STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE INDIANA UTILITY REGULATORY COMMISSION'S INVESTIGATION INTO THE IMPACTS OF THE TAX CUTS AND JOBS ACT OF 2017 AND POSSIBLE RATE IMPLICATIONS UNDER PHASE 2 FOR L.M.H. UTILITIES CORPORATION	)))))))	**CAUSE NO. 45032 S17**

TESTIMONY

OF

MARGARET A. STULL - PUBLIC'S EXHIBIT NO. 1

ON BEHALF OF THE

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

August 21, 2018

Respectfully Submitted,

Daniel M. Le Vay, Atty. No.22184-49
Deputy Consumer Counselor

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing ***Office of Utility Consumer Counselor Testimony of Margaret A. Stull*** has been served upon the following counsel of record in the captioned proceeding by electronic service on August 21, 2018.

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TESTIMONY OF OUCC WITNESS MARGARET A. STULL
CAUSE NO. 45032 S-17
L.M.H. UTILITIES CORPORATION

I. INTRODUCTION

Q: Please state your name and business address.

A: My name is Margaret A. Stull, and my business address is 115 W. Washington St., Suite 1500 South, Indianapolis, Indiana, 46204.

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

A: I am employed by the Indiana Office of Utility Consumer Counselor ("OUCC") as a Chief Technical Advisor with the Water/Wastewater Division. My qualifications are set forth in Appendix A of this document.

Q: What is the purpose of your testimony?

A: Effective January 1, 2018, the Tax Cuts and Jobs Act of 2017 ("TCJA"), among other things, reduced the federal corporate income tax rate to 21%. I provide background on the Indiana Utility Regulatory Commission's ("IURC" or "Commission") investigation in Cause No. 45032 (the "Commission Investigation") and discuss impacts of the TCJA tax reduction on regulated utilities. I respond to L.M.H. Utilities Corporation's ("LMH" or "Respondent") argument that no amortization of its excess accumulated deferred income taxes is necessary due to its net operating loss carryforward, and I recommend LMH be required to reduce its rates to incorporate the amortization of its excess accumulated deferred income taxes. I respond to LMH's proposal regarding the refund of federal income tax expenses collected by LMH from January 1, 2018 through June 30, 2018, when LMH's base rates and charges were reduced to reflect the current federal income tax rate of 21% (Phase 1 of the Commission's Investigation).[1] I recommend the Commission direct LMH to refund the over-collected income tax expense with one bill credit in early 2019. Finally, I recommend the Commission reject LMH's request to recover costs it incurred in this investigation in its next general rate case.

Q: Please describe the examination and analysis you conducted in order to prepare your testimony.

A: I reviewed LMH's direct testimony, exhibits, workpapers, and other supporting documentation provided in this Cause. I reviewed LMH's 30-Day Filing submitted in Phase 1 of the Commission Investigation. I prepared discovery questions and reviewed LMH's responses.

II. <u>TCJA BACKGROUND</u>

Q: What are the main effects of the Tax Cuts and Jobs Act of 2017 ("TCJA") on regulated utilities?

A: The main effects of the TCJA on regulated utilities are the reduction of the federal income tax rate to 21%, the elimination of bonus depreciation, and the taxation of contributions in aid of construction for water and wastewater utilities. Regulated utilities are still allowed to deduct interest expense without limitation.

Q: What adjustments are necessary to reflect these effects in a regulated utility's rates and charges?

A: There are three major adjustments necessary: (1) reduction of federal income tax expense embedded in utility rates to reflect the new 21% corporate tax rate on a going forward basis; (2) refunding of the federal income tax expense over-collected

[1] The new tariff was approved on June 13, 2018 and implemented with July billings per Ms. Wyne's testimony (page 2, line 18).

by the utility from January 1, 2018 until the federal income tax rate embedded in rates and charges is reduced to 21%;[2] and (3) reduction of federal income tax expense to reflect the return of excess accumulated deferred income taxes created when accumulated deferred income taxes ("ADIT") are revalued at the 21% rate. Item (1) is a Phase 1 issue in the Commission Investigation and items (2) and (3) are considered Phase 2 issues in the Commission Investigation.

