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BEFORE THE

IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF UNITED WATER IDAHO INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER SERVICE IN THE STATE OF IDAHO	)	**CASE NO. UWI-W-04-4**

DIRECT TESTIMONY OF KATHY STOCKTON

IDAHO PUBLIC UTILITIES COMMISSION

APRIL 6, 2005

Q. Please state your name and business address?
A. My name is Kathy Stockton. My business address is 472 West Washington Street, Boise, Idaho.
Q. By whom are you employed and in what capacity?
A. I am employed as a Senior Auditor by the Idaho Public Utilities Commission.
Q. Please describe your educational background and professional experience.
A. I received my B.B.A. degree in Accounting from Boise State University in December 1992. Following graduation I was employed by the Idaho State Tax Commission as a Tax Enforcement Technician. In that capacity I performed desk audits on individual state income tax returns. I was promoted to Tax Auditor and later to Senior Tax Auditor. In my capacity as an auditor, I performed audits on Special Fuel and Motor Fuel Tax returns, International Fuels Tax Agreement Returns and Special Fuel User tax returns. I accepted employment with the Idaho Public Utilities Commission Staff in July of 1995. I attended the National Association of Regulatory Utility Commissioners Annual Regulatory Studies program at Michigan State University. I have conducted numerous audits and cases for electric, gas, and water utilities. I have previously presented testimony before this Commission.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain Staff's adjustments for United Water Idaho (UWI) to Plant in Service regarding Allowance for Funds Used During Construction (AFUDC); to explain Staff's adjustment to federal income taxes to include the production credit; Staff's adjustment of Management and Service (M&S) fees; Staff's adjustment to revenues to recognize the "risk premium" from the sale of the Carriage Hill water system; to explain Staff's adjustment to the Accumulated Deferred Federal Income Taxes and to the Investment Tax Credit, and Staff's Income Tax and Debt Interest Synchronizations calculation.

Q. Are you sponsoring any exhibits?

A. Yes, I am sponsoring 7 exhibits, Exhibit No. 101 through Exhibit No. 107.

AFUDC Section

Q. Do you have any adjustments to United Water's Rate Base?

A. Yes, I have adjustments to Rate Base, specifically Plant in Service, relating to the Allowance for Funds Used During Construction (AFUDC), as well as the associated adjustments to Accumulated Depreciation.

Q. What types of adjustments to Plant in Service related to AFUDC do you have?

A. I have an adjustment to AFUDC to remove the equity gross-up portion of the AFUDC rate the Company has included in the AFUDC calculation for Plant in Service and Construction Work in Progress (CWIP). I also have an adjustment to AFUDC related to water rights, as identified in Staff witness Sterling's testimony.

Q. What is Allowance for Funds Used During Construction?

A. Allowance for Funds Used During Construction or AFUDC is an accounting mechanism, which recognizes capital costs associated with financing construction. Generally, the capital costs recognized by AFUDC include interest charges on borrowed funds and the cost of equity funds used by a utility for purposes of construction. The main purposes of AFUDC are to capitalize with each project the costs of financing that construction; separate the effects of the construction program from current operations; and to allocate current capital costs to future periods when these capital facilities are in service, useful and producing revenue. AFUDC represents the cost of funds used during the construction period before plant goes into service. When it is placed in service, the entire cost of the plant, including AFUDC, is added to rate base, where it earns a rate of return and is depreciated over the life of the plant.

Q. Has the Company properly accounted for this carrying charge on the construction work in progress accounts?

A. AFUDC has been improperly charged on water rights, which clearly are not construction work in progress. Plant items that are not construction projects do not accrue AFUDC. Staff's Adjustment to AFUDC, as shown on Staff Exhibit No. 101, removes AFUDC that was accrued on water rights.

