BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION

COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

COMPLAINANT,

VS.

RAINIER VIEW WATER COMPANY, INC.,

RESPONDENT.

REBUTTAL TESTIMONY

OF HERTA M. INGRAM

ON BEHALF OF RAINIER VIEW WATER COMPANY, INC.

January 18, 2002

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Herta M. Ingram. My business address is P. O. Box 976, Olympia, Washington 98507-0976.

Q. PLEASE STATE BY WHOM YOU ARE EMPLOYED, YOUR POSITION AND YOUR ROLE WITH THIS EMPLOYER.

A. I am employed by Economic and Engineering Services, Inc. I am a Financial Analyst. As a Financial Analyst, I provide financial consulting services to public utilities. These services include, but are not limited to, providing long-term financial planning, rate adjustment and design services, capital improvement financing assistance, and system development charge reviews.

Q. PLEASE BRIEFLY LIST YOUR EDUCATION AND PROFESSIONAL EXPERIENCE.

A. I hold a Bachelor of Arts with a Major in Accounting and a Master of Business Administration, both from Saint Martin's College in Lacey, Washington. I have been working in the arena of Public Utilities for over nine years. I have worked as a regulator, an accountant, a manager and an analyst. I have worked on all sides of utilities including governmental, private, public and consulting. I began my professional career at the Washington Utilities and Transportation Commission, working for four years as a Revenue Requirements Specialist in the Utilities Division. Following this, I was the Chief Accountant for Public Utility

District No. 1 of Lewis County. I held this position for two years, after which I began working for American Water Resources, Inc., as the Operations and Financial Manager. I began working in my current capacity in 2000 after having worked for American Water Resources, Inc.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. I have been asked to testify as an expert witness for Rainier View Water Company, Inc., ("Company", "the Company" or "Rainier View") in Docket UW-010877. My testimony will address two issues currently outstanding in this case. The first issue I will address is the treatment of income taxes and the second issue is the treatment of Rainier View's Ready to Serve Revenues.

Q. PLEASE EXPLAIN THE ISSUES SURROUNDING THE TREATMENT OF INCOME TAX.

A. In direct testimony prepared by Danny Kermode, Exhibit ___ (DPK-T1), p. 14, l. 23-25, Mr. Kermode states "The Company's filing is misleading since this line item represents to the Commission that the Company indeed has an income tax expense recorded on its general ledger of $167,639." His basis for this statement is Rainier View's election of Subchapter S corporate status. In brief, a Subchapter S corporation distributes its net earnings to each shareholder similar to the manner in which a partnership distributes net income. The tax on corporation income, therefore, is calculated on the individual shareholder's return and the

federal income tax is reported and paid on their personal tax returns. He then further states, "The proper way of presenting the Company's imputed income tax expense would have been through a pro forma adjustment and not by showing the expense was incurred and recorded "per books"." Mr. Kermode's first statement implies that Rainier View is trying to hide the fact that tax is not paid by the corporation itself. However, I believe that Rainier View, in presenting federal income tax as a "per books" item, was simply following the same practice it has for many rate case results of operations statements filed before the Commission prior to this one. Mr. Kermode's second statement, explaining where the imputed tax should have entered the results of operations sheet, explains his philosophy on the correct treatment of showing the income tax liability generated by regulated utility revenues, but he makes no such adjustment on his results of operations exhibit.

Mr. Kermode further states on lines 24 and 25 of page 15 of his direct testimony, Exhibit ___ (DPK-T1), that "the Commission has not issued any order or decision approving rates for an S corporation that included recovery of income taxes." This statement is not true and is evidenced in detail in Mr. Doug Fisher's rebuttal testimony beginning on page 8 of his Exhibit ____ (DF T-12). The Commission has also approved rates for both tariffed and non-tariffed charges for Rainier View that included the capture of the income tax liability related directly to the revenue generated from that charge. In Rainier View's tariff, an equation is included on

the tariff page that sets forth the method for calculating said income tax liability, Exhibit ___ (HMI-2). According to the tariff page, the Company is allowed to collect the tax liability on this charge at the time the charge is assessed.

Q. Is this common practice for similar charges?

A. Yes, this is a common practice. In cases where a charge does not have federal income tax included in the calculation of the rate, such as is the case with rates for the utility service itself, a calculation is usually included. This formula, in an effort to realize the full effect of the tax liability provides for a "gross up" of the federal income tax expense. What this means is that the full tax effect is paid by the "cost causer," the customer. Although, as an example, a company may charge a fee of $100 for an ancillary service that will create a tax liability, the company, under the gross up formula, is allowed to collect more than just $100 times the appropriate tax rate.

