



0000056365

**CITIZENS COMMUNICATIONS COMPANY  
ARIZONA GAS DIVISION  
DOCKET NO. G-01032A-02-0598**

**TESTIMONY OF ANTHONY APUZZO  
REVISED**

1 **INTRODUCTION**

2 Q. Please state your name and business address.

3 A. My name is Anthony Apuzzo. My business address is Citizens  
4 Communications Company, Three High Ridge Park, Stamford, Connecticut  
5 06905.

6  
7 Q. By whom are you employed and in what capacity?

8 A. I am employed by Citizens Communications Company ("Citizens") as  
9 Director, Tax and Actuarial Compliance.

10  
11 Q. Please summarize your educational background.

12 A. I graduated from Rochester Institute of Technology in 1984 with a Bachelor  
13 of Science Degree in Accounting. I am a CPA, certified in the State of  
14 Connecticut.

15  
16 Q. Please describe your work experience.

17 A. I joined Citizens in 1987 as a staff Internal Auditor. I was promoted from  
18 Senior Auditor into the position of Supervisor, Financial Tax Accounting in  
19 1992. In 1999, I was promoted into my present position. I have been  
20 responsible for all of Citizens' income tax accounting activity related to the  
21 operating properties including the Northern Arizona Gas Division ("NAGD")  
22 and the Santa Cruz Gas Division ("SCGD") since 1992.

23  
24 Q. What areas will you address in this testimony?

25 A. I will present the calculation of the accumulated deferred income taxes  
26 ("ADIT") included as Schedule B-7 for the Arizona Gas Division ("AGD" or  
27 "Company"), which is comprised of the NAGD and SCGD. I will also testify  
28

1 to the AGD's Taxes Other than Income (Adjustment H to Schedule C-2),  
2 Prior Period Tax Refunds (Adjustment K to Schedule C-2) and State and  
3 Federal Income Taxes (Adjustment S to Schedule C-2).

4 These schedules were filed as part of this application and are found in their  
5 own bound volume.  
6

7 **ADIT**

8 Q. What are deferred income taxes?

9 A. Deferred income taxes represent the tax effect of differences that arise  
10 between the time periods when revenues and expenses are recognized for  
11 financial reporting purposes and when they are considered for income tax  
12 return purposes. For AGD, the largest such difference is that which exists  
13 as a result of the use of accelerated methods and shorter lives in  
14 computing tax depreciation, as compared with the manner in which book  
15 depreciation is computed. For this purpose, it is useful to distinguish  
16 between "timing differences" and "permanent differences."  
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18 Q. Please discuss the distinction between "timing differences" and "permanent  
19 differences."

20 A. Timing differences represent disparities between book income before  
21 income taxes and taxable income that originate in one or more periods,  
22 and reverse or turn around, in one or more subsequent periods. Because  
23 public utilities are so capital intensive, the difference between book and tax  
24 depreciation is typically the largest timing difference affecting such  
25 companies.  
26  
27  
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29

1 Permanent differences represent disparities between book income before  
2 income taxes and taxable income, and do not reverse in subsequent  
3 periods. Examples of permanent differences include non-taxable interest  
4 income from municipal bonds and non-deductible lobbying expenses.

5  
6 Deferred income taxes are computed for timing differences, but not for  
7 permanent differences. The typical accounting for deferred income taxes  
8 involves recognition of a deferred income tax expense on the income  
9 statement, with a corresponding entry made to a balance sheet ADIT  
10 reserve account. As the timing differences reverse over time, the balance  
11 of the ADIT reserve account is also reversed.

12  
13 Q. Please describe Schedule B-7.

14 A. Schedule B-7 consists of two pages. Page 1 of 2 is a summary page, which  
15 groups the various ADIT amounts by Federal and State components. Page  
16 2 of 2 shows the ADIT by component, as recorded and adjusted at  
17 December 31, 2001. Columns [1] and [2] show the ADIT resulting from  
18 accelerated tax depreciation, Property, Plant & Equipment ("Plant")  
19 retirements and capitalized basis differences for Federal and State  
20 components, respectively. Columns [3] and [4] show the advanced income  
21 taxes ("AIT") resulting from the requirement to capitalize interest for  
22 income tax purposes ("CAP Interest"). Columns [5] and [6] reflect the AIT  
23 required on Contributions-In-Aid-of-Construction ("CIAC"). Columns [7]  
24 and [8] reflect the subtotal of columns [1] through [6]. Columns [9] and  
25 [10] reflect the AIT required on Advances-In-Aid-of-Construction ("AIAC").  
26 For Columns [1] through [10], the odd-numbered columns provide  
27 amounts associated with Federal taxes and the even-numbered columns

1 provide amounts associated with Arizona State taxes. Column [11] shows  
2 the ADIT amortized from the Federal Income Tax rate reduction in 1986,  
3 the State Income Tax rate reduction in 2001, and the ADIT for Schedule  
4 "M" items, which represent tax timing differences other than those related  
5 to Plant and AIAC.

6  
7 Q. Please explain what the ADIT related to the accelerated depreciation  
8 represents.

9 A. This ADIT results from the different rates and methods used in computing  
10 depreciation on Plant for income tax purposes as compared with the book  
11 rates and method used for computing book depreciation ("Method  
12 Difference"). This ADIT also includes the tax effect of the book-tax  
13 differences resulting from Plant retirements. These book-tax differences  
14 occur because, when Plant is retired, an income tax deduction is allowed  
15 for the remaining tax basis of the Plant while, under normal utility  
16 accounting, no deduction is recognized for book purposes. Rather, for book  
17 accounting, the retirement is reflected as a credit to Plant and a debit to  
18 the accumulated depreciation. This has no effect on expenses used to  
19 determine the operating income before income taxes for book purposes.

