BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Docket No. R-2015-2518438

UGI Utilities, Inc. – Gas Division

Statement No. 10-R

[PUBLIC VERSION]

Rebuttal Testimony of Nicole M. McKinney

Topics Addressed:	Consolidated Tax Savings Adjustment Repairs Tax Deduction Tax Updates to Exhibit A (Fully Projected)

Dated: May 10, 2016

I. INTRODUCTION

Q. Please state your full name and business address.

A. My name is Nicole M. McKinney. My business address is 2525 North 12th Street, Suite 360, Reading, PA, 19612-2677.

Q. Did you previously submit direct testimony in this proceeding on behalf of UGI Utilities, Inc. – Gas Division ("UGI Gas" or the "Company")?

A. Yes. I submitted my direct testimony, UGI Gas Statement No. 10, on January 19, 2016.

Q. What is the purpose of your rebuttal testimony?

A. My testimony responds to certain portions of the following direct testimony submitted by intervenors: the Direct Testimony of Lisa A. Gumby, I&E Statement No. 2; and the Direct Testimony of David J. Effron, OCA Statement No. 1. First, my testimony provides updates to certain income tax calculations in UGI Gas's Exhibit A - Fully Projected. Next, I address OCA's recommended treatment for the repairs tax deduction. Finally, I will address I&E's and OCA's recommended consolidated tax savings adjustments.

II. TAX RELATED UPDATES

Q. Do you have any updates to the income tax adjustments reflected in UGI Gas Exhibit A - Fully Projected?

A. Yes. UGI Gas has made two adjustments to UGI Gas Exhibit A - Fully Projected to recognize: (i) appropriate pro-rationing of the Company's fully projected future testy year ("FPFTY") accumulated deferred income taxes ("ADIT"); and (ii) a change in the Company's estimate of the FPFTY repairs tax deduction.

As explained in the Company's discovery response to I&E RE-23-D, UGI Gas mistakenly omitted the pro-rata calculation required under Treasury Regulation 1.167(l)-1(h)(6)(ii) that is necessary to be in compliance with IRS normalization requirements.[1] The pro-rationing concept requires that utilities pro-rate their rate base ADIT deduction to account for the time the ADIT will be accrued by the company. This pro-rata calculation is required by the IRS in order for a utility company to be permitted to use accelerated depreciation and not have a normalization violation. As such, the Company's update properly reflects a pro-rationing of the ADIT associated with its FPFTY plant additions. This is in line with other public utility FPFTY presentations, including that of Columbia Gas of Pennsylvania and PPL Electric Utilities. Corporation.

The second adjustment is to increase the Company's repairs tax deduction as explained in the Company's discovery response to I&E RE-49.2.[2] For the FPFTY, the company increased its estimated repairs tax deduction from $22,541,000 to $45,715, 000. This increase in the repairs tax deduction combined with pro-rating the ADIT, caused an overall decrease in the ADIT from $307,196,000 to $291,498,000 but also results in a substantially higher Repairs

[1] A copy of the Company's discovery response to I&E RE-23-D is attached to my Rebuttal Testimony as UGI Gas Exhibit NMM-1. This original response did not incorporate the change to the FPFTY repairs tax deduction estimate.

[2] A copy of the Company's discovery response to I&E RE-49.2 is attached to my Rebuttal Testimony as UGI Gas Exhibit NMM-2.

Tax related rate base deduction (previously 59,527,000, now $ 98,884,000 million) as reflected in Schedule C-6.

These updates to the ADIT and FPFTY repairs tax deduction are reflected on Schedules C-6 and D-34, respectively, of UGI Gas Exhibit A - Fully Projected (REVISED), as sponsored by the Rebuttal Testimony of Ms. Kelly, UGI Gas Statement No. 2-R.[3]

III. <u>TREATMENT OF REPAIRS TAX DEDUCTION</u>

Q. Please summarize the Company's federal repairs tax deduction proposal.

A. As explained in my Direct Testimony, UGI Gas Statement No. 10, UGI Gas is proposing to continue to normalize the tax repairs expense deduction for federal income tax purposes over the book life of the plant giving rise to the deduction. This continues the practice the Company has consistently followed since the adoption of the repairs allowance in 2009.

Q. Is the Company's state and federal treatment of the repairs tax deduction the same?

A. No. For state income tax purposes, the Company is continuing its current methodology of treating the repairs tax deduction like regular state accelerated depreciation and flowing through the benefit over the tax depreciable lives of the

[3] The change in the Company's estimate of the FPFTY repairs tax deduction also impacted its original pro-rata calculation submitted in discovery response I&E RE-23-D. See UGI Gas Exhibit NMM-3 for the revised pro-rata calculation which incorporates the changes of the FPFTY repairs tax deduction.

assets that generated the repairs tax deduction rather than the book depreciable lives.

