STATE OF ALASKA

BEFORE THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:	Stephen A. McAlpine, Chairman Paul F. Lisankie Rebecca L. Pauli Robert M. Pickett Janis W. Wilson
In the Matter of the Consideration of the Revenue Requirement Designated as TA 32-733 Filed by COOK INLET NATURAL GAS STORAGE ALASKA, LLC)	Docket No. U-18-____

PREFILED DIRECT TESTIMONY
OF
CATHERINE N. GARDNER
ON BEHALF OF
COOK INLET NATURAL GAS STORAGE ALASKA, LLC

PREFILED DIRECT TESTIMONY
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CATHERINE N. GARDNER

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I. POSITION AND QUALIFICATIONS

Q. State your name, business address and present position.

A. My name is Catherine N. Gardner. My business address is 3000 Spenard Road, Anchorage, Alaska 99503. I am Director of Finance & Accounting for ENSTAR Natural Gas Company, a division of SEMCO Energy, Inc. ("SEMCO"), and Alaska Pipeline Company, a subsidiary of SEMCO. For purposes of my testimony, I will refer to these two regulated entities collectively as "ENSTAR". ENSTAR performs management services for Cook Inlet Natural Gas Storage Alaska, LLC ("CINGSA" or "Company") through an Operation and Maintenance Agreement ("the OMA"), and I am appearing in this proceeding on behalf of CINGSA.

Q. Briefly describe your professional experience and educational background.

A. Since 2008, I have been the Director of Finance & Accounting for ENSTAR and a member of ENSTAR's senior leadership team. I joined ENSTAR as General Accounting Manager in 2006. Prior to joining ENSTAR, I held various accounting positions in California, which are listed on my summary resume attached as Exhibit CNG-1. I received a Bachelor of Science degree in Business Administration from California State University, Fresno in 1985 and a Master of Business Administration with a concentration in Accounting from University of Phoenix in 2004. I obtained a Certified Public Accountant license in the state of California in 1989, and in 2016 I became certified in the Internal Controls program of the Committee of Sponsoring Organizations.

Q. Briefly describe your current professional responsibilities.

A. As Director of Finance & Accounting for ENSTAR, I am responsible for preparation and review of periodic financial operating statements as well as the planning and

development of ENSTAR's and CINGSA's long-range planning programs. I am responsible for all aspects of general accounting for both ENSTAR and CINGSA, which includes payroll, accounts payable, general ledger, plant accounting, and gas accounting. In this capacity, I formulate accounting policies, prepare and review financial statements and reports, and coordinate systems and procedures. I perform the services indicated above pursuant to the OMA described above. In addition, I am responsible for the Customer Accounting and Credit departments at ENSTAR, which handle all aspects of customer billing and payments, including the customer call center.

Q. Have you previously testified before the Regulatory Commission of Alaska ("RCA" or "Commission") or any other regulatory commission?

A. Yes. I filed written testimony in RCA Docket No. U-07-174, which was ENSTAR's Depreciation Study in March 2008.

II. PURPOSE OF TESTIMONY AND BACKGROUND

Q. What is the purpose of your direct testimony?

A. I will describe certain aspects of CINGSA's accounting policies, procedures and records. I am sponsoring various schedules supporting CINGSA's revenue requirement filed pursuant to Commission regulation 3 AAC 48.275(a) ("275(a) filing"), which is included as Attachment B to CINGSA's overall rate filing. I also describe several of the adjustments to test year data that CINGSA witness Mr. Daniel M. Dieckgraeff incorporates in his cost of service ("COS") study to calculate CINGSA's normalized revenues, expenses and rate base using a test year ending December 31, 2017.

1 **Q. Which accounting policies, procedures and records will you be describing?**

2 A. I will discuss the Cost Allocation Manual ("CAM") used by CINGSA and ENSTAR,
3 which includes policies and procedures for allocating costs between the companies. I
4 will also discuss certain operating expense accounts and income tax accounts in
5 CINGSA's general ledger. In addition, I will discuss CINGSA's cost of debt and
6 capital structure.

7 **Q. Which schedules in CINGSA's 275(a) filing are you specifically sponsoring?**

8 A. I am sponsoring the following schedules of the 275(a) filing (Attachment B), which
9 were prepared by me or under my direct supervision:

10 - Comparative Statement of Assets, Liabilities and Other Credits (page 25);
11 - Comparative Statement of Income and Operating Expenses (page 26);
12 - Comparative Statement of Changes in Equity (page 27);
13 - Plant in Service and Accumulated Depreciation (pages 28-29);
14 - Depreciation Expense (pages 30-31);
15 - Long-Term Debt Outstanding (page 32); and
16 - Computation of Pro Forma Provision for Income Taxes (page 20).

17 These schedules are required by 3 AAC 48.275(a)(1)-(3), (8), (10) and (13).

18 **Q. Describe the source of the information contained on these schedules.**

19 A. These schedules contain historical financial data compiled from CINGSA's accounting
20 books and records, or are based on such data, for the test year ended December 31,
21 2017. CINGSA's accounting books and records are maintained in accordance with the
22 Uniform System of Accounts ("USOA") for gas utilities prescribed by the Federal
23 Energy Regulatory Commission ("FERC") and required by this Commission pursuant

to 3 AAC 48.277(a)(5). The books and records of ENSTAR and CINGSA are also maintained in accordance with generally accepted accounting principles ("GAAP") for the United States. Internal controls are in place to ensure compliance with the applicable accounting instructions, including internal and external audit functions that are performed by two of the four largest international accounting firms. For internal reporting and management purposes, CINGSA uses a more detailed chart of accounts than required by the USOA, but the Company's accounting system summarizes the accounts into categories to match the USOA. These accounting records are consistent with prior presentations of similar data to the Commission.

Q. Have you reviewed CINGSA's books and records in connection with this filing and made any adjustments to the data?

A. Yes. In preparing this filing, I (or persons acting under my direction and supervision) reviewed the data contained in CINGSA's accounting books and records and identified unusual events, non-recurring expense and revenue items, areas requiring or warranting adjustments for known and measurable changes, and other necessary and/or appropriate revenue, expense, and investment adjustments. This review identified and quantified adjustments needed for a fair and reasonable representation of CINGSA's base rates.