20  
21 Finally, this ADIT includes the impact of different book and tax amounts of  
22 overheads capitalized into the basis of Plant between book and tax. These  
23 differences are reflected as adjustments on Citizens' tax returns that result  
24 in ADIT at the time Plant is initially capitalized. These temporary book-tax  
25 differences will ultimately reverse in the future when depreciation is  
26 deducted at different amounts for book and tax reporting over the life of  
27 the Plant.

1 Q. Please explain what the AIT on CAP Interest represents.

2 A. AIT on CAP Interest represents the amount of taxes paid as a result of the  
3 requirement to assign interest to capital expenditures for the purpose of  
4 calculating income taxes. This requirement results in the prepayment of  
5 taxes that are recovered over the useful tax life of the Plant that was the  
6 basis for the initial CAP Interest and related tax payment.

7  
8 Q. Please describe the AIT on CIAC.

9 A. These amounts are the taxes paid by Citizens on CIAC amounts received in  
10 connection with the construction of plant. Citizens has paid these income  
11 tax amounts in the year of receipt and recovers them from the tax  
12 depreciation over the life of the CIAC plant. These are amounts of taxes  
13 paid in advance of taking the tax depreciation during the life of the Plant  
14 related to the CIAC.

15  
16 Q. Please describe the AIT on AIAC.

17 A. These amounts are the taxes paid by Citizens on AIAC amounts received in  
18 connection with the construction of plant. Citizens receives advances in the  
19 form of either plant or cash. Under both forms of advances, Citizens pays  
20 income taxes and recovers those tax amounts when it makes refunds to  
21 customers pursuant to the advance contracts. Therefore, the book-tax  
22 difference is reflected in the liability for customer advances that has been  
23 recognized as taxable income when first received.

24

25

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1 Q. Please explain the amounts shown for the "RGSM" on Schedule B-7,  
2 highlighted in footnote [a].

3 A. The Reverse South Georgia Method ("RSGM") amounts represent the  
4 amount of ADIT that is directly related to (i) the Federal Income Tax  
5 ("FIT") rate reduction included among the changes contained in the Tax  
6 Reform Act of 1986 ("TRA-86") and (ii) the State Income Tax ("SIT") rate  
7 reduction in 2001.

8

9 Q. Please describe the FIT rate reduction as it affects ADIT.

10 A. The reduction of the FIT rate from 46% to 34% meant that Federal income  
11 taxes deferred prior to the TRA-86 at the 46% rate would be repaid to the  
12 Federal government at the new 34% FIT rate. The difference, if not  
13 addressed by regulators, would have been retained by the utility.

14 Regulators have used one of several methods to provide this difference to  
15 customers and maintain compliance with the Internal Revenue Code with  
16 regard to the Method Difference ADIT amounts. The Arizona Corporation  
17 Commission ("Commission") has approved the RSGM to flow this difference  
18 back to customers.

19

20 Q. Please describe the SIT rate reduction as it affects ADIT.

21 A. The reduction of the SIT rate from 7.968% to 6.968% in 2001 meant that  
22 State income taxes deferred prior to 2001 would be repaid to the State of  
23 Arizona at the new 6.968% rate. The difference, if not addressed by  
24 regulators, would have been retained by the utility. Consistent with the  
25 treatment of the excess Federal ADIT, the AGD is using the RSGM to flow  
26 the difference back to customers.

27

28

29

1 Q. What is the total RGSM for FIT and SIT that is being flowed back to  
2 customers?

3 A. The amortization shown on line 7 of column [11] passes an annual amount  
4 to customers so that the difference will be eliminated over the remaining  
5 useful life of the Plant that was in place at the time the tax rate changed.  
6 The amortization for the test year ended December 31,2001 is \$12,791.  
7

8 Q. Please describe the amount in column [11] shown on line 5, Other  
9 Schedule "M" Items.

10 A. This amount represents the tax-effect of other book-tax timing differences  
11 (schedule "M" items) related to amounts that are not already reflected in  
12 other columns on schedule B-7. These amounts include Pension Expense,  
13 Medical benefits and other amounts that have been included in setting  
14 rates for the AGD. Consistent with prior rate applications in Arizona, I have  
15 used a four-year average to calculate the amount of the ADIT for these  
16 Schedule M items for the 2001 test year, based on the most recent four  
17 years of Citizens' income tax filings (1997 through 2000).  
18

19 Q. What adjustments have been made to the recorded ADIT for 2001?

20 A. On Schedule B-7, I have included adjustments on:

- 21 • Line 2---To reverse 2001 recorded ADIT estimates;
- 22 • Line 4---To update the recorded amounts to reflect full normalization  
23 as of December 31, 2000;
- 24 • Line 5---To reflect the Schedule "M" items for book-tax timing  
25 differences that are not included in the ADIT accounts recorded on  
26 the AGD's books;
- 27 • Line 7---To reflect an updated incremental estimate of ADIT for 2001;



1 2000 ADIT level by a number of items, including the most recent estimate  
2 of 2001 ADIT (shown on line 7) to derive the appropriate rate year ADIT  
3 amount.

4  
5 Q. Please explain the adjustment to reflect full normalization under Financial  
6 Accounting Standards Board ("FASB") 109 on line 4.

7 A. The adjustment provides the amount needed to reflect in the balance of  
8 ADIT the tax effect of all cumulative book-tax differences related to Plant  
9 as of December 31, 2000, at current income tax rates.

10  
11 Q. Why is the calculation based on the book-tax differences as of December  
12 31, 2000, instead of December 31, 2001?

