AP STATEMENT NO. 7

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

AQUA PENNSYLVANIA, INC.

Docket No. R-2011-2267958

DIRECT TESTIMONY OF
WILLIAM J. JERDON

With Regard To Taxes

November 18, 2011

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF WILLIAM J. JERDON

1. Q. What is your name and business address?

A. William J. Jerdon, 762 Lancaster Avenue, Bryn Mawr, PA 19010.

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

A. I am employed by Aqua Pennsylvania, Inc. ("AP" or "the Company") as Tax Manager.

3. Q. Would you please relate your education and business experience?

A. I am a 1974 graduate of Philadelphia College of Textiles and Science with a bachelor's degree in accounting. I also earned a Masters of Science Degree in Taxation from Drexel University in 1978.

Following graduation from the Philadelphia College of Textiles and Science, I was employed by ARA Services, Inc. and served in various capacities in its tax department. In 1978, I was employed by Westmoreland Coal Company and, in 1987, I was appointed Director of Taxes, which position I held until November, 1995. I joined AP's predecessor, the Philadelphia Suburban Water Company, in May, 1996.

4. Q. What are your duties as Tax Manager of the Company?

A. I am primarily responsible for the Company's tax accounting relating to federal, state, and local taxation.

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

A. The purpose of my testimony is to support the Company's tax claims and tax related rate base items.

6. Q. For which of the Company's adjustments are you responsible?

A. I am responsible for the following adjustments:

ADJUSTMENT	EXHIBIT 1-A PAGE REF.
Pa Capital Stock Tax	64
Computation of Federal and State Income Taxes	66
Deferred Federal and State Income Taxes	67

7. Q. Please explain the adjustment for Pennsylvania Capital Stock Tax on page 64.

A. The Pennsylvania capital stock tax is a tax on property and is imposed on domestic business corporations. The Pennsylvania capital stock and franchise tax is computed on the basis of the corporations' taxable value of capital stock. There are two components that comprise the capital stock taxable value. The first component is computed by averaging the current year and the last 4 years of book income and capitalizing the result at 9.5%. The second component is computed by multiplying the net worth of the corporation by 75%. The resultant net worth component and the average capitalized book income are added and multiplied by 50% to arrive at the capital stock taxable value. This value is reduced by a statutory exemption of $160,000. The (415,900) future test year adjustment is based on the above mentioned calculation. To calculate the five-year average of book income, I used actual results from 2008 through 2010 and budgeted estimates for 2011 and 2012. To calculate the net worth component, budgeted amounts were used for 2011 and 2012. I applied the 2012 tax rate of 1.89 mills.

8. Q. Please explain the basis for the state and federal income tax adjustments set forth on page 66 of Exhibit No. 1-A.

A. The calculation of current state and federal income taxes begins with pre-tax income (operating income before taxes minus total interest expense) for the future test year under present rates, which is $160,206,877 and under proposed rates, which is $198,333,677 calculated from the data presented on page 2 of Exhibit No. 1-A. To these pre-tax income amounts, appropriate adjustments have been made including the substitution of the amount of depreciation deducted for tax purposes for the amount of depreciation deducted on the Company's books, and an addition to reflect the future test year's difference related to the application of the Uniform Capitalization Rules on capital additions, stock options and meals & entertainment expenses. The Uniform Capitalization Rules are the capitalization of certain direct and indirect costs and interest charges that are incurred during the production period of certain assets. This taxable income is then used to calculate the appropriate amount of state income taxes to be included in the rate filing. The state income taxes are then deducted from the state taxable income to arrive at the adjusted current federal taxable income (I will address deferred federal income taxes later in my testimony.) I applied the 35% federal tax rate to the adjusted federal taxable income and reduced this amount by $539,292 to reflect so-called consolidated tax savings to arrive at the Company's federal tax claim under proposed rates of $22,850,900.

9. Q. What depreciable lives and depreciation methods does the Company use for federal income tax purposes?

A. The Company uses the following depreciable lives and depreciation methods for tax depreciation purposes:

Utility Property

1969 and prior	50 years (1)	Straight-Line
1970	50 years (1)	Double Declining Balance Switch to Straight-Line
1971 to 1980	40 years (2)	Double Declining Balance Switch to Straight-Line
1981 to 1986	15 years	Accelerate Cost Recovery System (ACRS)
1987 to June, 1996	20 years	Modified Accelerated Cost Recovery System (MACRS)
June, 1996 and subsequent	25 years	Straight-Line
Tax Exempt Financed Property	50 years	Straight-Line
Buildings		
1970 and prior	45 years (1)	Straight-Line

1971 to 1980	45 years (2)	Straight-Line
1981 to 1984 (portion)	15 years	ACRS
1984 (portion) to 1985	18 years	ACRS
1986	19 years	ACRS
Buildings		
1987 and subsequent	31 1/2 years	Straight-Line
Office Equipment		
1970 and prior	10 years (1)	Straight-Line
1971 to 1980	8 years (2)	Double Declining Balance
1981 to 1986	5 years	ACRS
1987 and subsequent	7 years	MACRS
Qualified Technological Equipment		
1987 and subsequent	5 years	MACRS

(1) Guideline Lives

(2) Lives under Asset Depreciation Range (ADR)