The results of this review are reflected in various adjustments to test year data made to arrive at the "normalized" test year included in this filing. I am sponsoring adjustments that appear in Schedules E to K of the 275(a) filing. CINGSA witness Mr. Dieckgraeff also sponsors various adjustments as set forth in his testimony. Normalizing test year data is a standard regulatory practice and is intended to produce

rates that more accurately portray CINGSA's expected annual costs and revenues for the period when the rates will be in effect.

III. ACCOUNTING POLICIES AND PROCEDURES

Q. What is the basis for CINGSA's accounting policies?

A. As previously stated, CINGSA's accounting policies are based on the USOA and U.S. GAAP. CINGSA also adheres to accounting policies and procedures prescribed by SEMCO, its indirect majority owner, including the CAM.

Q. Describe the CAM used by CINGSA and ENSTAR.

A. The CAM was developed to specify the procedures that ENSTAR uses to assign and allocate costs among the projects and entities for which ENSTAR provides services. It describes the allocation methodology for internal work orders and reimbursable construction projects. For accounting purposes, ENSTAR treats CINGSA like a reimbursable construction project, and CINGSA treats ENSTAR as a service provider.

The CAM was originally written to address internal accounting policies and procedures. It was updated more recently to address guidelines of the National Association of Regulatory Utility Commissioners and to incorporate recommendations made by Commission personnel.

Q. Does ENSTAR employ individuals directly?

A. No. Because ENSTAR is a division of SEMCO, all employees working in Alaska for ENSTAR are employees of SEMCO who are 100% dedicated to working on and for SEMCO's Alaska assets. I will refer to these individuals as "ENSTAR employees."

Q. How does CINGSA account for work performed by ENSTAR employees?

A. ENSTAR bills CINGSA each month for direct labor, materials and administrative & general ("A&G") overhead.

1 **Q. Does ENSTAR charge CINGSA a management fee?**

2 A. No.

3 **Q. How does ENSTAR track direct labor to be charged to CINGSA?**

4 A. ENSTAR employees charge their time to CINGSA account numbers when working on
5 CINGSA projects or operation and maintenance ("O&M").

6 **Q. How does this time get billed to CINGSA?**

7 A. ENSTAR compiles the labor charges to CINGSA accounts for the month, and then
8 adds payroll burden to the direct labor. The direct labor charges (with payroll burden)
9 are then allocated A&G overhead.

10 **Q. What is included in the A&G overhead that is allocated to CINGSA?**

11 A. The A&G overhead includes a portion of the labor for employees who work in areas
12 other than O&M, as well as other common and allowable A&G charges. These areas
13 include executive management, accounting/tax, regulatory, information technology
14 ("IT"), human resources ("HR"), safety/risk, legal, and communications/public affairs.

15 **Q. How are the A&G overhead rates calculated?**

16 A. The overhead rates are determined through an annual calculation made by ENSTAR,
17 which is audited by the Alaska Department of Transportation ("AK-DOT"). The
18 procedures are outlined in the CAM, but can be summarized as follows:

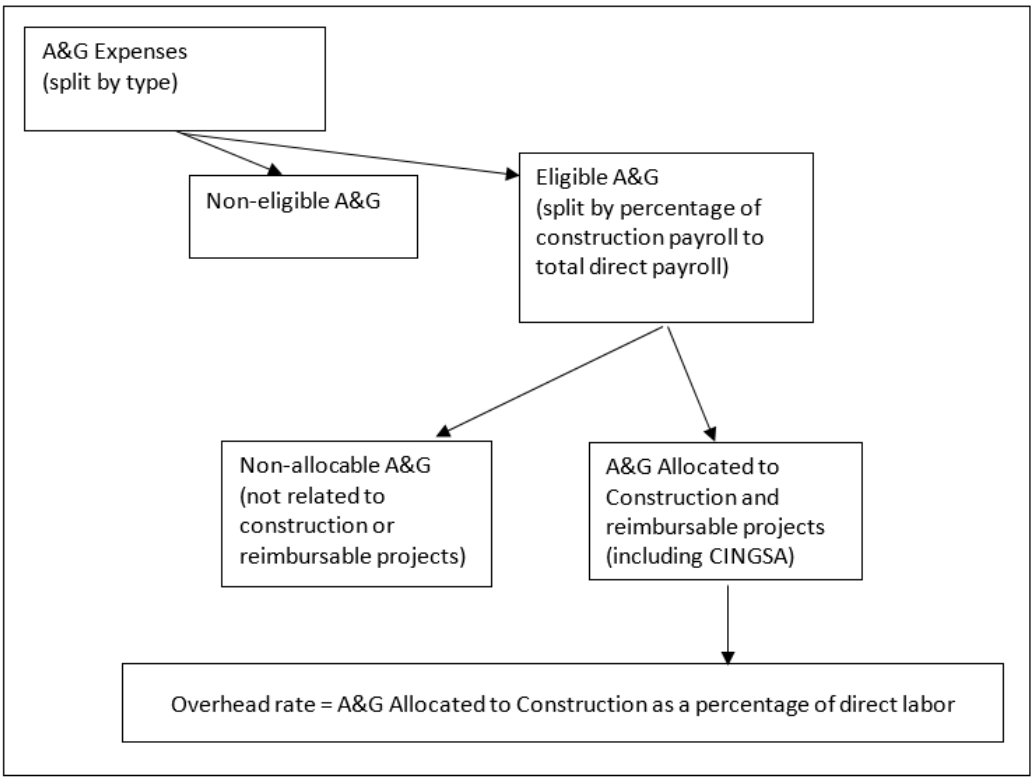
19 1. The calculation starts with ENSTAR A&G expenses from the prior year and is
20 performed after the annual audit of ENSTAR's books and records has been
21 completed.

22 2. Eligible A&G expenses are determined based on RCA, FERC, Federal
23 Acquisition Regulations ("FAR"), and AK-DOT guidelines, rules and

regulations. The basis for selecting the expenses in eligible accounts is their relationship to the normal operating functions of the utility. Some accounts are analyzed and split into eligible and non-eligible expenses based on the nature of the specific charges to the account.

3. Once eligible A&G expenses are determined, allocable A&G is calculated and is expressed as a percentage of direct labor.

The following flow chart illustrates the applicable overhead allocation process:



Q. Why doesn't ENSTAR charge CINGSA a monthly management fee instead?

A. Article V of the OMA between ENSTAR and CINGSA states as follows:

> The Company [(CINGSA)] shall pay to Operator [(ENSTAR)] reimbursement for all authorized, reasonable and necessary expenses incurred in the performance of its duties under this Agreement. Such reimbursement shall include only the actual costs of the Services provided, including reasonable overhead, benefits and tax loading, without any additional fees or charges.