13 A. This calculation reflects the fact that the 2000 calendar year income tax  
14 return is the latest return that Citizens has filed. The 2001 income tax  
15 return will not be filed until September (Federal return) and October (State  
16 return) of 2002. The estimated deferred income tax for 2001 reflected on  
17 line 7 incorporates Citizens' best estimate of a fully normalized incremental  
18 ADIT calculation for 2001.

19  
20 Q. How did you determine the normalization adjustment shown on line 4 of  
21 Schedule B-7?

22 A. The adjustment is based on comparing the recorded ADIT as of December  
23 31, 2000, (adjusted in 2001 to reflect the 2000 tax return filings) with the  
24 amount of ADIT computed under a full normalization calculation. This is  
25 accomplished by comparing the adjusted remaining tax basis of Plant with  
26 the adjusted remaining book basis of Plant. This difference is then tax-  
27 effected to arrive at the required level of ADIT under full normalization.

1 The difference between the required level of ADIT and the adjusted  
2 recorded balance of ADIT provides the amount of required adjustment as  
3 reflected on line 4.

4  
5 Q. How do you arrive at the recorded ADIT as of December 31, 2000?

6 A. As noted above, I derived the recorded ADIT at December 31, 2000,  
7 (adjusted for the 2000 tax return filings) by removing the amount recorded  
8 on the books during 2001 that relates to the estimated 2001 incremental  
9 ADIT. This balance is reflected on line 3, Schedule B-7, in columns [1]  
10 through [6].

11  
12 Q. Which columns of ADIT from Schedule B-7 are included in the recorded  
13 ADIT amounts for purposes of this adjustment?

14 A. Columns [1] through [6], which are summarized in the subtotal columns  
15 [7] and [8], are used because only these columns reflect ADIT amounts on  
16 book-tax timing differences related to Plant.

17  
18 Q. Does Schedule B-7 illustrate the ADIT balance under full normalization after  
19 this adjustment?

20 A. Yes. On line 6 in columns [7] and [8] this balance of Federal and State  
21 ADIT represents the tax effect of the cumulative net book-tax timing  
22 difference related to Plant as of December 31, 2000.

23  
24 Q. Please explain the estimated deferred income tax for 2001 on line 7.

25 A. These amounts represent Citizens' best estimate of the 2001 incremental  
26 amounts of ADIT for each type of book-tax timing difference as reflected  
27 under each column of the Schedule B-7. The amounts also incorporate the  
28

1 AGD's ratemaking adjustment to recorded book depreciation in arriving at  
2 the estimated ADIT for 2001.

3  
4 Q. Please explain the ADIT adjustments for the pro-forma Plant retirements.

5 A. This adjustment, as reflected on line 8 of Schedule B-7, is required to  
6 reflect the impact on ADIT of the AGD pro-forma Plant retirements that are  
7 described in Mr. Doherty's testimony as an adjustment to Schedule B-54A.  
8 ADIT is increased when Plant is retired because an income tax deduction is  
9 allowed for the remaining tax basis of the Plant that is retired, even though  
10 no book deduction is made for the same retirement. The ADIT increase on  
11 line 8 is the tax effect of the tax deduction that will be allowed for the  
12 remaining tax basis of the Plant that is being retired on a pro-forma basis.

13  
14 Q. Please explain the ADIT adjustments for the Yale Street property and for  
15 other miscellaneous Plant adjustments.

16 A. These adjustments, on lines 9, 11, 13, and 14, are necessary to adjust the  
17 ADIT to reflect the corresponding removal or addition to AGD Plant  
18 reflected as part of rate base adjustments presented in Schedule B-54A,  
19 and described in Mr. Doherty's testimony.

20  
21 Q. How were the ADIT adjustments for these Plant adjustments determined?

22 A. Similar to the full normalization adjustment under FASB 109, the tax effect  
23 of the difference between net book basis and net tax basis comprises the  
24 ADIT adjustment. The basis was determined as of December 31, 2001, so  
25 that no additional adjustments would be required with respect to Citizens'  
26 estimated ADIT for 2001 on line 7. That 2001 ADIT estimate on line 7 was  
27 made assuming that there were no Plant adjustments.

1 Q. Please describe your adjustment to ADIT relating to the NAGD acquisition  
2 adjustments.

3 A. As Mr. Doherty states in his testimony, the test year rate base does not  
4 include the acquisition adjustments related to: [1] the Southern Union  
5 Gas's acquisition of what is now the NAGD; [2] Citizens' acquisition of  
6 NAGD from Southern Union Gas, or [3] a certain portion of the costs  
7 associated with the Transwestern Pipeline capacity in the early years of the  
8 contract with Citizens. I have reduced ADIT by the amounts relating to  
9 these items that have been removed from rate base. This adjustment is  
10 shown on line 10 of Schedule B-7.

11  
12 The amount of ADIT removed is computed based on the accumulated  
13 depreciation/amortization taken on Citizens' tax returns for the acquisition  
14 adjustment from the date of acquisition through the test year (estimated  
15 for 2001). The amount of \$10,067,009 (representing accumulated  
16 depreciation/amortization), tax-effected, yields the ADIT adjustment of  
17 \$3,979,408, as reflected on line 10 of Schedule B-7. This adjustment  
18 effectively reverses the ADIT associated with the cumulative tax deductions  
19 on this acquisition adjustment that is included as part of the amounts  
20 shown on lines 6 and 7 of Schedule B-7.

21  
22 Q. Why is it appropriate to adjust ADIT for the NAGD acquisition adjustment?

