COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
	)	
ADJUSTMENT OF THE RATES OF KENTUCKY-AMERICAN WATER COMPANY	)	**CASE NO. 2004-00103**
	)	

REBUTTAL TESTIMONY
OF
JAMES I. WARREN
ON BEHALF OF
KENTUCKY-AMERICAN WATER COMPANY

October 8, 2004

1 **CASE NO. 2004-00103**

2 **REBUTTAL TESTIMONY OF JAMES I. WARREN**

3

4 Q 1. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

5 A. My name is James I. Warren. My business address is 875 Third Avenue, New York,

6 New York 10022.

7 Q 2. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

8 A. I am a tax partner in the law firm of Thelen Reid & Priest LLP.

9 Q 3. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT THELEN REID &

10 PRIEST LLP.

11 A. I am engaged in the general practice of taxation. I specialize in the taxation of and the

12 tax issues relating to regulated public utilities. Included in this area of specialization is

13 the treatment of taxes in regulation. I also chair the firm's Tax, Benefits and Trusts and

14 Estate Department.

15 Q 4. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

16 A. I joined Thelen Reid & Priest in November of 2003. Prior to that time I was affiliated

17 with the international accounting firms of Deloitte & Touche LLP (Oct. 2000 – Sept.

18 2003), PricewaterhouseCoopers LLP (Jan. 1998 – Sept. 2000) and Coopers & Lybrand

19 (Mar. 1979 – June 1991) and the law firm, Reid & Priest LLP (July 1991 – Dec. 1997).

20 At each of these professional services firms, I provided tax services primarily to utility

21 industry clients. My practice has included tax planning for the acquisition or transfer of

22 business assets, operational tax planning and the representation of clients in tax

23 controversies with the Internal Revenue Service (IRS) at the audit and appeals levels. I

1 have often been involved in procuring rulings or technical advice from the IRS National
2 Office. On several occasions, I have represented one or more segments of the utility
3 industry before the IRS and/or the Department of Treasury regarding certain tax positions
4 adopted by the federal government. I have testified regarding tax, tax accounting and
5 regulatory tax matters before a number of regulatory bodies including the FERC and the
6 commissions in Florida, Louisiana, Nevada, New Jersey, New York, Connecticut,
7 Maryland, Missouri, Illinois, Pennsylvania and Texas. I have also testified before several
8 Congressional committees and subcommittees and at the Department of Treasury
9 hearings regarding legislative and administrative tax issues of significance to the utility
10 industry. I am a member of the New York and New Jersey Bars and also am licensed as
11 a Certified Public Accountant in those two states. I am a member of the American Bar
12 Association, Section of Taxation where I am a past chair of the Committee on Regulated
13 Public Utilities and also a member of the AICPA.

14 Q 5. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

15 A. I received a B.A. (Political Science) from Stanford University, a law degree (J.D.) from
16 New York University School of Law, a Master of Laws (LL.M.) in Taxation from New
17 York University School of Law and a Master of Science (M.S.) in Accounting from New
18 York University Graduate School of Business Administration.

19 Q 6. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

20 A. I am testifying on behalf of Kentucky-American Water Company ("KAWC" or
21 "Company") in response to the direct testimony filed by Andrea Crane of The Columbia
22 Group, Inc. ("Columbia") on behalf of the Attorney General. Specifically, I shall rebut
23 Ms. Crane's proposal that it would be appropriate for this Commission to impute in

1 ratemaking for KAWC a benefit attributable to the tax effect of costs incurred by (and tax
2 deductions claimed by) various non-regulated businesses conducted within the American
3 Water Works consolidated tax group ("AWW Group"). Columbia refers to this as a
4 consolidated tax adjustment ("CTA").

5 Q 7. WILL YOU SUMMARIZE YOUR TESTIMONY?

6 A. Yes, I will. I believe that this is the wrong forum for the consideration of a CTA, should
7 this Commission decide to seriously entertain the proposal. However, on the merits, I
8 believe that a CTA is inappropriate because it extracts the tax benefits from those who
9 are most responsible for them and gives them over to a class which has virtually no claim
10 to them. This amounts to a cross-subsidy. The mechanics of the proposed CTA
11 themselves demonstrate its flawed nature. I also believe that several aspects of this
12 proposal define it as "result oriented" rather than principled and, for that reason, it should
13 be viewed skeptically.

