STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

CASE 17-W-0232

PROCEEDING ON MOTION OF THE COMMISSION REGARDING THE RATEMAKING IMPACTS ON SUEZ NEW YORK INC. AND NEW YORK AMERICAN WATER INC. OF CHANGES IN THE DEFINITION OF A QUALIFIED NEW YORK MANUFACTURER UNDER NEW YORK STATE LAW

DIRECT TESTIMONY OF

FRANK X. SIMPSON

September 28, 2017

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BACKGROUND

1. Q. Please state your name and business address.

A. My name is Frank X. Simpson. My current business address is 1025 Laurel Oak Road, Voorhees, New Jersey 08043.

2. Q. By whom are you employed and in what capacity?

A. I am employed by American Water Works Service Company, Inc. ("AWWSC" or the "Service Company") as Senior Director – Rates & Regulation for New York and New Jersey.

3. Q. What are your responsibilities in this position?

A. My present responsibilities include managing rates and regulatory issues for New York and New Jersey, including planning, forecasting, monitoring, implementing, and preparing work papers, exhibits, and pre-filed testimony in this proceeding and in other regulatory matters for New York American Water Company, Inc. ("NYAW" or the "Company").

4. Q. Please describe your educational background and professional affiliations.

A. I am a licensed Certified Public Accountant in the State of New Jersey. I earned a Bachelor of Science degree in Accounting from the College of New Jersey in 1978 and a Master of Science degree in Taxation from Drexel University in 1986. I have approximately 34 years of experience in the water and wastewater industry, starting in August of 1982, when I was employed by Garden State Water Company in various capacities including Controller, Vice President, Financial; Treasurer, and Chief Financial Officer. In March of 1999, Consumers Water Company merged with

Philadelphia Suburban Water Company, subsequently becoming Aqua America, and I was transferred to the Bryn Mawr, Pennsylvania location where I assumed a number of financial and regulatory roles, including Vice President – Rates for Consumers Water Company and Chief Financial Officer of North Carolina and New Jersey. In March of 2005, I joined AWWSC as Manager of Rates and Planning for New Jersey-American Water Company, Inc. and New York American Water Company, Inc., and in January of 2010, I assumed my current title of Director of Rates & Regulation. I have also served as the Chairman for both the New Jersey Chapter of the National Association of Water Companies ("NAWC") and the New Jersey Utility Association's ("NJUA") Tax & Accounting Committee, and have served as the Chairman of NAWC's Rates & Revenue Committee. Prior to August 1982, I was employed as an Accounting Officer for Provident National Bank and a Senior Accountant for Withum, Smith and Brown, P.A., Certified Public Accountants. I have also taught accounting as an Adjunct Professor at Rowan University.

5. Q. Have you previously testified before the New York State Public Service Commission ("Commission")?

A. Yes. I submitted pre-filed testimony before the Commission in Case 07-W-0508 and submitted pre-filed testimony and testified in Case 16-W-0259.

6. Q. What is the purpose of your testimony in this case?

A. The purpose of my testimony is to discuss the revenue requirement impact of the recent change in law that excludes the Company from the definition of a Qualified New York Manufacturer ("QNYM") and to propose a recovery mechanism for collecting the incremental expense associated with the change. Pursuant to the Ruling Requiring Testimony issued on June 1, 2017 in this proceeding, my testimony and supporting exhibits discuss: 1) the revenue requirement impact from January 1, 2018, through the end of the Company's four-year rate plan, March 31, 2021; 2) the current state income tax ("SIT") per rate year as of January 1, 2018 through March 31, 2021; 3) re-establishment of the of deferred SIT balance as of January 1, 2018 which was returned to customers in Case 16-W-0259; 4) deferred tax benefits to be accrued during the remaining term of the rate plan; 5) cash flow impacts and related carrying costs; 6) earnings impacts without deferral; 7) a projection of the resulting regulatory asset at the end of the rate plan (assuming full deferral authority is granted); 8) any related change in QNYM definition on the New York capital base tax obligations resulting from the New York State Department of Taxation and Finance audit position on eligibility; 9) any related federal income tax impacts to any of the items listed above; 10) the proposed recovery period for any regulatory asset (revenue short-fall); 11) alternatives to implementing recovery of any revenue requirement impacts; and 12) proposals to mitigate ratepayer impacts.