23 A. AGD is not permitted to earn a return on the portion of the initial  
24 investment of the Southern Union Gas operations that represents the  
25 premium paid for the property. This amount is commonly referred to as  
26 the "acquisition adjustment" and is maintained on the books of AGD in the  
27 amount as ordered by the Commission. As a result of the exclusion of this

1 acquisition adjustment in the Company's rate filing, any ADIT related to the  
2 tax deductions taken on this amount should also be excluded from the rate  
3 filing. This treatment of ADIT is consistent with the Internal Revenue Code  
4 requirements and related regulations that address normalization for rate-  
5 regulated utility companies.  
6

7 Q. Please explain your ADIT adjustment relating to the AFUDC adjustment.

8 A. Mr. Mason discusses the Commission's Decision No. 61848, adopting a  
9 settlement agreement with respect to the treatment of AFUDC and of  
10 AFUDC in connection with the Federal Energy Regulatory Commission's  
11 ("FERC's") Accounting Release No. 13. The AGD has made an adjustment  
12 to reflect the procedures that the Commission adopted in Decision No.  
13 61848. Mr. Doherty has adjusted rate base to reflect the AFUDC  
14 modification. Line 12 of Schedule B-7 reduces ADIT consistent with the  
15 AFUDC rate base adjustment.  
16

17 Q. Please explain your adjustment for the excess ADIT for income tax rate  
18 changes.

19 A. The ADIT adjustment on line 4 of Schedule B-7, and reflected in the  
20 balance on line 6 of columns [1] through [8] as of December 31,2000, was  
21 computed using current income tax rates. That adjustment effectively  
22 eliminated any excess ADIT that was reflected in the recorded balances  
23 shown on line 1. The adjustment on shown on line 15 reinstates the  
24 excess ADIT amounts that were reversed on line 4.  
25

1 **TAXES OTHER THAN INCOME TAXES**

2 Q. Please describe Adjustment H to Schedule C-2, relating to Taxes Other than  
3 Income Taxes.

4 A. Adjustment H is made to the recorded test year level of Taxes Other Than  
5 Income Taxes to reflect in cost of service, property taxes and payroll taxes  
6 at levels reflective of end-of-year Plant in Service and Materials and  
7 Supplies balances, and annualized salaries and wages. This adjustment  
8 consists of three pages. The first page is a summary of property and  
9 payroll taxes. Page two provides the detail supporting the property tax  
10 adjustment and page three provides the detail supporting the payroll tax  
11 adjustment.

12  
13 Q. How was the property tax adjustment computed?

14 A. It was first necessary to establish the assessed value of the property. The  
15 net book values of plant assets and materials and supplies inventories as of  
16 December 31, 2001, were reported in a property tax return filed with the  
17 Arizona Department of Revenue ("ADOR") in May 2002. Vehicles are not  
18 included in the report. Construction Work in Progress ("CWIP") is included,  
19 but only at fifty percent of book cost. In June, Citizens received its full cash  
20 valuation from the ADOR. Because the property taxes associated with  
21 CWIP are required by the FERC Uniform System of Accounts to be  
22 capitalized, an equivalent full cash value for use in this adjustment was  
23 determined by excluding the portion relating to CWIP. In addition, all of  
24 the plant adjustments shown on Schedule B-54A (and discussed in Mr.  
25 Doherty's testimony) have been reflected in the net plant in service amount

1 I use to derive the equivalent full cash value for property tax purposes.  
2 The assessment for property tax purposes was computed by multiplying the  
3 equivalent full cash value by the current statutory 25% assessment rate.  
4

5 Once the pro forma property tax assessment was determined, annualized  
6 property taxes were computed using the most current known property tax  
7 rates. The bills for the property taxes associated with the December 31,  
8 2001, plant will not be received until sometime in September 2003, with  
9 the first fifty percent payment not due until November 2003 and the  
10 remaining fifty percent due in May 2004. Accordingly, the most recent  
11 property tax bills available for use in connection with this adjustment were  
12 those paid in November 2001. The average tax rates paid on those bills  
13 were applied to the pro forma assessed valuation previously determined to  
14 arrive at annualized property tax expense.  
15

16 Q. How was the adjustment to payroll taxes computed?

17 A The payroll tax adjustment was computed using the annualized payroll  
18 costs computed in Adjustment B, based on current FICA and Federal and  
19 State unemployment tax rates. The current FICA tax rate is 7.65%,  
20 comprised of 1.45% of taxable wages for Medicare and 6.20% for Social  
21 Security. The maximum wages subject to the Social Security portion of the  
22 FICA tax increased from \$80,400 in 2001 to \$84,900 in 2002.  
23

24 Federal unemployment taxes are computed at a rate of 6.2% on the first  
25 \$7,000 earnings paid to each employee annually. Citizens receives a credit  
26 against its Federal unemployment tax liability for amounts paid to State  
27  
28  
29

1 unemployment funds equal to 5.4% of the first \$7,000 annual earnings,  
2 which, coincidentally, are the wage ceiling and tax rate for Arizona State  
3 unemployment taxes.  
4

5 **PRIOR PERIOD TAX REFUNDS**

6 Q. Please describe Adjustment K, relating to Prior Period Tax Refunds.

7 A. Adjustment K is made to remove from recorded test year Taxes Other Than  
8 Income Taxes certain out-of-period and non-recurring items. Included  
9 therein are credit entries totaling \$1.277 million recorded in connection  
10 with applications for sales tax refunds.  
11

12 In the year 2000, the Company became aware of certain provisions of the  
13 Model City Tax Code of the State of Arizona that allowed the Company to  
14 apply for a refund of sales taxes paid during the period July 1996 through  
15 July 2000 for the communities of Clarkdale, Flagstaff, Jerome, Kingman,  
16 Lake Havasu, Sedona, Show Low, Snowflake, and Winslow.  
17

