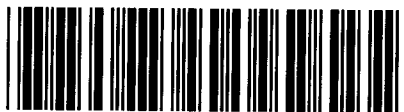




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APPLICATION OF MONARCH §
UTILITIES I, L.P. TO CHANGE RATES §
FOR WATER AND SEWER SERVICE §

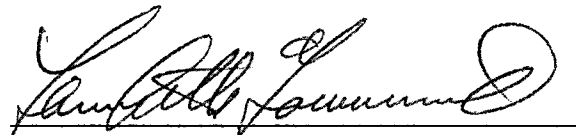
BEFORE THE STATE OFFICE
OF PUBLIC UTILITY COMMISSION
FILING CLERK
ADMINISTRATIVE HEARINGS

MONARCH UTILITIES I, L.P.'S ERRATA NO. 12
TESTIMONY OF JAMES I. WARREN

Monarch Utilities I, L.P.'s ("Monarch") files the attached errata to the testimony of James I. Warren. The errata to Mr. Warren's testimony is attached as Pages 21-23, and should be substituted for the testimony included within Monarch's rate filing package. The errata corrects (1) the requested return on page 21, line 12; (2) the synchronized interest on page 21, lines 14 and 15; (3) the Taxable Component of Return on page 22, line 15; and (4) federal income tax expense on page 23, lines 11 and 12.

Respectfully submitted,

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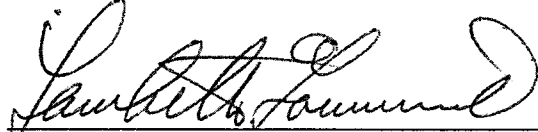
WILLIAM A. FAULK, III
State Bar No. 24075674

ATTORNEYS FOR MONARCH UTILITIES I, LP

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CERTIFICATE OF SERVICE

I hereby certify that on this 9th day of June, 2016, a true and correct copy of the foregoing document has been sent via facsimile, certified mail, return receipt requested, first class mail, or hand-delivered to all parties of record.



LAMBETH TOWNSEND

1 event for the imposition of a CTA. In short, no member of the SWMAC consolidated
2 group benefitted by virtue of the fact that Monarch was a member of the group.
3 Therefore, there is absolutely no basis on which to assign to Monarch any incremental
4 “fair share” of consolidated benefits. It simply did not even arguably contribute to
5 the creation of any such benefits.

6 **IX. THE CALCULATION OF INCOME TAX EXPENSE**

7 **Q. PLEASE DESCRIBE THE CALCULATION OF INCOME TAX EXPENSE.**

8 A. Monarch’s federal income tax calculation is set forth on Schedule II-E-3. That
9 schedule employs the return method (also referred to as “Tax Method 1”).

10 **Q. WHAT IS THE STARTING POINT FOR THE CALCULATION?**

11 A. The starting point for the calculation is the requested return. In this case, Monarch is
12 requesting a return of \$6,918,242 (\$5,963,512 water and \$954,730 wastewater).

13 **Q. HOW DOES THE FEDERAL INCOME TAX CALCULATION PROCEED?**

14 A. The return is first adjusted by synchronized interest of \$2,339,994 (\$2,017,070 water
15 and \$322,924 wastewater). This is done because part of the return consists of this
16 interest. Monarch can, for tax purposes, deduct its interest expense. As a
17 consequence, when it collects from its customers the amount necessary to fund its
18 interest expense, there is no net tax cost—that is, the taxable revenue it receives is
19 offset by the deductible interest it pays. Therefore, the portion of return attributable
20 to interest does not incur a net tax. On that basis, synchronized interest is removed
21 from the return so that only the equity component remains.

1 Q. WHAT OTHER ADJUSTMENTS ARE MADE TO THE RETURN?

2 A. The template provides for a number of such adjustments. However, in Monarch's
3 case, most of them do not apply. The template accommodates adjustments for the
4 amortization of ITC and EDIT. Because Monarch has no ITC or EDIT, there are no
5 adjustments for these items on its schedule. Adjustments are also made for items of
6 income or expense that are now, or were in the past, flowed through. Because
7 Monarch is fully normalized and this is its first rate case, there are no such
8 adjustments. Finally, adjustments would be appropriate for regulatory expenses that
9 provide no tax benefit because they are never deductible for tax purposes. Expenses
10 such as certain meals and entertainment expenditures, fines and penalties,
11 depreciation of the portion of an asset's basis attributable to equity AFUDC, etc. are
12 non-tax-deductible. To recognize the lack of a tax benefit, these amounts must be
13 added back to the equity return to derive the Taxable Component of Return.
14 Monarch's calculation includes no such adjustments. Monarch's Taxable Component
15 of Return is \$4,578,248 (\$3,946,441 water and \$631,807 wastewater).

16 Q. WHAT, THEN, IS DONE WITH THE TAXABLE COMPONENT OF
17 RETURN?

18 A. The Taxable Component of Return is then multiplied by a Tax Factor. The Tax
19 Factor is a factor that, when multiplied by the Taxable Component of Return,
20 produces the income tax that would be paid on the revenue that would be required to
21 yield an after-tax amount equal to the Taxable Component of Return. The formula
22 for deriving the Tax Factor is 1 divided by the inverse of the tax rate with the result
23 multiplied by the tax rate. Assuming an income tax rate of 35%, the Tax Factor is

1 53.85% $((1/(1-.35)) \times 35\%)$. A simple example proves the propriety of this formula.
2 If the Taxable Component of Return is \$100, then the associated federal income tax
3 expense would be \$53.85 $(\$100 \times 53.85\%)$. The proof is that if customers are
4 charged the aggregate of the Taxable Component of Return (\$100) and the income
5 tax expense (\$53.85), then Monarch would have taxable income of \$153.85. A 35%
6 income tax levied on that level of taxable income would produce an income tax of
7 \$53.85 $(\$153.85 \times 35\%)$. So, after paying its income tax, Monarch would retain
8 \$100—the Taxable Component of Return.

9 **Q. USING THE RETURN METHOD, WHAT IS MONARCH'S FEDERAL**
10 **INCOME TAX EXPENSE?**

11 A. Monarch's federal income tax expense computed as described above is \$2,358,492
12 (\$2,033,015 water and \$325,476 wastewater).

13 **Q. WHY DOES MONARCH USE A 51.52% TAX FACTOR RATHER THAN**
14 **THE 53.85% TAX FACTOR USED IN THE EXAMPLE ABOVE?**

15 A. While the applicable federal income tax rate for corporations that earn more than \$10
16 million of taxable income is the 35% used in the example, the tax rate for
17 corporations that earn less than \$10 million is only 34%. Since Monarch's pre-tax
18 book income is anticipated to be less than \$10 million, the availability of its
19 accelerated tax deductions (particularly accelerated depreciation) avoid tax at that
20 lower rate. Thus, Monarch proposes to charge customers for its deferred tax expense
21 computed at the beneficial 34% rate.