assembly has removed the Commission's discretion in this area. The Commission **must** include in the computation of current or deferred income tax expense the related income tax deductions and credits to reduce rates if an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes.

R.D. at 27.

The FirstEnergy Companies argue, however, that Act 40 changes nothing because the earnings cap functions to "reduce rates" to zero. FE Exc. at 14-15. That does not satisfy the explicit requirement of the statute. Section 1301.1 requires that the computation of current or

¹⁹ Id. at 870-71.

²⁰ 66 Pa. C.S. § 1301.1.

²¹ Id.

deferred income tax expense include the related income tax deductions and credits to reduce rates. The earnings cap is not part of the “computation of current or deferred income tax expense.”

While that is dispositive of the issue, the OCA seeks to correct FirstEnergy’s characterization of what the earnings cap can do. The earnings cap does not prevent the Companies from charging a DSIC rate that is calculated as if they received no income tax deductions. Current quarterly earnings are generated by the Company’s total rates, which may be below the Company’s overall allowed rate of return for any number of reasons, including an increase in costs that are wholly unrelated to distribution improvements.²² In this situation, the DSIC rate will not recognize the ADIT and incremental state tax deductions generated by DSIC investment. Moreover, unless the Company has had a recent base rate case, the earnings cap compares the Company’s quarterly earnings to an allowed rate of return calculated using an equity return rate that is a composite rate calculated by the Commission for all regulated electric distribution utilities, so there is no meaningful reflection of any one utility’s tax deductions and, even less, one utility’s DSIC-related income tax deductions.²³

As such, the ALJ correctly determined that the FirstEnergy Companies must change their DSIC computation to comply with Act 40. He stated:

The OCA, therefore, is correct that the companies must modify their DSIC calculation to include federal and state income tax deductions generated by DSIC investment. Doing so is what the General Assembly directed when enacting Act 40, regardless of McCloskey. No further analysis is required. The discretion previously afforded to the Commission in McCloskey is no longer present in light of the enactment of Act 40. The companies’ arguments to the contrary are without merit and should be rejected.

²² 52 Pa. Code §§ 71.1, et seq.; see FE Exc. at 14.

²³ 66 Pa. C.S. §§ 1357(b)(2)-(3), 1358(b)(3).

R.D. at 25.

As noted in the OCA's Reply Brief, the addition of ADIT and the state income tax deductions to the DSIC calculation is not the only impact of Act 40 on the Companies' DSIC Rider. OCA R.B. at 7-8. With Act 40, consumers will lose the benefit of the consolidated tax savings adjustment when calculating whether a utility is overearning. Act 40 will work to the Companies' benefit in this regard. When Act 40 is read in its entirety, the General Assembly balances these impacts by also requiring that "related tax deductions and credits" also be included in the calculation to reduce rates.

The OCA submits that the Commission should adopt the determination of the ALJ that FirstEnergy must modify its DSIC calculation to include federal and state income tax deductions generated by DSIC investment.

Reply to FE Exception No. 3: The ALJ Correctly Determined that the Plain, Unambiguous Language of Section 1301.1 Applies to the DSIC because the DSIC is a "Rate". R.D. at 25-26, 48; FE Exc. at 15-19; OCA M.B. at 11-15; OCA R.B. at 5-7; OCA S.M.B. at 9-12; OCA S.R.B. at 2-5.

The FirstEnergy Companies argue that Section 1301.1 does not apply to the DSIC because it was only intended to apply to base rates. FE Exc. at 15-19. The ALJ rejected this argument because the plain, unambiguous language of Section 1301.1, states, in relevant part:

(A) COMPUTATION. – If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates.

66 Pa. C.S. § 1301.1(a). The ALJ concluded, correctly, that the DSIC is a rate that recovers utility investment and income tax expense related to that investment.²⁴ FirstEnergy acknowledges that the DSIC is a rate. FE Exc. at 13 (“the entire DSIC Rider is a “rate”). “Rate” is a technical word defined in the Public Utility Code.²⁵ When technical words are defined in a statute, they “shall be construed according to such peculiar and appropriate meaning or definition.”²⁶ The requirement of Act 40, that related income tax deductions shall be included in the computation of current or deferred income tax expense to reduce rates, therefore, must be applied to the DSIC.

