BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

DOCKET NO. W-354, SUB 360

In the Matter of Application by Carolina Water Service, Inc. of North Carolina, 4944 Parkway Plaza Boulevard, Suite 375, Charlotte, North Carolina 28217, for Authority to Adjust and Increase Rates for Water and Sewer Utility Service in All of its Service Areas in North Carolina, Except Corolla Light and Monteray Shores Service Area	)))))))))	SUPPLEMENTAL TESTIMONY OF MICHELLE M. BOSWELL PUBLIC STAFF – NORTH CAROLINA UTILITIES COMMISSION

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

DOCKET NO. W-354, SUB 360

**SUPPLEMENTAL TESTIMONY OF MICHELLE M. BOSWELL
ON BEHALF OF THE PUBLIC STAFF
NORTH CAROLINA UTILITIES COMMISSION**

OCTOBER 12, 2018

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND PRESENT POSITION.

A. My name is Michelle M. Boswell. My business address is 430 North Salisbury Street, Dobbs Building, Raleigh, North Carolina. I am a Staff Accountant with the Accounting Division of the Public Staff – North Carolina Utilities Commission.

Q. ARE YOU THE SAME MICHELLE M. BOSWELL WHOSE DIRECT TESTIMONY WAS FILED IN THIS DOCKET ON OCTOBER 4, 2018?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY IN THIS PROCEEDING?

A. The purpose of my supplemental testimony is to present the accounting and ratemaking adjustments I am recommending regarding state Excess Deferred Income Taxes (EDIT), federal protected EDIT, federal unprotected EDIT, and the overcollection of federal taxes since January 1, 2018.

Q. MS. BOSWELL, PLEASE DESCRIBE THE SCOPE OF YOUR INVESTIGATION INTO THE COMPANY'S FILING.

A. My investigation included a review of the application, testimony, exhibits, and other data filed by Carolina Water Service, Inc. of NC (Company). The Public Staff has also conducted extensive discovery in this matter, including the review of numerous data responses provided by the Company in response to data requests and participation in conference calls with the Company.

Q. PLEASE DESCRIBE THE ORGANIZATION OF YOUR EXHIBITS.

A. Boswell Exhibit 1 presents the calculation of federal protected EDIT effects on the Company's rate base and income statement.

Boswell Exhibit 2 sets forth the calculation of an annual Federal Unprotected EDIT Rider to be in effect for three years.

Q. PLEASE DESCRIBE YOUR RECOMMENDED ADJUSTMENTS.

A. My adjustments are described below.

STATE EXCESS DEFERRED INCOME TAXES

Q. PLEASE EXPLAIN WHY THE PUBLIC STAFF IS NOT RECOMMENDING AN ADJUSTMENT TO STATE EDIT.

A. I am not recommending an adjustment to state EDIT in this case, as the Company has been amortizing the applicable regulatory asset over a three year period since its last rate case in Docket No. W-354, Sub 356.

FEDERAL EXCESS DEFERRED INCOME TAXES

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO FEDERAL EXCESS DEFERRED INCOME TAXES.

A. In initial testimony, the Public Staff reserved the right to supplement its filing in this docket at a later date to include the flowback to ratepayers of EDIT related to the federal tax rate decrease. Late in its investigation, the Public Staff determined that it needed additional information from the Company to clarify the Company's position regarding how it intended to handle EDIT in this rate case proceeding, so that the Public Staff could make an informed recommendation. As a result, the Company provided the information requested by the Public Staff subsequent to the Public Staff's initial filing. I have reviewed the information provided by the Company, and recommend two adjustments based upon the information provided.

The federal EDIT consist of two categories, protected and unprotected. The protected EDIT are deferred taxes related to timing differences arising from the utilization of accelerated depreciation for tax purposes and another depreciation method for book purposes. These deferred taxes are deemed protected because the Internal Revenue Service (IRS) does not permit regulators to flow back the excess to ratepayers immediately, but instead requires that the excess be flowed back to ratepayers ratably over the life of the timing difference that gave rise to the excess, per IRC Section 203(e). EDIT resulting from all other timing differences are unprotected, and can be flowed back to ratepayers however quickly regulators deem reasonable.

Based upon the foregoing, I recommend three adjustments to flow the federal EDIT back to ratepayers, one relating to protected and two relating to unprotected.

First, I have made an adjustment to include the return of protected federal EDIT based upon the Company's calculation of the net remaining life of the timing differences. Boswell Exhibit 1 presents the impacts of the protected federal EDIT on rate base and the income statement. Public Staff witness Henry's Supplemental Exhibit I depicts the impact of the updated protected federal EDIT as shown on Boswell Exhibit 1.

For unprotected EDIT, I recommend removing the entire EDIT regulatory liability associated with the unprotected differences from rate base, and placing it in a rider to be refunded to ratepayers over three years on a levelized basis, with carrying costs. The immediate removal of unprotected EDIT from rate base increases the Company's rate base, and mitigates regulatory lag that might occur from refunds of unprotected EDIT not contemporaneously reflected in rate base.

