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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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IN THE MATTER OF THE JOINT APPLICATION
OF WILLOW VALLEY WATER CO., INC. AND
EPCOR WATER ARIZONA, INC. FOR APPROVAL
OF THE SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

DOCKET NO. W-01732A-15-0131
DOCKET NO. W-01303A-15-0131

NOTICE OF FILING
REBUTTAL TESTIMONY

Willow Valley Water Co., Inc. files the Rebuttal Testimony of Ron Fleming and Paul Walker.

RESPECTFULLY SUBMITTED this 23rd day of October 2015.

SNELL & WILMER, L.L.P

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH - CHAIRMAN
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION) DOCKET NO. W-01732A-15-0131
OF WILLOW VALLEY WATER CO., INC. AND) DOCKET NO. W-01303A-15-0131
EPCOR WATER ARIZONA, INC. FOR)
APPROVAL OF THE SALE OF ASSETS AND)
TRANSFER OF CERTIFICATE OF)
CONVENIENCE AND NECESSITY)

Rebuttal Testimony of

Ron Fleming

on Behalf of

Willow Valley Water Co., Inc.

October 23, 2015

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1 **I. Introduction.**

2

3 **Q. Please state your name and business address.**

4 A. My name is Ron Fleming. My business address is 21410 North 19th Avenue, Suite 220,
5 Phoenix, Arizona 85027.

6

7 **Q. By whom are you employed and what is your position?**

8 A. I am employed by Global Water Resources, Inc. ("Global") as President and Chief
9 Executive Officer. In that capacity, I oversee the operations of our Arizona utilities,
10 including Willow Valley Water Co., Inc. ("Willow Valley").

11

12 **Q. Please describe your education.**

13 A. I earned my Bachelor of Science degree in Construction Management from School of
14 Engineering at Northern Arizona University in 2003. My emphasis was on Heavy Civil
15 Construction, with a minor in Business Administration.

16

17 **Q. Please describe your professional background and experience.**

18 A. From 2002 to 2004, I worked as a project manager and project engineer for general
19 contractors, supervising a number of significant projects. I joined Global as Senior Project
20 Manager (2004 – 2007), where I provided project management for Global's Maricopa
21 region. During this time, I directly oversaw Global's Capital Improvement Program for
22 Santa Cruz and Palo Verde while they were some of the fastest growing utilities in the
23 nation. In 2007, I was promoted to General Manager of the West Valley Region, where I
24 had direct responsibility for the five utilities Global acquired from the former owners of
25 West Maricopa Combine. From 2010 to December 2012, I was Global's General
26 Manager, Arizona, with direct responsibility for the operations of all of Global's utilities in
27 Arizona. In December 2012, I was promoted to President of the Regulated Utilities

1 Division of Global. I was promoted to President and Chief Operating Officer of Global in
2 June 2013, and I became Chief Executive Officer in January 2015.

3
4 I serve on the boards of the Maricopa Economic Development Alliance, the Pinal
5 Partnership, and WESTMARC. I also have co-chaired the Water Resources Committees
6 for the Pinal Partnership and WESTMARC. I am also a member of the board of Willow
7 Valley.

8
9 **Q. Have you previously testified before the Commission?**

10 A. Yes, I have testified or submitted written testimony in a number of Commission
11 proceedings, including:

- 12 • The recent CC&N hearing for Global Water – Santa Cruz Water Company (Docket
13 No. W-20446A-14-0290);
- 14 • Our last rate case. (Docket No. W-01212A-12-0309 et al.); and
- 15 • Arizona Water Company’s SIB proceeding (Docket No. W-01445A-11-0310)

16
17 **Q. What topics will your testimony address?**

18 A. I will describe Global’s concerns with certain proposals of Staff and RUCO. I will also
19 discuss the benefits of the proposed asset transfer to EPCOR Water Arizona (EWAZ). I
20 will provide an overview of Global’s 2006 acquisition of Willow Valley, the numerous
21 problems faced by the Willow Valley at that time, and the extensive efforts Global
22 undertook to rehabilitate Willow Valley’s system. Lastly, I describe the current state of
23 Willow Valley’s distribution system and the status of Willow Valley’s SIB program.

24
25
26 **Q. Is Global presenting the testimony of any other witnesses?**

27 A. Yes. Paul Walker will testify regarding regulatory policy issues concerning water utility

1 consolidation, as well as specifically addressing Staff and RUCO's proposals to create a
2 regulatory liability related to Accumulated Deferred Income Taxes ("ADIT").
3

4 **II. Concerns with Staff's and RUCO's recommendations.**

5
6 **Q. Did you review the Direct Testimony submitted by Staff and RUCO?**

7 A. Yes, I have reviewed the Direct Testimony of Staff's witnesses Gerald Becker and Jian
8 Liu, and RUCO's witness Jeffrey M. Michlik.
9

10 **Q. Do you have any concerns with the Staff and RUCO testimony?**

11 A. Yes. I believe that if the Commission adopts Staff's and RUCO's proposals, it will be
12 devastating to the cause of consolidation of water utilities in Arizona.
13

14 **Q. What aspect of their testimony concerns you most?**

15 A. Their proposal to create a regulatory liability for EWAZ in the amount of \$260,224 as an
16 offset to EWAZ's rate base. This is very significant in the context of Willow Valley's rate
17 base of approximately \$2.2 million, as contemplated in the Asset Purchase Agreement. An
18 11% reduction to rate base is significant; when also considering the fact that the ADIT
19 liability must still be accounted for by Global in future tax filings. This is akin to a double
20 accounting. If other companies face this issue of a significant cut to rate base due simply
21 to an asset sale, it will become very difficult to financially justify pursuing any such deals.
22 Mr. Walker will explain why this proposed regulatory liability should be rejected.
23

24 **Q. Are there any other issues that concern you?**

25 A. Yes. I take issue with Mr. Becker's statement that "Due to the state of the infrastructure at
26 Willow Valley and Global's failure to mitigate its water losses, Staff recommends that the
27 Commission be mindful not to create an incentive for those who fail to maintain water

1 systems to propose to sell those systems at an amount in excess of its rate base.” (Becker
2 Direct, page 4, line 23 to page 5, line 1).

3
4 This statement gives the wrong impression. Global certainly has not failed to maintain
5 Willow Valley. Indeed, Global invested approximately \$3.3 million into new
6 infrastructure for Willow Valley after the acquisition in 2006. Willow Valley has lost
7 money each year we have owned it. Even though Global has not earned a return on its
8 investment due to regulatory lag and a prolonged rate phase-in, it continued to invest
9 heavily in Willow Valley. The problem is simply the deplorable condition of the system
10 when we purchased it. There are certainly many more improvements that can be made, but
11 Global’s efforts to improve the system have been significant.

12
13 **Q. Do you agree with Mr. Becker’s implication that the purchase price is too high?**

14 **A.** Not at all. Not even considering the purchase price Global paid in 2006, Global invested
15 nearly \$3.3 million in capital improvements for Willow Valley. The purchase price under
16 the Asset Purchase Agreement is \$2,494,834, much less than Global has invested in this
17 Willow Valley.

18
19 **III. Benefits to customers of the asset transfer to EWAZ.**

20
21 **Q. Will the asset transfer benefit Willow Valley’s customers?**

22 **A.** Yes. Willow Valley is over 200 miles from Global’s headquarters in Phoenix, and even
23 farther from our main service areas in Pinal County. Currently, we only have three
24 employees located in Willow Valley, and any additional help is over 200 miles away. In
25 contrast, EWAZ has water systems only a few miles away. This means in any emergency
26 or outage event that requires resources beyond that of the direct personnel, that EWAZ can
27 provide a much quicker response with additional resources. In addition, having a pool of

1 nearby employees means that if a worker is on vacation or sick another employee can
2 easily be shifted over to cover.

3
4 Moreover, EWAZ should be able to realize economies of scale that will ultimately benefit
5 ratepayers. As Staff witness Mr. Liu explains, “EWAZ has a significant presence in the
6 Mohave County area which should result in economies of scale savings for Willow Valley
7 in the future.” (Liu Direct, Exhibit JWL, page 1).

8
9 Willow Valley is a fairly small system, with approximately 1,600 customers. In contrast,
10 EWAZ’s Mohave and North Mohave systems have approximately 19,000 customers.¹ The
11 reality is that while we are confident in the work and manner in which we improved and
12 currently operate Willow Valley, EWAZ can operate Willow Valley more effectively and
13 efficiently. That is not to say Global cannot get the job done; we are operating Willow
14 Valley in compliance with all regulatory requirements, and we will continue to do so if the
15 transaction is not approved by the Commission or if a closing does not occur. But the fact
16 of the matter is that EWAZ’s larger local footprint gives it an advantage that we cannot
17 match locally; that is why the transaction makes sense for Global, EWAZ, and Willow
18 Valley’s customers.

19
20 While Global has been able to successfully manage this system, and as the record shows,
21 dramatically improve the quality of the infrastructure and the service; it is also true that
22 proximity matters and EWAZ will be able to more easily oversee and manage the system.

23
24 **Q. Are there potential financial benefits to ratepayers?**

25 **A.** Yes. I have already explained that EWAZ will likely release operational efficiencies and

26
27 ¹ According to Decision No. 74174 (October 25, 2013), EWAZ’s Mohave System had approximately 17,000 customers, and the system acquired from North Mohave Valley Corporation had approximately 2,000 customers.

1 economies of scale upon closing. In addition, as Mr. Becker explains, EWAZ “has a
2 capital structure that is more favorable to the ratepayers”. (Becker Direct at page 10, line
3 9).
4

5 **Q. What about infrastructure improvements?**

6 A. As I understand it, EWAZ has pledged to invest \$1 million in infrastructure improvements
7 in Willow Valley (over and above the SIB projects), as part of its acquisition premium
8 proposal. Global has no plans for a similar program. In light of the many years of
9 financial losses experienced by Willow Valley, combined with having already plowed
10 nearly \$3.3 million into Willow Valley, with no return on this investment, we simply
11 cannot financially justify further investment on this scale in Willow Valley. Of course, if
12 Global retains ownership, we will continue to ensure that Willow Valley meets all
13 regulatory requirements and we will make the investments necessary for that to happen.
14 But the system could benefit from very significant investments, and EWAZ’s \$1 million
15 would no doubt be very well spent. What EWAZ is proposing is a rapid advance and
16 escalation of investment into Willow Valley. This is going to result in a more rapid
17 approach to the attaining the goal that Global, EWAZ, and the Commission share: A
18 system operating at maximum performance with maximum efficiency for the benefit of the
19 customers.
20

21 **IV. Global’s stewardship of Willow Valley.**

22
23 **Q. When did Global acquire Willow Valley?**

24 A. Willow Valley was part of the stock purchase of West Maricopa Combine (“WMC”).
25

26 **Q. What was WMC?**

27 A. WMC was a holding company that owned five utilities: Valencia Water Company; Water

1 Utility of Greater Buckeye; Water Utility of Greater Tonopah (WUGT); Willow Valley
2 Water Co., Inc. and Water Utility of Northern Scottsdale. Global purchased WMC in the
3 summer of 2006. After Global took possession, we discovered numerous serious problems
4 in these companies, including Willow Valley.

5
6 **Q. Please explain some of the problems Global discovered upon buying WMC.**

7 A. The condition of WMC's systems was deplorable. There were rocks used to keep open
8 electrical breakers, and bungee cords were used to close high voltage electrical panels.
9 The Valencia system lacked adequate capacity, which required us in the first summer post-
10 acquisition to shut off service to large non-potable irrigation customers to ensure there was
11 sufficient water for homes. In certain areas, distribution systems were in very poor
12 condition, and many remain that way as it will require significant additional investments to
13 rectify.

14
15 WMC had taken some steps towards complying with the EPA arsenic standards, but
16 overall they were not prepared and could not secure the necessary funding. Some of the
17 treatment systems that they did design and install, functioned poorly. We upgraded them as
18 possible, but often it is impossible to dramatically improve poorly engineered and
19 constructed systems once in-place, as this would require total replacement. In other
20 locations, we had to scramble to design and install treatment systems to meet the EPA
21 arsenic requirements and fast approaching deadline to comply with the rule.

22
23 **Q. What about Willow Valley in particular?**

24 A. Willow Valley was the most troubling situation. We discovered that under the former
25 management, Willow Valley providing non-chlorinated drinking water in an unlooped
26 distribution system in an area that had a history of coliform events. This created a
27 significant public health risk. Former management concealed this situation by tampering

1 with water samples, and by filing false reports or failing to file necessary reports with the
2 relevant regulatory authorities. This situation was totally unacceptable.

3
4 **Q. What did Global do?**

5 A. We immediately began chlorinating the Willow Valley system. We then began a
6 significant effort to correct the severe water quality and infrastructure issues in Willow
7 Valley.

