Response to Bench Request 1.

In Mr. Kermode's Exhibit No.____(DPK-T-1), page 35, lines 1 through 3, he refers to a cost of capital rate of 7.09%, a cost of equity of 15.83% and cost of debt of 5.55%. However, Mr. Kermode's Exhibit No.____(DPK-8), lines 21 through 35, indicates that a cost of equity of 15.83% and a cost of debt of 5.55% yields an overall rate of return of 8.56%. In addition, Mr. Kermode's Exhibit No._____(DPK-2) Schedule 1, line 54, column (J), reflects a rate of return of 8.69% at "Results at Staff Rates." Please clarify and/or reconcile the differences between the three percentages, 7.09%, 8.56% and 8.69%.

Page 35 line 2, 7.09% should be changed to 8.56% to be consistent with Exhibit No. _____(DPK-8) Line 37, overall rate of return of 8.56%. However, a clarification is needed; this return is the return on <u>year-end rate base</u>.

The return shown on Mr. Kermode's Exhibit No._____(DPK-2), line 54, of 8.69% is correct, however it is based on the company's <u>average rate base.</u>

Response to Bench Request 2.

In Mr. Kermode's Exhibit No.______(DPK-4) Schedules 1 and 2, he demonstrates that if the Commission authorized a fair rate of return of 12.0% and imputed taxes at 34%, that the after tax return to the shareholder would be 7.32% or 7.99%, depending on whether or not deferred taxes are deducted from rate base. On his Schedule 3 he demonstrates that if the Commission does not impute taxes, that the shareholder would receive an after tax return of 12.10%, which is slightly above the authorized return of 12.0% because the Company failed to deduct Deferred Income Taxes from Rate Base. Based upon this comparison, is it Mr. Kermode's position that if the Commission does impute income taxes for ratemaking purposes that the actual realized after tax return to shareholders would be less?

The statement "*On his Schedule 3 he demonstrates that if the Commission does <u>not</u> impute taxes, that the shareholder would receive an after tax return of 12.10%, which is slightly above the authorized return of 12.0%…*" is an incorrect interpretation of what Schedule 3 shows.

a. The after tax return of 12.10% is not equal to the authorized return of 12%. A authorized return is based on the investors' return expectation prior to computation and deduction of their personal tax situation. The correct comparison would be the pre-tax return of 19.83% on schedule 3 and the 12% authorized return.

b. Schedule 3 does <u>not</u> represent results if the Commission does not impute taxes. What it does show is the <u>actual</u> return on investment that the shareholder realizes if the Commission <u>does</u> impute income taxes to derive a revenue requirement.

c. I have included an additional schedule using the same format, which I have labeled Schedule 5. This schedule is an attempt to simplify the example by assuming that the tax benefits from accelerated depreciation flowed through to the shareholder and no additional plant was purchased with the tax savings.

Schedule 5 shows that with the deferred tax issue aside, the pre-tax return a C Corporation shareholder receives is the same as the pre-tax return of a S Corporation shareholder, the 12% authorized return.

" …**is it Mr. Kermode's position that if the Commission does impute income taxes for ratemaking purposes that the actual realized after tax return to shareholders would be <u>less</u>?"**

Referring to Schedule 3, no the actual realized return shown would remain the same since the schedule assumes that <u>for ratemaking purposes</u> income taxes were imputed.

Response to Bench Request 3.

In Mr. Kermode's Exhibit No._____(DPK-4), Schedule 3, he demonstrates that if the Commission authorized a fair rate of return of 12.0% and imputed no income taxes that the shareholder would receive an after tax return of 12.10%, which is slightly above the authorized return of 12.0% because the Company failed to deduct Deferred Income Taxes from Rate Base. However, to achieve the 12.10% return, apparently the Commission would have to authorize a return of 18.18% (Net Income of $218,182 divided by Net Rate Base of $1,200,000 equals 0.1818 or 18.18%.) Is Mr. Kermode's proposing that the Commission authorize a pre-tax rate of return as an alternative to imputing Federal Income Taxes for ratemaking purposes?

The purpose of schedule 3 is to show the true impact of imputing rates. Income taxes are assumed to already be imputed in Schedule 3. However, the statement in the Bench Request regarding the level of return needed to produce the $218,182 net income is correct. It correctly states "…to achieve the 12.10% return, apparently the Commission would have to authorize a return of 18.18%…"

This is the result that Staff is opposing, and the Company is proposing by requesting imputed income taxes. As Mr. Kermode states in his testimony at Page 16 line16-18: "The only difference between this [providing imputed income tax] and simply providing a larger than required return is the excess return would be provided cloaked in the guise of income tax expense."

Is Mr. Kermode proposing that the Commission authorize a pre-tax rate of return as an alternative to imputing Federal Income Taxes for ratemaking purposes?

Mr. Kermode is not proposing any change to the way rate of return on equity is currently determined, that is, rate of return is based on a return after corporate income tax. To be clear, Mr. Kermode is not recommending any rate of return methodology that is based on the shareholders' after-tax return on investment.

Response to Bench Request 4

In Mr. Kermode's Exhibit No._____(DPK-4), Schedule 4, which is the method he recommends the Commission adopt for ratemaking, he demonstrates that if the Commission authorized a fair rate of return of 12.0% and imputed no income taxes that the shareholder would actually receive an after tax return of 7.99%. Assuming for purposes of this question, that there is not deferred tax problem, is it Mr. Kermode's position that if the Commission authorizes a fair rate of return to investors of 12.0% and they actually realize an after tax return of 7.99% or some other return smaller than 12% that the investor has received a fair rate of return?