14 Q 8. AS A THRESHOLD MATTER, DO YOU BELIEVE THAT THIS PROCEEDING
15 COULD EVER BE AN APPROPRIATE FORUM IN WHICH TO IMPOSE A CTA?

16 A. No I do not.

17 Q 9. WHY NOT?

18 A. The vast preponderance of states do not impose CTAs of any type. Probably the most
19 comprehensive and thoughtful analysis of this type of proposal was produced by the
20 FERC in its Columbia Gulf Transmission Company decision (23 FERC ¶61,396 [1983]).
21 Notwithstanding the power of the FERC's reasoning, there are, as Ms. Crane, points out,
22 a very few states – three, in fact - which she identifies as imposing CTAs (I would note
23 that Texas generally imposes a CTA as well). However, even within this exclusive club,

1 the mechanics of the CTAs vary. New Jersey generally imposes a “comprehensive rate
2 base” CTA (where allocable tax benefits are computed based on 15 year schedules of
3 taxable income and loss for each member of a consolidated group and any benefit which
4 is allocated to a utility is used to reduce rate base). West Virginia, by contrast, employs a
5 “parent company” CTA (where it is only the parent company tax loss that is allocated).
6 There are numerous other possible CTA types. Texas often uses a procedure referred to
7 as the “interest credit” method (where allocated tax benefits computed based on 15 years
8 of historical results are multiplied by the long term debt cost). The particular mechanics
9 of each of these procedures are not important. What is important is (1) CTAs are not the
10 rule, they are the rare exception, and (2) even among the circumscribed group of states in
11 which they are employed, their mechanics vary significantly from state to state.
12
13 In Kentucky, there are a significant number of utilities that most probably file as part of
14 consolidated tax groups. Thus, a large percentage of the utilities in this state would likely
15 be affected should this Commission’s decide to adopt a CTA of any type. Moreover,
16 assuming for the sake of argument, that this Commission was inclined to adopt a CTA,
17 the precise type of adjustment would likely have radically different implications for
18 different companies. And finally, the adoption by this Commission of a new and
19 different ratemaking procedure which is clearly “shareholder unfriendly” may have
20 adverse financial market implications for the utilities operating in this state.
21
22 To my knowledge, the Kentucky Commission has never previously imposed a CTA. The
23 adoption of this type of adjustment would, therefore, represent a significant change in

1 regulatory policy. A shift of this magnitude, with potentially far-reaching implications
2 for all Kentucky utilities and which may well create "winners" and "losers" (at least on a
3 relative basis) should not be entertained within the context of a relatively modestly-sized
4 rate proceeding where only a single alternative is offered. If it is to be considered at all, it
5 should be a forum in which all of the interested parties can present their various positions
6 and all of the implications to all affected parties can be considered.
7 Q 10. WHAT IS THE AMOUNT OF THIS PROPOSED BENEFIT IMPUTATION AND
8 HOW IS IT COMPUTED?
9 A. Ms. Crane proposes to reduce KAWC's tax element of cost of service by $192,903 (see
10 Schedule ACC-39). This amount is the average of the results of an allocation process
11 applied to each of the tax years 2000, 2001 and 2002. In each of those years, the
12 following allocation process is followed. Each non-regulated member that produced a
13 tax loss is identified and the tax losses of all of the members so identified are aggregated.
14 Next, each member (regulated and non-regulated) that produced taxable income is
15 identified and the taxable incomes of all of the members so identified are aggregated. A
16 ratio is made between the taxable income of KAWC and the aggregate taxable income of
17 the members with positive taxable income. This ratio then is applied to the aggregate of
18 the tax losses produced the those non-regulated members with tax losses. The results of
19 this computation for each of the three years is averaged and then multiplied by the federal
20 statutory tax rate (35%). The result is the $192,903 figure referenced above.
21 Q 11. HOW WOULD YOU DESCRIBE THIS ALLOCATION PROCESS?
22 A. I would describe this process as an allocation of the benefits of the tax losses of non-
23 regulated members to those members with taxable income in proportion to the relative

1 amounts of taxable income.

2 Q 12. DO YOU BELIEVE THIS IS AN APPROPRIATE ADJUSTMENT?

3 A. No I do not.

4 Q 13. WHAT APPEARS TO BE THE THEORETICAL BASIS FOR COLUMBIA'S

5 PROPOSAL?

6 A. The foundation for this proposal appears to be embodied in the following three

7 statements made on page 73 of Ms Crane's testimony:

8 1. "By filing a consolidated return, KAWC can take advantage of tax losses

9 experienced by other member companies."