Q. Can you explain this further with an example?

A. Yes. In the example stated above, under a simple tax computation of the $100 times the tax rate, let's assume a 15% tax rate, the tax would be calculated at $15, for a cost collected from the customer of $115. However, the Internal Revenue Service classifies the $15 collected as taxable revenue as well, and assesses the 15% tax on the $15. This continues until such time as the tax on the additional revenue collected to pay the tax becomes negligible. The "gross up" formula

accounts for this. The gross up formula calculates the effective tax rate so that the company collecting the charge also collects the full tax effect. In our example, the company would collect $117.65 from the customer. This is calculated by using the gross up formula. The gross up formula is:

$$\frac{1}{(1\text{-tax rate})} - 1$$

This turns the 15% straight tax rate into a 17.65% effective tax rate.

Algebraically represented, then, the calculation looks like this:

$$\text{Grossed Up Tax Rate} = \frac{1}{(1-.15)} - 1$$

$$= \frac{1}{.85} - 1$$

$$= 1.17647 - 1$$

$$= .1765$$

In our example, this means an additional $2.65 of tax to be collected. While this figure may appear nominal, it becomes a substantial amount as more ancillary charges are collected and as the stated charge increases.

Q. Do you have any further discussion on why income tax is an appropriate cost to be included in regulated charges imposed by Rainier View?

A. Yes. Mr. Kermode states in his testimony that the federal income tax is not applicable because of the business entity chosen by Rainier View. In Rainier View's case, they have chosen Subchapter S Corporation (Sub S) status. Please

note that the entity chosen is a corporation. There is not difference in entity status between a C corporation and an S corporation. This is simply a tax filing election as is explained by Mr. Ault. According to the financial accounting text, Corporate, Partnership, Estate and Gift Taxation, written by James W. Pratt, Jane O. Burns, and William N. Kulsrad, Subchapter S was added to the Internal Revenue Code in 1958 to provide small businesses "the advantages of the corporate form of organization without being made subject to the possible tax disadvantages of the corporation". This means that income tax is not assessed on the subchapter S corporation income at the corporate level, but rather, the income is passed through to the shareholders, as with partnerships, and the corporate portion of the tax is then combined with tax on other income of each of the shareholders and paid at the shareholder level. In the case of Rainier View, regulated net income is passed through to each of Rainier View's shareholders (similar to the distribution to a partnership) and the tax on that revenue is paid off of the shareholder's return.

It is inappropriate, however, to claim that the tax is a shareholder responsibility solely on the basis that the tax is paid from the individual income tax return of each shareholder, when in fact, that portion of the tax liability of the shareholder would not exist if the regulated revenue did not exist. Therefore, under basic regulatory theory, the cost causer is the combined customers of the regulated utility, not the shareholder.

Mr. Kermode's theory that the tax liability is a shareholder responsibility, therefore begs the question of treatment of other business entities where tax is not paid directly by the regulated utility. For instance, under Mr. Kermode's theory, if the business entity is a sole proprietorship or a partnership, then no tax should be allowed in rates either. Taking his theory to yet another level, the same would be true if Rainier View was a C corporation, but a subsidiary of a larger corporation where tax was paid at the parent corporation level. Is the Commission planning on disallowing federal income taxes for such entities as Qwest, or Avista Corporation, Waste Management, and Washington Water Service? In previous rate cases of these corporations, (Qwest – UT-950200; Avista – UE-991606 and UG-991607; Waste Management – TG-950910, et. al.; and Washington Water Service – UW-010024) the Commission allowed income tax expense, even though the regulated net income is passed forward to the parent corporation (a non-regulated entity) and paid at that level. In the case of Qwest and Avista, the rate cases were taken through formal hearings and the federal income tax expense remained throughout and eventually was allowed in rates.

Ms. Parker demonstrates in her testimony cases where the Commission has allowed income tax for regulated utilities structured similar to Rainer View. Yet, in this case, Mr. Kermode attempts to go against both consistent treatment between the different industries regulated by the Commission, as well as against

precedent within the treatment of water utilities by suggesting that the tax is the responsibility of an entity outside of the regulated business. And finally, if any of the shareholders of the Sub S corporation failed to meet their income tax liability, including the tax liability on regulated operations, the IRS would pursue remedy of the unpaid tax on regulated operations from the regulated company. This poses an interesting scenario. For a regulated utility to recuperate federal income tax expense in rates, under Mr. Kermode's plan, the entity would either need to be a C corporation, or the shareholders would have to collectively default on their tax payments on regulated income so that the IRS would pursue the regulated entity for the tax payments. Then the regulated entity could demonstrate that the liability truly sits with the entity and not the shareholders or parent corporation.