A management fee is not authorized pursuant to the OMA. In determining "reasonable overhead" per the OMA, ENSTAR and CINGSA concluded that using the rates set in the independent audit performed by AK-DOT each year would give CINGSA's customers and partners assurance that the overhead amounts allocated to CINGSA are reasonable. Because that allocation process is annually determined in the course of AK-DOT audits, ENSTAR and CINGSA concluded that allocating administrative costs using another method, such as the Modified Massachusetts Formula, would not be necessary. A copy of the most recent audit report from AK-DOT is included as Exhibit CNG-2.

Q. Do one or more of the affiliate standards established in Alaska law apply to allocations between ENSTAR and CINGSA?

A. Yes. Pursuant to AS 42.05.990(1), "affiliated interest" includes a person owning or holding directly or indirectly five percent or more of the voting securities of a public utility engaged in intrastate business in Alaska. ENSTAR is a division of SEMCO, and SEMCO indirectly owns more than five percent of CINGSA. Therefore, ENSTAR and CINGSA are affiliates under Alaska law. There are two statutory requirements associated with evaluating affiliate transactions in rates: specifically, AS 42.05.511(c) and 42.05.441(c).

Pursuant to AS 42.05.511(c), the utility has the burden to prove that: (1) services provided by the affiliate are necessary and consistent with the public interest; (2) payment made for those services is reasonably based, in part, on the cost incurred by the affiliate to provide those services; and (3) the payment is reasonably based, in

part, on the estimated cost for the utility to perform those services if it were to self-provide those services with its own personnel and capital.

Pursuant to AS 42.05.441(c), if a utility makes payments to a person having an ownership interest of more than 70 percent in the utility, it also has the burden to make a clear and convincing showing that: (1) the payments made for the services provided by the affiliate were for services that were reasonably necessary for the operation of the utility; and (2) the services were provided to the utility at a cost that was competitive with the price at which the utility could have obtained the services from an unaffiliated third party. Since there is no owner of more than 70 percent of CINGSA's interests to whom CINGSA has made any payments, this statute does not apply.

Q. Are the allocated services ENSTAR performs for CINGSA necessary and consistent with the public interest?

A. Yes. CINGSA does not have stand-alone employees, and therefore it is necessary that it either receive services from its affiliates or procure such services through unaffiliated third parties. The services ENSTAR employees provide to CINGSA are necessary for it to function and operate its facilities. Operating a gas storage facility like CINGSA's is clearly in the public interest as described in the direct testimony of CINGSA witness Mr. John D. Sims. The services ENSTAR employees provide to CINGSA are therefore consistent with the public interest.

Q. How do the allocated services provided to CINGSA by ENSTAR employees benefit customers?

A. CINGSA and its customers benefit from the services that ENSTAR employees provide in several ways. CINGSA benefits from having experienced, competent professionals

perform the specialized tasks inherent in running any company, including a utility company. As a much larger utility entity, ENSTAR enjoys cost efficiencies that could not be achieved if it were to source these services from third parties or replicate these services on its own. Allowing ENSTAR employees to provide service to both ENSTAR and CINGSA enables cost-sharing so that each only bears a portion of these employee costs, allowing each entity to leverage the experience of these employees.

Q. Are the A&G overhead amounts allocated to CINGSA appropriate when compared to the cost that would be incurred by CINGSA if CINGSA were to self-perform the related services?

A. Yes. ENSTAR provides executive management, accounting, tax, regulatory, finance, treasury, IT, HR, safety/risk, legal and communications/public affairs services for CINGSA. If CINGSA were to provide these services through stand-alone CINGSA employees or unaffiliated third party vendors, the cost would be significantly higher. CINGSA performed an analysis of the estimated cost it would incur to perform the same services internally compared to the allocated services that ENSTAR currently provides. CINGSA's allocated costs for ENSTAR employees' services during the test year were $854,700. If CINGSA were to directly perform these functions and/or use the services of unaffiliated third parties, it estimates that such costs would more than double. Moreover, CINGSA would be required to incur capital expenditures for various systems and hardware currently provided by ENSTAR, resulting in increased capital expenditures, and therefore additional depreciation expenses added to CINGSA's revenue requirement.

Using ENSTAR resources and allocating A&G provides economies of scale and tremendous value to CINGSA, and these costs are more than competitive with costs that would be incurred if CINGSA were to self-provide these services or receive them from an unaffiliated third party. The allocated service costs from ENSTAR meet the affiliate transactions standards set forth in Alaska law.

Q. Do CINGSA's partners charge costs to CINGSA?

A. Yes, both SEMCO (CINGSA's 65% indirect owner) and Alaska Gas Transmission Company, LLC ("AGTC") (CINGSA's 26.5% indirect owner) have periodically charged *direct* costs to CINGSA. SEMCO has charged CINGSA for direct labor (primarily in the treasury and risk departments) and for specific costs related to CINGSA's governance, such as filing fees and board meetings. AGTC has charged CINGSA for direct labor related to project management and finance. The costs charged by both companies have been minimal from a financial perspective, totaling $2,856 during the 2017 test year. Other than these costs, CINGSA has not been charged any costs, directly or through allocations, from any of its members or affiliates, including SEMCO, AGTC, or any of their affiliates. Like the ENSTAR allocations mentioned above, these parent company costs meet the applicable affiliate transaction standard set forth in Alaska law.

IV. ADJUSTMENTS TO OPERATING EXPENSES

Q. Why is CINGSA proposing a series of expense adjustments for purposes of determining its revised base rates?

A. Base rates are intended to recover a utility's non-gas costs of providing service to customers. Just as test year revenue-related items often require adjustment to be

representative of expected conditions during the rate-effective period, test year expenses often must be adjusted for the same reason.

Q. What types of adjustments are proposed?

A. Adjustments to the historical test year are generally of three types. The first are normalization adjustments designed to eliminate unusual or non-recurring items during the test year. The second are adjustments to reflect known and measurable, or pro forma, changes in test year revenues, expenses, and rate base (or investment). The third are regulatory adjustments intended to account for items in a manner consistent with currently accepted ratemaking principles and objectives. Mr. Dieckgraeff sponsors certain of the rate base and revenue adjustments and further discusses them in his direct testimony.

