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| **Exhibit No.:** | ______________ |
| **Issue(s):** | Effects of the Tax Cuts and Jobs Act of 2017 ("TCJA") |
| **Witness/Type of Exhibit**: | Riley/Direct |
| **Sponsoring Party**: | Public Counsel |
| **File No**.: | GR-2018-0230 |

# DIRECT TESTIMONY

# OF

# JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

## SUMMIT NATURAL GAS OF MISSOURI, INC.

FILE NO. GR-2018-0230

** **

**Denotes Highly Confidential Information that has been Redacted**

February 26, 2019

Non-Proprietary

**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| In the Matter of the Propriety of the Rate | ) | |
| Schedules for Natural Gas Service of | ) | File No. GR-2018-0230 |
| Summit Natural Gas of Missouri, Inc. | ) | |

## AFFIDAVIT OF JOHN S. RILEY

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| **STATE OF MISSOURI** | **)** | |
| | **)** | **ss** |
| **COUNTY OF COLE** | **)** | |

John S. Riley, of lawful age and being first duly sworn, deposes and states:

1. My name is John S. Riley. I am a Public Utility Accountant III for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my direct testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

John S. Riley, C.P.A.
Public Utility Accountant III

Subscribed and sworn to me this 26th day of February 2019.

NOTARY PUBLIC
NOTARY SEAL
STATE OF MISSOURI

JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037

Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.

**DIRECT TESTIMONY**

**OF**

**JOHN S. RILEY**

**SUMMIT NATURAL GAS OF MISSOURI, INC.**

**CASE NO. GR-2018-0230**

**Q. What is your name and what is your business address.**

A. John S. Riley, PO Box 2230, Jefferson City, Missouri 65102

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

A. I am employed by the Missouri Office of the Public Counsel ("OPC") as a Public Utility Accountant III.

**Q. What is your educational background?**

A. I earned a B.S. in Business Administration with a major in Accounting from Missouri State University.

**Q. What is your professional work experience?**

A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity I participated in rate cases and other regulatory proceedings before the Public Service Commission. From 1994 to 2000 I was employed as an auditor with the Missouri Department of Revenue. I was employed as an Accounting Specialist with the Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court Administrator for the 19th Judicial Circuit until April, 2016, when I joined the OPC as a Public Utility Accountant III.

**Q. Are you a Certified Public Accountant ("CPA") licensed in the State of Missouri?**

A. Yes. I am also a member of the Institute of Internal Auditors ("IIA")

**Q. Have you previously filed testimony before the Missouri Public Service Commission ("Commission" or "PSC")?**

A. Yes. A listing of my case filings is attached as JSR-D-1

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

A. I provide a response to the Commission's February 18, 2018 *Order Opening Rate Case, Directing Notice, and Establishing Time to intervene, and Requiring Company to Show Cause Why Its Rates Should Not be Adjusted*. ("Feb. 18 *Order*") I discuss the effects of the Tax Cuts and Jobs Act of 2017 ("TCJA") on Summit Natural Gas of Missouri, Inc. ("Summit") rates and financial records. I propose that Summit's rates and account balances should reflect the full impact of the federal Tax Cut and Jobs Act of 2017 ("TCJA") which went into effect on January 1, 2018

**Q. How did this particular case originate?**

A. The Commission's Staff filed a motion on February 16, 2018, asking the Commission to open a rate case to consider the justness and reasonableness of Summit's existing rates in light of the Tax Cuts and Jobs Act of 2017. To consider the effect of the TCJA on Summit's rates, the Commission ordered File No. GR-2018-0230 opened to address the Staff motion.

**Q. What did the Commission order Summit to do?**

A. No later than March 19, 2018, the Commission ordered Summit to show cause, if any, why the Commission should not order it to promptly file tariffs reducing its rates for every class and category of natural gas service to reflect the percentage reduction in its federal-state effective income tax rate. (Feb. 18 *Order* at para 1)

**Q. Did the Commission specify a date by which Summit needed to take action?**

A. The Commission ordered that: "Summit shall quantify and track all impacts of the Tax Cuts and Jobs Act of 2017 potentially affecting natural gas service rates from January 1, 2018, going forward." The *Order* also stated: "Summit shall quantify and track its excess protected and unprotected ADIT for possible future flow back to ratepayers, and shall advise the Commission how best such flow-back may be accomplished." (Feb. 18 *Order* at para 2 and 3)

**Q. Did Summit object to the Commission's *Order*?**

A. Yes. In its March 19 *Response to Show Cause Order*, Summit challenged the Commission's authority (and thereby its discretion) to enforce its Feb. 18 *Order*.