8
9 **Q. What other issues did Global discover?**

10 A. There were significant compliance problems. Under former management, WMC failed to
11 issue required public notices, failed to complete required Customer Confidence Reports
12 (CCRs), failed to adequately monitor their systems, and failed to file required reports.

13
14 **Q. What occurred when Global began chlorinating the water in Willow Valley?**

15 A. The chlorine reacted with the naturally occurring high levels of iron and manganese in the
16 water and deposits of these minerals that had built up overtime within the distribution
17 system due to lack of proper treatment – the result was the drinking water turned brown,
18 literally the color of Coca Cola.

19
20 **Q. What other issues did Global encounter in Willow Valley?**

21 A. The distribution system was in poor condition. The distribution system emplaced by
22 earlier owners was often found to be substandard. Because of the high iron and manganese
23 concentrations in the area's source water (that was not properly removed with beneficial
24 treatment techniques by prior owners), those pipes had become highly congested with iron
25 and manganese deposits. A 6" inch diameter pipe had a 2 – 3" usable space left within the
26 interior of the pipe. This also resulted in system pressure issues.

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Q. How did Global deal with this issue?

A. First, you must start at the source as to eliminate the continued introduction of the minerals into the distribution system. So in 2007 and 2008, Global built new iron and manganese removal systems at the production facilities. This was part of a multi-year, multi-faceted approach to eliminate the water aesthetic and quality issues. Here is an outline of the plan that was executed:

- Installed new chlorine injection systems that help ensure water is properly disinfected.
- Installed auto-dialer alarm systems that notify our staff in the event there are operational issues at our facilities. This helps prevent service outages.
- Identified all existing water lines and performed Hydraulic Modeling to establish distribution system performance. This assists in planning system improvements to maximize benefits to the system as a whole.
- Installed automatic flushing devices and operate an active flushing program to reduce the built up iron and manganese accretion in the water pipelines.
- Completed the Unit 17 Water Distribution Center (WDC) Improvement Project. The project included a new iron and manganese removal system along with a new water source, and complete electrical/mechanical upgrades. These new facilities have improved water clarity and reliability of service.
- Completed the Cimmaron WDC Improvement Project. The project included complete site improvements and upgrades to the existing iron and manganese removal systems and electrical/mechanical systems. These rehabilitated facilities will improve water clarity and service reliability for the Cimmaron Development.
- Installed new control valves in strategic areas as to improve our ability to re-direct water, isolate line breaks, and reduce the number of customers affected by failures.
- Finally, recently we completed additional treatment upgrades to address the remaining water aesthetic and compliance issues, as discussed below.

1 Beyond these improvements that were required immediately, it remains clear that the
2 remaining pipeline system must be replaced. Willow Valley will need to install new water
3 mains, water line loops, and install new valves where needed to eliminate frequent line
4 failures and to improve service reliability.

5
6 Additionally, as one important element of addressing water loss issues and to improve
7 customer service and staff safety concerns (meters in Willow Valley are mostly located in
8 the backyards of customers which historically required utility personnel to access back
9 yards which is never a good situation if it can be prevented), in 2010 Global replaced each
10 and every customer meter with a new Neptune meter and a Fixed Network Meter reading
11 system. This advanced system allows Global to continuously read customer usage from
12 remote locations for billing, customer inquiry, and troubleshooting activities. The system
13 also includes leak detection and other abnormal usage alert capabilities. In addition to
14 these benefits, it greatly reduced the need to access utility meters through customer
15 property.

16
17 **Q. What other improvements did Global make to Willow Valley's treatment and
18 production systems?**

19 A. Ongoing issues in the Willow Valley system required a number of treatment upgrades. In
20 December 2011, Willow Valley completed chlorine dioxide generator facility
21 improvements to the Unit-17 and Cimarron water production sites, as well as instituting a
22 corrosion control chemical system. The treatment upgrades were necessary to ensure that
23 the systems meet the requirements of EPA's Lead and Copper Rule, as well as
24 Disinfectants and Disinfection By-Products rules.

25
26 **Q. Why were these improvements needed?**

27 A. As already noted, when Global acquired the Willow Valley system in the summer of 2006,

1 the system was in poor shape and was not chlorinated. Chlorination is standard practice
2 for Global Water in order to protect public health, and so chlorination was initiated
3 immediately, which in turn resulted in immediate water aesthetic issues.

4
5 As chlorine can act as both a disinfectant and oxidant, the Willow Valley system has
6 experienced a number of challenging water quality issues associated with oxidation of high
7 concentrations of iron, manganese and total organic carbon (TOC) levels in the source
8 water. In order to address the original water quality challenges related to discoloration due
9 to the reaction of high concentrations of iron and manganese with chlorine,
10 oxidation/filtration units were installed at the groundwater sources in 2007 and 2008.
11 Additionally, in 2009, the Federal Environmental Protection Agency (EPA) enacted the
12 Groundwater Rule of the Safe Water Drinking Act (SWDA). In response to the
13 requirements of this rule, Global installed continuous monitoring to ensure the necessary
14 chlorine residual is maintained at all times.

15
16 Although aesthetic water quality was improved, compliance issues related to copper
17 corrosion and high total trihalomethane formations resulted. To resolve these issues, in
18 2010 a corrosion control study was conducted. This study concluded water corrosion
19 chemistry can be affected by groundwater treatment techniques. In the case of Willow
20 Valley, incidental cuprosolvency (copper solvency) is caused by a number of factors
21 related to the treatment and disinfection of groundwater. For this system, slow oxidation
22 reactions due to organically bound metal compounds caused by high levels of TOC in the
23 raw water source, are caused by extended use of oxidants related to iron and manganese
24 removal. Coupled with the incidental aeration and increased Dissolved Inorganic Carbon
25 (DIC) concentrations related to the iron and manganese filtration process, these factors are
26 the leading causes of increased copper solvency of the water. To offset cuprosolvency
27

1 effects of the water in the Willow Valley distribution system, the following improvements
2 were required to be implemented:

- 3 • Oxidant levels must be managed in the distribution system.
- 4 • Oxidant levels must be managed in the pretreatment process of the iron and
5 manganese filtration process.
- 6 • TOC compounds must be oxidized and removed prior to disinfectant application.
- 7 • Chlorine compounds must be managed in the distribution system.
- 8 • Chloride compounds must be reduced to allow alkaline components to provide
9 naturally occurring protective films between the contact water and exposed metal
piping.

10 These areas were effectively addressed utilizing the following process changes and/or
11 capital improvements:

- 12 • Add oxygen scavenging inhibitors to reduce available dissolved oxygen and in
13 turn, reduce oxidation potential of the contact water.
- 14 • Change pre-oxidant chemical for TOC, iron and manganese removal to non-
15 chlorine base oxidant.
- 16 • Improve pre-oxidation techniques by adding in-line static mixers to improve
oxidation efficiency.
- 17 • Move chlorine disinfectant to the discharge side of the pressure boosting station.
18 Improve disinfectant dispersion by adding an in-line static mixer to the booster
station discharge piping.
- 19 • Add corrosion control chemicals to offset damage to naturally occurring protective
20 films from excessive chloride and sulfate concentrations, and sequester iron and
manganese concentrations in the finished water.
- 21 • Reduce pre-oxidant requirements and improve TOC, iron and manganese removal
22 through the addition of manganese dioxide, manganese greensands or other filter
media as required per site.
- 23 • Remove excessive chloride and/or sulfate levels of the source water through
24 additional treatment techniques.

25 These recommendations led to bench scale piloting of alternative oxidants in 2011
26 including chlorine dioxide, and potassium permanganate, as well as corrosion control using
27 two polyphosphates which were evaluated to resolve the water quality issues.

1 Additionally, a field pilot study included:

- 2 • THM Control – Alternative liquid chlorine dioxide oxidant system replacing the
- 3 sodium hypochlorite oxidant;
- 4 • Disinfection control - chlorine gas replacing the sodium hypochlorite disinfectant
- 5 system;
- 6 • Corrosion control – Tetrasodium Pyrophosphate Corrosion inhibiting chemical feed
- 7 systems; and
- 8 • Solids Handling – Incorporate cone bottom settling tanks to improve solids capture.

9 The following summarizes the documented water quality results of the resultant
10 installation of chlorine dioxide generator facility improvements to the Unit-17 and
11 Cimarron water production sites completed in December of 2011.

- 12 • Total copper levels in the King Street Distribution System decreasing by as much
- 13 as 61%, and all lead and copper samples conducted in 2011 and 2012 indicate
- 14 compliance with regulatory standards.
- 15 • Total copper levels in the Cimarron Distribution System decreasing by as much as
- 16 65%, and all lead and copper samples conducted in 2011 and 2012 indicate
- 17 compliance with regulatory standards.
- 18 • Total Organic Carbon (TOC) levels decreasing by as much as 11%
- 19 • Total Trihalomethane (TTHM) levels decreasing by as much as 41%, and all
- 20 samples throughout the pilot program and in 2011 and 2012 indicate compliance
- 21 with regulatory standards
- 22 • Iron removal - average of 98.8%.
- 23 • Manganese removal - average greater than 85%.

24 Since completion of these improvements, Willow Valley has been in full regulatory
25 compliance.

26 **Q. Overall, how much as Global invested in Willow Valley since it was acquired?**

27 **A.** From the purchase of WMC in the summer of 2006, through June 18, 2015, Global
invested \$3,296,326.63 in plant investments for the Willow Valley system.

1 **V. Update on distribution system and SIB mechanism.**

2

3 **Q. What about the distribution system?**

4 A. Due to the issues described above, Global focused on the urgently needed improvements to
5 the production and treatment systems. Significant issues remain with the distribution
6 system.

7

8 **Q. Have there been any studies on what improvements would be beneficial?**

9 A. Yes, Global utilized a WIFA technical grant to study the Willow Valley distribution
10 system. This study helped prioritize the areas that most needed and would provide the
11 most benefit if replaced first. A copy of the study was attached as Attachment Fleming-3
12 to my Direct Testimony in our 2012 rate case. Overall, the study determined virtually all
13 pipelines (except for those in the smaller, newer residential development of Cimarron
14 Estates) needed to be replaced through an ongoing replacement program. Global estimates
15 the cost of main replacement program could reach \$5 million.

16

17 **Q. What about the SIB Mechanism?**

18 A. Global was part of the process of developing the original SIB Mechanism in Docket No.
19 W-01445A-11-0310. We proposed a SIB Mechanism in our 2012 rate case. In the rate
20 case, we submitted the “Willow Valley Water Company Water System Engineering Report
21 for System Improvement Benefit (SIB) August 2013”. This 40+ page engineering report
22 included system maps, detailed engineering plans, and SIB plant tables for the proposed
23 SIB projects, which were our highest priority distribution system projects.

24

25 **Q. Have any SIB projects been completed in Willow Valley?**

26 A. No. After the Commission approved the SIB Mechanism (which didn't occur until
27 February of 2014), Global began additional engineering and pre-construction work,

1 focusing on Project #1 for the SIB—Gordon Street Waterline. Willow Valley’s
2 Engineering and Construction Staff conducted a thorough on-site data collection effort and
3 concluded the finite details of the project—including the service lateral installation
4 locations for each individual customer. During this on-site effort, Willow Valley’s staff
5 contacted and met with the appropriate City and County agencies to discuss the details of
6 the projects, obtain the required construction specifications, and determine the necessary
7 permitting processes. The team compiled this information and hired an engineering firm to
8 produce the detailed construction drawings—which were completed in late 2014. These
9 drawings will be submitted to a list of pre-selected contractors to obtain bids and award a
10 contract for construction.

11
12 **Q. Why have not SIB projects been constructed in Willow Valley?**

13 A. The original plan was to implement the first SIB project in 2015. However, ongoing
14 litigation by RUCO with the ACC pertaining to SIBs created a risk that the SIB
15 Mechanism would not operate as designed. In addition, as the Asset Purchase Agreement
16 with EWAZ was negotiated, the parties made the determination that where possible, it
17 would be best to put a hold on major capital projects as it was determined best for the
18 utility, its customers, and the Commission that these be implemented by the ultimate utility
19 owner. However, under the Asset Purchase Agreement, Global does retain the option of
20 proceeding with needed capital projects after notifying EWAZ. In practice, we would
21 confer with EWAZ to see if we could reach consensus as to whether to begin a capital
22 project or wait for EWAZ to assume ownership.

23
24 **Q. What is the current status of Willow Valley’s SIB mechanism?**

25 A. On October 20, 2015, the Commission voted to stay all of the SIB mechanisms, including
26 Willow Valley’s, in light of a recent Arizona Court of Appeals decision. I understand that
27 the Commission has asked the Arizona Supreme Court to review the matter.

1 **Q. Please summarize your testimony.**

2 A. Global has invested heavily in Willow Valley, but it's true that more needs to be done.
3 Global has been direct about this throughout the prior rate cases, and this docket. EWAZ is
4 in a better position to make those investments. EWAZ has a much larger local presence,
5 and upon closing, EWAZ should be able to achieve operational efficiencies and economies
6 of scale. Moreover, EWAZ has a lower cost of capital.

