CA-T-1
DOCKET NO. 2008-0266

DIRECT TESTIMONY AND EXHIBITS

OF

RALPH C. SMITH, CPA

THE DIVISION OF CONSUMER ADVOCACY

SUBJECT: REVENUE REQUIREMENT

ADIT balance for the impact of 2009 bonus depreciation as well as the revisions to projected 2009 Plant additions and retirements, and should provide an updated 2009 test year ADIT balance that reflects the combined impact of these changes.

VI. NET OPERATING INCOME ADJUSTMENTS.

Q. HAVE YOU PREPARED AN EXHIBIT WHICH SUMMARIZES THE CONSUMER ADVOCATE'S ADJUSTMENTS TO NET OPERATING INCOME?

A. Yes. These adjustments are shown on CA-112. The recommended adjustments to net operating income are discussed in the same order as they appear on CA-112.

Q. DO YOU ALSO SHOW THE IMPACT OF EACH ADJUSTMENT ON INCOME TAX EXPENSE ON CA-112?

A. Yes. The impact of each adjustment on income tax expense is shown on CA-111, line 20. Income taxes are generally computed using the combined state and federal income tax rate of 38.91% shown on CA-102 and YB's workpapers.

A. Income Taxes – Interest Synchronization

Q. PLEASE EXPLAIN THE ADJUSTMENT FOR INTEREST SYNCHRONIZATION.

A. As shown on CA-113, the interest synchronization adjustment synchronizes the rate base and cost of capital with the tax calculation. It is calculated by applying the Consumer Advocate's recommended weighted cost of debt to the adjusted rate base for YB to obtain a synchronized interest deduction for use in the calculation of test year income tax expense. As shown on CA-113, I applied Consumer Advocate witness Parcell's recommended weighted cost of debt, which is 3.61% and can be found on CA-105, line 14, to the adjusted intrastate rate base amount in order to determine the pro forma interest deduction to be used in calculating income tax expense for the 2009 test year. The combined state and federal income tax rates are applied to the resulting interest deduction difference to determine the amount of adjustment to income tax expense for interest synchronization.

Q. IS THE INTEREST SYNCHRONIZATION ADJUSTMENT ROUTINELY ACCEPTED BY UTILITIES AND UTILITY REGULATORS AS AN APPROPRIATE AND NECESSARY ADJUSTMENT FOR RATEMAKING PURPOSES IN THE UTILITY RATE CASES IN WHICH YOU HAVE BEEN INVOLVED, ESPECIALLY IN RECENT YEARS?

A. Yes. Utilities and utility regulators routinely accept the interest synchronization adjustment as appropriate and necessary for ratemaking purposes in the utility rate cases in which I and other Larkin & Associates' expert witnesses and rate analysts have been involved. Typically, the interest synchronization adjustment is presented in the utility's initial filing and then is only adjusted, if necessary, for changes to rate base or cost of capital. The interest synchronization method is widely used by other utilities and utility regulatory commissions because it appropriately coordinates the elements of the ratemaking formula and is fair to all parties. In prior YB rate cases, the Consumer Advocate urged the Commission to adopt interest synchronization as official policy moving forward because it is a superior method that results in appropriate coordination of the elements of the ratemaking formula (rate base, rate of return, and operating expenses) and because it balances the concerns of all stakeholders in an impartial and equitable way.

Q. DID YB REFLECT AN INTEREST SYNCHRONIZATION ADJUSTMENT IN ITS FILING?

A. No. In fact, YB's calculation of income taxes for ratemaking purposes (on YB-EX-06A and 06B, page 1 of 8, respectively), shows that YB calculated income tax expense by multiplying the amounts on the line labeled as "Net Operating Income Before Income Taxes" by the combined Income Taxes rate of 38.9098%, without reflecting <u>any</u> deduction for interest expense. Thus, the income tax expense calculation used by YB has not been properly coordinated with its rate base or cost of capital. YB's response to CA-IIR-24 confirmed that: "YB did not reflect any interest expense deduction in its calculation of income taxes for rate making purposes."

Q. DOES YB'S CAPITAL STRUCTURE FOR RATEMAKING PURPOSES

INCLUDE DEBT?

A. Yes. Although YB's balance sheet does not include any long-term debt, and YB is nominally 100 percent equity financed, this is because YB's debt is managed by its parent company.[14] YB's capital structure for ratemaking purposes reflects 55 percent equity and 45 percent debt.[15] As summarized on CA-105, both YB witness Sterling and Consumer Advocate witness Parcell have proposed a capital structure and cost of capital for YB in the current case that reflects a weighted cost of debt of 3.61 percent. In the interest synchronization adjustment, the weighted cost of debt that is used for ratemaking purposes is multiplied by the adjusted rate base in order to derive the related synchronized interest expense used for ratemaking purposes.

