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March 20, 2020

Debra A. Howland, Executive Director  
New Hampshire Public Utilities Commission  
21 South Fruit Street, Suite 10  
Concord, NH 03301

Re: DW 19-136 Hampstead Area Water Company, Inc., - CIAC Tariff Amendments  
Staff Recommendation for Approval

Dear Ms. Howland:

On August 19, 2019, Hampstead Area Water Company, Inc. (HAWC or Company), filed proposed tariff amendments relative to the recovery of the income tax liability associated with the receipt of contributions in aid of construction (CIAC), both in the forms of property and cash. In this letter, Staff recommends approval of the proposed tariff amendments with modifications.

### **Background**

The Company's submission is supported by the direct testimony of Harold Morse, President of HAWC, and a technical statement from Stephen P. St. Cyr, a consultant of HAWC. Mr. St. Cyr's statement describes recent changes in federal tax law relative to the receipt of CIAC that were enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). Specifically, Congress amended Section 118 of the Internal Revenue Code, removing the exclusion of CIAC from the gross income of regulated water utilities. This change became effective for tax years beginning January 1, 2018. As a result, the Company has proposed tariff amendments designed to mitigate the significant and unanticipated income tax liability arising from activities common and essential to their operation.

Specifically, the Company's proposed amendments require the contributor of the CIAC to pay to the Company an amount equal to the potential income tax liability associated with that contribution. The Company proposes to calculate this potential income tax liability by using a gross-up calculation. Upon subsequent clarification, this gross-up calculation uses the statutory state and federal income tax rates in effect for the year in which the Company receives the CIAC. The Company argues that without the proposed tariff amendments, the Company will incur increased income taxes, which will negatively affect their cash flow until ultimately recovered from ratepayers. The Company further contends that the tariff amendments would have a neutral impact on its revenues, as the monies collected from the CIAC contributors offset the additional income taxes incurred.

Staff propounded discovery on September 25, 2019 and January 3, 2020, to which the Company promptly responded. There are no intervenors in this docket.

### **Analysis**

When the TCJA removed the exclusion of CIAC from the gross income of regulated water utilities, it marked the second time in recent history of such a change. Specifically, the Tax Reform Act of 1986 (TRA '86) also removed the exclusion of CIAC from the gross income of regulated public utilities. As a result, Docket No. DF 87-113 was opened which resulted in Commission Order No. 19,055 (August 12, 1988).<sup>1</sup>

In that order, the Commission established that regulated public utilities in New Hampshire should be responsible for the tax liabilities resulting from the acceptance of CIAC. The utilities then would be eligible to earn a return on such additional tax payments by including them in rate base.

Commission Order No. 19,055, however, also indicated a possible exception to the general policy relative to a "small water utility." This possible exception arose based upon concerns raised relative to the potential for negative impacts on the cash flows of these smaller utilities. However, the Commission's discussion at the time was narrow in that it stated, in part, "[i]n the case of a small water utility that has problems raising funds, we will consider a policy of allowing taxes on CIAC to be collected." The Commission further opined that each small water utility should be encouraged to file a petition for consideration by the Commission for treatment under this potential alternative policy.

On August 19, 2019, HAWC petitioned for tariff changes citing similar concerns raised under the possible small water utility exception as contemplated in Order No. 19,055. In support of this, Staff understands that HAWC has routinely relied on CIAC for a large portion of the expansion of its public water system.<sup>2</sup> It is generally anticipated that this will continue into the foreseeable future. Therefore, the Company argues, and Staff agrees, that in the absence of the proposed tariff changes, the receipt of CIAC will increase the Company's income tax liability. The immediate demand for the cash to meet this increased income tax liability will then have to be borne by the Company until, and if, it is authorized to be recovered from its customers in the form of higher rates. In light of such facts, Staff believes HAWC will have difficulty in raising the funds to meet this increase in income tax liability relative to the routine receipt of CIAC in the expansion of their water system. Therefore, Staff recommends that the Commission approve HAWC's proposed tariff amendments, whereby those individuals or entities providing CIAC to the Company will also be responsible for the income tax liability associated with such contribution.

However, with regard to implementing the Company's proposed tariff changes, Staff recommends the following modifications to the Company's proposed pages:

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<sup>1</sup> The exclusion of CIAC from gross income enacted by TRA '86 and the subsequent Commission Order, No. 19,055, remained in effect until the passage of the Small Jobs Protection Act of 1996, which reinstated the exclusion of CIAC from gross income for water utilities only.

<sup>2</sup> See Docket Nos. DW 19-031, DW 16-825, DW 15-254, DW 14-319, et al. In addition, the Company's most recent PUC Annual Report indicates approximately \$9.1 million of the \$17.2 million (53%) of HAWC's plant is CIAC.