Q. PLEASE EXPLAIN WHY THE UNPROTECTED EDIT SHOULD BE REFUNDED TO RATEPAYERS OVER A THREE-YEAR PERIOD.

A. The Company did not recommend any flowback of unprotected federal EDIT relating to the Federal Tax Cuts and Jobs Act in the present docket.

The tax normalization rules are very clear – either EDIT is protected or it is not. Excess taxes that have been previously recovered in rates, but will never be paid to the IRS, rightfully belong to the ratepayers and should be returned to them as soon as reasonably possible. It should be noted that the Company will continue to collect accumulated deferred income taxes (ADIT) at a tax rate sufficient to meet its tax obligations.

Furthermore, the Public Staff has provided the Company with the benefit of removing the total amount of the unprotected EDIT credit from rate base in the current case, thus providing the Company with an increase in rates to moderate any potential cash flow issues. The financing cost to the Company will be imposed ratably over the period that the EDIT is returned through the levelized rider.

Q. WHAT IS THE PUBLIC STAFF'S POSITION REGARDING APPLYING THE UNPROTECTED EDIT REGULATORY LIABILITY AGAINST DEFERRED REGULATORY ASSETS?

A. The Public Staff believes that in this case, offsetting known and measurable reductions in taxes to be paid going forward against either unknown future regulatory assets, or regulatory assets previously approved by the Commission for recovery over a specified period, presents significant intergenerational issues and constitutes inappropriate ratemaking. Existing deferred regulatory assets are the result of accounting adjustments approved or adopted by the Commission, the purpose of which typically is to spread the recovery of incurred costs over a specified period (the amortization period). The amortization period for each regulatory asset is approved by the Commission based upon its determination of what is fair and reasonable for the ratepayers with regard to the costs associated with that specific regulatory asset, or other specific factors taken into consideration by the Commission at the time of that approval. Choosing simply to offset the new unprotected EDIT regulatory liability with the remaining unamortized portion of any regulatory asset would effectively override the Commission's prior decision as to the appropriate amortization period for the regulatory asset, by equalizing that remaining amortization period and the amortization period for the new EDIT regulatory liability. The Public Staff believes that the amortization periods for existing regulatory assets and the unprotected EDIT regulatory liability should be determined separately, based on the specific characteristics of each cost or benefit. Departing from this transparent process in the course of a general rate case simply to offset flowing through the benefit of reductions in an entirely separate category of costs (income taxes) is neither fair nor reasonable.

In the case of unknown future possible regulatory assets or other costs, currently offsetting them against the EDIT liability would likewise be inappropriate, not only because those costs are not currently known and actual, but also because doing so would be prejudging the appropriate amortization period for those future costs.

Q. WHAT IS YOUR RECOMMENDATION REGARDING HOW THE COMPANY SHOULD REFUND THE OVERCOLLECTION OF FEDERAL TAXES DUE TO THE FEDERAL TAX CUTS AND JOBS ACT SINCE JANUARY 1, 2018?

A. I recommend that the Company refund to ratepayers the overcollection of federal taxes related to the decrease in federal tax rates for the period beginning January 1, 2018. Additionally, I recommend that the refund include corresponding interest calculated at the overall weighted cost of capital, and that it be made as a surcharge credit for a one-year period beginning when the new base rates become effective in the current docket. The Company did not file a proposal to return the overcollection.

Q. WHAT IS THE PUBLIC STAFF'S POSITION ON WHETHER THE COMPANY SHOULD BE ABLE TO RETAIN THE OVERCOLLECTION OF TAXES SINCE JANUARY 1, 2018?

A. The Public Staff believes the Commission's October 8, 2018, Order in Docket M-100, Sub 148 was explicitly clear that the overcollection of taxes since January 1, 2018 should be flowed back to ratepayers. These funds rightfully belong to the ratepayers and should be returned to them as soon as reasonably possible.

Q. DOES THE PUBLIC STAFF BELIEVE THE COMPANY SHOULD RETURN THE OVERCOLLECTION OF TAXES EVEN IF THE COMPANY DID NOT EARN ITS THEN APPROVED RATE OF RETURN?

A. The approved rate of return in any general rate case represents the amount the Company has the potential to earn, with proper management. It does not represent guaranteed dollars or return for the Company. The actual return earned by a utility fluctuates over time, and may fall below the approved rate of return for significant periods of time. Nevertheless, it is ultimately the utility's choice as to when it should file for a general rate increase; otherwise, its rates as they exist at any moment in time are generally presumed to recover its costs. In this particular instance, even if the Company has not been recovering its currently approved rate of return during 2018, applying the future Commission-mandated refund of overcollected income taxes against that past return deficiency would, in principle, constitute inappropriate retroactive ratemaking. The tax overcollection in question was to be used to pay taxes that the Company expected to owe. As of January 1, 2018, the overcollected taxes are no longer owed. The overcollection is ratepayer money that should not be utilized to assist the Company in attaining its return, and thus benefit its shareholders.