7

8 Staff's and RUCO's proposed "regulatory liability" for ADIT should be formally rejected.
9 It will create a strong disincentive for future consolidation. I urge you to review Mr.
10 Walker's testimony in this regard.

11

12 **Q. Does this conclude your testimony?**

13 A. Yes.

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH - CHAIRMAN
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION) DOCKET NO. W-01732A-15-0131
OF WILLOW VALLEY WATER CO., INC. AND) DOCKET NO. W-01303A-15-0131
EPCOR WATER ARIZONA, INC. FOR)
APPROVAL OF THE SALE OF ASSETS AND)
TRANSFER OF CERTIFICATE OF)
CONVENIENCE AND NECESSITY)

Rebuttal Testimony of

Paul Walker

on Behalf of

Willow Valley Water Co., Inc.

October 23, 2015

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I. Introduction.

Q. Please state your name and business address.

A. My name is Paul Walker. My business address is 330 East Thomas Road, Phoenix, Arizona 85012.

Q. By whom are you employed and what is your position?

A. I am the founder, owner and President of Insight Consulting, LLC.

Q. Please describe your education.

A. I have a Master's Degree in Business Administration from the Thunderbird School of Global Management. I have a Bachelor's Degree in Business Management from the University of Phoenix. I am a graduate of numerous U.S. Army schools, including the U.S. Army War College's Combined Arms and Service School, the U.S. Army Officer Advanced Course (Transportation), and the U.S. Army Officer Basic Course (Military Police).

Q. Please describe your professional background and experience.

A. From 2004 to present I have worked as a lobbyist and regulatory consultant for clients in the utility and energy sectors. I worked with Wall Street investment firms from 2004 to 2009, conducting regulatory analysis of federal and state matters ranging from rate cases in numerous states, and evaluating liquefied natural gas export terminal feasibility. I have worked with several Arizona utilities, including Arizona Public Service, Tucson Electric Power, Arizona Water Company, Liberty Utilities, and, of course, Global Water Resources. Prior to that, I served as advisor to Commissioner Marc Spitzer at the Arizona Corporation Commission, and on Governor Jane Dee Hull's Indian Gaming

1 compact negotiation team. I have also served on the Commission's Power Plant and Line
2 Siting Committee.

3
4 **Q. Have you previously testified before the Commission?**

5 A. Yes, I have provided testimony in a number of Commission proceedings on issues such
6 as regulatory policy, water utility acquisitions, utility financial issues, the System
7 Improvement Benefit ("SIB") mechanism, and other topics. Dockets where I have
8 testified or submitted written testimony include:

- 9 • Arizona Water Company's SIB proceeding (Docket No. W-01445A-11-0310);
- 10 • Global Water's last rate case (Docket No. W-01212A-12-0309 et al.); and
- 11 • Arizona Water Company's Application to Extend its CC&N (Docket No. W-
12 01445A-03-0559)

13 I have also given numerous presentations at regulatory workshops and industry meetings.

14
15 **Q. Please provide an overview of your testimony.**

16 A. I will rebut Staff's and RUCO's unwarranted and unprecedented proposal to create a
17 "regulatory liability" for Accumulated Deferred Income Taxes ("ADIT"). I explain that
18 this proposal should be rejected because:

- 19 • It is unprecedented and contrary to normal accounting;
- 20 • It is very poor policy, making utility consolidation much more difficult;
- 21 • It fails to recognize the tax consequences of the asset sale; and
- 22 • It also appears to violate federal tax normalization rules, which could result
23 in serious negative consequences for EWAZ's ratepayers.

24 In addition, my testimony will describe the benefits of consolidation in the water utility
25 industry, and then will describe some of the policy options available to the Commission. I
26 will also respond to Mr. Michlik's and Mr. Becker's testimony on acquisition issues.

27

1 **II. Proposed regulatory liability for ADIT.**

2
3 **Q. What is ADIT and how does it impact rate base?**

4 A. ADIT occurs due to differences between regulatory and tax accounting. The primary
5 difference is in depreciation. For regulatory purposes, straight line depreciation is used,
6 while accelerated depreciation may be taken in certain tax situations. This creates a
7 temporary tax benefit to the utility, which is reversed over time as regulatory depreciation
8 catches up to the accelerated tax depreciation. This temporary tax benefit is referred to as
9 ADIT. For regulatory purposes, ADIT is considered a non-investor supplied source of
10 capital, and is thus treated as a reduction to rate base.

11
12 **Q. What happens to ADIT in an asset sale?**

13 A. Because the ADIT relates to the income taxes of the seller, it remains with the seller. No
14 ADIT is carried over to the buyer, although the buyer will begin recording new ADIT after
15 the purchase.

16
17 However, because the seller no longer owns the assets that generate the depreciation, the
18 taxes are no longer deferred; the regulatory and tax differences are trued up. In other
19 words, the previously deferred taxes become due.

20
21 Thus, ultimately, the ADIT will no longer exist, for either the seller or the buyer. Because
22 the ADIT will not exist, it is not appropriate to recognize it for ratemaking purposes.
23 Staff's and RUCO's proposed "regulatory liability", in essence, means pretending that
24 ADIT still exists when it does not.

25
26 In my experience, "pretending" and "accounting" are not things that go well together.
27 Ratemaking should reflect economic realities, and the reality is that these taxes will no

1 longer be deferred.

2
3 **Q. What about Staff's and RUCO's argument that the loss of the ADIT will harm**
4 **ratepayers?**

5 A. Their analysis is incomplete and speculative. ADIT will not be the only thing to change.
6 For example, as Mr. Becker notes, "EWAZ has a capital structure that is more favorable to
7 the ratepayers." (Becker Direct at page 10, line 9). Mr. Becker calculates the value of this
8 change as \$29,000 per year. In addition, the "value" of the regulatory liability of as an
9 offset to rate base will be lower due to EWAZ's lower cost of capital

10
11 As Mr. Liu and Mr. Fleming testify, the Willow Valley system should also benefit from
12 economies of scale under EWAZ's ownership. Certainly, there will be less need to make
13 the eight hour round trip from the Phoenix metro area to Willow Valley, given that EWAZ
14 has a large operation with a number of employees in the Mohave County region.

15
16 **Q. What are the policy implications of the proposed regulatory liability?**

17 A. The regulatory liability is very poor policy. That recommendation will not only end this
18 transaction, it will establish a phenomenally high level of regulatory uncertainty that will
19 make consolidating Arizona's water industry impossible

20
21 **Q. That's a strong statement. Please explain.**

22 A. What Staff and RUCO are proposing is unprecedented—they are proposing to take a tax-
23 related liability from one company and assign it to another company as a condition of
24 acquisition. If this is upheld by the Commission everyone looking at purchasing an
25 existing, ongoing entity will have to consider that every potential liability will be included,
26 by regulatory fiat. In this transaction, we have an asset sale. Yet Staff and RUCO are
27 proposing to go beyond the assets and into the stock ownership and assign a liability from

1 the stockholders of the selling entity to the stockholders of the purchasing entity.

2
3 **Q. How could creating a regulatory liability discourage water utility consolidation?**

4 A. As Mr. Fleming explains, the regulatory liability will significantly reduce rate base. And if
5 rate base is significantly reduced each time a utility is sold, there will be significant
6 disincentive for acquisitions of water utilities. Because the rate base will be higher before
7 the sale than after, the utility will be more valuable in the current owner's hands—even if
8 the current owner has difficulties providing service, lacks access to capital, and is lacking
9 in the technical and engineering areas. Basically, if this proposal is adopted, the
10 Commission will be sending a strong message to both potential buyers of water utilities
11 (including troubled water utilities), and sellers of water utilities, and that message will be
12 “**don't buy any utilities**” or “**don't sell your water utility**”. That is not the message the
13 Commission should send.

14
15 Moreover, it would be a precedent that is interpreted to mean much more than ADIT.
16 Water companies watch every major decision of the Corporation Commission to determine
17 the regulatory environment. If the Staff and RUCO recommendation is upheld, water
18 companies will certainly recognize that the Commission is going to go into every proposed
19 acquisition with an eye toward stripping value from the deal. What next? Staff and RUCO
20 are experts at many things, one of those things is finding ways to reduce rate base. But if
21 that approach is rolled into acquisitions, then acquisitions will never occur.

22
23 **Q. Is there any precedent for the proposed regulatory liability?**

24 A. I am not aware of any case where such a regulatory liability has been created.

25
26 **Q. Are there other issues with the proposed “regulatory liability” regarding ADIT?**

27 A. Yes, it may create serious tax risks that could harm ratepayers. A similar situation

1 occurred in an asset sale in Nebraska. The Nebraska Staff recommended transferring the
2 ADIT from a prior owner to the new owner. That raised serious tax questions. Before I
3 explain, let me issue the standard caveat: I am not an attorney, nor am I a tax accountant.
4 I am not opining on the tax consequences raised by the forced transfer of ADIT from one
5 owner to another—but with my experience assessing regulatory risk for Wall Street
6 firms, and with advising utilities on regulatory risk, and with my experience in utility
7 acquisitions, I find this to be a serious issue the Commission must consider.

8
9 The Nebraska company's witness, Mr. Lovinger, appears to be highly knowledgeable on
10 this issue and explained that the ADIT issue would violate IRS tax normalization rules.
11 A copy of this testimony is attached as Attachment Walker-1.

12
13 He explained that, "if the regulators were to require a flow-through of tax benefits or use
14 the prior owner's ADIT balance in the computation of rate base, this act would cause a
15 violation of IRS regulations and the utility would be prevented from computing
16 accelerated depreciation pursuant to IRC Section 168. As a result, ratepayers would pay
17 higher rates in the future due to the increase in rate base caused by the loss of accelerated
18 tax depreciation. Further, the utility would need to raise additional capital since it could
19 not count on interest free loans generated from the use of accelerated tax depreciation."
20 (Lovinger Testimony at page 12).

21
22 **Q. Do other authorities address the issue?**

23 A. Yes. Both the second edition of Professor Bonbright's *Principles of Public Utility Rates*
24 (1988)(under the heading "Normalization verses Flow-Through of Accelerated
25 Depreciation Tax Benefits", pages 286 to 290) and Professor Charles F. Phillips, Jr.'s *The*
26 *Regulation of Public Utilities* (1984)(under the heading "Interperiod Income Tax
27 Allocation," pages 267 to 273) discuss the historical debate between the flow through

1 method and the normalization method, and how the normalization method became
2 standard due to Congressional action restricting the flow through method by prohibiting
3 utilities from taking accelerated depreciation unless normalization is used. Copies are
4 included as Attachment Walker-2 (Bonbright) and Attachment Walker-3 (Phillips).

5
6 **Q. Are you testifying that Mr. Lovinger is correct?**

7 A. Again, I'm not a tax expert. But as a matter of regulatory policy, I am testifying that the
8 Commission should fully vet this issue and understand the consequences to EWAZ and
9 its ratepayers before considering creating a regulatory liability for ADIT. Staff's and
10 RUCO's testimony do not address the tax normalization issue.

11
12 **Q. Please summarize your testimony on the proposed regulatory liability for ADIT.**

13 A. The Commission should firmly reject the proposed regulatory liability. The proposal is
14 unprecedented, and if adopted, would make future consolidation very difficult if not
15 impossible. Moreover, the proposed regulatory liability does not reflect the economic
16 reality that the tax deferral ceases upon the asset sale.

17
18 **III. Benefits of Consolidation of Water Companies.**

19
20 **Q. Why is consolidation of water companies important?**

21 A. Arizona water utility sector is highly fragmented. While there are a few large,
22 sophisticated entities, the vast majority are small operations with limited technical,
23 managerial or financial capabilities. Arizona's multitude of small utilities are a constant
24 source of problems. Some fail spectacularly, causing massive Commission involvement
25 to clean up the mess – often requiring more capable utilities like Global to assume the
26 role of “interim manager”. Others are time bombs waiting to go off – just one failed
27 pump, ruptured tank or broken main away from collapse and without the resources to

1 respond to any problems. Still others limp along, lacking resources, expertise and
2 economies of scale. Moreover, small utilities lack the capacity to build the regional
3 infrastructure needed for sustainable water use and reuse. Similarly, many of the small
4 water systems have difficulties meeting current drinking water regulations, and many
5 more would be hard pressed to comply with new federal mandates.

6
7 **Q. What benefits can larger companies provide?**

8 A. Larger companies simply have more resources, with engineers, accountants and other
9 professionals on staff. Larger companies typically will have much better access to
10 capital, with the potential to raise debt capital by issuing bonds, as well as term loans or
11 lines of credit with major financial institutions. The same is true for equity capital; large
12 companies may raise equity capital directly through the capital markets if they are
13 publicly traded, or indirectly from parent entities or private investors.

