

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION**

**WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION,**

COMPLAINANT,

VS.

RAINIER VIEW WATER COMPANY, INC.,

RESPONDENT.

**REBUTTAL TESTIMONY
OF JULIA M. PARKER
ON BEHALF OF RAINIER VIEW WATER COMPANY, INC.**

January 18, 2002

Q. Please state your name and business address.

A. My name is Julia M. Parker. My business address is 627 South Market Boulevard, PO Box 977, Chehalis, Washington, 98532-0977.

Q. Please briefly describe your educational and professional history.

A. I graduated from St. Martin's College with a Bachelor of Arts in Accounting. I was employed by the Washington Utilities and Transportation Commission (WUTC) for a period of a little over 6 years as a Revenue Requirements Specialist in the water, natural gas, low-level radioactive waste and telecommunications industries. While at the WUTC, I attended the National Association of Regulatory Utility Commissioners' (NARUC) Annual Regulatory Studies Program sponsored by Michigan State University and the Eleventh Annual Western Utility Rate Seminar co-sponsored by NARUC, The Utah Public Service Commission and the Division of Continuing Education, University of Utah. During my employment at the WUTC, I testified in several contested rate filings in the water and low-level radioactive waste industries, to include UW-911041, UW-911512 and UW-930155, Alderton-McMillin Water Supply, Inc.; and TG-920234, US Ecology, Inc.

Since leaving the WUTC in 1996, I have been self-employed as an accountant. I provide income tax and accounting services to various businesses, non-profit organizations and individuals. As part of those services I am often asked to advise in the choice of business entities, including the tax consequences of Sole Proprietorships, S Corporations, C Corporations, Partnerships and Limited Liability Companies. In addition to general accounting service, I also provide assistance to small water companies in preparing their rate casework papers and financial statements for filing with the WUTC. As a private consultant I testified before the commission on behalf of American Water Resource Inc. in Dockets UW-9800072 et al. I hold a certificate, from the Washington State Board of Accountancy, as a Certified Public Accountant.

Q. In what capacity are you testifying today?

A. I have been retained by Rainier View Water Company, Inc. to respond to Mr. Kermode's adjustment to owner salary and to address the treatment of income tax for Subchapter S Corporations proposed by staff in this filing.

Q. Have you reviewed Mr. Kermode's testimony on owner's salary?

A. Yes, I have. In reading Mr. Kermode's testimony on owner's salary, I was struck by the one-sided consideration given for evaluating the salary was how the level paid in

owners salary compared to that paid in the test period used in a 1993 rate filing. In a page taken from the 1995 Water Manual, staff set forth a policy guideline on compensation which states that:

“Compensation is an expense to the regulated utility which is appropriately recovered through general rates. ...Recovery is based upon reasonable historical expenditures which are properly accounted for and justified pro forma increases.”

Examples included in this policy guideline to aid the determination of the reasonableness of the compensation include: “What is the benefit to the customers for the \$ the customer pays? According to institutional knowledge, is the amount reasonable? If no, what is unique about the company?” This policy was presented to the attendees of the water seminar sponsored by the WUTC staff in 1995 and again in 1996.

The only test applied by Mr. Kermode to determine the reasonableness of the 2000 owner’s salary was the application of the CPI or inflation to the salary level allowed in rates in Docket UW-930190 et al. This single test would be appropriate only if the operation of Rainier View Water Company has not significantly changed since that time. If significant changes have occurred in the operations of Rainier View, a more appropriate evaluation of the reasonableness of the salary paid to owners would include

some quantification of the changes in operations and whether or not the customer has received benefit for those changes.

However, Mr. Kermode fails to consider the progress of Rainier View over the last 10 years in terms of growth and meeting the needs of its ratepayers. If one were to look at the officer salaries in other industries, such as telecommunications, you would most certainly look at the size of the corporation and whether or not the company was meeting the needs of the ratepayers. In Mr. Fisher's testimony he lays out the changes in operations that have occurred in the last 10 years and the progress is commendable. The company has seen rapid growth in the number of customers from 4,600 as reported in the open meeting memo in Docket UW-930190, to 11,097 the average number of customers reported in the company's 2000 annual report. The number of complaints received by the Commission annually has decreased which is more impressive when you look at the growth experienced. The company has achieved consolidation its service area during this period by incorporating the operations of Indian Springs Water Company and Sound Water Company into its service area while improving the quality of service to the customers in these areas. I see no objective consideration of this or a comparison of the operations of Rainier View to other regulated companies in Mr., Kermode's analysis.