Q. WHY SHOULD THE INTEREST BE CALCULATED AT THE OVERALL WEIGHTED COST OF CAPITAL?

A. The interest should be calculated at the overall weighted cost of capital since the same methodology is utilized to calculate the revenue impacts of the collected taxes. Utilizing a lower rate would shortchange the ratepayers the full value of the refund.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

Carolina Water Serivce, Inc. of NC
Docket No. W-354, Sub 360
ADJUSTMENT TO FLOWBACK PROTECTED EDIT DUE
TO TAX CUTS AND JOBS ACT
For the Test Year Ended December 31, 2017

Boswell Exhibit 1

Line No.	Item	Amount	
1	Income statement		
2	Regulatory liability for federal tax change related to protected EDIT - NC retail	$4,907,523	1/
3	RSGM life of asset	45	2/
4	Annual amortization of protected EDIT - NC retail (L2 / L3)	109,056	
5	Income tax impact	(25,486)	3/
6	Annual amortization of protected EDIT - NC retail, net of tax (L4 + L5)	$83,570	
7	Rate base		
8	Adjustment to regulatory assets and liabilities (L4)	($109,056)	
9	Composite income tax rate	23.3700%	
10	Impact to accumulated deferred income taxes (L8 x L9)	25,486	
11	Adjustment to rate base (L8 + L10)	($83,570)	

1/ Based on Company amount of $4,907,523 grossed up per response to ADR34.4.
2/ Based on information provided by the Company in response to ADR34.4.
3/ Line 4 times composite income tax rate on Line 9.

Carolina Water Service, Inc. of NC
Docket No. W-354 Sub 360
CALCULATION OF LEVELIZED FEDERAL
UNPROTECTED EDIT RIDER CREDIT
For the Test Year Ended December 31, 2017

Boswell Exhibit 2

Line No.	Item	Year 1 Revenue Requirement		Year 2 Revenue Requirement		Year 3 Revenue Requirement		Total Revenue Requirement	
		(a)		(b)		(c)		(d)	
	Annuity Factor								
1	Number of years	3	1/						
2	Payment per period	1							
3	After tax rate of return	6.824%	2/						
4	Present value of 1 dollar over number of years with								
5	with 1 payment per year	2.6328							
6	1 plus (interest rate divided by two)	1.0341							
7	Annuity factor (L4 x L5)	2.7226							
8	Total NC retail regulatory liability to be amortized	$966,595	3/	$966,595	3/	$966,595	3/		
9	Annuity factor (L7)	2.7226		2.7226		2.7226			
10	Levelized rider federal EDIT regulatory liability (L8 / L9)	355,027		355,027		355,027		1,065,081	6/
11	One minus composite income tax rate	76.63%	4/	76.63%	4/	76.63%	4/	76.63%	4/
12	Net operating income effect (L10 x L11)	272,057		272,057		272,057		816,172	
13	Retention factor	0.765227	5/	0.765227	5/	0.765227	5/	0.765227	5/
14	Levelized rider federal EDIT credit (L5 / L6)	$355,525		$355,525		$355,525		$1,066,575	

1/ Rider period recommended by Public Staff.
2/ Boswell Exhibit 1, Schedule 2(a), Line 3.
3/ $966,595 Company-determined unprotected Federal EDIT grossed up per response to ADR34.4.
4/ One minus the composite income tax rate of 23.37%.
5/ Net Income retention factor.
6/ Sum of Columns (a) through Column (c).

Carolina Water Service, Inc. of NC
Docket No. W-354, Sub 360
CALCULATION OF ANNUITY FACTOR FOR EDIT LIABILITY RIDER
For the Test Year Ended December 31, 2017

Boswell Exhibit I
Schedule 2(a)

Line No.	Item	Amount	
	Annuity Factor		
1	Number of years	3	1/
2	Payment per period	1	
3	After tax rate of return (L9)	6.824%	
4	Present value of 1 dollar over number of years with with 1 payment per year	2.6328	
5	1 plus (interest rate divided by two)	1.0341	
6	Annuity factor (L4 x L5)	2.7226	

Line No.	Item	Capital Structure (a)		Cost Rates (b)		Overall Rate of Return (c)	6/	Net of Tax Rate (d)	
	After Tax Rate of Return								
7	Long-term debt	49.09%	2/	5.68%	4/	2.79%		2.14%	7/
8	Common equity	50.91%	3/	9.20%	5/	4.68%		4.684%	8/
9	Total	100.00%				7.47%		6.824%	

1/ Rider period recommended by Public Staff.
2/ Henry Supplmental Exhibit I, Schedule 1(a), Column (a), Line 7.
3/ Henry Supplemental Exhibit I, Schedule 1(a), Column (a), Line 8.
4/ Henry Supplemental Exhibit I, Schedule 1(a), Column (c), Line 7.
5/ Henry Supplemental Exhibit I, Schedule 1(a), Column (c), Line 8.
6/ Column (a) times Column (b).
7/ Column (c) times 1 minus the combined income tax rate of 23.37%.
8/ Amount from Column (c).