- 1) Page 5- The Company should remove the amendments to the definition of “State”. The term State should not be construed to also mean Federal. Whenever clarification is needed, it should be added to that specific area.
- 2) Page 24, 24-A and 30- The Company should clarify and or remove the references to the recovery of engineering, administration and inspection fees as they could be interpreted as additional fees which do not relate to the recovery of the incremental income tax relative to the receipt of CIAC which is the subject of this tariff change.
- 3) Page 32- The Company should replace “customer” with “contributor”.
- 4) Page 35 and 36- The Company should remove the amendments as they could be interpreted as annual fees, which this specific tariff page represents.
- 5) Page 33- The Company should add the following:
  - a. Clearly state the formula used for computing their effective tax rate, as well as the formulas for calculating the amount due to the Company and the CIAC Tax Rate per type of contribution. (Referencing Staff 2-3 and 2-4.)
    - Current Effective Tax Rate:  
 $\text{Current BPT Rate} + (\text{Current Federal Tax Rate} * (1 - \text{Current BPT Rate}))$
    - Plant or Equipment Tax Cost:  
 $((\text{CIAC} - [\text{CIAC} * (1/\text{Tax Life}) * .5]) / (1 - \text{Current Effective Tax Rate})) - \text{CIAC value}$
    - Land or Cash Tax Cost:  
 $((\text{CIAC}) / (1 - \text{Current Effective Tax Rate})) - \text{CIAC value}$
    - CIAC Tax Rate:  
 $\text{Tax Cost} / \text{CIAC value}$
  - b. Provide examples the proposed formulas based upon 1) \$1,000 of plant or equipment contributions and 2) \$1,000 of cash or land contributions. (Referencing Staff 2-3 and 2-4.)
    - Effective Tax Rate (as of 1/1/2020):  
 $.077 + (.21 * (1 - .077)) = 27.08\%$
    - Contributed Plant or Equipment example:  
 $\text{Tax Cost: } (\$1,000 - [\$1,000 * (1/25) * .5]) / (1 - .2708) - \$1,000 = \$343.94$   
 $\text{CIAC Tax Rate: } \$343.94 / \$1,000 = 34.39\%$

- Contributed Land or Cash example:  
Tax Cost:  $(\$1,000/(1-.2708)) - \$1,000 = \$371.37$   
CIAC Tax Rate:  $\$371.37/\$1,000 = 37.14\%$
- c. As tax rates are subject to change, include the following information with the calculations in their respective tariff:
- The following examples describe how this calculation is made based on proforma property value of \$1,000 and using, for example purposes only, tax rates effective as of January 1, 2020. These examples are for demonstrative purposes only – actual tax rates and property values are subject to change and will be determined at the time the CIAC payment is calculated.
  - Information about the Federal Corporate Tax Rate as of January 1, 2020 can be found at <https://www.irs.gov/pub/irs-pdf/p542.pdf>.
  - Information about the State of NH BPT rate can be found at <https://www.revenue.nh.gov/transparency/business-tax.htm>
- 6) The company should deposit and track all gross-up monies received and restrict the use of such monies to payment of the Company's state and federal tax obligations.
- 7) In circumstances where HAWC may be required, or choose, to file a consolidated tax return with affiliated, but unregulated, entities, the amount of gross-up monies contributed by the Company towards meeting the consolidated tax obligation in any one tax year should be limited to the amount of gross-up monies charged and collected by the Company during that year. This would avoid the possibility of HAWC subsidizing the tax obligations derived from those affiliated, but non-regulated, entities

Staff concludes that, based upon all the information presented herein, the proposed tariff amendments, with modifications, balances the interests of the Company and its ratepayers. *See* RSA 363:17a (the Commission shall be the arbiter between the interests of the customer and the interests of the regulated utilities). Placing the tax obligation solely on the CIAC contributor avoids the ratepayer bearing responsibility for the increased income tax liability in a future rate case and allows the Company to meet its tax obligation, without a rate increase, thus maintaining just and reasonable rates. *See* RSA 378:7 (the Commission determines just and reasonable rates); RSA 374:2 (all utility charges shall be just and reasonable). Further, Staff believes this outcome conforms to Commission precedent set by Order No. 19,055 where the Commissioners contemplated a secondary policy of allowing small water utilities to collect the potential income tax liability from the contributor of CIAC.

Prior to the filing of this recommendation, Staff provided a copy to the Company who provided their consent to Staff's modifications. Thank you for your attention, and if you should have any questions regarding this matter, please contact me.

Sincerely,

/s/ Anthony J. Leone

Anthony J. Leone  
Utility Analyst, Gas & Water Division

cc: Service list

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