10 2. "The tax loss benefits generated by one group member can be shared by

11 the other consolidated group members, resulting in a reduction in the effective federal

12 income tax rate of the Company."

13 3. "These tax benefits should be flowed through to ratepayers because these

14 benefits reflect the actual taxes paid."

15

16 Even a cursory analysis of these statements shows them to be, at best, logically circular

17 and, at worst, factually deficient.

18 Q 14. IN WHAT WAY IS THE FIRST STATEMENT LOGICALLY CIRCULAR OR

19 MISLEADING?

20 A. The tax law itself bestows no "advantage" whatsoever upon KAWC by virtue of its

21 filing as part of a consolidated tax group. The only arguable "advantage" to KAWC is

22 one bestowed by the action of regulators in the event they impose a CTA. Thus, any

23 "advantage" is produced not by the tax law but by the regulatory process of confiscating

1 a benefit produced by an affiliate. There is an "advantage" only if this Commission
2 creates one.
3 Q 15. IN WHAT WAY IS THE SECOND STATEMENT LOGICALLY CIRCULAR OR
4 MISLEADING?
5 A. The only "sharing" that takes place is where a CTA adjustment is imposed. Thus, any
6 such "sharing," again, would be attributable to regulatory action, not the tax law. And,
7 as will be discussed in more detail hereafter, this is not a sharing at all but a confiscation
8 of the entire benefit of the tax attributes of expenditures made by other companies which
9 conduct activities completely unrelated to KAWC.
10 Q 16. IN WHAT WAY IS THE THIRD STATEMENT MISLEADING?
11 A. Ms. Crane uses the phrase "actual taxes paid." While that phrase may have some
12 superficial appeal, any thoughtful analysis shows it not to be particularly useful in the
13 context of setting utility rates. The tax expense element of cost of service has always
14 focused on ascertaining the tax costs and benefits associated with the provision of
15 regulated service. Thus, the tax benefit of a disallowed or excluded cost (*e.g.*,
16 institutional, promotional or political advertising or charitable contributions) is never
17 used to reduce the tax expense element of cost of service even when it produces a
18 reduction in the company (or group) taxes paid. Nor would the "actual taxes paid" by a
19 single corporation engaged in both a regulated and a non-regulated business be an
20 appropriate input to the tax expense element of cost of service. Moreover, allocations
21 employed by multi-state utility companies, multi-service-line (*e.g.*, electric and gas)
22 utility companies and multiple regulation (*e.g.*, state and FERC) utility companies all
23 "de-link" the tax expense element of cost of service from any particular corporate tax

1 liability. Finally, it goes without saying that deferred tax expense, a critical part of the
2 computation of tax expense, is not "actually paid" – at least, not immediately. Thus, the
3 use of the term "actual taxes paid" in the context of ratemaking certainly doesn't add
4 much, if anything, to further one's understanding of how to determine tax expense.

5 Q 17. IS THERE AN INCONSISTENCY EVEN WITHIN MS. CRANE'S PROPOSED
6 ADJUSTMENTS?

7 A. Yes there is. On the one hand, on page 73 of its testimony, Ms. Crane pays homage to
8 "actual taxes paid." Ironically, on page 74, the very next page, she proposes to adjust
9 tax expense on account of an interest synchronization adjustment. Such an adjustment
10 moves tax expense yet farther away from "actual taxes paid." This blatant inconsistency
11 clearly discloses a "results-oriented," rather than a principled, approach.

12 Q 18. ARE THERE ANY NON-REGULATORY POLICY CONSIDERATIONS THAT
13 SUPPORT YOUR OPPOSITION TO THE IMPOSITION OF A CTA OF ANY TYPE?

14 A. There are two. The first is a tax policy consideration. Congress first provided the
15 ability to file a consolidated tax return in 1918. The purpose of this was to promote
16 economic efficiency by allowing business considerations, rather than tax considerations,
17 to govern the choice of the form of a business where there was a single economic unit.
18 For example, if a taxpayer had a successful business and wanted to enter a second, risky
19 business, Congress did not want to force a choice between insulation from liability by
20 using the corporate form and the ability to "income net" for tax purposes by using the
21 divisional form. Consolidated filings allowed both. The imposition of a CTA re-
22 elevates the form of business. If an enterprise which produces tax losses were operated
23 as a discrete corporation, an affiliated utility might have its rates reduced. If the same