Q. Why is it inappropriate to accrue AFUDC on water rights?

A. Water rights are not Construction Work in Progress. No physical construction is actually taking place. While the water rights are being pursued, the amounts expended can be booked to Preliminary Survey and Investigation Charges, Account 183. Once the water rights have been secured, they are either used and useful, and should be booked to the sub-account Land and Land Rights in the Plant in Service records; or, if they are not used and useful, but anticipated for future use, then the water rights should be booked to Land and Land Rights, Plant Held for Future Use. It may benefit the shareholders of the Company to make the investment in water rights for the future, but it does not benefit the customers until they are actually using the water rights.

Q. What is the amount of your adjustment to remove the AFUDC that was accrued by the Company on water rights?

A. My adjustment to remove the AFUDC accrued on water rights is $94,918, and is incorporated in Staff Exhibit No. 101.

Q. Do you have other concerns regarding the way the Company computes AFUDC?

A. Yes, I do. Beginning in 1995 the Company grossed-up, for income tax purposes, the equity portion of the AFUDC rate, and added this additional AFUDC component to the overall rate of return the Company was using to calculate AFUDC.

Q. Why did the Company change the way it was calculating AFUDC?

A. The Company changed the way it calculated AFUDC as a result of the Financial Accounting Standards Board's promulgation of Statement of Financial Accounting Standards No. 109 (SFAS 109), Accounting for Income Taxes, which was introduced in February of 1992. Under SFAS 109, a current or deferred tax liability or asset is recognized for the current or deferred tax consequences of all events that have been recognized in the financial statements or tax returns, measured on the basis of enacted law. This was a change from Accounting Principles Board Opinion No. 11, Accounting for Income taxes (APB 11). Under APB 11, deferred tax consequences were recognized based on the differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. This change from APB 11 to SFAS 109 affected the measurement and recognition of current and deferred income taxes reported in financial statements.

One of the changes that resulted from the promulgation of SFAS 109 is the way in which AFUDC is accounted for. SFAS 109 considers the equity component of AFUDC as a temporary difference for which deferred income taxes must be provided. Therefore, an entity should record the deferred tax liability for the equity component of AFUDC in a sub-account of Accumulated Deferred Income Taxes - Other, Account 283 (Uniform System of Accounts for Class A and B Water Utilities, National Association of Regulatory Utility Commissioners; which the Company is currently following) and the corresponding regulatory asset in sub account of Miscellaneous Deferred Debits, Account 186.

Currently the Company is including an income tax gross-up on the equity component of AFUDC as part of the AFUDC amount. Staff asserts that this is an incorrect application of SFAS 109. In discussions with Company witness Healy, Staff understood the Company's position to be that there were no adverse effects on the customer as a result of the Company including the equity income tax gross-up component of AFUDC as part of the total AFUDC amount. According to the Company, there is no effect on the customer because the amount of AFUDC attributable to the income tax equity gross-up included in rate base should be equal to the amount of the deferred tax liability associated with the AFUDC equity income tax gross-up component that is deducted from rate base, resulting in no net rate base change as a result of the way the Company calculates AFUDC.

Staff does not agree with the Company on this issue. Because the equity income tax gross-up component of AFUDC is included in the calculation of AFUDC, then the AFUDC is overstated. When a construction project is placed in service, the amount in the Construction Work in Progress account for that project, plus the associated AFUDC for that project, is transferred to Plant in Service. At this point Plant in Service will be overstated by the amount of the equity income tax gross-up component of AFUDC. Although this rate base amount, in theory, should net out to zero when the deferred income tax associated with the AFUDC is removed from rate base, the problem of the overstated depreciation expense still remains. It is this higher depreciation expense that adversely affects customers.

Q. Please describe the adjustments to correct this problem.

A. Staff adjustments (a) remove the equity income tax gross-up component of AFUDC from Plant in Service; (b) reclassify the Plant in Service amount associated with the equity gross-up of AFUDC as Miscellaneous Deferred Debits, Account 186; (c) reduce Accumulated Depreciation, and (d) reduce Depreciation Expense. The balance sheet adjustments 'a' and 'b' correct the equity income tax gross-up component of AFUDC from 2001 through the adjusted test year.