Q. What adjustments included in CINGSA's 275(a) filing do you sponsor?

A. Several adjustments to expenses are included in CINGSA's 275(a) filing. I will discuss and sponsor the following expense adjustments:

- Payroll Expense Adjustment (Schedule E);
- U-10-051 Amortization Adjustment (Schedule F):
- Rate Case Expense Adjustment (Schedule G);
- Miscellaneous Expense Adjustment (Schedule H);
- Insurance Expense Adjustment (Schedule I); and
- Depreciation Expense Adjustment (Schedule J).

I also sponsor the adjustment on Schedule K of the 275(a) filing, but discuss that in detail in Section V of my testimony.

Q. Please discuss the payroll adjustment shown on Schedule E.

1 A. The purpose of the payroll adjustment shown on Schedule E is to account for changes
2 in compensation of ENSTAR employees compared to the test-year data. As described
3 above, ENSTAR employees provide all the labor for CINGSA.

4 **Q. How did CINGSA develop the Payroll Expense Adjustment?**

5 A. The Payroll Expense Adjustment was developed by reviewing ENSTAR employee
6 rates on a position-by-position and person-by-person basis. Then, wage rates were
7 adjusted to reflect salary and wage rates for each non-union position in effect at January
8 1, 2018. For union-represented clerical and operations employees, wage rates were
9 adjusted to reflect scheduled grade changes along with a 1.5% across-the-board wage
10 increase specified by union contract that became effective April 1, 2018. The payroll
11 data was adjusted to account for only the portion of ENSTAR employees' time that
12 was charged to CINGSA. This adjustment increases CINGSA's revenue requirement
13 by $9,715.

14 **Q. Is there precedent for this type of Payroll Expense Adjustment?**

15 A. Yes. In Order U-08-157(10)/U-08-158(10), the Commission allowed Municipality of
16 Anchorage d/b/a Anchorage Water and Wastewater Utility ("AWWU") to use updated
17 wage rates that were known and measurable at the time it filed its rate case. AWWU
18 was required to hold the number of employees constant and then adjust its wage rates
19 for known and measurable changes. The Commission affirmed this approach in Order
20 U-13-184(22)/U-15-096(1)/U-15-097(1) in allowing ML&P to utilize test-year
21 employee levels and adjust for known and measurable pay increases. In ENSTAR's
22 recent rate case, the Commission in Order U-16-066(19) allowed ENSTAR to make
23 pro forma wage adjustments to update wage rates for known and measurable changes.

1 **Q. Is the Payroll Expense Adjustment reasonable?**

2 A. Yes. As discussed above, it is a longstanding Commission policy that base rates should
3 recover the utility's expected costs of providing service to customers in the rate
4 effective period. The adjustment of wages and salaries reflects the known changes in
5 labor rates that ENSTAR (and thus CINGSA) will experience at a minimum during the
6 rate-effective period.

7 **Q. Please discuss the adjustment for Docket No. U-10-051 Amortization Adjustment**
8 **shown in Schedule F.**

9 A. This adjustment removes the amortized costs of obtaining CINGSA's Certificate of
10 Public Convenience and Necessity and Initial Rates, Docket No. U-10-051, which were
11 amortized over a five-year period ended April 30, 2017. The amortized costs included
12 in 2017 expenses were $77,074, and have been adjusted out in Schedule F. Mr.
13 Dieckgraeff describes the rate base adjustment related to Docket No. U-10-051 in his
14 direct testimony.

15 **Q. Please discuss the Rate Case Expense Adjustment shown in Schedule G.**

16 A. CINGSA has incurred costs of $143,960 as of April 26, 2018 in relation to this rate
17 case, and expects to incur $1 million in total by the end of the proceeding. These
18 expenses include both legal and consulting fees. Schedule G amortizes this amount
19 over an expected three-year rate period.

20 **Q. How did CINGSA determine the expected cost of this rate case proceeding?**

21 A. CINGSA bases its estimate for rate case expenses in part on ENSTAR's recent
22 experience in Docket No. U-16-066. In that case ENSTAR was granted $1.8 million

in rate case expense to be amortized over five years. ENSTAR's actual costs were well over $1.8 million in that case.

Q. How does the CINGSA rate case compare to the ENSTAR rate case?

A. ENSTAR's rate case was more complicated than CINGSA's in some respects due to the number of rate classes and the vastly different customers it serves. CINGSA's rate case is equally complicated, however, when considering the number and sophistication of likely intervenors and the relative similarity in the complexity of the issues.

Q. Is CINGSA asking for a post-hearing true-up of rate case expenses?

A. No. In Order U-16-066(19) regarding ENSTAR's recent rate case, the Commission stated "Rate case expense is not intended to represent a post-hearing calculation of actual rate case costs." Therefore, CINGSA is not requesting a post-hearing true-up to actual costs.

Q. Why is CINGSA using a three-year amortization period for the rate case expense adjustment?

A. Three years is the most common amortization period used by the Commission. In addition, CINGSA anticipates its next rate case will follow shortly after the conclusion of this one, as discussed by Mr. Dieckgraeff in his testimony, so an amortization period longer than three years would be inappropriate and would potentially preclude CINGSA a reasonable opportunity to recover these costs.

Q. Please discuss the Miscellaneous Expense Adjustment shown in Schedule H.

A. CINGSA is removing non-recoverable expenses related to coffee, snacks, late fees and in-town meals as well as non-recurring expenses in employee benefits.

Q. How did CINGSA arrive at the amount of the adjustment for Miscellaneous Expenses?

A. I personally reviewed all entries made to CINGSA's general ledger, with particular focus on expense accounts. This included all O&M and A&G accounts. When reviewing these accounts, I took the following steps, among others:

1. In reviewing the general ledger, I removed entries that had been reclassed to another account. In these instances, the net impact is zero.
2. I reviewed the general ledger descriptions and underlying support for uncertain items to determine whether they should remain in CINGSA's expenses for the test year.

Q. How did you determine which items to include and which to remove?

A. I based my decisions largely on Order U-16-066(19) from ENSTAR's most recent rate case, including its discussion regarding miscellaneous expenses. Based on this precedent, I did the following: (1) removed meals that were not clearly for working lunches; (2) removed coffee, donuts, and other incidental employee benefits unless they were clearly related to utility service; and (3) kept safety program expenses, including those associated with the "811 call before you dig" program. The 811 program is a statewide program to promote safe digging practices. The goal is to protect underground infrastructure and promote public safety. As an underground storage operator, this program provides benefits to CINGSA and its customers.