Q: How are the impacts of the TCJA on LMH's rates being addressed?

A: On March 26, 2018, LMH made a 30-Day filing in compliance with the Commission's February 16, 2018 order in this investigation. This 30-day filing implemented revised rates based on the new 21% income tax rate effective on July 1, 2018[1], resolving Phase 1 of the Commission Investigation. Phase 2 tax issues are being addressed in this subdocket (Cause No. 45032 S-17).

A. <u>Accumulated Deferred Income Taxes ("ADIT")</u>

Q: How are deferred income taxes generated?

A: Deferred income taxes are the result of temporary timing differences created by how revenues or expenses are recognized on a company's financial statements or its "books" and how those same revenues or expenses are recognized for tax purposes. For regulated utilities, the primary source of deferred income taxes is accelerated tax depreciation. But deferred income taxes can be generated by other revenues and expenses, such as unbilled revenue, accrued wages, unamortized rate

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[2] Per the Commission's order dated January 3, 2018 in Cause No. 45032, all Indiana investor-owned utilities are required to begin using regulatory accounting, such as the use of regulatory assets and liabilities, for all calculated differences resulting from the TCJA and what would have been recorded if the TCJA did not go into effect.

case expense, pension expenses, bad debts, and capital loss carry forward. Deferred income taxes can be either a deferred liability (taxes paid are less than book taxes) or a deferred asset (taxes paid are more than book taxes).

Q: How does accelerated tax depreciation create deferred income taxes?

A: Accelerated tax depreciation uses a higher depreciation rate than the depreciation rate used for book purposes.[3] This higher rate of tax depreciation results in more expense being recognized earlier in an asset's life for tax purposes than is recognized for book purposes.

A higher rate of tax depreciation coupled with a lower depreciation expense rate for book purposes results in a higher taxable income on the company's financial statements and, therefore, a higher income tax expense for book purposes. A higher accelerated depreciation expense for tax purposes lowers the net income on which the utility is taxed, thereby decreasing the income taxes paid. With accelerated tax depreciation, the utility avoids taxes in the early years, and this temporary timing difference is recognized as deferred income tax. The accumulated deferred income tax begins to reverse when accelerated tax depreciation is exhausted. The temporary timing difference is eliminated over the remaining life of the asset. Table 1 sets forth an example of how this process works.

[3] The Modified Accelerated Cost Recovery System ("MACRS") is the current tax depreciation system in the United States (i.e. depreciation for tax purposes). For LMH, the depreciation rate used for book purposes is the Commission's composite rate.

Table 1: Accumulated Deferred Income Tax Example

$30,000 Asset with 10-year book depreciable life and 3-year MACRS life.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Tax	10,000	10,000	10,000	-	-	-	-	-	-	-	30,000
Book	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	30,000
Deferred Taxe:	(7,000)	(7,000)	(7,000)	3,000	3,000	3,000	3,000	3,000	3,000	3,000	-
ADIT	(7,000)	(14,000)	(21,000)	(18,000)	(15,000)	(12,000)	(9,000)	(6,000)	(3,000)	-	

B. Excess ADIT

Q: What is excess ADIT and why is it necessary to return it to the ratepayers?

A: Under tax normalization rules, a utility's income tax expense embedded in rates is based on its book depreciation expense rather than its tax depreciation expense. Because utilities use accelerated depreciation rates for tax purposes, the amount of current income tax expense paid by the utility is generally less than the amount of income tax expense recovered from customers through rates and charges. The difference between these two expense amounts is recorded as ADIT, a long-term liability on the utility's balance sheet.[4] The value recorded for ADIT is based on the utility's income tax rate and calculated by taking the difference between book and tax expense and multiplying by the current tax rate.

When tax rates change, ADIT balances must be revalued at the new tax rates. The difference between the ADIT balance valued at the old income tax rate and the ADIT balance at a new lower income tax rate is known as excess ADIT.

