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MAR -5 2018

BOARD OF PUBLIC UTILITIES  
TRENTON, NJ



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March 2, 2018

**VIA HAND DELIVERY**

Aida Camacho-Welch  
Secretary  
Board of Public Utilities  
44 South Clinton Ave.  
3rd Floor, Suite 314  
PO Box 350  
Trenton, NJ 08625-0350

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MAR 05 2018

BOARD OF PUBLIC UTILITIES  
TRENTON, NJ

**Re: In the Matter of the New Jersey Board of Public Utilities' Consideration of  
the Tax Cuts and Jobs Act of 2017  
BPU Docket No. AX18010001**

**In the Matter of the Petition of New Jersey-American Water Company, Inc. with  
Calculation of Rates under the Tax Cuts and Jobs Act of 2017  
BPU Docket No. WR18030233**

Dear Ms. Camacho-Welch:

This firm represents New Jersey-American Water Company, Inc. ("NJAWC" or the "Company"). NJAWC files an original and ten copies of this letter petition in compliance with the January 31, 2018 Order (the "Order") of the New Jersey Board of Public Utilities (the "Board") in the above-referenced matter, BPU Docket No. AX18010001. The Order directs all public utilities with revenues equal to or greater than \$4.5 million to file a petition by this date setting forth the impact of the 2017 Tax Cuts and Jobs Act (the "Act") on the utility's revenue requirement along with proposed interim rates effective April 1, 2018 and rate and tariff design proposals.

The Order provides that for ratepayers to receive the benefit from the Act's reduction in taxes, NJAWC must take certain steps to reflect the effective federal corporate tax rate under the Act. The Order seeks to accomplish the foregoing in three ways. First, the Board directs NJAWC to defer as of January 1, 2018 with interest at the Company's overall allowed weighted cost of capital the effects of the Act on accumulated deferred income taxes ("ADIT"). Second, the Board directs NJAWC to provide tariff rates reflecting the new tax rate of 21% to be effective April 1, 2018 on an interim basis and to propose a rate mechanism for refunding the deferrals of the over-recovery to ratepayers. Third, the Board directs NJAWC to defer as of January 1, 2018 with interest at the Company's short term debt rate the difference between rate recovery made utilizing the tax expense calculated at 35% and the tax expense calculated at 21% for the period January 1, 2018 through March 31, 2018.

Although NJAWC submits the information and proposals required under the Order, NJAWC contends that the Order is legally defective as it is single-issue ratemaking, prohibited by the New Jersey Supreme Court *In re Central Railroad Company of New Jersey*, 66 N.J. 12, 21-22

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(1974). Further, that portion of the Order requiring NJAWC to refund the purported over collection of rates from January 1 to January 31, 2018, the effective date of the Order, is unlawful, retroactive ratemaking.

**I. The Order Is Unlawful Single-Issue Ratemaking under *In re Central Railroad Company of New Jersey*, 66 N.J. 12, 21-22 (1974)**

The Order directing NJAWC to propose and implement new rates as of April 1, 2018 based solely on the decrease in the federal corporate tax rate with no consideration for rate base, other expenses, or a proper rate of return is unlawful, single-issue ratemaking under *In re Central Railroad Company of New Jersey*, 66 N.J. 12, 21-22 (1974) ("*Industrial Sands*"). Indeed, the Order focuses on one expense item from a utility's income statement to the exclusion of all others, as it relies solely on the utility's income tax expense. The Order also ignores potential additional financing requirements and cash flow impacts resulting from the Act. Rather than utilizing the established ratemaking concepts that rates must be set through a determination of just and reasonable rates based upon findings of rate base, prospective operating income, and fair rate of return, the Board requires use of a test period that in the case of NJAWC is several years old. Indeed, the Order forces NJAWC, which is in the midst of a current base rate case, to propose and implement new rates based on a test year ending July 31, 2015 and to disregard any other financial changes since that test year end. Thus, the Board's Order isolates a single expense and considers it solely from an historical perspective.