It is well-established that when enacting legislation, it is presumed that the General Assembly is familiar with existing law.²⁷ It, therefore, must be presumed that in passing Act 40, the General Assembly was aware of the recent Commonwealth Court order finding it unnecessary to account for federal and state income tax deductions in calculating the DSIC. Had the General Assembly wished not to disturb the Commission’s DSIC orders and McCloskey, it could have specifically excluded the DSIC computation from the mandates of Act 40 or it could

²⁴ The ALJ rejected the Companies’ argument that Section 1301.1 does not apply to the DSIC because it is not a “base rate” stating:

The Public Utility Code specifically defines “rate” to include, in pertinent part, “every individual, or joint fare, toll charge, rental or other compensation whatsoever of any public utility ... made, demanded, or received for any service within this part, offered, rendered or furnished by such public utility.” 66 Pa. C.S. § 102. This is a broad definition and includes the DSIC. As OCA witness Smith testified, “a utility DSIC is a form of utility rates. That form of utility rates is commonly referred to as a surcharge.” OCA S.M.B. at 9-10 (citation omitted). I agree. The Companies’ argument to the contrary must be rejected.

R.D. at 29-30; see also 66 Pa. C.S. §§ 102, 1351.

²⁵ 66 Pa. C.S. § 102.

²⁶ 1 Pa. C.S. § 1903(a). See, e.g., Pa. PUC v. Seder, 139 A.3d 165, *172 (Pa. 2016) (Commonwealth Court held that it was bound by the definition of “Commission” in the Public Utility Code in construing 66 Pa. C.S. § 335(d)).

²⁷ See, e.g., Commw. v. Ramos, 623 Pa. 420, 428, 83 A.3d 86, 91 (2013).

have limited the effect of the first sentence of Act 40 to base rates only, or to CTA's specifically.²⁸ Instead, the General Assembly required related income tax deductions to be included in the computation of income tax expense to reduce all utility rates.

The ALJ agreed with this point, stating:

If Section 1301.1 were only to apply to base rates, the explicit language of Section 1301.1 would say so. It does not.

R.D. at 27. Pursuant to 1 Pa. C.S. § 1921(b), the courts must accept that when the General Assembly selects the words to use in a statute, it has chosen them purposefully, and courts cannot change those words to reflect their own public policy concerns.²⁹ FirstEnergy's attempt to insert words or language into Act 40 that the General Assembly did not include must be rejected.

The FirstEnergy Companies' make the claim, however, that there is ambiguity in Section 1301.1 because the statute includes the term "rate base" and "final order." FE Exc. at 17-18. They contend that those terms are not relevant to the DSIC and, therefore, their use in Act 40 creates ambiguity. FE Exc. at 15-19. The Companies ignore that the DSIC provides recovery of depreciation and pretax return on plant investment "not previously included in rate base."³⁰ The

²⁸ This is not the first time the General Assembly has amended a statute and legislatively overruled decisions of the judiciary. 66 Pa. C.S. §§ 1350, *et seq.* See, e.g., Commonwealth v. State Conference of State Police Lodges of the Fraternal Order of Police, 525 Pa. 40, 575 A.2d 94 (1990), superseded by statute, 71 Pa. C.S. § 5955. In 2005, the Commonwealth Court found the Commission could not approve a DSIC mechanism for wastewater utilities. Popowsky v. Pa PUC, 869 A.2d 1157, 1160 (Pa. Commw. Ct. 2005). In 2012, the General Assembly enacted Act 11, which allowed all utilities, including wastewater, to establish a DSIC. Indeed, both parties are in agreement that Act 40 itself overrules Pennsylvania Supreme Court precedent in regards to the Consolidated Tax Adjustment (CTA).

²⁹ See, e.g., Commw. v. Scolieri, 571 Pa. 658, 661, 813 A.2d 672, 673-74 (2002).

³⁰ Final Implementation Order at 29.

same plant investment will be rolled into the rate base on which the utility earns depreciation and pretax return in its new base rates.³¹

The Companies also ignore that, in addition to the DSIC, Act 11 of 2012 established the fully projected future test year mechanism (FPFTY).³² Because the FPFTY enables utilities to include plant investment in rate base that is made after new base rates are in effect, when the utility could otherwise recover return of and on the same plant investment in the DSIC, these mechanisms must be coordinated to prevent double recovery.