**Q. What do you propose for addressing the impacts of the TCJA?**

A. I propose four adjustments that should be recognized in either Summit's annual revenue requirement used for setting current, ongoing rates or as an AAO adjustment that will be reviewed in Summits next general rate case pursuant to the Commission's Feb. 18 *Order* and subsequent orders .

1. The first adjustment is a reduction to rates going forward, due to the change in the federal corporate income tax rate from 35% to 21%. This represents a 40% reduction in a major component (taxes) of the Company's revenue requirement.

2. The second adjustment is to create a regulatory liability to account for the excess earnings that Summit incurred from January 1, 2018, to the date on which the Commission orders new rates effective. In recent income tax cases argued before the Commission, this period of time has been referred to as the "stub period". Due to the length of time for processing this case, the stub period is well over 12 months. The

excess earnings created by the change in tax rates, along with carrying charges, should be amortized in Summit's next general rate case.

3. The third adjustment is to create a separate regulatory liability account to properly amortize the <u>protected</u> portion of the excess-accumulated-deferred income tax ("ADIT"). The 40% reduction in the federal tax rate has created a permanent timing difference in the balance of ADIT. This portion of the excess ADIT is associated with the use of accelerated depreciation and is commonly referred to as the protected portion of excess ADIT.

4. Create another separate regulatory account, to recognize the amortization of the <u>unprotected</u> portion of the excess accumulated deferred income tax balance.

**Q. Have you been able to quantify each of these four proposed adjustments?**

A. No, not with the data currently available to OPC. However, Staff should be able to quantify the proposed reduction in current rates and develop the amount of the stub period balance by adjusting the final EMS run from Summit's last general rate case to account for the new federal tax rate of 21%.[1]

**Q. Has Summit provided any estimates concerning the protected and unprotected amounts of excess ADIT?**

A. Yes. Through correspondence between Staff and Company, and the work papers Summit provided in case number AW-2018-0174, it is my understanding that the company has an excess protected ADIT balance of ** ** that would be amortized by the average rate assumption method ("ARAM"), and an unprotected <u>regulatory asset</u> of ** **

[1] OPC did not have access to the final EMS run from GR-2014-0086

that Summit offered to amortize to make the protected and unprotected amortization amounts offset each other so that the transactions would be revenue neutral.

**Q. Do you agree with these balances and the amortization periods proposed by Summit?**

A. The Company has stated that they have the capability to amortize by the required ARAM so its excess protected ADIT should be fairly accurate. The balance can be revisited when the Company files their next rate case. I disagree with the proposal to amortize a regulatory asset for a period between 21 and 25 years. .

**Q. What is your reason for opposing Summit's proposal concerning the unprotected portion of excess ADIT?**

A. Summit included its Net Operating Loss ("NOL") carryforward in the unprotected portion of ADIT and proposes to amortize that balance over 25 years. An NOL carryforward is the income tax effect of the cumulative balance of unexpired tax deductions the taxpayer (e.g. Summit) could not use in determination of taxable income in prior years' income tax returns. These amounts of unexpired tax deductions can be used to reduce taxable income in future years' income tax returns when the Company generates positive taxable income. If the Company does not generate taxable income in future years, these NOL carryforwards will be unused and expire.

**Q. What do Summit's customers pay in rates?**

A. Summit's customers pay rates that include income tax expenses to pay state and federal income taxes so that Summit will have the funds needed to earn the amount of profit included in customers' rates. In the past, the state and federal governments have required that certain deductions used to determine taxable income be treated in a different manner to determine income tax expense to be included in customer rates. This method is referred to as normalization. It requires a specific timeframe in recognizing some of these deductions. If this condition is not satisfied, the utility will be penalized and unable to use those tax deductions on their income tax returns. This creates the so-called <u>protected</u> deferred taxes.

**Q. What is the difference between how the Company records income taxes on its books and how the Company reports deductions on its income taxes?**

A. There are many items treated differently on the company's financial books than on their income tax returns. The difference can be that the company recognizes the item in different years for financial reporting than in its tax returns. These are referred to as "timing differences". One of the most common tax timing differences is expensing repairs or small additions to plant that are expensed immediately for tax purposes but are depreciated for regulatory cost of service. Timing differences make up a majority of the <u>unprotected</u> deferred taxes.

**Q. What is your concern with Net Operating Losses?**

A. The Commission should not overlook the fact that NOL carryforward is not a regulatory asset that qualifies for inclusion in rate base. Customers have paid and continue to pay rates that include federal and state income taxes that Summit is <u>not</u> paying to the Federal government or the State of Missouri. The federal and state deferred tax reserve reduction to rate base is the surrogate recognition for these unpaid taxes. Only a reconciliation of the amount of income taxes paid by ratepayers to the deferred- tax-reserve-rate-base reductions should be utilized to adjust rate base for this concern.