14
15 **Q. Are there other potential benefits to consolidation by a larger utility?**

16 A. Yes. Depending on the location of the acquired utility, there may be additional benefits if
17 the purchasing utility has a system nearby. For example, a utility with a large system
18 nearby could potentially interconnect the smaller company into its system. Or perhaps in
19 the longer term, the smaller system could be included in future regional infrastructure
20 projects. And even if the systems are not physically interconnected, there will be
21 economies of scale from being part of a larger operation. For example, a single regional
22 supervisor could oversee both the existing system and the smaller system. Another
23 example is that the customers of the smaller system could have access to a call center,
24 which could offer longer hours of operation, at a lower cost, than a single customer
25 service representative for a small system.

1 **IV. Policies that can encourage consolidation.**

2
3 **Q. Are there policies that can support consolidation?**

4 A. Yes, there are numerous policies that could support consolidation. Some examples
5 include acquisition adjustments, ROE adders, and allowing developers to pay for
6 consolidation through ICFA agreements. There are many regulatory tools that can be
7 tried. The problem is not the lack of tools, it is that the tools have stayed in the toolbox
8 for decades.

9
10 **Q. You said that these tools have stayed in the toolbox. Please explain.**

11 A. We have been talking about promoting consolidation through acquisitions for many
12 years, but very little action has been taken. For example, in Global's 2009 rate case,
13 Staff's witness, Linda Jaress, testified that acquisition adjustments were a policy tool that
14 could be used to promote acquisitions.¹ But she testified that since the early 1990's, she
15 was aware of only two instances where the "policy tool" of acquisition adjustments were
16 the Commission approved.² She also testified that "the Commission has a long practice
17 of not allowing acquisition adjustments"³.

18
19 Similarly, in that case, the Staff recommended against using ICFAs as a means of having
20 developers pay for consolidation; instead Staff recommended and the Commission
21 approved treating approximately \$60 million of developer money spent on acquisitions as
22 CIAC. In Global's 2012 rate case, the CIAC imputation was reversed, but Global was
23 prohibited from ever using ICFAs again.

24
25
26

¹ Hearing Transcript, page 788, Docket No. SW-20445A-09-0077 et al.

27 ² Hearing Transcript, page 788 to 790, Docket No. SW-20445A-09-0077 et al.

³ Hearing Transcript, page 792, Docket No. SW-20445A-09-0077 et al.

1 **Q. Mr. Michlik refers to the 2001 Staff Proposed Policy on Acquisitions. How do you**
2 **respond?**

3 A. That proposal was part of the Commission's 1999 Water Task Force. I am shocked that
4 Mr. Michlik referred to the proposed policy favorably. Frankly, the 1999 Water Task
5 Force was a disaster as a policy initiative. A huge amount of effort went into the Task
6 Force, both from the Staff and the industry. The Water Task Force came up with many
7 good ideas, but few of them were ever implemented. The Staff Proposed Policy was never
8 adopted by the Commission. The Task Force Report recognized the need for changes in
9 Arizona's regulatory system, but those changes never came.

10
11 **Q. Mr. Michlik also refers to the RUCO / Responsible Water White Paper on**
12 **Acquisitions. How do you respond?**

13 A. As a co-author of the report (with Pat Quinn when he was RUCO Director), I am proud of
14 the work we did. But this too was a complete failure. RUCO backed out of the report, and
15 the recommendations in the report have not been adopted.

16
17 Furthermore, Mr. Michlick was careful to only cite the portions of the white paper that
18 bolstered his argument. I would like to bring the Commission's attention to other
19 portions of the white paper that do support the policy reasons that support the acquisition
20 and EWAZ's proposal to enact a new approach, a new tool, for incenting consolidation.

21
22 **Q. What portions of the white paper that you co-authored with Mr. Quinn support the**
23 **acquisition and EWAZ's recommended approach to dealing with the acquisition**
24 **premium?**

25 A. First and foremost, in Section One: The Policy and Factual Landscape of Arizona Water
26 states that there are three major forces that confront the Arizona water industry:
27 Economic Facts, Environmental Reality, and Regulatory Principles. Mr. Quinn and I

1 explain that those three forces have an interplay with each other – economic facts and
2 choices shape regulatory policy, environmental reality shapes regulatory policy and
3 affects economic facts. The three major forces all work in relation to each other,
4 constantly, to define the world for Arizona water companies.
5

6 **Q. What economic facts did you discuss in the paper as having an effect on**
7 **consolidating the industry?**

8 A. Economies of Scale and Small Firm Capital Attraction challenges are persistent
9 economic facts that affect the long-stated policy goal of the Corporation Commission to
10 incent and encourage the consolidation of Arizona’s highly fragmented water industry.
11

12 **Q. How does Economies of Scale relate to the proposed transaction between EWAZ**
13 **and Global Water?**

14 A. In the discussion of Economies of Scale, we wrote: “A utility requires not just the day-to-
15 day operational staff; it also requires a management team to oversee the accounting,
16 capital improvement plans, financing, environmental compliance and reporting, human
17 resources, and investor relations.”⁴
18

19 In this transaction, the management team that will oversee the capital improvement plans
20 and projects of Willow Valley will be located much closer to Willow Valley. While it is
21 true that the other elements of Economies of Scale are largely distance indifferent, when
22 it comes to overseeing construction there is no substitute for “boots on the ground”.
23 EWAZ has operations within a few miles of Willow Valley, Global’s management is
24 located 200 miles away. By no means am I suggesting that Global cannot oversee
25 construction projects, but it is indisputably true that EWAZ will be able to react to and
26 travel to construction challenges and sites much, much more quickly and easily than
27

⁴ Page 6

1 Global. This benefits customers because if and when problems arise, EWAZ will be able
2 to put “boots on the ground” almost immediately. And with the looming infrastructure
3 needs and the scope of the construction required in Willow Valley, that will matter.
4

5 **Q. How does Small Firm Capital Attraction Challenges relate to this transaction?**

6 A. Global has already invested over \$3 million into the Willow Valley system, as Mr.
7 Fleming explains in his testimony. This investment has had an incredible impact in
8 improving the system for the customers. Yet, as Mr. Fleming also explains, the
9 distribution system itself is in need of significant capital investment. EWAZ proposes, in
10 this transaction, to invest \$1 million into Willow Valley to address this need – as a result
11 of EWAZ’s proposal, Willow Valley will be able to address and resolve that challenge
12 much more quickly.
13

14 **Q. The second “major force” that you and Mr. Quinn described was “Regulatory
15 Principles”, how does that section of the white paper relate to this transaction?**

16 A. We wrote that “There are three key regulatory principles that must be strictly adhered to
17 should Arizona move forward with a policy and incentives to encourage consolidation of
18 the Arizona water and wastewater industry: Cost Causation, the Equity Principle, and
19 Sustainability.”⁵
20

21 **Q. How does the issue of Cost Causation relate to this transaction?**

22 A. We then wrote, “The reality is this: Consolidations and Acquisitions come with costs –
23 and those costs must be recovered in a fair and manageable manner...Investors and
24 customers are, quite literally, in the same position here: Both can benefit from a stronger,
25 more consolidated industry, the key is to understand how to balance these costs.”⁶
26

27 ⁵ Page 8

⁶ Ibid

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In the transaction, the acquisition price reflects a premium that cost is real, EWAZ will have to pay Global more than the book value of Willow Valley. For the customers to gain the benefits of management more proximate and a \$1 million program of improvements to be enacted in the near term, the acquisition premium is a real cost.

Q. Do the other principles relate to this transaction, i.e., the Equity Principle and Sustainability?

A. They do tie in as we describe in the following section: "If done correctly, establishing a consolidation enabling framework for Arizona water companies will integrate these three principles in a more holistic way. First, the true cost of one's water system may be hidden from customers if needed upgrades are not made or systems are neglected. Second, equity is a principle that is dependent on one's time horizon. In the medium to long run, the consolidation of two water systems may bring resiliencies and efficiencies that overcome short run inequities. Third, sustainability comes when the true long run costs of operating a successful water system are recovered and allocated within a system that is resilient and efficient. Smart consolidation between companies should leverage all three of these principles in a way that delivers long-term net benefits to all ratepayers involved."

EWAZ's proposal to invest \$1 million in the near term will result in beneficial upgrades for the customers; in the medium to long term the consolidation and proximity of EWAZ's existing systems should bring resiliencies in staffing and efficiencies in management; and the result will be a system that is more resilient and efficient.

1 **Q. The final “major force” that you and Mr. Quinn wrote about was Environmental**
2 **Reality. How does that relate to this transaction?**

3 A. In our white paper we cautioned against viewing consolidation as a “least cost” option –
4 in the long term, it will be the least cost. But in the near term, we wrote that “While
5 economies of scaled [sic] will provide downward pressure on prices and rates, it must be
6 clearly understood that consolidating and strengthening Arizona’s water infrastructure
7 will be a massively expensive effort that will take decades. So, economies of scale and
8 consolidation will not result in decreasing rates in the near term – they will only provide
9 downward pressure as Arizona deals with, and invests in, its 21st Century water
10 challenge. Drought, volatile and diminished Colorado River supplies, desalination,
11 reclaimed water and increased monitoring and conservation efforts are each costly, and
12 all necessary and prudent to secure Arizona’s water future.”

13
14 **Q. Likewise, Mr. Michlik brings up the March 19, 2012 Staff Report in the generic water**
15 **financing docket. Please respond.**

16 A. This report was the result of a series of workshops that the Commission ordered in
17 Decision No. 71878, the order in Global’s 2009 rate case. Workshops were held in 2011.
18 Again a great deal of industry and Staff effort went into this process. And again there was
19 no result. The Staff Report acknowledges that acquisition adjustments can be an
20 appropriate policy tool, yet it notes that only two have been approved by the Commission.
21 [Report at page 3]. Again a report has been produced, only to gather dust on the
22 bookshelves.

23
24 **Q. What about the specific limits on acquisition adjustments proposed in the Staff**
25 **Report?**

26 A. These seem quite restrictive. In particular, the requirement to wait for a rate case to find
27 out whether an acquisition adjustment has been approved does not seem appropriate. In

1 many cases, whether the acquisition adjustment is approved will drive the economics of
2 the deal, and the decision to close the deal or not would then depend on the approval of the
3 acquisition adjustment.

4
5 **Q. Were the recommendations of this Staff Report adopted in Global's subsequent rate**
6 **case?**

7 A. No.

8
9 **Q. Is there a regulatory principle that supports allowing acquisition adjustments?**

10 A. Yes. Professor Bonbright, in his classic treatise, *Principles of Public Utility Rates*, stated
11 in Chapter XII, Original Construction Cost Versus Subsequent Acquisition Cost, that “if
12 the transfer... was an essential, or at least a desirable, part of a program of integration,
13 justified in the public interest for the purpose of securing operating efficiencies... a claim
14 by the present company that its purchase of the acquired properties was, in effect, a
15 devotion of capital to the public service, cannot be dismissed as without merit.” ¶ 6

16
17 And furthermore, Professor Bonbright wrote in Chapter XIII, The Depreciation or
18 Amortization of Acquisition-Adjustment Costs, that assuming the utilities commission
19 found the acquisition was in the public interest (as earlier outlined) then the cost above
20 book should be amortized – but “an arbitrary rate, such as characterizes accounting
21 practice with respect to some intangibles, may be chosen.” ¶ 3

22
23 **Q. Is Willow Valley taking a position on the EWAZ's acquisition adjustment**
24 **mechanism?**

25 A. While we are not taking a position on the specifics of EWAZ's proposed mechanism, I
26 think EWAZ's proposal should be seriously considered. My point is that doing nothing
27 will get us nothing. My good friend, David Tenney, the Director of RUCO, likes to quote

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the maxim of college wrestling’s greatest coach, Dan Grable, who said “If nothing changes, nothing changes.”

In the past 16 years, nothing has changed with regard to consolidating the Arizona water industry – meanwhile, Pennsylvania continues its consolidation approach and has gone from over 500 water companies to under 150. ICFAs were a phenomenal tool for allow developers to pay for water utility consolidation, and the RUCO Responsible Water white paper had numerous recommendations—neither was implemented and nothing changed. But if we try new things we will learn new things—and if we don’t try new things, as Mr. Tenney likes to say “nothing changes.”

There current fragmented structure of the water utility industry is the result of the policies and practices of the Commission. Policy change must happen if a change is desired. There are plenty of policy options; what has been lacking is actual action on those options.

22749636.6

Attachment Walker - 1

**In the Matter of the Application of
SourceGas Distribution LLC
for Approval of a General Rate Increase**

**Docket No. NG-____
Volume 3 of 4**

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF NEBRASKA

In the Matter of the Application of)
SourceGas Distribution LLC for Approval) Docket No. NG _____
of a General Rate Increase.)

PRE-FILED DIRECT TESTIMONY OF

ALAN R. LOVINGER

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1 **I. EDUCATIONAL BACKGROUND AND PROFESSIONAL QUALIFICATIONS**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Alan R. Lovinger and my business address is 1155 15th Street, NW,
4 Suite 400, Washington, DC 20005.

