STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

IN THE MATTER OF THE
REVISION OF RATES FILED BY
MIDDLESEX WATER COMPANY
BPU DOCKET NO. WR2105_________

PREFILED TESTIMONY

OF

A. BRUCE O'CONNOR
SENIOR VICE PRESIDENT, TREASURER AND CHIEF
FINANCIAL OFFICER

MAY 2021

MIDDLESEX WATER COMPANY
PETITION FOR APPROVAL OF AN INCREASE IN RATES FOR WATER SERVICE AND OTHER TARIFF CHANGES
MAY 2021
DIRECT TESTIMONY OF A. BRUCE O'CONNOR

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

A. My name is A. Bruce O'Connor and my business address is 485C Route One South, Iselin, New Jersey 08830.

Q. **Please state your professional qualifications and experience.**

A. I am the Senior Vice President, Treasurer and Chief Financial Officer of Middlesex Water Company ("Middlesex" or "Company"). I am a licensed Certified Public Accountant and I have been employed with Middlesex since 1990. I have overall responsibility for accounting, taxes, payroll, customer service, billing and disbursement procedures, inventory control, cash management, and financial statement preparation. My responsibilities also include the Company's financing program, Securities and Exchange Commission and other financial regulatory filings. A copy of my professional qualifications is attached as Appendix A.

Q. **Have you ever testified before or submitted testimony to the New Jersey Board of Public Utilities ("NJBPU" or "Board")?**

A. Since 1990, I have submitted testimony and/or testified before the NJBPU on behalf of Middlesex and its regulated water and wastewater utilities for their base rate proceedings. I have also participated in all Distribution System Improvement Charge filings, Purchased Water Adjustment Clause filings and equity and long-term debt securities filings made by Middlesex to the NJBPU since 1990.

Q. **What is the purpose of your testimony?**

A. As I had described previously in my testimony, because I have overall financial responsibility at Middlesex Water Company I am able to provide information and observations that supports testimony sponsored by other Company witnesses as well as sponsor specific testimony.

Q. **Are you familiar with Exhibit P-5, which is included as part of Mr. Robert Capko's pre-filed direct testimony?**

A. Yes, I am. Exhibit P-5 is a pro forma income statement reflecting operating income at present and proposed rates, including adjustments the Company deems appropriate to more accurately reflect revenues and expenses during the Test Year. It also includes a calculation showing the Company's proposed rate of return on rate base. In this filing Middlesex has selected as the Test Year the twelve-month period ending September 30, 2021, with adjustments for known and anticipated changes. Based on the Board's filing policies, these adjustments appropriately reflect the Company's best effort to start with a test year to anticipate the business environment within which the Company expects to be operating during the period rates are anticipated to be in effect. If this case takes the statutory 9 months to complete, the first full year of rates set in this case would be approximately January 18, 2022 through January 17, 2023. Obviously, an earlier or later conclusion for this rate case would adjust the dates of that first year of rates. Although I believe the Board's current test year policies, originally set in the

Elizabethtown Water case decades ago, does not really reflect what costs and investment Middlesex and its customers will face during the life of the rates set in this case, we have not made any adjustments beyond the 3-6-9 approach designated in that Elizabethtown Water case.

It is obvious that even the adjustments made through June 30, 2022, for known and measurable items impacting revenue and expenses, can only begin to estimate the business environment expected during the first full year these rates are expected to be in effect. Adjustments through June 30, 2022, do not reflect the business environment into 2023, which will be most of the first full year new rates will be in effect, and will not estimate any period beyond that at all.

The first column, entitled "Test Year September 30, 2021", contains actual results of operations for the five months ended February 28, 2021, plus forecasted results of operations for the seven months ended September 30, 2021. The second column, entitled "Adjustments", contains known and anticipated changes to occur by June 30, 2022, as well as events that are expected to be known by the time this proceeding is anticipated to be concluded. The third column, entitled "Adjusted Test Year", represents the arithmetic results of combining the first and second columns. The fourth column entitled "Proposed Adjustment", shows the requested increase in operating revenues, in addition to the Gross Receipts and Franchise Tax and Federal Income Tax effects, required to (1) recover those prudently incurred operating costs, and (2) earn a fair and reasonable return. The fifth column, entitled "At Proposed Rates", contains the Statement of Income with adjustments at proposed rates. It is the Company's intention to update Exhibit P-5 with actual results of operations through September 30, 2021, as well as any further known and anticipated changes beyond September 30, 2021, as appropriate, during the course of this proceeding.