[4] Temporary tax differences can create either a deferred tax asset or a deferred tax liability, depending upon whether the tax expense is less than (asset) or greater than (liability) the book expense. For purposes of my testimony in this case when I mention a deferred tax liability, I am referring to the utility's net deferred tax liability.

Excess ADIT represents the amounts that a utility has collected from ratepayers to pay future taxes that, as a result of the reduction in tax rates, will not now be imposed. Essentially, ADIT represent a "loan" from ratepayers to the utility. When the income tax rate decreases, the amount of the "loan" from ratepayers is reduced and needs to be "repaid" or returned to the ratepayers. Excess ADIT represents the amount of the "loan" to be repaid to ratepayers.

C. Protected vs. Unprotected ADIT

Q: Are there different classifications of ADIT?

A: Yes, there are two types of ADIT - protected and unprotected. "Protected" ADIT refers to all temporary federal income tax differences generated by the difference between book and tax depreciation rates used. All other temporary federal income tax differences are considered "unprotected."

Q: Why is the distinction between "protected" and "unprotected" ADIT important?

A: This distinction is important because it affects how excess ADIT will be returned to ratepayers. Congress has imposed rules regarding how any "protected" excess ADIT should be returned to ratepayers in order for the utility to comply with tax normalization rules. "Unprotected" excess ADIT is not subject to these normalization rules, and how these amounts are returned to ratepayers is left to the discretion of the jurisdictional regulating body.

Q: How is "protected" excess ADIT returned to ratepayers?

A: "Protected" excess ADIT must be returned to ratepayers using the average rate assumption method ("ARAM"). If the utility does not have adequate data to apply

ARAM, the "Reverse South Georgia" method may be used as an alternative. In general, both the ARAM and the Reverse South Georgia method spread the flow-through of excess ADIT over the remaining lives of the property that gave rise to the excess.

Q: Are there any other regulatory impacts as a result of TCJA?

A: Yes. In Indiana, accumulated deferred income taxes may be included in a utility's capital structure as a zero-cost source of capital. This has the effect of reducing the utility's weighted average cost of capital. In future rate cases, the amount of accumulated deferred income taxes included in the capital structure will be reduced due to the amortization of excess ADIT, thereby increasing the weighted average cost of capital (all other things being equal).

III. OVER-COLLECTED FEDERAL INCOME TAX EXPENSE

A. LMH Proposal

Q: What is LMH's proposal regarding its over-collected federal income tax expense in this Cause?

A: LMH estimated it over-collected $10,446 of federal income tax expense during the period January through June 2018. LMH proposes to refund this amount to its customers during the period January through June 2019.

Q: How does LMH propose to implement this refund to customers?

A: LMH witness Tracy Wyne stated LMH proposes to allocate the refund evenly to the customers billed during the period January through June 2019. (Wyne Testimony, page 3, lines 18-20.) To reflect this refund, LMH will "prepare a new tariff which reduces the volumetric rate to provide the refund to customers." (See

Wyne testimony, page 3, lines 20-21 (emphasis added).). LMH said its proposal will refund the actual amounts required to be refunded "because it is a set amount of dollars spread evenly over 6 months." (Wyne Testimony, page 4, lines 1 – 2.). Finally, Ms. Wyne stated LMH will file a reconciliation to show the amount has been refunded to customers.

B. OUCC Response

Q: Do you accept LMH's proposal?

A: No. I disagree with the amount of the refund proposed, the method proposed to provide the refund, and the timeframe over which the refund will be provided.

Q: Why do you disagree with the amount of the refund proposed by LMH?

A: While it was necessary for LMH to estimate the amount to be refunded, the actual amount to be refunded is now known. In response to OUCC Data Request No. 2.1, LMH stated the actual revenues billed through June 2018 were $422,725.78. Therefore, the actual amount to be refunded to customers is $10,272.24 ($422,725.78 x 2.43%). (See Attachment MAS-1.)

Table 2: Calculation of Refund

Cumulative 2018 Revenues billed through June 2018	(A)	$ 422,725.78
Times: Phase I Decrease to rates	(B)	2.43%
Over-Collected Federal Income Tax Expense		$ 10,272.24
Additional decrease in customer rates ($10,272 / $741,276)		1.39%

(A) Attachment MAS-1 (LMH Response to OUCC Data Request No. 2.1.)