When setting rates, the Board is required to take into account rate base, expenses, and rate of return. *Id.* If any one of these three items is not "reasonably supported by the proofs, the rate . . . itself is unreasonable." *Id.* at 22. See also *In re Bd.'s Investigation of Tel. Companies*, 66 N.J. 476, 497-98 (1975); *In Matter A. Fiore & Sons, Inc.*, 96 N.J.A.R.2d 64 at \*5, 1995 WL 863035 (App. Div. 1995).

In *Industrial Sands*, the New Jersey Supreme Court considered whether a Board-approved rate increase for Central Railroad Company of New Jersey ("CNJ") was proper. At the time of CNJ's application for a rate increase, CNJ was in dire financial straits. *Industrial Sands* at 14. The Board determined that requiring CNJ to hire experts to establish rate base and rate of return would be an "exercise in futility" as CNJ was operating at a loss and would continue to do so even after the proposed rate increase went into effect, resulting in a negative rate of return. *Id.* at 17-18. Thus, the Board approved CNJ's proposed rates without considering proof of rate base and reasonable rate of return. *Id.*

CNJ contended that the "lesser proofs" reviewed by the Court were acceptable. *Id.* at 18-19. However, our Supreme Court found "no merit" in CNJ's contentions that anything less than the "usual foundation of proofs of rate base and reasonable rate of return" were required. *Id.* at 19.

The Court held that the Board can only consider the reasonableness of rates "after an examination of a company's property valuation which constitutes its rate base; its expenses, including income taxes and an allowance for depreciation; and the rate of return developed by relating its income to the rate base," and that "if any one of three be not reasonably supported by the proofs, the rate or fare itself is unreasonable." *Id.* at 21-22. See also *In re Revision of*

*Rates by Redi-Flo Corp.*, 76 N.J. 21 (1978)<sup>1</sup>; *In re Bd.'s Investigation of Tel. Companies*, *supra*, at 497-98 (1975); *In Matter A. Fiore & Sons, Inc.*, *supra*, at \*5.

Here, the Board is attempting through the Order to adjust rates solely based on one expense item – the federal income tax expense. Under the Order, the Board would lower utility rates without consideration of rate base, rate of return, and expenses other than federal income tax. This violates *Industrial Sands*. By way of example, the Board would disregard the negative effect on cash flow stemming from the Act.

In addition, the Board cannot rely upon an argument that “lesser proofs” are acceptable due to emergent circumstances arising from the Act. The *Industrial Sands* court rejected that argument noting that the theory that rates could be adjusted on a permanent basis without exploring rate base and rate of return had “long since been discarded.” *Id.* at 23. Moreover, the Legislature codified those limited, emergent circumstances in which the Board need not find a rate base at N.J.S.A. 48:2-21.1, and none of them are present here.

## **II. The Order Is Unlawful Retroactive Ratemaking Under *In re Elizabethtown Water Co.*, 107 N.J. 440 (1987)**

On January 31, 2018, the Board directed the Company to go back and refund a tax expense that the Company collected, *inter alia*, from January 1, 2018 to January 31, 2018. The Board's directive is retroactive ratemaking, as such a refund would be retroactively applying an expense reduction to customer rates.

Retroactive ratemaking occurs when a utility is permitted to recover an additional charge for past losses, or when a utility is required to refund revenues collected, pursuant to then lawfully established rates. *In re Elizabethtown Water Company*, 107 N.J. 440, 448 (1987). Moreover, retroactive ratemaking is impermissible regardless of whether it favors the utility or the ratepayers.” *Id.* at 449. *See also, Pennpac, Inc. v. Passaic county Utilities Authority*, 367 N.J. Super. 487, 500-01 (App. Div. 2004). Utility rates may only be prospective. An increase or decrease in rates cannot be intended to recover or refund prior under- collections or over- collections, as the case may be. *In re Elizabethtown Water Company*, *supra*, at 451. *See also Pennpac, Inc.*, *supra*, at 499.