18 In August 2000, the Company submitted a formal application seeking a  
19 refund of approximately \$1.98 million for the overpayment of taxes. In May  
20 of 2001, the Company received a partial refund totaling \$703,658. That  
21 amount was credited to Other Income, and at the same time, a receivable  
22 for the \$1.277 million remainder of the requested refund was established,  
23 with the corresponding credit made to Taxes Other than Income Taxes.  
24 Adjustment K removes the credits to Taxes Other than Income Taxes,  
25 totaling \$1.277 million; from test year operating results because the credits  
26 in question relate to a prior period.  
27  
28  
29

1 In addition, Adjustment K reflects other miscellaneous prior period  
2 amounts. The total adjustment for prior period amounts is \$1,213,112,  
3 which is shown on Schedule C-2, page 2 of 2, column 3.  
4

5 **COMPUTATON OF STATE AND FEDERAL INCOME TAXES**

6 Q. Please describe Adjustment S of Schedule C-2.

7 A. Adjustment S relates to the calculation of state and federal income tax  
8 expenses. The current effective state tax rate is 6.968%. The federal tax  
9 shown on this schedule, \$4,427,136, reflects the current federal tax rate of  
10 35%. Total test year income tax expense has been calculated at both  
11 present and proposed rate levels using these tax rates.  
12

13 Q. Please explain the calculation of the current year federal and state tax  
14 expenses.

15 A. Operating income before income taxes is calculated in Adjustment S, as  
16 shown from the data included in Schedule C-1. The interest deduction on  
17 line 7 of Adjustment S has been calculated by multiplying the original cost  
18 rate base, shown on Schedule B-1, by the weighted embedded cost of  
19 debt, shown on Schedule D-1. Tax expenses are then calculated using the  
20 currently effective state and federal tax rates.  
21

22 Q. Does this conclude your direct testimony?

23 A. Yes, it does.  
24  
25  
26  
27  
28  
29

1 **INTRODUCTION**

2 Q. Please state your name and business address.

3 A. My name is Anthony Apuzzo. My business address is Citizens  
4 Communications Company, Three High Ridge Park, Stamford, Connecticut  
5 06905.

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7 Q. By whom are you employed and in what capacity?

8 A. I am employed by Citizens Communications Company ("Citizens") as  
9 Director, Tax and Actuarial Compliance.

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11 Q. Please summarize your educational background.

12 A. I graduated from Rochester Institute of Technology in 1984 with a Bachelor  
13 of Science Degree in Accounting. I am a CPA, certified in the State of  
14 Connecticut.

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16 Q. Please describe your work experience.

17 A. I joined Citizens in 1987 as a staff Internal Auditor. I was promoted from  
18 Senior Auditor into the position of Supervisor, Financial Tax Accounting in  
19 1992. In 1999, I was promoted into my present position. I have been  
20 responsible for all of Citizens' income tax accounting activity related to the  
21 operating properties including the Northern Arizona Gas Division ("NAGD")  
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25 companies.

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4 income from municipal bonds and non-deductible lobbying expenses.

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6 Deferred income taxes are computed for timing differences, but not for  
7 permanent differences. The typical accounting for deferred income taxes  
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9 statement, with a corresponding entry made to a balance sheet ADIT  
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7 Q. Please explain what the ADIT related to the accelerated depreciation  
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9 A. This ADIT results from the different rates and methods used in computing  
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13 differences resulting from Plant retirements. These book-tax differences  
14 occur because, when Plant is retired, an income tax deduction is allowed  
15 for the remaining tax basis of the Plant while, under normal utility  
16 accounting, no deduction is recognized for book purposes. Rather, for book  
17 accounting, the retirement is reflected as a credit to Plant and a debit to  
18 the accumulated depreciation. This has no effect on expenses used to  
19 determine the operating income before income taxes for book purposes.  
20

21 Finally, this ADIT includes the impact of different book and tax amounts of  
22 overheads capitalized into the basis of Plant between book and tax. These  
23 differences are reflected as adjustments on Citizens' tax returns that result  
24 in ADIT at the time Plant is initially capitalized. These temporary book-tax  
25 differences will ultimately reverse in the future when depreciation is  
26 deducted at different amounts for book and tax reporting over the life of  
27 the Plant.  
28  
29

1 Q. Please explain what the AIT on CAP Interest represents.

2 A. AIT on CAP Interest represents the amount of taxes paid as a result of the  
3 requirement to assign interest to capital expenditures for the purpose of  
4 calculating income taxes. This requirement results in the prepayment of  
5 taxes that are recovered over the useful tax life of the Plant that was the  
6 basis for the initial CAP Interest and related tax payment.

7

8 Q. Please describe the AIT on CIAC.

9 A. These amounts are the taxes paid by Citizens on CIAC amounts received in  
10 connection with the construction of plant. Citizens has paid these income  
11 tax amounts in the year of receipt and recovers them from the tax  
12 depreciation over the life of the CIAC plant. These are amounts of taxes  
13 paid in advance of taking the tax depreciation during the life of the Plant  
14 related to the CIAC.

15

16 Q. Please describe the AIT on AIAC.

17 A. These amounts are the taxes paid by Citizens on AIAC amounts received in  
18 connection with the construction of plant. Citizens receives advances in the  
19 form of either plant or cash. Under both forms of advances, Citizens pays  
20 income taxes and recovers those tax amounts when it makes refunds to  
21 customers pursuant to the advance contracts. Therefore, the book-tax  
22 difference is reflected in the liability for customer advances that has been  
23 recognized as taxable income when first received.

