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JUNE 18, 2018
INDIANA UTILITY
REGULATORY COMMISSION

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 S4**
UNDER PHASE 1 AND PHASE 2 FOR INDIANA	)	
AMERICAN WATER COMPANY, INC	)	

OUCC PREFILED TESTIMONY

OF

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

ON BEHALF OF THE

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

June 18, 2018

Respectfully Submitted,

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

Tiffany T. Murray, Atty. No. 28916-49
Deputy Consumer Counselor

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing ***Office of Utility Consumer Counselor's Prefiled Testimony of Margaret A. Stull*** has been served upon the following counsel of record in the captioned proceeding by electronic service on June 18, 2018.

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TESTIMONY OF OUCC WITNESS MARGARET A. STULL
CAUSE NO. 45032 S-4
INDIANA AMERICAN WATER COMPANY, INC.

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

A: I reviewed the direct testimony, workpapers, and discovery responses presented by Indiana American Water Company, Inc. ("Indiana American" or "Respondent") related to its proposal in Phase 1 of this subdocket addressing the reduction of embedded income tax expense in current customer rates and charges.

Q: What is the purpose of your testimony?

A: I explain the OUCC's response to Indiana American's Phase 1 subdocket proposal regarding regulatory treatment of federal income taxes necessitated by the Tax Cuts and Jobs Act of 2017 ("TCJA"). Indiana American has not reduced its current base rates to cease over-collecting federal income tax expense from ratepayers. Indiana American proposes to reflect in its rates less than all of the tax decrease it now enjoys. More specifically, Indiana American proposes to phase-in the effects of the tax rate reduction, with 62.5% of the effect upon issuance of an order in Phase 1 of this subdocket with the balance (37.5%) to be incorporated in rates in its next base rate order (Respondent's Exhibit No. 1, page 4, lines 10-13). The OUCC recommends the Commission deny Indiana American's proposal to phase-in the rate decrease associated with the change in the federal corporate income tax rate. Instead, the OUCC recommends an immediate reduction in customer rates for the full amount of the excess income tax expense embedded in current rates and charges ($10,544,252) effective the date an order is issued in Phase 1 of this sub-docket.

Q: Is the OUCC responding to the Phase 2 issues raised by Indiana American?

A: No, not at this time. While Respondent filed more than thirty pages of testimony in this subdocket, most of it related to Phase 2 issues. The testimony presented here relates solely to Phase 1. The OUCC will address Phase 2 issues in the Phase 2 portion of the Commission's tax investigation.

II. TAX CUTS AND JOBS ACT OF 2017

Q: What are the main effects of the Tax Cuts and Jobs Act of 2017 ("TCJA") on regulated utilities?[1]

A: The main effects of the TCJA on regulated utilities are the reduction of the corporate federal income tax rate from 35% to 21%, the elimination of bonus depreciation, the inclusion of cash and utility plant contributions (to water and wastewater utilities) in taxable revenues, and the elimination of the Section 199 domestic manufacturing deduction ("Section 199 deduction"). Because regulated

[1] The TCJA was passed by Congress on December 22, 2017.

utilities are not eligible for bonus depreciation, they may still deduct all interest expense without limitation.

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

A: Three major adjustments are necessary to reflect the impact of the TCJA in a regulated utility's rates and charges: (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) Amortization of the federal income tax expense over-collected by the utility from January 1, 2018 until the federal income tax rates 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. In addition, a relatively minor increase to federal income tax expense may also result from the elimination of the Section 199 deduction.

Q: Is an adjustment to rates and charges needed to reflect the taxation of contributions-in-aid of construction?

A: No. There should be no current impact to a regulated utility's rates and charges related to the taxation of contributions-in-aid of construction ("CIAC"). While the Commission has not yet provided specific guidelines on this issue, CIAC contributions year over year tend not to be consistent, making it untenable to include the tax effect of such contributions in the calculation of a utility's revenue

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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.

requirement. This approach could lead to over-collection or under-collection of these costs by the utility. Other cost recovery options could include rate base treatment or a tracker mechanism, both of which would provide better ratemaking treatment for this issue.