The seminal New Jersey case addressing retroactive ratemaking is *In re Elizabethtown Water Company*, *supra*. In that case, the New Jersey Supreme Court considered whether the Board's decision to delay implementation of Elizabethtown's new rates, in an attempt to give ratepayers recognition for prior alleged “overearnings” by Elizabethtown, was permissible. *Id.* at 445. The court affirmed the Appellate Division's determination that the Board's actions constituted improper retroactive ratemaking, since the delay in implementation of new rates was clearly designed to give ratepayers recognition for prior overearnings – the Board's determination was unambiguously not prospective. *Id.* at 451.

The Board's intention under the Order is to relate whatever ratemaking changes are made back to January 1, 2018 and require a refund to ratepayers from January 1 to January 31, 2018, a period commencing a month before the issuance of the Order. As such, the Order would

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<sup>1</sup> *Redi-Flo* provided that a fuel cost clause could be implemented if there were a “nexus” to a base rate case. 76 N.J. at 22.

implement retroactive ratemaking and would violate the principles of *In re Elizabethtown Water Company*.

For the foregoing reasons, the Order is unlawful.

### **III. This Filing is In Compliance with the Order**

Despite NJAWC's belief that the Order is unlawful, NJAWC provides the information below in compliance with the Order. The Board should not construe such compliance as an acknowledgment of lawfulness. NJAWC contends that any rate adjustments implemented and not based upon the traditional findings of a test year rate base, operating income and rate of return would be unfair and unlawful. NJAWC submits the calculations below based on the Act and the Company's interpretations thereunder to the best of its knowledge, information and belief.

#### **A. The Impact of the Act on NJAWC's Revenue Requirement**

In calculating the impact of the Act on NJAWC's revenue requirement, the Order directed that the Company compare the income tax expense during the last Board-approved base rate case or clause orders for the Company to the tax expense resulting from the Act. NJAWC has calculated the impact of the Act on its revenue requirement. The result is a revenue reduction of \$42,561,477, including gross-up. The revenue requirement reduction includes the recalculation of taxes in NJAWC's last base rate case, BPU Docket No. WR15010035, in the last base rate case of the Shorelands Water Company ("Shorelands"),<sup>2</sup> BPU Docket No. WR14080905, and in the Company's last DSIC Foundational Filing, BPU Docket No. WR15060724.

NJAWC's last rate case was a "black-box" settlement and the income tax expense contained within that settlement was not specifically defined. NJAWC, however, used the Company's litigation schedules and adjusted the revenue requirement on its schedule to reflect the Board-approved, stipulated revenue increase of \$22,000,000 resulting in corresponding revenue-based tax and income tax adjustments. NJAWC then recalculated the income tax expense under the old rate (35%) and the new rate under the Act (21%). The recalculation resulted in an income tax expense reduction of \$38,545,608.

The Company also recalculated the income tax expense in Shorelands' last rate case in the same manner. The recalculation resulted in an income tax expense reduction of \$247,043.

Lastly, the Company recalculated the income tax expense in the Company's last DSIC Foundational Filing. The recalculation reduced the pre-tax ROE gross up factor resulting in an income tax expense reduction of \$3,768,826. The Schedules supporting the foregoing calculations are attached at Exhibit A.

#### **B. Tariff Design**

The Order further directs NJAWC to provide the tariff rates reflecting the new tax rate at 21% to be effective on April 1, 2018 showing how each rate was developed using the last approved rate design on an inter-class and intra-class basis. Attached at Exhibit B is a proposed tariff giving

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<sup>2</sup> Shorelands, was acquired and merged in NJAWC pursuant to Docket No. WM16101036.

effect in rates to the proposed revenue reduction of \$42,561,477. This reflects the tax decrease for the revenue requirements of NJAWC and Shorelands.