Q. What is the total amount of the Miscellaneous Expense Adjustment?

A. The total amount of $26,414, shown on Schedule H, can be broken out into three areas:

- Other employee benefits: $25,000 were removed as non-recurring charges.

- Longevity awards: $500 related to employee longevity awards were removed as non-recoverable expenses.
- Miscellaneous: $914 for coffee, snacks, lunches, and other incidentals were removed as non-recoverable expenses.

Q. How else did CINGSA analyze its expense accounts prior to filing this rate case?

A. With input from ENSTAR personnel familiar with CINGSA's day-to-day operations, I reviewed CINGSA's various expense accounts to ensure the variation in expense accounts from one year to another was reasonable.

Q. Please describe some of the steps that were taken in performing this analysis.

A. Among other things, the CINGSA Operations Manager, a Regulatory Analyst and I went through each account to discuss reasons for any expense variances compared to prior year expense levels. In many cases, we pulled the detailed general ledger entries for the account in order to more thoroughly analyze the entries to the account for each year.

Q. What did you conclude after this analysis?

A. I found that while the expense account balances varied from one year to another, there were valid operational reasons for the fluctuations.

Q. Can you give examples of the operational reasons for some of the fluctuations?

A. Yes. One example is in the account that tracks operations costs related to CINGSA's wells. There was a $47,119.28 increase in the account in 2017 compared to the five-year average. We identified a payment to the U.S. Pipeline & Hazardous Materials Safety Administration ("PHMSA") of approximately $49,000 that was billed to CINGSA for the first time in 2017. This PHMSA fee was imposed on operators of

1 underground natural gas storage facilities per Section 12 of the Protecting our
2 Infrastructure of Pipelines and Enhancing Safety ("PIPES") Act of 2016 and it was
3 determined that it will be an ongoing expense.

4 In another example, purification costs can vary depending on how much water
5 is pulled from the system and must be disposed of responsibly. Purification costs are
6 also based on how well the dehydration unit is working. The dehydration unit required
7 more call-outs for maintenance in 2017 than in 2016, resulting in higher, but not
8 unreasonable, labor costs.

9 Finally, in 2016 there were many maintenance issues on the compressors,
10 resulting in high maintenance costs. In the test year, CINGSA saw a decline in
11 compressor maintenance, since most of the issues had been resolved in the prior year.
12 I believe that the lower costs incurred in 2017 are more representative and therefore
13 did not recommend an adjustment to the test year amount.

14 **Q. Please describe the Insurance Expense Adjustment shown on Schedule I.**

15 A. CINGSA purchases property, liability, and various other insurance policies. Most of
16 these policies are purchased for twelve months of coverage, and many were renewed
17 during the latter portion of 2017. This adjustment calculates the normalized annual
18 expense for all the policies (including broker fees) purchased and/or renewed during
19 the past twelve months. In order to calculate this, I prepared a schedule comparing the
20 actual insurance expense amortization for the test year with what the amortization
21 would have been assuming the current policies were in place for a full year. This
22 schedule is attached hereto as Exhibit CNG-3. The net effect of the this adjustment is
23 an increase of $8,836 in expenses.

1 **Q. Are there any other adjustments to Insurance Expense included in Exhibit CNG-**
2 **3?**
3 A. Yes. Marsh USA Inc., the company that provides CINGSA's property and terrorism
4 insurance policies, sent a letter on April 17, 2018 discussing an upcoming policy
5 renewal. A copy of this letter is included as Exhibit CNG-4. Two CINGSA policies
6 renew in May 2018 and will have a premium increase of $14,179. This known and
7 measurable increase was added to the adjustment described above, for a total increase
8 in Insurance Expense of $23,015.
9 **Q. Is this adjustment reasonable?**
10 A. This adjustment understates CINGSA's expected insurance premiums during the rate-
11 effective period. CINGSA's insurance brokers have cautioned that premiums will
12 increase this year, as shown in the Marsh USA, Inc. letter referenced above. The letter
13 only covers two of the numerous policies held by CINGSA, therefore CINGSA is
14 expecting additional increases in premiums. The expected increases are a result of
15 events in other areas of the country that have made gas storage facilities appear to be a
16 higher risk. Because of the uncertainty around the premium renewal rates, CINGSA
17 plans to update this proposed adjustment with its premium amounts then in effect when
18 it files reply testimony.
19 **Q. Please discuss the Depreciation Expense Adjustment in Schedule J.**
20 A. This schedule reflects changes to depreciation expense to apply the depreciation rates
21 calculated pursuant to the Depreciation Rate Study performed by CINGSA witness Mr.
22 Peter S. Huck. Mr. Huck's testimony discusses the study and its results. Mr. Huck's
23 recommended depreciation rates were then applied to ENSTAR's plant balances,

resulting in a net adjustment of $299,001 in decreased depreciation and amortization expense due to the lower depreciation rates recommended in the Depreciation Rate Study. The adjustment takes the recommended rates and applies them to the actual monthly balances of CINGSA's Plant, Property & Equipment to come up with what depreciation expense would have been if the new rates had been in effect during the test year.

V. TAX RATES AND DEFERRED TAXES

Q. Please generally describe how CINGSA's income is taxed.

A. CINGSA was formed as a limited liability company and is not directly subject to income taxation on a separate-entity basis because it is classified as a pass-through partnership for income tax purposes. However, the ultimate owners of CINGSA (its "members"), through their investment in Alaska Storage Holding Company ("ASHC"), are subject to federal and state income taxes on CINGSA's net income based upon each member's pro-rata investment in ASHC.

Q. Do CINGSA's existing rates include federal and state income taxes in its revenue requirement?

A. Yes. CINGSA's initial rates set in U-10-051, and its existing rates approved in TA 14-733, included in its revenue requirement federal income tax expense at 35% and state income tax expense at 9.4%.

Q. Did CINGSA use a 35% federal income tax rate and a 9.4% state income tax rate in this filing?

A. No. CINGSA used a state income tax rate of 9.4%, consistent with previous filings. However, for the federal income tax rate CINGSA used 21%. Additionally, it should be noted that state income taxes were taken out of pre-tax income in order to calculate the required federal income taxes. The calculations are shown on Schedule K.

Q. Why did CINGSA use a different federal income tax rate for this filing than the 35% that was used in the previous filing?