Q. At pages 26-29 of OCA Statement No. 1, Mr. Effron recommends that the fully projected future test year ("FPFTY") federal and state repairs tax deduction be flowed through in its entirety in the determination of the income tax expense included in the cost of service. Does the Company agree with Mr. Effron's federal repairs tax deduction proposal?

A. No. The Company believes that the regulatory treatment of the federal repairs tax deduction should be normalized. The Company has consistently normalized for the federal repairs tax deduction since its adoption in 2009, and this approach is fully consistent with the approach taken by many other major Pennsylvania utilities. Normalization also benefits customers by assuring that they receive a fair portion of the benefit of the repairs allowance deduction through rate base deductions regardless of when the Company files a rate case. Moreover, normalizing the repairs allowance deduction provides an important source of cash flow to the Company which can be used to support the Company's major capital spending program, reduce outside borrowing and lower the Company's cost of capital. Finally, even if OCA's adjustment is adopted, it is substantially overstated.

Q. Why do you believe that the Commission should accept the Company's position that the repairs tax deduction should be normalized?

A. As stated in my Direct Testimony, the Company originally adopted the repairs tax accounting method for the tax year ended September 30, 2009. Under this method, the Company continued to capitalize certain types of repairs expense on its books, but was able to deduct them immediately for tax purposes instead of taking the deduction over the life of the property as it would under accelerated tax depreciation. In addition, in making the accounting method change, UGI Gas was permitted to take a "catch up" tax deduction for federal purposes, and a "catch up" tax deduction for state purposes. In addition, since 2009, the Company has taken annual repairs tax deductions associated with certain asset groups. Since 2009, these deductions are typical and recurring, and should continue into the future.

In 2009, UGI Gas also examined the impact of this tax deduction on its customers to determine a fair and prudent ratemaking methodology. Two choices were presented: flow through and normalization. Under the flow-through methodology, the tax benefit of the repairs tax deduction would have flowed through in the year in which the deduction was taken. Importantly, since the Company did not have a rate case in 2009, the entire benefit of this tax deduction would have flowed through the Company's income statement and would have gone to the benefit of shareholders. In contrast, under the normalization method, the benefit of the repairs tax deduction would be given back to the ratepayers over the book life of the asset that generated the tax deduction through a rate base deduction for the deferred taxes associated with the adoption of the repairs allowance and, consequently, lower resulting ratemaking return and tax requirements.

Additionally, under normalization, the Company is able to re-invest the cash tax savings into additional plant and lessen the need to acquire debt or equity to purchase and install new plant. As a result, this would lower the cost of capital and further benefit ratepayers. During the period before the Company's next rate case, flow through treatment would have deprived ratepayers of all the cash and capital benefits provided by the repairs tax deduction, including the one-time "catch up" deduction. For these reasons, UGI Gas believed that normalization was the best mechanism to assure that neither the ratepayer nor the Company was unfairly benefited or penalized as it transferred the cash tax benefit into a capital benefit.

As a result, the Company decided to normalize the repairs tax deduction, for federal purposes, from the time it first adopted the repairs tax method, because it believed that normalization was most equitable for its ratepayers. By normalizing the repairs tax deduction, the Company preserved a portion of the tax benefit of the "catch up" deduction for the purposes of this rate case and any future repairs tax deductions through the accrual of deferred taxes, which allowed a portion of the tax benefits to be returned to customers through the rate base reduction earlier discussed. As listed in the Schedule C-6 of UGI Gas' Exhibit A - Fully Projected (REVISED), the repairs tax ADIT rate base reduction for the fully projected future test year is $98,884,000. Through normalization the tax savings of the repairs tax catch-up adjustment and future deductions were not flowed through and lost to ratepayers.

Q. Are there other factors concerning the Company's repairs tax normalization strategy that should be considered?

A. Yes. In addition to preserving tax benefits, normalization of the repairs tax deduction enabled UGI Gas to defer entering into a base rate case. UGI Gas has not filed a rate case in over 20 years. This was partly possible because of *the reduced rate base and income taxes resulting from normalizing the repairs* tax deduction. The Company did not need to immediately enter into a base rate case to cover the future taxes due when the repairs temporary timing difference reversed because it did not have to immediately flow through, or give back, all of the current cash tax savings. If the repairs tax deduction had been flowed-through, the Company may have needed to file a rate case sooner to collect the revenues to cover the future taxes due. As such, ratepayers have benefited from the Company's normalization of the repairs tax deduction because the Company was able to prolong its need for its first rate case since 1995.