Q. How did you calculate the balance sheet adjustments?

A. Staff Exhibit No. 101 shows these adjustments. Staff received from the Company, a spreadsheet with the amount of AFUDC, by project, by year. I backed out the amount of AFUDC that is attributable to the income tax gross-up on equity.

United Water Idaho used an AFUDC rate of 8.84%, the overall rate of return granted the Company in their last rate case, Case No. UWI-W-00-1, Order No. 28505. The Company calculated the equity gross-up factor to be 2.78%. This calculation and factor were verified from a spreadsheet requested by Staff and provided by the Company during this rate case.

Q. Please explain how the Accumulated Depreciation Adjustment and the corresponding Depreciation Expense were calculated.

A. These two adjustments were calculated using the Company's overall depreciation rate. Staff did not have sufficient information at the detailed plant level to adequately make the adjustments by plant account. The Accumulated Depreciation Adjustment is $13,482 and the Depreciation Expense adjustment is $7,067 as shown on Staff Exhibit No. 101.

Q. Do you have an adjustment to Deferred Debits as a result of moving the equity gross-up component of AFUDC out of Plant in Service and into a Miscellaneous Deferred Debits account?

A. Yes, Staff Exhibit No. 101 shows the inclusion in deferred debits of the equity gross-up component of AFUDC reclassified as a miscellaneous deferred debit to Account 186XXX.

Q. Do you have a recommendation regarding the AFUDC equity gross-up component included in the various Plant in Service accounts?

A. Yes. I recommend that the Commission order the Company to correct its Plant in Service records to remove the equity gross-up component of AFUDC improperly included in Plant in Service. The Company should recalculate its Plant in Service from the time it implemented the SFAS 109 equity gross-up AFUDC component. The Company should be required to correct the AFUDC components of Plant in Service as well as accumulated depreciation and depreciation expense; and provide Staff an opportunity to review the corrected Plant in Service accounts. At that point it may be necessary to update the rate base and operating income included in the final order for this case and to update the rates that are set in the final order in this case as a result of a Commission ordered change in accounting method.

Q. Are there other issues associated with AFUDC that the Commission should address?

A. Yes. For all Construction Work in Progress projects that are included in rate base but are not yet placed in service at the time rates become effective, special treatment must be implemented by the Company. Project work orders for plant included in rate base must stop accruing AFUDC when rates from this case are implemented. If AFUDC is not stopped, the Company will be earning a return on the plant in rates and still accruing an AFUDC return for future recovery. This would allow over-recovery and is inappropriate.

American Jobs Creation Act of 2004 Section

Q. Do you have an adjustment associated with the American Jobs Creation Act of 2004?

A. Yes. I have an adjustment that reduces federal income taxes as a result of the production credit from the American Jobs Creation Act of 2004.

Q. How did the American Jobs Creation Act of 2004 affect public utilities?

A. On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004. This act includes tax relief for domestic manufacturers by providing a tax deduction up to 9 percent (when fully phased in) of the lesser of (1) "qualified production activities income" as defined in the act or (2) taxable income (after the deduction for the utilization of any net operating loss carryforwards). This tax reduction applies to specific public utility operations.

Qualified domestic production gross receipts (QDPGR) include gross receipts from the production in the United States of electricity, gas and potable water, but exclude gross receipts from the transmission of these items. Activities included in the production of potable water include the acquisition, collection and storage of raw (untreated) water, as well as the transportation of raw water to, and the treatment of raw water at, a treatment facility. However, gross receipts attributable to the storage of potable water or the delivery of potable water to customers do not give rise to QDPGR. A taxpayer that both produces and distributes potable water must properly allocate gross receipts between qualifying and non-qualifying domestic production gross receipts (H. R. Conf. Rep. No. 108-755). (Tax Legislation 2004; American Jobs Creation Act of 2004; Law, Explanation and Analysis; CCH Editorial Staff Publication; pages 88-89)

Q. The Commission Staff, in Production Request Nos. 146 and 147, asked the following questions: "Has United Water Idaho or its parent corporation(s) done any investigation or research to ascertain how this act applies to the Company or its parent corporation? Please provide a schedule and a description of how this Act applies to the Company, and/or its parent; and a schedule showing the financial impact and how it was calculated." How did the Company respond?