(B) Revised Phase I 30-Day Filing #50166 dated 5/25/18.

Q: Why do you disagree with LMH's proposed methodology for providing the refund?

A: LMH's proposal as described appears to be contradictory. In one part of Ms. Wyne's testimony, she states the refund will be "allocated evenly" and that the refund will be a "set amount of dollars spread evenly over 6 months." (Wyne Testimony, page 3, line 19, and page 4, lines 1-2.) Then she states LMH "will prepare a new tariff which reduces the volumetric rate to provide the refund to customers" (Wyne Testimony, page 3, lines 20-21). If LMH will be adjusting the volumetric rate to provide this refund to customers, then it cannot be a set amount or be allocated evenly over the 6 months, as volumes will vary from month to month. Further, LMH has provided no calculation of the volumetric rate reduction it proposes or the methodology it proposes to calculate this rate reduction. For purposes of evaluation and securing approval, LMH's proposal is not adequately defined or clear.

Q: Why do you disagree with the timeframe proposed by LMH for providing the refund to customers?

A: By January 2019, LMH will have had the benefit of these over-collected income tax expenses for the better part of a year. Because the amount to be refunded is relatively small, LMH should provide the full amount of the refund in one bill credit. This method is simpler than LMH's proposal, will not require any adjustments to its tariff rates, and will provide customer refunds more quickly and with fewer administrative costs. The refund amount can be calculated on a *pro rata* basis or it can be based on actual volumes billed during the over-collection period.

IV. AMORTIZATION OF EXCESS ADIT

A. LMH's Proposal

Q: Does LMH propose to refund protected excess ADIT to its customers?

A: No. LMH argues it has no net accumulated deferred income taxes and, therefore, no excess ADIT to refund to its customers.

Q: What is the basis for the assertion that LMH has no excess ADIT?

A: LMH bases this position on its treatment of net operating loss carry forwards and its interpretation of generally accepted accounting principles ("GAAP"). According to Ms. Wyne, LMH has been experiencing net losses on its tax return since 2007 and has accumulated net operating loss carryforwards of $2,445,036 as of 12/31/17. Ms. Wyne argued that the "deferred tax benefit created by the net operating loss should be considered protected," stating that "this benefit cannot be used until [LMH] generates sufficient income to offset the net operating losses ["NOL"]." Ms. Wyne added that "Under generally accepted accounting principles, when the benefit of an asset is not expected to be fully realized, an allowance should be established to reduce the asset to the amount expected to be utilized." (See Wyne Testimony, pages 4-5.) According to Ms. Wyne's Exhibit TW-2, LMH will not generate sufficient income at current rates to recognize the future tax benefit of its NOL. Based on the foregoing rationale, LMH has recorded an allowance to offset all ADIT it has recorded on its books.

B. OUCC Response

Q: Do you agree with LMH's reason for not recognizing excess ADIT?

A: No. LMH has been recovering income tax expense through its approved rates and charges. Whether LMH has paid income taxes because of its NOL has no bearing on this fact. According to Ms. Wyne's testimony and exhibits, LMH has not paid any income taxes since at least 2007. During this same period of time, the rates charged LMH customers have included $64,497 of income tax expense every year, or $644,970 over a ten-year period. None of these monies were needed or used to pay federal or state income taxes.[5] LMH should be required to refund its excess ADIT to its customers.

Q: Why do you consider the accounting rules to not provide guidance on LMH's treatment of excess ADIT?

A: US GAAP is only <u>one</u> source to guide the treatment of various accounting related regulatory issues. GAAP accounting principles are designed to provide general guidance, not just in a regulatory context. There are situations in which a general accounting principle either cannot apply or should not apply to a regulated utility for ratemaking purposes. There are many situations in which US GAAP does not provide meaningful guidance for ratemaking purposes and this is one of those situations. The US GAAP rule quoted by Ms. Wyne in her testimony is not appropriate to apply to this situation. LMH is a regulated utility and, as such, has been recovering income tax expense as a revenue requirement. To argue that LMH has not or will not receive any benefit from its ADIT or its NOL is incorrect - LMH has recovered approximately $644,970 for income tax expense it has not paid and may never pay. LMH's ratepayers should have the benefit of recognizing the reality

[5] Annual income tax expense of $64,497 consists of $48,024 of federal income tax expense and $16,473 of state income tax expense. See LMH's revised 30-day filing (#50166) dated May 25, 2018, Revenue Requirement Schedule.

of excess ADIT.