A. The federal corporate income tax rate was reduced from 35% to 21% in the Tax Cuts and Jobs Act of 2017 ("TCJA") passed by Congress on December 22, 2017, which

1 became effective January 1, 2018. Therefore, CINGSA incorporated the new federal
2 income tax rate of 21% in this filing.

3 **Q. What other pro forma adjustments are included in the income tax calculation?**

4 A. For purposes of this filing, CINGSA has calculated the federal and state tax expense
5 that will be required based on the calculated revenue requirement before taxes and after
6 all other pro forma adjustments.

7 **Q. Did the TCJA cause you to make any other adjustments?**

8 A. Yes. In accordance with GAAP, CINGSA's accumulated deferred income tax
9 ("ADIT") balances were required to be revalued to the revised federal income tax rate
10 of 21% at December 31, 2017. Since CINGSA is a regulated entity, regulatory
11 liabilities were established for the estimated excess ADIT of approximately $15.7
12 million at December 31, 2017, which includes a regulatory tax gross-up of
13 approximately $3.3 million, on the respective members' books.

14 **Q. Why was the estimated, and not the actual, excess ADIT impact recorded on**
15 **December 31, 2017?**

16 A. Actual ADIT balances are not available until the federal income tax return schedules
17 are completed, which typically occurs during the first half of the subsequent year.

18 **Q. What happens to the excess ADIT accumulated through December 31, 2017?**

19 A. The TCJA includes normalization provisions for regulated utilities, which require a
20 specific treatment of excess ADIT resulting from the corporate income tax rate
21 reduction. These normalization provisions only apply to accelerated federal tax
22 method/life depreciation differences on public utility property.

23 **Q. What is "excess ADIT?"**

1 A. The TCJA defines excess ADIT as the excess of: (1) the reserve for deferred taxes as
2 of the day before the corporate rate reductions take effect, over (2) the amount which
3 would be the balance in the reserve if the amount of the reserve were determined by
4 assuming that the corporate rate reductions provided in the TCJA were in effect for all
5 prior periods.

6 **Q. How do the normalization provisions of the TCJA work?**

7 A. The excess ADIT normalization provisions require that excess ADIT be used to reduce
8 revenue requirements no sooner than would occur as the book/tax difference reverses.
9 The utility must identify the deferred tax reversal pattern (comparing book depreciation
10 versus tax depreciation) and start to reverse the excess ADIT when book depreciation
11 exceeds tax depreciation. This method is referred to as the "Average Rate Assumption
12 Method" ("ARAM").

13 **Q. Is ARAM the only method of normalization that utilities may use?**

14 A. No, an alternative approach allowed in the TCJA is the "Reverse South Georgia"
15 ("RSG") method. The RSG spreads the excess ADIT evenly over the remaining
16 estimated book life of the utility assets that created the excess ADIT.

17 **Q. Which method is CINGSA using?**

18 A. CINGSA is evaluating whether it has the data required in order to use ARAM. A
19 determination is expected closer to the completion of the annual tax return process
20 during the late summer.

21 **Q. Please describe the Deferred Income Taxes Adjustment shown in Schedule N.**

22 A. CINGSA has adjusted the deferred taxes to reflect the 21% federal income tax rate
23 passed in the TCJA and has established an excess deferred income tax regulatory

liability. CINGSA has not made an adjustment for amortization of the excess ADIT in this rate case as the normalization method has yet to be determined. Mr. Dieckgraeff sponsors this rate base adjustment and further discusses it in his direct testimony.

VI. COST OF DEBT

Q. Please explain CINGSA's requested weighted cost of capital on page 3 of the 275(a) filing.

A. The schedule shows the calculation of the cost of long-term debt and the cost of common equity. It then weights these costs based on the proposed debt/equity split, which I will discuss later. The result is a weighted cost of capital of 8.53%.

Q. What is the cost of long-term debt used by CINGSA?

A. CINGSA, which issues its own debt, has senior secured notes due in 2032 at 4.48%. This rate is applied to the balance of $67,942,858 outstanding for those notes at December 31, 2017. The amortization cost of the unamortized loss on reacquired debt was then added to the calculated interest expense. The total interest is then divided by the debt outstanding as of December 31, 2017, net of the loss on reacquired debt. The result is an overall embedded cost of debt of 4.76%.

Q. Is it reasonable to use this cost of debt for the rate-effective period?

A. Yes. It is based on CINGSA's actual long-term debt rate through March 2032.

VII. CAPITAL STRUCTURE

Q. Please describe CINGSA's proposed capital structure as shown on page 3 of the 275(a) filing.

A. CINGSA is proposing a debt/equity split of 46.96% debt and 53.04% equity.

Q. How did CINGSA develop that capital structure?

A. The proposed capital structure reflects CINGSA's actual debt/equity balances as of December 31, 2017.

VIII. CONCLUSION

Q. Does this conclude your direct testimony?

A. Yes.

Catherine N. Gardner

EMPLOYMENT

ENSTAR Natural Gas Company, Anchorage, AK: 2006 – Present
Director of Finance & Accounting: 2008 – Present
General Accounting Manager: 2006 – 2008

Anchorage School District, Anchorage, AK: 2006
Senior Budget Analyst

Self Employed, Alexandria, VA: 2000 – 2002
Accounting Consultant

Vista Information Solutions, Inc., San Diego, CA: 1997 – 2000
Assistant Controller

Loral Test & Information Systems (Lockheed Martin), San Diego, CA: 1994 – 1996
Cost Accounting Manager

Household Credit Services (Household Bank), Salinas, CA: 1992 – 1994
Senior Financial Accounting Analyst

Brown & Lawrence, Inc., Bakersfield, CA: 1990 – 1992
Controller: 1991 – 1992
Assistant Controller: 1990 – 1991

Castle & Cooke, Inc., Bakersfield, CA: 1988 – 1990
Senior Staff Accountant

Roberts & Wright, CPAs, Bakersfield, CA: 1987 – 1988
Senior Staff Accountant

EDUCATION

California State University, Fresno, CA: Bachelor of Science, Major in Business Administration: 1985

University of Phoenix, Phoenix, AZ: Master of Business Administration, Concentration in Accounting: 2004

OTHER

Certified Public Accountant (CA): 1989 – Present

Committee of Sponsoring Organizations, Internal Controls Certificate: 2016

American Institute of Certified Public Accountants, Member

Habitat for Humanity, Board Member: 2012-2014

Utility Systems Audit

of

ENSTAR Natural Gas Company

Audit Number 17-UA-07

May 11, 2017

The Internal Review Section has no objection to the release of this report, at the discretion of the Contracting Officer, to duly authorized representatives of the Contractor. However, release to the public of any Contractor information contained in this report should only be made in accordance with Department of Transportation and Public Facilities Policy and Procedure No. 01.04.010 (9/05).