Q: Which of the above adjustments are the subject of this Phase 1 subdocket?

A: This Phase 1 subdocket is primarily intended to address the reduction of federal income tax expense embedded in Indiana American's current rates and charges in order to reflect the new 21% corporate tax rate. (Cause No. 45032, Order, February 16, 2018 at 2.) In its February 16, 2018 Order, the Commission stated "Respondents that have contributions in aid of construction that <u>may</u> be impacted by the tax changes made in the Act may also include in its 30-day filing a request for Commission approval of a cost option set forth in 170 IAC 6-1.5-33 and 170 IAC 8.5-4-32." (emphasis added.)

Q: How will any remaining impacts of the TCJA on Indiana-American be handled?

A: All remaining impacts of the TCJA on Indiana-American not addressed in Phase 1 will be addressed as part of Phase 2 of this subdocket.

III. <u>PHASE 1</u>

Q: What is the purpose of this Phase 1 subdocket?

A: According to the Commission's Order issued on February 16, 2018 ("February 16 Order"), this Phase 1 subdocket "… is intended to *ascertain the real time existing customer rate impact* directly related to the change in the federal income tax rate on the ongoing revenue requirement for each Respondent and *to foster an expedient process to reflect such impact in customer rates going forward*." (emphasis added.)

A. **Indiana American Proposal**

Q: What is the amount of excess income tax expense embedded in Indiana American's current rates and charges?

A: The Commission approved base rates designed to provide Indiana American with total operating revenues of $207,529,092 in Cause No. 44450, as revised in Indiana American's compliance filing dated December 30, 2015 (Appendix A, line 13).[3] In Indiana American's 30-Day Filing made on March 26, 2018 in this Cause[4], total operating revenues were recalculated to be $196,984,841 using the 21% federal income tax rate authorized by the TCJA instead of the 35% federal income tax rate in effect at the time. (See Indiana American 30-Day Filing #50163, Schedule 1 "Adjustment Summary," Column C, Line 1.) Therefore, $10,544,252 ($207,529,092 - $196,984,841) represents the total normalized excess income tax expense embedded in Indiana-American's current rates and charges. (See Indiana American 30-Day Filing #50163, Schedule 1 "Adjustment Summary," Column B, Line 1.)

Q: What is Indiana American's Phase 1 proposal?

A: Indiana American proposes to phase-in the effects of the tax rate reduction, with 62.5% reflected immediately upon issuance of an order in Phase 1 of this subdocket and the balance (37.5%) reflected upon issuance of an order in its next base rate case (Respondent's Exhibit No. 1, page 4, lines 10-13).

Q: How much of an operating revenue decrease does Indiana American propose?

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[3] Indiana American's compliance filing updated rate base and depreciation expense for actuals as of November 30, 2015, pursuant to Ordering Paragraph 5 of the Commission's January 28, 2015 Order in Cause No. 44450.

[4] Indiana American withdrew its thirty day filing on April 12, 2018.

A: Based on its proposal to provide 62.5% of the benefits of the tax rate reduction to customers immediately, Indiana American proposes an immediate operating revenue reduction of $7,059,283 (Indiana American Workpapers, Schedule 2).

Q: What justification did Indiana American provide for delaying the full benefit of a reduced federal income tax rate to its customers?