I also note that normalization has been accepted by the OCA, other parties, and the Commission in a number of rate case settlements, including the *four FirstEnergy companies*, PPL Electric Utilities, Pennsylvania-American Water Co., Columbia Gas Company, and Duquesne Light Company. Normalization also was adopted as part of the UGI Central Penn Gas rate case and was not challenged by any party to the case. To my knowledge, only PECO Energy and

Aqua-PA have adopted flow through and they, unlike UGI Gas, filed for rate cases at or about the time they adopted the repair allowance, which allowed them to flow the tax savings benefits through to customers through an amortization.

Q. How would Mr. Effron's recommendation alter that strategy?

A. Mr. Effron's recommendation represents a hybrid strategy, where he flows through the current tax deduction in its entirety but, also retains the deferred tax component which serves to offset rate base and reduce return and tax requirements. This works to the detriment of customers and the Company in two ways. First, Mr. Effron's proposal, by removing the cash generated by the deduction, the Company will need to borrow additional funds or issue equity to cover the additional capital spend. Second, Mr. Effron retains the deferred tax rate base offset that results from the Company's repairs tax deduction normalization claim. Thus, not only is the Company required to forfeit the benefits of the accelerated repairs tax deduction in the pro forma income tax calculation (lower income taxes), but it is also required to preserve the vestiges of its normalization strategy for the benefit of ratepayers(lower rate base and associated return and taxes). The Company believes this "have your cake and eat it too" strategy is entirely inappropriate.

I submit that UGI Gas has effectively preserved the tax benefits of the repairs tax deduction via normalization. If UGI Gas had utilized the flow-through methodology since 2009, rate payers would not have realized the tax benefits through the rate base deduction the ompany has included in this case. Under the Company's revised claim, the remaining rate base reduction is $83,845,000 after Mr. Effron's deduction of the current year rate base effect. Mr. Effron should not have retained this rate base reduction on top of his flow through of the current tax deduction.

Mr. Effron should either adopt flow through or normalization. UGI Gas should not be required to use flow through prospectively to reduce tax expense and rates, while at the same time use normalization and reduce rate base for the previous benefits of normalization.

Q. What could be done to correct Mr. Effron's hybrid approach to achieve a strictly flow-through approach?

A. To the extent that Mr. Effron's flow through approach is adopted, which the Company opposes, the rate base reduction, which represents the accumulation of recurring annual repairs tax deductions under the Company's normalization approach since 2009, should be removed. Amortizations should be used for ratemaking only where the costs are extraordinary and nonrecurring, and not for items such as annually recurring tax deductions. In this case, there is no evidence that the repairs tax deduction claimed by the Company is other than a normal, recurring event for the Company. Therefore, it would be inappropriate to reach back to prior years to further reduce the Company's revenue requirement.

Q. Are there other flaws with Mr. Effron's adjustment?

A. Yes. Mr. Effron's adjustment is incomplete as it does not coordinate with his proposal to use the average rate base for the FPFTY. Specifically, Mr. Effron did not consider how his adjustment to plant additions for the average rate base method impacts the repairs tax deduction. Mr. Effron proposed reducing FPFTY plant additions from $157,340,000, using the year end method to $78,670,000 using the average rate base method. Under Mr. Effron's average FPFTY rate base proposal, the Company's repairs tax deduction would also need to decrease by half because the repairs tax deduction correlates directly to the Company's plant additions. Stated another way, the Company receives a repairs tax deduction for certain qualified plant additions that will be placed into service throughout the year. If plant additions are decreasing, then the Company's qualified repairs also are going to decrease. Thus, under Mr. Effron's proposal to use the average rate base for the FPFTY, the flow-through of the current year tax savings from the repairs tax deduction would decrease.

Although Mr. Effron proposed to use the average rate base for the FPFTY, he failed to properly take into account his proposed repairs tax flow-through proposal. This, again, reflects another unacceptable approach employed by Mr. Effron, by denying the Company a return on half of the plant additions it claims but calculating the repairs tax deduction on the full amount claimed.

While the Company disagrees with both of Mr. Effron's average year plant addition and repairs tax deduction flow through proposals, had Mr. Effron been consistent with his average test year plant addition method, he should have *calculated the repairs tax deduction on only half of the plant. If he had done so,* his repairs tax deduction would have been cut in half. See UGI Gas Exhibit NMM-4 for a corrected calculation of Mr. Effron's repairs tax deduction under the average rate base method.

Q. Please summarize how Mr. Effron's tax adjustments would need to be corrected in order for them to be internally consistent.