Department of Transportation
and Public Facilities
Office of Internal Review
Issued by:
Lee R. Ellenburg, CIA, CMA
Chief of Internal Review

INTRODUCTION

A utility systems audit has been conducted on ENSTAR Natural Gas Company (ENSTAR), a Division of SEMCO Energy, Inc. (SEI). Under the systems audit concept, the department will perform annual reviews of ENSTAR's accounting system and overhead rates if work is anticipated with the company during the current year.

PURPOSE AND SCOPE

The purpose of the audit was to review ENSTAR's indirect cost allocation procedures and work order accounting system. In addition, overhead rates were established based on 2016 actual financial data.

The scope of the audit was limited to the company's calendar year 2016 financial data, cost allocation procedures and work order accounting system.

Our examination was performed in accordance with generally accepted governmental auditing standards, and accordingly, included such tests of the financial records and such other auditing procedures as we considered necessary in the circumstances.

In planning and performing our audit, we conducted a limited review and considered the company's internal control structure in order to determine the nature and extent of the auditing procedures necessary for this audit.

The criteria used to determine the acceptability of ENSTAR's accounting system and allowable costs were 23 CFR 1-645, Highways and 48 CFR 31, Federal Acquisition Regulations.

RESULTS OF AUDIT

1. Work Order Accounting System

   ENSTAR has an acceptable work order accounting system, which is capable of identifying, segregating and accumulating costs to specific work orders.

2. Indirect Cost Allocation System

   - Overhead Rate 156.18% (as a percentage of direct gross wages)
   - Materials Handling Rate 26.22% (as a percentage of materials issued)
   - Transportation Rate 15.89% (as a percentage of direct gross wages)

   ENSTAR distributes its indirect expenses (administrative & general and construction overhead) to the construction activities on a monthly basis. The allocation methodology utilizes a base of reimbursable construction direct labor. ENSTAR uses a monthly allocation procedure; their allocation methodology is not in conformance with 23 CFR 1-645. Internal Review has annualized the allowable indirect expenses and reimbursable construction direct labor base to establish an audited overhead rate. The methodology used to establish the audited overhead rate is in conformance with 23 CFR 1-645.

3. Materials Handling Rate

The methodology utilized by ENSTAR to develop their materials handling rate is based on the relationship of the stores expense loaded out divided by total inventory issues. Because ENSTAR uses a monthly allocation procedure, their allocation methodology is not in conformance with 23 CFR 1-645. Internal Review has annualized the allowable stores expense loaded out and inventory issues base to establish an audited rate. The methodology used to establish the audited materials handling rate is in conformance with 23 CFR 1-645.

4. Transportation Rate

The methodology ENSTAR uses to develop their transportation rate is based on the relationship of indirect transportation expense to direct labor by accounting unit. This allocation process is done on a monthly basis. Therefore, it is not in conformance with 23 CFR 1-645. Internal Review has established an annualized audited rate based on the relationship of reimbursable construction transportation charges divided by reimbursable construction unloaded labor. This methodology is in conformance with 23 CFR 1-645.

5. 2017 Rates

Internal Review recommends that the following rates be utilized for reimbursement of overhead costs of ENSTAR in utility relocation agreements with the department for calendar year 2016:

- Overhead Rate 156.18% (as a percentage of direct gross wages)
- Materials Handling Rate 26.22% (as a percentage of materials issued)
- Transportation Rate 15.89% (as a percentage of direct gross wages)

7. Discussion of Audit Results

The results of the audit were discussed with the utility section and ENSTAR officials.

THE STATE of ALASKA
GOVERNOR BILL WALKER

Department of Transportation and Public Facilities

OFFICE OF INTERNAL REVIEW

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Anchorage, Alaska 99508
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Anchorage, Alaska 99519-6900
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Fax: 907-269-0733

June 5, 2017

Natalia Nelson
General Accounting Manager
ENSTAR Natural Gas Company
P.O. Box 190288
Anchorage, AK 99518-0288

Re: Utility Systems Audit of ENSTAR Natural Gas Company, Audit Number 17-UA-07

Dear Ms. Nelson:

Enclosed is a copy of our report on the recently completed audit of ENSTAR Natural Gas Company for establishing your calendar year 2017 overhead costs based on your calendar year 2016 actual financial information.

Thank you for the courtesies and cooperation you extended to our staff during this engagement.

If you have any questions, please contact Joyce Seekatz or me.

Sincerely,

Lee R. Ellenburg

Lee R. Ellenburg, CIA, CMA
Chief of Internal Review

LRE/tmr

Enclosure

CINGSA
72.18110
Prepaid Insurance
2017 Adjusted with Current Insurance Charges

Transaction Description & Reference		Billed Amount	Monthly Amortization	Beginning Balance	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12 Month Balance
					-	-	-	-	-	-	-	-	-	-	-	-	-
Marsh USA Land Use Bond		6,000.00	500.00		500.00	500.00	500.00	500.00	500.00	500.00	500.00	500.00	500.00	500.00	500.00	500.00	6,000.00
Marsh USA Property/Terrorism Insurance		339,201.40	28,266.78		28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	28,266.78	339,201.40
Marsh USA Property/Terrorism Insurance		16,592.00	1,382.67		1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	16,592.00
Marsh USA Control of Well Insurance		10,235.14	852.93		852.93	852.93	852.93	852.93	852.93	852.93	852.93	852.93	852.93	852.93	852.93	852.93	10,235.14
Marsh USA Bond		3,149.00	262.42		262.42	262.42	262.42	262.42	262.42	262.42	262.42	262.42	262.42	262.42	262.42	262.42	3,149.00
Marsh USA Excess Liability Insurance (ACE)	XOOG278964200	8,770.34	730.86		730.86	730.86	730.86	730.86	730.86	730.86	730.86	730.86	730.86	730.86	730.86	730.86	8,770.34
Marsh USA Excess Liability Ins (Lex-Buffer Layer)	15375550	3,218.50	268.21		268.21	268.21	268.21	268.21	268.21	268.21	268.21	268.21	268.21	268.21	268.21	268.21	3,218.50
Marsh USA Excess Liability Ins (2nd & 4th layers)	1000030667171	3,126.50	260.54		260.54	260.54	260.54	260.54	260.54	260.54	260.54	260.54	260.54	260.54	260.54	260.54	3,126.50
Excess Liability Ins (3rd Layer EIM)	253791-17GL	9,800.00	816.67		816.67	816.67	816.67	816.67	816.67	816.67	816.67	816.67	816.67	816.67	816.67	816.67	9,800.00
		Monthly Amortization		-	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	33,341.07	400,092.88