A: Indiana American Witness John M. Watkins asserts a phase-in of the TCJA benefits would avoid "confusion and customer frustration over the yo-yo of water bills." (Respondent's Exhibit No. 1, page 24, lines 18-19.) Mr. Watkins states that Indiana American just raised its rates in March 2018 for DSIC-11 and will be sending notices to its customers advising them of the general rate case to be filed in July 2018. Mr. Watkins also states that the rate increase to be requested in its base rate case will "be a higher percentage than it would be without the TCJA reduction and so customers would be frustrated by the percentage increase caused by that yo-yo." Finally, he states Indiana American will be eligible to file DSIC-12 in January 2019 as it is currently below the 10% statutory cap. Mr. Watkins commits that if Indiana American's phase-in is approved, it will not file another DSIC while the rate case is pending. (See *Id.*, page 24, line 18, through page 25, line 9.)

Q: How does Indiana American propose to implement its proposed Phase 1 rate reduction?

A: Indiana American proposes to allocate this revenue decrease among customer classes according to the cost of service approved in Cause No. 44450. However, Indiana American is proposing a rate design change such that all utility rates, <u>except</u> the monthly customer charge, be adjusted to reflect its proposed $7,059,283 decrease to operating revenues.

Q: What justification did Indiana American provide for not adjusting its monthly customer charges?

A: Mr. Watkins asserts that "94% of Indiana American's costs of service are fixed and 6% are variable. At the same time, only 45% of the revenues under the Company's rates are fixed." Mr. Watkins further asserts that this means "51% of Indiana American's fixed costs (94% - 45%) must be recovered through volumetric charges." Mr. Watkins argues that it "makes no sense to be reducing our fixed cost recovery due to a reduction in this one expense item (federal income tax) when the customer charges component of our rates was already insufficient to recover our fixed costs." (See *Id.*, page 26, lines 11-21.)

Q: Has Indiana American reduced any of its current rates and charges to reflect the new 21% corporate income tax rate?

A: Yes. Indiana American has included the effects of the TCJA in its Cause No. 42351 Distribution System Improvement Charge ("DSIC") tracker approved by the Commission on March 14, 2018 (DSIC-11). As part of this filing, Indiana American also adjusted its DSIC-9 and DSIC-10 rates to reflect the reduced federal income tax rate of 21%.

B. OUCC Response

Q: Does the OUCC accept Indiana American's Phase 1 proposal?

A: No. Indiana American's case includes no compelling justification for this relief. Indiana American's case includes no evidence as to how immediately adjusting its current rates and charges to reflect the full benefit of the tax relief ($10,544,252) would affect *its* operations. Even though Indiana American does not deny that its tax liability has been reduced as a result of the TCJA, it proposes that only a portion

(62.5%) of the embedded excess income tax expense be passed back to customers immediately. Indiana American proposal is not reasonable, nor is it justified or necessary, and it does not comply with the Commission's directive to pass back TCJA benefits to customers in an expedited manner.

Q: Does the OUCC accept Indiana American's rate design proposal related to its Phase 1 rate decrease?

A: No. This subdocket is not the appropriate venue for making changes to rate design. Rate design is a broader subject that deserves a more thorough review and analysis than can be adequately addressed in this tax investigation. Any rate design issues that Indiana American has should be raised in its next base rate case.

Q: Has Indiana American adequately supported its claim that it will experience cash flow problems as a result of the TCJA?

A: No. Generally, Indiana American Witness John M. Watkins argues the TCJA could cause "a material reduction of much-needed cash flow." (See Respondent's Exhibit No. 1, page 15, lines 11-14.) Mr. Watkins states that water utilities are one of the most capital intensive industries in the country. "Immediately adjusting utility rates solely to account for the mathematical calculation (35% - 21%) of the impact of the reduction in the federal corporate tax rates is not appropriate without consideration of … cash flow concerns and the impacts to the cost of service to our customers." (*Id.*, page 15, lines 19-22.) While Indiana American has provided testimony discussing how the tax law changes may affect regulated utilities in general, it has provided no specific analysis or study conducted by or on behalf of Indiana American regarding the projected impact of implementing TCJA on Indiana American's operations.

Q: Mr. Watkins attempts to justify Indiana American's proposal as a means to avoid "confusion and customer frustration over the yo-yo of water bills." Did the Commission make any statement regarding this issue in Cause No. 38194?