A. The Company responded with the following answer to Production Request 146: "This provision will apply to United Water Idaho. However, at this time United Water Idaho is still in the process of determining how it will separate gross receipts from production vs. gross receipts from distribution and storage. Guidance will be provided through U.S. Treasury Regulations that have yet to be released."

The Company further responded to Production Request 147 with the following answer: "It is premature to determine how the domestic production deduction will impact United Water Idaho because the U.S. Treasury has yet to promulgate regulations that will give guidance on how to allocate between gross receipts from production and gross receipts from distributions."

Q. Should the impact of the production credit be considered in this proceeding?

A. Yes. Staff notes that the Company has stated that this provision will apply to United Water Idaho, but did not attempt to determine an amount to include in this filing. Staff recognized the fact that there will be a reduction to the Company's income taxes beginning with the 2004 income tax filing and the impact will increase going forward. Staff finds it reasonable to include an amount that recognizes a benefit to customers in this case since the production credit will benefit the Company.

Q. Has the Staff calculated such an amount?

A. Yes, Staff has calculated an amount as a proxy for the production credit that the Company will be receiving. It is reasonable to include a proxy amount for the production credit since the Staff is recommending that the Columbia Water Treatment Plant be included in rates as if it were in service for a full year. The CWTP is a large portion of plant in service that will be eligible for this credit. Including a proxy for the production credit better reflects the cost of the plant and will allow this advantage of the new water treatment plant to flow to customers since increased expenses that are not fully known are being charged to customers.

It is also reasonable to include a proxy for the production credit because it is known that the credit will be available to the Company. The exact amount is not fully measurable at this point but the 3% production credit in the 2004 tax year and increasing to 9% for United Water Idaho is known.

It is also reasonable to include a proxy for the production credit because it is measurable. Staff has proposed a conservative way to measure the credit. The proxy amount is conservative, since only the production and water treatment plant in service is being used to calculate the proxy production credit amount and only the 3% credit is being used. Although the exact method to be accepted by Treasury is unknown, Staff's conservative proxy allows this Commission to recognize that in the 2004 tax year there will be an amount of the production credit that United Water Idaho will be able to take advantage of. Including at least this conservative amount in recognition of the existence of this income tax credit will help insure customers are not overcharged.

Q. What is the adjustment Staff proposes to recognize the impact of the production credit and how did you calculate it?

A. Staff proposes to reduce federal income taxes by a proxy amount for the production credit. I have calculated this adjustment by reducing federal income taxes by the production credit percentage for the first year (3% in 2004, increasing to 9% by 2010) multiplied by the amount of production and water treatment Plant in Service, as supported by Staff witness Harms. The calculation is shown in Staff Exhibit No. 102. I used the production and water treatment accounts when calculating this adjustment, as shown on Staff Exhibit No. 102, Column (5).

Q. What is the amount of the proxy production credit used to reduce federal income taxes?

A. The proxy production credit is $87,501 as shown on Staff Exhibit No. 102.

Management and Service Fees Section

Q. During your on-site audit, did you review the allocation method that the affiliate company, Management and Service Corporation uses to allocate costs to the various subsidiaries of United Water Works?

A. Yes. I reviewed the allocation methodology that the Management and Service corporation uses to allocate costs to the subsidiaries that they serve. Staff is satisfied that the allocation method in the agreement that United Water Idaho has with the Management and Service Company is being applied properly.

Q. What is the relationship between United Water Idaho and United Water Management & Service Company?

A. United Water Management & Service Company (M&S) provides services to United Water Idaho for accounting, engineering, information technology, treasury, regulatory, central purchasing, management, human resources and other functions based upon the agreement that United Water Idaho has with the M&S Company. The relationship established with the M&S Company is designed to take advantage of economies of scale in the provision of the common services. The desired result is that the relationship avoids inefficiencies and duplication of costs that could occur if each operating group that contracts with the M&S Company were to perform these functions separately. In other words, the M&S Company can save the overall parent corporation money by handling all these functions centrally for the various operating units of United Water Resources. The M&S Company is operated as a cost center, billing all costs out to the various operating groups which they serve. The personnel code their time to the operating units that they serve in proportion to the amount of time spent working on behalf of each operating group.