The connection between rate base and the DSIC is demonstrated by the June 9 Orders. Therein, the Commission directed each of the FirstEnergy Companies:

to include in its compliance tariff filing updated plant data so the Commission may accurately discern when DSIC-eligible plant investment has exceeded the level being recovered via the Company's base rates. Met-Ed should provide the amount of DSIC-eligible investment assumed in the fully projected future test year used in the rate case and a comparison of that test year amount to the amount of DSIC dollars actually expended in the projected test year for the period ending April 30, 2016.

June 9 Orders (MetEd) at 8-9. Thus, the term "rate base" is relevant to the DSIC and creates no ambiguity by its use in Act 40.

FirstEnergy's similar argument with regard to "final order" should also be rejected. The Companies' state that "final order" is mentioned in the Public Utility Code with regard to a general base rate case but not the DSIC and, based on this, posit that its mention in Act 40 creates ambiguity whether the Act only applies to base rates. FE Exc. at 18. This argument fails because cases under 66 Pa. C.S. § 1308(d) are not the only cases where a final order is entered. A final order of the Commission is a technical term, defined in the Rules of Appellate Procedure,

³¹ "The DSIC will be reset at zero upon application of new base rates to customer billings that provide for prospective recovery of the annual costs that had previously been recovered under the DSIC." Final Implementation Order, App. A at 8; 66 Pa. C.S. §§ 1357(a)(3), 1358(b)(1)-(2).

³² 66 Pa. C.S. § 315.

that “disposes of all claims and of all parties” for purposes of judicial review.³³ Although there is no mention of “final order” in the statute providing for non-general rate cases, 66 Pa. C.S. § 1308(b), the Commission enters final orders in those cases.³⁴ Likewise, while the term “final order” does not appear in DSIC-related statutes, final orders disposing of all claims and all parties are entered in DSIC-related cases, including petitions to implement a DSIC, petitions to implement a long-term infrastructure improvement plan (LTIIP), petitions to refund DSIC overcollections and filings requesting waiver of the statutory DSIC cap.³⁵ In addition, in its Final Implementation Order, the Commission notes that it will enter a final order where the results of DSIC audit, required by the DSIC statute, 66 Pa. C.S. § 1358(e), are contested.³⁶ Thus, there is no factual support for the Companies’ argument because “final order” applies to the DSIC as well as base rates.

In a final attempt, the FirstEnergy Companies also argue that there is ambiguity in the text of Act 40 because its application to the DSIC conflicts with 66 Pa. C.S. § 1357. They claim that the OCA agrees there is a conflict, citing to the OCA’s Supplemental Main Brief in this case. They are incorrect. The OCA pointed out, *arguendo*, that if a conflict existed, Act 40

³³ 42 Pa. C.S. § 763(a)(1). This Rule of Appellate Procedure states:

A final order is any order that:

(1) disposes of all claims and of all parties; or

...

(3) is entered as a final order pursuant to paragraph (c) of this rule.

³⁴ See, e.g., Popowsky v. Pa. PUC, 683 A.2d 958 (Pa. Commw. 1996) (the Court considered an appeal from a final order authorizing a non-general rate increase).

³⁵ McCloskey at 864-65; Petition of Metropolitan Edison Co. for Approval of an LTIIP, Docket Nos. P-2015-2508942, et al. (Order entered Feb. 11, 2016) (approving the FirstEnergy Companies’ LTIIPs); Petition of Peoples Natural Gas Co. LLC – Equitable Division, Docket No. P-2015-2486463 (Order entered July 30, 2015) (approving refund plan for overrecovery of DSIC); Petition of UGI Utilities, Inc. – Gas Division, Docket No. P-2016-2537586 (Order entered Aug. 31, 2017) (denying petition for waiver of the 5% cap). Indeed, FirstEnergy has made the finality of the June 9 Orders an issue in this case, bearing on the burden of proof and the application of Act 40. FE Exc. at 11, 20, n.20.