Attached at Exhibit C are the workpapers supporting the proposed tariff. NJAWC adjusted its tariff rates utilizing the Board-approved tariff design in the Company's last rate case. The Company proposes to implement the revenue reduction through an across the board rate decrease for both NJAWC and Shorelands. The impact on NJAWC's average residential customer utilizing 6,000 gallons per month is a decrease of approximately 5.90%. The impact on Shorelands' average residential customer is a decrease in annual rates of approximately 2.25%.

### **C. Over-Recovery of Income Taxes to Be Deferred and Returned with Interest**

Notwithstanding the aforementioned objections to the Order, NJAWC has deferred with interest the impact on income tax expense resulting from the difference between a tax rate of 35% and 21%, effective January 1, 2018. For NJAWC and Shorelands, the Company proposes to allocate the over-collection in base rate revenues from January 1 through March 31, 2018 ("Stub Period") by profiling the average amount of revenues earned in the same months in 2015 through 2017, and on a straight-line basis for NJAWC DSIC revenues. The calculation of the total deferral during the Stub Period totals \$9,358,921, which includes interest of \$36,419. See Exhibit D.

As directed by the Order, in arriving at the interest due as a result of the over-collection, NJAWC applied its short term borrowing rate of 1.527% as of December 31, 2017 to the accumulated deferral balance on a net of tax basis.

As directed by the Order, NJAWC proposes the following rate mechanism for refunding the Stub Period deferrals to ratepayers. The Company proposes to implement a flat rate customer credit, to be applied to monthly bills for 12 months, to return each of the Stub Period balances deferred – NJAWC base rates, NJAWC DSIC, and Shorelands base rates.

### **D. Accumulated Deferred Income Taxes**

In addition to calculating with interest the effects of the Act on the Company's revenue requirement, the Order directs NJAWC to calculate the effects from the Act on accumulated deferred income taxes ("ADIT") and interest at the Company's overall weighted average cost of capital.

NJAWC has remeasured its ADIT balance as of December 31, 2018 at an estimated level for financial accounting purposes using the now federally enacted rate of 21%. Excess deferred taxes fall into two categories: those restricted by normalization provisions of the Act, referred to as "Protected Assets", and those that are not, referred to as "Unprotected Assets." These balances may be comprised of plant and non-plant asset values. The result is a net excess ADIT position, meaning a net ADIT balance that overstates the taxes that will be payable in the future. NJAWC's ADIT balance includes both deferred tax assets ("DTAs") and deferred tax liabilities ("DTLs") requiring remeasurement on the enactment date. NJAWC anticipates that the net of those DTAs and DTLs is an ADIT liability balance, and the remeasurement results in a net excess deferred tax liability.

At this time, NJAWC cannot possibly provide the exact amount of tax savings due to remeasurement of ADIT resulting from the Act. As the Company works through the impact of the Act, some tax changes may not be fully recognized for months or even years because Congress and the IRS are still developing accounting and tax guidance. Such guidance is expected to clarify how various provisions of the new law should be treated, and the December 31, 2017 estimates will be modified as the Company files its 2017 tax returns.

Calculating the effect on ADIT balances that need to be normalized into future rates and implementing a method to normalize the resulting excess is a complex and involved process. NJAWC must invest significant time and resources on the computation. The Company will likely conduct several refinements before reaching a reasonably reliable estimate. Provisions of the Act may also require accounting system upgrades that may require an extended period of time to complete. NJAWC's estimated impact of the remeasurement of ADIT balances in its 2017 financial statements will need to be revised over at least the next year as more information becomes available, in preparing 2017 tax returns yet to be filed, and resolving prior tax returns.