Q. Do you have an adjustment to the M&S fees?

A. Yes. My adjustment is based on using the M&S fees for the calendar year ended December 31, 2004. As stated in the testimony of Company witness Healy in the last rate case, Case No. UWI-W-00-1, "The calendar year provides a more reliable indication of the true level of M&S expense since these expenses are planned, accounted for and adjusted, if needed, on a calendar basis." (Healy, Di, pgs 11 & 12). In the last rate case, the Commission accepted the Company's adjustment that was based on the calendar year basis rationale. Staff proposes to use the same rationale in this case. Staff notes that the new computer software from PeopleSoft now allocates the M&S fees between corporate, regulated, and non-regulated activities. Staff has removed the non-regulated M&S fees as part of this adjustment.

Q. What is the amount of Staff's adjustment?

A. Staff's adjustment to M&S fees, as shown on Staff Exhibit No. 103, reduces operating expenses by $20,678, increases state income taxes by $1,654, increases federal income taxes by $6,658, and increases net income by $12,366.

Carriage Hill Revenue Section

Q. Please explain the Carriage Hill issue.

A. United Water requested authority, in Case No. UWI-W-04-3, to remove the Carriage Hill Subdivision from the Company's certificated service area and for an accounting order regarding distribution of proceeds from the sale of the Carriage Hill domestic water system by United Water to the City of Nampa. The Commission in Order No. 29625 addressed the sale and ordered revenue as a result of the sale to be included in this rate case.

Q. What has the Company proposed to do in this case regarding the proceeds from the sale of the Carriage Hill water system?

A. Company witness Wyatt states that "The Company has no objection to booking whatever remains of the 'risk premium' as regulated revenue on its books, however the actual amount of that revenue will not be fully known until the transaction in that proceeding closes sometime in December. All transaction costs must be netted against the amount before a final accounting of the remainder can be recorded as regulated revenue." (Case No. UWI-W-04-4, Wyatt, Di, pg 18).

Q. Did the Commission, in Order No. 29625, direct the Company to book the remainder of the "risk premium" after final closing as regulated revenue?

A. No, the Commission, in Order No. 29625 made the following statement about the allocation of the sale proceeds, "We further find it reasonable and direct United Water to book the $28,138 amount **originally** proposed as a risk premium distribution to United Waterworks as regulated revenue to be passed through to customers in the Company's upcoming general rate case." (emphasis added)

Q. Did the Commission in Order No. 29625 require the Company to submit the actual revenue amount when it was known so that the Commission Staff could include that amount in this rate case, as proposed by Company witness Wyatt?

A. No, the Commission specified the exact amount. The Commission in Order No. 29625 did not direct the Company to provide numbers for the Commission Staff to include as the actual revenue, nor did the Commission direct the Company to submit a final accounting of the sale proceeds. The directive was provided in the above quote.

Q. Did the Commission propose that the revenue for ratemaking purposes be amortized over a three-year period as proposed by the Company?

A. No, the Commission did not specify ratemaking treatment other than including $28,138 in revenues in the next general rate case. Staff believes, due to the affiliate transaction and generous treatment to accomplish the sale, the fixed amount was the amount intended to be included in regulated revenues by the Commission.

Staff proposes that the full revenue amount be amortized over a five-year period for ratemaking purposes. A five-year amortization period is consistent with other amortization periods recommended by Staff in this case.

Q. What is your adjustment to revenues as a result of Commission Order 29625?

A. My adjustment, as shown on Staff Exhibit No. 104, increases revenues by $5,628; increases state income taxes by $450; increases federal income taxes by $1,812; and increases net income by $3,365.