Q. HAS THE COMMISSION ADOPTED THE INTEREST SYNCHRONIZATION ADJUSTMENT?

A. Yes. The Commission's Decision and Order No. 24068, filed on March 4, 2008, in Docket No. 04-0113 in a rate case involving Hawaiian Electric Company, Inc. ("HECO") adopted the interest synchronization adjustment.

Q. WHAT REASONS FOR <u>NOT</u> MAKING THE INTEREST SYNCHRONIZATION WERE PRESENTED IN DOCKET NO. 2006-0386, HECO'S 2007 TEST YEAR RATE CASE?

---

[14] See, e.g., YB's Application at page 41.
[15] Id. Also see CA-105, which summarizes the capital structure and cost of capital proposed by YB witness Dr. Sterling and CA witness Mr. Parcell.

A. The response to DOD-IR-104(e) in Docket No. 2006-0386 stated HECO's reasons for disagreeing with the interest synchronization procedure. HECO's primary reasons were basically that the Commission had not applied interest synchronization in prior cases, and that "interest synchronization imputes hypothetical interest on rate base funded by federal investment tax credits, which is interest-free."

Q. IS THAT A VALID REASON FOR NOT USING INTEREST SYNCHRONIZATION?

A. No. The objections that have historically been raised by utilities regarding the application of synchronized interest to rate base funded by federal investment tax credits have been thoroughly refuted. The controversy over interest synchronization on rate base funded by federal investment tax credits existed for several years, but is no longer a legitimate issue. Several FERC rate decisions in which interest was synchronized were appealed to the Courts by the respective utilities on the grounds that such orders placed the companies' Investment Credits in jeopardy. In each instance, the Appeals Court upheld the FERC decision. Nevertheless, the controversy continued.

In 1985, the IRS finally agreed to clarify its position on the matter of interest synchronization. After extensive consideration, it issued Treasury Decision 8089 in May, 1986. That document contained final regulations clearly indicating that interest synchronization was <u>not</u> a violation of the Internal

Revenue Code for utilities that selected Option 2 for ratemaking. The IRS concluded that synchronization of interest does not result in a reduction of cost of service that is attributable to the Credit. That conclusion was based on the presumption similar to the reasoning underlying the aforementioned decisions of the appeals Court, that:

> "In the absence of the credit the additional capital needed to finance investment property generally would be obtained from a similar proportion of debt and equity as in the existing capital structure of the utility. Synchronization of interest properly takes into account the additional interest expense that would have been incurred in those circumstances."

Q. ARE YOU AWARE OF ANY THEORIES THAT COULD BE ASSERTED BY A UTILITY AS A REASON FOR FAILING TO MAKE AN INTEREST SYNCHRONIZATION ADJUSTMENT?

A. Not valid ones. As noted above, many years ago, before the interest synchronization adjustment began to gain overwhelming regulatory support and recognition, sometimes utilities would assert that it could result in a “normalization violation” under the Internal Revenue Code and thus jeopardize the use of accelerated tax depreciation or investment tax credits. However, as described above, it has subsequently become well settled and widely acknowledged that such arguments have no current validity. Consequently, the interest synchronization adjustment is routinely made in utility rate cases, and the basic calculation method, or its validity and appropriateness, is typically no longer even a topic of debate.

Q. WHAT ADJUSTMENT TO YB'S INCOME TAX EXPENSE RESULTS FROM THE INTEREST SYNCHRONIZATION ADJUSTMENT?

A. As shown on CA-113, applying the weighted cost of debt recommended by Consumer Advocate witness Parcell to my adjusted intrastate rate base produces a synchronized interest amount for use in computing income tax expense for ratemaking purposes. As shown on CA-113, the interest synchronization adjustment reduces YB's proposed income tax expense by $945,000.

B. Cost Savings Related to Tug Operations and Sailing Schedule Changes

Q. PLEASE EXPLAIN THE ADJUSTMENT FOR COST SAVINGS RELATED TO TUG OPERATIONS AND A SAILING SCHEDULE CHANGE.

A. In response to informal discovery, YB has identified net savings of $810,502 related to changes in its tug operations and sailing schedule. YB's response to CA-IIR-26 confirmed that this $810,502 of net savings is not reflected in the 2009 Test Year that YB submitted with the application filed on December 19, 2008. These savings are known and measurable and were not included in YB's 2009 Test Year. Consequently, an adjustment should be made to reflect these savings. This net savings amount incorporates changes in depreciation and