It is not appropriate for NOLs to be included in rate base. The purpose of establishing a rate base amount is to determine the amount of interest expense and profit to be included in customers' rates. Since Summit does not incur any expense or said another way, have not expended any funds, there is <u>no debt</u> (i.e. interest expense) or equity (i.e. profit) caused by Summit investing funds into the utility's operation. Since NOL carryforward is not an asset, Summit should not be allowed to include this non-asset in any rate case amortization.

An NOL carryforward should be reduced to reflect the new tax rates from the TCJA because the cumulative deductions have a reduced income tax but this is not a rate case concern. NOL flows through the income tax return at the pace of positive net taxable income. The Company's offer to amortize the NOL through rates would be an unjust and unreasonable overcharge of income tax expense to Summit customers. It is noteworthy that Summit proposes to make its customers pay a return of and on unpaid income taxes that are already in customers' rates. This double recovery of income tax expense already recovered through rates should be rejected.

In addition, Summit's proposed recovery period does not recognize the possibility that Summit may never have the opportunity to use this income tax advantage. Summit's annual financial filing with the Commission indicates that the NOL carryforwards will begin expiring in 2025 and carry through to 2037.[2] Meaning that a set amortization of up to 25 years guarantees customers will be paying for NOL even if Summit never uses the tax feature or the NOL is exhausted or expires.

**B What is your recommendation?**

A. The unprotected balance of excess ADIT should be included in the Commission's ordered AAO, however, its accuracy should be reviewed and corrected when the Company comes in for a general rate increase. The NOL balance should not be included in the amortization of an unprotected excess ADIT.

**Q. The Company has argued that changing tariff rates based only on the change in the federal income tax rates constitutes single issue ratemaking, What would you recommend if your first proposed rate adjustment was found to be in conflict with statute?**

[2] Summit Natural Gas of Missouri, Inc. Financial Statements, December 31, 2017, Page 19 Lines 1 & 2

A. In that instance, I propose that the dollar amount of the rate reduction be recorded as a regulatory liability much like the stub period amount in proposal two. The amount would then be amortized in rates when the Company comes in for a general rate case. As with the stub period amount, carrying charges should also be computed.

**Q. Could you summarize your testimony?**

A. Yes. The reduction in federal income tax rates has an extraordinary impact on Summit's rates and should be recognized and adjusted. This adjustment should either be an immediate reduction in rates or an AAO to accumulate the reduction, stub period, excess protected ADIT and the true balance of the unprotected excess ADIT without any consideration of a NOL carryforward or related amortization.

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

A. Yes.

# John S. Riley, CPA
# Summary of Case Participation

| | |
|---|---|
| ST LOUIS COUNTY WATER COMPANY | CASE NO. WR-88-5 |
| SOUTHWESTERN BELL TELEPHONE COMPANY | CASE NO. TC-89-21 |
| EMPIRE DISTRICT ELECTRIC COMPANY | CASE NO. ER-2016-0023 |
| KCP&L GREATER MISSOURI OPERATIONS COMPANY | CASE NO. ER-2016-0156 |
| KANSAS CITY POWER & LIGHT COMPANY | CASE NO. ER-2016-0285 |
| AMEREN MISSOURI | CASE NO. ER-2016-0179 |
| EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW | CASE NO. EO-2017-0065 |
| LACLEDE GAS COMPANY | CASE NO. GR-2017-0215 |
| MISSOURI AMERICAN WATER COMPANY | CASE NO. WU-2017-0351 |
| MISSOURI AMERICAN WATER COMPANY | CASE NO. WR-2017-0285 |
| EMPIRE DISTRICT ELECTRIC COMPANY | CASE NO. EO-2018-0092 |
| LIBERTY (MIDSTATE NATURAL GAS) | CASE NO. GR-2018-0013 |
| KANSAS CITY POWER AND LIGHT | CASE NO. ER-2018-0145 |
| KCP&L GREATER MISSOURI OPERATIONS COMPANY | CASE NO. ER-2018-0146 |
| EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW | CASE NO. EO-2018-0244 |
| EMPIRE DISTRICT ELECTRIC COMPANY | CASE NO. ER-2018-0228 |
| EMPIRE DISTRICT ELECTRIC COMPANY | CASE NO. ER-2018-0366 |
| EMPIRE DISTRICT ELECTRIC COMPANY | CASE NO. EO-2018-0092 |
| AMEREN GAS COMPANY | CASE NO. GR-2018-0227 |
| LIBERTY UTILITIES EMPIRE ELECTRIC CO | CASE NO. EA-2019-0010 |