³⁶ Final Implementation Order at 39.

would prevail. OCA S.M.B. at 14. The OCA then established that there is no conflict. As stated there, and discussed in more detail in the next Reply Exception, using an effective tax rate in the DSIC calculation does not change the applicable statutory state income tax rate. There is, therefore, no conflict between the statutes and no ambiguity within Section 1301.1. Id. at 14-16. The ALJ agreed. See R.D. at 31.

In conclusion, the language of Act 40 is clear and unambiguous, and as such, “the letter of it is not to be disregarded under the pretext of pursuing its spirit.” 1 Pa. C.S. § 1921(b). Section 1301.1 applies to the calculation of the DSIC because the DSIC is a “rate.” The ALJ’s recommendation should be adopted.

Reply to FE Exception No. 4: The ALJ Correctly Determined that Section 1301.1 Applies to the Companies’ DSIC Riders because the Final Order Approving Them Will be Issued After the Statutes Effective Date. R.D. at, 48; FE Exc. at 15-19; OCA M.B. at 11-15; OCA R.B. at 5-7; OCA S.M.B. at 9-12.

Section 1301.1(c) provides that the statute applies “to all cases where the final order is entered after the effective date of this section.”³⁷ As discussed in the prior Reply Exception, the use of the term “final order” in Act 40 does not create any ambiguity whether the Act applies to the DSIC. Continuing with that refuted argument, however, FirstEnergy contends that it is difficult to discern what the “final order” might be in the context of the DSIC. It argues that “since a utility proposing a DSIC *must* adopt the Model Tariff, and the Commission, to allow a DSIC to be implemented *must find* that the utility’s proposed tariff conforms to the Model Tariff, the only order that has real substantive effect in this context is the Final Implementation Order.”

³⁷ 66 Pa. C.S. § 1301.1(c).

FE Exc. at 19-20, n.40 (emphasis in original). The Companies are incorrect because they misstate the function and effect of the Model Tariff.

The applicable statute, Section 1353(b)(1), states with regard to the Model Tariff:

A petition for commission approval of a distribution system improvement charge shall include the following:

(1) An initial tariff that complies with a model tariff adopted by the commission.³⁸

The Model Tariff is not a regulation or otherwise a binding norm.³⁹ FE Exc. at 20. The Model Tariff is, simply, an example. It reflects the Commission's determination that, if a utility files a tariff adopting the model tariff language, the tariff is likely to be approved. That is why the Commission will consider and has approved initial DSIC tariffs that differ from the model tariff.⁴⁰ Notably, and as will be discussed in the next Reply Exception, the FirstEnergy Companies' DSIC tariffs differ from the Model Tariff because they allow the Companies to recover gross receipts tax through the DSIC. June 9 Order (MetEd) at 11-12.

Thus, the "final order" for purposes of any individual utilities' DSIC rate is not the order adopting the Model Tariff, which was issued before any utilities filed a proposed tariff and DSIC calculation for the Commission to review. The "final order" for purposes of the FirstEnergy Companies' DSIC rate is any order that approves the Companies' DSIC rate and disposes of all claims and all parties.⁴¹ The Final Implementation Order did not approve FirstEnergy's DSIC

³⁸ 66 Pa. C.S. § 1358(b)(1).

³⁹ Mid-Atlantic Power Supply Ass'n v. Pa. PUC, 746 A.2d 1196, 1197 (Pa. Commw. 2000) ("The General Assembly's directive to promulgate guidelines to implement provisions of legislation does not constitute a regulation, but instead is a policy statement not subject to the regulatory review process").

⁴⁰ See, e.g., Columbia Gas at 59; Petition of Peoples TWP, LLC to Implement a DSIC, Docket No. P-2013-2344595 at 39 (Order entered Aug. 21, 2014); Petition of Philadelphia Gas Works to Implement a DSIC, Docket No. P-2012-2337737 at 8-11 (Order entered May 9, 2013).

⁴¹ See discussion accompanying notes 2 and 33, supra.

rate and the June 9 Orders did not dispose of all claims and all parties. Therefore, for purpose of applying Act 40 to the DSIC, no final order has yet been issued. The ALJ reached the same conclusion and rejected the Companies' argument, stating:

These consolidated cases arise from the DSIC filings made by the companies on February 16, 2016.