5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am a Vice President with the firm of Brown, Williams, Moorhead & Quinn, Inc.

7 **Q. WHAT SERVICES DOES THE FIRM OFFER?**

8 A. The firm provides technical and policy assistance to various segments of the natural
9 gas, electric and oil industries on business and regulatory matters.

10 **Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT
11 EXPERIENCE.**

12 A. I graduated from Bryant University in 1965 with a B.S. Degree in Business
13 Management. That same year, I enrolled in an MBA program at Texas Tech
14 University majoring in Accounting. Prior to joining Brown, Williams, Moorhead &
15 Quinn, I was employed by the Federal Energy Regulatory Commission as a Senior
16 Accountant, for twenty-five years, from 1966 to 1969 and from 1976 to 1998. My
17 work at the Commission primarily related to cost of service matters with an
18 emphasis on income tax issues. I provided expert testimony on accounting and
19 accounting-related policy matters before the Commission. I also presented expert
20 testimony on cost of service matters and provided accounting and tax advice and
21 assistance on various projects, including construction of facilities to serve new or
22 expanded markets. I also represented the Commission in dealings with the Internal
23 Revenue Service on income tax issues relating to tax normalization that arose in
24 various rate proceedings and assisted the Commission on rulemakings for such cost
25 of service matters as tax normalization, cash working capital, and post-retirement
26 Benefits Other than Pensions.

1 permitted by the NPSC is to recognize book/tax timing differences prescribed by
2 Section 168 is tax normalization.

3 **III. BACKGROUND OF THE INTERNAL REVENUE SERVICE NORMALIZATION**
4 **REQUIREMENT**

5 **Q. CAN YOU PLEASE EXPLAIN THE BACKGROUND OF THE INTERNAL**
6 **REVENUE SERVICE NORMALIZATION REQUIREMENT?**

7 A. Yes. To understand the IRS Tax Normalization requirement, it is helpful to begin
8 with the background of the rule. Congress enacted accelerated depreciation in 1954
9 to encourage industrial expansion. Accelerated depreciation defers taxes that a
10 company would otherwise pay. Congress perceived this deferral of taxes as an
11 interest free loan, which can be used by companies for capital improvements and
12 expansion that would stimulate the post World War II economy.

13 **Q. HOW DID REGULATORY BODIES TREAT ACCELERATED DEPRECIATION**
14 **AFTER CONGRESS ENACTED IT IN 1954?**

15 A. Initially, regulators had two choices. They could choose either a Flow-through
16 method of regulation or a Normalization method.

17 **Q. COULD YOU EXPLAIN THESE TWO METHODS OF HANDLING ACCELERATED**
18 **DEPRECIATION?**

19 A. Yes. Let me first explain the Flow-Through method. In this method, the regulators
20 allow the regulated utility to collect in its cost of service for tax expense only what it
21 actually pays. In the early years of an asset, the lower income taxes that result from
22 accelerated depreciation "flow-through" to the utility's customers. In essence, the
23 regulator gives the customers the government "loan" to use. Under this method,
24 later customers will have to pay the higher tax bill because while accelerated
25 depreciation results in lower taxes initially, ultimately those lower taxes are paid to

1 the IRS in the later years of the assets' useful life when less depreciation can be
2 claimed for tax purposes.

3 **Q. CAN YOU EXPLAIN THE OTHER METHOD KNOWN AS "NORMALIZATION"?**

4 A. Yes. Under the Normalization Method, the utility customers pay the same amount
5 for tax expense in the cost of service that they would have paid had the taxes paid
6 by the utility been calculated using straight line depreciation. Under this method, the
7 utility collects from its customers more in taxes than it pays the IRS during the early
8 years of the assets' useful life. The income tax effect of the book/tax timing
9 difference is recorded in a deferred tax account. The deferred tax account for
10 utilities subject to the Federal Energy Regulatory Commission's Uniform System of
11 Accounts is Account No. 282, Accumulated Deferred Income Taxes – Other
12 Property. The "deferred" taxes are removed from Account No. 282 in the later years
13 of the asset life when the utility pays higher taxes to the IRS than it collects from its
14 customers in rates. The point in time when the utility begins to drawn down on the
15 ADIT associated with a particular asset is referred to as the "cross-over" point.

16 **Q. SO UNDER THE NORMALIZATION METHOD, IS IT CORRECT THAT THE**
17 **UTILITY KEEPS THE IRS "LOAN"?**

18 A. Not entirely. Under the Normalization Method, the utility does not keep the full
19 advantage of the IRS "loan" because the amount of ADIT is deducted from rate
20 base; however, the utility has the unrestricted use of the funds until the loan is paid
21 back. The ratepayers share in the benefit of normalization because this cost free
22 capital, ADIT, is used as a reduction to rate base; consequently, ratepayers do not
23 pay a return on the funds that the utility received as a loan from the IRS. The
24 utility's deduction of ADIT from rate base in later years decreases, after the "cross-
25 over" period, as prior period deferred taxes are paid to the government.

1 Q. WHICH METHOD DID REGULATORS USE -- THE FLOW-THROUGH METHOD
2 OR THE NORMALIZATION METHOD?

3 A. For many years after Congress introduced accelerated depreciation, regulatory
4 agencies did not hold consistent positions regarding rate treatment. Regulators
5 handled accelerated depreciation differently, depending upon how they viewed
6 accelerated depreciation and whether the advantages of this "loan" should accrue to
7 the customers or to the utility and depending upon the regulator's view of the need
8 to match the income tax allowance in the cost of service to the incurrence of the
9 utility's tax liability.

10 Q. DID THAT CHANGE?

11 A. Yes. Ultimately, Congress became concerned that "flow-through" decisions by
12 regulators, which passed on the tax deferral to the customers, resulted in a
13 "doubling of the Government's loss of revenue, from the use of accelerated methods
14 of depreciation for tax purposes. This is because the flow-through of the tax
15 reduction reduces the rates charged to customers, which in turn reduces the utility's
16 taxable income and therefore reduces its income tax. This second level of tax
17 reduction is passed on to the utility's customers, with the same effect." H.R. Rep 94-
18 413, 91st Cong., 1ST Sess. 1969, 1969 U.S.C.A.N. 1645, 1969 WL 5895 at 121.

19 Q. SO WHAT DID CONGRESS DO ABOUT THIS CONCERN RELATED TO FLOW-
20 THROUGH TREATMENT BY REGULATORS?

21 A. In the Tax Reform Act of 1969, Congress enacted a rule in Section 441 of the Tax
22 Reform Act, which added § 167 (l) to the Internal Revenue Code. This rule basically
23 provided that if a taxpayer is taking accelerated depreciation and is not normalizing
24 its deferred taxes, then it must use the straight line method when determining its
25 depreciation expense for federal income tax purposes. Congress considered no
26 longer permitting utilities to use accelerated depreciation. However, Congress

1 believed that removing accelerated depreciation from regulated utilities would place
2 the utilities at an unfair competitive disadvantage both in terms of the sale of their
3 products and services and their attractiveness to equity investors. Id. at 122. The
4 legislative history reflects that Congress intended to remove regulatory agencies'
5 ability to require flow-through of deferred taxes. As stated in the legislative history,
6 regulatory agencies "will be permitted to in effect force the taxpayer to straight line
7 depreciation by not permitting normalization. The regulatory agency will not, in such
8 cases, be permitted to require flow through of deferred taxes." Id. In other words, as
9 a practical matter, Congress took away a regulatory agency's ability to order flow-
10 through of deferred taxes by taking away the utilities' ability to use accelerated
11 depreciation in the event the regulator ordered the flow-through method of
12 accounting.

13 **Q. DID CONGRESS BELIEVE THAT ACCELERATED DEPRECIATION WAS GOOD**
14 **FOR BOTH THE UTILITY AND ITS CUSTOMERS?**

15 **A.** Yes. The 1969 tax change was at issue in a case that went to the United States
16 Supreme Court. This case involved Texas Gas Transmission Corp.'s request for
17 permission from the Federal Power Commission to use accelerated depreciation
18 with normalization with respect to its post-1969 expansion property. Federal Power
19 Comm'n v. Memphis Light, Gas & Water Div., 41 U.S. 464, 93 S.Ct. 1723 (1973).
20 The Supreme Court opinion discussed the fact that accelerated depreciation is good
21 for both the customers and the company:

22 "[Accelerated depreciation with] normalization in computing the tax
23 allowance for rate purposes . . . offers more hope for stability of
24 rates for its customers and more assurance that the company can
25 earn its fair rate of return without future rate increases. Further
26 benefits of normalization are that it will improve the company's
27 before tax coverage of interest, thereby enhancing the quality of its
28 securities, and that it will help alleviate present day cash
29 shortages." Id. at 465.

1 Q. ARE YOU AWARE OF ANY ADDITIONAL SIGNIFICANT EVENT RELATED TO
2 TAX NORMALIZATION?

3 A. There are two other significant events: the Economic Recovery Tax Act of 1981 and
4 the IRS Normalization Regulations.

5 Q. COULD YOU EXPLAIN HOW THE 1981 ACT RELATES TO ACCELERATED
6 DEPRECIATION?

7 A. Yes. The 1981 Act requires the normalization approach by regulators as a condition
8 for accelerated depreciation by public utilities of post-1981 properties. S.Rep. 97-
9 144, at 56 (1981), as reprinted in 1981 U.S.C.C.A.N. 105, 161. The purpose of the
10 1981 amendment was to provide an investment stimulus that Congress viewed as
11 essential for economic expansion. Congress viewed accelerated depreciation as a
12 way of increasing the profitability of investment and encouraging businesses to
13 replace old equipment and structures with modern assets that reflect better
14 technology. Congress was trying to restructure the depreciation deduction . . . as a
15 way of stimulating capital formation, increasing productivity and improving the
16 nation's competitiveness in international trade. Id. at 1981 U.S.C.C.A.N. 105, 152.

17 Congress was also trying to make the rules simpler. Id. The legislative
18 history of the 1981 Act makes it clear that Congress viewed "deferred taxes" as an
19 interest-free loan to the utility. Id. at 149. The utility is able to use this money in lieu
20 of funds that otherwise would have to be obtained by borrowing or raising equity
21 capital. Id. Thus, Congress did not want to allow accelerated depreciation unless the
22 regulatory body used the normalization method to account for it. This is why the act
23 states that the amount of capital that is deducted from rate base must not exceed
24 the amount of the deferred taxes recorded in compliance with tax normalization.

1 **IV. IRS NORMALIZATION RULE**

2 **Q. WITH THAT BACKGROUND, COULD YOU EXPLAIN THE IRS NORMALIZATION**
3 **RULE?**

4 A. Yes. The tax normalization method of accounting, Regulations Section 1.167(l)1(h),
5 requires a utility that uses accelerated depreciation to use the straight-line method
6 of depreciation (a straight-line method that matches annual book depreciation
7 expense, i. e. service life and rate) in computing its tax expense and its depreciation
8 expense for purposes for establishing cost of service for ratemaking purposes. The
9 Regulations further require the utility to calculate the annual tax effect of book/tax
10 timing differences and record the increase or decrease on its books in a deferred tax
11 account. The Regulations further require that the ADIT balance be used as a
12 reduction to the utility's rate base.

13 However, if the regulator requires the utility to continue to carry an ADIT
14 balance on its books when that ADIT balance has been eliminated, the utility would
15 be prevented from using accelerated depreciation in current and future years. Thus,
16 the utility would not get the benefit of any tax savings from accelerated depreciation
17 and the cost free capital associated with the book/timing difference.

18 **Q. PLEASE PROVIDE MORE DETAILS AS TO THE HARM A UTILITY WOULD**
19 **INCUR IF IRS DETERMINED THAT A VIOLATION OF THE TAX**
20 **NORMALIZATION RULES WERE TO OCCUR IN THIS RATE CASE.**

21 A. As stated above, Congress originally enacted the normalization rules to ensure that
22 the capital formation benefits of accelerated depreciation be retained by the utility
23 and for the ratepayer to benefit from reduced rates through the adjustment to rate
24 base. The intent of the tax normalization is to prevent regulators from passing the
25 benefits of accelerated depreciation to ratepayers by reducing the income tax
26 allowance. The normalization rules dictate that accelerated depreciation deductions

1 determined under Section 168 do not apply to any utility property if the taxpayer
2 does not use normalization method of accounting. Tax normalization rules also
3 require that ADIT reserve be reduced to reflect asset retirement. Thus, when a utility
4 that owns public utility property that it depreciates under an accelerated method for
5 tax purposes sells public utility assets, it is required by the normalization rules to
6 eliminate all associated deferred taxes recorded in Account No. 282 to reflect the
7 retirement of those assets.