7. Q. Are you sponsoring any exhibits in support of your testimony?

A. Yes, I am supporting the following exhibits:

- **Exhibit FXS-1** – Service Area ("SA") 1 schedules from Joint Proposal, Appendix A, Case 16-W-0259, adjusted to reflect the New York SIT rate changing from 0.00% to 8.34% for all years of the Rate Plan;

- **Exhibit FXS-2** – SA-2 schedules from Joint Proposal, Appendix A, Case 16-W-0259, adjusted to reflect the New York SIT rate changing from 0.00% to 8.34% for all years of the Rate Plan; and
- **Exhibit FXS-3 –** Calculation of the re-established deferred SIT balance as of January 1, 2018, including deferral of the impact on capital base tax from the change in QNYM cap as of March 31, 2017.

8. Q. What is a Qualified New York Manufacturer or QNYM?

A. On March 31, 2014, New York Governor Andrew Cuomo signed into law S.B. 6359-D, A 8559-D (Chapter 59), enacting significant changes to New York State's corporate tax regime, most of which took effect for the 2015 tax year. The legislation created important tax benefits specifically applicable to certain qualified manufacturers (i.e., QNYMs), some of which were effective for tax years beginning on or after January 1, 2014. Among various QNYM benefits is a 0% business income tax rate. To be considered a QNYM, a company must meet both a property and receipts test which requires that: 1) either all or at least $1 million of manufacturing property is in New York; and 2) at least 50% of receipts must be from manufacturing.

9. Q. What is the Company's status as a QNYM?

A. The Company qualified as a QNYM effective January 1, 2014 and will hold that status through December 31, 2017. Thus, during that time period, the Company benefited from a 0% SIT rate, and should have had its capital base tax limited to $350,000, which was the tax position reflected in the Commission's Order in Case 16-W-0259. In New York, the taxpayer is subject to the greater of the SIT or the capital base tax. However, a recently enacted state law, effective January 1, 2018, changed the definition of QNYM in a manner that excludes water utilities such as the Company. Therefore, starting January 1, 2018, the Company will no longer be a QNYM and therefore will no longer receive the benefit of a 0% SIT rate. Instead, the Company will be subject to SIT. The New York State Department of Taxation and Finance in a recently completed audit of the Company concluded that the change in the definition for purposes of computing the state tax rate has an earlier effective date than January 1, 2018, impacting periods prior to 2018. The State agent would not allow the Company to apply the lower capital base tax rate and $350,000 cap available to QNYM in computing its franchise tax liability for the audit period.

10. Q. How does the Company's current rate plan address SIT and Capital Base tax?

A. The Company's current rate plan reflects a 0% SIT rate and expense on the Company's business income base for all four years of the rate plan. The Company forecasted a capital base tax of $115,334 and $75,175 for each of the four rate years for SA-1 and SA-2, respectively. The rate plan expressly allows the Company to seek deferral treatment for the revenue requirement impact for changes in operating expense due to legislative action.

11. Q. Does the Company believe that the change in the state tax law removing the Company from QNYM status is a change in operating expense due to legislative action?

A. Yes.

12. Q. During the time period that the Company was a QNYM, did the Company's prior rate plan include in rates a SIT expense?

A. Yes, the Company's old rate plans included recovery for SIT expense.

13. Q. How were those SIT expense amounts treated in the past for regulatory accounting purposes?

A. Starting on January 1, 2014, the effective date of the QNYM (with its 0% SIT), the Company calculated SIT expense at a rate of 8.63%, and deferred the entire amount as a regulatory liability due to customers. The Company deferred the entire benefit resulting from the SIT rate dropping from 8.63% to 0.00% as a result of its QNYM status. This deferred balance was returned to our customers in Case 16-W-0259. In reducing the SIT, the Company recognized that it would be subject to the capital base tax.