There has been no "final order" for purposes of this particular issue in this case entered prior to the effective date of Act 40 that would bar the application of Section 1301.1, as the companies argue. Rather, the final order in this proceeding will be entered following the issuance of this decision and the Commission's consideration of any exceptions and reply exceptions. The final order will be entered after August 11, 2016, the effective date of Section 1301.1 and, therefore, Section 1301.1 is applicable to this proceeding. The companies' argument to the contrary will be denied.

R.D. at 27-28.

Contrary to FirstEnergy's argument, there is no difficulty in determining what is a final order approving a DSIC rate and, therefore, no ambiguity surrounding the use of "final order" in Act 40. The Companies' arguments with regard to the Final Implementation Order and June 9 Orders should be rejected, consistent with the recommendation of the ALJ. Section 1301.1 applies to the FirstEnergy Companies' DSIC Rider and, as such, the Companies must change their calculation to include federal and state income tax deductions related to placing DSIC-eligible plant in service in their DSIC computations.

Reply to FE Exception No. 5: The ALJ Correctly Determined that Changes to the DSIC Calculation Are Required to Comply with Section 1301.1 and the OCA's Proposal Is Supported by Substantial Record Evidence. R.D. at 29-33; FE Exc. at 20-28; OCA M.B. at 12; OCA S.M.B. at 12-16; OCA S.R.B. at 5-9.

FirstEnergy also argues that the OCA's proposals for applying Section 1301.1 to the DSIC conflict with terms in Sections 1351 and 1357(b) of the DSIC statute and should be

rejected for this reason and because they require more steps than the current calculation.⁴² FE Exc. at 20-28. The OCA will address the Companies' myriad arguments below. The two main points, however, are that (1) there is no conflict in the statutes and (2) the Companies' arguments are no longer relevant since the passage of Act 40. The new law requires a change to the Companies' DSIC calculation.

A. Accumulated Deferred Income Tax (ADIT)

With regard to how ADIT should be included in the DSIC calculation, the OCA recommended that it be deducted from the value of eligible property. OCA St. 1 at 110. As OCA witness Smith stated:

Reflecting the infrastructure investment-related tax benefits to reduce rates would typically take the form of reducing the net plant investment amount by the directly related ADIT.

Id. FirstEnergy argues that ADIT does not "fit" into the DSIC calculation because "rate base" is not an element of the DSIC calculation. FE Exc. at 21-22. As discussed supra at pages 12 to 13, in fact, "rate base" is directly related to the "eligible property" recovered through the DSIC. The DSIC recovers incremental investment – on which the utility earns depreciation and pretax return – that is rolled into utility rate base so the utility can recover depreciation and pretax return on the same investment through base rates.⁴³ The Commission has also recognized the need to distinguish the incremental investment recovered through the DSIC with the investment that is recovered in base rates through the fully-projected future test year. This is because the FPFTY enables utilities to include plant investment in rate base that is made after new base rates are in effect, when the utility could otherwise recover return of and on the same plant investment in the

⁴² 66 Pa. C.S. §§ 1351, 1357(b).

⁴³ 66 Pa. C.S. §§ 1357(a)(3), 1358(b)(1)-(2).

DSIC.⁴⁴ Thus, the Companies' assertion that "rate base" is not an element in the calculation of quarterly DSIC charges ignores the overlap between rate base and the DSIC's "original cost" of eligible property. See, e.g., June 9 Orders (MetEd) at 8-9.

As the Companies indicate, ADIT is an additional source of zero-cost capital. FE Exc. at 22. The Companies contend that ADIT does not fit into the statutory definition of "pretax return" and the calculation provided in Section 1357(b)(1) and (2).⁴⁵ The OCA has not recommended, however, that there be any adjustment to the pretax rate of return to reflect federal or state income tax deductions. Federal income tax deductions are deferred and not flowed through pretax return.⁴⁶ OCA St. 1 at 108-09.