1 enterprise operated as a division of a larger corporation which did not produce tax
2 losses, the affiliated utility would not have its rate reduced. In a "CTA world,"
3 operational structure becomes critical. Given the current availability of the limited
4 liability company (LLC) form, in many, if not most, situations, CTAs can be avoided by
5 paying attention to entity type.
6
7 The second consideration is an economic one. Most businesses of any size operate as
8 part of a consolidated tax group. A non-regulated business which produces tax (but not
9 necessarily economic) losses is inherently less profitable where it is included in a
10 consolidated tax group that includes a regulated entity that is subject to CTA ratemaking
11 than is precisely the same business operated by a corporation which is included in a
12 consolidated tax group that includes either no regulated enterprises or regulated
13 enterprises that are not subject to CTA ratemaking. Thus, the imposition of a CTA
14 produces a "skewed" playing field.
15 Q 19. ASIDE FROM POLICY CONSIDERATIONS, WHY DO YOU BELIEVE THAT
16 CTAS OF ANY TYPE ARE INAPPROPRIATE?
17 A. The primary reason I believe they are inappropriate is that they provide customers with a
18 cost-of-service adjustment which bears no relationship whatsoever to the provision of
19 regulated services. The cost-of-service is arbitrarily reduced merely because the
20 regulated company which services them happens to file as part of a consolidated tax
21 group with one or more corporations that happen to produce tax losses.
22 Q 20. WHAT IS YOUR VIEW OF "CONSOLIDATED TAX SAVINGS?"
23 A. "Consolidated tax savings," when used in a utility rate proceeding in one of those few

1 jurisdictions in which it is even considered, generally refers to the ability within a
2 consolidated tax return to offset tax net operating losses ("NOLs") incurred by one or
3 more corporate members against taxable income produced by one or more other
4 corporate members. I will hereafter refer to this feature of consolidated filing as "income
5 netting."

6 Q 21. TO WHICH ENTITIES DOES MS CRANE'S PROPOSAL ALLOCATE THE
7 BENEFITS OF "INCOME NETTING?"

8 A. Ms. Crane's proposal allocates the benefits of income netting exclusively to those
9 companies producing taxable income. And it does so on a year-by-year basis so that no
10 corporation can ever derive a tax advantage of its own NOL.

11 Q 22. IN GENERAL, WHAT IS THE BASIC PRINCIPLE BY WHICH YOU APPROACH
12 TAX ALLOCATION?

13 A. I attempt to ascertain which member is most responsible for producing the tax benefit or
14 incurring the tax cost. I then allocate that tax consequence to that member.

15 Q 23. YOU USE THE PHRASE "MOST RESPONSIBLE," WHY?

16 A. The tax law is very complex when applied to a single corporation. When it is applied to a
17 group of corporations, the many interactions of situations which routinely occur often
18 result in no single member being definitively and exclusively responsible for a particular
19 tax outcome. Thus, any attempt to allocate consolidated taxes must, in many situations,
20 involve an inquiry into the member most responsible. The relevant question is, if the
21 benefit has to go somewhere, which member has the strongest claim?

22 Q 24. WHAT DOES THIS SUGGEST WITH REGARD TO THE ALLOCATION OF THE
23 BENEFIT OF "INCOME NETTING?"

1 A. It suggests that a simple "but for" analysis is inappropriate. The "but for" analysis I refer
2 to is the one that is based on the statement, "But for the taxable income of KAWC and
3 the other taxable members, the NOLs of certain non-regulated affiliates could not have
4 been used and, thus, the tax benefits could not have been produced."

5 Q 25. WHY DO YOU BELIEVE THIS ANALYSIS IS FLAWED?

6 A. While it is appealingly simple, it is grossly incomplete. It is just as true that, "But for the
7 NOLs of the tax loss affiliates, there would have been no tax reduction."

8 Q 26. WHAT ARE THE ELEMENTS OF KAWC'S CLAIM TO THE BENEFIT OF
9 "INCOME NETTING?"

10 A. In order to determine which consolidated group member possesses the highest
11 entitlement, further inquiry into each member's contribution to the creation of the benefit
12 is necessary. With regard to KAWC, its only contribution to the creation of the benefit
13 was its production of taxable income – something it would have done in precisely the
14 same way and in precisely the same amount whether or not there was an "income
15 netting" benefit to be had. By itself, KAWC could have done absolutely nothing to
16 produce the benefit. In short, KAWC was a completely passive participant and, to the
17 extent it is allocated any of the benefit, it would be fair to say that the benefit essentially
18 "falls into its lap." It reaps a windfall.