A: Yes. In its previous tax investigation, Cause No. 38194, the Commission rejected arguments to delay base rate reductions to reflect lower taxes as a means to avoid alleged "yo-yo effects." In that Cause, Indianapolis Power & Light's ("IPL")'s witness recommended IPL's rate reduction "be delayed . . . in order to prevent the decrease/increase scenario." (Cause No. 38194, Interim Order, June 1, 1987 at 31.) In response, the Commission was "not persuaded [that] Indianapolis Power & Light's ratepayers should be denied the benefits of the Federal Income Tax rate reductions over any period of time" and ordered IPL to change its rates to reflect lower taxes even though its new base rates and charges were to go into effect thirty-eight days later. (*Id.*)

Q: Are there other facts and circumstances to consider when evaluating the impact of the TCJA on Indiana American's cash flows?

A: Yes. As discussed by OUCC Witness Edward Kaufman, American Water (Indiana American's parent company) announced a 10% increase in its shareholder dividends on April 20, 2018. Further, Mr. Kaufman discusses Indiana American's aggressive acquisition policy. Neither of these actions is consistent with a company that is concerned about negative cash flows.

Q: Would it be appropriate for Indiana American to provide evidence of the impact of the TCJA on its Indiana operations in response to the OUCC's testimony?

A: No. In its February 16, 2018 Order, the Commission allowed utilities to withdraw the March 26, 2018 30-Day Filing and request a subdocket in order for the utility to file "its case-in-chief supporting its proposal for revising its Rates and Charges to reflect the new tax rate." (February 16 Order at 2.) Implicit in the creation of the subdocket is a requirement that Indiana American establish an exception to the general requirement that rates should be based on the actual tax liability of the utility. Indiana American has not done this in its case-in-chief filing. Further, this filing by the OUCC is the OUCC's one and only chance to respond to that proof with its own case. It would be improper and manifestly unfair for Indiana American to provide such support for the first time in its rebuttal case.

Q: Mr. Watkins questions the propriety of adjusting utility rates solely to account for the "mathematical calculation (35% - 21%) of the impact of the reduction in the federal corporate tax rate." Did the Commission make any statement regarding the flow-through of tax expense in Cause No. 38194?

A: Yes. The Commission has previously recognized that taxes are a flow-through expense (Cause No. 38194, Interim Order, June 1, 1987, page 27) and, therefore, ratepayers should begin receiving the benefits intended by federal tax reform immediately. In Cause No. 38194, the Commission discussed the reasonableness of adjusting a utility's rates and charges based on information relating to a change in only one expense item. In its deliberations, it stated:

> This Commission realizes that a change in the Federal Income Tax Rate should have no substantive bearing on whether a utility is or is not earning its authorized return. Federal Income Tax Expense, like many other utility expense items, is a pass through expense. In other words, the utility's Federal Income Tax obligation is passed-through as a cost of doing business to its ratepayers. <u>Because of the pass-through nature of this expense, a change in the Federal Income Tax rate should have no effect on a utility's net operating income and therefore its ability to earn its authorized return.</u> Further, this Commission has often stated that public utilities are in no fashion guaranteed to earn their authorized return, or any return at all, but, are only provided an opportunity to earn such return.

(Cause No. 38194, Interim Order, June 1, 1987, page 27.) (emphasis added)

Q: What does the OUCC propose?

A: The OUCC proposes Indiana American reduce its current rates and charges to reflect the 21% federal income tax rate and begin passing back 100% of the TCJA savings to its customers immediately, effective on the date a final order is issued in this phase of the subdocket. Indiana American's withdrawn 30-Day Filing #50163 reflects new base rates at the lower federal income tax rate based on the rate design approved in its last rate case. It is undisputed that Indiana American's federal income tax rate was reduced effective January 1, 2018 to 21%.