24

25

26

27

28

29

1 Q. Please explain the amounts shown for the "RGSM" on Schedule B-7,  
2 highlighted in footnote [a].

3 A. The Reverse South Georgia Method ("RSGM") amounts represent the  
4 amount of ADIT that is directly related to (i) the Federal Income Tax  
5 ("FIT") rate reduction included among the changes contained in the Tax  
6 Reform Act of 1986 ("TRA-86") and (ii) the State Income Tax ("SIT") rate  
7 reduction in 2001.

8  
9 Q. Please describe the FIT rate reduction as it affects ADIT.

10 A. The reduction of the FIT rate from 46% to 34% meant that Federal income  
11 taxes deferred prior to the TRA-86 at the 46% rate would be repaid to the  
12 Federal government at the new 34% FIT rate. The difference, if not  
13 addressed by regulators, would have been retained by the utility.

14 Regulators have used one of several methods to provide this difference to  
15 customers and maintain compliance with the Internal Revenue Code with  
16 regard to the Method Difference ADIT amounts. The Arizona Corporation  
17 Commission ("Commission") has approved the RSGM to flow this difference  
18 back to customers.

19  
20 Q. Please describe the SIT rate reduction as it affects ADIT.

21 A. The reduction of the SIT rate from 7.968% to 6.968% in 2001 meant that  
22 State income taxes deferred prior to 2001 would be repaid to the State of  
23 Arizona at the new 6.968% rate. The difference, if not addressed by  
24 regulators, would have been retained by the utility. Consistent with the  
25 treatment of the excess Federal ADIT, the AGD is using the RSGM to flow  
26 the difference back to customers.

1 Q. What is the total RGSM for FIT and SIT that is being flowed back to  
2 customers?

3 A. The amortization shown on line 7 of column [11] passes an annual amount  
4 to customers so that the difference will be eliminated over the remaining  
5 useful life of the Plant that was in place at the time the tax rate changed.  
6 The amortization for the test year ended December 31,2001 is \$12,791.  
7

8 Q. Please describe the amount in column [11] shown on line 5, Other  
9 Schedule "M" Items.

10 A. This amount represents the tax-effect of other book-tax timing differences  
11 (schedule "M" items) related to amounts that are not already reflected in  
12 other columns on schedule B-7. These amounts include Pension Expense,  
13 Medical benefits and other amounts that have been included in setting  
14 rates for the AGD. Consistent with prior rate applications in Arizona, I have  
15 used a four-year average to calculate the amount of the ADIT for these  
16 Schedule M items for the 2001 test year, based on the most recent four  
17 years of Citizens' income tax filings (1997 through 2000).  
18

19 Q. What adjustments have been made to the recorded ADIT for 2001?

20 A. On Schedule B-7, I have included adjustments on:

- 21 • Line 2---To reverse 2001 recorded ADIT estimates;
- 22 • Line 4---To update the recorded amounts to reflect full normalization  
23 as of December 31, 2000;
- 24 • Line 5---To reflect the Schedule "M" items for book-tax timing  
25 differences that are not included in the ADIT accounts recorded on  
26 the AGD's books;
- 27 • Line 7---To reflect an updated incremental estimate of ADIT for 2001;

28

29



1 2000 ADIT level by a number of items, including the most recent estimate  
2 of 2001 ADIT (shown on line 7) to derive the appropriate rate year ADIT  
3 amount.  
4

5 Q. Please explain the adjustment to reflect full normalization under Financial  
6 Accounting Standards Board ("FASB") 109 on line 4.

7 A. The adjustment provides the amount needed to reflect in the balance of  
8 ADIT the tax effect of all cumulative book-tax differences related to Plant  
9 as of December 31, 2000, at current income tax rates.  
10

11 Q. Why is the calculation based on the book-tax differences as of December  
12 31, 2000, instead of December 31, 2001?

13 A. This calculation reflects the fact that the 2000 calendar year income tax  
14 return is the latest return that Citizens has filed. The 2001 income tax  
15 return will not be filed until September (Federal return) and October (State  
16 return) of 2002. The estimated deferred income tax for 2001 reflected on  
17 line 7 incorporates Citizens' best estimate of a fully normalized incremental  
18 ADIT calculation for 2001.  
19

20 Q. How did you determine the normalization adjustment shown on line 4 of  
21 Schedule B-7?

22 A. The adjustment is based on comparing the recorded ADIT as of December  
23 31, 2000, (adjusted in 2001 to reflect the 2000 tax return filings) with the  
24 amount of ADIT computed under a full normalization calculation. This is  
25 accomplished by comparing the adjusted remaining tax basis of Plant with  
26 the adjusted remaining book basis of Plant. This difference is then tax-  
27 effected to arrive at the required level of ADIT under full normalization.  
28  
29

1 The difference between the required level of ADIT and the adjusted  
2 recorded balance of ADIT provides the amount of required adjustment as  
3 reflected on line 4.

4  
5 Q. How do you arrive at the recorded ADIT as of December 31, 2000?

6 A. As noted above, I derived the recorded ADIT at December 31, 2000,  
7 (adjusted for the 2000 tax return filings) by removing the amount recorded  
8 on the books during 2001 that relates to the estimated 2001 incremental  
9 ADIT. This balance is reflected on line 3, Schedule B-7, in columns [1]  
10 through [6].

11  
12 Q. Which columns of ADIT from Schedule B-7 are included in the recorded  
13 ADIT amounts for purposes of this adjustment?

14 A. Columns [1] through [6], which are summarized in the subtotal columns  
15 [7] and [8], are used because only these columns reflect ADIT amounts on  
16 book-tax timing differences related to Plant.

17  
18 Q. Does Schedule B-7 illustrate the ADIT balance under full normalization after  
19 this adjustment?