#### 1. Protected ADIT

Further, although the Order directs the Company to provide the rate mechanism related to refunding excess ADIT to ratepayers, NJAWC cannot propose such a rate mechanism without violating IRS normalization rules. Indeed, protected ADIT are subject to IRS normalization rules restricting the allowable flowback of such balances. Under Section 203(e) of the Tax Reform Act of 1986 and Section 13001(d) of the Act, NJAWC cannot reduce cost of service more rapidly or to a greater extent than the rate at which the book/tax temporary differences reverse over the life of the property that gave rise to the excess. NJAWC would determine the timing of the reversal using the Average Rate Assumption Method ("ARAM"). But ARAM is a process by which vintage property information is scheduled out by year and by class for book and tax purposes in each year for which a book/tax difference exists to determine the appropriate timing of the reversal to avoid violating IRS normalization rules. The calculation is very time-consuming because, among other reasons, NJAWC has acquired many water and wastewater systems over the years where the vintage property information was not available. Thus, NJAWC has not yet completed these calculations.

For the foregoing reasons, NJAWC cannot begin flowing the benefits of the Act related to protected ADIT until the Company completes the ARAM calculations to mitigate the risk of violating normalization rules. The Company would risk the loss of the accelerated tax depreciation and the repairs deductions if it violated normalization rules.

NJAWC proposes to defer the excess ADIT liability balance and the refunding of the same to ratepayers until its next rate case. The Company also proposes to "play catch up" for the amount not returned to ratepayers beginning July 1, 2018 up until the time of the next rate case. In the next rate case when the amortization amount is known, the Company will begin to pass back that amount to ratepayers. In addition to that amount, "the catch up amount" will be divided by five years and added to the passback amount. The Company contends that any passback will not include interest, as to do so *with interest* would be "double-dipping" and would not be proper ratemaking. These ADIT balances are a reduction to rate base and a decrease to the cost of service and revenue requirement borne by customers. Ratepayers are currently realizing the benefit of the protected ADIT at the weighted cost of capital of 7.5496%. Any further interest would be duplicative, excessive and punitive in nature. If the Board requires

NJAWC to pay interest on the excess ADIT, NJAWC will need to remove the ADIT balance from rate base in the proposed July 1, 2018 reset contemplated in the Order.

## 2. Unprotected ADIT

Excess unprotected ADIT balances are those related to accounts subject to ratemaking; however, the method of returning and/or collecting such excess is not subject to IRS regulation. However, as stated above regarding protected ADIT, the Company cannot adequately calculate its unprotected ADIT balance at this time without violating normalization rules.

NJAWC recommends deferring the excess unprotected ADIT until the resolution of the Company's next rate case.

### **E. Contributions in Aid of Construction and Customer Advances**

For contributions related to the extension of service, the Company has been using the Board approved gross up factor only for the contributions related to the extension from the main and the customer's property. The Company does not gross-up any other category of contributions related to the extension of service.

Under the Act, all contributions received for extension of service will now be taxable. Thus, the Company proposes to use the gross up factor used for the extension between the main and the customer's property for all contributions related to the extension of service. The gross up factor is 1.1336 for NJAWC and 1.1295 for Shorelands. See Exhibit E.

### **F. Other Material Impacts to the Company**

The Company also proposes that before final rates are implemented on July 1, 2018, that the Board authorize the Company to use the tax expense savings to offset the Company's cost of removal ("COR") balances. In essence, the Act has materially altered the Company's risk profile, which translates directly into a higher cost of capital.