14. Q. How did the Company re-establish its state deferred tax balance as of January 1, 2018?

A. The Company's Tax Department started with the actual state cumulative gross temporary basis on its books as of December 31, 2016. The next step was to layer in the 2017 activity to get a projected balance as of December 31, 2017. Please note that although the SIT rate will not change from the current 0.00% to the newly calculated rate of 8.34% until January 1, 2018, the Company was required by accounting rules to re-establish the deferred SIT once it was aware that the rates would change effective January 1, 2018. The deferred SIT balances are established based on when the timing difference between tax and book income, mainly depreciation expense, are expected to turn. The Company estimates that the state cumulative gross temporary difference between tax and book income at December 31, 2017 is $178,079,151. The Company then tax effected the state cumulative gross temporary difference between book and tax income by the new tax rate of 8.34%. This resulted in a state deferred tax of $14,851,801.

15. Q. How was the new tax rate calculated?

A. The applicable New York tax rate is 6.5%. In addition to that rate, the Company needs to add in the Metropolitan Transit Authority ("MTA") Surcharge. The surcharge is 28.30% of the state rate of 6.5%. This equals 1.84%. This is then added to the 6.5% to come up with the 8.34% rate.

16. Q. Is there a federal income tax effect for this SIT change amount?

A. Yes, the Company is allowed a deduction for these state taxes on its federal tax return. Therefore, the net tax expense is 65% (or 1- 35%) of the state taxes mentioned above, or $10,045,822 (including franchise tax assessment) as depicted on Exhibit FXS-3.

17. Q. How will the Company handle the offset to the net tax calculated deferred SIT?

A. A regulatory asset will be established and authorized. This regulatory asset must be grossed up to reflect state and federal tax. The offsetting entry to this regulatory asset will be deferred taxes. On January 1, 2018 (Day One) the deferred taxes established and the regulated asset will equal and offset, creating no impact on rate base. However, the Company proposes a 40-year amortization of the regulated asset, which may not perfectly match the reversal of the deferred taxes. Therefore, the regulated asset should be netted in all future proceedings against deferred tax balances to properly computed rate base.

18. Q. Why does the regulatory asset need to be grossed up?

A. Since the regulatory asset is booked to deferred taxes, it needs to be grossed up so that the net effect is the correct tax amount to be recovered from the rate payers over time though amortization to income tax expense. In other words, when the regulatory asset is amortized and the expense is recovered from rate payers, the revenue received by the company will be taxable on both a federal and state basis. Therefore, the regulatory asset must be grossed-up so that the company recovers the correct amount, after paying those associated taxes. The gross up has no effect on rate base, as both the resulting balance of deferred taxes and the regulated asset are netted out in, or excluded from the computation of rate base

REVENUE REQUIREMENTS IMPACT

19. Q. What is the revenue requirement impact on the Company related to the recent change in the definition of QNYM that excludes water utilities?

A. The revenue requirement impact related to the changes in the definition of QNYM is comprised of four (4) separate components:

1) The annual rate year impact of re-establishing the SIT expense for NYAW at an effective tax rate of 8.34%. The annual SIT expense has an effective rate of 8.34%, but is comprised of current SIT expense and deferred SIT expense. Please note that the SIT expense is not effective until January 1, 2018 and only the last three months of Rate Year 1 are impacted by the

re-established SIT expense. For Rate Year 1, for both S-1 and SA-2, an effective tax rate of 2.09% (25% of 8.34%) was utilized.

2) Elimination of the Capital Base tax which was included in each of the four (4) rate year plans at $115,334 and $75,175 for SA-1 and SA-2, respectively. With the re-establishment of the SIT expense, the Company will no longer be paying the capital base tax, and therefore it has been removed from the revenue requirement. The capital base tax is booked to Taxes Other Than Income and has been removed for all four years of the rate plan for SA-1 and SA-2.

NYAW, for the calendar tax years 2014 through 2017, has been paying the Capital Base tax, which was capped at $350,000 per year for a QNYM. The New York State Department of Taxation and Finance is currently taking the position that NYAW did not qualify as a QNYM and has assessed the Company in an amount greater than $350,000 per year. This additional amount of $392,151 is included in the regulatory asset requested in this proceeding since it is a direct result of the tax law removing the Company from QNYM status.