Q. Has Rainier View done anything further on its proposed results of operation statement that demonstrates that the income tax proposed to be included in rates is not based upon the shareholder's tax liability?

A. Yes. Rainier View has requested recovery of a standard tax rate on regulated net income for ratemaking purposes. If Rainier View was requesting recovery of taxes as they apply to shareholder income, the tax rate would be a weighted tax rate based upon the individual investment and income producing habits of each of the shareholders. This would likely cause a much higher expense based upon the combined average of the tax rates applicable to each of a Sub S corporation's shareholders since each shareholder has his or her own tax planning strategies.

Q. What implications does Mr. Kermode's suggested treatment of federal income tax have on the shareholders of the corporation?

A. Shareholders have the general responsibility of determining whether an investment is worthy of the risk involved. This evaluation of risk in relation to their investment includes an evaluation of other investment activities. Under Mr. Kermode's proposed treatment, he is suggesting that the risk associated with the income tax liability on the taxable revenue from regulated activities of a subchapter S corporation be applied solely to the shareholders. However, he makes no adjustment in the rate of return afforded to equity to reflect this additional risk. If the Commission chooses to agree with Mr. Kermode's theory, then the risk component of the rate of return on equity should be adjusted accordingly.

His suggestion further creates a situation where each shareholder would have to re-evaluate his or her investment to determine whether the investment is worthy of the risk involved. This could be detrimental to the customers of a Sub S corporation if any of the shareholders chooses to liquidate his or her stock.

Further, to suggest that the income tax liability is not a responsibility of the corporation, Mr. Kermode violates the basic tenants of fair, just, reasonable, and sufficient as set forth in basic ratemaking theory and, in essence, causes a

confiscation of private property by requiring a liability be paid by a non-cost causing taxpayer and also by not reflecting the increased risk to the shareholder in the rate of return on equity.

Q. What other implications does Mr. Kermode's treatment of income taxes have on this case?

A. By treating income taxes as a shareholder expense and thereby increasing the risk of the shareholders' investments, Mr. Kermode's discussion on return on equity and overall rate of return is flawed.

Q. Why is Mr. Kermode's discussion on return on equity and rate of return flawed?

A. In Mr. Kermode's calculation of rate of return, he utilizes a discounted cash flow method. In a very basic sense, this method compares the operations and structure of Rainier View to utilities of similar size, risk and revenues. However, no where does Mr. Kermode recognize the increase in risk to the shareholders created by his treatment of income tax in the comparison of Rainier View to other entities. I don't believe Mr. Kermode would be able to find a similar utility to contrast Rainier View to, thereby rendering his discussion of discounted cash flows and his related calculations inaccurate.

Q. Does this conclude your testimony on the issue of income taxes?

A. Yes.

Q. Please review the issues surrounding the ready to serve charge.

A. Mr. Kermode suggests in his testimony that the revenue generated from the ready to serve charges set forth in developer contracts held by Rainier View should be included as operating income for the utility.

Q. Why is this treatment inappropriate?

A. This treatment is inappropriate for a number of reasons. First of all, Mr. Kermode defines these revenues as "Guaranteed Revenues" in his Response to the Data Request generated after direct testimony was filed. This is erroneous as these revenues are not consistently guaranteed. What I mean by this statement is that these revenues disappear as soon as the lot is sold to an end-user, therefore removing the so-called "guarantee". The contracts in question have a stated expiration of five years after the beginning of the ready to serve charge yet they can, and do, expire prior to this five year term.

Mr. Kermode also states that this revenue should not be considered non-utility revenue by virtue of the definition he uses to define non-utility revenue. He states, "If the Company sold refrigerators or gas stoves, revenue from these sales would obviously be non-utility related." (Exhibit ___ (DPK-T-1), p. 8, l. 8 and 9).