There are several major financial consequences that flow from the Act that will negatively affect the Company. First, a lower federal corporate income tax rate (21% versus 35%) will lower the Company's pre-tax interest coverage and, therefore, will reduce its credit quality and increase risk. Second, with a lower marginal federal corporate income tax rate, the variability of the Company's returns will increase, which increases its business risk. When the federal corporate income tax rate was 35%, investors only needed to absorb 65% of any changes in revenues and expenses. This happens because the Company had a tax benefit equal to 35% of any increase in deductible expenses or 35% of any decrease in taxable revenue. At the current federal corporate income tax rate, the tax benefit is reduced to 21% and, therefore, investors will need to absorb 79% of any increase in expenses or reduction in revenue. As a result, lower federal corporate income taxes will make investor returns more volatile than before, and higher volatility translates into increased business risk for NJAWC. Third, utilities, such as NJAWC, will require more investor-supplied capital to fund its construction program because the level of deferred taxes will decline, the new federal corporate income tax law eliminates bonus depreciation, and "excess" ADIT created by the reduction in the federal corporate income tax rate will be flowed back to customers. This will also impact another credit metric that is important to capital-intensive industries such as water utilities, namely, internally generated funds as a percentage of construction expenditures. This percentage will decline because of

the new lower federal corporate income tax rate. In response to these financial challenges caused by the new lower federal corporate income tax rate, the Company's risk will increase, thereby causing an increase in the cost of capital in response to higher business risk and weaker credit quality measures.

Moody's Investor Service published a Global Credit Research paper on January 19, 2018 and Standard & Poor's published a paper entitled "U.S. Tax Reforms: For Utilities' Credit Quality, Challenges Abound." Essentially, both credit rating agencies have noted the negative consequences related to the new federal corporate income tax rate, and especially the negative cash-flow implications of the change. Both papers noted that regulators need to take mitigating steps to sustain the cash flow of public utilities under the Act. Moody's has gone so far as to single out NJAWC's parent company, American Water Works Company, Inc., and its financing subsidiary, American Water Capital Corp., for a change in rating outlook from "stable" to "negative" due to the change in the federal corporate income tax rate.

To reduce or mitigate the risk facing NJAWC under the Act, NJAWC proposes the following to accommodate lower future cash flows. The Company's net COR balance for the twelve months ending March 31, 2018 was estimated in the Company's pending rate case to be \$104.4 million. The COR balance is comprised of a COR asset of \$141.2 million and a COR liability of \$36.8 million. Currently, the regulatory liability balance is being amortized and returned to ratepayers over a 40-year period, starting in 2008. NJAWC proposes that the COR asset balance be amortized over three years instead of 40 resulting in an increase in the annual amortization of COR balances of \$36 million and a net COR annual amortization of \$34.8 million when combined with the previously authorized annual amortization of (\$1.2) million for the regulatory liability balance. Thus, the Company proposes to utilize \$36 million of straight tax expense savings to amortize the net COR deferral balance over a period of three years, thus reducing future ratepayer costs after the write off period, and mitigating or reducing the impact of the Act on cash flow, credit ratings and the cost of capital. A key feature of this proposal is that termination of the amortization after three years would offset future rate increase requests, as the Company has been proceeding on approximately three-year rate case cycles and has a currently pending base rate case.

NJAWC submits the foregoing information and proposals in compliance with the Order. NJAWC made the foregoing calculations pursuant to the Act, and its interpretations of the same, to the best of NJAWC's knowledge information and belief.

Respectfully,

COZEN O'CONNOR, PC

  
By: Ira G. Megdal

IGM/k  
Enclosure

cc: Attached Service List (via email)

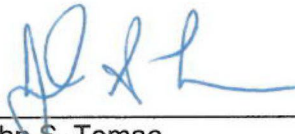


VERIFICATION

STATE OF NEW JERSEY            )  
  ) ss:  
COUNTY OF CAMDEN            )

John S. Tomac, of full age, being duly sworn according to law upon his oath  
deposes and says:

1. I am Senior Director of Rates and Regulations of New Jersey-American  
Water Company, Inc. and I have reviewed the contents of the Letter Petition.
2. The statements as contained therein are true to the best of my  
knowledge, information and belief.

  
\_\_\_\_\_  
John S. Tomac  
Senior Director of Rates and Regulations  
New Jersey-American Water Company

Sworn and Subscribed  
before me this 2<sup>nd</sup> day  
of March, 2018.

  
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