8 **Q. DOES THAT COMPLETE YOUR EXPLANATION OF THE BACKGROUND OF**
9 **THE IRS TAX NORMALIZATION RULES?**

10 A. Yes.

11 **V. APPLICATION OF THE TAX NORMALIZATION RULE IN THIS CASE**

12 **Q. PLEASE DESCRIBE THE TRANSACTION THAT RESULTED IN SOURCEGAS**
13 **DISTRIBUTION ACQUIRING UTILITY ASSETS FROM KINDER MORGAN.**

14 A. SourceGas Holdings LLC is a Delaware limited liability company that was formed in
15 2006. SourceGas Holdings is fifty percent owned by an affiliate of the General
16 Electric Capital Corporation, and fifty percent collectively owned by Alinda
17 Investments LLC, a private equity firm, and an affiliated Alinda equity fund.
18 SourceGas LLC is a wholly-owned subsidiary of SourceGas Holdings. Immediately
19 prior to the closing of the sale of the natural gas utility business by Kinder Morgan in
20 March 2007, Kinder Morgan, Inc. contributed the natural gas utility assets that
21 constituted its natural gas distribution business to SourceGas Distribution LLC, a
22 Delaware limited liability company. When the sale was closed, SourceGas LLC
23 became the owner of 100% of the limited liability interests of SourceGas Distribution
24 LLC.

25 **Q. WHAT WERE THE TAX CONSEQUENCES TO THE SELLER WITH THE ASSET**
26 **SALE AS DESCRIBED ABOVE?**

1 A. The transaction was treated as an asset sale for federal income tax purposes.
2 Accordingly, the sale was recognized as a taxable transaction of the LDC assets
3 resulting in taxable gain or loss to KM. Under the Code, gain is determined by the
4 amount realized reduced by the seller's adjusted tax basis in the asset sold and is
5 reportable by the seller under Code Section 1001.

6 KM has further obligations under tax normalization rules. When a utility that
7 owns public utility property that it depreciates under an accelerated method for tax
8 purposes sells public utility assets, it is required by the normalization rules to reduce
9 its deferred tax reserve to reflect the retirement of those assets. Accordingly, the
10 ADIT balance associated with the sold assets is removed from the seller's
11 regulatory books of account. This removal reflects the fact that utility's interest free
12 debt is now payable to IRS to recognize the seller's gain or loss on the sale of utility
13 assets, pursuant to Code Section 1001. The buyer takes a new basis in the
14 acquired utility assets that reflects the buyer's asset purchase price (referred to as a
15 step-up cost basis to reflect the fact that the new buyer has a higher basis than the
16 previous owner).

17 **Q. WHAT IS THE SIGNIFICANCE OF THE STEP-UP IN THE TAX BASIS OF THE**
18 **UTILITY PROPERTY FOR SOURCEGAS DISTRIBUTION?**

19 A. As a result of the acquisition by SourceGas, the ADIT balance on KM's regulatory
20 books was reduced to zero in recognition of KM's taxable gain on its sale of utility
21 assets. Consequently, the purchased assets were recorded on SourceGas
22 Distribution's books with a zero balance in the deferred tax account, Account No.
23 282. The transaction was treated as an asset purchase. Consequently, SourceGas
24 Distribution's tax basis of the acquired assets increased, from what was KM's tax
25 basis for those assets just prior to the acquisition, to the acquired cost for those
26 assets, which for regulatory purposes was determined to be equal to the remaining

1 net book basis of the depreciable plant on the date of the purchase. Because the
2 new tax basis established for SourceGas Distribution's depreciable assets
3 exceeded the prior remaining tax basis on the books of KM, on a going forward
4 basis, SourceGas Distribution will recognize higher tax depreciation expense that
5 will generate more ADIT over the assets' depreciable lives than KM would have had
6 if the sale did not take place.

7 **Q. IS THERE ANOTHER REASON WHY SOURCEGAS DISTRIBUTION WILL**
8 **RECOGNIZE ANNUAL INCREASES TO ACCUMULATED DEFERRED TAXES**
9 **ABOVE WHAT KM WOULD HAVE GENERATED ON AN ANNUAL BASIS?**

10 A. Yes. Besides the fact that SourceGas Distribution has a larger tax depreciable
11 basis than that available to KM, SourceGas Distribution will depreciate the balance
12 at an accelerated rate due to SourceGas Distribution's election for the use of
13 MACRS. MACRS establishes a depreciable life for most of the acquired assets of
14 15 years. MACRS depreciation rates in the early years use accelerated rates that
15 decrease in each succeeding year. Thus, SourceGas Distribution will recognize
16 significantly more tax depreciation and accordingly higher yearly deferred tax
17 accruals than would have been recorded by KM had the acquisition not taken place.

18 **Q. YOU TESTIFIED ABOVE THAT ON THE DATE OF SALE THE BUYER WOULD**
19 **HAVE A DEFERRED TAX BALANCE OF ZERO FOR TAX PURPOSES. WILL**
20 **SOURCEGAS DISTRIBUTION ALSO HAVE A DEFERRED TAX BALANCE OF**
21 **ZERO?**

22 A. Yes. Both SourceGas Distribution's financial records and its regulatory books will
23 reflect a beginning zero balance for deferred taxes.

24 **Q. DO SOURCEGAS DISTRIBUTION'S REGULATORY BOOKS ALSO BEGIN WITH**
25 **A ZERO BALANCE IN THE RESERVE FOR DEPRECIATION?**

1 A. No. The depreciable basis and the reserve for depreciation for rate purposes and
2 accordingly for SourceGas Distribution's regulatory books remain consistent with the
3 depreciable basis and reserve reflected on the books of KM prior to the acquisition.
4 These balances are maintained to be consistent with the "original cost" regulatory
5 concept.

6 **Q. WHAT ARE THE RATE AND TAX IMPLICATIONS IF A REGULATOR DOES NOT**
7 **RECOGNIZE THE FULL IMPLEMENTATION OF TAX NORMALIZATION RULES?**

8 A. The normalization rules dictate the regulatory treatment of income tax expense and
9 accumulated deferred income tax reserves or ADIT. The IRC further provides that
10 accelerated depreciation determined under IRC Section 168 does not apply to any
11 public utility property if the taxpayer does not use a tax normalization method of
12 accounting. Thus, a utility cannot use accelerated methods of depreciation for utility
13 property if that taxpayer does not comply with the tax normalization rules.

14 Simply stated, the tax normalization rules require a utility to maintain an
15 accumulated deferred income tax (ADIT) account for the tax effect of the difference
16 between regulatory book depreciation and accelerated depreciation. The ADIT
17 recorded on the utility's regulatory books must be maintained in accordance with tax
18 normalization rules. The Internal Revenue Code ("IRC") further requires that the
19 ADIT balance be maintained in accordance with IRC Section 168 and that such
20 balance be used in the determination of rate base. Thus, if regulators were to
21 require a flow-through of tax benefits or use the prior owner's ADIT balance in the
22 computation of rate base, this act would cause a violation of IRS regulations and the
23 utility would be prevented from computing accelerated depreciation pursuant to IRC
24 Section 168. As a result, ratepayers would pay higher rates in the future due to the
25 increase in rate base caused by the loss of accelerated tax depreciation. Further,

1 the utility would need to raise additional capital since it could not count on interest
2 free loans generated from the use of accelerated tax depreciation.

3 **Q. PLEASE IDENTIFY THE SPECIFIC IRC REFERENCE THAT PRESCRIBES THE**
4 **METHOD USED TO DETERMINE TAX DEPRECIATION IF IRS DETERMINES**
5 **THAT A VIOLATION OF TAX NORMALIZATION HAS OCCURRED?**

6 A. The specific reference is Internal Revenue Code Section 168(i)(9)(c) provides:
7 Public Utility Property Which Does Not Meet Normalization Rules – In the case of
8 any public utility property to which this section does not apply by reason of
9 subsection (f)(2), the allowance for depreciation under section 167 (a) shall be the
10 amount computed using the method and periods referred to in subparagraph (A)(i).
11 Subparagraph (A)(i) of Section 168(i)(9) provides:

12 the taxpayer must, in computing its tax expense for
13 purposes of establishing its cost of service for ratemaking
14 purposes and reflecting operating results in its regulated
15 books of account, use a method of depreciation with respect
16 to such property that is no shorter than the method and
17 period used to compute its depreciation expense for such
18 purposes;
19

20 Thus, the Internal Revenue Code restricts tax depreciation to the utility's
21 regulatory depreciation method when there is a normalization violation.

22 **Q. ARE YOU AWARE OF ANY IRS RULING IN WHICH A REGULATED UTILITY**
23 **INVOLVED IN A DEEMED SALE OF ASSETS WOULD HAVE INCURRED A**
24 **NORMALIZATION VIOLATION?**

25 A. Yes, I am. On August 4, 1994, the IRS, in Private Letter Ruling 9447009, ruled that
26 there would be a normalization violation if, subsequent to the date of the acquisition
27 and deemed sale of assets of a natural gas transmission company, the natural gas
28 company's rate base were reduced for the balance in the reserve for the ADIT
29 attributable to accelerated depreciation on public utility property before the

1 acquisition date. Its parent sold the gas company to the buyer pursuant to a Section
2 338(h)(10) transaction. Such transaction, although structured as a stock sale, was
3 treated as an asset sale by the selling and buying corporations for tax purposes.
4 The IRS ruled that because of the deemed sale of the seller's assets, the seller's
5 ADIT balance ceased to exist and had to be removed from the seller's regulated
6 books of account and could not be flowed through to customers. Further, the IRS
7 ruled that a normalization violation would occur if the seller's ADIT balance that
8 existed before the acquisition were used to reduce the buyer's rate base.

9 **Q. HOW DOES THE FEDERAL ENERGY REGULATORY COMMISSION'S**
10 **UNIFORM SYSTEM OF ACCOUNTS ADDRESS THE ACQUISITION OF ASSETS**
11 **WITH RESPECT TO ADIT?**

12 A. The tax effect of the book/tax timing differences for plant investment is recorded in
13 FERC Account No. 282. With respect to the Regulations, Part 201, Account No.
14 282, Part D, the FERC specifically restricts the use of Account No. 282 to the
15 purpose for which the account was established. Deferred income tax recorded in
16 Account No. 282 must represent the tax liability due because of the recognition of
17 book/tax timing differences. Further, the regulations specifically restrict transferring
18 any balance to retained earnings or making any other use thereof, except as
19 provided by instructions to Account No. 282. The instructions state that:

20 "Upon the disposition by sale, exchange, transfer, abandonment or
21 premature retirement of plant on which there is a related balance
22 herein, this account shall be charged with an amount equal to the
23 related income tax expense, if any, arising from such disposition . . ."

24 Thus, the FERC rules recognize that upon an asset sale (or a deemed asset
25 sale for income tax purposes as is the case with SourceGas Distribution), the
26 seller's ADIT balance is extinguished since any deferred taxes are due and payable
27 by the seller at the time of sale.

1 Q. HAVE YOU DISCUSSED THE PROCEDURES USED BY SOURCEGAS
2 DISTRIBUTION IN THE COMPUTATION OF ADIT RECORDED IN ACCOUNT NO.
3 282 TO BE USED IN THE COMPUTATION OF RATE BASE IN THIS
4 PROCEEDING AND, IF SO, WHAT IS YOUR CONCLUSION?

5 A. Yes, I have discussed those procedures and it is my opinion that SourceGas
6 Distribution has put in place on its books all of the necessary steps needed to
7 properly determine an ADIT balance that will be fully compliant with the
8 requirements of tax normalization and the Uniform System of Accounts.

9 Q. IN YOUR OPINION, HAS SOURCEGAS DISTRIBUTION TAKEN THE
10 APPROPRIATE STEPS NEEDED TO AVOID A NORMALIZATION VIOLATION?

11 A. Yes.

12 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

13 A. Yes.

Attachment Walker - 2

APR 11 1950

Principles of Public Utility Rates

Second Edition

by
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\$1 billion excess acquisition price (or any part thereof) has been held to be a proper component of the rate base, as reflecting capital devoted to the public service, it should then receive corresponding treatment in the manner in which it should be depreciated or (in other words) amortized. But how rapidly it should be amortized is a difficult question to answer with confidence unless the excess purchase price can be intelligently distributed to the various plant accounts, tangible and intangible. If this is not feasible, an arbitrary rate, such as characterizes accounting practice with respect to some intangibles, may be chosen. But in any event, the amortization should be treated as an operating charge for ratemaking purposes — a conclusion which militates against a speed of amortization seriously burdensome to present consumers.

Current practice is to treat assets purchased at a price in excess of net book value as an excess cost. A utility would like to recover the excess cost and earn a return through acquisition adjustments, but the most common practice is to amortize the cost as an expense over a period of years so that there is a return of investment, but no return on the excess cost of the investment. A utility may be allowed to include the unamortized part of the excess cost in the rate base, thereby permitting a return on the unrecorded excess cost. However, most commissions are skeptical of transfers between utilities at excess costs, so rate base adjustments are generally not made unless the utility can demonstrate actual, distinct, and substantial benefits to all affected ratepayers (see Nixon, 1985). A utility that acquires a new service territory with the newly purchased assets may be held to a higher standard in proving benefits to ratepayers. But the point is that the burden of proof is on the company.