Q. W**hich Test Year Adjustment schedules of Exhibit P-5 are you testifying to?**

A. I plan to testify on the new Assistant Controller position (page 11) and on the development and calculation of the federal income tax expense shown on (page 16), which will also be used to describe certain corresponding adjustments to the rate base calculation identified as Exhibit P-6 to the pre-filed testimony of Ms. Michele Tilley.

Q. **Why are you proposing to add the position of Assistant Controller as shown on Exhibit P-5, page 11?**

A. This position is being created to meet the increasing financial reporting requirements for federal and state regulators, as well as to initiate aspects of prudent succession planning to ensure that critical institutional knowledge is timely transferred by existing personnel. The Company expects to fill the position by September 1, 2021.

Q. **Can you explain the federal income tax expense calculation shown on Exhibit P-5, page 16?**

A. This schedule sets forth the federal income tax calculation at present and proposed rates. The beginning point of the calculation is operating income before income taxes as shown on Exhibit P-5, page 1. To this amount, I deducted the following:

- Repair expenditures on tangible property,
- Interest expense, and
- Preferred dividends paid.

Q. **Can you explain the reasons for these three deductions that result in a lower federal income tax expense that is recoverable in customer rates?**

A. The first of the deductions pertains to expenditures incurred by the Company that are classified, or accounted for, as capital under generally accepted accounting principles ("GAAP") but are accounted for as an expense under the Internal Revenue Code ("IRC" or the "Code"). For GAAP purposes, also known as Book, these expenditures are capitalized, recorded as utility plant in service ("UPIS") and depreciated over the useful life of the UPIS asset. Under the Code, or for Tax purposes, these expenditures are deducted in the year incurred. This creates Book/Tax difference in the tax expense recorded.

Q. **Has this Book/Tax accounting difference been addressed in a prior Middlesex base rate proceeding?**

A. Yes, it was addressed specifically in paragraph 10 of the DISCUSSIONS AND FINDINGS section of the Board Order issued in BPU Docket No. WR17101049 (the "2018 Order") as follows:

> "In 2013, the Internal Revenue Service ("IRS") issued final Tangible Property Regulations ("TPR")[1] to provide clarity to the question of whether expenditures to maintain, replace or improve tangible property must be capitalized or charged to expense for income tax purposes. Middlesex adopted the final TPR by timely filing with the IRS a required accounting change form as part of, and included with, the Company's 2014 federal income tax return. IRS rules allow taxpayers changing their accounting method to apply the change retroactively or, apply it prospectively only. Middlesex elected to apply the change retroactively. Because this accounting change applies only for income tax purposes and not financial or regulatory accounting, it creates book/tax differences for reporting purposes. Middlesex has proposed the Board approve special accounting treatment of the associated net income tax

[1] Guidance Regarding Deduction and Capitalization of Expenditures Related To Tangible Property, 78 Fed.Reg. 57747(Sept. 19, 2013) (amending 26 C.F.R. parts 1 and 602) <https://www.gpo.gov/fdsys/pkg/FR-2013-09-19/pdf/2013-21756.pdf>.

benefit with the adoption of the final TPR for all relevant tax years before the tax year of adoption of the final TPR ("Look Back Period"), the tax year of adoption (2014), and the subsequent tax years (2015, 2016 and 2017). Specifically, Middlesex proposes to defer, for financial accounting purposes only, $28,738,642 for the Look Back Period and years 2014, 2015, 2016 and 2017. This deferred amount shall be recorded as a regulatory liability in accordance with financial and regulatory accounting requirements and amortized as a reduction of income tax expense over 48 months. Beginning with the tax year 2018, the TPR related income tax benefits are recognized in the year incurred and shall also be recorded in accordance with financial and regulatory accounting requirements. Current capital planning estimates indicate that Utility Plant investment will likely grow by approximately an additional $305 million by the end of 2022. By the Board specifically authorizing the special accounting treatment described herein, Middlesex expects to mitigate prospectively the impact on customers of future base rate filings. The Signatory Parties therefore agree that the Company's request to receive approval, in its entirety, of the special accounting treatment described herein should be approved."

Q. **Which part of the special accounting treatment cited in the 2018 Order does this deduction category come under?**

A. These deductions fall under the category created by the following language in the 2018 Order: "Beginning with the tax year 2018, the TPR related income tax benefits are recognized in the year incurred and shall also be recorded in accordance with financial and regulatory accounting requirements." The TPR related deductions used for purposes of this case are for the Test Year Ending September 30, 2021.