20 A. Yes. On line 6 in columns [7] and [8] this balance of Federal and State  
21 ADIT represents the tax effect of the cumulative net book-tax timing  
22 difference related to Plant as of December 31, 2000.

23  
24 Q. Please explain the estimated deferred income tax for 2001 on line 7.

25 A. These amounts represent Citizens' best estimate of the 2001 incremental  
26 amounts of ADIT for each type of book-tax timing difference as reflected  
27 under each column of the Schedule B-7. The amounts also incorporate the

1 AGD's ratemaking adjustment to recorded book depreciation in arriving at  
2 the estimated ADIT for 2001.

3  
4 Q. Please explain the ADIT adjustments for the pro-forma Plant retirements.

5 A. This adjustment, as reflected on line 8 of Schedule B-7, is required to  
6 reflect the impact on ADIT of the AGD pro-forma Plant retirements that are  
7 described in Mr. Doherty's testimony as an adjustment to Schedule B-4A.  
8 ADIT is increased when Plant is retired because an income tax deduction is  
9 allowed for the remaining tax basis of the Plant that is retired, even though  
10 no book deduction is made for the same retirement. The ADIT increase on  
11 line 8 is the tax effect of the tax deduction that will be allowed for the  
12 remaining tax basis of the Plant that is being retired on a pro-forma basis.

13  
14 Q. Please explain the ADIT adjustments for the Yale Street property and for  
15 other miscellaneous Plant adjustments.

16 A. These adjustments, on lines 9, 11, 13, and 14, are necessary to adjust the  
17 ADIT to reflect the corresponding removal or addition to AGD Plant  
18 reflected as part of rate base adjustments presented in Schedule B-4A, and  
19 described in Mr. Doherty's testimony.

20  
21 Q. How were the ADIT adjustments for these Plant adjustments determined?

22 A. Similar to the full normalization adjustment under FASB 109, the tax effect  
23 of the difference between net book basis and net tax basis comprises the  
24 ADIT adjustment. The basis was determined as of December 31, 2001, so  
25 that no additional adjustments would be required with respect to Citizens'  
26 estimated ADIT for 2001 on line 7. That 2001 ADIT estimate on line 7 was  
27 made assuming that there were no Plant adjustments.

1 Q. Please describe your adjustment to ADIT relating to the NAGD acquisition  
2 adjustments.

3 A. As Mr. Doherty states in his testimony, the test year rate base does not  
4 include the acquisition adjustments related to: [1] the Southern Union  
5 Gas's acquisition of what is now the NAGD; [2] Citizens' acquisition of  
6 NAGD from Southern Union Gas, or [3] a certain portion of the costs  
7 associated with the Transwestern Pipeline capacity in the early years of the  
8 contract with Citizens. I have reduced ADIT by the amounts relating to  
9 these items that have been removed from rate base. This adjustment is  
10 shown on line 10 of Schedule B-7.

11  
12 The amount of ADIT removed is computed based on the accumulated  
13 depreciation/amortization taken on Citizens' tax returns for the acquisition  
14 adjustment from the date of acquisition through the test year (estimated  
15 for 2001). The amount of \$10,067,009 (representing accumulated  
16 depreciation/amortization), tax-effected, yields the ADIT adjustment of  
17 \$3,979,408, as reflected on line 10 of Schedule B-7. This adjustment  
18 effectively reverses the ADIT associated with the cumulative tax deductions  
19 on this acquisition adjustment that is included as part of the amounts  
20 shown on lines 6 and 7 of Schedule B-7.

21  
22 Q. Why is it appropriate to adjust ADIT for the NAGD acquisition adjustment?

23 A. AGD is not permitted to earn a return on the portion of the initial  
24 investment of the Southern Union Gas operations that represents the  
25 premium paid for the property. This amount is commonly referred to as  
26 the "acquisition adjustment" and is maintained on the books of AGD in the  
27 amount as ordered by the Commission. As a result of the exclusion of this

1 acquisition adjustment in the Company's rate filing, any ADIT related to the  
2 tax deductions taken on this amount should also be excluded from the rate  
3 filing. This treatment of ADIT is consistent with the Internal Revenue Code  
4 requirements and related regulations that address normalization for rate-  
5 regulated utility companies.  
6

7 Q. Please explain your ADIT adjustment relating to the AFUDC adjustment.

8 A. Mr. Mason discusses the Commission's Decision No. 61848, adopting a  
9 settlement agreement with respect to the treatment of AFUDC and of  
10 AFUDC in connection with the Federal Energy Regulatory Commission's  
11 ("FERC's") Accounting Release No. 13. The AGD has made an adjustment  
12 to reflect the procedures that the Commission adopted in Decision No.  
13 61848. Mr. Doherty has adjusted rate base to reflect the AFUDC  
14 modification. Line 12 of Schedule B-7 reduces ADIT consistent with the  
15 AFUDC rate base adjustment.  
16

17 Q. Please explain your adjustment for the excess ADIT for income tax rate  
18 changes.

19 A. The ADIT adjustment on line 4 of Schedule B-7, and reflected in the  
20 balance on line 6 of columns [1] through [8] as of December 31, 2000, was  
21 computed using current income tax rates. That adjustment effectively  
22 eliminated any excess ADIT that was reflected in the recorded balances  
23 shown on line 1. The adjustment on shown on line 15 reinstates the  
24 excess ADIT amounts that were reversed on line 4.  
25

1 **TAXES OTHER THAN INCOME TAXES**

2 Q. Please describe Adjustment H to Schedule C-2, relating to Taxes Other than  
3 Income Taxes.

4 A. Adjustment H is made to the recorded test year level of Taxes Other Than  
5 Income Taxes to reflect in cost of service, property taxes and payroll taxes  
6 at levels reflective of end-of-year Plant in Service and Materials and  
7 Supplies balances, and annualized salaries and wages. This adjustment  
8 consists of three pages. The first page is a summary of property and  
9 payroll taxes. Page two provides the detail supporting the property tax  
10 adjustment and page three provides the detail supporting the payroll tax  
11 adjustment.