In general, acquisition adjustments are now amortized "below-the-line" over a period not to exceed the life of the property to which they relate unless the utility can demonstrate that ratepayers benefited by the acquisition. If such a showing can be made, which, according to Faudree (1987), to this point has been relatively rare at FERC, a utility may include the amortization expense "above-the-line" and include the expense in its cost of service. The unamortized balance, where above-the-line amortization is approved, would normally be allowed as a component of rate base.

NORMALIZATION VERSUS FLOW-THROUGH OF ACCELERATED DEPRECIATION TAX BENEFITS

In the public utility field, one of the more important controversies

about depreciation has concerned the accounting and ratemaking effects of the provisions of the tax codes permitting business corporations, in calculating taxable income, to use diminishing-charge procedures of depreciation accounting: specifically, a declining-balance method and a sum-of-the-years-digits method. These liberalized tax-accounting allowances were historically supported in the Congressional committee hearings partly on the ground that they would stimulate business investments, and partly on the ground that they come closer than straight-line depreciation accounting to a reflection of the rates at which most fixed assets actually depreciate in value from the dates of acquisition to the dates of retirement.

But many public utility companies have chosen to stress the first point and to ignore the second. That is to say, they have fairly generally decided to take advantage of the diminishing-charge deductions for tax purposes, while resting content with straight-line depreciation procedures for their financial statements and, presumably, for ratemaking purposes. As a result, and since they have been in an era of heavy plant expansion rather than in an era of stable equilibrium between acquisitions and retirements, their Federal income taxes are reduced by the accelerated rate of tax depreciation, whereas their annual allowances for depreciation as reported to the public service commissions remain unaffected.

By way of making accounting adjustments for this discrepancy between their income reports for tax purposes and their income reports for regulatory purposes, many companies have sought leave to include, as operating charges, the higher income taxes to which they would be subject were they to report taxable income on a straight-line basis. The excess in these "normalized" taxes over current tax liabilities is to be carried to a special deferred-tax account, against which to charge any later, offsetting enhancements in income taxes. This accounting procedure was sanctioned very early on by the Federal Power Commission, Federal Communications Commission, and many state commissions. Today the state and federal commissions are divided fairly evenly on normalization versus flow-through; the FERC, FCC, and 23 state commissions require flow-through (Shepherd, 1985, p. 365).

But the really important issue is concerned with the ratemaking aspects of this accounting problem, and here each of three major alternatives (along with some rather question-begging compromises) has derived support from some commissions. The first position, is that a public utility company which elects to pay income taxes on a diminishing-charge basis of depreciation accounting may receive no allowance for any taxes beyond those for which it is actually liable in a given year (i.e., tax savings flow-through to ratepayers). The second

position is that a ratemaking allowance shall be made for normalized taxes as an operating deduction but that no offsetting deduction shall be made in the measurement of the rate base, since the account for deferred taxes is deemed to constitute a restricted surplus and not a reserve representing amortized capital costs. The third position is that (both for ratemaking and for accounting purposes) normalized taxes shall be accepted as operating deductions but that any excess in such tax allowances over actual taxes shall be credited to a special reserve account, the amount of this reserve being deducted from cost used in arriving at the rate base just as is the ordinary depreciation reserve. Almost all utilities now follow the third method.

The second alternative at one time was popular with the public utility industries since, from their point of view, it had the charm of imposing upon the consumers the obligation to pay deferred-tax allowances which, instead of being transmitted forthwith to the United States Treasury, were treated as capital investments entitled indefinitely to the enjoyment of a fair rate of return for the benefit of the corporate stockholders. In this respect it had the same charm as that once possessed by the practice under which some public utilities would demand straight-line allowances for accruing depreciation while insisting on the deduction of nothing but a minimum "observed depreciation" in the measurement of the rate base. Support for this position of the industry was once forthcoming from the Federal Power Commission and from a few state commissions. However, this was changed in FERC Order No. 530B.

We never have seen a plausible defense for a claim to the enjoyment of a profit on funds not contributed by the corporate investors. The defense usually offered was that plant expansion financed by these funds enhances management costs and increases the risk factor. But management costs are covered in the allowances for operating expenses, not in the rate of return. And the risk factor (which may even be reduced, not increased, if the company is permitted to accrue a so-called deferred-tax reserve, as it will under Alternative Number 3) is properly taken into account in the allowance of a fair rate of return on capital contributed by the investors. Hence, there is no need to concede to stockholders a return on capital contributed, in effect, either by the taxpayers or by the ratepayers.

The Case for Flow-through

The main argument for a commission's refusal to make any deferred-tax allowance in a rate case — for the flow-through principle — is that, as long as the tax law remains unchanged and as long as

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additions to depreciable corporate assets exceed retirements, the tax deferral will be continuous and hence will amount, in effect, to a permanent tax saving. With qualifications, this contention is correct in that a reduction in current taxes below what these taxes would be under straight-line accounting will not later be offset by an increase in these taxes beyond what they would be under straight-line.

But under flow-through, the major benefit of the tax reduction would go to the earlier ratepayers, in the years in which the tax payments have been reduced, instead of being apportioned among ratepayers more nearly in proportion to their relative responsibility for payments for services resulting in eventual tax liabilities. As an argument against the accrual of a tax-deferral reserve, the permanent-deferral theory is suspiciously similar to the discredited "plant immortality" theory of depreciation, mentioned early in this chapter, which was once adduced by the utility industry as an argument against the deductibility of accumulated depreciation from cost new in the determination of the rate base.

The Case for Normalization

As we see it, the only reasonable controversy as to the choice among the three aforementioned alternatives is that between the view that, for ratemaking purposes, companies should receive no allowances for taxes other than for actual current taxes, and the view that, if they practice liberalized-depreciation accounting for purposes of income taxation, they should receive an annual allowance for deferred taxes combined with a deduction of the resulting deferred-tax reserve from what would otherwise be the rate base. Here we are convinced that the weight of the argument lies with the latter position, and this for three reasons: first, that this position is in harmony with the modern tendency to regard straight-line depreciation as erring on the side of a retarded allowance for cost recoupment rather than excessive allowance as was once often thought to be the case; secondly, that the very practice of taking rapid depreciation for tax purposes tends to reduce more rapidly the actual values of the depreciating assets — namely, their tax-saving values; and thirdly, that unless utility companies are permitted to set up reserves against deferred taxes, thereby protecting themselves against the possible repeal of the diminish-charge provision of the present tax law, they are likely to exercise what has been held to be their option to ignore these provisions in favor of the orthodox straight-line tax accounting — an option adverse to the long-run interests of their customers. Substantially all utility companies follow this practice and it is required by FERC. That is, FERC rules currently

require that deferred taxes be deducted from the rate base and many state commissions follow this practice. The utilities prefer normalization as it increases their profitability and preserves a stimulus or incentive to investment.

The FERC and many of the state commissions now require that full interperiod income tax allocation be followed for accounting and ratemaking purposes. In all of the jurisdictions that we are aware of in which income tax normalization is followed, the accumulated deferred income tax balances are used as a rate base deduction (or included in the capital structure for rate of return calculation purposes at zero cost). Further, even in those jurisdictions where some flow-through of taxes is required for ratemaking purposes, the Internal Revenue Code requires that most property-related timing differences be normalized in order for the utility to be eligible for liberalized depreciation.

Summary of Final Rule Requiring Tax Normalization

FERC Docket No. RM80-42, R-424, R-446. In a ruling that became effective July 6, 1981, the FERC amended its regulations to require tax normalization for the tax effects of certain timing differences of transactions involving electric utilities and interstate gas pipelines. The final rule also codified the existing Commission rulemaking practice of adjusting rate base for accumulated deferred income taxes. Finally, the final rule required adjustments in the deferred taxes for utilities' and pipelines' cost of service for two types of circumstances:

- (1) when inadequate or excessive provision for deferred taxes had been made for the tax effects of timing different transactions within the scope of the rulemaking that had previously been given flow-through treatment.
- (2) when inadequate or excessive provision for deferred taxes had been made as a result of changes in tax rates.

Although the limited extent of FERC jurisdiction restricts required range of applicability, the companies often argue for their application to properties devoted to both jurisdictional and nonjurisdictional service. Not only does this simplify their accounting procedures, but it also helps to avoid a "no one's land" where incurred costs can be charged to neither federal nor state jurisdictions.

Attachment Walker - 3

The Regulation of
Public Utilities
Theory and Practice

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on to them, thereby tending to lull the public into a frame of mind which allows government expenditures to be increased without strong opposition.¹⁴⁰

*Interperiod Income Tax Allocation*¹⁴¹

Although public utilities are subject to many types of taxes, federal income taxation presents the most complex and controversial issues. At the outset, it must be recognized that there is commonly a difference between income and expenses for accounting (book) purposes and for income tax purposes. As explained by the Accounting Principles Board of the American Institute of Certified Public Accountants:

The principal problems in accounting for income taxes arise from the fact that some transactions affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period. A major problem is, therefore, the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income.¹⁴²

Where there are book/tax timing differences,¹⁴³ income taxes must be apportioned among accounting periods. That process is known as *interperiod income tax allocation*. Three major areas that require allocation follow: accelerated depreciation, investment (job development) tax credit, and consolidated tax returns.

Accelerated Depreciation: The "Phantom Tax" Issue. Under the Revenue Act of 1954, business firms are permitted to adopt accelerated

¹⁴⁰*Re Intermountain Gas Co.*, 35 PUR 3d 342 (Idaho, 1960). See also *Re Bell Teleph. Co. of Nevada*, 31 PUR 3d 392 (Nev., 1959); *Re Florida Water Service*, 32 PUR 3d 320 (Fla., 1960); and *Re Missouri Utilities Co.*, 43 PUR 3d 423 (Mo., 1962). In Illinois, and in a few other jurisdictions, even franchise taxes are treated in this manner. See, e.g., *Village of Maywood v. Illinois Commerce Comm.*, 178 N.E. 2d 345 (1962).

¹⁴¹For a more comprehensive discussion, see Hahne and Aliff, *op. cit.*, chap. 17.

¹⁴²Accounting Principles Board, Opinion No. 11, "Accounting for Income Taxes" (1967).

¹⁴³Differences may be either timing (differences between book income and tax income that will reverse in subsequent periods, i.e., deferred income taxes) or permanent (differences between book income and tax income that will not reverse in some future period, i.e., interest on governmental obligations, which is exempt for tax purposes but is recognized for book purposes). Timing differences, in turn, may refer to items that relate to revenues (gains or losses from sale of utility property), expenses (fuel expenses), or property (due to depreciation methods). For examples of major timing differences, see Hahne and Aliff, *op. cit.*, pp. 17-74—17-77.

depreciation in calculating taxable income, thereby charging higher depreciation expenses in the early years of the service life of assets than would be allowed under straight line depreciation and lower rates in later years. The effect is to produce lower tax payments with respect to the early years which are offset by increased tax payments in the remaining years. The act posed a problem for the regulatory commissions: should they include, for rate-making purposes, as operating costs the higher income taxes to which utilities would be subject were they to report taxable income on a straight line basis ("normalization" method) or should they include only the taxes actually paid ("flow through" method) by the utilities? If the normalization method is adopted, the utilities, in effect, are granted during the early years of the property's life an interest-free loan of the difference between taxes paid and taxes due under the straight line method.¹⁴⁴ The implication is that the act results in a tax deferral rather than a permanent tax saving. The difference could be used for modernization and expansion or for other financial needs. If the flow through principle is adopted, the tax deferrals are denied to the utilities and the reduced tax expense can be used to raise reported earnings or to reduce consumer rates.

The normalization and flow through methods are compared in Table 7-3. Assume that a utility invests \$10,000 in new equipment, that its estimated useful service life is ten years, that it has no removal cost, and that the estimated salvage value is \$1,075. Using the straight line method, \$892.50 would be charged to depreciation expense annually. Using accelerated depreciation (assuming the double-declining balance method), the annual depreciation charge would start at \$2,000 and decline to \$268 over the ten-year period. In either case, the utility would receive a tax saving during the first four years. However, the effect on net income would not be identical: normalization accounting would result in no effect on net income, while under flow through accounting net income would be increased in the first four years and decreased in the last six years of the equipment's service life.

The Controversy. Income tax normalization has been the subject of considerable controversy. It is charged by many consumer groups that normalization results in ratepayers paying "phantom taxes."

... The argument relies on the assumption that because the utility's business will probably continue to grow, the deferred tax account will also continue to grow indefinitely. The phantom tax advocates contend that, as the deferred taxes grow at a rapid pace, there will always be more revenues collected to cover the deferred tax expense than deferred taxes paid out.

¹⁴⁴For accounting purposes, the tax effect of the depreciation difference is placed in a reserve for deferred income taxes.