A. As previously noted, I must state that the Company fully disagrees with the premise behind Mr. Effron's flow-through and average test year plant addition adjustments. However, to correct for the errors in his analysis, the Company's entire rate base reduction associated with normalization must be removed. As shown in Schedule C-6 of UGI Gas Exhibit A - Fully Projected (REVISED), that reduction equals $98,884,000. This elimination would increase rate base with associated increases in return and state and federal income tax requirements. Moreover, to the extent that Mr. Effron's average test year plant additions calculation is adopted, only one half of the tax basis for the repairs tax deduction should be used in calculating the repairs tax deduction. Using Mr. Effron's figures would effectively reduce his state tax deduction by $ 395,000 and his federal tax deduction by $3,944,500.[4] I understand that Ms. Kelly and Mr. Lahoff will address a related adjustment to FPFTY revenues as a result of the effect on FPFTY customer additions of Mr. Effron's average year plant additions, but I have not addressed that here.

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[4] See UGI Gas Exhibit NMM-4 for a revised calculation of Mr. Effron's adjustment using the updated repairs tax deduction estimate for the FPFTY.

IV. CONSOLIDATED TAX SAVINGS ADJUSTMENT

Q. Please explain the Company's proposed consolidated tax adjustment.

A. The Company did not include a consolidated tax adjustment for the reasons explained in my Direct Testimony, UGI Gas Statement No. 10.

Q. Do I&E and OCA agree with the Company's proposal?

A. No. Both I&E and OCA recommend a consolidated tax savings adjustment of $181,000, which results in a reduction in the Company's income tax expense. See I&E Statement No. 2, 34-35; OCA Statement No. 1, p. 29. Both I&E and OCA contend that this adjustment is necessary to account for the Company's allotted share of consolidated tax savings. I&E also dismisses the Company's reliance on House Bill 1436, which proposed to eliminate the consolidated tax adjustment, because it has not been passed.

Q. Do you agree with I&E's and OCA's consolidated tax adjustment?

A. No. For the reasons fully explained in my Direct Testimony, UGI Gas Statement No. 10, the Company does not believe a consolidated tax adjustment is appropriate. Again, as the Company does not expect that its customers should bear the income requirement of its non-utility affiliates as an increase to our utility revenue requirement, our customers should not expect that our rates should be reduced by tax losses generated from our non-utility affiliated business enterprises. For example, the subsidiary UGI HVAC Enterprises ("UGI HVAC") consistently generated losses from 2012-2014. UGI Gas has neither asked for recovery of UGI HVAC's operating expenses nor a return on UGI HVAC's assets in this rate case filing. Furthermore, when UGI HVAC was part of the UGI Utilities, Inc. regulated group, its income and expenses were considered non-operating, and it was never included within UGI Gas' revenue requirement nor were its operating losses used in calculating its tax requirement. Therefore, if UGI HVAC's income requirement is not and never was part of UGI Gas' revenue requirement, the tax benefit of its losses should not be included. This conclusion can be drawn as to each and every affiliated business that gave rise to UGI Corporation's overall income tax liability during the 2012-12014 period. So, unless ratepayers bear the cost causing the consolidated tax losses, it would be unfair for the Company to make a consolidated tax savings adjustment.

Q. Does this conclude your rebuttal testimony?

A. Yes.

UGI Gas Exhibit NMM-1

CONFIDENTIAL

UGI Gas Exhibit NMM-2

CONFIDENTIAL

UGI Gas Exhibit NMM-3

CONFIDENTIAL

UGI Gas Exhibit NMM-4

Impact of Average Rate Base Method on Repairs

	1		2		3 = 2-1	4		5 = 4/3	
	9/30/16 Plant in Service (in 000s)	Source	9/30/17 Plant in Service (in 000s)	Source	Additions (in 000s)	Repairs Estimate (in 000s)	Source	% of Repairs to Additions	Tax Effect of Repairs Tax Deduction
Year End Method	1,492,227	A	1,649,567	B	157,340	45,715	D	29.055%	18,969
Average Method - **REVISED**	1,492,227	A	1,570,897	C	78,670	22,858	E	29.055%	9,484

Sources:

(A) UGI Exhibit A (FTY), Schedule C-1
(B) UGI Exhibit A (FPFTY), Schedule C-1
(C) OCA Statement No. 1, Schedule B-1
(D) UGI Interrogatory Response, Confidential Attachment RE-49.2
(E) If you utilize the same repairs tax deduction under the average rate base method (as the year end method) the ratio of repairs to additions increases to **58.110%** This is illogical since the additions decreased under the average rate base method. Thus, the repairs tax deduction should decrease to **$ 22,858** such that the ratio of repairs to additions remains constant.