10. Q. Please explain how you calculated the consolidated tax savings adjustment of $539,292.

A. The calculation of the consolidated tax savings adjustment is detailed in Schedule 1, which is attached to this statement. In short, I used the same Modified Effective Tax Rate Method that has been employed in numerous prior cases for AP and other utilities with the Commission's approval. That method begins with net taxable losses of non-regulated companies in the affiliated group for a multi-year historical period which, in AP's case, has been three years. The data are adjusted to remove anomalies, such as tax losses attributable to companies that are no longer part of the affiliated group or tax losses attributable to conditions that will not exist in the future. The results are averaged, and the average taxable loss is allocated to all members of the consolidated group (regulated and non-regulated) that have positive taxable income. My calculation uses data for the years 2008 through 2010, which are the last three years for which tax returns are available. I also made certain adjustments to the taxable losses, as shown on Schedule 1. The resulting three-year average of tax losses is $3,430,940, of which 44.91% is allocable to AP. Based on the federal income tax rate of 35%, the adjustment to federal income taxes is $539,292. It should be noted that Pennsylvania does not permit the filing of consolidated returns for Pennsylvania corporate net income tax. Consequently, there is no consolidated tax savings adjustment for Pennsylvania corporate income taxes.

11. Q. Please identify the adjustments you made to the tax loss data for the years 2008 through 2010.

A. The adjustments are shown on Schedule 1 under the caption "Adjustments" on the lines identified as "Loss On Sale," "New Business," "Merger Costs," "Aqua Development," "Aqua Operations," and " Bonus Depreciation."

12. Q. Why were adjustments made for "Loss On Sale"?

A. In 2008, Aqua America, Inc. realized a tax loss on the sale of Bio Advance warrants.

13. **Q. Why was an adjustment made for "New Business"?**

A. Calendar 2006 was the first year of operations for Aqua Wastewater Management, Inc., and, as a result, it incurred various startup costs that will not be experienced on an ongoing basis. Indeed, Aqua Wastewater Management is producing taxable income during the future test year.

14. **Q. Why was an adjustment made for "Merger Costs"?**

A. The $193,812 deduction for merger costs relate to the amortization for the Consumers Water acquisition cost which will not exist in the future test year. The merger costs were legal costs and other costs that were incurred in the acquisition of Consumers Water, Inc. in March, 1999 and were amortized over a ten year period beginning in 1999.

15. **Q. Why was an adjustment made for "Bonus Depreciation"?**

A. The deduction for bonus depreciation of $1,601 relates to property of Mayfore, Inc., and will not exist in the future test year. Mayfore will not have any property that is eligible for bonus depreciation for 2012.

16. **Q. Why was an adjustment made for "Aqua Operations"?**

A. Expenses incurred on the books of Aqua Operations, Inc. will not exist in the future test year. The expenses relate to the write off of depreciable property There are no remaining fixed assets on the books of Aqua Operations, Inc.

17. Q. Why was an adjustment made for 'Aqua Development"?

A. The losses of Aqua Development, Inc. have decreased from 2008 through 2010, and the Company anticipates taxable income in the future test year. The primary reason for the income is mainly due to the company charging a management fee in 2010 that did not exist in prior years.

18. Q. Mr. Jerdon, would you please explain the data shown on page 67 of Exhibit No. 1-A regarding deferred income taxes?

A. Certainly. Deferred income taxes arise as a result of the difference between tax depreciation and normalized depreciation for post-1969 utility property. Tax depreciation is calculated by multiplying the depreciation rates, which result from the application of the asset lives and the depreciation methods that I previously detailed, to the tax basis of the assets. Normalized depreciation differs depending on the vintage year and applicable tax depreciation method. For property of those vintage years for which ADR lives apply, normalized depreciation is calculated by using the straight-line remaining life method times the tax basis of the assets. For property of those vintages for which the ACRS and MACRS methods apply, normalized depreciation is the same as book depreciation. For assets acquired prior to 1970, there is no deferred tax calculation because depreciation differences are flowed through to customers.

The deferred tax expense set forth on page 67 in the amount of $41,214,682 was calculated by multiplying the amount by which the tax depreciation exceeded the normalized depreciation, or $117,756,234, by the federal tax rate of 35%. This amount was then adjusted for the future test year portion of the Company's anticipated deferred tax benefit resulting from the application of the Uniform Capitalization Rules to the current year's capital additions and the flow-back to customers of a portion of the accumulated deferred tax difference reflecting the reduction in federal tax rates from 46% to 35% that occurred between 1986 and 1993. This latter adjustment is similar to those proposed and accepted in the Company's prior rate filings. The net amount of $41,357,034 represents the Company's anticipated deferred tax expense under proposed rates as set forth on page 2 of Exhibit No. 1-A.

This amount, along with an adjustment for deferred taxes associated with taxable contributions in aid of construction (CIAC), is then added to the beginning balance of accumulated deferred federal income taxes to arrive at the accumulated deferred tax balance as of June 30, 2012, as set forth in the Company's rate base calculation on page 81 of Exhibit 1-A.

19. Q. Please explain the adjustment for deferred taxes associated with taxable CIAC which is reflected on page 67.

A. The adjustment of $(3,645,388) represents the cumulative amount of CIAC taxable income in excess of the cumulative amount of the tax depreciation taken on assets acquired with CIAC from 1987 through June 2011, multiplied by the federal income tax rates in effect for those years.

The adjustment for CIAC of $306,400 represents the tax depreciation for the year ended June 30, 2012 taken on CIAC-related property from 1987 through June, 2012, multiplied by the federal income tax rates in effect for those years.

20. Q. Does that conclude your direct testimony?

A. Yes, it does.