More generally, FirstEnergy argues that because the DSIC statute does not specifically address ADIT, it prohibits ADIT from being included in the calculation. FE Exc. at 21-22. By this reasoning, the DSIC calculation cannot recover gross receipts tax (GRT) on DSIC revenue because it is not specifically identified in the statute. Yet, the Commission approved a DSIC calculation for FirstEnergy that recovers GRT.⁴⁷ The OCA did not oppose the inclusion of GRT as an addition to the DSIC calculation because an electric utility will "incur" gross receipts taxes when it recovers revenue to "repair, improve or replace DSIC-eligible property" and the OCA

⁴⁴ 66 Pa. C.S. § 315.

⁴⁵ 66 Pa. C.S. § 1357(b)(1), (2).

⁴⁶ I.R.C. §§ 167, 168; FE S.M.B. at 9, n.34.

⁴⁷ June 9 Orders (MetEd) at 11-12. The addition of GRT is reflected as "T" and adds another step to the DSIC calculation contained in the Model Tariff:

$$\text{DSIC} = \frac{((\text{DSI} * \text{PTRR}) + \text{Dep} + e) * (1/(1-T))}{\text{PQR}}$$

See also Petition of PPL Elec. Util. Corp. for Approval of a DSIC, Docket No P-2012-2325034 at 8-9, 18-19 (Order entered May 23, 2013).

agrees that those taxes can be part of the DSIC calculation, even though they are not specifically identified in the statute.⁴⁸

Moreover, the plain language of Act 11 allows the Commission to implement the specific rate mechanisms for recovery of eligible costs incurred by the utilities, subject to the overriding requirement that the rates must comply with all provisions of the Public Utility Code.⁴⁹ The Commonwealth Court affirmed that the Commission could approve a DSIC that did not include ADIT and state income tax deductions.⁵⁰ The Commonwealth Court did not determine – and the Company is incorrect to interpret – the omission of these specific adjustments in the statute to mean that the adjustments cannot be made under Act 11. Indeed, by enacting Section 1301.1, the General Assembly has required that they shall be reflected in the DSIC rate.

B. State Income Tax Deductions

The OCA proposed two methods to recognize the impact of the deductions related to the state income taxes recovered through the DSIC. OCA St. 1 at 2-3; OCA St. 1SR-Supp. at 3-4, 6-7, 8-9. Both methods accomplish the same thing; they reduce the DSIC by the amount the utility’s state income tax decreases as a result of state income tax deductions related to the DSIC includable property. OCA St. 1SR-Supp. at 3-4. As Mr. Smith explained:

One method is to use an “effective” tax rate. This converts the impact of the state income tax deductions related to DSIC investment, which is the dollar amount by which taxable income is reduced, to a percentage that can be used in the Company’s existing DSIC calculation.

...

⁴⁸ The plain language of Act 11 limits DSIC recovery to costs incurred by utilities. The term “costs incurred” appears twice – in Sections 1351 and in 1353(a), which address the scope of the charge and the Commission’s authority to approve a DSIC. 66 Pa. C.S. §§ 1351 (Definitions), 1353(a) (Authority).

⁴⁹ 66 Pa. C.S. §§ 1301, 1351, 1353(a), 1357(c).

⁵⁰ McCloskey at 870-71.

Another method to recognize the impact of the deductions is to have a separate calculation of the amount of state income tax expense that is reflected in the DSIC revenue requirement. Here, the amount is not converted to a percentage and the unadjusted statutory state income tax rate is used in the calculation. Either method will produce the same DSIC rate.

While either method will serve to include related income tax deductions and credits in the computation of current or deferred income tax expense to reduce DSIC rates, I recommended using the effective tax rate method because it does not alter the Companies' existing DSIC formula.

OCA St. 1SR-Supp. at 3.

The first method would not change the existing DSIC formula contained in the FirstEnergy Companies' tariffs. It would adjust the revenue conversion factor (or tax multiplier) used to calculate the pre-tax rate of return (PTRR) in the DSIC formula used by the Companies to flow-through the state income tax deductions related to DSIC investment:

$$\text{DSIC} = \frac{(\text{DSI} * \text{PTRR}) + \text{Dep} + e}{\text{PQR}}$$

OCA St. 1SR-Supp. at 8-9. Specifically, the tax multiplier would reflect the actual amount of state income taxes that the utility will pay on DSIC income. Id. at 3, 6-7; OCA St. 1-Supp. at 2.