Accumulated Deferred Federal Income Taxes Section

Q Do you have an adjustment to Accumulated Deferred Federal Income Taxes?

A. Yes. Since depreciation expense was adjusted by Staff witness Harms, Accumulated Deferred Federal Income Taxes (ADFIT) has a corresponding adjustment. Staff's Total Accumulated Deferred Federal Income Tax balance of $14,521,668 is shown on line 13 of Staff Exhibit No. 105. Staff's adjustment is the difference between the Staff's calculated Total Deferred FIT and the Company's Total Deferred FIT July 31, 2004 Balance of $11,144,389.

Staff's adjustment increases Accumulated Deferred Federal Income Tax by $3,377,279.

ITC Amortization Section

Q. Do you have an adjustment to the Income Tax Credit Amortization?

A. Yes, I do. The Company's Exhibit No. 1, page 8 of 9 represents the pro forma calculation of pre-1971 investment tax credits that are deducted from rate base and amortized at a rate of $750 annually. The balance at July 31, 2004 was adjusted by the Company to reflect the balance at May 31, 2005. Because Staff used an average of monthly averages rate base, Staff reversed the Company's adjustment to investment tax credits, as the booked amount would already reflect an average amount using the Average of monthly averages rate base methodology. As a result of the average rate base methodology, Staff witness Harms Exhibit No. 111, Column (C), line 8 shows the Company's investment tax credit balance as of July 31, 2004. Staff Exhibit No. 106 summarizes Staff's adjustment.

Income Taxes & Debt Interest Synchronization Section

Q. Please explain Staff Exhibit No. 107, which shows the income tax calculations and the debt interest synchronization.

A. The purpose of Staff Exhibit No. 107 is to determine both the state of Idaho and federal income tax expense and the debt interest synchronization.

Lines 13 through 18 of Staff Exhibit No. 107 calculate the tax deductible interest expense. The result of this calculation is carried to line 3 to calculate the tax expenses. The calculation, using the debt ratio of 53.41% and debt cost rate of 4.65% from Staff witness Hall's Exhibit No. 117, together with the rate base Staff witness Harms developed on Staff Exhibit No. 111, is commonly referred to as interest synchronization. The purpose is to match the tax deductible interest expense with the case filings and ultimately the Commission's findings for the other three items. Any time one of these factors is changed, this calculation must be made to maintain the synchronization of the expense with the tax effect.

Lines 19 through 22 on Staff Exhibit No. 107 calculate the difference between the Company's proforma tax depreciation and the adjusted book depreciation. The excess of tax depreciation over book depreciation shown on line 22 is carried to line 4 of the exhibit to calculate the tax expenses. This calculation only affects the calculation of state income taxes for which the benefits of accelerated depreciation are flowed through to the Company's customers. Accelerated depreciation benefits are required to be normalized for the federal tax calculation.

The resulting income tax expenses shown on line 7 for Idaho state income taxes and on line 11 for federal income taxes, are also shown on lines 23 and 24, Column (P) on page 2 of Staff witness Harms' Exhibit No. 111.

The calculations shown on Staff Exhibit No. 107 incorporate all of the financial data shown in Columns (A) through (N) of Staff witness Harms Exhibit No. 111 for the computation of the income taxes. The calculated taxes are shown in the end result in Column (P) of Staff Exhibit No. 111. The difference between the amount on Column (P) and the amounts shown on Staff Exhibit No. 107 are due to the interest synchronization effect and the book vs. tax depreciation effect in the other columns, and are shown in column (O). The debt interest synchronization calculation results in a decrease of state income tax of $96,102 and an increase of federal income tax of $444,429. These amounts are shown on lines 23 and 24, Column (O) of Staff witness Harms Exhibit No. 111. Columns (D) through (N) were calculated at the statutory tax rates to approximate the tax effect of the individual adjustments. Staff Exhibit No. 107 and Column (O) of Staff Exhibit No. 111 incorporate the debt interest synchronization for all of Staff's adjustments.

Q. Does this conclude your direct testimony in this proceeding?

A. Yes, it does.