19 Q 27. WHAT ARE THE ELEMENTS OF THE TAX LOSS MEMBERS' CLAIMS TO THE
20 BENEFIT OF "INCOME NETTING?"

21 A. By far the most important element is that each dollar of NOL represents a dollar
22 expended or a dollar of liability incurred by the tax loss member. In other words, each
23 loss member suffered a substantive change in its economic position to produce the NOL.

1 Q 28. ARE THERE ADDITIONAL ELEMENTS OF THE TAX LOSS MEMBERS' CLAIMS
2 TO THE BENEFIT OF "INCOME NETTING?"
3 A. Yes. In many cases, the NOLs exist as a result of choices made by the loss companies
4 that produced them. This control over the existence of the NOLs is yet another factor
5 that supports the proposition that they are "most responsible" for their respective NOLs.
6 Q 29. CAN YOU PROVIDE EXAMPLES OF HOW, IN MANY CASES, THE LOSS
7 MEMBERS "CONTROL" THE EXISTENCE OF THEIR NOLS?
8 A. Yes, I can. The tax loss members could have done a fair amount to render their
9 expenditures "tax efficient" even in the absence of the consolidated return. First and
10 foremost, they could have moderated their deductible expenditures. For example, they
11 could have leased depreciable assets instead of owning them, extracting the benefits of
12 accelerated tax depreciation through lower lease payments. They could have organized
13 along alternative lines. For example, they could have operated as divisions of larger
14 corporations or as wholly owned limited liability companies (the existence of which are
15 ignored for tax purposes). They could have co-ventured in partnership form and specially
16 allocated deductible items to a co-venturer that could make efficient use of additional tax
17 deductions in exchange for enhanced ownership terms.
18 Q 30. WHAT DOES THIS SUGGEST REGARDING THE TAX LOSS MEMBERS'
19 ENTITLEMENT?
20 A. It was well within the power of many of the tax loss members to recognize the tax
21 benefits (directly or indirectly) in the absence of KAWC's or any other member's taxable
22 income. The implementation of alternative strategies was, however, unnecessary due to
23 the fact that other group members did in fact produce taxable income. This element of

1 control over the recognition of tax benefits further supports the notion that the loss
2 members are the ones “most responsible” for the NOLs and that, therefore, the benefit of
3 “income netting” should properly reside with those companies.

4 Q 31. BASED ON THE ABOVE, WHICH MEMBER DO YOU BELIEVE IS “MOST
5 RESPONSIBLE” FOR THE BENEFITS OF “INCOME NETTING?”

6 A. It is clear to me that it is the tax loss members that are “most responsible” for the cash
7 benefits of their NOLs when those benefits are realized by the consolidated group and
8 they should, therefore, be allocated the benefit.

9 Q 32. IN YOUR EXPERIENCE, IS PAYING EACH TAX LOSS MEMBER FOR THE TAX
10 BENEFIT OF ITS NOL AS THAT NOL REDUCES THE GROUP’S TAXABLE
11 INCOME A COMMON TAX ALLOCATION METHODOLOGY?

12 A. This is the method employed by the vast preponderance of consolidated groups with
13 which I am familiar – both those which include utility members and those that do not. I
14 have been advised that it is AWW’s method. In fact, I cannot recall seeing a consolidated
15 tax group that does not compensate members for utilized benefits.

16 Q 33. IN YOUR VIEW, DOES A CTA EFFECT A CROSS-SUBSIDY?

17 A. Yes it does. It is interesting to note that Ms. Crane does not include the NOLs of other
18 AWW group regulated companies in her computation. Her ostensible rationale for this
19 exclusion is that, ”…since the adjustment is prospective, tax losses generated by
20 regulated entities are not allocated, since such tax losses are not expected to reoccur in
21 the future.” However, she offers absolutely no analysis to support this expectation. In
22 fact, in a world in which there is bonus depreciation allowing the “write off” in the first
23 year of more than 30% of the cost of assets placed in service between 9/11/01and 5/5/03

1 and more than 50% of the cost of assets placed in service between 5/6/03 and 12/31/04,
2 capital intensive, regulated companies are unusually prone to NOLs. It is notable that
3 Ms. Crane makes no effort whatsoever to ascertain the extent to which the tax losses of
4 any non-regulated companies are expected to reoccur. It is my belief that this
5 "expectation" is no more than a convenient way to avoid the unseemly situation where
6 one regulatory jurisdiction extracts the benefit of tax losses from another regulatory
7 jurisdiction. But that is just what the theory underlying CTAs requires. In fact, such a
8 reticence to do this recognizes the true nature of the proposed adjustment. While Ms.
9 Crane may be uncomfortable extracting tax benefits associated with expenditures made
10 on behalf of other ratepayers, she has no such compunction when the expenditures are
11 made on behalf of shareholders. This, again, demonstrates a "result oriented," rather than
12 a principled, approach.