The second method would change the existing DSIC formula contained in the Companies' DSIC tariffs. Specifically, a separate component would be added to the formula to provide for the allowance for income taxes. OCA St. 1SR-Supp. at 8-9. The income tax calculation would reflect the impact of state income tax deductions on DSIC eligible property.

$$\text{DSIC} = \frac{(\text{DSI} * \text{ROR}) + \text{Dep} + e + \text{IT}}{\text{PQR}}$$

where "IT" is the allowance for income taxes, and "ROR" is the weighted cost of capital (aka rate of return), exclusive of income taxes.

Id. at 9.

The ALJ recommended that the OCA's first method be adopted. R.D. at 29-31. He noted that this method would not change the existing DSIC formula contained in the Companies'

tariffs but would adjust the revenue conversion factor used to calculate the pre-tax rate of return in the DSIC formula to reflect the actual amount of state income taxes that the Companies will pay on DSIC income. Id. at 31 (citing OCA S.M.B. at 13; OCA St. 1SR-Supp at 8-9). He noted, further, that the mechanics of the pre-tax rate of return are not included in the Companies' tariff riders but are provided in the calculations supporting each Companies' quarterly DSIC updates. Id.; see OCA Exh. LA-ME-1.

In their Exceptions, the FirstEnergy Companies repeat arguments from their briefs that were duly considered and rejected by the ALJ on the basis that the law now requires the inclusion of federal and state income tax deductions in the DSIC rate. R.D. at 31-32. Specifically, with regard to the OCA's first method, the Companies argue that Section 1357(b)(1) prohibits use of an effective tax rate. FE Exc. at 24. The cited provision of Act 11 states that "the pre-tax return shall be calculated using the Federal and State income tax rates."⁵¹ Using an effective tax rate in the DSIC calculation, however, does not change the applicable statutory state income tax rate. Just as calculating an average tax rate or a marginal tax rate does not change the applicable statutory tax rate. OCA S.R.B. at 7; OCA S.M.B. at 14-15; OCA St. 1-Supp. at 3-4. The statutory state income tax rate is still "used" in the calculation of pre-tax return. This is best exemplified by the fact that both methods identified by the OCA for reflecting deductions produce the same DSIC rate, even though one does not adjust the statutory state income tax rate. R.D. at 11 (Finding of Fact no. 16), 31; OCA St. 1-Supp. at 3; OCA M.B. at 14-15. There is, thus, no inconsistency in using the statutory income tax rate pursuant to Section 1357(b)(1) and reducing the DSIC rate to reflect state income tax deductions pursuant to Section 1301.1. See R.D. at 31.

⁵¹ 66 Pa. C.S. § 1357(b)(1).

The Companies do not argue that they are not able to calculate the required offset, only that it is more difficult than the current calculation because it would require a three-step process. FE Exc. at 24-26. The OCA has pointed out that if the Company's informed estimates are different than the actual adjustment for state income tax deductions, Act 11 provides for reconciliation.⁵² Moreover, the additional steps will not change the timeliness of the Companies' recovery of DSIC-eligible investment. The surcharge can still take effect in as few as 10 days.⁵³ If the calculation is contested, the rates can be put into effect, subject to refund or recoupment, as was done in the case sub judice. June 9 Order (MetEd) at 20-21.

The OCA also refuted the Company's claim that using an effective tax rate will double count book depreciation. FE Exc. at 25. FirstEnergy's arguments regarding double-counting are misleading. The Companies point out that the existing DSIC formula already gives customers credit for a deduction in an amount equal to the depreciation recognized as an allowable expense in the DSIC calculation. FE S.I.B. at 17. As a result, if the deductions included in the depreciation expense were also included in the revenue conversion factor, there would be a double-count. Id. That much is correct but it is not what the OCA proposed.

There are additional state income tax deductions related to DSIC investment that are not included in the existing calculation of the DSIC rate (in the depreciation expense).⁵⁴ FE Exh. 1 at 1-2; OCA St. 1-Supp. at 5; see OCA M.B. at 15-16. The OCA's recommended adjustments to

⁵² 66 Pa. C.S. §§ 1358(d)(2), (e).