3) Recognition of the rate base impact of the deferred SIT in each of the four (4) rate year plans, per the SIT schedule provided for each year of the rate plan. The deferred SIT expense, per the SIT expense schedules, is multiplied by the gross up revenue factor (11.077%) to determine the revenue impact of the additional deferred SIT that would have been

booked to rate base had the SIT been in effect when the Joint Proposal was signed. The federal deferred income tax was properly booked in the Joint Proposal and needs no further adjustment.

4) Re-establishment and amortization of the deferred SIT balance based on the changes in the definition of QNYM. The prior deferred SIT balance at December 31, 2013 was returned to customers in Case 16-W-0259. The newly calculated deferred SIT as of January 1, 2018 is calculated and depicted on Exhibit FXS-3. The balance will be recorded on the books of the Company with a debit to a Regulatory Asset and a credit to the Deferred SIT. The Company is proposing an adjustment of 40 years. This 40-year amortization is intended for this specific proceeding and is subject to change by the Company, requesting a shorter amortization, in its next base rate case proceeding.

20. Q. What is the revenue requirement impact per rate year from January 1, 2018 through March 31, 2021 (i.e., the end of the rate plan)?

A. Please see Exhibit FXS-1 for SA-1 and Exhibit FXS-2 for SA-2.

21. Q. What is the current SIT expense per rate year for the four-year rate plan ending March 31, 2021?

A. Please see Exhibit FXS-1 for SA-1 and Exhibit FXS-2 for SA-2.

22. Q. What is the re-established deferred SIT balance as of January 1, 2018?

A. Please see Exhibit FXS-3 for the allocated deferred SIT for SA-1 and SA-2.

23. Q. What are the additional deferred tax benefits to be accrued during the four-year rate plan ending March 31, 2021?

A. Please see Exhibit FXS-1, page 1, for SA-1 and Exhibit FXS-2, page 1, for SA-2. The Company has already recognized the federal tax benefits in the Joint Proposal and only needs to reflect the deferred SIT benefits.

24. Q. What are the cash flow impacts and carrying costs related to the recent change in the definition of QNYM to exclude water utilities?

A. The Company does not anticipate a noticeable cash flow impact and as a simplifying assumption and for rate moderation has decided not to request any carrying costs during the remainder of the four-year rate plan, but reserves the right and anticipates requesting such during the Company's next base rate case proceeding.

25. Q. What is the earnings impact without deferral for SA-1 and SA-2 during the remainder of the four-year rate plan ending March 31, 2021?

A. Please see Exhibit FXS-1, page 1, for SA-1 and Exhibit FXS-2, page 1, for SA-2.

26. Q. What is the regulatory asset balance at the end of each rate year?

A. Please see Exhibit FXS-1, page 1, for SA-1 and Exhibit FXS-2, page 1, for SA-2.

27. Q. Does the Company believe that there is an alternative to implementing recovery of the revenue impact related to the recent change in the definition of QNYM to exclude water utilities?

A. No. The Company is entitled to recovery for the significant change in state tax law that generates additional expense for the Company.

28. Q. What proposals has the Company put forth to mitigate the ratepayer impacts related to the change in state tax legislation?

A. The Company has proposed a 40-year recovery of the regulatory asset associated with the re-establishment of the state deferred income tax and the loss of QNYM benefits in computing Capital Base stock tax. The Company has agreed not to seek carrying costs for the remainder of the current four-year rate plan.

PROPOSED RECOVERY MECHANISM

29. Q. Please describe the Company's proposed recovery mechanism for collecting the incremental costs associated with the change in the definition of QNYM.

A. The Company is proposing that the incremental costs associated with the change in the definition of the QNYM be surcharged to customers starting on April 1, 2018, the beginning of Rate Year 2, or earlier on March 1, 2018 or February 1, 2018.

30. Q. Does this conclude your direct testimony at this time?

A. Yes, it does.