Mr. Kermode also states that the ready to serve charge is paid to "guarantee a connection to the water system" in the Staff Response to the Company's Data Request. This too, is incorrect. The only way in which a customer is legally guaranteed of a water connection to a regulated water utility is through the issuance of a water availability letter which later is replaced by the guarantee to serve associated with the payment of the service connection charge. Up until one of these two stand-alone conditions exists, the utility company is not legally bound to provide water service to the lot in question. Further, the ownership of a water availability letter or the payment of a service connection charge is independent of any other charges paid to the water utility. In fact, standard language in a typical development contract states:

> "Nothing in this Agreement entitles Developer or Developer's successors or assigns to connect to Owner's water system, including System Extension, except in accordance with the terms, conditions and charges in Owner's tariff filed with the Washington Utilities and Transportation Commission."

Under Mr. Kermode's approach, anyone who pays any type of fee to a regulated utility would, by default, be guaranteed water service, whether either one of the legally binding situations exists.

Q. What is Rainier View's position on ready to serve charges?

A. In discussions with Mr. Doug Fisher and Mr. Bob Blackman of Rainier View and Mr. Richard Finnigan, attorney for Rainier View, they have each stated that the ready to serve charges are a financing mechanism for purchasing rate base. Mr. Fisher, in his rebuttal testimony, goes to great length to demonstrate the history and method for charging the ready to serve charge as a financing mechanism. I have also further discovered that the ready to serve charge was called such in order to provide a name to the charge that would be understandable by the developer. It could as easily been called a "system finance charge" or a "system development charge" or any other name. Rainier View chose "ready to serve" because this was the term of choice of the developers when the contracts were first instituted.

Q. What do you mean when you say the ready to serve charge is a financing mechanism?

A. Without duplicating too much of Mr. Fisher's rebuttal testimony, the purpose of the charge as a financing mechanism was initially instituted to increase the rate base of the Company so that the Company could demonstrate a better capital asset ratio. If the charge was instituted for reasons other than this, it would have been more appropriately treated as a regular rate and thus been included in the Company's tariff. Ratemaking principles prescribe that any regularly charged fee for services provided by the regulated utility should appropriately be tariffed. In

Rainier View's case, the fee was only charged in association with these rate base enhancing contracts. If the fee were a regular charge, it would be charged of all customers who have a lot within the utility's service area where water service is not yet received. This is not the case for Rainier View. The evolution of the contracts, as described in depth in Mr. Fisher's rebuttal testimony, further demonstrates the intent of the charge. By the Company's own action, the ready to serve charge has been excluded from the most recent contracts filed with the Commission for approval because the rate base level has been improved to a point where the Company feels the ready to serve charge is no longer necessary.

Q. What implications to Rainier View's rates for water service does Mr. Kermode's methodology have?

A. Mr. Kermode's inclusion of ready to serve charges increases the operating income of the Company, thereby reducing the deficiency in revenue requirement by the same amount. This calculation creates a portion of the rate decrease as proposed by Mr. Kermode.

Q. Why is this inappropriate?

A. This is inappropriate for a number of reasons. First of all, it is inappropriate for Mr. Kermode to include this revenue as operating revenue when it has been treated as non-operating revenue by the Commission in the past. While the Commission has the ability to treat each case filed before it independent of any

other case filed previously or by other companies, it becomes impossible for a regulated utility to know how to report income and expenses if each case is going to be treated in a completely opposite manner than any prior case. Second, it is inappropriate because a rate reduction makes no sense in a time of increasing costs and instability. This is particularly true when the utility can demonstrate that its costs have increased, as is the case for Rainier View, yet the revenues have not.

Q. Is there an alternative treatment the Commission should consider?

A. In this case, Mr. Kermode is including the revenue as a restating adjustment. A restating adjustment is intended to reflect restatements of amounts from a per-books level to a restated test-year level. While this treatment might be appropriate if the Commission accepts Mr. Kermode's theory of the ready to serve charge revenues, Mr. Kermode should have further provided for a pro forma adjustment to this same account.

Q. What would the pro forma adjustment be?

A. The second adjustment, if the restating adjustment is accepted, should be a pro forma adjustment to remove the revenues completely.

Q. Why is this?

A. The reason the revenues should be removed completely is due to the fact that Rainier View is no longer assessing these charges in their contracts. The removal of this charge from their developer contracts indicates that this revenue source will not exist in the future, therefore the inclusion of these revenues for determining rates overstates the amount of revenue available for operating expenses and return. The inclusion of this revenue in the calculation of rates without the revenue actually existing creates a 5% understatement of revenue in Mr. Kermode's results of operations statement.

Q. Does this conclude your written testimony?

A. Yes.