Docket No, UG-06____
Exhibit ____(JEH-1T)
Witness: James E. Haug

BEFORE THE

WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

UG-06_____

GENERAL RATE APPLICATION

OF

CASCADE NATURAL GAS CORPORATION®

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February 14, 2006

Prepared Direct Testimony of
James E. Haug

Increase in Federal Income Taxes from Non-normalized Depreciation Differences on Pre-1981 Fixed Assets
Income Tax Adjustment for Proforma Capitalization

PREPARED TESTIMONY OF JAMES E. HAUG

(Proforma Income Tax Expense Adjustments)

Q. Please state your name and address for the record.

A. My name is James E. Haug. My business address is 222 Fairview Avenue North, Seattle, WA 98109.

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

A. I am employed by Cascade Natural Gas Corporation as its Controller.

Q. Please describe your education and employment background.

A. I graduated from the University of Washington in 1972 with a Bachelor of Arts degree in Business Administration, with emphasis in accounting. From 1972 to 1977, I was employed in various accounting capacities. In 1977, I was hired by Cascade Natural Gas Corporation as an accountant. I subsequently held various positions of increasing responsibility in Accounting, and in 1997 I began my current position as Controller.

Q. What are your primary responsibilities as Controller?

A. My responsibilities entail financial measurement and control. I serve as the Company's principal accounting officer, and am responsible for the general supervision of all accounting functions for the Company. This includes both internal and SEC financial reporting, compliance with all applicable accounting standards, taxation, billing, and cash receipts. I am responsible for the Company's Sarbanes Oxley compliance and reporting, and

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for overseeing the Company's system of internal controls over financial reporting. My responsibilities also include income tax compliance and income tax accounting.

Q. Have you previously testified or sponsored testimony before utility commissions?

A. Yes. I have testified before the Washington Utilities and Transportation Commission and I have sponsored testimony before the Oregon Public Utility Commission in several rate case filings.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain two proforma adjustments of income tax expense that are shown in my exhibits. Both are necessary to develop the correct level of income tax expense to be included in the Company's cost of service in this rate case.

Q. Do you sponsor exhibits in this filing?

A. Yes, I sponsor two exhibits, each of which adjusts test year expenses. They are Exhibit ____ (JEH-2), adjustment for increased income tax expense resulting from the effect of non-normalized depreciation differences on utility plant assets placed in service prior to 1981, and Exhibit ____ (JEH-3), the adjustment of income tax expense to reflect proforma capitalization.

Exhibit ___ (JEH-2)

ADJUSTMENT FOR FEDERAL INCOME TAXES

Q. Please describe Exhibit ____ (JEH-2).

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A. Exhibit ____ (JEH-2) shows the adjustment to restate the test period provision for current income tax expense. The adjustment is the result of the difference between book and tax depreciation on pre-1981 utility plant assets.

Q. Please explain why this adjustment is necessary.

A. Prior to 1981, differences between book and tax depreciation were not normalized in setting base rates. Current income taxes were calculated using "flow through" depreciation. In other words, the level of income taxes included in operating income was calculated using accelerated depreciation rates that the Company utilized on the income tax return. No offsetting entry to deferred taxes was made; therefore, the benefit of accelerated depreciation was "flowed through" to the ratepayer with the understanding that in the future the ratepayer would incur the additional income tax expenses the Company incurs when the book depreciation expense is greater than that on the income tax return. Each year the current tax expense increases due to the declining tax depreciation levels, resulting in the need for the proforma adjustment.

Q. Please explain how the adjustment was calculated.

A. We have projected the 2007 tax depreciation based on the tax depreciation schedules in place during 2005 for the pre-1981 assets. In 2007, tax depreciation on these assets will be less than book depreciation by $1,990,334, resulting in an increase in taxable income (over book income) in the same amount. Multiplying the increase in taxable income by the federal tax rate of 35% produces a projected 2007 increase in income tax of $696,617. The increase for 2005, using the same methodology, and the Company’s 2005 tax rate of 34% produces a 2005 increase in income tax of $420,150. Applying the Washington tax allocation factor of 66.83% to the difference between the 2007 and 2005 income tax increases produces the tax

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increase applicable to Washington. The resulting tax applicable to Washington is $184,763, an amount carried forward to Exhibit ___ (JTS-2), Schedule 1, page 3, column (f), line 17.

Q. Why were different tax rates used for 2005 (34%) and 2007 (35%) used in this adjustment?

A. In 2005, the Company's taxable income for the current income tax provision was below $10 million. Thus a 34% rate was applicable. In 2007, the Company's taxable income is projected to be at such a level that a 35% tax rate will be applicable.

Q. Why was 2007 compared to 2005 in developing the adjustment?

A. We anticipate that this base rate increase will become effective during our 2007 fiscal and tax years; therefore, it is appropriate to base this adjustment on projected 2007 tax depreciation levels compared to 2005.

EXHIBIT ____ (JEH-3)
INCOME TAX ADJUSTMENT FOR PROFORMA CAPITAL STRUCTURE

Q. Please explain Exhibit ____ (JEH-3).

A. This exhibit develops the amount by which federal income tax expense must be adjusted to reflect the proforma capital structure being proposed in this case. Dr. Morin proposes a proforma capital structure with a debt ratio that is different from that experienced in the test year. I used the resulting proforma weighted cost rate for debt to develop an amount of proforma interest expense. These calculations are shown in detail in my exhibit. The resulting proforma interest expense is $9,053,750, as shown on line 3. For the test year, an interest deduction of $9,792,663 was used to develop the amount of federal income tax expense charged to Washington utility operations. The difference between these two

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amounts represents a pro-forma decrease in interest expense of $738,913, as shown on line 5. Multiplying this decreased interest expense by the federal income tax rate of 35% produces the resulting increase in federal income tax of $258,619 shown on line 7. This amount is carried forward to Exhibit ____ (JTS-2), Schedule 1, page 3, column (g), line 17.

Q. Does this conclude your testimony?

A. Yes.

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