12  
13 Q. How was the property tax adjustment computed?

14 A. It was first necessary to establish the assessed value of the property. The  
15 net book values of plant assets and materials and supplies inventories as of  
16 December 31, 2001, were reported in a property tax return filed with the  
17 Arizona Department of Revenue ("ADOR") in May 2002. Vehicles are not  
18 included in the report. Construction Work in Progress ("CWIP") is included,  
19 but only at fifty percent of book cost. In June, Citizens received its full cash  
20 valuation from the ADOR. Because the property taxes associated with  
21 CWIP are required by the FERC Uniform System of Accounts to be  
22 capitalized, an equivalent full cash value for use in this adjustment was  
23 determined by excluding the portion relating to CWIP. In addition, all of  
24 the plant adjustments shown on Schedule B-4A (and discussed in Mr.  
25 Doherty's testimony) have been reflected in the net plant in service amount

1 I use to derive the equivalent full cash value for property tax purposes.

2 The assessment for property tax purposes was computed by multiplying the  
3 equivalent full cash value by the current statutory 25% assessment rate.

4  
5 Once the pro forma property tax assessment was determined, annualized  
6 property taxes were computed using the most current known property tax  
7 rates. The bills for the property taxes associated with the December 31,  
8 2001, plant will not be received until sometime in September 2003, with  
9 the first fifty percent payment not due until November 2003 and the  
10 remaining fifty percent due in May 2004. Accordingly, the most recent  
11 property tax bills available for use in connection with this adjustment were  
12 those paid in November 2001. The average tax rates paid on those bills  
13 were applied to the pro forma assessed valuation previously determined to  
14 arrive at annualized property tax expense.

15  
16 Q. How was the adjustment to payroll taxes computed?

17 A The payroll tax adjustment was computed using the annualized payroll  
18 costs computed in Adjustment B, based on current FICA and Federal and  
19 State unemployment tax rates. The current FICA tax rate is 7.65%,  
20 comprised of 1.45% of taxable wages for Medicare and 6.20% for Social  
21 Security. The maximum wages subject to the Social Security portion of the  
22 FICA tax increased from \$80,400 in 2001 to \$84,900 in 2002.

23  
24 Federal unemployment taxes are computed at a rate of 6.2% on the first  
25 \$7,000 earnings paid to each employee annually. Citizens receives a credit  
26 against its Federal unemployment tax liability for amounts paid to State  
27

1 unemployment funds equal to 5.4% of the first \$7,000 annual earnings,  
2 which, coincidentally, are the wage ceiling and tax rate for Arizona State  
3 unemployment taxes.

4  
5 **PRIOR PERIOD TAX REFUNDS**

6 Q. Please describe Adjustment K, relating to Prior Period Tax Refunds.

7 A. Adjustment K is made to remove from recorded test year Taxes Other Than  
8 Income Taxes certain out-of-period and non-recurring items. Included  
9 therein are credit entries totaling \$1.277 million recorded in connection  
10 with applications for sales tax refunds.

11  
12 In the year 2000, the Company became aware of certain provisions of the  
13 Model City Tax Code of the State of Arizona that allowed the Company to  
14 apply for a refund of sales taxes paid during the period July 1996 through  
15 July 2000 for the communities of Clarkdale, Flagstaff, Jerome, Kingman,  
16 Lake Havasu, Sedona, Show Low, Snowflake, and Winslow.

17  
18 In August 2000, the Company submitted a formal application seeking a  
19 refund of approximately \$1.98 million for the overpayment of taxes. In May  
20 of 2001, the Company received a partial refund totaling \$703,658. That  
21 amount was credited to Other Income, and at the same time, a receivable  
22 for the \$1.277 million remainder of the requested refund was established,  
23 with the corresponding credit made to Taxes Other than Income Taxes.  
24 Adjustment K removes the credits to Taxes Other than Income Taxes,  
25 totaling \$1.277 million; from test year operating results because the credits  
26 in question relate to a prior period.

1 In addition, Adjustment K reflects other miscellaneous prior period  
2 amounts. The total adjustment for prior period amounts is \$1,213,112,  
3 which is shown on Schedule C-2, page 2 of 2, column 3.  
4

5 **COMPUTATON OF STATE AND FEDERAL INCOME TAXES**

6 Q. Please describe Adjustment S of Schedule C-2.

7 A. Adjustment S relates to the calculation of state and federal income tax  
8 expenses. The current effective state tax rate is 6.968%. The federal tax  
9 shown on this schedule, \$4,427,136, reflects the current federal tax rate of  
10 35%. Total test year income tax expense has been calculated at both  
11 present and proposed rate levels using these tax rates.  
12

13 Q. Please explain the calculation of the current year federal and state tax  
14 expenses.

15 A. Operating income before income taxes is calculated in Adjustment S, as  
16 shown from the data included in Schedule C-1. The interest deduction on  
17 line 7 of Adjustment S has been calculated by multiplying the original cost  
18 rate base, shown on Schedule B-1, by the weighted embedded cost of  
19 debt, shown on Schedule D-1. Tax expenses are then calculated using the  
20 currently effective state and federal tax rates.  
21

22 Q. Does this conclude your direct testimony?

23 A. Yes, it does.  
24  
25  
26  
27  
28  
29