	2017	2018	
Marsh USA Property/Terrorism Insurance	339,201.40	352,580.00	13,378.60
Marsh USA Property/Terrorism Insurance	16,592.00	17,392.00	800.00
			414,271.48
Broker Fees will remain the same.			391,256.67
			23,014.81

Actual 12 Month Charges for 2017 - 72001 Business Unit

Transaction Description & Reference		Billed Amount	Monthly Amortization	Beginning Balance	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12 Month Balance
Marsh USA Control of Well Insurance	6/16-5/17	9,747.75	812.31	4,061.55	812.31	812.31	812.31	812.31	812.31								4,061.55
Marsh USA Terrorism (Property) Insurance	6/16-5/17	19,184.50	1,598.71	7,993.55	1,598.71	1,598.71	1,598.71	1,598.71	1,598.71								7,993.55
Marsh USA Property Insurance	6/16-5/17	132,736.00	11,061.33	55,306.65	11,061.33	11,061.33	11,061.33	11,061.33	11,061.33								55,306.65
Marsh USA Property Insurance	6/16-5/17	33,184.00	2,765.33	13,826.65	2,765.33	2,765.33	2,765.33	2,765.33	2,765.33								13,826.65
Marsh USA Property Insurance	6/16-5/17	64,000.00	5,333.33	26,666.65	5,333.33	5,333.33	5,333.33	5,333.33	5,333.33								26,666.65
Marsh USA Property Insurance	6/16-5/17	96,000.00	8,000.00	40,000.00	8,000.00	8,000.00	8,000.00	8,000.00	8,000.00								40,000.00
Marsh USA Excess Liability Insurance-EIM	9/16-8/17	9,575.58	797.97	6,383.76	797.97	797.97	797.97	797.97	797.97	797.97	797.97	797.97					6,383.76
Marsh USA Excess Liability Insurance-ACE	9/16-8/17	8,810.00	734.17	5,873.36	734.17	734.17	734.17	734.17	734.17	734.17	734.17	734.17					5,873.36
Marsh USA Excess Liability Insurance	9/16-8/17	3,057.62	254.80	2,038.40	254.80	254.80	254.80	254.80	254.80	254.80	254.80	254.80					2,038.40
Marsh USA Excess Liability Insurance	9/16-8/17	239.39	19.95	159.60	19.95	19.95	19.95	19.95	19.95	19.95	19.95	19.95					159.60
Marsh USA Excess Liability Insurance	9/16-8/17	3,075.00	256.25	2,050.00	256.25	256.25	256.25	256.25	256.25	256.25	256.25	256.25					2,050.00
Marsh USA Land Use Bond	6/17-5/18	6,000.00	500.00							500.00	500.00	500.00	500.00	500.00	500.00	500.00	3,500.00
Marsh USA Property/Terrorism Insurance	6/17-5/18	339,201.40	28,266.78							28,266.79	28,266.79	28,266.79	28,266.79	28,266.78	28,266.78	28,266.78	197,867.50
Marsh USA Property/Terrorism Insurance	6/17-5/18	16,592.00	1,382.67							1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	1,382.67	9,678.69
Marsh USA Control of Well Insurance	6/17-5/18	10,235.14	852.93							852.93	852.93	852.93	852.93	852.93	852.93	852.93	5,970.51
Marsh USA Bond	7/17-6/18	3,149.00	262.42								262.49	262.41	262.41	262.41	262.41	262.41	1,574.54
Marsh USA Excess Liability Insurance-ACE	9/17-8/18	8,770.34	730.86										730.88	730.86	730.86	730.86	2,923.46
Marsh USA Excess Liability Insurance-EIM	9/17-8/18	9,800.00	816.67										816.74	816.66	816.66	816.66	3,266.72
Marsh USA Excess Liability Insurance	9/17-8/18	3,218.50	268.21										268.30	268.20	268.20	268.20	1,072.90
Marsh USA Excess Liability Insurance	9/17-8/18	3,126.50	260.54										260.56	260.54	260.54	260.54	1,042.18
		Monthly Amortization		164,360.17	31,634.15	31,634.15	31,634.15	31,634.15	31,634.15	33,065.53	33,328.02	33,327.94	33,341.28	33,341.05	33,341.05	33,341.05	391,256.67

Robert Albino
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Mr. Richard Straney
Director of Risk Management
SEMCO Energy Inc.
1411 Third Street, Suite A
Port Huron, MI 48061

April 17, 2018

Subject: **2018-2019 Estimated Property & Terrorism Cost**

Dear Rich,

Please find outlined below our project costs for the premium and taxes due for the May 17, 2018-2019 period for your Property 'All Risk' and Terrorism policies:

$340,000 – Property All Risk Premium
$ 12,580 – Property Surplus Lines Taxes
$16,800 – Terrorism Premium
$ 592 – Terrorism Surplus Lines Taxes
$369,972 – Total Premium & Taxes for Property/Terrorism

The above projected costs are based the followings assumptions & thoughts:

- Based on our review of the provided information TIV for CINGSA has declined from ~$169M in 2017 to $156M for the 2018 renewal. This represents a reduction of about 7.5% over the expiring
- The estimated premium of $340,000 includes a rate increase of 10%, which given your location in AK, which a critical earthquake zone, is the type of increase insurers will likely be seeking. After 5 years of rate reductions, underwriters will be seeking price increases as a result of the 2017 Hurricane losses (not a CINGSA event but one that is forcing underwriters to pass along increased treaty reinsurance rates).
- The estimated Terrorism premium represents a 5% premium increase over expiring. This is due to general market direction of trying to get increases
- The cost for the May 17, 2017-2018 period was $355,793 and our projections for the May 17, 2018 to 2019 period represent an increase of $14,179
- We've assumed all insurers are on a surplus lines basis which includes a tax of 3.7% that is payable to the State of AK

- The above estimated costs assume there is no loss deterioration for CINGSA operations or a major event that affects the industry

Please let us know if you have any questions or if you would like to discuss.

Regards,

Robert Albino