For regulatory purposes, "after-tax" refers to income taxes associated solely to the corporation. The after-tax concept should not be applied or confused with the return shareholders ultimately receive. Assuming, for purposes of discussion only, there is a regulatory theory or method for setting a fair return based on a post-tax return to the shareholder, it would also hold that such a theory should apply not only to S Corporations but also to C Corporations. Mr. Kermode has no knowledge there is such a regulatory theory.

It is Mr. Kermode's position that if the Commission authorizes the company to receive a post-tax fair rate of return of 12%, whether it is a C Corp or S Corp, the investors will realize a pre-tax 12% return on their investment again, whether it is a C Corp or S Corporation.

Yes, if the investors receive a 12% pre-tax return, the investors have received a fair return on their investment.

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<u>Response to Bench Request 5</u>

In Mr. Kermode's illustrations in Exhibit No. _____(DPK-4), Schedules 1 through 4, does he assume that all income is equity income and therefore taxable?

Yes, all income is assumed to be equity income.

Response to Bench Request 6

Please provide any analysis Mr. Kermode has, which demonstrates that his proposed working capital allowance of $231,387 is investor-supplied.

Attached

<u>Response to Bench Request 7</u>

The WUTC Staff has advocated and the Commission has adopted the so-called Pro Forma Debt or Interest Synchronization Adjustment in innumerable rate cases. Why has Mr. Kermode not adopted this standard approach in this case?

Mr. Kermode did synchronize interest as reflected in Staff pro forma adjustment #10. Pro forma adjustment #10 decreases interest expense from $344,648 to $ 208,047 to match the weighted cost of debt multiplied by rate-base.

<u>Response to Bench Request 8</u>

Mr. Kermode's exhibits do not appear to include a Net-To-Gross Conversion Factor calculation. Please provide one.

Attached

<u>Response to Bench Request 9</u>

Mr. Kermode's exhibits do not appear to include a Revenue Requirement Calculation. Please provide one.

Attached

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<u>Response to Bench Request 10</u>

In Mr. Kermode's calculations of cost of capital, he recommends a Debt Service Ratio (DSCR) of 1.25 at page 34 of his prefiled testimony. The 1.25 ratio is apparently a pre-tax ratio. Does Mr. Kermode's assume in these calculations that 100% of RVW's pre-tax income would be retained by the Company and would be available to pay interest expense, and that the Company would not distribute any amount of income to shareholders to pay Federal Income Taxes or as a distribution of earnings to shareholders?

The Request states, in part **"The 1.25 ratio is apparently a pre-tax ratio."** This statement is incorrect. This ratio is after the corporation has recognized all taxes it has incurred. To clarify, "pre-tax" <u>must</u> refer to only to income taxes associated solely to the corporation. The pre-tax concept should not be confused with the tax liability of the shareholders. Rainier View is a Corporation, separate and distinct from its shareholders.

Does Mr. Kermode's assume in these calculations that 100% of RVW's pre-tax income would be retained by the Company and would be available to pay interest expense, and that the Company would not distribute any amount of income to shareholders to pay Federal Income Taxes or as a distribution of earnings to shareholders?

No, there was no assumption regarding RVW's distribution of its net income.

<u>Response to Bench Request 11</u>

At page 34, lines 16 through 23 of his prefiled testimony, Exhibit No._____(DPK-T-1), Mr. Kermode indicates that he adjusted the equity component of the Company's capital structure downward by 7% or by $553,793 for "cash and short-term liquid assets" which he asserts are equity financed and are non-rate base investments. a) Please identify any precedent established in any other litigated rate case, in which the Commission adopted such an adjustment. b) Please provide any analysis Mr. Kermode has made to determine that cash and short-term liquid assets are financed 100% by equity. c) In the working capital allowance of $231,387 proposed by Mr. Kermode, what does he assume to be the composition of his working capital allowance and does he consider this in his adjustment to reduce the Company's capital structure by 7%.

Please identify any precedent established in any other litigated rate case, in which the Commission adopted such an adjustment.

WUTC vs. American Water Resources, Inc. UW-980072 et al. Fifth Supplemental Order (Nov. 1998). Although the Commission in its decision used a hypothetical capital structure, the decision discusses Staff's computed capital structure as the company's actual capital structure without exception to the same type of adjustment.

The following references are provided for support:

"Reconciling Rate Base and Capital Structure - In determining the required rate of return, a regulatory commission must reconcile the jurisdictional rate base with the capital structure." *Principles of Public Utility Rates,* James C. Bonbright p.236

"The meaning and functioning of a utility's weighted cost of capital is interrelated with its companion rate of return on rate base. If the regulator applies the cost of capital to a rate base which deviates from total capital, then to the extent that rate base deviates from total capital, if authorized returns are achieved, dollar earning available for common equity will exceed or fall short of the dollars necessary to satisfy the claims of shareholders." *Utilities' Cost of Capital,* Roger A. Morin p.291

"In general, if there is a discrepancy between the total capital investment, on the one hand, and the total rate base on the other, the fair return on common equity will not be achieved." *Utilities' Cost of Capital,* Roger A. Morin p.291

"Shareholders act as the residual bearers of the gain or loss consequences of rate base-invested capital discrepancies." *Utilities' Cost of Capital,* Roger A. Morin p.291

Response to Bench Request 11 (pg 2)

a) **Please provide any analysis Mr. Kermode has made to determine that cash and short-term liquid assets are financed 100% by equity.**

   Attached

b) **In the working capital allowance of $231,387 proposed by Mr. Kermode, what does he assume to be the composition of his working capital allowance and does he consider this in his adjustment to reduce the Company's capital structure by 7%.**

   The composition is assumed to be all equity investor supplied funds and yes, the working capital allowance is recognized in the amount included in rate base as equity financed capital.