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They further allege that such a method gives rise to a "permanent tax savings" rather than a "tax deferral" that would eventually be paid out when the timing differences reach a reversal point (i.e., the book expense is higher than the tax expense).¹⁴⁵

The phantom tax argument is fallacious. As explained by Hahne and Aliff:

The error of the phantom tax argument may be seen by analogy with the growth of a long-term debt account. As any issue of long-term debt reaches maturity, it must be repaid. At the same time, new plant additions may require that capital be raised through additional long-term borrowing to finance the additions. That new issues may exceed repayment of maturing debt over any period so as to result in net growth of long-term debt in no way means that the debt is not being repaid nor that, in the future, when the new issue matures, it will not have to be repaid.¹⁴⁶

For many years, the utilities themselves debated the wisdom of adopting accelerated depreciation, even when permitted by the commissions. The Bell System, to illustrate, did not take advantage of accelerated depreciation until 1970. Its decision to use straight line depreciation for both accounting and tax purposes was based on three considerations:

1. Congress might suspend, modify, or repeal the accelerated tax depreciation provisions at some future date, thereby resulting in a sudden decline in per share earnings and a possible drop in the market price of a utility's stock.
2. A multistate utility, subject to several jurisdictions, might find some commissions permitting normalization and others flow through; a situ-

¹⁴⁵Hahne and Aliff, *op. cit.*, p. 17-26. Compare, e.g., *Re Alabama-Tennessee Nat. Gas Co.*, 52 PUR 3d 118 (FPC, 1964), *aff'd*, 359 F.2d 318 (1966), *cert. denied*, 385 U.S. 847 (1966), with *Colorado Municipal League v. Pub. Utilities Comm.*, 597 P.2d 586 (Colo., 1979). See also D. Kiefer, *Accelerated Depreciation and the Investment Tax Credit in the Public Utility Industry: A Background Analysis* (Columbus, Ohio: National Regulatory Research Institute, 1979).

¹⁴⁶Hahne and Aliff, *op. cit.*, pp. 17-26—17-27. The Revenue Act of 1978 (Pub. Law 95-600) lowered the federal corporate income tax rate from 48 to 46 percent. How should the commissions recognize the fact that deferred taxes had been accumulated at the 48 percent rate for many years? Some commissions held that the deferred tax reserves should be reversed at the original rate of 48 percent. [See, e.g., *Re Southwestern Bell Teleph. Co.*, 36 PUR 4th 283 (Mo., 1980).] Others took the position that the deferred tax reserves were excessive, and that the surplus deferred taxes should be amortized over one to ten years. [See e.g., *Re Chesapeake & Potomac Teleph. Co. of West Virginia*, 40 PUR 4th 279 (W. Va., 1980).] The latter method, which results in a reversal of the tax deferred over a period shorter than the lives of assets, may not meet the statutory normalization requirements, thereby resulting in the disallowance of accelerated tax depreciation. [See, e.g., *Kansas Power & Light Co. v. Kansas State Corp. Comm.*, 620 P.2d 329 (1980).]

TABLE 7-3
Illustration of Effect of Accelerated Depreciation, for Tax Purposes, on Net Income*

Year	A. NORMALIZATION ACCOUNTING					
	Straight Line Depreciation (a)	Accelerated Depreciation (b)	Effect On Taxable Income (c = b - a)	Effect On Taxes Payable (d = c x .46)	Credit (or Charge) to Deferred Taxes (e = -d)	Effect On Net Income (f = d + e)
1	\$ 892.50	\$ 2,000.00	\$ -1,107.50	\$ -509.45	\$ +509.45	0
2	892.50	1,600.00	707.50	-325.45	+325.45	0
3	892.50	1,280.00	387.50	-178.25	+178.25	0
4	892.50	1,024.00	131.50	-60.49	+60.49	0
5	892.50	819.00	-73.50	+33.81	-33.81	0
6	892.50	655.00	-237.50	+109.25	-109.25	0
7	892.50	524.00	-368.50	+169.51	-169.51	0
8	892.50	419.00	-473.50	+217.81	-217.81	0
9	892.50	336.00	-556.50	+255.99	-255.99	0
10	892.50	268.00	-624.50	+287.27	-287.27	0
	\$ 8,925.00	\$ 8,925.00	0	0	0	0
Salvage value	\$ 1,075.00	\$ 1,075.00				
Total	\$10,000.00	\$10,000.00				

Total \$10,000.00

Total \$10,000.00

B. FLOW THROUGH ACCOUNTING

Year	Straight Line Depreciation (a)	Accelerated Depreciation (b)	Effect on Taxable Income (c=b-a)	Effect on Taxes Payable (d=c x .46)	Effect on Net Income (e = -d)
1	\$ 892.50	\$ 2,000.00	\$ -1,107.50	\$ -509.45	\$ +509.45
2	892.50	1,600.00	- 707.50	-325.45	+325.45
3	892.50	1,280.00	- 387.50	-178.25	+178.25
4	892.50	1,024.00	- 131.50	- 60.49	+ 60.49
5	892.50	819.00	+ 73.50	+ 33.81	- 33.81
6	892.50	655.00	+ 237.50	+109.25	-109.25
7	892.50	524.00	+ 368.50	+169.51	-169.51
8	892.50	419.00	+ 473.50	+217.81	-217.81
9	892.50	336.00	+ 556.50	+255.99	-255.99
10	892.50	268.00	+ 624.50	+287.27	-287.27
	\$ 8,925.00	\$ 8,925.00	0	0	0
Salvage value	\$ 1,075.00	\$ 1,075.00			
Total	\$10,000.00	\$10,000.00			

*The following assumptions underlie the computations: original investment, \$10,000; no removal cost; salvage value, \$1,075.000; estimated service life, ten years; accelerated depreciation, 20 percent declining balance method; 46 percent federal income tax rate.

ation which would result in confusion on the part of investors and expensive record keeping on the part of a utility.

3. Flow through, which was required by many of the commissions, impairs the financial integrity of a utility by: (a) failing to recognize current costs, since a tax cost is understated during the early life of the property; (b) increasing investor risk, since future depreciation deductions might not be available to offset the past costs which were not recognized under this method, while economic conditions or regulatory commissions might not allow future rate increases; and (c) endangering the ability of a utility to raise funds because of large amounts of unprovided-for costs overhanging the business.¹⁴⁷

Commission Treatment. Prior to 1969, the regulatory commissions were split over the proper method to employ. The Federal Power Commission, which at first permitted normalization,¹⁴⁸ adopted the flow through method early in 1964.¹⁴⁹ The Federal Communications Commission, until 1971, required the flow through method. As of July 1, 1967, 20 state commissions permitted various forms of the normalization method for rate-making purposes, 23 (including the District of Columbia commission) had either ordered or favored the flow through method, and two permitted either method.¹⁵⁰

¹⁴⁷See Gerald J. Glassman, "Objections to Taking Liberalized Depreciation," 77 *Public Utilities Fortnightly* 29 (March 31, 1966); Herman Green, "Proper Regulatory Treatment of Liberalized Depreciation," 78 *ibid.* 31 (July 7, 1966); and C. N. Ostergreen, "Accelerated Depreciation and Rate Making Once More," 81 *ibid.* 48 (January 18, 1968). But see Donald C. Cook, "The Flow Through of Tax Benefits," 77 *ibid.* 170 (June 9, 1966), for an argument that accelerated depreciation should be adopted even if flow through is required.

It has been estimated that if the Bell System had elected to use accelerated depreciation in 1954, its income tax liabilities would have been reduced by a total of \$1.6 billion by the end of 1965, resulting in cumulative reductions in charges to consumers of about \$3 billion. Testimony of A. L. Stott, FCC Docket No. 16258 (Bell Exhibit 38, October 17, 1966) Attachment C; and Testimony of William J. Powell, FCC Docket No. 16258 (FCC Staff Exhibit No. 29), p. 10.

¹⁴⁸*Re Panhandle Eastern Pipe Line Co.*, 3 PUR 3d 396 (FPC, 1954), *aff'd sub nom. City of Detroit v. Federal Power Comm.*, 230 F.2d 810 (D.C. Cir. 1955); and *Re El Paso Nat. Gas Co.*, 29 PUR 3d 469 (FPC, 1959). See Note, "Liberalized Depreciation: About-Face by the FPC," 50 *Virginia Law Review* 238 (1964).

¹⁴⁹*Re Alabama-Tennessee Nat. Gas Co.*, *op. cit.* Further, in 1966, the FPC held that the increased federal income tax payments resulting from the decision of a natural gas pipeline company to discontinue the use of accelerated depreciation were not a reasonable and prudent business expense. *Re Midwestern Gas Transmission Co.*, 64 PUR 3d 433, 444 (FPC, 1966).

¹⁵⁰Federal Power Commission, *Federal and State Commission Jurisdiction and Regulation. Electric, Gas, and Telephone Utilities, 1967* (Washington, D.C.: U.S. Government Printing Office, 1968), p. 38; Eugene F. Brigham, "Public Utility Depreciation Practices and Policies," 19 *National Tax Journal* 144 (1966); and H. Bierman, Jr., "Accelerated Depreciation and Rate Regulation," 44 *Accounting Review* 65 (1969). For typical decisions, compare *Re Gulf Power Co.*, 10 PUR 3d 273 (Fla., 1956) (normalization permitted) with *City of Pittsburgh v. Pennsylvania Pub. Utility Comm.*, 17 PUR 3d 249 (1957) (flow through required).

Then, in the Tax Reform Act of 1969, public utilities were required to use either straight line depreciation or accelerated depreciation with normalization for tax purposes. Most commissions, therefore, beginning in 1970, permitted normalization of deferred taxes for both book and rate-making purposes (although some continued to use flow through on pre-1970 property).¹⁵¹ In such instances, a utility is not permitted to earn a return on the deferred taxes; that is, they are either deducted from a utility's rate base or included in a utility's capitalization at a zero cost rate.¹⁵² Further, it should be noted again that normalization is required for a utility to elect the accelerated cost recovery system under the Economic Recovery Tax Act of 1981.

The Investment (Job Development) Tax Credit. The Revenue Act of 1962 (Pub. Law 87-834) provided, as an incentive to investment, that a business firm could deduct from its federal income tax liability a specified percentage based on the amount of new investment in most plant and equipment which it put into service during a taxable year. The Code has been suspended and modified over time.¹⁵³ Under the latest laws (Tax Reduction Act of 1975, Pub. Law 94-12, as modified by the Economic Recovery Tax Act of 1981, Pub. Law 97-34), all businesses are eligible for a credit graduated up to 10 percent on property placed in

¹⁵¹The most publicized exception was in California, where the commission's decision to permit normalization in 1970 (Decision No. 77984, November 24, 1970) was overturned by the California Supreme Court [*San Francisco v. California Pub. Utility Comm.*, 91 PUR 3d 209 (1972)]. If the 1969 act did prohibit utilities from using accelerated depreciation and the investment tax credit with flow through, the court's position would have resulted in Pacific Telephone and General Telephone of California having tax liabilities in excess of \$2.2 billion for delinquent taxes, penalties, and interest. In fact, in 1978, the Internal Revenue Service sent Pacific Telephone a deficiency notice. Congress resolved the dispute by adding an amendment to federal gasoline tax legislation which made more specific "the rules under which public utilities lose the investment credit and accelerated depreciation when these tax benefits are flowed through too rapidly to consumers" and which resulted in compromise payments of \$321 million by Pacific Telephone and \$97.7 million by General Telephone. 49 *Telecommunications Reports* 1, 26 (January 10, 1983). On the dispute, see A. Dahl, "The California Remand Case: Controversy over Normalization," 104 *Public Utilities Fortnightly* 13 (December 20, 1979).

A few other state commissions continue to use the flow through method [see, e.g., *Gulf States Utilities Co. v. Louisiana Pub. Service Comm.*, 364 So. 2d 1266 (1978)] or the flow through method for computing a utility's state income tax expense [see, e.g., *Continental Teleph. Co. of Maine v. Maine Pub. Utilities Comm.*, 397 A. 2d 1001 (1979)]. See also "Recent Decisions on Accelerated Depreciation and Normalization," 105 *Public Utilities Fortnightly* 49 (May 8, 1980).

¹⁵²See, e.g., Eugene F. Brigham and James L. Pappas, *Liberalized Depreciation and the Cost of Capital* (East Lansing: MSU Public Utilities Studies, 1970).

¹⁵³Under the 1962 act, nonregulated firms, as well as natural gas producers and pipeline companies and transportation firms received a percentage that was graduated up to 7 percent, depending on the estimated life of the new property; other public utilities received a percentage graduated up to 3 percent. To qualify for the full credit, the property had to have a life of eight years or more. The act further provided that the tax base of the eligible property was to be lowered by an amount equal to the tax credit. The Revenue Act of 1964 (Pub. Law 88-272), among other things, prohibited the federal