In Exhibit ____ (JMP-2), I have prepared a comparison of regulated water companies obtained from the staff's results of operations in rate cases filed in the last 3 years. This Exhibit sets forth the staff pro forma figures of each company filing rate cases in the last 3 years, providing per the per customer cost of officer/owner salary, the per customer revenue, and per customer rate base cost. Also in this Exhibit, ratios are presented which show what percentage of revenue is used to pay owner/officer salaries, what percentage of expense the owner/officer salaries represent and the percentage of how owners/officer's salary compares to rate base. Finally, this same information is presented for Rainier View using the company's proposed pro forma figures in this filing and the staff pro forma figures in Docket UW-930190 et al.

Compared to the the companies who have properly recorded their officer's salary, Rainier View's officer's salary per customer is \$6.89, which is lower per customer cost than every other company listed. Rainier View also has a lower per customer revenue and per customer expense than other companies. Even more significant is the comparison of these same ratios from the figures in Rainier View's 1993 rate filing to those of this rate filing. The per customer cost of the owner's/officer's salary has gone down by 29% from the period used in the 1993 rate filing to the test period in this case. This would indicate that the company's operations as directed by Mr. Richardson, the owner, has actually caused economies of scale to occur. This evaluation shows a

benefit to the customer in the decrease in costs per customer as well as the increased quality of service. This benefit to the customer outweighs the increase cost above the inflationary impact calculated in Mr. Kermode's adjustment and indicates the level of owner's salary in the company proposal is reasonable and therefore recovery in rates should be allowed.

Q. Please explain your position regarding income tax.

A. In summary, federal income tax is a cost of doing business regardless of the form of entity you choose to do business as. As a basic cost of doing business, it is an appropriate expense to be included in the rate making process. The level of income tax included in rates should be the only issue discussed in determining revenue requirement for regulated utilities. To simply state, as Mr. Kermode has done, that S Corporations are a tax reporting entity which do not pay income tax at the corporate level, so therefore it is inappropriate to including income tax expense as an element of rates is very short-sighted at best, and fails to recognize the bigger picture. The Commission needs to realize here that this question extends itself to more than one utility company and more than one type of entity.

Q. Please explain further.

A. To begin with, let me agree with Mr. Kermode when I state that the type of business entity most commonly seen at the Commission is the Corporation or C Corporation. The Commission daily provides regulatory oversight to multimillion-dollar corporations in the natural gas, electric, and telecommunications industries. It is in these industries that most of the Commission's resources are devoted. These utility companies are, for the most part, publicly traded companies with many, even thousands of investors or shareholders. They do not qualify to be an S Corporation and so by default they are C Corporations. When rates are set for these C Corporations, the recovery of the corporate income tax is provided for in rates. These C Corporations then, upon management's choice, declare dividends to their shareholders who pay tax on the dividend distribution. The dividends paid to the individual shareholders represent the return on investment for the shareholder. The dividends belong to the investor to do as they wish. And, as such, the individual shareholders fully expect to pay the taxes from the dividend distribution on their individual income tax return. There is never any question that the shareholder's income tax liability from the dividend is to be paid by the Company's ratepayer.

Not all regulated utility companies are C Corporations. In the water, transportation, and solid waste industries, it is very common to see companies operating as S Corporations, Limited Liability Companies (LLC), Partnerships and Sole

Proprietorships. With the exception of the occasional LLC that has elected to be treated as a corporation for income tax purposes, all of these entities are, as Mr. Kermode has so eloquently stated, nontaxable entities. They all are tax-reporting entities that pass their income directly though to its shareholder, member, partner or owner, who then pays the tax liability on their individual return(s). In fact, each of these types of entities pass 100% of their net earnings on to the shareholder/owner level for tax purposes, regardless of whether the shareholder/owner receives a physical distribution of income from the utility. It is unreasonable to expect the shareholder to pay the entire cost of the income tax liability resulting from the utility operations when no distribution of income occurs.

In the water industry it is very common that all of the cash from operations is tied up in operations and no distribution of income occurs. Rainier View follows this pattern. In fact, the company's witness Mr. Ault indicates in his testimony that the shareholder distributions made were actually estimated tax payments based on tax related to the corporate income. Even then, the Company paid the tax, although the payment was ultimately recognized as a distribution to the owner. Thus, most of the earnings are retained by the S Corporation and used to reinvest in the company. When the company is retaining its earnings it is only appropriate for the recovery of income tax on the utility earnings to be provided through rates.

Rainier View is not asking for the Commission to provide for the recovery of the shareholders income tax liability through rates. All that the company is stating is that the income derived by utility operations has an income tax consequence and that income tax is a cost of doing business and should be recovered through rates.

Q. Mr. Kermode points out in his testimony that the Commission has not issued any order or decision approving rates for an S Corporation that included recovery of income taxes, do you agree?

A. I see this concept as ironic. In my experience, it was a forgone conclusion that the income tax recovery would always be in rates, and the only question was at what rate, the corporate or individual rate. It was presented to me as a cause and effect situation. When one has income, one incurs income tax. It is pretty much the old adage that the only two things that you can count on are death and taxes. In fact, I recall specifically staff meetings amongst the water staff members about whether it was appropriate to calculate the tax at the lowest individual rate, or because the sole proprietor or S Corporation shareholder undoubtedly had other income to pay taxes on was it more appropriate to allow an income tax rate of a higher bracket.

While these conversations do not have the same impact on the rate setting process as an adjudicated case or Commission order, they are indicative of the line of thought that occurred in the past regarding rate setting for small utility companies. In fact, at least one Commission order approving a settlement agreement between staff and a sole proprietorship which has the same tax effect as an S corporation-- does exist, which approves the recovery of income tax through rates. The Commission's Third Supplemental Order in Docket U-88-2294-T provides for a surcharge to recover the income tax liability incurred because of the acceptance of contributions in aid of construction. The surcharge went into effect in February 1989 and was effective for five years. The name of the company was Richardson Water Companies, the predecessor of Rainier View Water Company, Inc. After the Company became an S corporation, the surcharge remained in the Company's tariff. This and other similar filings set precedents in the Commission's history, some of which is in Mr. Fisher's testimony, which speaks volumes regarding the appropriateness of the recovery of federal income tax on utility operations through rates.

Q. Mr. Kermode asserts that implementing income taxes for S Corporations provides a windfall to the shareholders, do you agree?

A. Absolutely not, for all of the reasons I discussed before. Mr. Kermode's Exhibit _____ (DPK-4) Schedule 3 even illustrates my point. In order for Mr. Kermode's

assumptions to be correct, 100% distribution of the company's net income must occur with no strings attached for the excessive earnings to occur. One hundred percent distribution of net income is more than highly unlikely; I would venture to state that especially for water companies, it never occurs.

Q. Do you agree with Mr. Kermode's discussion of accrual of deferred taxes?

A. No. Mr. Kermode makes a point of discussing the accrual of deferred taxes as another point to differentiate between S and C Corporations. However, it has been my experience in working with regulated water companies that the practice of accruing deferred taxes to reflect the timing differences between tax and book depreciation is followed only by a handful of companies. Even then it usually is only calculated in the rate-setting process.

For small water companies, I have routinely recreated the deferred tax amount to deduct from the rate base when a rate proceeding is involved. It is not a very difficult process, and actually creates a consistent approach in setting rates for water companies. The difference in tax and regulatory or book depreciation is experienced by all water utilities regardless of the choice of business structure. If a standardized adjustment was developed to apply to all regulated water utilities, and was consistently applied, the issue

of the timing difference between tax basis accelerated and regulatory basis straight-line depreciation would be resolved or at least minimized to an immaterial level.

Q. Has income tax expense been allowed for other companies even if there is no “book” tax expense?

A. There is an inference in Mr. Kermode’s testimony that because no income tax is recorded that it is improper to allow an income tax expense. This is contradictory to the practice of allowing income tax expense in rates for other companies. While they are not adjudicated cases, they show precedent of allowing income tax as an allowable expense even when no income tax is owed. For example, income tax for Harbor Springs was allowed in Docket UW-000126 even though Harbor Springs has a net operating loss carryover that will last several years. A review of the Commission’s records indicate that the Commission staff allowed for the recovery of income tax in several recent cases where no income tax was ever recorded in the test period. Specifically: UW-990970, Alderbrook Water Company; UW-001415 Aquarius Utilities; UW-000297 Basin Water Company, Inc.; UW-000164 Guemes Island Water Company, Inc.; UW-981017 H & R Waterworks, Inc. and others. See my Exhibit _____ (JMP-3) for a more complete listing. Also illustrated in this Exhibit is that the recovery of income tax has been allowed in the past for other non C corporation water companies who are operating as LLC, S Corporation, and sole proprietorships. Many of these increases were specifically approved by the Commission acting at its open meeting.

Q. What would be the impact on the company if the recovery of federal income tax was not allowed?

A. By not recognizing the federal income tax expense as a component of rates you are shifting this expense from the cost causer, in this case the utility customer who is receiving the benefit of the service from the efforts of the S corporation, to the shareholder. The shareholder has not received any cash distribution of the income, only the pass-through of the income affect on his tax return. In other words, the shareholder bears the cost without any benefit, ending up subsidizing the ratepayer for this cost. The ratepayer is not paying the true cost of service, and the income tax would be paid from a now further reduced retained earnings. There will be an economic impact that will only degrade the quality of service now seen by the ratepayer.

Further, in not allowing for the recovery of income tax for entities other than C Corporations the Commission would be impacting the long term decision making and management of this company and the entire industry.

Q. What is your recommendation regarding the calculation of income tax rates?

A. I would recommend that the approach adopted by this Commission be as consistent as possible. As such I believe that using the C Corporation rates would provide the consistency needed to give water companies the assurance that they are being treated equitably between them.

Q. Does this conclude your written testimony?

A. Yes. It does.