Q: Does the OUCC have any additional proposals regarding the implementation of TCJA benefits?

A: Yes. If the Commission accepts Indiana American's phase-in approach, it would be appropriate for the balance of the tax reduction not yet provided to ratepayers to accrue carrying charges. Indiana American's proposal would not provide the remaining 37.5% or $3,484,969 ($10,544,252 - $7,059,283) of the reduction in the federal corporate tax rate until an order is issued in its next base rate case. Indiana American has not yet filed its base rate case. Its customers will be required to wait a material amount of time to receive this full benefit, and they should be compensated for this delay. Indiana American's proposal will require it to continue to record over-collected income taxes to the regulatory liability it began accruing in January 2018 in accordance with the Commission's January 3, 2018 Order in Cause No. 45032. The OUCC proposes that carrying charges should accrue beginning on the date an order is issued in Phase 1 of this subdocket at 6% or Indiana American's weighted average cost of capital, whichever is larger.

IV. CONTRIBUTIONS-IN-AID OF CONSTRUCTION

Q: Pursuant to 170 IAC 6-1.5-33 and 170 IAC 8.5-4-32, which CIAC option did Indiana American choose?

A: Indiana American chose CIAC option 3, which allows the contributor to choose whether or not to pay the income tax associated with their contribution of cash or utility plant. To the extent the contributor opts not to pay the associated income tax, then Indiana American would pay the tax.

Q: In its testimony, how did Indiana American support its decision to choose option 3?

A: Mr. Watkins states "This is the option that best balances the cash flow concerns with the desire not to stifle growth in the areas served by the Company." (See Respondent's Exhibit No. 1, page 31, lines 20-21.)

Q: Does the OUCC have any concerns with Indiana American's implementation of its cost option?

A: Yes. The OUCC has concerns with Indiana American's proposed treatment of contributors of mains and other utility plant. Indiana American states that if the contributor or developer opts not to pay the tax, then it will forfeit any subsequent connector fees to which it would otherwise be entitled. Depending on the size and location of the development, these subsequent connector fees could be greater than the tax that would be owed on the contribution. Therefore, the OUCC proposes Indiana American be allowed to keep any subsequent connector fees *only up to* the amount of income tax paid on the contributed plant. Any subsequent connector fees in excess of the amount of taxes paid should be flowed through to the contributor/developer. The OUCC also notes that Indiana American did not say whether the contributor or developer would still be entitled to its three-year revenue allowance. If Indiana American will withhold subsequent connector fees, it should not also eliminate the three-year revenue allowance.

Q: Does the OUCC have any additional concerns regarding the taxation of CIAC?

A: Yes. Indiana American does not state how it intends to handle the income taxes on cash contributions received through its system development charge. If Indiana American intends for the contributor to pay the taxes due, then it should file a 30-day filing with the Commission for approval of its grossed-up calculation of its current system development charge.

V. RECOMMENDATIONS

Q: Please summarize your recommendations.

A: I recommend the Commission deny Indiana American's request to delay the full impact of its reduced income tax expense in rates as a result of the TCJA and require Indiana American to immediately reduce its rates by the full impact of this tax rate change. I also recommend the Commission deny Indiana American's proposed rate design changes and require Indiana American to apply any rate decrease to all of its utility tariff rates. I further recommend the Commission accept Indiana American's proposed CIAC option 3 with my additional recommendations regarding the three-year revenue allowance and treatment of taxes on Indiana-American's system development charges. However, to the extent a contributor/developer opts not to pay the taxes, I recommend the Commission prohibit Indiana American from retaining subsequent connector fees in excess of the actual income taxes paid. Any excess subsequent connector fees should be paid to the contributor/developer.

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.

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.

AFFIRMATION

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

Margaret A Stull

By: Margaret A. Stull
Cause No. 45032 S4
Indiana Office of
Utility Consumer Counselor

JUNE 18, 2018

Date: