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Aloha Utilities, Inc.
Response to PSC Audit
Docket No. 000737-WS
Earnings Investigation

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FPSC-RECORDS/REPORTING

Aloha Utilities, Inc.
Response to PSC Audit
Docket No. 000737-WS

Disclosure No. 1

Auditors recommend that $99,794 of capitalized plant previously expensed for the Seven Springs water system should be removed, along with accumulated depreciation of $31,602. In the Aloha Gardens Systems auditors recommend that capitalized plant previously expensed of $3.669 and $4,567 be removed from the respective water and wastewater plant accounts, together with respective accumulated depreciation of $1.125 and $1,567.

Response

Cronin, Jackson, Nixon & Wilson, CPA's, reviewed plant additions since 1976 in preparation for the 1998 PSC audit. Aloha had not been audited since 1976, a period of some 23 years. The purpose of the review was to organize plant documentation and, hopefully, assist the Commission auditors in conducting the audit in an efficient and cost effective manner. The purpose was not to manipulate earnings or look for ways to unfairly increase rate base.

As a result of the review, $99,794 of Seven Springs water invoices were found that had been expensed in error, along with the immaterial amounts noted above for the Aloha Gardens Systems. In keeping with long-standing Commission practice, these errors were corrected in good faith. In fact, the auditors admitted they had made similar adjustments in other cases and their recommendation in Disclosure No. 6 of this audit is no different than what was done by Aloha. The audit adjustments for Aloha Gardens are immaterial, and the rest of this response relates solely to Seven Springs water.

To determine if correction of the error would have caused the Company to over earn in the year items were expensed, the Company went back to the Annual Reports for the applicable years and recalculated rate base, operating income, and rate of return as if the invoices had been capitalized. Attached to this response is a schedule showing that over the years involved, no overearnings would have resulted.

The Company believes that capitalization of invoices previously expensed was an appropriate correction of an error. The net amounts involved amount to approximately $9,000 in revenue. The amounts capitalized represent just 1.2% of total plant at December 31, 1999. This is hardly an attempt to manipulate earnings or rate base.

Disclosure No. 2

Auditors recommend increasing Aloha Gardens land account for the Seven Springs wastewater land adjustment made in their audit in Docket No. 991643-SU. After application of the non-used and useful percentage, an increase in land of $3,030 results.

Response

Aloha has no knowledge concerning whether an error was made in Order No. 99-1917-PAA-WS or not. However, the Company does not object to this adjustment.

Also, to be consistent with order No. 99-1917-PAA-WS, the non-used and useful portion should be amortized over 7 years as loss on plant abandonment. This would increase amortization expense by $1,299 ($12,120 x .75/7 yrs).

Disclosure No. 3

Auditors recommend depreciating computer equipment over 6 years, instead of the 15 years used by Aloha. Since some equipment was purchased in 1998, an adjustment to increase accumulated depreciation is proposed.

Response

Aloha has no objection to this adjustment. However, the Company does not believe any adjustment to accumulated depreciation is appropriate, consistent with the auditor's recommendation concerning capitalized plant in Disclosure No. 1.

Disclosure No. 4

Auditors recommend correction of a posting error for purchased water expense between Aloha Gardens water and Seven Springs water of $15. 277. The correction decreases Aloha Gardens expense and increases Seven Springs expense.

Response

Aloha agrees.

Disclosure No. 5

Auditors found transportation expense of $1,102 recorded twice in December, 1999. Although Aloha corrected this entry in January, 2000, test year expense should be reduced for the double entry in 1999.

Response

Aloha agrees.

Disclosure No. 6

Auditors recommend capitalizing the costs of a new pump that was expensed in Aloha Gardens sewer division ($3,816).

Response

Aloha agrees and believes this adjustment is consistent with its capitalization of previously expensed plant discussed in Audit Disclosure No. 1.

Disclosure No. 7

Auditors recommend decreasing the Vice President's salary by $28,764 benefits by $10,871 and related payroll taxes by $2,486. The adjustment is based on the belief that the Vice President does not warrant a greater annualized salary than the President. Since the Vice President devotes 20 percent of her time to utility matters, the salary should be capped at 20 percent of the President's salary.

Response

Aloha believes this is bizarre logic and ignores the following factors, which have been used by the Commission in the past to determine appropriate salary levels:

1. Does Vice President contribute to the operations, management, and success of the Company?

2. What duties and responsibilities are performed?

3. Is compensation reasonable compared to contribution to Aloha?

4. How does compensation compare to other similar sized utilities for Vice President and total officer compensation?

5. Is salary commensurate with level of business experience and total compensation?

Auditors have ignored these traditional tests on the assumption that all employees are of equal worth and their recommendation should be rejected.

Disclosure No. 8

Auditors recommend that $4,348 of unidentified expenses resulting from software conversion be allocated among Aloha's four operating divisions. The effect is to reduce Seven Springs water expenses by $2,174 and increase Aloha Gardens water and sewer expenses by $2,174.

Response

Aloha agrees.

Disclosure No. 9

Auditors recommend reducing accounting expenses for assisting Aloha in reviewing system output, balancing, and testing accounts associated with implementation of new general ledger and billing software. The impact is to reduce expense for the Aloha Gardens systems by $1,564 each, and by $4,021 for Seven Springs water. Auditors view these as non-recurring expenses and recommend amortization over 5 years.

Response

Aloha believes no adjustment is warranted. Until August 1999, the Company was not able to produce a general ledger or financial statements due to software conversion. Aloha believes the charges for these services simply took the place of the charges for the normal semi annual review of accounts. In addition, the financing with Bank of America requires the submission of quarterly statements which Cronin, Jackson, Nixon and Wilson will review before submission to the Bank. The annual estimated cost is expected to equal or exceed any costs proposed by this audit adjustment.

Disclosure No. 10

Auditors recommend removing $761 of Shell Oil credit card expenses apparently used by the Vice President's husband.

Response

Utility agrees.

Disclosure No. 11

Auditors propose adjustments to taxes other than income for available discounts not taken and method of allocation of real estate taxes. Impact is to increase taxes other than income for Aloha Gardens water and sewer by $1,141 and $5,836 respectively, and Seven Springs water by $4,370.

Response

Utility agrees.

Disclosure No. 12

Auditors state that Aloha Gardens 1999 purchased water expense decreased $76,574 from similar expense in 1998. Further, the Company sold 35,601,000 gallons more water than was available. The cause of the expense decrease is a faulty Pasco County meter.

Response

Aloha believes that the underbilling of water by Pasco County distorts its earnings for 1999 in the Aloha Gardens water system. In evaluating such earnings, the Company believes the Commission should increase reported O&M expense to take this temporary distortion of normal and necessary expense into account.

Pasco County has been notified of the slow running meter and believes it is likely the County may eventually back-bill them for this water. Rates should not be reduced. When the meter is fixed, rates would need to be increased again.

The problems related to the meter were noted in the 1999 Annual Report, along with an explanation as to why an expense for unbilled water was not accrued. A copy is attached.

Disclosure No. 13

Auditors note that the customer deposits account balance includes $41,782 of non-regulated deposits related to street light and garbage customers. Auditors recommend that the non-regulated deposits be removed.

Response

Aloha agrees.

Disclosure No. 14 - Deferred Taxes and Contributed Taxes

Auditors recommend netting all deferred tax assets, deferred tax liabilities, and contributed taxes and reducing rate base by the net amount. Auditors apparently believe this is normalization as required by Order No. 23541, issued October 1, 1990. Further, auditors believe that the unamortized contributed taxes (gross-up) received from developers to pay the tax impact on CIAC should be regarded as CIAC. This conclusion is based on auditors reliance on Order No. 11487, issued January 5, 1983, four years before CIAC became taxable. Auditors state, "we believe that Order 11487 is very clear and that all contributions received should be considered CIAC and included in rate base even if taxes were paid in the year received." Auditors claim that "after reading the above Orders and further review of the issues, it is clear as to the proper accounting treatment of these accounts for regulatory purposes."

Response

Unfortunately, Aloha does not believe that the auditors have obtained a clear understanding of gross-up, the related deferred taxes, or proper regulatory treatment of these accounts. Their reliance on Order No. 11487, issued four years before CIAC became taxable, is totally misplaced and the issue cited in that Order is totally unrelated to Aloha's accounting practices for CIAC.

Auditors seem to be unaware that meter fees, tap fees, and connection fees, as defined by Section 118 I.R.C., have always been taxable and were not eligible for gross-up. The Tax Reform Act of 1986 changed Section 118(b) I.R.C. to make all CIAC taxable effective January 1, 1986. In response, the Commission issued several Orders allowing utilities to collect the tax impact on previously untaxed CIAC from the contributor of CIAC. Since meter, tap, and connection fees were taxable prior to the enactment of the 1986 Tax Reform Act, utilities were prohibited from collecting the tax impact associated with the receipt of these types of CIAC.

Aloha obtained tariff authority to collect tax impact charges on CIAC and fully complied with the various related regulatory requirements. These included placing the charges in an interest bearing escrow account, making withdrawals only to pay taxes, and filing annual gross-up reports with the Commission. These reports showed the amounts collected, actual taxes paid, and proposed disposition of any remaining funds.

The Commission issued three Orders disposing of Aloha's gross-up collections during the period January 1, 1987, through June 12, 1996. Refunds were required for collections in the years 1987, 1989, and 1991. Aloha kept track of the tax impact charges received in an account called "Contributed Taxes." The first Order disposing of gross-up funds and requiring refunds covered the years 1987 through 1989 and was not issued until 1991. The second Order disposing of gross-up and requiring a refund covered the years 1990 through 1992 and was not issued until 1994. The final Order covered the years 1993 through July 12, 1996, and was not issued until 1998. Aloha's policy was to begin amortizing contributed taxes to above the line income, when a Commission Order was issued disposing of tax impact collections for the respective years. For this reason only, the balance in the "Contributed Tax" account is greater than the "Deferred Tax Asset - CIAC" account.

In response to Audit Disclosure No. 7, filed in Docket No. 991643-SU on June 30, 2000, Aloha demonstrated that if the Commission had issued Orders disposing of gross-up in the year received, the net balance in the "Contributed Taxes" and "Deferred Tax Asset - CIAC" accounts would be approximately equal.

The auditors have concluded that Order No. 11487 requires that contributed taxes should be treated as CIAC and deducted from rate base. The issue cited in that order dealt with tax on connection and tap fees. Avatar Utilities, Inc. of Florida, Barefoot Bay Division, sought to reduce the CIAC recorded for these charges by booking them net of tax. The Commission refused to accept this treatment, with which Aloha agrees. Aloha has recorded all types of CIAC received at their full value, whether taxable or not. Auditors fail to understand that the taxes paid by Avatar were investments in the taxes associated with connection and tap fees. Presumably, the deferred tax assets (debits) associated with Avatar's payment of taxes on connection and tap fees were an offset to the deferred tax liabilities (credits) recognized at zero cost in the capital structure.

Disclosure No. 14 - Deferred Taxes and Contributed Taxes

All this Order says is that CIAC should be recorded at full value, which Aloha has done. It could not reflect the policy proposed by the auditors since other forms of CIAC were not taxable and the concept of CIAC gross-up was unknown and not needed in 1983.

Auditors cite normalization requirements in Order No. 23541 for gross-up and non-gross up companies, as follows: "As discussed above, normalization involves offsetting debit-deferred taxes against credit-deferred taxes in the capital structure with any net debit-deferred tax balance included in rate base". Yet, the auditors are proposing to abandon normalization and are recommending a net reduction to rate base.

In the 1983 Avitar Order cited above, Avitar had reduced rate base by the net credit-deferred taxes. Sheet No. 3 of that order under Deferred Taxes reads as follows:

> "In its application, the utility reflected deferred taxes as a reduction to rate base. Consistent with the normalization method of accounting approved for this utility, deferred taxes should be included in the capital structure as zero cost."

Thus, the auditors' position is contrary to the very order they are relying on to support their recommendation to reduce rate base

Aloha believes that it is using the full normalization method for a gross-up company required by Order No. 23541. The difference in normalization for a gross-up company vs. a non-gross-up company is the existence of "contributed taxes" for a gross-up company.

A non-gross-up company is one who elected to invest in taxes related to taxable CIAC and did not collect the tax impact from contributors. As a result, there is no "contributed tax" account with which to offset deferred tax assets (debits) arising from taxable CIAC. The deferred tax assets (debits) are used to offset any deferred tax liabilities (credits) and the net debit balance is included in rate base. In this manner, a non-gross-up company's investment in taxes is recognized in the rate setting process.

In contrast, a gross-up company collected the tax impact of CIAC from the contributor. A deferred tax asset (debit) was created each year for the receipt of taxable CIAC, just like a non-gross-up company. However, the deferred tax asset is not recognized in the rate setting process since the company did not make the investment in the tax. Rather, the tax was paid by the contributor of CIAC and reflected in the "contributed tax" account. Thus, a gross-up company has no investment basis in either the deferred tax asset (debit) or "contributed taxes" (credit) accounts. As a result, both of these accounts are ignored in the rate setting process.

It is apparent that the auditors are looking for a way to include the difference between Aloha's "deferred tax asset-CIAC" (debit) account and the "contributed tax" (credit) account of ($185,455) in the rate setting process. This would reduce the revenue requirement. As noted above, the difference for Aloha arises solely because of the timing of when amortization of "contributed taxes" began, due to delays in Orders from the Commission. Rate setting treatment of this difference would be bad policy and punitive for the following reasons:

1. Regulatory treatment of the difference will result in returning a greater benefit to the general body of rate payors than required by Order No. 23541. The only benefits Aloha receives are the tax depreciation benefits on CIAC which was taxable.

Disclosure No. 14 - Deferred Taxes and Contributed Taxes

2. Aloha is returning the tax benefits of depreciation to the general body of rate payors by 1.) including the deferred tax liabilities associated with the depreciation of taxable CIAC assets, as zero-cost capital in the capital structure and 2.) amortizing the "contributed tax" account to above the line income. Over the tax depreciation/amortization lives, all benefits received will be returned to the general body of rate payors.

3. For some gross-up companies, the "contributed tax" (credit) balance is less than the "deferred tax-asset-CIAC (debit)" balance. Aloha does not believe that this debit difference should be treated as an investment, under the auditors' theory of normalization. A gross-up company has no investment basis in either of these accounts, regardless of their balances.

4. Aloha (or any other company which grossed-up CIAC) received no benefit from the contributed taxes received, except for tax depreciation benefits. No cost fee capital or other discretionary flow of funds resulted from receipt of tax impact charges. Rather, all amounts received were used to pay income taxes and were unavailable for any other purpose. As noted above, they were closely regulated and disposed of by Commission Order.

Finally, it is not clear what the auditors understand the "contributed tax" account to be. In their proposed adjustment it is labeled "CIAC Grossed up" and the accumulated amortization is labeled "Amortization of CIAC". As noted above, none of the CIAC that was subject to tax is in this account. One hundred percent of the CIAC received was recorded as such.

The statement is made that "In Aloha's case, no distinction is made for deferred taxes relating to meter fees received that were not grossed-up and deferred taxes relating to plant capacity charges that were grossed up." Aloha does not understand this statement since separate accounts for deferred taxes on meter fees are maintained. Regardless of who paid the tax on various forms of CIAC, a deferred tax asset (debit) will result because of the book/tax timing difference. The distinction regarding meter fees deferred taxes should be self evident, since taxes on such CIAC were paid for by Aloha and represent an investment. As noted above, the Commission prohibited collection of gross-up on meter fees. Deferred tax assets (debits) for meter fees were not used to offset deferred tax liabilities (credits) in the wastewater rate case since they relate to water operations. If there is any meaning in the auditors' statement beyond this, Aloha doesn't get it.

In summary, the auditors' clear understanding of the issues in disclosure No. 14 should be rejected.

Aloha Utilities, Inc.
Analysis of Invoices Capitalized in 1997
Seven Springs Water Division
Response to Audit Disclosure No. 1
Docket No.000737 - WS

Year of Addition	Cost Expensed		Proforma Depreciation Expense	Operating Income Per Annual Report	Rate Base Per Annual Report	Rate of Return Per Annual Report	Proforma Operating Income Had Cost Been Capitalized	Proforma Rate Base Had Cost Been Capitalized	Proforma Rate of Return Had Cost Been Capitalized
1980		$ 1,622	$ 20	$ 25,201	$ 551,946	4.57%	$ 26,803	$ 553,346	4.84%
1981			$ 41	$ 99,173	$ 890,350	11.14%	$ 99,132	$ 891,911	11.11%
1982			$ 41	$ 57,640	$ 578,208	9.97%	$ 57,599	$ 579,728	9.94%
1983			$ 41	$ 74,120	$ 588,315	12.60%	$ 74,079	$ 589,794	12.56%
1984			$ 41	$ 63,410	$ 539,345	11.76%	$ 63,369	$ 540,783	11.72%
1985			$ 41	$ 44,485	$ 481,214	9.24%	$ 44,444	$ 482,611	9.21%
1986		3,095	$ 80	$ 28,111	$ 384,809	7.31%	$ 31,126	$ 388,834	8.00%
1987	$ 9,728 7,601 885	18,214	$ 346	$ (38,312)	$ 448,618	-8.54%	$ (20,098)	$ 468,621	-4.29%
1988			$ 573	$ 502	$ 284,203	0.18%	$ (71)	$ 305,910	-0.02%
1989	1,567 15,794	17,361	$ 790	$ (1,562)	$ 210,166	-0.74%	$ 15,799	$ 246,274	6.42%
1990	22,465 9,623 11,660	43,748	$ 1,554	$ (19,538)	$ 222,480	-8.78%	$ 24,210	$ 297,484	8.14%
1991	1,800 5,565 8,389	15,754	$ 2,300	$ 11,262	$ 251,326	4.48%	$ 27,016	$ 343,283	7.87%
Total		$ 99,794	$ 5,868						
Average for Periods				$ 28,708	$ 452,582	6.34%	$ 36,951	$ 474,048	7.79%

UTILITY NAME: Aloha Utilities, Inc.
SYSTEM NAME / COUNTY: Aloha Gardens / Pasco

YEAR OF REPORT
December 31, 1999

SCHEDULE OF YEAR END WATER RATE BASE

ACCT. NO. (a)	ACCOUNT NAME (b)	REF. PAGE (c)	WATER UTILITY (d)
101	Utility Plant In Service	W-4(b)	$ 892,853
	Less:		
	Nonused and Useful Plant (1)		
108.1	Accumulated Depreciation	W-6(b)	763,201
110.1	Accumulated Amortization		
271	Contributions in Aid of Construction	W-7	438,245
252	Advances for Construction	F-20	
	Subtotal		(308,593)
	Add:		
272	Accumulated Amortization of Contributions in Aid of Construction	W-8(a)	295,627
	Subtotal		(12,966)
	Plus or Minus:		
114	Acquisition Adjustments (2)	F-7	
115	Accumulated Amortization of Acquisition Adjustments (2)	F-7	
	Working Capital Allowance (3)		56,222
	Other (Specify):		
	WATER RATE BASE		$ 43,256
	UTILITY OPERATING INCOME	W-3	$ 108,617
	ACHIEVED RATE OF RETURN (Water Operating Income/Water Rate Base) (Note (4))		251.10 %

NOTES: (1) Class A calculate consistent with last rate proceeding. Class B estimated if not known.

(2) Include only those Acquisition Adjustments that have been approved by the Commission.

(3) Calculation consistent with last rate proceeding.
In absence of a rate proceeding, Class A utilities will use the Balance Sheet Method and Class B Utilities will use the One-eigth Operating and Maintenance Expense Method.

UTILITY NAME: Aloha Utilities, Inc.
SYSTEM NAME / COUNTY: Aloha Gardens / Pasco

YEAR OF REPORT
December 31, 1999

SCHEDULE OF YEAR END WATER RATE BASE

Note (4): During 1999, The Pasco County bulk meter used to measure purchased water was not working properly. Management notified Pasco County Utility Department but the meter has yet to be repaired or replaced. As a result, Aloha has been underbilled for purchased water by approximately $85,000. As shown on Page W-11, Aloha sold 35,601 gallons (000) more than was purchased and pumped. The total gallons purchased and billed amounted to 68,185 gallons (000) This compares to gallons purchased in 1998 and 1997 of 115,515 and 118,672 respectively.

Based on these circumstances, the operation and maintenance expenses are artificially low for 1999 and result in an appearance of abnormally high earnings. The Company considered accruing a liability for unbilled purchased water expense, but decided not to book such an entry at this time, due to uncertainties as to Pasco County's action on this matter in the future.