⁵³ 66 Pa. C.S. § 1357(d)(3).

⁵⁴ As discussed in the OCA's Reply Brief, the record demonstrates that depreciation on DSIC-eligible property for state income taxes, *i.e.* the state income tax deduction for depreciation, will exceed the book depreciation on the DSIC-eligible property that is included in the existing DSIC rate calculation. The state tax depreciation rate is the MACRS for 20-year plant plus an additional 3/7ths (or 42.68%), which is greater than the book depreciation rate. See FE Exh. 1 at 1-2; see e.g., Metropolitan Edison Exh. KMS-3, Sch. 4; see OCA S.R.B. at 7-8. There is, thus, an incremental amount of state income tax deductions for tax depreciation that is required by Act 40 to be recognized to reduce the DSIC rate but is not recognized by the Companies' existing calculation.

the formula are intended to capture the impact of these additional state income tax deductions only. See OCA St. 1SR-Supp. at 5-6. There will be no double-count if the revenue conversion factor is calculated to reflect the impact of tax deductions that are not already included in the depreciation expense component of the formula. Id. If the Companies' are opposed to taking the steps necessary to correctly calculate the revenue conversion factor, the OCA has pointed out that its second proposed method will also avoid double-counting, in that it separates the calculation of related income tax impacts from the rest of the DSIC equation. OCA S.R.B. at 7-8; OCA St. 1SR-Supp. at 9.

Finally, the Companies argue that that OCA's first method should not be adopted because it is not "straightforward" and "would require the kind of comprehensive revenue requirement analysis [the Commission] has previously held is not required for calculating the [quarterly] DSIC." FE Exc. at 25-26. The ALJ rejected these arguments as not relevant because the law has changed. R.D. at 31-32. Section 1301.1 was enacted after the Commission's Final Implementation Order and McCloskey and Section 1301.1 requires the Companies to modify their existing DSIC. Id. He stated further:

Neither of the proposals presented by the OCA appear to be so complex that the DSIC would no longer be straightforward and easy to calculate and audit. While adopting either of the OCA's proposals would require some additional efforts on behalf of the companies, and may also require additional efforts to audit, doing so is necessary to comply with Section 1301.1. Although there may be the need for additional development and refinement of what the OCA specifically proposed in this proceeding, such efforts can be conducted in the compliance filing phase of this proceeding and are not sufficient to warrant denying adoption of either of the OCA's proposals. Even with a possible three additional steps, as the companies argue, the OCA's proposals are not unduly burdensome and should be adopted. Adopting the OCA's proposed method is not the "broad, costly time-consuming inquiry required in general base rate cases," but necessary to comply with Section 1301.1. In addition, if the specific rates developed are contested, the rates could go into effect subject to further review and recoupment. See, OCA S.M.B. at 9.

R.D. at 32-33.

FirstEnergy criticizes the ALJ for stating that additional development and refinement of the OCA's specific proposal can be addressed in the compliance phase. FE Exc. at 26. The fact is that the Company did not offer its own proposal to recognize the impact of the deductions related to the state income taxes recovered through the DSIC. The OCA provided two reasonable methods and the ALJ preferred the first of those, for the reasons stated above. The OCA is willing to work with the Companies to implement the method adopted by the Commission.

As required by Act 40, the FirstEnergy Companies should be directed to include ADIT and state income tax deductions related to placing DSIC-eligible plant in service in their DSIC computations.

III. CONCLUSION

For the reasons set forth above and in its Briefs and Supplemental Briefs, the Office of Consumer Advocate respectfully requests that the Pennsylvania Public Utility Commission deny the Exceptions of the FirstEnergy Companies. The OCA submits that the Commission should uphold the ALJ's Recommended Decision and direct the FirstEnergy Companies to account for related federal and state income tax deductions and credits in the computation of current or deferred income tax expense to reduce DSIC rates. For federal income tax deductions this is accomplished by reducing the net plant investment (original cost of DSIC-eligible plant net of depreciation) by the directly related ADIT. With regard to the specific method for calculating state income tax expense, the OCA submits that the Commission should adopt the ALJ's recommendation to require the Companies to adopt the first method proposed by the OCA in this proceeding.

Respectfully submitted,



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