Q. **Can you describe the interest expense deduction?**

A. Interest expense for income tax purposes was calculated by applying the weighted cost rate of debt component of the proposed rate of return and applying the debt cost rate to the rate base amount shown on Exhibit P-6 to arrive at the interest expense deduction.

Q. **What is the preferred dividend paid deduction?**

A. Dividends paid by regulated public utilities on preferred stock issued prior to 1942 are allowed as a deduction in determining taxable income for federal purposes

Q. **What is the next step in determining the pro forma income tax expense?**

A. Income taxes are then calculated at the applicable Federal income tax rate in effect at the time of preparing the revenue requirement and testimony for this filing. Based on specific announcements and proposals regarding national spending and taxing programs, it is expected that the current corporate income tax rate will increase prior to the conclusion of this rate case. If income tax legislation were to pass during the period this rate matter is in process, the Company would update its filing as needed.

Q. **Are there other adjustments related to the 2018 Order that need to be made to the pro forma income tax expense calculation?**

A. In order to record the full impact of the special accounting treatment authorized in the 2018 Order, it is necessary to adjust the income tax expense for the calculated tax on the amortization of the:

TPR Look Back Period & Pre 2018 TPR Deductions – Pursuant to the 2018 Order, Middlesex received approval for regulatory accounting treatment of accumulated deferred income tax benefits associated with the adoption of TPR. The 2018 Order allowed flow-through accounting treatment of pre-2018 TPR tax benefits which the Company had previously deferred. Per the 2018 Order, the pre-2018 tax benefits were to be recorded as a Regulatory Liability and amortized through income tax expense over 48 months ending March 31, 2022. The offsetting account is a Regulatory Asset which is also amortized through income tax expense for the purposes of setting rates to collect revenue sufficient to satisfy the future income tax liability when the obligation becomes payable to the IRS.

Post-2017 TPR Deductions – The 2018 Order also approved Middlesex to utilize the flow-through accounting treatment for post-2017 TPR deductions. As previously described, under the flow-through method, TPR related income tax benefits are recognized in the year incurred as a reduction to current income tax expense. An offsetting Regulatory Asset is established instead of recording a charge to deferred tax expense, resulting in lower federal income tax used for setting rates. The Regulatory Asset represent the future collection in rates of the deferred tax liability created as a result of the TPR deductions and is amortized over a period of time to satisfy the future income tax liability when the obligation becomes payable to the IRS.

Q. **Is there another adjustment that needs to be made to the pro forma income tax expense calculation?**

A. Yes and it is identified as "2017 TCJA Regulatory Liability" on the Exhibit P-5 schedule at page 16. The Tax Cuts and Jobs Act of 2017 ("2017 TCJA") reduced the federal corporate income tax rate to 21% from 35% effective for tax years beginning after December 22, 2017. The lower income tax rate was incorporated in the rate setting process approved in the 2018 Order. The 2017 TCJA Regulatory Liability deduction in the pro forma income tax expense represents the amortization of the protected or normalized excess deferred income taxes related to depreciation of utility plant previously collected in customer rates. The return to customers of the 2017 TCJA Regulatory Liability through amortization is in accordance with the requirements of Section 168 of the Internal Revenue Code

(IRC), associated Treasury Regulations and Internal Revenue Service Revenue Procedures. This is also known as normalization rules. Failure by the Company to abide by the IRC normalization rules, which is commonly described as normalization violation, results in the loss of utilizing accelerated tax depreciation methods by the offending utility.

Q. **Is there a final adjustment to the pro forma income tax expense calculation?**

A. The amortization of the investment tax credit ("ITC") represents the required normalization of tax benefits for ITC as required by the IRS.

Q. **In the 2018 Order, reference was made to the expected growth in the Company's Utility Plant investment by "….an additional $305 million by the end of 2022." How much has Middlesex invested since base rates were last set by the Board?**

A. The level of utility plant for the adjusted Test Year on which the 2018 Order was issued was approximately $439 million. The proposed level of utility plant for the September 30, 2021 Test Year in this rate proceeding is approximately $706 million, or approximately $267 million higher than what is currently being recovered in rates.