13 Q 34. PLEASE ELABORATE ON YOUR PREVIOUS STATEMENT THAT THE
14 PROPOSED CTA CONFISCATES THE ENTIRE TAX BENEFIT OF
15 EXPENDITURES MADE BY OTHER COMPANIES.

16 A. This is best understood with the assistance of a simplified illustration. Assume three
17 corporations, Holdco, Utility and Corp. A, file as part of a consolidated tax group.
18 Holdco has no income or expense. Utility produces $100 of taxable income in each of
19 Years 1 and 2. Corp. A, a non-regulated operation, must spend $100 to attract $100 of
20 revenue. If Corp. A incurs its expense on December 31 of Year 1 and realizes the
21 revenue on January 1 of Year 2, the very next day, it will reflect a $100 NOL in Year 1
22 and $100 of taxable income in Year 2. This situation is depicted as follows:
23

	Holdco	Utility	Corp.A	Total
Year 1	$0	$100	($100)	$0
Year 2	$0	$100	$100	$200
Total	$0	$200	$0	$200

If Corp. A had filed on an unconsolidated basis, it could have carried forward its Year 1 NOL to offset Year 2's taxable income and would have paid no tax. However, because it files as part of a consolidated tax group with Utility, under Columbia's proposal, Corp. A's Year 1 NOL would be allocated to Utility and customer rates would be reduced to reflect the tax benefit of that NOL. Thus, the tax benefit produced by Corp. A's expenses would be extracted from the group for the benefit of KAWC's customers even though (1) they did not fund the costs that produced the benefit and (2) the benefit could have been realized by Corp. A had it not filed on a consolidated basis. Significantly, there is no mechanism to recoup all or any portion of the benefit passed through to KAWC's customers. Moreover, it is the entire benefit of the NOL.

Q 35. IS THIS A REALISTIC SITUATION?

A. While it is a highly unlikely situation, it points out some of the major conceptual flaws and discontinuities of CTAs in general and of the particular CTA proposed by Ms. Crane.

Q 36. WITH REGARD TO THE PARTICULAR CTA PROPOSED BY MS. CRANE, ARE YOU SATISFIED WITH THE USE OF A THREE YEAR AVERAGE ALLOCATED TAX BENEFIT?

A. Absolutely not. Ms. Crane tacitly admits that no one year is predictive. The necessity of a three year average bears testimony to the general unpredictability of NOLs. However,

1 she presumes that if she averages three non-predictive data points, she gets a predictive
2 one. NOLs are highly variable. Hurricanes, law changes, major investments, customer
3 bankruptcies, interest rate swings – the list of non-recurring, unusual or even unique
4 events that impacts NOL creation is extensive if not endless. When it comes to NOLs,
5 the predictive power of history is often highly questionable.

6 Q 37. IF MS. CRANE'S PROPOSAL IS ADOPTED, WHAT WILL BE THE EFFECT ON
7 KAWC'S ABILITY TO EARN ITS ALLOWED RATE OF RETURN?

8 A. If a CTA of any type is imposed, KAWC's ability to earn its allowed rate of return will
9 be compromised. If a CTA is imposed, even if KAWC earns precisely the level of
10 revenues predicted in this rate proceeding, incurs precisely the level of expenses
11 predicted, owns precisely the projected level of rate base and incurs precisely the
12 predicted cost of capital, it will not earn its allowed return. This is because a CTA is an
13 imputed, not an actual, benefit. The only way it gets reflected in the company's financial
14 reports is as a reduction in revenues. There is no offsetting benefit. Holding all other
15 elements the same, diminished revenues translate into diminished return. Thus, the
16 imposition of a CTA effectively reduces the Company's allowed return.

17 Q 38. DOES THIS CONCLUDE YOUR TESTIMONY?

18 A. Yes it does.