Q: What is the OUCC's recommendation regarding excess ADIT?

A: The OUCC recommends LMH be required to return excess ADIT to its customers. LMH uses the Commission's composite depreciation rate for wastewater utilities (2.5%) and all of its excess ADIT is due to its use of acceleration depreciation. It is unlikely LMH has accumulated the data necessary to calculate ARAM; therefore, my recommendation is based on the Reverse South Georgia method for determining the period over which LMH's excess ADIT should be amortized.[6] LMH's Exhibit TW-2 provides the information necessary to calculate this amortization period, and based on this information, an amortization period of 14.5 years should be applied. This period is reflected in Table 3 below yielding an annual reduction to income tax expense of $25,014 and a $35,189 reduction to LMH's revenue requirement (after gross-up). This results in a reduction to LMH customer rates of 4.75%.

[6] In response to OUCC Data Request No. 2.5, LMH stated that it would use the ARAM method to determine the annual reduction to its federal income tax expense. (See Attachment MAS-2.) LMH has not provided its calculation of ARAM in this case.

Table 3: Calculation of Excess ADIT Amortization

UPIS - Original Cost		$ 8,177,945
Less: Land		(61,000)
Depreciable UPIS		$ 8,116,945
Less: Accum. Depreciation		(5,184,002)
Net UPIS		$ 2,932,943
Divided by: Annual Depreciation Expense	[A]	202,924
Amortization Period		14.45
(rounded up to 14.5 years)		
Excess ADIT		$ 362,700
Divided by Amortization Period		14.5
Annual Amortization of Excess ADIT		25,014
Times: Gross Revenue Conversion Factor		140.6788
Reduction to Revenue Requirement		$ 35,189
Percent Reduction to Customer Rates	[B]	4.75%

[A] Depreciable UPIS times 2.5%

[B] $35,189 / $741,276 (Revenue Requirement per Revised 30-Day Filing dated May 25, 2018.)

V. OTHER CONCERNS

Q: Does LMH address other concerns it believes are relevant to this Cause?

A: Yes. LMH seeks approval to defer the cost of its participation in this proceeding as a regulatory asset that can be addressed in its next base rate case, which it says will be filed in the fall of 2018.

Q: Do you accept LMH's proposal?

A: No. This is a single issue case – an investigation into the effect of the TCJA on customer rates. Compliance costs should be minimal and involve perfunctory filings unless the utility is arguing against the reduction of its rates to reflect the effects of the TCJA. It is the utility's prerogative to make these arguments, but ratepayers should not be expected to pay these costs. These types of costs are more appropriately borne by the utility's shareholders, the party that would benefit from these proposals.

Also, the cost of determining LMH's excess ADIT and other related calculations would have been incurred even if the Commission had not initiated this investigation. Finally, in a regulatory environment, unexpected, one-time legal and accounting bills will occur. LMH has legal and accounting fees embedded in its current rates. No additional compensation should be approved.

Q: Does LMH address any other issues in its testimony?

A: Yes. LMH proposes that the method of handling taxes related to contributions in aid of construction be considered in its next base rate case.

Q: Does the OUCC accept this proposal?

A: Yes. The OUCC can accept deferring the selection of a cost methodology until LMH's next base rate case, which is expected to be filed in fall 2018.

VI. RECOMMENDATIONS

Q: Please summarize your recommendations.