Q. **The 2018 Order also observed that in authorizing the special accounting treatment "Middlesex expects to mitigate prospectively the impact on customers of future base rate filings." Do you have observations with regard to that statement?**

A. From a historical perspective, since the Company's 2003 base rate case filing through the 2017 filing (on which the 2018 Order was issued) the average period between filings has been approximately 24 months. The time between the 2017 filing and this filing was 43 months, which is significantly greater than the rate filing gaps for the prior 18 years.

Q. **Without the special accounting treatment relative to the TPR, what impact would that have had on the outcome of the 2017 filing and rate filing cycle?**

A. As we said at the time, special accounting treatment relative to TPR was an essential element of the resolution of the 2017 Rate Case as well as a likely increase in the expected life cycle of the rates established in that rate case. We believe that significant lag in the time between 2017 filing and this filing has provided a substantial benefit to our customers, especially considering that the Company has subsequently invested approximately $267 million in plant to serve our customers. Given those additional investments, Middlesex would have been forced to file for an increase in its base rates much sooner than the 24 month average filing lag experienced prior to 2018 and the 43 months since the conclusion of the 2017 Rate Case.

Q. **Will you discuss the proposed changes to the rate schedules in the tariff sheets designated as Exhibit A to the Petition?**

A. The Company engaged John Guastella, a Principal of Guastella Associates, to prepare a full Cost of Service Study based on the revenue requirements in this proceeding. Mr. Guastella has submitted the results of that study through separate expert testimony with supporting exhibits sponsored by him. Based on the initial findings of that study, along with the desire to lessen the rate impact to municipalities, the Company is proposing a 4.0% increase to the public fire class of customers. The rationale for this increase is that these rates are expected to be in effect for about two years and this 4.0% increase effectively increases rates 2% annually over the life of the rates. The proposed increase for the public fire class of customer would be allocated 100% to the fire hydrant charge. The study indicates that Public Fire charges are significantly under-contributing relative to its class cost of service. This imbalance has been caused by years of considering the sensitivity of municipal and fire district budgets by Middlesex and its regulators. But that appears to have resulted in a serious disconnect between class cost responsibility and rates.

The Company is also proposing that there be no increase to the Private Fire class of customers who are still paying above their allocated cost of service. As we have in the past, we are also recommending a unitary increase for all the customer categories under the general metered class of customers in the Middlesex system. Those categories are residential, commercial, and industrial.

Q. **Why has the company proposed tariff rates that differ from the pure cost of service study results?**

A. The Company believes that its recommended allocation of the proposed increase in revenue requirement is consistent with the tariff design methodologies adopted by the Company and intervening parties in prior Middlesex rate proceedings. Those methodologies could be viewed as counter-intuitive when compared to widely accepted traditional cost of service study guidelines. Nonetheless, the hybrid methodology often utilized to set rates appears to satisfy policy preferences of the Company, its regulators, and customers in the Company's prior proceedings. We are continuing our efforts to accommodate those policy preferences within the context of the cost of service results.

Q. **Are there any other tariff changes that the company is proposing?**

A. There are specific non-revenue tariff changes and clarifying tariff changes proposed and included in a marked-up copy of the Tariff in Exhibit A and are further described in testimony sponsored by Mr. Fullagar.

Q. **Does this conclude your testimony?**

A. Yes.

APPENDIX A

PROFESSIONAL QUALIFICATIONS OF
A. BRUCE O'CONNOR, C.P.A.

EXPERIENCE

Middlesex Water Company, Iselin, New Jersey

1990 - Present; Senior Vice President, Treasurer and Chief Financial Officer - Responsibilities include administering, monitoring and providing oversight to ensure that timely, accurate and meaningful financial information is delivered to internal and external stakeholders. Monitor, interpret and implement changes in Securities and Exchange Commission rules, Accounting Standards Codification pronouncements, public utility regulatory requirements and tax laws. Administer internal control procedures. Manage Company's daily cash requirements, cash management program, and maintain banking relations. Develop and execute long-range financial plans, recommend type of financing, and coordinate documentation with investment bankers and attorneys. In addition, all financial based regulatory filings and customer service operations are the responsibilities assigned to this position.

Deloitte & Touche LLP

1984 - 1990; Staff Auditor to Tax Manager - Specialization in public utilities.

PROFESSIONAL ASSOCIATIONS

American Institute of Certified Public Accountants
New Jersey Utilities Association
National Association of Water Companies
New Jersey Society of Certified Public Accountants

EDUCATION

Rutgers University, New Brunswick, New Jersey
Master of Business Administration - Finance
Monmouth University, West Long Branch, New Jersey
Bachelor of Science-Accounting