A: I recommend the Commission approve the OUCC's proposed ratemaking treatment of the tax regulatory liability created by LMH's over-collection of income tax expense in 2018 as well as the actual value of the over-collection to be refunded - $10,272. I recommend the Commission require LMH to refund its excess ADIT, all of which is protected, to its customers based on my calculation shown in Table 3. Finally, I recommend the Commission deny LMH's request to defer the cost of its participation in this proceeding as a regulatory asset that can be addressed in its next base rate case

Q: Does this conclude your testimony?

A: Yes.

APPENDIX A

Q: Please describe your educational background and experience.

A: I graduated from the University of Houston at Clear Lake City in August 1982 with a Bachelor of Science degree in accounting. From 1982 to 1985, I held the position of Gas Pipeline Accountant at Seagull Energy in Houston, Texas. From 1985 to 2001, I worked for Enron in various positions of increasing responsibility and authority. I began in gas pipeline accounting, was promoted to a position in financial reporting and planning, for both the gas pipeline group and the international group, and finally was promoted to a position providing accounting support for infrastructure projects in Central and South America. In 2002, I moved to Indiana, where I held non-utility accounting positions in Indianapolis. In August 2003, I accepted my current position with the OUCC. In 2011, I was promoted to Senior Utility Analyst. In 2018, I was promoted to Chief Technical Advisor. Since joining the OUCC I have attended the National Association of Regulatory Utility Commissioners ("NARUC") Eastern Utility Rate School in Clearwater Beach, Florida, and the Institute of Public Utilities' Advanced Regulatory Studies Program in East Lansing, Michigan. I have also attended several American Water Works Association and Indiana Rural Water Association conferences. I have also attended several NARUC Sub-Committee on Accounting and Finance Spring and Fall conferences. I have participated in the National Association of State Utility Consumer Advocates ("NASUCA") Water Committee and the NASUCA Tax and Accounting Committee. In March 2016 I was appointed chair of the NASUCA Tax and Accounting Committee.

Q: Please describe your duties and responsibilities at the OUCC.

A: I review Indiana utilities' requests for regulatory relief filed with the Commission. I also prepare and present testimony based on my analyses, and make recommendations to the Commission on behalf of Indiana utility customers. I have been involved with the Commission's investigation in Cause No. 45032 since its inception, conducting analysis of the Tax Cuts and Jobs Act of 2017 and the effect this Act has on the rates of the various utilities involved in the investigation.

Q: Have you held any professional licenses?

A: Yes. I passed the CPA exam in 1984 and was licensed as a CPA in the State of Texas until I moved to Indiana in 2002.

Q: Have you previously testified before the Indiana Utility Regulatory Commission ("Commission")?

A: Yes. I have testified before the Commission as an accounting witness in various causes involving water, wastewater, electric, and gas utilities.

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE INDIANA UTILITY REGULATORY COMMISSION'S INVESTIGATION INTO THE IMPACTS OF THE TAX CUTS AND JOBS ACT OF 2017 AND POSSIBLE RATE IMPLICATIONS	**)))))**	**CAUSE NO. 45032 S17**

PETITION OF LMH UTILITIES CORPORATION RESPONSES TO THE INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR'S SECOND SET OF DATA REQUESTS

Comes now LMH Utilities Corporation, by counsel, and submits to the Indiana Office of the Utility Consumer Counselor ("OUCC") its responses to the OUCC's Second Set of Data Requests dated August 9, 2018, as follows:

II. Data Request.

Q-2-1: What were the actual revenues billed for June 2018?

A. $422,725.78.

Q-2-2: What is the actual amount of the excess collections recorded as a deferred regulatory liability?

A. $10,272.24.

[redacted]

[redacted]

[redacted]

[redacted].

[redacted]

[redacted] [redacted]

Q-2-5: If LMH were ordered to begin refunding the excess ADIT (protected) which method would it use – ARAM or Reverse South Georgia?

A. ARAM.

[redacted]

[redacted] [redacted]

[redacted]

[redacted]

[redacted] [redacted]

[redacted]

[redacted] [redacted]

AFFIRMATION

I affirm, under the penalties for perjury, that the foregoing representations are true.

Margaret A. Stull

By: Margaret A. Stull
Cause No. 45032 S17
Indiana Office of
Utility Consumer Counselor

8/21/18

Date: